Chapter-VIII

Summary and Conclusion

The rationale for fiscal policy rule in India arises from deteriorating situation in India. India has done a tremendous economic growth within these two decades. Its GDP growth rate has become 8 per cent but its sustainability has been in question, first with the 1991 fiscal-balance of payments crisis, and then again after 1997-98, when fiscal deficits returned to the 10 per cent of GDP range and government debt grew. To make this economic growth sustainable with macroeconomic stability, fiscal policy is a critical component. High deficits, unproductive expenditure and tax distortions have constrained the economy from realizing its full growth potential (Economic survey, 2007). The fiscal position of both central and State government worsened significantly since the fiscal consolidation achieved after the 1991 balance of payments crises. Remarkable downward inflexibility was demonstrated by fiscal deficit and stubborn upward movement was exhibited by revenue and primary deficits.

The combined fiscal deficit of the centre and the states which was 9.3 per cent of GDP in the crisis year of 1990-91 dropped to 6.3 per cent in 1996-97 before creeping back up to 9.0 per cent in 1998-99. The fiscal deficit had remained at over 9.0 per cent until 2002-03 and has since been on a downward shift declining to 4.2 per cent in 2007-08. Due to the global economic crisis it is again estimated to up to 10.2 per cent for 2009-10(BE). Similarly, the combined revenue deficit of the Centre and the States which was 4.2 per cent in the crisis year of 1990-91 and had declined to 3.2 per cent by 1992-93 grew to an alarming level of 6.9 per cent by 2001-02. Like fiscal deficit, revenue deficit too has shown a welcome downward shift since 2002-03 declining to 0.2 per cent for 2007-08. Due to the global economic crisis it is again estimated to up to 5.5 per cent for 2009-10(BE).

Persisting fiscal imbalance in India has been a major macro-economic concern to policy makers. More and more revenue deficit implies preemption of private saving for
government current consumption which tends to crowd out private investment without corresponding increase in capital spending by the government. It is also recognized that since the 1990s primary deficit has turned negative, implying that State are borrowing to meet their current expenditure or significant part of the fiscal deficit is due to the burden of the serving the past debt. It is obvious that, it is not the problem of growing deficit, which deserves concern, but the composition of this deficit and the way it is being financed because the impact of fiscal deficit depends on it. India economy can not sustain long with high deficit unproductive expenditure and tax distortions. It may hamper our economic growth. So, fiscal policy rule is needed to achieve economic growth.

Though from an empirical perspective, it is true that India’s high fiscal deficits have not, over an extended period, had an adverse economic impact by way of higher inflation or interest rates. But this apparent paradox is the result of a fortuitous combination of circumstances. The economic reforms launched in 1991 notably, the abolition of industrial licensing, degeneration of industries and trade liberalization had unleashed competitive forces resulting in higher investment as well as higher efficiency in production leading to an increase in production capacity which ran ahead of demand. It was because of this sluggish private investment demand that we escaped higher interest rates despite higher fiscal deficits.

At national level, deficit bias, time inconsistency, pro-cyclical fiscal stance, over borrowing and unsustainable public debt is the major fiscal problems which the economies face. At the sub national level vertical imbalance, free rider common pool, unsustainable debts are the major fiscal problem. A fiscal policy rule is implemented to solve these problems. An appropriate fiscal policy in the long run can promote economic growth and in the short run can bring macro economic stability. The success of fiscal policy rules, in particular, the growth response, depends on the quality and durability of the specific measures that underpin it. Transparency, and good governance, can also play an important role in achieving high quality, durable, adjustment. They should cover a broad definition of government. Those targeting a broader coverage of the public sector
tend to be more successful than those using a narrow indicator. In countries with a weak track record of policy implementation, procedural rules may work better than numeric rules. Under these circumstances, fiscal discipline can be promoted through increased transparency and accountability.

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 and introduction of rules at the sub-national level. In other words, it is necessary to adopt a mechanism of intergovernmental relations with strong incentives for expenditure control and revenue-raising at the sub-national level the recent agreement on indirect taxation at the State level is a key element in this regard. 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.

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. Following the central government almost every State has already enacted fiscal responsibility Legislations except West Bengal and Sikkim. There are certain design failures in the FRBM Act which may act as an obstacle in achieving its objective.
No doubt FRBM Act is an important development in managing Centre and States finances. Recently after the implementation of FRBM Act Central Government major fiscal deficit indicators showing a declining trend. This improvement in fiscal deficit indicators at the both central level is due to improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that at central level among expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there are not much changes. Fiscal Policy Rules should also take capital expenditure as a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment.

An issue that has gathered substantial interest in the wake of fiscal correction at the States Government level in line with TFC recommendations and their FRL is the need to ensure that the correction is not at the cost of reduction in either quantity or quality of expenditure. In this context, it may be mentioned that in the post-FRL period, there has been some reduction in revenue expenditure as a ratio to GDP. States have also not been able to step up the developmental component of expenditure, though capital outlay as a ratio to GDP has shown an upward trend.

The improvement in States finances during the recent years owes a great extent to the various fiscal reforms, viz., implementation of FRLs, introduction of VAT, imposition of new taxes and measures to improve tax administration, measures aimed at limiting non-development expenditure, etc. The larger devolution and transfer of resources from the Central Government backed by strong macroeconomic growth also aided the fiscal correction and consolidation process at the States Government level. The States Governments may pursue their efforts for improving revenue collection from non-tax resources, ensuring the quantity and quality of major expenditure heads, reducing recourse to borrowed funds for financing expenditure and enhancing devolution of resources to the local Government level. The States Governments may have to design post-FRL architecture after assessing their performance under the rule-based framework.
There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing, by States level public sector undertakings and power sector deficit. Contingent liabilities should be capped, but in addition off budget borrowing, where debt serving will fall to government, should be consolidated with on budget borrowing.

Inter-states comparison of fiscal adjustment shows that general category states performed better than special category States in reducing fiscal deficit, but reverse were the case in revenue deficit. Among the former, the low income States performed better in revenue deficit reduction, but the performance of high income state was better in reducing fiscal deficit. Both high income and low income categories of state brought down fiscal deficits by more than two per cent, but the latter category state increased their capital outlay by a larger magnitude than the former.

From the empirical result we can found out that FRBM act does not have a significant effect on the Gross Fiscal deficit (GFD) to GDP ratio where as GDP (at factor cost) growth rate has a significant negative effect on the GFD to GDP ratio. Population growth does not have a significant effect on Gross Fiscal deficit to GDP ratio.

The main weaknesses in the fiscal Responsibility and budget management Act design in India are:

1. **Absence of clear accounting definitions for target fiscal indicator:** This has allowed creative accounting as reflected by the issuance of off-budget bonds to finance subsidies, which have thus been excluded from the definition of the FRBMA-relevant deficit variable.

2. **Insufficient transparency in budget preparation:** Numerical targets have not been supported by comprehensive expenditure reform plans. In addition, the assumptions underpinning the budget do not always include annual forecasts for key macroeconomic variables, and the discussion of fiscal risks is limited.
(3) **Focus on a current balance target:** This allows weaknesses in budget classification to be exploited, by misclassifying current expenditures as capital expenditures. Targeting the current balance may also bias spending against education and health, which have a large current expenditure component. In addition, international experience illustrates that deficit type targets such as the current balance are more likely to reduce incentives for fiscal savings in good times, and to force adjustment in bad times (i.e. procyclicality).

(4) **Lack of explicit debt and expenditure targets:** Despite rapid economic growth and buoyant revenues, India’s inability to contain expenditure growth led to modest declines in the general government debt. Since the enactment of the FRBMA, general government debt fell by only 7-8 percentage points of GDP and, at 80 per cent of GDP, is high by emerging markets standards.

(5) **Absence of well-defined sanctions for noncompliance:** There are no explicit automatic penalties for missing fiscal targets and/or not following budget procedures. International experience shows that institutional sanctions (e.g., withholding of transfers, borrowing restrictions, and fines) and/or personal sanctions (e.g., fines, dismissal, and penal prosecution) are likely to be needed especially in countries with a history of weak fiscal discipline.

(6) **No independent assessment of compliance with the FRBMA:** Historically, budget projections have been subject to systematic forecast errors. Expenditures have consistently being underestimated in recent years even more particularly so if off-budget bonds are included.

**The Way Forward**

A. **Reforming the FRBMA:**

1. **In terms of target variables:** (i) include an explicit national medium-term debt target and define a path to achieve it; (ii) discuss with state the setting of state debt targets consistent with such path, for example, based on net revenue as in Brazil; (iii) on the basis of the desired debt path and a revenue projection based on a prudent trend growth assumption, derive annual nominal primary expenditure growth rules on the basis of the
government’s flow budget constraint; and (iv) consider including specific rules to protect capital spending if there is a concern that it may be cut excessively during adjustment. These changes will put the medium-term focus of fiscal policy squarely on debt sustainability, tackle the deficit bias at its very core (expenditure overruns), and reduce the tendency to pro-cyclical responses of fiscal balance targets by allowing automatic stabilizers to operate.

2. **In terms of coverage:** (i) bring all subsidy-related expenditures on budget; (ii) gradually expand the coverage of the fiscal accounts to include public enterprises that pose fiscal risks; and (iii) the accounts of special purpose vehicles created for funding government spending such as PPPs both at Central and Sub-national levels. This coverage expansion will address existing loopholes and reduce possibilities of circumvention.

3. **In terms of procedure and transparency:** (i) explicitly provide a plan of measures and reforms that support the achievement of targets (e.g., subsidy reform); (ii) systematically discuss the macroeconomic assumptions underlying the targets (including GDP growth, inflation, imports, exports and the exchange rate); (iii) provide exact definitions of the concepts underpinning the target variables; and (iv) include a statement of fiscal risks, including from PPPs. Additional disclosure along these lines will allow improved market monitoring and pricing of risk. In addition, (v) strengthen public financial management by reforming the budget classification and the accounting framework, and (vi) ensure timely and reliable reporting of sub national fiscal operations since these are important preconditions for the successful implementation of a fiscal rule.

4. **In terms of escape clauses:** tighten the definition of escape clauses so that they only apply to exceptional circumstances and require objective analysis and scrutiny in their application by an independent Fiscal Council to strengthen credibility.

5. **In terms of correction of deviations and enforcement:** (i) reduce the size of deviations that trigger corrective actions; (ii) introduce automatic and time bound mechanisms to correct deviations from targets that prioritize areas of spending that would
be cut if there was a need; (iii) introduce explicit penalties that are applied automatically when fiscal targets are missed and/or budget procedures are not followed; and (iv) institute independent fiscal councils to assess compliance with statistical and accounting standards and fiscal rules ex ante (i.e., budget forecasts, assessment of the impact of measures and targets) and ex post (execution, invocation of escape clauses, assessment of compliance with medium-term fiscal strategy). Consideration should be given as to whether existing bodies (such as the Controller Accountant General, Controller Auditor General, and Estimates Committee of the parliament) could carry out some or all of these functions before creating new institutions. Timely corrective actions and sanctions for non compliance coupled with independent oversight will reduce the likelihood of deviations and increase the cost of deviations to key players, thus strengthening the credibility of the rules.

6. To reduce opportunities for creative accounting and biased forecasts: define precisely the accounting framework and definitions for target fiscal indicators. Adopting an international standards budget classification (such as GFSM (2001)) and reforming the chart of accounts to be fully consistent with it could be useful in curbing possibilities for creative accounting. (ii) Empower an independent scorekeeper. Consider expanding the role of existing independent agencies that monitor government funds (e.g., Controller Accountant General and Controller Auditor General) before creating a new one for this purpose. The autonomous scorekeeper could be in charge of: (a) providing and assessing compliance with standardized accounting standards for all levels of government; (b) preparing objective and timely reports that allow to verify compliance with the FRBMA and other budgetary rules and targets. With these functions, the score keeper would have a role similar to that of EUROSTAT in the European Union. (iii) Expand the coverage of the fiscal accounts and target fiscal indicators. This includes bringing all subsidy-related expenditures above the line and gradually expanding the coverage of the fiscal accounts to include public enterprises that pose fiscal risks and the accounts of special purpose vehicles created for funding government spending such as PPPs, both at the central and sub-national levels.
7. **To focus medium-term fiscal policy on debt sustainability, consider using debt and expenditure growth targets:** This approach would tackle the deficit bias at its core, and allow room for macroeconomic stabilization through automatic stabilizers. This could be achieved by: (i) Setting a medium-term debt target and debt reduction path to achieve it. Given the stated central objective of the FRBMA, i.e. ensuring fiscal sustainability, a direct rule on gross public debt should be a logical part of the FRBMA successor. Setting the exact debt level target requires judgment about sustainable debt levels and India’s debt tolerance. As India continues its gradual integration with global financial markets, the judgment should also be informed by the debt levels observed in other emerging markets following sound fiscal policies. While theory does not provide a clear rationale for any specific debt target level in general, recent research suggests that emerging markets tend to have less debt tolerance than advanced economies. The debt target level should also be prudently defined to allow some room for discretionary countercyclical fiscal policy if automatic stabilizers were not sufficient.

8. **Given similarities of subnational FRLs with the FRBMA, reforms of FRLs at the subnational level should be consistent with reforms at the center,** in terms of ensuring well defined targets and statistical standards, enhancing fiscal transparency, moving to a debt target cum expenditure rule combination, incorporating an independent assessment of compliance with the rules, and a strengthening of automatic deviation correction mechanisms and sanctions for non compliance. In particular the sub-national reforms should seek to: (i) Define sub-national debt targets that are consistent with national debt reduction objectives and with the repayment capacity of the different states. (ii) Ensure timely and reliable reporting of sub-national fiscal operations.

9. **Combine fiscal rule reforms with other strategies to promote fiscal discipline:** In particular, continue to strengthen financial market control mechanisms as well as cooperative arrangements across government levels and pursue reforms to the intergovernmental fiscal relations system. To strengthen these arrangements: (i) Provide the conditions necessary for an effective market-based control mechanisms for fiscal discipline. An important step in this regard would be to gradually eliminate the
availability of large non-market based and captive sources of financing such as a statutory liquidity requirement for banks to hold state issued paper, compulsory investment by the National Small Savings fund in state paper and borrowing from the state employees’ pension fund. Establishing a firm commitment to a no-bailout policy will also strengthen the incentives for discipline faced by local authorities. (ii) Explore further possibilities for cooperative approaches to promote fiscal discipline. Arrangements enhancing cooperation between the center and regional governments such as the bi-annual conference of State Finance Secretaries could be transformed into a forum where both the center and the states could discuss sub-national FRL reforms and facilitate discussions on borrowing ceilings consistent with national objectives. (iii) Persevere with intergovernmental fiscal reforms in particular to reduce states’ dependence on central transfers, simplify the transfer system, and review the design of the transfer system on the basis of needs and fiscal capacity of the different states.

Mere implementation of FRBM Act can not solve the problem further improvement is require in terms of target variable, in terms of coverage in terms of procedure and transparency. FRBM Act in India need to be accompanied by an overarching structural reform effort covering intergovernmental fiscal relations, public sector employment, subsidies, and the financial system. For achieving transparency clarity in institutional arrangements (intergovernmental fiscal relations, relations between the government and the so-called public accounts, relations between the government and public utilities), in fiscal reporting (including timely, accurate and comprehensive financial statements) and in accounting (in particular through accruals-based treatment). In India sharing of tax powers between Central and state Government is also a source of complexity and the expenditure framework needs to be strengthened by clearly distinguishing between current and capital spending and by placing more emphasis on performance audit.
BIBLIOGRAPHY


IMF, various years “Staff Report of Article IV Constitution” (Washington: International Monetary Fund)


Growth in India, ed. by Edgardo Favaro and Ashok Lahiri (New Delhi: Oxford University Press).


Sarma Atul and Gupta Manis, (2002), “A Decade of Fiscal Reform in India” International studies programme Andrew Young School of policy studies, Georgia state university.


