Implications of Fiscal Policy in India
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India encountered a serious macroeconomic crisis in the early 1990s. A series of economic reforms, implemented in response, supported a higher growth rate and a more secure external payments situation. Decreased trade barriers and modernization of regulatory institutions characterized reforms in industry, trade and finance. However, growth only marginally accelerated in the 1990s compared to the 1980s. At times, structural reforms seem to have stopped and little progress has been made in labor markets and bankruptcy reforms.

The most striking aspect of reform is the lack of progress in restoring fiscal balance. A high fiscal deficit of around 9.5% of GDP contributed to the crisis of 1991. Containing this deficit was one of the key structural adjustments undertaken by the Indian government at the time.

A key element to learn is how to control fiscal deficits. The difficulty lies in not being able to accurately measure off budget elements. The uncertainty associated with this makes formulating budgetary policies more challenging. Fiscal policy cannot be analyzed in isolation. Other factors like monetary policy, exchange rates, microeconomic polices and institutional reforms have to be carefully studied in order to achieve the desired results of growth and stability under realistic assumptions about sustainable capital inflows from abroad.

Fiscal Policy and its impact on development

A major concern with any fiscal adjustment is its potential cost in slowing economic development, and its possible adverse effects on the poor, whose dependence on public services is higher than the rich. There are two factors that suggest that such cost may not be high. First, India is in a position to implement some fiscal adjustment before a crisis possibly hits. This allows India's government the opportunity to choose carefully how to go about getting its fiscal house in order, without constraints that would be imposed in a crisis situation. There appears to be a reasonable technical consensus on needed reforms and on how sufficient political support can be mobilized to implement these reforms.

In India, delivery of public services is often ineffective due to high domestic debt, which remains a long-term national concern. The delivery of health and education services in rural areas can be significantly improved through restructuring government efforts and involving the private sector and NGOs.

Current Situation-Tight Fiscal Policy isn't a solution

Multilateral lenders and investors believe that fiscal consolidation should be the centerpiece of economic policy changes implemented by India's current government headed by Prime Minister, Manmohan Singh. The call for fiscal consolidation is supported by the mistaken conviction that reduction of the fiscal deficit will accelerate long-term economic growth in India. As proven in Latin America since the early 1990s, fiscal consolidation in India will lead to slower economic growth and political and social instability.

If the current government intends to accelerate economic growth it must increase public sector investment and government subsidies. A more effective income based tax structure should also be aggressively pursued where substantially higher tax rates are imposed on the wealthiest.

India should take advantage of the economic policy latitude it enjoys as a result of the limited leverage multilateral lenders hold over the country.

Multilateral lenders, foreign analysts and investors expect changes on economic policy to include tighter fiscal policy implicit to which is further reduction of public sector investment, expenditure on subsidies and the decline of social development.

Despite evidence to the contrary lenders, analysts and investors believe that tight fiscal policy will lead to accelerated economic growth in India. Argentina and Brazil, which have long followed IMF-directed adjustment policies, provide concrete examples of the negative impact tight fiscal policy has on economic growth and social and political stability.
Over the past 15 years the IMF has conditioned credit for Argentina and Brazil on the maintenance of tight fiscal policy. The IMF assumed that tight fiscal policy would lead to steady decline of the debt burden in these countries, thus supporting accelerated economic growth and underpinning foreign and domestic investor confidence.

However, the outcome has been quite different. Tight fiscal policy in both Argentina and Brazil undermined economic growth, leading to rapidly increasing debt burdens in both countries.

In comparison to Argentina and Brazil, fiscal policy has been easier in India over the last 15 years. Apart from the short period in the early 1990s following the country's balance of payments crisis, India has not been subject to IMF-directed fiscal adjustment policies.

Economic growth in India could have been even faster over the past 15 years if public sector investment had not been sharply reduced after the country's balance of payment crisis in 1991.

The consolidation of public sector investment and subsidy payments has had an enormous negative impact on rural India. In addition, the steady reduction of import tariffs has further contributed to deteriorating social conditions by subjecting both the agricultural and manufacturing sectors to imports that are often heavily subsidized.

Increasing the rate of public sector investment, targeting agricultural infrastructure and consolidating a more effective income based tax structure would significantly increase long-term growth of India. Investment in agricultural infrastructure and increased food subsidies would benefit a large proportion of people promoting political and social stability.

Role of UNDP

The Poverty Group at the Bureau for Development Policy at UNDP is currently working on a series of country studies entitled "Securing Fiscal Space for Millennium Development Goals (MDGs): Pro-Poor Domestic Resource Mobilization". The objective of this project is to assess the "fiscal space" available to developing countries to mobilize domestic resources for interventions to attain the MDGs. It presents evidence-based work drawing on country studies from Bangladesh, Morocco, Senegal, Thailand, Venezuela and Zambia on enhancing and securing fiscal space for pro-poor policies and financing interventions to operationalize the MDGs.

Most policy research on fiscal reform has focused on efficiency issues, including effective tax administration, enhancing efficiency in tax collection, and debt sustainability. Relatively little attention has been paid to the question of "fiscal space" – identifying concrete policy actions for enhancing domestic resource mobilisation, and the reforms necessary to secure the enabling governance, institutional and economic policy environment for these policy actions to be effective.

UNDP policy research at the country and regional level reveals that scope exists to enhance the "fiscal space" available to governments to enhance domestic resource mobilisation, using both the above channels. However it is important to identify and design modes of resource mobilisation that are pro-poor in nature, meaning that the instruments chosen are such that the net incidence of incremental domestic resource mobilisation on the disposable income of the poor is minimized. This involves designing a progressive tax system but also devising ways to access resources from the relatively well-off parts of the population through recourse to non-tax instruments, including public borrowing. Equity is therefore central to the design of a pro-poor resource mobilisation strategy.

It is now recognised that achieving the MDGs would require countries to undertake a range of appropriate public investments. It has historically been the case that domestic borrowing for public investment has been an important source of resource mobilisation for growth and development in many developing and, indeed, industrial countries. While domestic borrowing to finance government consumption is widely recognised as undesirable, domestic borrowing for appropriate public investments with demonstrable returns in terms of socio-economic and human development are regarded as perfectly acceptable in most developed countries. The 'rules' for fiscal deficits advocated by British Chancellor Gordon Brown allow for borrowing for critical public investments. It is imperative that long term strategic thinking on such issues be encouraged and a policy platform found to encourage such thinking in macroeconomic documents like PRSPs, so that an important potential source of development finance is not overlooked by exclusively relying on short term doctrinal evaluations of a countries domestic fiscal "sustainability".

In partnership with a research institution, UNDP will present a conceptual and analytical review of the existing challenges and opportunities with respect to pro poor domestic resource mobilization in the context of financing the MDGs. This assessment of the "fiscal space" available to developing countries to mobilise domestic resources for interventions to attain the MDGs will therefore be of high relevance for the deliberations of this ongoing work. This project will use this analytical work to present empirical evidence from Asia and Africa on enhancing and securing fiscal space for pro poor policies and financing interventions to operationalise the MDGs.

If you have any questions regarding fiscal policy, please contact Dr. Rathin Roy, Public Resources Management Adviser at UNDP, Bureau for Development Policy at Rathin.roy@undp.org

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