I.S. Gulati Memorial Lecture – 2006

June 10, 2006, Thiruvananthapuram

Some Challenges of Plan Financing Today

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Let me say to begin with how honoured I am to actually be given the second I.S. Gulati Memorial Lecture. I didn't quite know Gulati as a friend; he was much too old for me to belong to his generation, I think. But he has been a legend at least in the part of the economic profession in which I have grown up. And it is one of those stories which I suppose we see less and less, of movement with partition, being in Delhi, coming into contact with Raj, working on Kaldor's very important work of reform of Indian taxation, moving to LSE, coming back to Baroda, and then when comes to Kerala I suppose, I don't quite know, it must have been through K.N.Raj, becoming involved in Kerala budgets, staying on and then devoting oneself totally to Kerala, and to Kerala's financial and the entire planning and development issues. It is that sheer individual belief, I suppose on the one hand in cosmopolitanism- it doesn't really belong where I am born, it is also a tremendous assertion of belief and I think, we have seen cosmopolitanism in various ways. But it goes hand-in-hand with that sort of a commitment to one's ideology - it's an old fashion word, but to me and I hope, to most people here - it's a good word.

He is among those people whose contribution spans a lot, although, most of it is within the realm of finance and public finance in one sense. It spans a lot because it goes beyond the stuff of his Ph.D. work on Capital Valuation and Taxation. He has worked in the whole area of international financial transfers. When it came to the planning issue, his real contribution was to put inter-state financial issues beyond just the public finance issues to the whole issue of flows through the banking system. I am sure that there was about Kerala and there was something clearly a great deal of importance about his home. Leela had a great deal of input into what he did and I think it is our duty to give such lectures to put all that into context. What I am going to be talking about is going to be a lot more pedestrian than that grandstand of history. What I am going to be talking about and I am really going to cheat a bit is trying to test out among audience in some ways what we have been doing over the last one year or so in terms of the coming Eleventh Plan and its background. That obviously has behind it a huge consideration of the sort of issues that Professor Gulati used to think about and it is all the more so because amongst the things I am supposed to look after in the Planning Commission is a part of the Planning Commission called financial resources which is in fact the financial flows between the Centre and the States and the taxation issues.

Let me begin by making one or two points which are about where we stand as we look into the next five years and what the problems or the prospects appear to be if you just look at some broad numbers, simply put, the story seems to be that our growth prospects look rather good. But the moment we go beyond GDP growth, things don't look all that great. The growth prospects look good, in part because we can comfortably say that we have crossed the 6 per cent limit which we used to think about throughout the eighties, throughout the nineties - we were growing near about 6 per cent during both those two decades. But we still used to have some doubts about it. In the Ninth Five Year Plan, the growth rate dipped. It averaged about 5.5 per cent. In the first two years of the Tenth Five Year Plan it came back over six, but it hung just about six. In the last three years, it averaged to eight. These three years cannot be taken to be an indicator of the future. But it's been accompanied by fairly significant increases in the rate of savings and in the rate of investment. And most of all I think, suddenly India has become the flavour of the month; it doesn't depend which financial institutions in the world you look at. External finance does not seem to be a problem. And therefore things look quite rosy on the savings and investments side and translated into a rate of growth that translates pretty easily and pretty comfortably to a seven per cent rate of growth and an eight per cent rate of growth on those numbers is certainly not unfeasible. And one can even dream of crossing that eight per cent level and thinking in terms of ending the Eleventh Five Year Plan at some where say 8.5 average and in the end of the Plan reaching something like 9.5 per cent or may be even ten per cent. And that is the bright side, I think. The point is those numbers seem to be pretty robust. I won't say ten per cent is robust. But eight per cent looks certainly touchable, seven looks almost there.

Having said that, the Tenth Plan is a plan period during which employment in the sense of 'good' employment didn't grow at all, particularly in the organized sector.

Agriculture did miserably. We had now almost ten-year period during which GDP growth in agriculture was less than the rate of growth of population. And during that period not only did output not grow, but also prices turned against agriculture. And therefore a vast section of our people who depended on agriculture did actually do very badly although the economy itself did rather well in terms of GDP growth. The other big sector, manufacturing, didn't do that really well. We as a country, a large country, had till very recently the dream of becoming an industrial power, lot of our old Plans had to do with becoming an industrial power. But still the share of manufacturing sector in GDP is less than 15 per cent. In China, is about 36 per cent. In most of other Asian countries, it is close to 25 per cent. Why it matters is that, if you are going to get people out of agriculture to do something worthwhile, it is going to be manufacturing. If over time, you are going to produce the goods that people are going to buy, it's manufacturing. Otherwise, it would be dependence on someone else. We need a minimum share of manufacturing in GDP, of around 20 per cent in the next 5 or 10 years and to go from our current share of less than 15 to 20 per cent in that sort of space, we would need to grow at about 10 per cent per annum in manufacturing at a minimum and the fact is that we have not reached that sort of rate of growth, we didn't do it in the Ninth Plan, Tenth Plan or even in the Eleventh Plan even with having 8 per cent GDP growth in the last three years running.

So, that leaves us really only with services. And that's where, things have really been good and that has delivered the numbers. But it has also been obvious that much limited in terms of the number of people it benefits or indeed the way the whole growth process plays down over them. As you know, when you put these basic sets of facts, and none of these is contested and has been accepted by everybody.

When we ask a question where do we go from here - and that's where all differences start beginning. And ours today is a Government which within itself and from the outside has a lot of ideological ground which must be traversed. It is not something on which we can totally agree. Nonetheless, a plan has to be written and when a plan has to be written there has to be some common points of agreement. The plan hasn't yet been written. What has almost more or less been completed is something called the approach to the Eleventh Plan. To give a sleek preview of that, the approach is the following.

That we will skirt some extremely important issues. Most of them have to do with the growth of manufacturing.

The important issues being skirted are, one the one hand, the whole set of issues to do with selecting sectors - that is doing with the old fashioned planning of 'picking winners' - of actually putting government money into those sectors which might win. Ideologically, to a lot of my colleagues in the Commission, that is old fashioned and that should not be done. And there is another reason. It goes with a degree of protectionism either, by protecting it from the international competition or by providing it with resources which would have to be taken from other sectors, implicitly which are less important. It is one area in which, I think what we have done is the middle path. Let there be a level playing field. We won't go for more protection. In fact, we accept that the level of protection will come down, if not for anything else by virtue of the way international negotiations in the WTO and other things are going.

Picking winners in manufacturing is something which has been kept out. But when we keep them out we do also need to keep out another issue which comes on manufacturing. People who don't want to pick winners and who want low rates of tariff immediately come up against complaints from industry saying that, in the rest of the world in order to compete we need a level playing field and there is the whole issue which then comes up, which has to do with so called 'labour flexibility'. It has to do with changing labour laws, labour reforms and from the other side of the political spectrum - that's an untouchable. So we keep that one out as well. So keeping those two out, leaves you in a situation where, more or less, on manufacturing, you got very little offered in terms of definite direction. What will happen if you are not going to address either of these two problems, is essentially to say that we must create a field in which the growth of manufacturing will depend not on what the Central government does but on what other agents in the economy - private agents and possibly the state governments will do. State governments would have to operate within a particular scenario in which the international situation is a fairly liberal one and into which they must of course fit their own industrial relations, their own ways of 'picking winners', if they have any. Then it becomes an issue of attracting industry to my state rather than to somebody else's state. But the moment you do that you raise probably the biggest issue in Indian planning, which has a lot of what Centre-State relations used to do with. We are an awfully unequal country; unequal in the sense that the ratio of per capita GDP between our poorest and our richest state is close to six. You don't see that sort of inequality across states in most countries which have federal finance. The role of the central government in doing something about this becomes extremely important and it is one area in which we have failed. But what we are doing by not addressing the issue of manufacturing, by actually saying that let capital move wherever it can, we are essentially opening up. If you don't do anything at all to this inequality, it will be widening.

Now having said all those negative things let me actually tell you what the Common Minimum Vision in that sense comes down to. The Common Minimum Vision comes down to something which is on the one hand rather old fashioned. It says, we are going to actually put in most of our money into infrastructure particularly of two types. One, which actually improves infrastructure where it is worst to actually meet the problem that otherwise regions which are backward will fall even more behind and infrastructure of a different kind which is where it is short all over the country. For example, the whole power sector which is one huge thing holding back manufacturing growth. So take critical infrastructure build on to that and try to give it enough regional balance as you can. So infrastructure is one place where you agree. And the other thing you agree on is that there are two other sectors where you must do a lot; one, agriculture by virtue of the fact that it employs so many people. So put in resources into agriculture. But recognizing that agriculture is not going to actually be the solution, if you grow at 7 or 8 per cent per annum. If you grow at 7 or 8 per cent per annum, and agriculture grows at 3, people in agriculture will actually keep falling behind those in non-agriculture unless large sections are actually moving out of agriculture. Because the numbers simply add up that way. That is, there is no way you can reconcile an 8 per cent growth in the economy as a whole with say 3 or 4 per cent growth in agriculture and yet have per capita incomes in agriculture growing as the total per capita income and they are starting from a level well below the average.

So the whole idea is that you got to actually move people out of agriculture and that brings me to my third point where we have all agreed and that is, that a very large part of the next Plan must be on human resources. That is, in making people capable of doing something different. And that has to be where we are very very backward as a country which still have a situation of only about 70 per cent literacy in the country, and when you talk about primary education, we are years/decades behind where we should be. But it is not just that. It is across the line of education and it is across the line of health.

So the spirit of Common Minimum Vision or the Common Minimum Programme says agriculture, human capital - primary, secondary and tertiary - and the real challenge in the next five year plan is the secondary sector. We moved fairly close to 100 per cent gross enrolment in primary, quality is not that great; we got to improve quality. But we do have the problem that there will be a lot of people wanting secondary education and we don't have the place to take them in. And that's where the major thrust in education will have to come. And we have to actually do something fairly substantial on the health side.

So human capital, physical infrastructure - especially that physical infrastructure which eases divides between regions. Well all of that is something which I think has to do with planning to some extent, at least as the programme put down. But it then raises the main issues where that can be fitted into issues which always interested Professor Gulati. And those have to do- 1) with its financing – How to finance it and how to divide that financing as well as the institutions that will make this work.

Let me first deal with the financing issue. The main issue which has grabbed our attention for a very long time is how do Centre and the States participate in financing any such plan. It has been an issue which had very important debates in the past on the whole idea of what our fiscal federalism has to be. The Centre has often especially in its heydays of Mrs. Indira Gandhi it was also riding roughshod over this State or that State and that became major issue of politics. In the last ten years or so, we have found that in many ways State governments as a whole became very subservient to the Centre. And this particularly happened after the Fifth Pay Commission. The Fifth Pay Commission note the budgets of State governments in such a way that in many many areas, State governments had to become totally dependent on the Centre. That process became even more so because for the first time, a requirement was put that the Eleventh Finance Commission was not simply about what the Constitution had envisaged Finance Commissions to do. The Eleventh Finance Commission was charged with doing fiscal responsibility, something which the Twelfth Finance Commission was also charged with.

From the mid nineties onwards, and the process got accelerated after the Fifth Pay Commission, you found a sharp reduction in expenditure on precisely the sort of things I just talked about. That is on health, on education, on required social services like roads and power infrastructure and you actually got the seed sown for precisely that divide between growth and all those other things that I talked about. In other words, we went into a fiscal consolidation process, in part driven by the fact that in an economy which has set itself certain fiscal responsibility targets you could not absorb what was an exogenous award of a fairly large transfer of money to employees of the government. For several years, I think that's the battle we have had to fight on the fiscal side and we did it in a way where a considerable part of the responsibility was put on State Governments and on the State Fisc

I am not going to stretch the story too much, but it is important to note that in many ways, although not perfectly, it worked. By the first two or three years of this millennium i.e., 2002 or 2003, most states, not all, were beginning to get the fiscal numbers looking much better. But those fiscal numbers were looking much better while the numbers on everything else was looking pretty bad. They are looking pretty bad on primary education, on health on other things. Therefore, when the fiscal situation started improving a little bit, you started getting things like the Sarva Siksha Abhiyan, a large primary education thing, you started getting the Prime Minister's Gram Sadak Yojana, which is again a Central government driven programme for the construction of rural roads. These were major flagship programmes of the previous government. The Central government with its plan money was getting into areas which states should have been doing. The reason the States were not doing it was because they were going through this fiscal consolidation. Over the last two and half years, we have been stretching this even more. We got an expanded Sarva Siksha Abhiyan, we added to that a large component on school meals, we got a National Rural Health Mission, we got a huge Backward Areas Development Grant, we got a National Employment Guarantee Scheme.

In many ways, what we have ended up doing is that the Central government has entered areas, such as - infrastructure and human capital, which have been traditionally and constitutionally, all of them have been the responsibility of the States. And the reason this comes so almost in the simplest manner is because everybody agreed that the States didn't have money to spend. I would say that this process puts in challenge the way we look at these matters in terms of Centre-State finances. And I think it would have been a challenge to which Professor Gulati, had he been alive, would have been immediately been saying a lot.

In fact just coming here I read the last chapter of the little very nice book and I think is Behind the Coir Curtain No. III or IV where he says a thing about the ways State government were responding in 1957 to the then Second Finance Commission and how everybody was saying, is the Centre's responsibility. Kerala then which was apparently having Achutha Menon's first budget was one which actually went against the stream. But the situation now is a lot more difficult. Between the plan and the responsibilities of the States and the Centre there is a big divide. And that big divide is going to get even more complicated because all of this is being done within the constraints and the straight jackets of what I certainly consider to be a rather unnecessary constraint of fiscal responsibility. This unnecessary constraint of fiscal responsibility can be demonstrated by the following small example. 'Small' because that's the way I am going to leave it. But is large, because its implications are huge. What is the small thing? The Central Plan has been heading towards areas such as health, education, agriculture, employment guarantee and the Twelfth Finance Commission did something else. The Twelfth Finance Commission decided (and this too has lot to do with fiscal responsibility) that the Central government shouldn't lend to the States. So all loans were taken out from the Central government side. States would no longer be borrowing from the Central government. Central government will give only grants. So all the loans that were taken out of the Central budget and put somewhere else and the implication of that became the following and I will tell you why it became the following.

- Today of the total Central plan, only 20 per cent is capital expenditure, 80 per cent is revenue expenditure….Its revenue expenditure, why? Well in part, it is because we are spending on health and education which even in National Accounts shows up as not capital expenditure. Because national account conventions don't treat human capital formation as the same as physical capital formation. But the main reason is not that. The main reason is that all responsibility acts, all sets of accounts have to do with definitions. And a common definition all over the world is that if one arm or one tier of the government lends money to another tier of government or to the private sector, that is defined as a capital expenditure even if that loan is used for purposes which are totally consumption purposes. But the very act that you are building up as such by lending makes it appear in the budget as a capital expenditure. On the other hand, if central government gives a grant to the State; in conventional financial accounting terms it is shown as a revenue expenditure even if that grant is used to actually build a road, which is clearly a capital expenditure.

We have a tyranny of concepts. But it is a tyranny of concepts on the basis of which we have to stick to unless we legislate otherwise to Fiscal Responsibility Act based on definition which we agree for the purposes of budgetary accounting. Now what is happening and this is I think the real challenge that we would have to face. In the last three years, the revenue component of plan expenditure has gone up by about 1.5 per cent of GDP. But in the next two years, the FRBM Act requires us to reduce the revenue deficit to zero, i.e. by 2008-09. It also requires us to bring down the fiscal deficit to 3 per cent. It turns out that even if we meet the fiscal deficit target (and on that Prabhat, last year talked a great deal), the revenue deficit target is going to be the real killer. There is no way it can be done without doing either of the following things.

Either, we have to simply cut back all of the revenue expenditure that we are doing. We have to cut down the expenditure on education, health, agriculture and all of these things in all States by Central Departments. If we do that, mind you, the whole thing then has the final use definition which defines what is capital and what is revenue expenditure and no longer does it depends on grants and loans. So you do have a one other solution and that solution is that the extent of centralization which would be considered absurd by anyone in this society. But that would be a solution. Legally that is a solution. And legally that is the only solution consistent with keeping the definition that they are actually following up with the FRBM. Obviously, the other possibility is that you redefine the FRBM so that, for example, the revenue deficit target do not have to go down to zero. And there is a very good reason why you might say that and its partly us on the left who have forced this idea of revenue deficit on to those will be talking about the fiscal deficit. We did it, because the revenue deficit usually seems to conform closely to the idea of savings. Revenue expenditure have to do with consumptions and so you put a limit on that by keeping revenue deficit. Fiscal deficit puts a limit on investment.

We have done it. But, as I shown you by an example just now, when you have grants, loans, different tiers of government and the definitions and budgetary accounting which have nothing to do with investment and savings, those definitions no longer apply. What applies is really transfers between levels of government. And State governments are also going to feel this, if all of them do what Gulati and Isaac tried to do which is actually to implement large transfers to the PRI organizations. All those grants would appear in the State government budget as revenue expenditure. And it's the revenue deficit problem which may become the constraint. It would of course depend on the State concern. But we are at this point stuck with that in a sense as the major constraint, simply because as I said, tyranny of concepts. I think may be I should probably at this stage wind down what I have to say; not actually say anything new; wind it down and say, where do we stand and where do we stand is the following.

The Common Minimum Vision that I talked about forces us to look at things which States ought to have done a long time ago. They couldn't because of the whole set of constraints that have been put on them. When the Central government tries to do all of that, it comes up against certain legal, certain conceptual, certain conventional debt. It comes up against some of those barriers. At which point you got to either push the law or you got to actually push institutions. Today, I think, we are seriously in danger that unless we reopen the notion of what comes first. In a federal system where are the responsibilities, who are the actors, who can do things and put those questions prior to those of accounting or conventions; we are in serious danger of getting things rocked.

Thank you.