FAR EASTERN ECONOMIC REVIEW

JUNE 2005 VOL. 168 NO. 6 US$15.

Don't Panic Over Delhi's Deficit

Vivek Moorthy PAGE 8

China's Energy Woes: Running on Empty
Philip Andrews-Speed PAGE 13

Mongolia: Asia's Outpost of Democracy
John J. Tkacik, Jr. PAGE 18

Behind Japan's Foreign Policy
Shigenori Okazaki, Masaru Tamamoto, Colum Murphy PAGE 23

Turning the Tide on AIDS in Asia *Peter Piot* PAGE 33

Before IPOs, Fixes for China's Banks *Javed Hamid* PAGE 36

Asia's Looming Biotech Food Fight *John Hepburn* PAGE 40

How the Market Can Save the Tiger *Barun Mitra* PAGE 44

REVIEWS

Michael Barnett ON SADAKO OGATA'S REFLECTIONS ON A TURBULENT DECADE PAGE 52

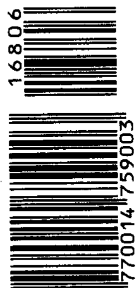
Jonathan Mirsky ON A BLOCKBUSTER ACCOUNT OF MAO'S RUTHLESS RULE PAGE 55

Salil Tripathi ON A COLLECTION OF ESSAYS ON ARGUMENTATIVE INDIANS PAGE 62

Fred Armentrout ON A STUDY OF HONG KONG'S INEFFICIENT CIVIL SERVICE PAGE 67

Stephen J. Morris ON A REVISIONIST HISTORY OF THE VIETNAM WAR PAGE 70

Ron Gluckman ON A POIGNANT INSIGHT INTO CAMBODIA'S AUTOGENOCIDE PAGE 74



Don't Panic Over Delhi's Deficit

by Vivek Moorthy

INDIA'S LARGE FISCAL deficit is routinely cited as the biggest threat to its currently robust economy. The sum of the fiscal deficits of the central government and states was close to 10% of GDP in the fiscal year 2003-04, roughly the same as in 1990-91, the year when a severe balance of payments crisis set the country on the road to reform. For more than a decade, analysts have been telling the politicians that their spending is unsustainable and will sooner or later bring on another crisis. However, while India does need to find a political formula to regulate spending, the situation is not as dire as some have predicted, and indeed the crisis mentality has spurred some misguided measures.

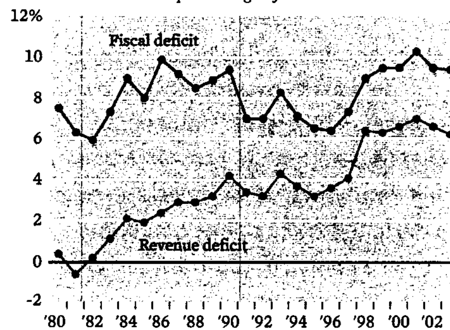
That's because within India most of the Parliament's attention has focused on another measure of spending, the revenue deficit, an indicator that is not even reported in many other countries. Roughly speaking, the revenue deficit is the fiscal deficit less the government's capital expenditure, such as on infrastructure projects. A revenue deficit implies the government is borrowing to finance current expenses, and not spending on productive capital assets vital for growth. Hence the country is considered to be living beyond its means, a precursor to financial ruin.

As the graph nearby shows, during the 1990s the combined center-state revenue deficit doubled to 6% from 3% of GDP, ostensibly a severe fiscal worsening. The immense concern of Indian policy makers with the high revenue deficit led to the framing of India's Fiscal Responsibility and Budget Management Act (FRBMA). The crux of this legislation was a target of a zero revenue deficit to be achieved within five years.

Mr. Moorthy is a professor of economics at the Indian Institute of Management in Bangalore, India.

PARADIGM SHIFT

Combined center-state fiscal and revenue deficits as a percentage of GDP.



SOURCE: RESERVE BANK OF INDIA

First introduced in Parliament in 2000, the original bill also stipulated a 2% of GDP fiscal deficit target. A modified version abandoning the fiscal deficit target but maintaining the zero revenue deficit target was adopted by both houses of Parliament in 2003 and its rules notified in mid-2004. Following the lead of the central government, a few Indian states have also enacted their own Fiscal Responsibility Acts with revenue deficit targets.

In the very first year after its enactment, however, the law's target was breached. Roughly 2.5% of GDP when the law was enacted, the revenue deficit is supposed to be steadily reduced to zero over five years. For the current fiscal year 2005-06, the FRBMA revenue deficit target is 2.0%, but the budget projection shows a much larger deficit of 2.7% of GDP.

Veteran Finance Minister P. Chidambaram explained this by stating that he has "pressed the pause button" on fiscal reforms and is pushing back the FRBMA targets by one year. This led one well-known journalist to remark that the pause button is likely to become a rewind.

In all likelihood, the FRBMA will die a slow death. The target of a 50 basis point improvement in the revenue deficit to GDP ratio every year will not be met. It appears that the most important goal of India's new fiscal reform is already being shelved.

However, the current setback provides an opportune moment to scrutinize India's entire fiscal predicament. The logic underlying the FRBMA is fundamentally flawed, and the particular circumstances underlying India's revenue deficit mean that its rise should be ignored. India's fight to rein in spending has been hampered by unrealistic goals targeting wrong indicators. Instead of focusing on the revenue deficit, lawmakers should shift their attention to a primary deficit target, i.e., the fiscal deficit less interest payments.

Is a Revenue Deficit Harmful?

FOR A PRIVATE company, a zero revenue deficit is a must and a revenue surplus is highly desirable. If a company borrows only to meet current expenses (i.e. salaries etc. plus interest) instead of borrowing to build or purchase equipment, its stock of productive assets will diminish, and its sales and hence net revenue will decline at some point. The drop in revenue will lead to further borrowing to pay interest, and worsen the revenue deficit in a vicious circle. A revenue deficit is thus financially ruinous for a company.

However, the same constraints do not apply to national finances. The growth of a country's sales (i.e. private sector GDP) and thus government tax revenues results not only from government investment but

also from private sector investment. As long as private sector investment is adequately high, the economy's growth rate can comfortably exceed the (average) interest rate on government debt. In most economies this is usually the case.

As long as this "Domar condition" (GDP growth rate should be higher than the interest rate) is satisfied for a given primary deficit, the government can forever run a revenue deficit with all fiscal variables remaining stably under control. The government can use the "dividend" from (private sector) growth to keep paying off the interest on debt. If the private sector as a whole runs an adequate revenue surplus, that should usually ensure enough investment to generate GDP growth higher than the interest rate. The nation as a whole can build assets even while the government continues to run a revenue deficit.

Indeed, in most developed, free-market economies the creation of productive assets (which includes education and training) comes mainly from private-sector activity. The role of the state is primarily to undertake critical revenue expenditure on legal infrastructure such as the police, judiciary and also on social welfare. Barring critical infrastructure projects, the government need not engage in capital accumulation, which should come mainly from the private sector. Furthermore, much of the new infrastructure can be paid for through user charges and by private financing. Thus deficits in developed countries are mainly revenue deficits.

Like a private company, a public sector commercial entity such as Indian Railways (IR) needs to run a revenue surplus. Its own sales are its sole source of net revenue growth. Unless it uses its borrowings to buy or build assets (freight wagons, passenger coaches and track), revenues will be inadequate to sustainably pay the interest burden. However, India is not a company, and IR is not the government of India. This fundamental distinction seems to have eluded India's policy makers.

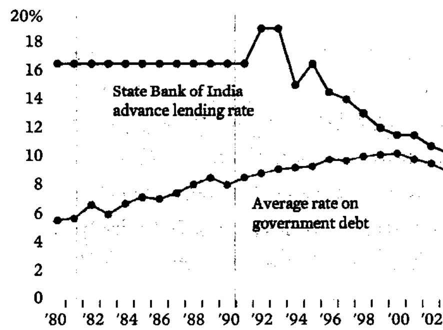
The economic logic underlying the FRBMA was very relevant to an era when the government directly, or through its public sector commercial enterprises, made huge investments in steel, coal and railways (the private sector was banned from entering) that were a major source of growth. This was so in the mixed, semisocialist economy of the 1960s and 1970s, but is no longer true in an increasingly private sector dominated economy. The mindset of the policy makers was shaped by the old environment, and so the FRBMA was not geared to this new economy.

A Benign Rise

APART FROM THE above consideration, the specific breakdown of the rise in India's revenue deficit indicates that it has not been anywhere as economically damaging as generally considered. The revenue deficit is the sum of the primary revenue deficit and interest payments. As it stands, the bulk of the rise in the revenue deficit, which was close to zero in 1980, has been mainly due to the latter. As the second graph nearby shows, interest payments rose mainly due to a rise in the (average) interest rate on government. *De facto* and later *de jure* policy changes simultaneous-

NO CROWDING OUT

The cost of borrowing for the private sector and government as shown by benchmark interest rates.



SOURCE: RESERVE BANK OF INDIA

ly eased restrictions on lending to the private sector and removed concessional terms for government debt. As shown, the benchmark private lending rate (the advance lending rate of the State Bank of India, the largest bank) has come down sharply over the 1990s, although the cost of government borrowing rose.

Another vital indicator of private sector borrowing conditions indicates much greater credit availability for private borrowers. During the financial repression which prevailed in the 1980s, banks were compelled to hold a large chunk of their assets in government bonds (40% in 1989-90). This requirement prevented them from lending to the private sector. After liberalization, that ratio was reduced to 25%, and has been maintained at that level since 1997. However, most recently, banks have been voluntarily holding as much as 45% of their assets in government bonds, indicating that private borrowers have not been "squeezed out" by the large fiscal deficit.

Macro data also indicate that the share of investment in GDP has remained stable, with private investment taking the place of public investment. Although government capital expenditure has fallen, the nation as a whole has been creating assets, despite the large rise in the revenue deficit of the government during the 1980s and 1990s.

Setting Realistic Goals

INDIA'S POLICY MAKERS should allow bygones to be bygones, and should treat the revenue deficit as a "one-off" resulting from financial easing that has lowered private borrowing costs and fostered private sector investment and thus growth.

Those who concede that this has been so, nevertheless may still argue that the zero revenue deficit is a good policy, especially since the debt ratio has risen sharply. Should not a deficit reduction program anytime, anywhere, always be welcomed? And the larger the magnitude of the proposed reduction the better? If so, the logic goes, the government should persevere with the FRBMA target despite slippage in its first year.

However, such a view is far removed from the reality on the ground. Reduction of the revenue deficit to GDP ratio by 50 basis points a year would require raising taxes significantly, since spending cannot be cut easily. Indeed the roadmap for FRBMA implementation is focused on higher tax revenue. The target is supposed to be achieved by broadening the tax base via more service taxes, higher service tax rates, and increased collections with the advent of a nationwide value added tax that went into effect on April 1, 2005. However, as this year's budget outcome shows, it is not politically feasible to raise taxes.

Moreover, since the stringent targets for revenue deficit reduction in the next four years are also likely to be abandoned, the Finance Ministry will keep losing credibility in the eyes of domestic and foreign investors. This could raise the cost of borrowing for the government, even if only by a few basis points, and thus push up the fiscal deficit.

Feasibility apart, such sharp increases in taxes will have negative (short-term) demand effects, as Keynesian economists emphasize. They could also have a supply-side effect of deterring investment and production. The risks of a recession are severe, and hence it may not be desirable to raise taxes so sharply. The FRBMA zero revenue deficit target can be described as the equivalent of trying to run a marathon. Such an exertion is not necessary for the country to remain in good fiscal health, and it is not even desirable since the strain of doing so could lead to a heart attack. If all that is required to stay in good health is to run one-tenth that distance regularly, far better to focus one's energies on that more achievable target. The well intentioned efforts of India's policy makers have not borne fruit. The revenue deficit target should be formally scrapped, or else it is likely to die a natural death.

Focus on the Primary Deficit

THIS IS BY no means intended to deny that India does face a fiscal crisis. With the combined center-state debt-to-GDP ratio now close to 80%, the fiscal situation needs serious attention and suitable legislation. Fiscal control should be achieved mainly by Constitutional rules that pre-emptively cap spending, not by numerical ratios that reactively trigger spending cuts as the FRBMA attempted to do. Along with these rules to curb spending up front, some numerical deficit targets would need to be an integral part of fiscal legislation.

Keeping some statutes of the FRBMA intact, new legislation should be introduced with a primary deficit target. The Domar condition indicates that under normal circumstances, i.e. with growth higher than the interest rate, the fiscal situation can worsen only if the primary deficit rises.

A modest primary deficit cap such as 2% of GDP, to be met on a two- or three-year average basis, with the further specification that at least three quarters of it (i.e. 1.5% of GDP) should be spent only on capital expenditure, would perhaps be best suited to India's current circumstances. For fiscal year 2003-04, the combined center-state primary deficit was 2.9%. Thus a 2% primary deficit target is more likely to be achieved and sustained, and doing so would boost the government's reputation, lowering borrowing costs. Such a target allows the government leeway to borrow for vital infrastructure projects, but also keeps a lid on the overall deficit and debt.

In the last four years, fiscal ratios have not worsened significantly largely because the primary deficit has fallen slightly. The primary deficit is the root cause of real fiscal problems and policy makers should redraft legislation accordingly. A modest, primary deficit target is most likely to ensure that what at present is a manageable fiscal burden does not spiral into a full-blown crisis.