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Is India's public finance unsustainable? Or, are the claims exaggerated?☆

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Abstract

Growing concerns about the sustainability of the fiscal policy in India have evoked serious concerns in the recent past. The present paper has assessed the Indian fiscal trends in terms of inter-temporal budget constraint (IBC) for the Central and State Governments separately and together by employing Gregory and Hansen [J. Econometrics 70 (1996) 99] tests of co-integration with structural breaks. By addressing the issue of regime shift, this paper finds that while the fiscal stance of the Central and the State Government at the individual level is unsustainable, it is weakly sustainable for the combined finances as it nets out inter-governmental financial flows. Thus, claims about sustainability of India's public finance, made on the basis of the assessment of individual finances and neglecting inter-governmental flows and the possibility of regime shifts seems exaggerated.
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1. Introduction

In the recent times, the issue of sustainability of public finance has drawn considerable attention. Significantly, this concern for fiscal sustainability is spread

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over both the developed and developing world. For example, while Maastricht treaty required governments not to run budget deficit and debt–GDP ratio beyond a point (3% and 60% of GDP, respectively) as a precondition to enter the European Monetary Union, the recently passed Fiscal Responsibility and Budget Management Bill of India has envisaged complete elimination of revenue deficit in the medium term.

For a federal country like India having 28 States and 2 Union Territories (UTs), with the State Governments having independent executive, legislative and judicial wings, the issue of sustainability of public finance has an added dimension. During the 1980s and 1990s, there has been a steep rise in the outstanding liabilities of the Government at both national and sub-national level. The liabilities of the Central Government as a proportion to GDP increased from 41.4% as at end-March 1981 to about 60% as at end-March 2002. Similarly the aggregate liabilities of the State Governments increased from 16.6% to 25.0% during this period.

These numbers indeed seem to be alarming, and in the recent times, serious concerns have been expressed about the sustainability of India's public debt at various fora. Reports from the Comptroller and Auditor General of India, a statutory body that audits the finances of both the Central and the State Governments, expressed concern about the level of sustainability of the Central Government finances. More recently, a World Bank Report found that the fiscal deficit of the general government (i.e., Centre plus States) averaging over 9% over the past 6 years to be alarming. This Report also found that about 60% of this deficit is at the Centre and 40% at the State level, where much of the recent fiscal situation has occurred (World Bank, 2003).

There are, thus, two sources to this crisis viz., the Central Government and the State Governments, and efforts to look into the empirics of debt sustainability in India by concentrating only on Central Government finances are at best partial and hence faulty. In this light, we, in the present paper, have looked into the ramifications of the fiscal scenario from three standpoints, viz., Centre, States and combined.

How do we measure sustainability? The term fiscal or debt sustainability perhaps implies a set of fiscal policies that could be continued unaltered without jeopardising the economic policy objectives such as economic growth, price stability and external balance. Traditionally, the ability of the government to maintain its fiscal policies is measured in terms of debt–GDP ratio and a given fiscal stance is considered sustainable if debt–GDP ratio does not grow to explosive proportions over time. There are, however, alternative approaches to test the sustainability of debt. One approach, which is sometimes referred to as "Accounting Approach", is that of satisfying the steady-state Domar condition in which rate of growth of income must exceed the interest rate on public debt, subject to the condition that primary balance is either positive or zero. As is evident, in this approach, income growth–interest rate differential is the key element for ensuring debt or fiscal sustainability. In case of rate of GDP growth less than the interest rate, fresh borrowings due to rising debt-service obligations would grow more rapidly than

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