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Economic Policy, Accrual Accounting and Regional Growth

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***Abstract:** There is some controversy on the extent to which the recommendations of the Finance Commission have helped poorer States. It is, however, true that the non-devolution related recommendations of the Commission this time may have more impact than the earlier Reports, in the implementation of which the government of India gave greater priority to the tax and non-tax devolution formulas and figures. This time on account of precedence to "economic and fiscal reform" over development expenditure policies, it is already being reported that the allocation of borrowings as a part of the Central Plan will be given up and even for the present Annual Plan where apparently certain figures were agreed upon there is considerable confusion. The need for reform is obvious, but the lack of a well orchestrated transition path from the existing structures, is not very desirable, since the collapse of public development expenditure already under way, may cost the country dearly. The mid-term appraisal of the plan underway may well bring out this feature of the economy in the nineties.*

Key Words: recommendations, Finance, Commission, poorer, States, non-devolution .

Some of the non-traditional recommendations of the Finance Commission include grants for debt restructuring formulas, equalization grants and the recommendation to move over to a accrual system of accounting. Grants for restructuring of debt seem to have gone to the richer States like Punjab. Gujarat, Harayana, Maharashtra and Andhra Pradesh. On the other hand, having chaired the process of debt restructuring in one State, one can also say that meeting the conditions of the Finance Commission is not going to be easy and hence the inequity implied in the proposals may not work out in practice. A plea for the Equalisation Grant was passionately made to the Commission by the author when he met it with a Rajiv Gandhi Foundation team. It was based on my experience with the Candian Federation. I was happy to read that the Commission has accepted it. But the fine print shows that the Finance Commission's recommendations are a pale shadow of the principle as applied not only in countries like Canada, but also in developing countries like South Africa. This, therefore, leaves only the idea of accrual accounting for discussion. I believe this idea is important and while the Finance Commission has not underlined it, it could have a major impact on Indian development finance is properly implemented.

The concept accrual accounting goes back to the International Data Dissemination of Data Standards of the IMF accepted by India. We attempt to explain the aspects not highlighted or perhaps fully appreciated in the sector production activity in the first say land sector. However, to the Government sector flows of service defined in Tables 1 and 2 will now have to be added flows on account of production or distribution activities in the public sector in the first sector intensive second sector and universal intermediaries related with the first sector. These activities can be fairly important. An issue for discussion is the separation of general government services from the activities of the public sector. This separation has been provided following the UN Classifications on the subject However, two aspects may be noted : (a) for working out the impact of the public sector (including general government) on the first sector, the two sub-components would need to be aggregated: and (b) as regards the impact on the first sector, transactions within the government/ public sector will have to be consolidated, e.g. expenditures of public sector industries supplying

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to the first sector and contra entries in the government accounts relating to subsidies on such inputs cannot be double counted or again loans to the first sector will have to be shown at the point of disbursement to the sector and transactions within government/financial institutions will have to be netted out. This is not always done in Cash Flow Accounting.

The IMF Accrual System of Accounts Now- The foregoing discussion is important because the IMF has now broadened its concepts of government expenditure to include expenditures that build production potential (R. Basanti, IMF, 2004). The issues discussed in the last section are important to appreciate the importance of what the IMF is doing now, namely integrating government expenditure with economic sectors and capital formation.

In this context it is important to take into account the comments of Dr. Rifaat Basanti, who is currently Deputy Division Chief, Government Finance Division, Statistics Department, International Monetary Fund, on the work by Sayuri Shirai, Keio University (Sayrui Shirai, 2004). The advantage of the Basanti paper presented in the Panel on "How To Improve Governance at the Inter-Governmental, Governmental and Private Sector Levels in Japan and Asia" is that the KEIO University's 21st Century Centre of Excellence Programme, discusses actual attempts at integrating accrual accounting in a centre-local context of reform. Incidentally this programme is a brain child of PM Fujimori as this is his University. While Japan is not a federal country, the concepts have been introduced in the context of reform in the central/local context and have direct relevance to the Indian discussion. The only problem is the complete innocence of the technical and theoretical aspect of the discussion in the Indian proposals.

Basanti brings out that the Government Finance Statistics Manual 2001 (GFSM 01) essentially brings the balance sheet approach to government finance. It is practical in India because it starts with the statement of sources and uses of cash which is there at present and is the basis of the concept of revenue and fiscal deficit. But there will have to be the statement of government operations and the difference between net operating balance and net acquisition Commission's analysis. Conceptually the principle of accrual accounting moves over from cash flow accounting on an annual basis to the principle of the completion of a project as the accounting cycle. Thus, a balance sheet component is introduced in public accounts. The Finance Commission appreciates that this will mean the consideration of loan finance. What it does not bring out is that borrowings, which are anathema in the fiscal policy stance from the early nineties since by definition the fiscal deficit was "bad" policy (a stance endorsed by the Commission), will have to be built up from a disaggregated basis. For instance, borrowing for projects in an advanced state of completion may turn out to be profitable and this profile in a federal economy will have to be built up from the State and in principle even lower levels. This will be inconsistent with ad hoc borrowing rules like all fiscal deficits are "bad" and the budget constraint built up more sensitively. After the East Asian meltdown such a priori borrowing or fiscal deficit rules are in disarray all over the World, but continue as an objective and a mind set, strangely even when actual borrowings are at profligate levels in India. There is then a complete disconnect between theory and practice of economic policy. The Accrual Accounting recommendation could have bridged this disconnect, but the paradigm stance of the Finance Commission does not help it to do so. We attempt to start the discussion at the conceptual level.

This paper, therefore :

* Discusses the earlier neo-classical concepts of government expenditure of the IMF and their relation with concepts of deficits, which were the basis of earlier policies;
* Presents Indian work on intersectoral accounts to discuss some problems that arise with these earlier concepts and which provide the basis of Accrual Accounting in theory;
* Suggests that the IMF proposals on accrual accounting are a break with the past and should be implemented as suggested by the Finance Commission;
* Presents a non neo classical theoretical framework of development to base this process on;

* Suggests that implementation should be expeditious; and,

* Suggests the relation between Accrual accounting and deficit concepts need to be discussed in the context of the proposal to useexchange reserves for infrastructure development.

Government Expenditure : Earlier IMF Concepts- The earlier IMF concepts on Government expenditure were very narrow. It included expenditure where there was no fee component. This led to many problems (See Y.K. Alagh and Atul Sarma's country case studies for details, 1990). A recent elaboration of these difficulties is in a Group, under the chairmanship of senior macro-economist B.B.Bhattacharya, which has been estimating resource flows to agriculture. The Ministry of Agriculture states the following in this connection:

"The Bhattacharya Committee on Capital Formation in Agriculture has recommended a procedure for compilation of GFCF for agriculture which includes activities such as agro-chemicals production, construction of rural roads, rural electrification, rural go-downs, agricultural cooperative banks, etc. The Committee has also recommended inclusion of expenditure on agricultural research and education as part of capital formation for agriculture." (GOI, 2004, p.7).

There is a logical sequence in these arguments. From a narrow concept of Government the movement is to including a more inclusive concept and then capital formation and effectiveness of the government sector. There is a long history to this debate. For example, the FAO had always argued that resource flows to agriculture should be in a gross sense, as compared to the earlier IMF concept of government expenditure which was very narrow, namely expenditure without a fee component (FAO, 1980, 1981). The High Level Evaluation Committee of the CSO in India took this more inclusive definition of resource flows as the more appropriate one (CSO, 1984). It argued; " The objectives for which estimates of resource flows to agriculture are required are the following: impact in terms of size and quantum) of resource flows, particularly from the government sector, on the growth and developments of that sector; in particular the separate impact of investment flows and current expenditure flows; the estimation of resource flows and government expenditures such that relationships with past flows and future requirements not only of fixed investment and working capital but also of technology diffusion and nonmaterial inputs like development of institutions, skills and price support, can be examined. Such issues have been generally emphasized in the Five Year Plan documents and discussion on policy matters. The details' of resource flows in a consistent system with empirical counterparts is presented in Appendix VII." (CSO, 1984, pp. 25-26).

Flows: A Consistent System- To begin with, consider a simple economy (complications are introduced subsequently) with two production sectors: call them Agriculture and non-Agriculture. There is a government sector but it only produces services which are also produced by a private non-profit sector. Abstract from taxes and subsidies Table I describes the current flows of this system.

In this Example the government sector does not produce commodities. Intermediate purchases by industries of domestically produced goods (at and in by the agricultural sector : a2 and n2 by the non-agricultural sector) are separate from imported purchases (ml by the agricultural sector and m2 by the nonagricultural sector). Only current flows are shown and hence purchase of capital equipment by producing sectors is not indicated. Value added has only two components, compensation to employees and the rest called surplus In Accrual

Purchasing Sector/ Supplying Sector	Agriculture	Non Agriculture	Govt. Services	Private Non-Profit Services	Net Export Expen-	Private consumption diture formation	Invest-ment stock capital	Total
0	1	2	3	4	5	6	7	8
Agriculture	a1	a2	ag	ap	ae	ac	ak	A
Non-Agriculture	n1	n2	ng	np	Ne	nc	nk	N
Govt. Services	g1	g2				gc		
Private Nonprofit-services	p1	p2				pc		
Imports	m1	m2	mg	mp				
Compensation of employees	w1	w2	wg	wP				
Surplus	u1	u2						
Total	A	N						

accounts similar principles are implemented through the life of a project. In addition there will be the problem of the Union, the States and local bodies

Table 1. Current Inter-sectoral Flows of a Simple Two Sector

Concepts of agriculture's inter-sectoral flows can now be illustrated in Table 2.2. A moment's reflection shows the relationship between Table 2 and the SNA.3. Table 2 is a consolidation of the commodity and the production account of the key economic activity agricultural sector in the SNA. However, in addition to the SNA, the inter-sectoral aspects are disaggregated, e.g. al, nl, gl pl, ml a2, ag, ap and ae. With the clarifications. Table 1 can be read with Table 1.6 of SNA, UN, New York, 1968), p.92 (for framework of inter-sectoral flows, see O. Lange, 1981; P. Cornillase, 1972; SNA, p. 218; FAO, 1974, pp. 7-8).

Policy interests, of the kind expressed for the Bhattacharya group or the FAO were on gross flows (the first item listed in each bracket in the last sentence) since the concern was with impacts on levels of development of resource flows from non-agriculture to agricultural sectors. The impact of a resource transfer of a programme in which Rs. 1000 are spent on subsidies in agriculture would surely be different from another programme in which Rs. 1,000,000 are spent on an irrigation-cum-fertilizer distribution scheme but Rs. 999,000 are collected back, although the net financial flows would be the same in both cases. The categorization of inter-industrial flows, governmental flows and external flows is helpful in this context. Each of these sets of flows is related with specific institutional arrangements important for the deveopment of the economy. However, for examination of certain policy questions. e.g. marginal impact of relative price changes and also certain welfare indicators the derivation of net flows from the price flows may also be important (the bracketed items listed above). External flows in Table 2 can be measured gross as intermediate imports by the agricultural sector (ml) or on a net basis after subtracting from such imports net exports of the agricultural sector (ml-ae). Since capital flows have not yet been considered. Imports of fixed capital formation items. e.g., machinery and contra items for balancing are discussed subsequently.

The assumption that the Government sector produces only services in Tables 1 and 2 has, therefore, to be relaxed. In addition, the concept of the first (agriculture) sector's linkage with the rest of the economy has to be delineated somewhat carefully. Taking the second point first, it is useful to classify the second sector into three separate sub-sectors. The first is the second sector intensive first sector. In this sector will be included industries which produce inputs almost exclusively for the first sector. The second sector will be the second proper sector and the third will be universal intermediaries. Universal intermediaries will be industries like electricity, POL products, other energy, transport and construction and will be important for the Government sector. Current account flows will include only rental or maintenance and repair costs of items of a capital nature. Assume that the remaining definitions of Tables 1 and 2 are as before with the addition that indirect taxes and subsidies have been added. A moment's reflection will show that as regards flows this disaggregation only sharpens the definition of flows developed earlier but does not add on any further conceptual dimensions. The importance of flows to and from the first sector stand out in sharper relief and government services to the first sector intensive second sector can be estimated.

The conceptual advantages of the expanded system for the present discussion of government budgeting are two-fold. It helps in introducing the government and public sector explicitly in inter-sectoral production flows. Further, if sharpens the issues involved in estimating capital flows to the sectors. A simplifying assumption may be made that there is no direct public of non-financial assets will be net borrowing. Other economic flows will measure valuation of assets through time. The balance sheet will then measure changes in net worth.

The heart of the Japanese discussion is the concept of introducing a borrowing constraint in addition to a realistic revenue gap at the local level and its consistency with the national level. The India discussion does not set the conceptual base for this

and is thus in a policy cul de sac.

The Need for New Rules and Theory

There will now have to be new rules : These will be

* The Golden rule of net borrowing through the cycle
* The Sustainable Investment rule which is the Borrowing and Debt/GDP rule.

That all fiscal deficits are "bad" becomes very simplistic. This of course is not a plea of extravagance. Any recommended rule would need a justification and then vindication in terms of decentralized analysis. This work would be the backdrop of the proposed Loan Council. However, there is very little discussion of these aspects of Indian federal finance. The implications of these lacunae are not being understood, apart from works of scholars like Amaresh Bagchi'.

There is the larger question as to why these issues are not raised in the Indian discussion. This is particularly so when the county is close to a major acceleration of its growth process higher than from its present excellent trajectory. A section of its policy making is caught in its own cobwebs. In the early nineties it argued that India did not do well in the eighties, since that was the only way to differentiate itself from the eighties reform and justify the Bretton Woods reform bought uncritically and with its attendant costs. It now finds a strategic policy stance in the reform process anathema, even when the proposals comes from the Bretton Woods institutions, who have gone through a process of learning after the East Asian crises.

In this larger context three serious points being raised in meetings and discussions in Delhi are : First, Did India grow faster in the nineties as compared to the eighties: Second, critiques of the policies which were followed in the eighties and changes in the nineties. Third, how to improve things?

The first issue is decided at the expert level. Around a decade after our journals carried the story that India is growing at around 6% annual and that we have been doing so from the eighties, the West discovered it this year. Being one of the first to write that our growth was higher and more stable. We also knew that there were aspects which should worry us. even though our growth trajectory is indeed a great achievement. Fist in the nineties agricultural growth collapsed. Second, employment growth was much lower. Third, the distance between the rich and poor areas and urban and rural areas became greater.

The present author had pointed out nearly a decade back that : "There are therefore two characterstics of growth in recent years. It is higher. It is more stable. The characterization of the economy as a gamble in the monsoons needs change Similar views were expressed by other experts (S. Morris 1997 : R. Nagaraj 2000; Arvind Virmani 2004). GDP growth from 1980 to 1990 was 5.6%, which was not statistically significantly different at 5.7% from 1991 to 2002. In 1997 in my Inaugural Address to the Indian Society of Labour Economics at Trivandrum, comparing the period since the late seventies with the earlier period I had argued :

"Per capita growth was less than 1% in the early period and is 2.65% in the later period. In the later period, registered manufacturing is growing at around 7.5% and agriculture at above 3% (Table-2). In the early period agricultural growth was appreciably lower. Growth is now becoming a built-in part of the strucutre of the Indian economy.

Table 3 suggests that in the Eighties, there was hardly any year in which the growth was less than 3% compound annual and in around 80% of the years it was more than 4% compound annual. The situation was the other way round in earlier decades."

When Dani and Subrahmanian (2004) discovered Indian growth earlier this year at the IMF, they said it happened in the eighties, because we favoured the capitalist. They were a little late in discovering the "mystery" of Indian growth, but now are worse in describing it. In a larger context, Lord Meghnad Desai summarises the past as follows:

"Opening out the economy to foreign borrowing on official account in the 1980s was the beginning of an admission that self reliance was not a successful strategy, that the Indian economy was trapped in a low growth equilibrium.

" Therefore, " A lifetime of living off tariffs and subsidized interest rates has inured the big business classes against the virtues of competition." (M. Desai, 2004).

In the early seventies, India did miss out on outward looking industrial growth of many countries and its main economic achievements were in the food and energy sectors. For example, gross capital formation in the agricultural sector at Rs. 5566 crores at 1993 prices in 1976/77 rising to Rs. 7301 crores in 1980/81 has not been achieved in the nineties and since in absolute terms. But the argument that the policy systems of the eighties were designed to establish a cosy relationship between the capitalists and the establishment through tariffs and directed credit is silly and not based on facts. By the mid eighties the National Institute of Public Finance and Fiscal Policy stated that 65% of Indian industry was out of controls on prices, output and to a large extent on investment. Policy broke the back of the one to one link between the babu and the sethji and was very clear that global reform was to come next. Reform was in a strategic framework. In the first round the efficient Indian firm was protected by tarrifs and policies were harmonized and phased in a manner such that the efficient man did not suffer, because his supplier was not reformed to the extent necessary. Industry had to cope with domestic competition, prices growth strategy when it is operationalised. Approaching the Indian economy with double negatives (the past was bad and we cannot reduce the fiscal deficit since we have a coalition regime) policy making in India becomes incapable of developing the conceptual basis to trigger a faster growth trajectory in a consistent manner.

However, the SPV the Government has announced leads only to airport kind of projects and a very narrow perspective becomes a bottleneck to the design of a worthwhile investment programme. In fact given the complete lack of concern for the transition to a reform regime, the States do not have funds to give their contributions to land and water, social sector and employment schemes and many of these intitiatives will fall by the wayside of ill designed fiscal strategies. Ths background is important on account of a narrow fiscalmonetary angle to the exchange reserves use idea proposed by the RBI and Finance Ministry. Recently, Deputy Chairman Planning Commission has argued correctly that the SPV in the budget for big ticket infrastructure projects will add to the fiscal deficit.

On Alternative Models- It is being correctly argued that open economy paradigms, price and behavior determined models have a larger role to play in development and planning policy modelling in the next phase. There are some traditions of this in the nineties which need to be reinforced. There was perceived a link between market reform, technology and macro policies. Models which used income Imports were freed from quantitative controls, particularly in the intermediate and capital good sectors. But tariff policy was modulated at the industry level, breaking the protection link with the firm. The objective was to set tariff and tax policies in a manner such that in critical intermediates the efficient producer got a fair return for capacity creation and/or expansion. This was the policy of setting returns using LRMC principles (Alagh, 1991). Second, interrelated clusters of industries were freed from controls and subjected to competition in a coordinated and harmonized manner (Alagh, 1989). This was to avoid efficient producers from suffering financial losses on account of negative protection, since the input industries might not be reformed. There was high growth and a lot of churning. India did well then in industry and infrastructure and it is only now that we are picking up the tracks again.

These developments are missed out by NRI and Western economists because their policy advising system was ignored and the economists who designed the policy systems of the nineties on account of an urge to whom they were different. It is also argued by these groups that growth of the eighties was not sustainable since it led to fiscal deficits and policy has corrected this in the nineties. But the combined fiscal deficit of Central and State Governments was 9.4% of GDP in 1990-91 and 9.9% of GDP in 2001-02 the last year for which accounts have been given in the Economic Survey. More seriously borrowings in the nineties were increasingly for consumption. The revenue deficit of the Government of India which was 49.4% of the fiscal deficit in 1990/91 went up to 59.2% in 1995-96 and was 71.1% in 2001-02. Investment in agriculture and infrastructure collapsed, the growth rate of the manufacturing sector went down, but borrowing

went on rising. Gross Domestic Investment which had reached 26 to 27% of GDP went down to 24.4% in 2001/02 with public investment going down from 7.7% to 5.8% and private investment from 18.9 to 16.5%. No wonder fiscal sustainability is the task at hand and not a great achievement of the Nineties.

The fiscal sustainability argument is buttressed by citing the crises of 1991. India we are told had to sell gold, because it had splurged. 1990-91 was a very unusual year. The Janata Government of 1990 was explicitly against growth. The Eighth Plan Approach Paper they brought out was the only one not to have a growth target. With the level of short term debt we have today, wouldn't we have a crisis of confidence if the Prime Minister Manmohan Singh's closest economic advisers like Montek Singh Ahluwalia and C. Rangarajan, constantly kept on saying that growth was not an objective of policy and deriding past achievements.

I believe the Government is wisely accepting the advice some of us give from outside and hopefully targeting to reverse the investment famine of the nineties and economists must empathies with them rather than deriding investment strategies of the past. The negative mindset put brakes on any-

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