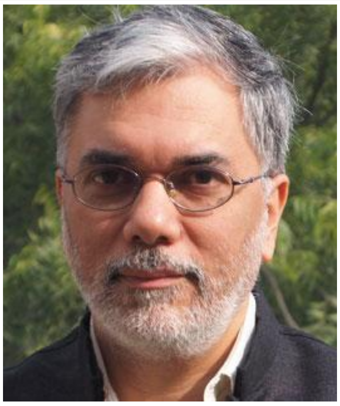
How to achieve fiscal responsibility in India



Dr.Ajay Shah
Professor
National Institute of Public Finance & Policy

The FRBM Act has not delivered in reining in Leviathan. India continues to suffer from chronic fiscal problems. Recently, Montek Ahluwalia and Rathin Roy have written about the new thinking that must go into fiscal responsibility legislation.

Laws that protect against fiscal irresponsibility

It's hard to restrain Leviathan by using a fiscal responsibility legislation. In recent years, we have a procession of Finance Bills that disregarded the FRBM Act. The FRBM Act is a mere Act of Parliament, and can be amended each time a Finance Act is enacted.

There are a few success stories of very strong legal protections against fiscal irresponsibility, such as the `Debt Brake' constitutional amendment that was done in Germany and a few other places. Short of this, it's hard for Parliamentary legislation to make a significant difference. We in India are unlikely to summon the political capacity to do this.

The role of the bond market

It's also interesting to see that most countries have achieved superior fiscal responsibility than India, without a Debt Brake style constitutional amendment. The key thing to focus on is financial repression. When the government faces a captive bond market, it feels it can get away with fiscal irresponsibility.

What has really mattered to advanced countries achieving fiscal discipline is not fiscal responsibility legislation but the pressure of the bond market. E.g. look back at how in recent years, the bond market stopped European governments in their tracks. The famous quotation by James Carville, sourced from the Wall Street Journal, 25 February 1993, says: I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody.

In the present Indian arrangement, we don't do public debt management in a serious sense of the term; we just force financial firms to buy government bonds. This is a tax on formal finance, which has far reaching adverse implications for the financial system and for the economy. It yields easy sale of bonds till the numbers associated with financial repression are exhausted, and an exceedingly difficult time beyond.

Exacerbating the marginal social cost of funds

It is useful to link up financial repression with the concept of marginal social cost of public funds. In OECD countries, this is generally thought to be 1.7: the cost to society of Rs.1 of government expenditure is ~ 1.7. In India, this needs to be adjusted upwards twice: first, for a badly designed and badly administered tax system, and second for financial repression. This demands a very high bar on what is a useful government expenditure: the gains to society for Rs.1 of government spending may have to be as large as Rs.3 for the expenditure to make sense.

As a side note, one of the most important questions in public economics in India is the estimation of the marginal social cost of public funds, and estimates about how this would change under reforms of tax policy, of tax administration, and of public debt management. It's embarrassing, how little we know about this.

The way forward

Hence, the first step in our fiscal journey is the establishment of the Public Debt Management Agency (PDMA), and getting bond market regulation out of RBI. We need to replace the forcible conscription of savings from institutional investors by sound debt management which knows how to sell bonds to voluntary buyers, into a liquid and well regulated market where the bond market regulation is arms length from either debt management or monetary policy or banking regulation.

Micro-prudential regulation should be technically sound. This involves ensuring that banks do not go bankrupt, as they have in India. It should not support and enable financial repression, as has been done. The European crisis has taught us the extreme dangers that come from hitching bank fragility to sovereign fragility. If we wanted banks to not take risk, and we were willing to use intrusive rules about portfolio composition, technically sound micro-prudential regulation should ask of them to hold short maturity bonds issued by high rated countries. Similar considerations apply with micro-prudential regulation of insurance and pensions.

The full picture of macro and finance policy

Israel is an inspiring story of a country that built modern macro and finance institutions, and was bountifully rewarded by the bond market. But it's useful for us to remember that even at the starting point of their reforms, they were never as bad as us; in other words, the gains to us of doing the orthodox macro and finance reforms are even greater than what was seen in Israel.

There are strong linkages between bond market development, price stability and debt management. Hence, we must see the overall strategy for fiscal, financial and monetary reform in a unified way. As an example, see the inter-relations between the three components which were begun in February 2015, of which two were shot down. The debates of March and April 2015 displayed a low appreciation of these inter-relationships, which led to the rollback of two out of the three components. We have begun with one piece, inflation targeting, but haven't done the rest of it. This is the heart of the question of fiscal prudence.