Chapter-I

Background, Issues and Objectives of the Study

1.1. Introduction
Growing interest in fiscal policy rule is in part attributable to the deterioration in fiscal performance, the so-called deficit bias, experienced for more than two decades by a large part of the world. Fiscal policy rule is moderated by some attempts to reverse this trend. Kopits and Symansky (1998) define a fiscal policy rule as a permanent constraint on fiscal policy expressed in terms of a summary indicator of fiscal performance, such as the budget deficit, borrowing, debt or a major component thereof.

The need for fiscal adjustment may be seen in the context of the impact of the fiscal policy on stabilisation and growth objectives, the sustainability of the fiscal policy stance, and the linkages between fiscal and other policy instruments. Persistent fiscal imbalances reduce national savings, leading to lower private investment and more tepid economic growth (Fischer, 1993). High quality fiscal adjustment can mobilize domestic savings, increase the efficiency of resource allocation, and help meet development goals. Loose fiscal policy, on the other hand, can lead to inflation, crowding out, uncertainty, and volatility, all of which hamper growth (IMF, 2006).

Loose fiscal policy, especially when financed by printing money, can lead to high and volatile inflation. In addition to other costs, this undermines the efficiency of the price system as it leads firms and households to make incorrect decisions, confusing movements in the price level with changes in relative prices. This in turn reduces overall productivity. When the government borrows to finance a looser fiscal position, the greater demand for loanable funds can reduce private investment (and other interest-sensitive components of private spending) by raising interest rates. Under a floating exchange rate, higher interest rates will also tend to attract foreign capital, leading to an appreciation of the exchange rate, which will also crowd out exports.
Background, Issues and Objectives of the Study

Loose fiscal policy may not be sustainable. It leads to continuously rising debt levels creates uncertainty (regarding inflation, a disorderly depreciation, price and foreign trade restrictions, or large tax increases). These states of affairs reduce private investment as they cause investors to wait and see. Loose fiscal policy may also make the economic environment more volatile (e.g., by recurrent, and ill-timed, bursts of fiscal contraction and expansion), which can weaken investment by increasing risk and focusing investment on the short run. Indeed, in situations of high debt and deficits, fiscal consolidation can expand output, reduce the risk premium on interest rates, catalyzing higher private investment and raising asset values. This boosts private consumption and eases supply constraints. The expectation of lower government spending can also signal the private sector to reduce its estimates of current and future tax liabilities, further boosting consumption and investment. It is not only the size of the fiscal deficit and the initial debt reduction that matter, however, but also the composition and the perception of the sustainability of the adjustment effort.

Fiscal adjustment can help mitigate cyclicality (recurrent recessions and booms), reduce large external current account imbalances, and contain inflation. In capital account crisis, fiscal adjustment can restore confidence, ease financing constraints, and support growth. Fiscal adjustment may be needed to facilitate external adjustment, especially to reduce excessive current account deficits or surpluses. As an ex post identity, a fiscal deficit must be matched by net domestic private sector savings (the excess of private savings over private investment), an external current account deficit, or a combination of both. But cutting the fiscal deficit (surplus) will not generally result in a one-to-one cut in the current account deficit (surplus), as the private sector’s saving-investment balance will be affected too. For example, lowering the fiscal deficit could spur private investment as credit becomes cheaper and more plentiful, which in turn, might result in reduced private sector savings. Fiscal adjustment can also support current account adjustment through its effect on the real exchange rate. Fiscal consolidation, for example, will tend to depreciate the real exchange rate by reducing the demand for, and thus the price of, non-tradables, thereby increasing the relative profitability of the tradable sector and boosting (net) exports. And devaluing the nominal exchange rate without correcting fiscal disequilibria
Background, Issues and Objectives of the Study

may primarily affect inflation rather than the real exchange rate, thus failing to bring about significant external adjustment.

Fiscal adjustment can safeguard the economy from vulnerabilities or shocks (for instance, terms of trade shifts, “sudden stops” in capital inflows, natural disasters, and aid shortfalls), which adversely impact directly or indirectly the public finances. Such shocks can reduce revenue, raise the expenditure needs, and make financing more difficult and expensive. Countries that have built up reserves in good times can draw on these resources during bad times, and those with low levels of debt may be able to increase their fiscal deficits, during a downturn or even a crisis, without loss of market confidence. But countries without such buffers are often forced to take emergency fiscal measures, and have limited scope for counter-cyclical fiscal policy. Such emergency fiscal tightening measures are more likely to damage investment, growth, and social indicators, as they can be less well planned, and are often based on measures that produce short-term financial gains at the expense of longer-term efficiency.

Successful fiscal adjustments durably and efficiently improve the fiscal position while minimizing any welfare costs. Success depends on a range of factors especially, the timing, speed, size, and quality of adjustment. Accordingly, fiscal policy rules – if well designed and properly implemented – are viewed as potentially useful techniques for emerging market economies exposed to macroeconomic volatility and high capital mobility (IMF, 2006). From a political economy perspective, fiscal rules can be instrumental in avoiding the myopic policies resulting from dynamic inconsistency and/or political distortions, especially in highly decentralized countries. In a way, fiscal rules can even help depoliticize the macroeconomic policy framework.

Previously, a history of fiscal indiscipline had often yielded high inflation, depleted foreign exchange reserves, a private sector starved of credit, a flight from domestic currency, foreign exchange rationing, and an overvalued exchange rate. In these circumstances, rapid reduction of the fiscal deficit became an imperative. In the past decade, several advanced economies have shifted from discretion-based to rules-based
Background, Issues and Objectives of the Study

fiscal policies often reacting to the deterioration of their public finances. This shift has taken place in countries such as New Zealand, Australia, and United Kingdom, but perhaps most visibly in the European Union (EU) in support of monetary unification. In emerging market economies, the adoption of fiscal policy rules has been much more recent and limited mainly to Latin America. In some instances, the rules were introduced following a financial crisis; in others they were adopted to reduce vulnerability to a potential crisis. Often the immediate motivation has been to reverse the buildup of public debt, to restore fiscal sustainability and, more generally, to enhance the credibility of macroeconomic management. In addition, in some regions, mainly Central and Eastern Europe, rules are increasingly viewed as an anchor in the convergence to a broader monetary union (Kopits, 2001a).

Across the world, from the European Union’s Stability and Growth Pact to the United Kingdom’s Golden Rule and Sustainable Investment Rule, there have been attempts to bind governments to fiscal rectitude through formal legal or even constitutional devices. European Union fiscal policy rules aims at firstly, credible reduction in fiscal deficit within a range that will stabilize debt ratio at a prudent level and then, containing the debt ratio over the medium to long term. Broadly the task is to ensure fiscal discipline that contributes to price stability and is conducive to sustained economic growth. The traditional rationale for fiscal policy rules is macroeconomic stability. In several western European countries and Japan, the current budget balance rule was largely enacted to support the post-war macroeconomic stabilization. As this goal was accomplished, the rules were relaxed or abandoned. Much of the recent interest in fiscal rules has been prompted by the need to achieve or maintain long run fiscal stability. In fact, the main objective of fiscal rules introduced in New Zealand and proposed in Switzerland and Japan has been to consolidate the gains from earlier discretionary adjustments and prevent future increase in public indebtedness associated, for instance, with prospective ageing of population. Rules intended for containing the public debt possibly including a measure of unfunded contingent liabilities relative to GDP under a certain threshold can contribute to a fair distribution of benefits and burden across generations. More immediately, such rules should help moderate real interest rates in financial markets, ease
crowding out of private investment, and reduce income redistribution from wage earner to interest earner (Kopits and Symansky, 1998).

For a fiscal policy rule to be credible, it must involve commitment over a long period of time. Fiscal rules vary considerably across countries in terms of the target variables, institutional coverage, and methods of implementation. The country specific context, experiences and environments have a bearing on the nature of the rules (Kopits and Symansky, 1998).

1.2. Rationale for Fiscal Responsibility in India

The rationale for fiscal policy rule in India needs to be examined mainly against the widespread deterioration in public finances. 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 deficit, unproductive expenditure and tax distortion have constrained the economy from realizing its full growth potential (Economic survey, 2007). The fiscal position of both central and states government worsened significantly since the fiscal consolidation achieved after the 1991 balance of payments crises. Remarkable downward inflexibility demonstrated by fiscal deficit and stubborn upward movement exhibited by revenue and primary deficit.

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 showed
Background, Issues and Objectives of the Study

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 states 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 (Mohanty, 2004).

1.3. India’s Efforts towards Achieving Fiscal Responsibility

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.

In 2000-01 the finance ministry issued guidelines to state 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 states to make time bound reform in four areas like, fiscal, power, and public sector and budgetary. The main objectives 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 MTFRPs could not achieve its target rather during this time period fiscal situation deteriorated. There was a design failure in prescribing a uniform 5 per cent point improvement in the ratio for all states. If states started off with larger base year deficits, it became relatively easier for them to make huge improvements.
Background, Issues and Objectives of the Study

On April 2000 the Eleventh Finance Commission (EFC)\(^1\) recommended, an incentive fund in the form of Fiscal Reform Facility (FRF). EFC recommended releasing 15 per cent grant to the states by linking with improvement in fiscal performance. Under FRF, Government of India prescribed a single monitor able 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.

In the tax devolution process time to time various Finance Commissions of India have taken certain criteria like tax effort, fiscal discipline and have assigned them certain weights, considering the urgency of fiscal consolidation. Though the transfer formulae contain weights for efficiency ("tax effort", fiscal discipline etc.) their effects are often perceived to be weak and subdued by equity factors.

Twelfth Finance Commission (TWFC) recommended for debt write off scheme to enhance the fiscal prudence on the part of the states, but it also recommended that each state has to enact Fiscal Responsibility Law with a target to eliminate revenue deficit and reducing fiscal deficit. A debt write off scheme became linked with the reduction of revenue deficit of the states. The quantum of repayment was linked to the absolute amount by which the revenue deficit was reduced in each successive year during award period.

Thirteenth Finance Commission has recommended two debt relief measures to be extended to all states. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to states 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 Commission has also recommended that structural reforms should be brought in the

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\(^1\) The Finance Commission is a constitutional body established under article 280 of the Indian Constitution every five years with the primary purpose of determining the sharing of centrally collected tax proceeds between the central and state governments and the distribution of grants-in-aid of revenues across states. The terms of reference of the Finance Commissions can be expanded by order of parliament.
NSSF to make it more market linked. The second debt relief recommended by the Commission is write-off of Central loans to states. All the above mentioned debt relief is available to states only if they amend/legislate FRBM Acts in accordance with the recommendations of the Commission. The Commission has also recommended that the states will be eligible for the states Specific Grants only if they comply with this condition.

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. In terms of Fiscal Responsibility and Budget Management (FRBM) Act centre’s fiscal deficit was required to be reduced to 3 per cent of GDP and revenue deficit to be eliminated by 2008-09. The rules under the Act further require the central government to reduce the revenue deficit by an amount equivalent to 0.5 per cent or more of GDP at the end of each year beginning with 2004-05. The fiscal deficit is to be reduced by 0.3 per cent or more of GDP at the end of each financial year beginning with 2004-05. 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 has enacted Fiscal Responsibility Acts. States government accepted similar obligations of reducing fiscal deficit to 3 per cent of Gross States Domestic Product (GSDP) and eliminating revenue deficits by 2008-09. The case for fiscal responsibility, both at the centre and in the states, was made on the argument that fiscal consolidation is an essential condition for accelerating growth.

However, there are always doubts remain about how far Fiscal Policy Rule will be helpful in attaining the primary objectives, as distinguished from the intermediate ones of reducing deficit and debt. Some of the developmental economist argues that limiting fiscal deficit to 3 per cent may be too restrictive though it may affect development expenditure or social expenditure (Ghosh and Sekhar, 2005). They also argue that if the fiscal deficit is dominantly in the form of capital expenditure, it contributes to future growth through demand and supply linkages. Infrac can create so much demand in the economy that private investment may crowed in to supplement autonomous investment.
Background, Issues and Objectives of the Study

There is nothing wrong in maintaining large fiscal deficit if restoring to public debt is made only to meet investment requirements as long as their social rate of return is higher than the rate of interest. Deficit per se is not bad as the Indian economy is a demand-constrained economy (Mohanty, 2004). There is no theoretical reason cited for having a fiscal deficit target of 3 per cent. FRBM Act has been enacted not because it is a sound finance but because international speculators demand it. Fiscal deficit financed itself by generating an excess of domestic saving over private investment exactly equal to itself. If the objective of an economy is, employment generation public expenditure through borrowing finance is useful. On the other hand, a society with egalitarian goals should aim to keep down fiscal deficit, and finance public expenditure through progressive taxation (Patnaik, 2006).

The most important argument in favour of introduction of FPR is the failure in the last ten years to produce fiscal adjustment in India both at Central level and state level. India’s public deficit bias and indebtedness can not be sustained much longer with stepped-up external liberalization. Thus there is a strong case for adopting Fiscal Responsibility Legislation that involves a high degree of transparency, well designed fiscal policy rules at national and sub national levels of government (Kopits, 2001). On account of high fiscal imbalance there are hidden costs on the Indian economy in terms of the foregone potential for even higher economic growth than that has recently been experienced. The large and increasing fiscal deficit led to a crowding out of productive public expenditure and constrained the scope for further structural reforms and liberalization and rooms for macroeconomic policy maneuver adversely impact the growth prospects. In order to avoid the crisis, there is a strong need of revenue mobilization efforts and reorientation of expenditure away from subsidies and towards physical and social infrastructure projects. India’s medium term economic prospects, among others depend critically on progress with the closely intertwined tasks of fiscal consolidation and structural reforms. The rising level of fiscal imbalances and resultant high level of debt may create a vicious circle inducing a fall in the ratio of private to total credit, rising inflation and falling economic growth (Kochhar, 2006).
1.4. Objectives of the Study

Broadly the main objective of this study is to examine the suitability and effectiveness of the fiscal responsibility effort in India and to suggest how to improve the mechanism of fiscal monitoring in India. The specific objectives of the study are:

(i) To analyse the need for fiscal policy rule and constraints in India
(ii) To find out the major factor behind rising fiscal imbalance in India and to examine whether there is an electoral motive towards high fiscal deficit to GDP ratio or not.
(iii) To review how Fiscal Policy Rules (FPRs) designed in different countries and to analyze the success and failure of FPRs in achieving fiscal discipline through different mechanism.
(iv) To analyse the effectiveness of various measures undertaken at the central and state level to inculcate fiscal discipline in the fiscal management.
(v) To do a critical in depth reviews of the Fiscal Responsibility and Budget Management Act and make an attempt at examining effectiveness and suitability of FRBM act through a quantitative analysis.
(vi) To suggest improvements in the fiscal monitoring mechanism in India.

1.5. Approach and Methodology of the Study

In order to find out the factor behind rising fiscal deficit and to examine whether there is electoral motive towards rising fiscal deficit an Ordinary Least Square (OLS) method has been used. Whether election leads to increase in fiscal deficit to GDP is checked through econometric investigation covering the period from 1980-81 to 2008-09. The impact of election year on the fiscal deficit to GDP ratio is examined by regressing Gross Fiscal Deficit (Combined Government) to GDP (at market price) ratio against GDP growth rate (at factor price), Population growth and Election (where Election is taken as a dummy 1 for one year proceeding to election year and 0 is taken for other years).

The effectiveness and suitability of the recent FRBM Act has been found by analyzing provision and rules under taken by FRBM Act. In order to study the impact of FRBM Act
on fiscal indicator, the performance of major fiscal indicators trend such as, Gross Fiscal Deficit to GDP ratio, Revenue Deficit to GDP ratio, Primary deficit to GDP ratio, Tax to GDP ratio, Revenue expenditure to GDP ratio, capital expenditure to GDP ratio and Total Outstanding Liabilities to GDP ratio trend have been analyzed before and after the FRBM Act, both at the central as well as at state level.

In order to examine effectiveness and suitability of FRBM Act on fiscal indicator through a quantitative analysis Gross Fiscal Deficit (Combined Govt) to GDP (at market price) ratio has been regressed against GDP growth rate (at factor price), Population growth and FRBM (where dummy is taken as 1 for year in which FRBM have been implemented and 0 in other years).

The debt sustainability of centre and states is examined by the Domar stability condition, larger the gap between the interest rate and growth rate the higher will be the d/y. Thus, to stabilize debt/GDP ratio (d/y), rate of interest should be lower than the output growth

\[ Y - r > 0 \]  
\[ r = (IP) t / (OD) t-1 \]

Where,

\[ Y \] = Trend growth rate of GDP at current Market price
\[ r \] = Average Interest Rate, IP= Interest Payment, OD = Outstanding Debt, t = Time Period (r<g).

**1.6. Data and Period of Study**

The data for the study have been collected from the secondary sources. Indicator such as GDP (at market price), Population, Gross Fiscal Deficit, Revenue Deficit and Primary Deficit has been taken from *Handbook of Statistics on the Indian Economy*, which is published by Reserve Bank of India. For state level analysis data has been taken from *State Finances: A study of Budget*, which is also published by Reserve Bank of India. The yearly data have been taken for the period of 1980-81 to 2008-09.
1.7. Justification of the Study
The study tries to find out the rationale of rules based fiscal policy in India and their appropriateness. The effectiveness and suitability of FRBM Act is still a debatable issue. There exists a lot of literature on measuring the effectiveness of rules based fiscal policy in different countries. But there are very few studies in the context of India. That is what provides the motivation for the present study. The present study tries to analyze how the fiscal policy rules has been designed in different countries and how they are different from India. It also does a critical review of the performance of fiscal indicators taken under fiscal Responsibility and Budget Management Act and their appropriateness.

1.8. Organisation of the Thesis
The present study is organized into eight chapters. The first chapter introduces the study, gives the rationale for fiscal policy rule in general and in particular the case of India. It also analyzes what steps India Government has taken upto now towards fiscal responsibility and there suitability and effectiveness. The chapter also explains the objectives, methodology, data sources and period of study.

The second chapter reviews some of the existing theoretical and empirical studies relating to rationale of fiscal rules, the political economy issues, design issues of fiscal policy rules, arguments for and against fiscal policy rules in India, International and national experience of fiscal policy rules.

The third chapter describes theoretical analysis of different school of economics for the rationale for fiscal responsibility and accountability. One line of argument is the mainstream fiscal literature and the other form of argument is the political economy literature. In the mainstream approach views of economists differ; the circumstances under which debt, and its increment, i.e. fiscal deficit become unsustainable. There are three theoretical perspectives, namely, neo-classical, Ricardian and Keynesian. Depending on the circumstances and the relevant theoretical perspectives, fiscal deficit may be bad, indifferent or good. Neo-classical view considers fiscal deficits detrimental to investment and growth, while in Keynesian paradigm, it constitutes a key policy
Background, Issues and Objectives of the Study

prescription and theorist persuaded by Ricardian equivalence assert that fiscal deficits do not really matter except for smoothening the path of adjustment to expenditure or revenue shocks. This chapter also tries to find out whether there is an electoral motive towards high fiscal deficit or not.

The fourth chapter explains the international experiences of fiscal policy rules. It does an evolution of different country experience of Fiscal policy rules. It also explain how the fiscal policy rules is designed in different countries their success and failure in achieving fiscal discipline through different mechanism.

Fifth chapter describes an evolution of various measures undertaken by the Governments at the central and states’ levels over the years since Independence to inculcate some degree of discipline in the fiscal management. This chapter also analyses the suitability and effectiveness of those measures.

The sixth chapter explains the fiscal policy rule design in India at central and sub-national level. This chapter also analyses the justification of indicators taken under FRBM act and their effectiveness in improving fiscal discipline mechanism.

The seventh chapter analyses major fiscal indicators like Gross Fiscal Deficit to GDP ratio, Revenue Deficit to GDP ratio, Primary Deficit to GDP ratio, Tax to GDP ratio, Revenue Expenditure to GDP ratio, Capital Expenditure to GDP ratio and Debt to GDP ratio both before and after the FRBM Act at central as well as at states level. The debt sustainability at central and states level is examined by using the Domar stability condition. In this chapter the impact of FRBM Act has been examined through a quantitative analysis.

Finally, the eighth chapter summarizes the study, concludes and suggests for improving the fiscal monitoring mechanism in India.
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Background, Issues and Objectives of the Study


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