Monetary and Fiscal Policy, and Poverty, and Public Policy: What is New ?*

Professor Raja Chelliah, Professor Govinda Rao, and distinguished participants.

I am thankful to Professor Rao for giving me the privilege of being part of this distinguished gathering assembled to honour Professor Chelliah. Papers presented in the seminar covered a wide spectrum of theory and practice; analysed a broad range of topics, from inter-governmental issues to poverty alleviation schemes and brought to bear varying experiences of landlocked Nepal, island economy of Sri Lanka and large continental-sized India.

In this address, I will focus on what appears to be new, in the context of economic reform, in the package of policies deliberated in this seminar. India orientation and a central banker's perspective would, of course, be inevitable.

Monetary Policy

The objective of monetary policy has been clearly enunciated as price stability while ensuring provision of adequate credit for productive purposes. The main contribution of monetary policy to poverty alleviation is thus ensuring price stability in a growth-environment, and significance of its role is brought out by the oft-quoted statement that containing inflation is the best anti-poverty programme.

Towards this end, as part of economic reform in the 'nineties, monetary policy sought clearer enunciation of objectives or mandate on price stability and operational flexibility in the conduct of the policy to fulfill the mandate. Among the measures taken in this direction, are: elimination of system of automatic monetisation of budget deficit, clearer delineation of roles between the Reserve Bank of India (RBI) and Government in financing of development by keeping levels of monetisation consistent with inflation and growth objectives, reduction in fiscal dominance by attempting to reduce deficits, and improvements in monetary policy-transmission, through market integration as part of financial sector reforms, especially in banking sector. The implications of each of these measures in terms of changing expectations on the role of the RBI, perhaps need to be detailed.

The introduction of Ways and Means Advance system, and termination of automatic monetisation of budget deficit of the Government of India in 1997 implies that the RBI now considers the extent of monetisation at its discretion, consistent with internal debt management policy objectives in respect of timing, maturity structure and mode of primary issues of Government debt. In a sense this imposes some limitations, if not a precise limit, on expansionary fiscal policy to fund all expenditures including poverty alleviation programme. In a longer-term perspective, however, such overall limit helps the cause of the poor by restricting build up of inflationary potential. Dr. C. Rangarajan had researched to show that, in the current state of our economy, this approach helps the cause of the poor and that of growth far better, in the medium-term.

In the past as part of the regime of administered interest rates, the banking and financial institutions were providing loans on concessional terms to certain sectors and also certain categories of borrowers, leading to cross-subsidisation. The credit allocation by banks was also directed to many such sectors/borrowers through various target prescriptions. RBI had also been contributing regularly to Long-Term Operations (LTO) Funds to finance industrial or agricultural development through the Industrial Development Bank of India (IDBI), National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), etc., generally on concessional terms. Combined with automatic monetisation of budget deficits, such contributions also caused significant increases in primary or reserve money. This practice has been gradually discontinued in the recent years on the ground that in a liberalised environment, institutions should expand the avenues of raising resources from the market and if all such activities result in cross-subsidisation, it should rightfully be the primary responsibility of Government of India and whatever support the RBI could give, should really be through and to Government of India. Thus, while discontinuing LTO Funds, net transfer of profits of the RBI as dividend has increased from Rs.200 crore in 1991-92 to Rs. 2,000 crore in 1998-99. No doubt, there still exists flow of concessional funds under General Line of Credit (GLC) to NABARD for rural development. Thus, the overall responsibility and accountability in regard to use of such monetised resources have been clearly delineated.

The need for reduction of fiscal deficit and revenue deficit has been emphasised by the RBI for several reasons. In the context of use of resources raised through borrowings, it can be rightly argued that allocation of such resources for poverty alleviation should not be viewed with disfavour. However, in order to be able to justify the uses of borrowings, under normal circumstances for purposes which do not give direct financial return, there should be reasonable assurance that overall return on such of the assets that are funded by the total borrowing is commensurate with overall cost. In other words, borrowings can be used to fund poverty alleviation programmes provided public enterprises which are also funded by borrowings yield adequate returns to cover the cost of borrowing for all purposes put together. Unfortunately, this is not the case in India. Choices become even more difficult if the return on assets already created with borrowed funds in the past do not generate adequate return or cash flows to finance the debt-servicing needs. In brief, the RBI advocates in the current context, reduction in revenue and fiscal deficits and adequate return on overall asset portfolio to ensure sustainability and, this implies that Government will have to consider a package of public policies that would combine anti-poverty elements and highly productive investments, in a way that the poor do not have to bear the burden of inflation, especially since most of them have no hedge against inflation.

Financial sector reform has several dimensions and of particular interest to the poverty issue is cost of credit as well as its availability. Interest rates have been deregulated to a significant degree not only to aid movement of monetary policy to the use of more effective indirect instruments, but also because administered interest rate regime proved to be inefficient and costly, without necessarily ensuring flow of credit to the needy. The RBI's recommended approach, however, does not preclude subsidisation by the Government but, it disfavours excessive use of banking system to cross subsidise especially, if it were to ultimately favour non-poor. RBI favours a financial system that provides incentives to encourage flow of credit and at the same time ensuring servicing of interest and principal, i.e., bankability of schemes.

Thus, the RBI has introduced modified interest rate prescriptions, linking concessionality to size of credit limits, rather than to specified sectors or groups of borrowers. Thus, for small borrowers with credit limits up to Rs.2 lakh, the maximum rate applicable is Prime Lending Rate (PLR), which is the rate charged for the best borrowings by a bank. The only other interest rate prescriptions relate to differential interest rate (DIR) scheme and export credit. The rationale is that since most of poor can afford to borrow only limited amounts, finance is being made available to them at the best possible interest rates without impinging upon viability of the banking system. The choice of borrowers is left to banks in these cases, except in regard to Government sponsored subsidy lending schemes.

There are two related issues on which the RBI's initiative is sought, namely, regional dimension and rural-urban divide. The regional variations or inter-State disparities in credit-deposit ratio existed in the past and continue to persist in the post-reform period also. The variations may be less pronounced in some cases if ratio of credit plus investments to deposits is taken into consideration. RBI has been sensitising banks to ensure flow of credit to all States, while at the same time, urging State Governments to create enabling environment for flow of credit. However, progressively, the instruments available with the RBI to 'direct' credit are less in a de regulated environment, especially since financial intermediation through non-banks including mutual funds and NBFCs, is justifiably expanding. In fact, uneven distribution of burden of social obligations between banks and non-banks could undermine the health of banking system, and health of banking is vital to our economy.

Similarly, on the rural-urban divide in flow of bank resources, there are some constraints, as mentioned above, on the policy instruments available. The RBI therefore, encourages local level financial intermediaries to address this issue. These include expanding the network of urban cooperative banks which are also local, revitalising the Regional Rural Banks (whose banking business in recent years is growing faster than scheduled commercial banking activity), promoting local area banks, apart from efforts to improving the cooperative credit system as a whole.

In brief, monetary policy is increasingly focussed on efficient discharge of its objectives, that no doubt help poverty alleviation, *albeit* indirectly, while the more direct attack on poverty alleviation would rightfully be the preserve of fiscal policy, aided by conducive monetary and financial conditions. Monetary policy in India, should, perhaps be focussing increasingly on what Dreaze and Sen call "growth mediated security" while "support-led security", mainly consisting of direct anti-poverty interventions are addressed mainly by fiscal and other governmental activities.

Fiscal Policy

An important area of overlap between financial sector and fiscal policy relates to taxation as also tax exemptions or concessions to financial instruments and institutions. To the extent tax free status is given to a large segment of financial instruments, those investors who are tax payees' benefit while those who are not in the tax bracket do not. Technically, this could be termed regressive, but in any case is not directly related to poverty alleviation programmes as such. Similarly, the fact that services sector is not taxed or that tax as a proportion of GDP is coming down, in a ways, restricts the maneuverability of fiscal management to identify resources for poverty alleviation programmes though it has no direct bearing on specific programmes. Further, in regard to non-tax revenues, insufficient user charges, say for water, and inadequate returns from public enterprises also constrain fiscal management to locate resources for poverty alleviation programmes.

On the expenditure side, interest burden, salaries, pensions do preempt significant resources, while existence of subsidies not directly related to poverty alleviation programmes in areas such as water, power, and fertilisers may indicate potential for maneuverability in favour of the poor. The critical role of expenditure policy in poverty alleviation must be clearly recognised since support-led security is possible essentially through public expenditures. Major issues in expenditure policy relate to magnitudes, composition and quality encompassing allocational and technical efficiency aspects in regard to all expenditures. Further, merely increasing the expenditure on the existing poverty alleviation programmes, or on merit goods such as education and health would not necessarily mean that the objectives are actually achieved. There is, therefore, need to look at the link between instruments and objectives of expenditure policy in our country.

There has been a view that decentralisation would enhance prospects for poverty alleviation. Genuine decentralisation would warrant significant local freedom in designing the programmes, which would be possible only when untied financial resources flow from the top. Since the poor are usually concentrated in poorer localities and regions, such transfers become necessary. It has been argued by some that without significant redesigning of approaches for fiscal management and, instruments of policies for poverty alleviation, mere decentralisation of powers now may mean decentralisation of fiscal problems. However, it is useful to recognise that there is scope for improved quality of services such as primary education and health and for more appropriate poverty alleviation programmes. I recall, about twenty years ago, there was a seminar in this very hall on decentralisation in which among others, Mr. C. Subramaniam, former Finance Minister, Dr. K.N. Raj, eminent economist and Dr. V.K.R.V. Rao, founder of this Institute, participated. I had made a strong plea for decentralisation and possibly a three-tier Government, Centre, State and District. Mr. C. Subramaniam remarked that decentralisation may enhance efficiency in Andhra Pradesh, but could result in greater exploitation in Bihar, and hence there is need for caution. One is not sure whether such divergent outcomes are impossible after all these years.

Poverty Issue

Currently, there is an interesting debate on the impact of economic reform on poverty alleviation. The data and analysis, whether in terms of direct poverty ratios or indirectly looking at unemployment and wages are reported to suggest that in the post-reform period, rural poverty reduction has been arrested while urban poverty recorded a decline. Though the conclusions of studies happen to be tentative, it is noteworthy that the arresting of a desirable trend happened though GDP growth has been around 5.7 per cent.

The major explanation for this phenomenon could lie in the fact that acceleration in SDP growth was concentrated in a few States. Some fast growing States especially in Southern and Western parts of India appear to have recorded a decline in poverty, while some others, especially in North India where SDP growth is lagging do not appear to show reduction in poverty.

In linking poverty reduction with reform, the first question that arises is with regard to the counter factual, viz., if there were no reform, would the reduction in poverty ratios have continued. Perhaps, the policy package of the 'eighties, which delivered a respectable ratio of growth in GDP and comfortable reduction in poverty, was clearly unsustainable. The external position as well as domestic developments indicated that achievements during the 'eighties were, in a sense, based on borrowed time and borrowed money, both domestic and external. It can even be argued that the price for such unsustainable policies of the 'eighties is being paid in the 'nineties, especially on poverty alleviation.

The second question, given the increasing inequalities among States in the rate of growth in the reform period, relates to whether the poverty reduction has taken place mainly in those States which have demonstrated significant progress in reform and these States have simultaneously registered impressive improvements in growth of State Domestic Product. Thus, State-level analysis deserves to be looked into carefully before arriving at the conclusion that reforms have failed to reduce poverty or that the assumption of 'trickle down' has been invalidated. In fact, a detailed State-level analysis may even confirm 'trickle down' effect of growth due to reform, or as some people would prefer to say, uplift of the poor through growth-process.

Public Policy

In terms of public policy, it is necessary to recognise that we have the hindsight of experience besides excellent analytical studies to be able to revisit the policy package to enable poverty reduction or poverty alleviation. Even assuming for a moment that as a result of reform the poverty reduction has been arrested, the optimal solution may not be in questioning the reform policy framework but in fact, the solution may be in redesigning the strategies for poverty reduction. The issues in this regard clearly appear to be many, and a few major ones are listed here.

First, given the fact that status of agriculture is an important determinant of rural poverty, should there be greater focus on public investment in agriculture which has been decelerating recently?

Second, is it possible that, as some studies indicate, expenditure on roads, agricultural research and irrigation have more impact on poverty alleviation than the expenditure on direct poverty alleviation programmes?

Third, is it possible that higher growth in agriculture facilitated by deregulation/liberalisation, at least in domestic/national market facilitating better terms of trade, would contribute to reduction in rural poverty?

Fourth, whether without improvements in design and implementation of poverty reduction programmes including the public distribution system, any increase in outlays would amount to larger wastage?

Fifth, whether removal of all price based subsidies, direct or indirect, would ensure release of resources both for public investments in rural areas, especially agriculture and anti-poverty programmes, and thus also contributing more effectively to the objective of growth besides poverty alleviation.

Sixth, studies have also shown that in periods of 'distress' such as drought, poverty alleviation programmes make impressive welfare impact. In such an event, is there a case for substantial and automatic launching of such programmes on a massive scale (such as in Orissa) while in normal circumstances, poverty alleviation programmes could be on only the most vulnerable sections addressing issues of physically handicapped or destitutes.

Seventh, what would be the role of local bodies, which are being revamped in many States, and of non-Governmental organisations, in poverty alleviation programme? Would it be appropriate to consider them as good vehicles for such programmes only or should they be encouraged to take interest in multidimensional approach to poverty alleviation and empowerment of the poor.

Conclusion

In brief, poverty alleviation requires provision to the poor of both indirect or 'growth mediated security' and direct or 'support led security'. The reform process appears to have succeeded in the first set of policies. As regards the second set, most of the policy instruments of pre-reform era appear to continue virtually unchanged into the reform era. It is, perhaps necessary to review and reform programmes that directly deal with poverty alleviation, to make them more purposeful.

In any case, significant progress in poverty alleviation is possible mainly through fiscal actions, especially expenditure policies. To release large resources for poverty reduction, it is essential to phase out price-subsidies of commercial goods significantly and improve return from public sector. Unfortunately, the constituency that is strongly pro-poor in our country is the one which often makes pro-poor policies difficult to implement or function since the same constituency pleads for continuation of price subsidies and many actions that lead to persistence of low productivity in public sector. Perhaps, in our country we have to plead with all those who are actively pro-poor to give overriding priority to poverty related issues, and thus expand the reform process to the benefit of the poor.

In fact, the process of economic reform itself would be endangered if public policy neglects the issue of poor, not merely absolute poverty but also relative poverty. The cost of emerging social tensions due to such inequalities may seriously undermine the benefit of reform itself. The public policy needs to relook at enhancing amounts of and quality of public expenditures addressed to both poverty alleviation and provision of merit-goods, especially drinking water, health/sanitation, and primary education. Such a reorientation requires a recognition of the fact that the tyranny of ten per cent, i.e., of organised work force, needs to be overcome whenever it exists.

A time has come when a choice has to be made between being soft to what has been described as 'proletariat-aristocracy' and the deprived poor since Government can no longer serve both. It is time we also recognise that the vague concept of 'social justice' has in many ways diluted the attention to poor. It is time we preempt resources for real priority items. In terms of public policy, therefore, the objective of public-policy itself, viz., “growth with social justice” may need to be replaced by “growth with elimination of poverty and ignorance”.

Let me again thank the distinguished participants.

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* Valedictory Address by Dr.Y.V. Reddy, Deputy Governor RBI, at the International Seminar on January 18, 2000, at the Institute for Social and Economic Change, Bangalore.