Chapter-V

Evolution of Fiscal Policy Rules in India

5.1. Introduction

In India fiscal policy rule is not a new concept. For more than fifty years since the inception of the constitution, government debt and borrowing programmes for the central as well as the state governments in India were managed without any explicit targets or rules except for the constitutional provisions under articles 292 and 293. Apart from this India has been tackling the fiscal deterioration by adopting fiscal reform mechanism to improve fiscal responsibility. In the last decade India has enacted mechanisms to bind government to fiscal rectitude through formal legal or even constitutional devices.

5.2. Constitutional Provisions on Public Debt

Dr. Ambedkar highlighted the importance of Parliamentary Legislation in Constituent Assembly debates on articles 292 and 293 and expressed the hope that “Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the union”. He referred to the need for an “Annual Debt Act”. Article 292 of the constitution of India contemplates limiting government borrowing through a parliament law. It mandates “borrowing by government of India- the executive power of the union extends to borrowing upon the security of the consolidated fund of India within such limits. Under Article 266 any disbursement from the consolidated fund of India mandatorily requires parliamentary approval. Similarly article 293 provides that the legislation of a state can fix limits on borrowing by a state as well as limits on guarantee given by it. Further under this article the central government may make loans to state provided the limit on central government borrowing under article 292 is not exceeded.

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1 In the constituent assembly debates article 292 of the constitution was referred to as article 268. Dr. Ambedkar had observed “that the borrowing power of the executive shall be subject to such limitations as Parliament may by law prescribe. If parliament does not make a law it is certainly the fault of Parliament and I should have thought it very difficult to imagine any future Parliament which will not pay sufficient or serious attention to this matter and enact a law. Under the article 268 even concede that there might be an Annual Debt Act made by Parliament prescribing or limiting the power of the executive as to how much they can borrow within that year.”
Clause 3 of article 293 provides that if any central loan is outstanding with a state or a loan in respect of which guarantees given by the central government is outstanding, and then a state may not raise any loan without the consent of the government of India. Therefore, Parliament has a vital role in regulating borrowing and other liabilities that are likely to affect the parliament’s effective control on future outflows from consolidated fund by way of debt serving and redemption, which is expenditure charged on consolidated fund. The issue of fixing borrowing limits by the parliament no doubt rose time to time. Estimates Committee in 1957-58, and in some of the subsequent reports of Estimates Committee and Public Accounts Committee raised the issue of fixing borrowing limits. Despite this, no legislative action took place to fix on borrowing.

**Shortcoming:** Article 292 of the constitution covers only the Public Debt. This is forming part of consolidated fund of India, as this alone can be deemed to be “borrowing upon the consolidated fund of India”. Other liabilities forming part of the Public Account such as post office saving deposits, deposits under small saving certificates and provident funds are not recorded as “borrowing upon the security of consolidated fund of India” (IMF, 2001).

The term fiscal deficit was not part of the budgetary parlance until late eighties. It was only when towards the end of the nineties that interest payment began to account for a large portion of central government and a good amount of revenue sources that issues of sustainability of debt and solvency of borrowing governments gained prominence (Srivastava, 2008).

**5.3. RBI Attempts towards Controlling Borrowing**

In September 1994 an agreement (without legislated sanction) was signed between the central government and the RBI to phase out the system of ad-hoc treasury bills by 1997-98. Adhoc treasury bills facilitated automatic monetization of the budget deficit. The borrowing gap after all other financing instruments got exhausted. On November 8, 1997, Dr. Rangarajan, the Governor of the RBI, in his inaugural address at the first Conference of the State Finance Secretaries convened by RBI, had flagged the issues that needed to
be focused upon in management of state finances. These included alternative methods for borrowing by the state, statutory ceiling on debt, setting up of consolidated sinking fund and the issuance of state government guarantees.

**Shortcoming:** This, in itself did not preclude the RBI from participating in primary issues of central government securities or operating in the secondary markets for central government debt, but it left these decisions to RBI discretion. While the central government’s automatic access to stabilized RBI financing has ended, and reliance on RBI financing by the central government has diminished over recent years, there are no formal limits on overall RBI lending to government. This leaved the RBI free to purchase government securities that are not sold to banks and public financial institution under the central government market borrowing program, and to subsequently sell them through open market operations as part of its monetary and public debt management. The central government also has access to ways and means advances from the RBI. The RBI no longer provides exchange rate or other guarantees (IMF, 2001).

5.4. Provision of Extend Ways and Means Act and Finance Act to Control Borrowing

Eleventh Finance Commission (EFC) recommended Extended Ways and Means Advance (EWMA) and additional open market borrowings in order to give the incentive for better performance. Fiscal reform programme linked assistance, by way of Extended Ways and Means Advance (EWMA) and additional open market borrowings. The scope and dimension of these facilities were decided by the central government, bearing in mind their macro-economic implications and the centre’s fiscal position. The facilities were linked to the monitor able fiscal reform programme drawn up by the state. Eleven States signed confidential Memoranda of Understanding (MoU) with the central government in 1999-00, which promised fiscal reforms in return for advances of tax shares (Government of India, 2000).

**Shortcoming:** The incentive given under this EWMA was not enough encouraging for better fiscal performance.
5.5. Debt-Swap Scheme

Government of India (GOI) formulated a Debt Swap Scheme realising the mounting burden of interest payments on the states, and to supplement their efforts towards fiscal management. The scheme was in operation from 2002-03 to 2004-05. The scheme capitalized on the current low interest regime, to enable states to prepay expensive loans contracted from GOI, with low coupon bearing small savings an open market loans. The scheme covered outstanding high cost loans with interest rate of 13 per cent and above. An amount of Rs 106076 crore was prepaid to GOI by the States from small savings loans and open market borrowings.

These additional recoveries enabled the centre to repay some of its high cost debt to NSSF. The central government used the proceeds of debt swap to effect prepayment of its debt to the National Small Saving Fund (NSSF) at lower interest rate. This had the effect of bringing down centre’s overall debt as well as its effective interest rate. During 2002-03, the state Governments swapped Rs 13766 crore had with 20 per cent of small saving share and additional market borrowings. During 2003-04, according to provisional data, loan amounting to Rs 46211 crore had been swapped with 30 per cent of small saving share and additional market borrowings. During 2004-05 additional debt swap amounted to Rs 433887. There has been a fall in centre’s liabilities relative to GDP because of the redemption of special securities issued to the NSSF based on the debt swap programme for the state.

**Shortcoming of the Debt-Swap Scheme:** The debt-swap scheme was only a small step in the direction of dealing with the unsustainable deficit faced by the States. It covered only 15 per cent of their total debt. Here, again, the scheme merely aimed at reducing the cost of servicing the debt, and not extinguishing it. Though there was a benefits of Debt-Swap Scheme in terms of reducing pressure on the state by way of lower interest rate but it lead to loss of revenue for centre as the high cost loan were brought to lower level (Government of India, 2005).
5.6. Debt-Relief Scheme of Tenth Finance Commission

Tenth Finance Commission recommended debt relief scheme in two parts, namely, (i) specific relief for state with high fiscal stress (ii) a scheme for general debt relief for all states. The second one was linked to fiscal performance. Improvement of fiscal management was measured by comparing the ratio revenue receipt (including devolution and grants from centre) with the total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. The performance of each state was measured against its own performance. Twice the excess of the ratio over the average ratio of fiscal improvement during the preceding three year was recommended for relief on loans contracted during the period 1989-95 and failing due for repayment after 31st March 1995. The relief was admissible only to the extent of 10 per cent of the amount due for repayment from loan in any year. Tenth Finance Commission took specific relief for all special category state, and three other states, Orissa, Bihar and Uttar Pradesh, which were characterized by high fiscal stress as indicated by average interest payments to revenue expenditure exceeding 17 per cent during 1989-90 to 1993-94. For these state Tenth Finance Commission recommended writing off of 5 per cent of repayment due with respect to fresh central loans given during 1989-95 and outstanding on 31st March 1995. The actual relief sanctioned to state was Rs 212 crore during the period 1995-2000 compared to the relief of Rs 565.51 crore estimated by Tenth Finance Commission (Government of India, 2005).

**Shortcoming:** Though the improvement of fiscal management was measured by comparing the ratio revenue receipt (including devolution and grants from centre) with the total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. So when the devolution and grants from centre was increasing the revenue receipt to total revenue expenditure ratio was showing an improvement but it was not an actual improvement of fiscal management of state.

5.7. Debt-Relief Scheme of EFC

Eleventh Finance Commission (EFC) did not consider any special debt relief for the fiscally stressed states, but continued general debt relief of Tenth Finance Commission.
EFC enhanced general incentive from 10 per cent to 25 per cent. In addition to it instead factors of two, a factors of five was applied on the ratio of fiscal improvement in terms of revenue receipts to total revenue expenditure. In the calculation of revenue receipts, the revenue deficit grants recommended by EFC under article 275 were excluded. This relief was to be available in respect of fresh loans granted during 1995-2000 and outstanding on March 2000. The actual relief sanctioned to state was Rs 131.77 crore till September 2004, compared to the relief of Rs 600 to 700 crore estimated by EFC (Government of India, 2005).

**Shortcoming:** Though under EFC in the calculation of revenue receipts, the revenue deficit grants recommended by EFC under article 275 were excluded still devolution from centre remained as a part of revenue receipts. So when the devolution from centre was increasing the revenue receipt to total revenue expenditure ratio was showing an improvement but it was not an actual improvement of fiscal management of state.

5.8. Debt Relief Scheme under Twelfth Finance Commission (TWFC)

Twelfth Finance Commission also recommended for debt relief scheme but, it also recommended that each state has to enact Fiscal Responsibility Law (FRL) with a target to eliminate revenue deficit and reducing fiscal deficit by 2008-09. Enacting FRL became a precondition for availing debt relief. A debt write off scheme became linked with the reduction of revenue deficit of the state. The quantum of repayment was linked to the absolute amount by which the revenue deficit is reduced in each successive year during award period. Fiscal performance measured with reference to the revenue deficit/ revenue surplus as worked out in absolute numbers by taking an average of three years, viz, 2001-02 (Actual), 2002-03(Actual) and 200-04 (RE). This average was taken as the base year for 2003-04. For state which were in revenue surplus, as per the base year figure, and continued to remain so in subsequent years till the end of award periods the installment of repayment due on central loans was written off in each years from 2005-06 onwards so long as revenue surplus of the state did not go below the base year level in absolute terms. In the year the revenue surplus was less than that in the base year figure no write off was permitted. In a year if the reduction in revenue deficit was more than the
minimum required for debt write-off the entire repayment due in that year, the excess was carried forward fully to the next year, provided the revenue deficit continued to follow a downward trend in the next year and was lower than the base year figure (Government of India, 2005). TWFC also recommended a stricter borrowing ceiling with the center setting global ceilings on borrowing and only lending to fiscally weak states.

**Shortcoming of the TWFC Debt-Relief Scheme:** The scheme of debt-write off linked to revenue deficit reduction recommended by the TWFC favored state with low base year revenue deficit. The relatively better of state received large benefits from debt write-off scheme, though they had relatively lower revenue deficit. Thus, the state with larger deficit gained less in terms of debt write-off in terms of the overall transfers they received. This did not induce them to undertake the fiscal adjustment. It encouraged creative accounting while preparing budget. The recommendation of the TWFC particularly for backward state allowing them to directly access the market, made debt stressed and difficult for the backward state to raise loans from market due to their lower credit worthiness and higher risk perception of lending agency. Placing borrowing limits based on capacity to service debts and uniform target for fiscal deficit reduction accentuated regional imbalances. The scheme of debt write off which was recommended by the TWFC commission guided more by the need for fiscal consolidation rather than providing relief to debt stressed poor state (Rao and Jena, 2005).

Debt Swap Scheme and the Debt Consolidation and Relief Facility (DCRF) recommended by the Eleventh and Twelfth Finance Commission, respectively. However, it may be noted that interest payments on special securities issued to NSSF, which was kept out of the purview of DCRF, constituted more than half the total interest payments obligations in a number of state such as Maharashtra (57.9 per cent) and Gujarat (55.1 per cent), and it accounted for more than 40 per cent in other state such as West Bengal (49.1 per cent), Goa (47.4 per cent), Karnataka (45.4 per cent), Punjab (44.7 per cent), Haryana (44.1 per cent) and Chhattisgarh (43.3 per cent) in 2008-09 (RE). Further, interest payments on market loans constituted more than one-fourth of the total interest payments in some state such as Andhra Pradesh, Kerala, Goa, Tamil Nadu, Rajasthan and Uttar...
Pradesh in 2008-09 (RE). Despite the initiation of DCRF, interest payment on account of loans from the centre is quite high in state such as Orissa (29.4 per cent), Madhya Pradesh (16.7 per cent), Karnataka (16.3 per cent) Bihar (16.1 per cent) and Chhattisgarh (15.7 per cent) in 2008-09 (RE) as compared to state like Punjab (0.9 per cent), Maharashtra (5.5 per cent), Haryana (7.0 per cent), Goa (7.6 per cent) and Tamil Nadu (8.6 per cent). As per the recommendations of the TWFC, the state need not compulsorily avail of the loan portion of the Normal Central Assistance. Considering this problem Thirteenth Finance Commission did a little modification in Debt Consolidation and Relief Facility (DCRF) (Government of India, 2010).

5.9. Debt Consolidation and Relief Facility (DCRF) under Thirteenth Finance Commission

The Commission has recommended two debt relief measures to be extended to all state. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to state contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9 per cent. The implication of this relief during the award period is estimated by the Commission to be Rs. 13517 crore. The financial implication over the entire period till the maturity of the last loan covered in this relief measure is estimated to be Rs. 28360 crore. The Commission has also recommended that structural reforms should be brought in the NSSF to make it more market linked. The second debt relief recommended by the Commission is write-off of central loans to state that are administered by central ministries other than Ministry of Finance outstanding as at the end of 2009-10. The amount of loans outstanding as at the end of 2007-08 was Rs. 4506 crore as noted by the Commission. The Commission has also recommended that any further loans under Centrally Sponsored Schemes should be completely avoided. The Commission has also recommended extension of the debt consolidation facility recommended by the Twelfth Finance Commission to state that have not yet availed this benefit.

All the above mentioned debt relief is available to state only if they amend/legislate FRBM Acts in accordance with the recommendations of the Commission. The
Commission has also recommended that the state will be eligible for the state specific grants only if they comply with this condition (Government of India, 2010).

5.10. Eleventh Finance Commission Provision of Fiscal Reform Facility (FRF) to State

On April 2000, Eleventh Finance Commission drew a monitor able fiscal reform programme, aimed at reduction of revenue deficit of the state. It recommended the manner in which the grants to the state to cover the assessed deficit in their non plan revenue account may be linked to progresses in implementing programme. EFC identified growth of tax revenue, growth of non tax revenue, growth of non-plan revenue expenditure on salaries and allowances, interest payments and reduction of subsidies as the five indicators as a measure of the fiscal performance of the state and recommended weights for each. As recommended by EFC, an incentive fund in the form of Fiscal Reform Facility (FRF) was set up by Ministry of Finance leaving 85 per cent of the revenue deficit grant recommended by EFC to be released to the state without linking it with performance. The remaining 15 per cent was linked with improvement in fiscal performance. While introducing the scheme of FRF, Government of India prescribed a single monitorable indicator for the purpose of making releases from the incentive funds. The indicator expected each state to achieve a minimum improvement of 5 per cent in revenue deficit/surplus as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-2000. The revenue deficit was to be inclusive of contingent liabilities and subsidies due to public sector enterprises (Government of India, 2000).

**Shortcoming of FRF:** Only a minor portion of the grants of non plan revenue account was linked to fiscal performance so it did not give any incentive to state towards fiscal responsibility.
5.11. Medium Term Fiscal Reform Programs (MTFRPs)

In 2000-01 the finance ministry issued guidelines to states for Medium Term Fiscal Reform Programs (MTFRPs). The MTFRP had dual aim of reducing wasteful expenditure (cutting low priority spending) and improving tax collection or improving the efficiency of the tax administration. The MTFRPs required the states to make time bound reform in four areas like, fiscal, power and public sector and budgetary. The main objective of MTFRPs were to bring the consolidated fiscal deficit to sustainable levels by 2005 and to bring down debt-GDP ratio as well as interest payment to revenue expenditure rate over the medium term. The MTFRPs finalised for nine states, namely Nagaland, Andhra Pradesh, Karnataka, Orissa, Kerala, Arunachal Pradesh, West Bengal, Himachal Pradesh and Manipur. Despite the operation of Fiscal Reform Facilities (FRFs) states achieved 6.23 per cent reductions in RD/RR ratio by 2002-03 as against the targeted 15 per cent reduction over the base year 1999-00. In 2003-04, the position deteriorated by 1.89 per cent. The aggregate fiscal deficit of states actually increased from 2.35 per cent of GDP in 1993-94 to 3.5 per cent in 2004-05. Similarly state revenue deficit increased marginally from 0.45 per cent of GDP in 1993-94 to 1 per cent of GDP in 2004-05. The outstanding debt to GDP ratio of states increased substantially from 21.79 per cent of GDP in 1993-94 to 31.15 per cent in 2002-03. FRF did not play a significant role in bringing about an improvement in state fiscal position in past five years. On the basis of performance five states classified as consistently improving (Kerala, U.P, Goa, Sikkim and Chhatisgarh). Some states classified as consistently deteriorating (Gujarat, H.P, Uttarachhal and Jharkhand). Twelve states showed initial improvements and then deteriorated (W.B, Rajasthan, Punjab, Bihar, T.N, Manipur, M.P, Assam, Haryana, Karnataka, Tripura and Meghalaya). The remaining states were initially deteriorating and then improved such as, Maharashtra, J&K, A.P, Mizoram, Nagaland, Arunachal Pradesh and Orissa) (Government of India, 2005).

Shortcoming of MTFRPs: There were certain reasons, why MTFRPS could not achieve its target. There was a design failure in prescribing a uniform 5 per cent improvement in the ratio for all states. If states start off with larger base year deficits, it was relatively easier for them to make huge improvements. In the initial years MTFRPs target were set in
terms of revenue deficit as a per cent of total revenues of state and when transfer to state declined, the ratio went up. The single monitor able factor was needed to be removed. The definition of revenue deficit was not uniform for all state. The size of fund, which was promised to be given to a state, as an incentive for achieving targeted reduction in fiscal deficit was insignificant, so could not give sufficient incentive to state to restore fiscal balance (Rao and Jena, 2005). The Twelfth Finance Commission (TFC) and Thirteenth Finance Commission recognized this problem and it recommended for linking the debt write off to improvement in revenue deficit. It has a lot merit as there is a direct link to absolute in the revenue deficit. The debt relief will be available, only if state enacts appropriate legislations to bring down the revenue deficit to zero and commit to reducing the fiscal deficit in a phased manner. MTFRPs was an important development in managing state finances, as the state started thinking about fiscal matters on a medium term frame work.

5.12. Restructuring the System of Fiscal Transfer towards Fiscal Responsibility
Under various Finance Commissions in the process of Tax Devolution

Even though the system of transfer is always guided by equalization and efficiency criteria, but still an objective for providing incentive to state towards achieving fiscal discipline has been always taken care of by different Finance Commissions (FCs). The critical aspect of the recommendations of the 12th and 13th FCs has been to link resource transfers to enhance the fiscal prudence on the part of the state, in general, and the enactment of Fiscal Responsibility Legislations by the state, in particular. The increase in transfers recommended through tax devolution and grants are expected to facilitate the state to undertake fiscal correction even while undertaking social and infrastructure expenditure required moving on an accelerated growth path.

In the tax devolution process time to time different Finance Commissions have taken certain criteria and have assigned them certain weights, considering the urgency of fiscal consolidation.
Table 5.1: Criteria and Relative Weights for Tax Devolution under Various Finance Commissions

<table>
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<th>11th FC</th>
<th>12th FC</th>
<th>13th FC</th>
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<td>0</td>
<td>47.5</td>
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(a) Tax Effort: Tenth Finance Commission (TFC) for the first time took tax effort as criteria for tax devolution to state. It worked as an incentive among the state to raise tax potential capacity. Tax effort was measured by the ratio of per capita own tax revenue of a state to its per capita income. It was weighted by the inverse of per capita income. It ensured that if a poorer state exploited its tax base as much as a richer state, it got an additional consideration in the formula. TFC gave 10 per cent weight to tax effort criteria. Eleventh Finance Commission (EFC) also recommended this criterion but it reduced the weight of inverse of per capita income from 1 per cent to 0.5 per cent. EFC gave 5 per cent weight to tax effort criteria. Twelfth Finance Commission (TWFC) also took tax effort criteria for tax devolution and it also raised the weight to 7.5 per cent considering the urgency of fiscal consolidation (Government of India, 2005). Thirteenth Finance Commission dropped this criterion for tax devolution (Government of India, 2010).

(b) Fiscal Discipline: Eleventh Finance Commission for the first time introduced the fiscal discipline criteria for tax devolution. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the state. The ratio so computed was used to measure the improvement in the index of fiscal discipline in reference period in comparison to a base period. TWFC also recommended fiscal discipline criteria for tax devolution to state. Fiscal discipline criteria got the relative weight age of 7.5 per cent in both the Eleventh and Twelfth Finance Commission. Twelfth Finance Commission had worked out the index with the reference period of 2000-01 to 2002-03 and the base
period of 1993-94 to 1995-96. These criteria provided an incentive for better fiscal management. Thirteenth Finance Commission have retained this criterion and have worked out the index of fiscal discipline with 2005-06 to 2007-08 as reference years and 2001-02 to 2003-04 as the base years. The own revenue receipts of a state include own tax revenues and thus, the criterion of fiscal discipline also captures the tax effort of state. Thirteenth Finance Commission has, therefore, dropped the use of tax effort as a separate criterion. Twelfth Finance Commission assigned a weight of 7.5 per cent each to fiscal discipline and tax effort. Thus, the combined weight assigned by Twelfth Finance Commission to these two criteria was 15 per cent. There is a strong case to incentives state following fiscal prudence, particularly in the context of the need to return to the path of fiscal correction. Thirteenth Finance Commission, therefore, assigned a weight of 17.5 per cent to fiscal discipline. Under this criterion, if all state improved their respective ratios of own revenue to total revenue expenditure, then the state with relatively higher improvement than the average receives higher transfers. Similarly, if the ratio has deteriorated in all state, then state with lower deterioration than the average receives higher transfers (Government of India, 2005).

**Shortcoming of the Transfer System:** Although the Finance Commission has earned appreciation as a useful fiscal institution for a federation, the transfer system that has been operating on the ground is marked by features that are widely perceived to be not very conducive to fiscal discipline among state. Multiplicity of transfer channels with little effective coordination among them and mediation of capital transfers (loans from the centre) without adequate regard for the repaying capacity of the recipient governments are the major road block on the way of achieving fiscal discipline. The allocation of the other component of the FC's transfers (share of central taxes, which accounts for the bulk of the “statutory transfers”) is decided on the basis of formulae which are also believed to have generated wrong signals for fiscal discipline. However, the emphasis is on equity rather than efficiency. While the transfer formulae also contain weights for efficiency (“tax effort”, fiscal self-reliance etc.) their effects are often perceived to be weak and subdued by equity factors. Even though criteria like tax effort, fiscal discipline has been taken in the tax devolution process under different FCs to
Evolution of Fiscal Policy Rules in India

achieve fiscal consolidation; it could not act as an incentive to the state for going towards fiscal stability. These criteria are mainly based on efficiency without considering equity. Though these criteria constitute only a minor portion of the total devolution process, it could not have any significant effect on the efficiency or on the equity among the state. Even the Thirteenth Finance Commission have taken Fiscal Discipline criteria and has given the weight of 17.5 per cent, in the tax devolution process to achieve fiscal consolidation, under the presumption that it will act as an incentive to the state for going towards fiscal stability. Though this criterion constitutes only a minor portion of the total devolution process, it will not have any significant effect on the efficiency or on the equity among the state (Rao and Jena, 2005).

The conflict between equity and efficiency in the transfer formulae is often overplayed as both can be taken care of simultaneously if the revenue gaps of the state are assessed normatively. However, for practical reasons, application of norms has not proceeded far and it may not be unfair to say that the persistence of gap filling approach in the FC’s transfers noted above continues to generate perverse incentives for fiscal indiscipline among state. With such a transfer system, the states have found it profitable to undertake expenditure commitments exceeding their available revenues on the expectation that the gap would ultimately be made up by the FC. The design of statutory transfers thus has tended to create a bias towards improvident budgeting by “legitimizing incipient deficits” caused by inadequate revenue effort and imprudent expenditure decisions of the past.

Contrary to the scheme of inter Governmental transfer that was apparently contemplated in the Indian Constitution with FC as the chief mediator, central funds are transferred to state in India through other channels as well, of which Plan transfers constitute the main component. Some transfers are made directly by central ministries for implementing Centrally Sponsored Schemes (CSS). Initially, central assistance for the state plans used to be project-specific. In 1969, this system was replaced by the Gadgil formula whereby support for state plans was extended out of central budget in the form of grant and loan with the share of individual state determined largely on the basis of population, and, in part, with reference to relative income levels. Some weight was given to tax effort but its
Effect was submerged by the other factors. An element of discretion was provided in the form of weightage for special factors.

There is lack of effective coordination between FC and PC. As a result, it was possible for a state to underplay its resource availability before the FC but present a different picture before the PC to obtain approval for its Plan of a size unwarranted by available funds. In the pursuit of national objectives like literacy program, the Centrally Sponsored Schemes (CSS) under the ‘Plan’ which are implemented through the state but are not all funded fully by the centre adding to their expenditure commitment. Often they carry a matching component, casting an additional burden on the state budgets and distorting their priorities. Finally, resources transferred to state in the form of loans are made up largely of ‘plan loans’. These are the on-lending by the centre from its own borrowing constituting the largest component of funds flowing from the centre to the state as loans. These, together with the system of state's borrowing from the market mediated by the Centre at uniform rates of interest and maturity, taking no account of the debt sustainability of individual state or their varying creditworthiness, constituted a potent source of budgetary instability of state. Unless the distortions in the fiscal federal system are removed, any attempts at fiscal correction at the state level are doomed to failure (Anand, Sen and Bagchi, 2001).

5.13. Restructuring the System of Fiscal Transfer towards Fiscal Responsibility

Under Planning Commissions Transfer to State

Planning commission transfers financial assistance to the state on basis of Gadgil formula in the fourth and fifth five year plan. Under Gadgil formula basically population, per capita income, tax efforts, on going irrigation and power projects and special problems were taken as the bases for financial transfers. Under these formula tax efforts was taken as indicator to achieve fiscal responsibility but though it constitute only 10 per cent of total financial assistance it could not achieve its objective. For 1991-92 annual plans some modification took place in formula and in the modified formula population, per capita income, financial arrangement and special development problems taken as the bases for financial transfers. Under these formula financial arrangement was taken as the
base to achieve fiscal responsibility but though it constitute only 5 per cent of total financial assistance it could not achieve its objective. Again in eight five year plan some modification took place financial assistance to the state was made on the basis of Mukherjee formula. Under this formula basically population, percapita income, performance and special development programmes was taken as the bases for financial transfers. Performance base was given 7.5 per cent weight of total assistance. It took tax effort, financial management; progress in the form of national objectives as the indicator of performance base. Though this performance base constitutes only a minor portion of the total transfer, it did not have any significant effect on the efficiency or on equity among the state.

In the case of plan assistance for general (non-special) category state, 30 per cent of plan assistance was given as grant and 70 per cent as loan. In the case of special category state 10 per cent of plan assistance was given as grant and 90 per cent as loan. Interest rate charged by the central government on the plan loan to State, which has been, in the past sometimes 300 to 400 basis points higher than the cost of funds to centre. Plan grant are not interest free grants. While at least two-thirds of the Plan expenditure have always been debt-financed (since 1974-75), in 1998-99, borrowings of the State meant for Plan Financing reached an unprecedented high of 139 per cent of Plan expenditure.

**Shortcoming:** Several features of plan financing and plan transfers tended to generate imbalance in the revenue budget of the state, of which the following deserve mention: 1) Approval of state Plans by the Planning Commission in terms of the ‘outlay’ without specification of its revenue and capital components. 2) The practice of the PC to approve large state Plans even when a state failed to achieve the targets set in the preceding year by a large margin. 3) Plan, non-Plan dichotomy in budget accounting with the revenue component of a Plan project shown under ‘Plan’ for the given Plan period but under ‘non-Plan account’ thereafter. This added to the state's ‘committed’ expenditure. It also provided a built-in incentive to launch new programs involving substantial expenditure on current account without regard for the consequence for future budgets.
5.14. Non Plan Revenue Grant by Thirteenth Finance Commission

It has been argued that Non-Plan Revenue Deficit (NPRD) grants risk moral hazard by providing an incentive to state to run non-plan revenue deficits. In Thirteenth Commission’s award there has been a significant reduction in the volume and state-wise incidence of NPRD grants, which is to be expected, given the structural improvements in the fiscal position of much state, including special category state. In the latter case, in recognition of the effort made to exit NPRD, Thirteenth Commission, deemed it appropriate to acknowledge such achievement with a performance incentive. Therefore, the need for NPRD grants diminishes as structural fiscal reforms are implemented and economic performance improves (Government of India, 2010).

5.15. Budgetary Reforms towards Fiscal Responsibility

A system of performance budgeting by Ministries handling development programmes was introduced in 1969 following the recommendations of the Administrative Reforms Commission. For long, a need has been felt to address certain weaknesses that have crept into the performance budgeting. This outcome budget will be major steps toward accountability and in this way it may bring fiscal accountability. Ministries present performance Budget that specifies results to be achieved by major programs. Actual performance is accessed in ministries’ Annual Reports. The Planning Commission has a Program Evaluation Organization that carries out evaluation of plan projects.

**Shortcoming:** There is little incentive for Ministries to carry out evaluation of plan projects and this practice is not widespread. Evaluations have not had much impact on subsequent budgets (IMF, 2001). There is lack of clear one to one relationship between the financial and the performance budgets and inadequate target setting the physical terms for ensuring year are the major weaknesses that have crept in to performance budgeting framework.

5.16. Fiscal Responsibility and Budget Management Act

Even though fiscal reform has been done time to time to improve fiscal responsibility piece meal reform became successful. Widespread deterioration in fiscal position with
associated impact on fiscal sustainability, macro economic vulnerability and economic growth led an emerging, consensus about the urgent need for imposing statutory ceilings on central government’s borrowings, debt and deficits. Therefore, in 2003 the central government of India enacted FRBM Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macro economic variable. FRBM act aims at intergenerational equity, macro economic stability, fiscal sustainability and fiscal solvency, eliminating deficit bias, fiscal transparency, fiscal accountability, autonomy of monetary policy and including limits on access of government to central bank credit. The Fiscal Responsibility and Budget Management (FRBM) Act mandates the centre to reduce fiscal deficit to 3 per cent of GDP and to completely eliminate revenue deficit by 2008-09. Similarly, acting in response to the debt relief package recommended by TWFC in return for fiscal correction, almost every state except West Bengal and Sikkim have enacted fiscal responsibility acts accepting similar obligations - fiscal deficit of 3 per cent of Gross State Domestic Product (GSDP) and zero revenue deficits by 2008-09.

The FRBM Act implemented with the debatable issues of: how to meet these objectives without eroding supremacy of Parliament itself in matters relating to fiscal management; and with suitable flexibility needed to meet emerging situations. The Parliamentary system and federal nature of polity would add to the complexities in the design and implementation of legislation (Reddy, 2000).

**Institutional Issues:** The more important institutional issues would perhaps be: (a) whether there is a need to bring about FR through a new constitutional provision, or a mere law, and if it is the latter, whether it should be linked to the existing constitutional provisions on ceilings on debt and guarantees; (b) whether the FR would be passed by Parliament to cover only the centre or whether it should be made applicable to all state in addition, by obtaining necessary authorisations, or whether it should leave the matter to the concerned state with or without some persuasion or through a model law by centre; (c) whether the law should be so designed as to avoid or limit judicial interpretation and jurisdiction; (d) whether the convention of secrecy of budgetary process is consistent with the most significant aspect of FR, namely transparency. It can be argued that, except
where anticipatory actions are possible, such as specific tax-measures, secrecy is not warranted and indeed secrecy of budget process stifles transparency of not only annual exercise, but also medium-term, and perhaps intra-year measures. There are universally recognised fiscal policy rules, and legislation incorporates one or several specific targets or ceilings or conditionalities or even prohibitions. There are broadly three types of rules, balanced-budget or deficit rules; borrowing rules and debt or reserve rules. Of direct relevance to the RBI is a borrowing rule that prohibits or limits borrowing by Government from a central bank. The FR has to balance between a credible rule, quantitatively determined and need for flexibility in fiscal management. Yet another aspect relates to the time frame within which these rules can be implemented. It is possible to visualise milestones, on these rules, incorporated into the legislation or enabling provisions made in FR to fix milestones from time to time.

**Accounting Issues:** Significant operational issues relate to accounting principles and practices. These would include budget coverage, adoption of accrual system to some degree, projections or medium term parameters, explanations for short-term deviations, valuation of assets at market value or foreign currency liabilities at current rate of exchange, contingent liabilities accounting and providing there for, etc.

**Fiscal Management Issues:** Illustratively, fiscal management issues in our country comprise: (a) the fact that a significant part of liabilities is not covered by assets even as per current valuation methods; (b) a significant part of current expenditure is “charged”; (c) there is passive growth of salaries, pensions, dearness allowance etc.; (d) there are also vertical and horizontal issues. If FR is imposed rigidly on centre there can be impact on state and differential impact among state, (e) the overhang of the past makes corrections possible only over the medium term, and hence need for delineation of transition path from the current situation to full-fledged fiscal responsibility.

**Procedural Issues:** The most important procedural issue relates to defining a trigger for what constitutes noncompliance with fiscal responsibility, warranting corrective action, and if so what are the corrective actions. At one extreme, there may just be reputation risk, while at the other extreme; there could be automatic revenue enhancement, or
expenditure containment. Apart from defining trigger and options of automatic sequestration or revenue surcharges, since the budget is annual, the tracking of intra-year situation becomes critical. This is particularly relevant in view of the acute intra-year mismatches observed between receipts and expenditures both at centre and state. The penalty for non-compliance should be built into the process, recognising that repudiation through revision of law itself is not impossible, since this was done by Parliament in several cases. Further, a view has to be taken on who should be the monitoring authority or authorities to track and disclose degree of compliance Comptroller and Auditor General, Parliamentary Committee or Oversight Committee of eminent experts. Whether and how budget documentation needs to be altered and intra-year reporting documentation introduced (say every quarter) to Parliament would also have to be considered. In particular, a case is made out by some experts for periodical reporting directly to public, with remarks of Oversight Committee of experts in addition to reporting and accountability to Parliament.

Another issue is whether Oversight Committee, without prejudice to Parliamentary Committee, should indulge in a pre-budget review or only post-budget review, and whether it should be concerned with intra-year reviews. There is, in cases of some countries, personal accountability, of say the Minister for the estimates and adherence to it. It has to be seen whether such accountability is feasible in India. Finally, there are a set of issues relating to the RBI. Recognising that the ultimate fiscal authority is with Parliament and that cannot be constrained except by self imposition, should FR bar automatic monetisation by the RBI or prescribe rules for it and should the RBI be banned from participating in primary issues of Government stock and finally should FR promote effectiveness of monetary policy by divesting it of its role as Public Debt Manager.

**Procedural Coordination with State:** Inevitably, there would be need for coordination in many areas of fiscal management, between centre and state. This could conveniently extend to even procedures relating to tax administration, which may be desirable irrespective of a view on FR. Let us take an example. States have recently agreed to adopt uniform floor rates of tax in respect of sales tax. This is only the first step towards having
uniform rates of taxation. However, neither uniform floor rates nor uniform rates of tax would be meaningful unless there is a standard and universally accepted classification of goods. The customs and Excise Departments of Government of India adopted the Harmonized System of Nomenclature at the eight-digit classification, though not the twelve digit classification currently in use in Europe. Perhaps, central government should urge all the state to adopt a standard and universally accepted classification of goods for effective coordination of revenue administration. Government of India may have to consider several such initiatives to ensure what may be termed as sound all-India fiscal management.

5.17. Conclusion

In India, among the reform tasks the most challenging one involves re-examination of fiscal relations between the central and state governments, with a view to restoring vertical balance and paving the way to fiscal responsibility. In other words, it is necessary to adopt a mechanism of inter governmental relations with strong incentives for expenditure control and revenue-raising at the sub national level. Failure to develop such a mechanism carries the risk that sub national governments will continue to incur sizable deficits and rely on costly bailouts. Other structural reforms that should help adherence to fiscal rules include downsizing the government’s work force, further rationalization of subsidies, and elimination or streamlining of quasi- fiscal operations.

Part of fiscal mess that exists now is due to the confusion persisting around the federal sharing. Fiscal responsibility can not be planned from the above; Subject this condition, state autonomy should not be affected by the system of central transfers. Policies such as adoption of gap filling approach by finance commission, the policy of the planning extending loan assistance to the state in accordance to a set of entitlement form with no reference to borrowing or repayment capacity or the existing level of public debt and the policy of pay revision of government servant regardless of payment capacity of governments of different state. Mere implementation of FRBM Act can not solve the problem an institutional reform is required in order to achieve the FRBM Act objectives.
BIBLIOGRAPHY


