2nd State Finance Secretaries Conference

11th April, 2016

<u>Closing Remarks of the Finance Secretary</u>

Dear State Finance Secretaries,

We have had an excellent discussion on a variety of topics which have a profound impact on the evolution of public financial systems at the Central and the State levels.

I am encouraged by your enthusiastic response. We will make this conference a regular feature for exchange of ideas and coordination of economic policy matters between the Central and the State Governments.

2015-16 was the first year of the Fourteenth Finance Commission. It was challenging for us, as we had to manage the affairs of the Union with 10 percent less share of central taxes and duties, and also challenging for you as you had to suddenly deploy additional 10 percent untied resources for productive use. It is understandable that being a poor middle income country, the needs of income transfers and redistribution are imperative, but we must bear in mind that sustainable growth and rise in income levels can only be achieved through a sustained increase in capital spending. I seek your co-operation and more focused attention in this regard.

If I were to summarize our job in five words, I would say, *Growth with Inclusion and Macro-stability.* Union Budget 2016-17 is a thoughtful step in that direction. As already mentioned in the morning, it was a thematic document which rests on nine pillars that precisely hope to achieve this. I seek your co-operation in converting this dream into reality.

An important announcement was made in para-109 of the Budget Speech. 2016-17 is the last year of the Twelfth Plan. From the next financial year onwards, the plan non-plan distinction will be done away with as far as expenditure classification is concerned. This, however, does not mean planning will go away. Medium term planning framework and financial approval of schemes and projects can be easily synchronized with the Finance Commission Cycle over which both Central and State Governments have a clarity over the flow of resources. We also need to move to a cost centre approach, where establishments, schemes and projects are treated as such, and revenue-capital distinction will be the basis of expenditure classification as required by the constitutional framework. We have constituted a Committee under Special Secretary Expenditure which will also co-opt a few willing State Secretaries to come up with the new format of budget statements and finance accounts. The primary units of appropriation at both Central and State levels will also be revisited to create a clear distinction between revenue and capital object items of expenditure, so that revenue-capital accounts can be prepared in a bottoms-up manner. We will also see how a more outcome oriented relationship can be evolved between the golden rule (revenue surplus as defined in the FRBM Act) and the revenue-capital classification of expenditure in the finance accounts.

I will now come to our fundamental role in ensuring macro-stability that provides a platform for sustainable growth. We need to clearly differentiate between our medium and long term growth potentials. Medium term growth is the normal operating level of the economy around which the stabilisation policy, both monetary and fiscal, can be practiced. It is, by definition, dependent on past performance. Long term growth, on the other hand, can only be enhanced by structural reforms and improving the productive capacity of the economy. There is no short cut to this, and in fact, use of stimulus instruments beyond the normal operating level of the economy can create serious imbalances - a cure worse than the disease. It is important not to get obsessed with a particular growth number, but to create conditions for a sustained and balanced growth that can incrementally raises our per capita incomes over the next two decades, giving our fellow citizens their rightful place in the comity of nations.

I will next come to our role in helping the conduct of monetary policy. We tend to focus very often on the setting of policy rates. While this is important, equally important is the monetary policy transmission, which cannot be left entirely to the Central Bank. Our policy interventions can often interfere with the transmission of monetary policy actions. You must be aware that from 1st April, 2016 onwards, we have moved to a new system of marginal setting of lending rates. This cannot succeed unless we remove the marginal distortions that have crept into our system over the years. Our decision to rationalize small savings rates should be seen as a positive development in this light. Small savers and ordinary households are also needy creditors who deserve a better deal than they have been getting in the past. We also need to revisit our interest subventions schemes and replace them with back-ended interest subsidies that do not interfere with the marginal lending rates, and yet have the same effect on the loan repayments as the interest subventions have.

Another area of concern has been the management of liquidity in the financial markets. While the RBI has announced a number of path-breaking measures to systemically improve liquidity conditions in our markets, I must also mention to all of you that post October 2015, one important cause of tight liquidity was too much government securities simultaneously off-loaded by the State Governments to meet their normal borrowing requirements. Having learnt from this experience, we have now proposed a better coordinated and more evenly spaced borrowing schedule over the fiscal year 2016-17. While we will address your concerns, in the true spirit of cooperative federalism I seek your help in the matter.

Lastly, I will come to the fiscal rules, popularly known as the FRBM framework. We have announced in the Union Budget 2016-17 that we will set up a Committee that will listen to all suggestions to help us adapt and improve with the changing times. We also seek your counsel and advice to help us put in place what can be called the next generation fiscal framework. You have given some thoughtful suggestions today, which we will carefully consider. I would also like to place before you a few thought for your consideration.

We need to stop looking at the Centre and the States separately. We need to take a national view of the problem, and start looking at the general government deficits and the impact they have on the savings-investment equilibrium in our economy, as also its internal and external balances. To grow in a sustainable manner we need to maintain a fine balance between crowding-in and crowding-out. The speed of adjustment is also of critical importance. Our experience since liberalisation has been that growth has accelerated whenever crowding-out of the private sector has been moderated with gradual fiscal consolidation at both the Central and the State levels.

The existing FRBM framework was carefully evolved by the Experts and our constitutionally mandated Finance Commissions keeping the saving-investment equilibrium of our economy in mind. As reported in some sections of the media, it would not be correct to blame it on the European Growth and Stability Pact. As a matter of fact, a national fiscal deficit of 6.0 percent was thought appropriate in conditions when the household financial savings were near double digits. True, the times have changed, and that is why we need to take a fresh look, with an open mind and together as partners-in-arms. We must keep in mind that ordinary households which are net savers participate in the nation building and provide a valuable pool of savings to both the governments and the private sector which are net dis-savers. In our zeal to spend more, we must keep in mind the fine balance that is needed between different sectors of the economy and need to maintain both internal and external stability which is the bed-rock over which the edifice of sustained growth and prosperity can built for our people.
Another important aspect of the fiscal framework anywhere in the world is the sustainability of debt dynamics. It is often forgotten that sustainability is two dimensional. It is difficult to make a sustainability judgement by looking at the debt stock alone. Nations with seemingly similar debt stocks can actually have very different flow dynamics. How much of our current revenues will be sacrificed in servicing the past debt burden is a function not just of the outstanding debt stock, but also of our tax-gdp ratios, and the cost of borrowing, called the average yield to maturity. Here also comes the role of sovereign risk premium and the subjective confidence. In short, we must keep in mind that similar looking debt-gdp ratios can have very different implications for the debt flow dynamics, and it is the latter which matters for the working of governments at the centre and state levels. This is another complex area and the new FRBM framework needs to work out these modalities not only for the Centre, but also State-wise.

Last but not the least, I have an observation about our desire to create a framework that enables the practice of counter-cyclical policy. While monetary policy is more easily amenable to counter-cyclical interventions, the fiscal loosening becomes challenging unless the debt-dynamics are stable. Equally important is the national accounts framework which is necessary to compute what the normal operating level of an economy is, both with and without the external demand support? In the absence of reliable employment and capacity utilisation data, the traditional approach to growth-inflation trade-off becomes challenging. I seek your co-operation in helping us modernize the national accounts framework at the State levels. It is important that a full demand and supply side view is available to the policy makers at both the Central and the State levels. The present FRBM framework does give some flexibility, as was used in the post-recession period, but a systematic practice of counter-cyclical policy needs a more robust institutional and national account framework.

We will keep this effort going. I seek your cooperation in institutionalizing a more coordinated approach to macro-policy for the country as a whole. We must always remember that over-zealous action, by any one of us, individually, can create a tragedy of commons for others.

I am grateful for your enthusiastic participation and such meaning contribution to these federal deliberations. As the Hon'ble Prime Minister has often said, we must keep the spirit of cooperative federalism, truly alive.

Jai Hind, Jai Bharat!