Chapter-II

Review of Literature

2.1. Introduction

There is a growing interest in fiscal policy rule all over the world. Several advanced economies have shifted from discretion-based to rule-based fiscal policies. Some of the countries introduced fiscal policy rules following a financial crisis; in others they were adopted to reduce vulnerability to a potential crisis. The traditional rationale for fiscal policy rule is macroeconomic stability. Now recent interest in fiscal rules has been prompted by the need to achieve or maintain long run fiscal stability. A prudent sustainable fiscal position promotes economic growth. In the long run, low and stable levels of government deficits (the difference between government revenues and expenditures) and debt are typically as associated with higher rates of economic growth.

Fiscal policy rules involve many fundamental and complex issues, about which much has been written and the debate still continues. This chapter attempts to review some of the existing literature. The studies on fiscal policy rules can be categorized in many ways but the present review prefers to divide the studies based on the issues that are primarily focused. Accordingly, this chapter is divided into the following sections: (1) Studies focusing on rationale for fiscal policy rules from empirical and from political economy point of view (2) Studies focusing in favour of fiscal policy rules in case of India (3) Studies focusing in against the fiscal policy rules in case of India (4) Studies devoted to choice of the design and type of instruments used for fiscal policy rules (4) Studies dealing with the international experience of fiscal policy rules (5) Studies relating with India experience of fiscal policy rule

2.2. Studies Relating to Rationale of Fiscal Policy Rules

International Monetary Fund (2006) focuses that sound and sustainable government finances play an important role in promoting macroeconomic stability and growth. High
quality fiscal adjustment can also 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. 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 and speed, size, and quality of adjustment. Adjustment will be more successful when well coordinated with monetary policy. The exact amount of fiscal adjustment needed depends on individual country circumstances, objectives. Fiscal adjustment is needed for countries which face macro-stability constraints. The success of fiscal adjustment, in particular, the growth response, depends on the quality and durability of the specific measures that underpin it. Government expenditures that are productive and a tax system that is efficient and broad based contribute to growth and development, and measures that are perceived as durable allay concerns about debt sustainability and alter people’s behavior. Fiscal responsibility laws, transparency, and good governance, can also play an important role in achieving high quality, durable, adjustment. There is also some evidence to suggest that emerging market economies with lower subsidies and transfers or higher revenues are more likely to sustain consolidations. Similarly, developing countries that cut selected current spending while protecting capital expenditures tend to experience longer lasting adjustment. For countries with low revenue-to-GDP ratios (as in most developing countries), revenue increases can also lengthen the duration of fiscal consolidation. For the success of fiscal responsibility law Institutions should be sufficiently developed to support the requirements included in the framework. Public finance management systems, in particular, should be sufficiently advanced to credibly implement the procedural and fiscal rules and to enforce them. They require broad political consensus to be successful and are not a substitute for political commitment. While the adoption of fiscal responsibility laws can potentially serve as a catalyst for meaningful reforms promoting fiscal prudence, experience suggests that broad support for fiscal prudence is a pre-condition for their success. Designing the framework takes time and should be geared toward addressing country-specific weaknesses in fiscal management that lie at the root of poor fiscal outcomes. These requirements may not be met in countries facing large macroeconomic imbalances or
political instability. 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. If including numeric fiscal rules, these should be carefully designed. Numerical rules can potentially be helpful, for instance, in containing a deficit bias, but are not in themselves the solution to structural fiscal problems. Numeric fiscal rules could even foster creative accounting and low-quality measures. Fiscal rules should be: (1) well defined regarding the specific fiscal indicator to be targeted, the institutional coverage and, if any, escape clauses; (2) simple and transparent, to serve as an effective instrument of communication of government policy objectives; and (3) monitorable, so that noncompliance can be easily detected and addressed. Their credibility ultimately depends on the government’s track record and on political and social consensus. Enforcement mechanisms should be credible and effective. Escape clauses should be reduced to a minimum to ensure the credibility of the process. They should enhance transparency. Countries with poor transparency and budget procedures are also unlikely to monitor effectively a meaningful quantitative fiscal target or enforce accountability.

Heller (2002) provides a perspective on how the IMF assesses a ‘sound fiscal policy’ focusing principally on industrial and emerging market economies. It observes six central criteria: the short term fiscal policy stance, with greater emphasis on automatic stabilizers than discretionary fiscal policy, relevance of medium and sometimes long term issues: fiscal sustainability capacity for aggregate fiscal policy implementation (including political economy factors) structural content of fiscal policy (tax efficiency and public expenditure quality) and institutional governance and process issues associated with budget implementation and revenue collection. Greater emphasis could be placed on adequate margin to deal with uncertain long term challenges. What constitutes a sound fiscal policy in one country will be different from that in another. Automatic stabilizers should be allowed to operate high tax burden is not conducive to increasing labour supply and could become a constraint on economic growth. Meeting a more stringent
expenditure target while accommodating higher spending in priority areas would require a critical review of other areas, including social spending where spending is relatively high by international standards. Short term fiscal policy stance should consider not only the position of central government, but also sub federal level, extra budgetary agencies and public sector enter prizes. Aggregate expenditure policy should be set according to medium term targets, rather than allowing them to higher (lower) in weak (boom) period. Having sets its fiscal policy objectives; Government should have a demonstrated capacity-analytically, legislatively and institutionally to coordinate, manage and implement aggregate fiscal policy to achieve them. IMF recognizes institutional rules can play an important role in achievement of broad fiscal policy objective. IMF emphasizes on structural content of fiscal policies. Importance is given to macroeconomic aggregates. Efficiency and effectiveness of public expenditure programme should improve and dead weight losses associated with mobilization of tax revenue should minimize. IMF had a bias towards expenditure reductions rather than tax increases, particularly for more advanced economies with already high tax rate burden. Emphasis should be given to minimize the adverse allocative effects and to instill an investment and growth supportive environment. Excessively high margin tax rates should be reduced and broadening of tax base and tax neutrality should be emphasized. IMF emphasizes the importance of high quality; transparent budget process, good governance and a well manage expenditure and revenue administration. Sound fiscal policy should be supported by an efficient system for managing public expenditure and collecting revenues.

2.3. Studies Relating to Rationale of Fiscal Policy Rules from Political Economy Perspective

Drazen (2004) highlights a number of conceptual issues in the political economy of fiscal rules. This paper gives significant insight into why rules often don’t work – they don’t address the cause of fiscal bias; they attach no real costs to deviating from the rules; they attach no real cost to changing the rules. It also suggested some different kinds of costs that may help enforce rules. Both perspectives should be helpful in thinking how rules should be designed. This paper concerned the more basic question of what problems a fiscal rule is meant to address and how a rule can address these problems. This in turn
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raises more general questions of how formal rules or laws can be more effective than announced non-legal commitments to the same objectives. He summarized the rationale for fiscal rules, which is primarily to address the bias toward positive budget deficits that characterizes the political process of budgeting in many countries. The strongest case for fiscal rules is based on political economy arguments that the rules correct the bias of short-sighted governments who accumulate public debt at the expense of future generations, and help avoiding time-inconsistency issues. He discussed the general question of how legislated restrictions can have an effect and make policy more credible relative to simply announcing a commitment to the same goal. More credible fiscal rules must be enforced by an open and politically independent review panel or court with significant sanctions for violations. Rules without independent enforcement, he suggests, are simply not credible. Fiscal rules cannot force legislators to be fiscally responsible. But, they may significantly increase the public’s awareness of deviations from fiscal responsibility and the negative publicity that such deviations incur. A skeptic may point to the problem of the “creative fiscal accounting” that fiscal rules often engender. That is, the formalization of a fiscal rule may induce the creation of mechanisms to monitor compliance is, the problem of creative accounting is a problem of the difficulty of making it transparent that a target has not been met, not a problem that not meeting targets has no cost. He made some more specific observations on the choice between fiscal policy rules and fiscal procedure rules. Fiscal rule is more likely to be effective the more it is designed to address the specific cause of the problem. This is a key argument in favor of procedural instead of numerical policy rules fiscal rules should shift away from numerical policy rules towards more focus on institutions and the budget process. He discusses the “alternative” of reputation for fiscal discipline and argued that adoption of a rule may itself be a device to help build reputation. He considered the issue of how it can be made credible that a fiscal rule won’t be changed whenever a government finds it inconvenient not to follow the rule, and he considered why in fact governments often have not been able to make a commitment to the given rule credible.

Eslava (2006) reviews the recent literature on the political economy of fiscal policy. Three lines of argumentation and their empirical implications have been considered:
political opportunism in fiscal decision making, distributive conflicts, and budget institutions. One could very briefly summarize this literature as indicating that a series of political and institutional features are key determinants of the fiscal balance. First, voters tend to be fiscal conservatives, but they frequently face difficulties in monitoring the government’s spending and taxing choices; voters’ conservatism therefore only translates into fiscal prudence in more transparent systems. Second, the presence of distributive conflicts generates a fight for resources across groups with heterogeneous preferences, which in turn leads to overspending. As a result, systems in which the fiscal decision making process is more centralized and/or political contexts are characterized by less fragmentation of the fiscal authorities are conducive to greater discipline. Finally, budget institutions are also important in determining fiscal outcomes; besides transparency and centralization of the decision making process, fiscal discipline should also be enhanced by numerical limits to the deficit and by limits to judicial involvement in fiscal choices.

2.4. Studies Relating to Rationale of Fiscal policy Rules in India

Rao and Nath (2000) explain fiscal adjustment in India is essentially crisis driven. Once the immediate compulsions were met, not much steam was left to make real changes. Since the attempt has been only to create an illusion of fiscal adjustment, fiscal consolidation has remained an elusive goal. Illusion of reforms has been created by placing emphasis on an inadequate measure of fiscal balance. Even in containing the fiscal deficit, the performance of the government has been dismal, but to show it in better light the scope and definition have been changed from time to time. In terms of comparable fiscal deficit numbers, there is not much to commend the effort to contain the imbalance. On the contrary, emphasis on fiscal deficit has caused distortions, as containment of the fiscal deficit was achieved by crowding out infrastructure investment expenditures at the margin. In terms of achieving fiscal correction in the real sense, the performance of the government during the last decade leaves much to be desired. The revenue deficit rather than showing a decline has increased over the years and this has happened despite reduction in the current transfers to the state governments. Equally worrisome is the sharp decline in capital expenditures and the effects of infrastructure bottlenecks are already visible in the economy. Thus the story of fiscal adjustment in
India is one of choosing the wrong targets, operating the instruments in inappropriate ways and creating an illusion of achieving targets while the reality is entirely different. The government has been concealing deterioration in the fiscal balance by placing emphasis on the fiscal deficit rather than more meaningful summary measures, and frequently changing its definition and method of measurement. Analysis shows that on a comparable basis fiscal deficit reduction has been marginal. On the contrary, other fiscal indicators have shown significant deterioration. Thus the claims about fiscal adjustment are illusory. Fiscal consolidation in India perhaps requires another crisis.

Kopits (2001) assesses the potential usefulness of fiscal policy rules for India, in the light of rapidly growing international experience in this area. As part of this assessment, it explores various design options and institutional arrangements that seem relevant for India, in the context of the Fiscal Responsibility and Budget Management Bill. India’s public deficit bias and indebtedness cannot be sustained much longer, especially 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 the national and sub-national levels of government; short-run contingency measures and a multiyear macro-budgetary process; an institutional framework for implementation of rules; and appropriate preparation and sequencing, including the phase-in of supporting structural reforms. As illustrated by international experience, all of these components are critical for the success of fiscal policy rules in India. The bill recently submitted to parliament goes a long way toward incorporating many of these elements. However, the bill leaves considerable scope, partly through delegated legislation, to strengthen provisions on the balanced-budget requirements and the public debt limit that are open to interpretation. An important step in this regard would consist of shifting to accrual accounting, which implies redefinition of the balanced budget rules in terms of operating balance. More important, the bill is silent on an area that has yet to be addressed, namely, the modalities of fiscal responsibility at sub national levels of government. In fact, a major challenge in India will be to extend fiscal policy rules to sub national levels, while preserving a sufficient degree of regional or local autonomy. There are some institutional issues especially, those with significant and
complex political economy implications on which it is difficult to formulate specific recommendations. Lessons for India from the experience of other countries, for example, on the statutory instrument, the authority of arbitration, or on the sanctions for noncompliance, are mixed. On transparency, however, the lessons are unequivocal: 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). To ensure the success of the rules, their implementation needs to be preceded by a concerted outreach campaign, broad legislative consensus, and an adequate convergence path, all of which are beginning to be tackled in the context of the bill.

Khatri and Kochar (2002) discuss the lead up to the current fiscal situation in India; compare India’s key fiscal indicators with those of other emerging markets, and draws lessons for India from the successful fiscal adjustments of other countries. India’s deficit and debt levels are high by international standards and are broadly accepted to be unsustainable. Revenue to GDP in India is significantly lower than that of other emerging markets (while expenditure is comparable), suggesting much scope to pursue improvements in revenue collection. Factors such as the size and composition of the adjustment, and a high initial debt level are associated with these successful fiscal adjustments. Concerted effort to substantially reduce fiscal deficits is required. Increasing deficits, a growing debt stock and a narrowing of the growth-interest rate differential imply that the conditions for fiscal sustainability have further worsened. The current level of the primary deficit, if left unchecked, implies a growing and unsustainable debt stock. Further, the international comparisons show that India’s revenue to GDP ratio is particularly low. Thus while reductions in the public sector wage bill, inefficient expenditure and government subsidies are essential, the key challenge appears to be on the revenue side to get agriculture into the tax net, to increase the taxation of services, and to raise the number of tax payers, particularly high income tax payers. As in other countries, many groups in India will oppose deficit reduction, but the literature on the political economy of fiscal adjustment provides some grounds for optimism. While that
literature indicates that consolidation may be more difficult to pursue for a coalition government, as is in power in India, there is no evidence of a systematic electoral penalty or decline in popularity for fiscally prudent governments. The need for ensuring corrective action in a “depoliticized” framework of fiscal rules prompted the push for Fiscal Responsibility legislation. The draft legislation specified target rates for reduction of the central government deficit and revenue deficit, and a target debt to GDP ratio. Whatever form the bill eventually takes, it will be important that its medium term objective is to achieve a sustainable fiscal situation. This will be difficult to achieve unless two essential features of the draft bill committing to a rules based reduction in deficits and the ultimate target of a zero revenue (current) balance are retained in the final legislation.

Karnik (2002) explains the target of 2 per cent for Gross Fiscal Deficit of TFC seems to be unduly restrictive. India’s fiscal scenario at the moment is about as it was in 1991-92, beginning of economy reforms process. For a verity of reasons, many of them in the realm of political economy, the government has been unable to reduce its expenditure and increase revenues. A fiscal responsibility bill, of the being discussed currently, is meant to offer a credible commitment that the government is serious about fiscal consolidation. By trying its own hands the government signals that it is serious about reducing deficit. The FRBM bill stipulates that by 2006 the gross fiscal deficit (GFD) as a proportion of GDP must be 2 per cent. This mean that government can borrow from the economy only to the extent of 2 per cent of GDP, whatever be the level of savings. In 1990-91 the ratio of capital expenditure to GDP was 4.4 per cent, which had declined to 2.6 per cent as per the budget estimates of 2000-01. However GFD was high due to high revenue deficit. There is already a feeling that government should increase its capital expenditure beyond current levels since public investment is believed to crowd in private investment. Real problem that economy face is the presence of RD. Running a GFD is not per se dangerous. One of the major lacunas of government finance has been the low levels of capital expenditure which had to be sacrificed in order to bridge revenue deficits. It may be expected that henceforth all borrowing will be employed for capital expenditures.
However, it is moot if 2 per cent level of borrowing will be sufficient to meet the development needs of the economy.

Pinto and Zahir (2004) explains that the public finance fundamentals have deteriorated after 1997-98 even when compared to the period which preceded the 1991 fiscal-Bop crisis. The recent record lows in interest rates have not softened this deterioration because of slowing growth and because public debt dynamics are driven by the average cost of the whole stock of debt, not just the marginal cost of new borrowings. While low interest rates help at the margin, the low inflation environment which produced them hurts to the extent that high nominal interest rates on dated securities were contracted in past years. While much of the recent emphasis in explaining the fiscal deterioration has been on the Fifth Pay Commission award, the elimination of financial repression and incomplete tax reforms have ‘cost’ the exchequer a minimum of 2.5 percentage points of GDP over the 1990s. The thrust of the fiscal response so far has been to contain the gross fiscal deficit in the 10-11 per cent of GDP range by cutting capital and developmental expenditure. This is a sub-optimal response from the perspective of long run growth and poverty reduction. If India is to reap the benefits associated with greater financial liberalization, there must be a fiscal adjustment focused in the first instance on revenue mobilization and tax reform to compensate for the loss of revenues from financial repression and customs duties in order to lower the supply of government debt and create more space for the private sector. At the same time, power sector losses and guarantees extended by state governments for bonds issued by loss-making public enterprises have become a significant threat to state government finances. Moreover, the decline in interest rates over the past 18 months or so is unlikely to survive a recovery in the global economy. Therefore, a programme of robust fiscal reform is needed to combat unsustainable public debt dynamics and help India achieve its long-run growth and poverty reduction targets. To urge a phased ‘fiscal adjustment now’, the paper presents debt projections under a base case with no reform, and an alternative reform case focusing on a small set of well-defined reforms. In the base case, the debt and interest burden become unmanageable by the end of the Tenth Plan period, while under reform, deficits come down and the composition of spending greatly improves. In conclusion, the paper has argued that India
is unlikely to grow out of its debt problem in spite of today’s low interest rates. To the contrary, a fiscal adjustment is needed to underpin faster growth.

Mohanty (2004) explains fiscal responsibility act issues and concerns. The FRBM act is based on the presumption that the fiscal deficit is the key parameter adversely affecting all other macro economic variables. It is argued that lower fiscal deficit apparently lead to inflation. It is also argue that large fiscal deficit may lead to huge accumulation of public debt. Fiscal deficit if is dominant in the form of capital expenditure it contributes to future growth through demand and supply linkages and create so much demand in the economy that private investment may croued in to supplement autonomous investment. There is nothing wrong in maintaining large fiscal deficit if restoring to public debt is made only to meet investment requirement as long as their social rate of return is higher than rate of interest. Deficit per se is not bad as the Indian economy is demand constraint economy. Resource development if it is properly managed will help pumping in purchasing power in the economy and boost demand. In India it is not the problem of growing deficit, which deserves concern but the composition for these deficit and the way these are being financed. Eliminating revenue deficit require reducing revenue expenditure drastically. Interest payment takes away around 30 per cent of total expenditure. But it is charger on consolidated fund of India, so the Government can no way actually reduce this expenditure except deferring a part of it, which will further aggravate the fiscal situations. Expenditure on defense is not compromise. So if Government tries to reduce expenditure it may do so in crucial sector like social services. This will affect all round development of country further aggravate the fiscal situation. On receipt side the amount raise from disinvest for public sector undertakings (PSUs) is also being spent for current expenditure. The trend 0f Government commitment towards direct tax is clear so Government can go for indirect tax in order to mobilize more receipts. But it will actually reduce the over all demand further through its impact on purchasing power of the consumer. Implementation of VAT also cannot solve the problem. Though VAT require much higher tax rate on the value added in order to get the same revenue, it will also lead to revenue losses for the states and affect the distribution of revenue among states. Therefore, the optimism expressed in FRBM Act towards
eliminating the revenue account deficits is only a misnomer. India needs a policy for fiscal prudence but FRBM in its present form is not the answer.

Rangarajan and Srivastav (2005) examine the long term profile of fiscal deficit and debt relative to GDP in India, with a view to analysing debt-deficit sustainability issues along with the considerations relevant for determining suitable medium and short-term fiscal policy stance. The impact of debt and fiscal deficit on growth and interest rates that arises from their effect on saving and investment are critical in any examination of sustainability of debt and deficit. It is argued that large structural primary deficits and interest payments relative to GDP have had an adverse effect on growth in recent years. The Fiscal Responsibility and Budget Management Act (FRBMA) of the central government has certain positive features. While the fiscal deficit target has been defined, it should be considered in conjunction with a target debt/GDP ratio. Further, the central FRBMA should be supplemented by state level fiscal responsibility legislations and an effective hard budget constraint on sub national borrowing. There is a clear need to bring down the combined debt-GDP ratio from its current level, which is in excess of 80 percent of GDP. The process of adjustment can be considered in two phases: adjustment phase and stabilisation phase. In the adjustment phase, fiscal deficit should be reduced in each successive year until revenue deficit, and correspondingly, government dis-saving, is eliminated. In the second phase, fiscal deficit could be stabilised at 6 percent of GDP. The debt-GDP ratio would eventually stabilise at 56 percent. In this process, the ratio of interest payments to revenue receipts will fall, enabling a progressively larger amount of primary revenue expenditure to be incurred on the social sectors.

Builter and Patel (2005) explain in India overall net public debt burden does not give cause for immediate alarm. The reasons India has remained fundamentally solvent despite the sustained fiscal deficits of the past twenty years are fast nominal GDP growth and financial repression. Capital formation is a key driver of the growth of potential output. With India’s continuing widespread capital controls and persistently small inward foreign direct investment, the volume of capital formation in the country is constrained by domestic saving. Depressed by the continuing large public sector deficits, the national
saving rate in India (the sum of the saving rates of households, enterprises and the state) is much below. Even the extant Indian saving rate should be able to support a higher growth rate than has been achieved thus far. An important reason it does not is that the intermediation of savings, by the formal financial system, into domestic capital formation is inefficient. The first is financial crowding out the negative effect of public borrowing on aggregate (private and public) saving. The second is the effect of government institutions, policies, actions, and interventions (including public ownership, regulation, taxes, subsidies, and other forms of public influence) on private savers, private investors, and the financial markets and institutions that intermediate between them. The composition of the public debt, however, has undergone substantial change. While public and publicly guaranteed external debt continues to decline in both gross and net terms (as a ratio to GDP), internal indebtedness of the government (that is, debt denominated in domestic currency) has shot up to 75 percent of GDP. Review (both informal and formal) indicates that the repression means that both the nominal and the real interest rates on the public debt are kept artificially low. Then they reflect on the likelihood of the rules being enforced, and on the scope for the FRBMA to create a mechanism that enhances macroeconomic volatility and promotes a pro-cyclical fiscal policy a fate that befell the EU’s Stability and Growth Pact. Without a vocal and influential domestic constituency in favor of fiscal responsibility and restraint, the adoption of a formal set of fiscal-financial rules in India is likely to prove as ineffective in India. In the study of the consolidated deficit tension therefore in the design of fiscal rules for India, whether at national or sub-national level, between providing enough flexibility to respond to the business, which is the source for the figures and table displayed, the econometric results show evidence that the fiscal deficit in India responds to both the political cycle and the business cycle. Fiscal rules in India are a start, and a very necessary one, toward requiring that fiscal correction should focus on the current account rather than on capital expenditure.

Kochhar (2006) examine both the evolutions of fiscal imbalances and key developments in major macroeconomic variables in order to assess the macroeconomic impact of the growing fiscal imbalances. Keeping in view the persistent fiscal imbalance and indebtedness, arguably, the fiscal situation is the single biggest threat to macroeconomic
stability. The rising fiscal imbalances and debt reflects a weakening in revenue mobilization, persistent deficit at Centre and State level and narrowing of the gap between real interest rate and growth rate. The author interestingly finds that on account of high fiscal imbalance there were hidden costs on the 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 impacting the growth prospects. In order to avoid the crisis, the author feels that there is 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.

Roubini and Hemming (2006) use a balance sheet approach to assess India’s vulnerability to a crisis as a result of its high fiscal imbalances. The authors explore the question of the finance ability of a country debt position, the vulnerabilities associated with the way in which India’s public debt is financed and the experience from other emerging market economies which face high debt ratios in recent years. The authors find that India’s debt is clearly financeable over the short term, reflecting such important strengths as modest rollover/liquidity risk, lack of currency mismatches and limited liability dollarisation, small current account imbalances and low external debt, financial repression and capital controls. In principle, these are insulating factors to the large deficit and high share of debt to GDP. The paper concludes that a failure to tackle fiscal consolidation in the near term will only increase India’s vulnerability in the future.

Singh and Srinivasan (2006) assess India’s current fiscal situation, its likely future evolution and impacts on the economy. The authors examine possible reforms of macroeconomic policy and broader institutional reforms that will bear on the
macroeconomic situation. The authors also take into account the factors such as political feasibility of possible reforms. They also examine both medium and longer run scenarios, fiscal sustainability and adjustment going beyond conventional government budget deficits, to include off-budget liabilities, both actual and contingent. They concludes that some short run fiscal adjustments are clearly necessary to avoid any possibility of a crisis, but at the same time more fundamental adjustments in the tax system, the structure of the expenditure and the financial sector must be on the agenda for reforms.

Heller (2006) provides an alternative perspective on why India needs to move soon to address the fiscal imbalances. A continuation of current fiscal policies, the level of fiscal deficits and character of government expenditure, would put India on an unsustainable course in terms of the constraints that it would impose, in the future, on the role that public sector would be able to play in effectively addressing these longer term challenges. The author emphasizes on undertaking the appropriate reforms in order to placing fiscal house in order today so that India have sufficient fiscal leeway in the future to address the long term fiscal challenges including those of demographic developments in the population at large, the demographics of civil service and military pensions, the imperatives of social insurance reforms and urbanization patterns and the effects of the globalization. The paper states that India now has a fiscal policy framework that neither offers that futures fiscal leeway, nor provides an appropriate expenditure programme that is responsive to the obvious and immediate needs of the economy of the coming decades. Current fiscal policy is recognized by most analyses as unsustainable. An important policy message may be drawn from the paper is that India should be cautious about how it formulates new policy commitments so as to avoid excessive preemption of future budgetary resources and thereby avoiding the mistakes of industrial economies.

Srivastav (2008) discusses the rationale of fiscal policy rules arising from both political economy literature and conventional public finance literature. He reviewed the international experience regarding fiscal policy and fiscal transparency rules. He analyzes states FRBMAs and related experiences. Empirical evidence supports at least in an international setting the predictions of models based on opportunistic manipulation of
fiscal policy. First debt accumulation is related to the degree of transparency of the budget. Second while, there appear to be electoral increase in fiscal deficits and government expenditures, these are limited to countries where voters are less successful in monitoring fiscal outcomes. There are some shortcomings in center’s FRBMA. Many countries are going for defining fiscal deficit targets in countercyclical intervention can be strengthened by having reliable forecasting models for anticipating downturns. This should be done after the debt GDP ratio has fallen significantly. It can also be undertaken earlier if the household sector’s savings in financial for increases and a private investment is not able to absorb it. It is best to stick with revenue deficit target. This is specified in the Act rather the rules in center’s FRBMA. It can also make better economic sense for government not to use up available saving for current or consumption expenditure. There is an improvement in the deficit indicators comparing the levels relative to GDP before and after the FRBMA. The improvement was not only the result of following the targets until 2007-08 but also because of steady improvement in the growth rate. In fact, very largely the fiscal improvement was responsible for the increase in growth rate. In particular, the improvement in the revenue deficit was responsible for an increase in the savings ratio for about 4 percent point.

Rajaraman (2006) focuses on the factors underlying the continued weak fiscal position during the previous one and half decades as well as the prospects of recent fiscal reforms. The author identifies that the impact of trade liberalization measures and their associated loss of tariff revenue remained the major factor underlying the weakened fiscal position since the early 1990s. Unlike other countries which undertook tariff rate reductions, India did not compensate the loss of revenue by a commensurate increase in domestic taxes. The author is of the view that buoyant growth in India is essential for fiscal reforms to be possible and this requires that the kinds of physical and social infrastructure should go up in both quality and quantity. The author finds two strands to the fiscal imbalance path in India. First, high interest rates on public debt which started rising sharply in the 1980s and details the political economy pressure that fuelled this rise. Second, non-interest fiscal indicators which worsened sharply in 1998 with the real wage hike introduced that year for government employees and pensioners raising the consolidated salary bill
substantially. An econometric exercise investigates whether this event was endogenous to the political economy. The regression equations show an election year response, which has become more marked in the last 30 years. The author recognises the importance of two major reforms, i.e., the reforms of the interest rates guaranteed under the NSSF and passage of the Fiscal Responsibility Legislation.

Shome (2006) find that though there have been significant changes in the tax structures in the 1990s, however, the insufficiency in streamlining the wide prevalent incentives and exemptions has adversely affected the full potential of revenue productivity in both individual and corporate income tax. It was recognized that competitive sales tax reductions by States aimed at attracting investments had led to revenue losses without commensurate gains. The author emphasizes on the reforms on both tax policies and revenue administrations.

Hausmann and Purfield (2006) provide thought provoking views and find that India’s tendency to run large deficit and accumulate debt has deep institutional roots embedded in its highly decentralized democratic system. The paper mainly studies three aspects of fiscal consolidation. First, it accounts for the lack of symptoms of an impending crisis by pointing to some aspects. However, the lack of symptoms is double-edged sword: it makes crisis less likely for any level of debt, but society is less responsive to fiscal imbalances, thus making the eventual problems much larger. Second, it analyses possible implications of the fiscal responsibility legislation on India’s imbalances. Third, it studies India’s federal system and the role of States in the fiscal adjustment effort. The authors find that India’s ability to tolerate high deficit and debt without encountering the types of crises experienced by many other emerging economies is a mixed blessing. It reflects the comparatively large and closed nature of its economy as well as its deep domestic capital market and large, albeit captive, pool of domestic savings. The last has allowed the Government to finance deficits with long term fixed rate debt instruments. The authors recognize the recent institutional reforms based on legal backing. The authors suggest a State level fiscal consolidation plan including those of imposition of borrowing ceiling on States to constrain their deficits and reforms to the system of intergovernmental transfers.
to give a more stable and reliable source of revenue. In a federal set up, stable and reliable sources of flow of funds helps in formulating the future strategies at sub national levels governments. For sound fiscal management, however, the efforts should be undertaken by both the Central and State Governments. The federal budgetary systems bring especially difficult challenges.

2.5. Studies Relating to Against Fiscal Policy Rules in India

Patnaik (2006) explains there is no theoretical reason cited for having a fiscal deficit target of 3 per cent. FRBM act has been enacted 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.

Baduri, (2006) explains FRBM Act enacted at a time when the Indian economy was not facing any international payment crisis; instead, foreign exchange position was comfortable and the stock market was booming. The Act by crippling government action certainly does not serve the interest of the poorer section of the Indian population.

2.6. Studies Relating to Fiscal Policy Design

Kopits and Symansky (1998) address a number of questions. What are the fiscal policy rules? What are the principal benefits and drawbacks associated with various fiscal rules, particularly compared with alternative approaches to fiscal adjustment? Can fiscal rules contribute to long run sustainability and welfare without sacrificing short run stabilization? If so, what characteristics of fiscal rules make this contribution most effective? Growing interest in fiscal policy rules 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. A fiscal policy rule is moderated by some attempts to reverse this trend. For a policy rule to be credible, it must involve commitment over a long period of time. Fiscal policy rules tends be more heterogeneous and complex than monetary and
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exchange rate rules. They listed some desirable characteristics which any FPR should have. Ideally a fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient. Binding fiscal policy rules are likely to influence the level and composition of government expenditure and taxation. In addition, fiscal rules have major macroeconomic consequences for inflation, external indebtedness, and economic growth. For the most part, economic performance under fiscal rules has been mixed. Besides a number of successes, some rules have been ineffective, suspended, or abandoned. In the advanced economies attempts to comply with fiscal rules contributed to a decline in inflation and interest rates, mitigated the crowding out of private investment, and alleviated the external imbalance. In developing economies, in the absence of sufficiently deep internal financial markets, restrictions on bank financing or domestic borrowing were partly accommodated by a substantial buildup in foreign indebtedness. To some extent, the latter was facilitated by the credibility gains associated with implementation of the fiscal rule. Apart from broadly favorable macroeconomic effects, compliance with fiscal rules has led to distortions in the composition of government expenditures or tax increases. On the expenditure side, often the brunt of the adjustment has been borne by cuts in public investment. In some instances, fiscal rules induced a lack of transparency in the budget process, proliferation of creative accounting practices, and recourse to one-off measures. Also distortions in tax structure and administration may have been compounded, along with an increase in the overall tax burden. In his paper a set of stochastic simulations were performed for the group of seven economies, on the basis of shocks derived from historical data, to ascertain the likely effects of various balanced budget rules on the variability of macroeconomic performance. A basic premise underlying these simulations is that if a major source of the variability is irresponsible fiscal policy, then fiscal rules will tend to dampen macroeconomic fluctuations. If, on the other hand, output variability is the result of disturbances due to shocks other than fiscal policy, then fiscal rules will be procyclical and will tend to exacerbate these fluctuations. In general, the source of overall macroeconomic variability is a result of shocks to the behavioral equations of the method. The effect of fiscal rules on output variability is determined by the relative size and
persistence of fiscal policy shocks compared with the size of other underlying shocks, and by their interaction with automatic stabilizers.

IMF (2005) pays considerable attention to accounting and reporting issues raised in connection with the quest for transparency, guarantees raise a wider set of issues which are also addressed. Guarantees are a legitimate form of government support for infrastructure investment when the government is best placed to anticipate risk, control risk exposure, and thereby minimize the cost of risk. However, guarantees create problems insofar as they are not usually subject to the same degree of scrutiny through the budget process as regular spending. These problems are compounded by the fact that guarantees can often have potentially significant fiscal consequences, and these can be particularly severe if they are exposed during crises. This places a premium on developing a rational, forward-looking policy towards guarantees, for which transparency is a precondition. The main accounting and reporting challenge is that the contingent nature of guarantees makes valuing them difficult. Transparency with respect to guarantees under any basis of accounting can be strengthened by disclosing supplementary information in budget documents, fiscal reports and financial statements. In this connection, the paper proposes a set of comprehensive disclosure requirements for guarantees. The potential fiscal costs associated with guarantees argue in favor of carefully controlling them with a view to managing fiscal risk. Centralized controls over the granting of guarantees are often appropriate, and a government wishing to assert firm discipline should consider introducing a quantitative ceiling on guarantees. Governments should also appropriate in their annual budgets the expected cost of payments to meet called guarantees in the next year. In addition, where reasonably reliable estimates of the future expected cost of guarantees can be made, governments should reflect this in the budget when guarantees are granted. While this will require an appropriation, funds do not have to be set aside or earmarked to meet the full expected cost of guarantees. Charging fees to beneficiaries can help to control guarantees. Debt sustainability analysis should take into account guarantees.
2.7. Studies Relating to Fiscal Policy Design in India

Rangarajan and Rao (2007) explains even if India achieve zero revenue deficits, and use borrowings only for investment expenditure as the golden rule, we still need to restrain fiscal deficits because the budgetary returns on investment are typically lower than the cost of borrowing. From an empirical perspective, it is true that our 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. It is argued that internationally fiscal rules do not target revenue deficits; they focus instead on the fiscal deficit and on the primary deficit. The case for focusing on the primary deficit is simply that interest costs on accumulated debt are outside the scope of government control and while they may vary with interest rate changes, this variation does not reflect the quality of fiscal control. It is not correct to say that the revenue deficit target is not internationally recognized. The UK, for example, has the ‘golden rule’ which mandates the government to restrict borrowing to the extent of capital expenditure. Accordingly, under the golden rule, capital expenditure equals borrowing plus any plough back from surplus on the revenue account. The golden rule is, therefore, similar to our zero revenue deficit targets. In a conceptual sense, of the three variables, fiscal deficit, primary deficit and revenue deficit, it does not matter which two variables we target. It is argued that India too must adopt a similar cyclically adjusted fiscal management. Notwithstanding the appeal of this argument, we would be better off with a fixed target. A cyclically adjusted policy works only when the debt-GDP ratio is already at a sustainable level. Debt sustainability and fiscal deficit are interlinked and should not be viewed on a stand-alone basis. In our case the debt-GDP ratio is above the sustainability level. We need to first bring it down and then stabilize it at that low level. This cannot be achieved unless we maintain a low fiscal deficit over a period. A cyclically adjusted policy can certainly be an option after the adjustment phase is
complete. Cyclical adjustment, of course, presupposes that the economy is subject to economic cycles.

Srivastav (2008) discusses the rationale of fiscal policy rules arising from both political economy literature and conventional public finance literature. He reviewed the international experience regarding fiscal policy and fiscal transparency rules. He analyzes states FRBMAs and related experiences. Empirical evidence supports at least in an international setting the predictions of models based on opportunistic manipulation of fiscal policy. First, debt accumulation is related to the degree of transparency of the budget. Second, while, there appear to be electoral increase in fiscal deficits and government expenditures, these are limited to countries where voters are less successful in monitoring fiscal outcomes. There are some shortcomings in center’s FRBMA. Many countries are going for defining fiscal deficit targets in countercyclical intervention can be strengthened by having reliable forecasting models for anticipating downturns. This should be done after the debt GDP ratio has fallen significantly. It can also be undertaken earlier if the household sector’s savings in financial for increases and a private investment is not able to absorb it. It is best to stick with revenue deficit target. This is specified in the Act rather the rules in center’s FRBMA. It can also make better economic sense for government not to use up available saving for current or consumption expenditure. There is an improvement in the deficit indicators comparing the levels relative to GDP before and after the FRBMA. The improvement was not only the result of following the targets until 2007-08 but also because of steady improvement in the growth rate. In fact, very largely the fiscal improvement was responsible for the increase in growth rate. In particular, the improvement in the revenue deficit was responsible for an increase in the savings ratio for about 4 percent point.

Howes and Jha (2004) argue on the basis both of international experience and on the basis of the specific circumstances that India is facing. From the international experience they drew a negative conclusion from international experience with FPRs that they are neither necessary nor sufficient for fiscal adjustment. The argument in favour of introduction of FPRs is India’s failure in the last ten years to produce fiscal adjustment in India either at the central level or the state level. In India much-needed fiscal adjustment
would be enhanced by the introduction of legislated fiscal policy rules (FPRs) at the levels of the state as well as that of the central government. India’s borrowing regime allows state government’s greater freedom except for foreign debt. GOI actual control of states’ borrowing behaviour is far below its constitutional limit. Much borrowing by states is formula based, and so not linked at all to a state borrowing capacity. There is no points introducing a FPR covering only the budget, as government will go off budget borrow. Contingent liabilities should be capped, but in addition off budget borrowings where debt serving will fall to the government, should be consolidated with on budget borrowing in setting Targeting revenue deficit in the one hand protect capital spending on the other hand can lead to budgetary distortions. These can already be observed as states, for example, classify their budgetary support to the power sector as equity investments to avoid counting them as revenue expenditures. Another reason for targeting the fiscal rather than the revenue deficit is the need to cap off-budget borrowing, argued for above, much of which finances capital expenditure. With capital expenditures uncapped, states could continue to bankrupt themselves by shifting capital expenditure, and borrowing for the same, off budget. Capital spending in India generates very little revenue for government. It would thus seem that, whether or not a revenue balance target is given, the overall deficit should definitely be capped. While institutional reforms such as the introduction of FPRs cannot substitute for the policies needed to realize fiscal adjustment, they can help catalyze these reforms. Much more analysis and debate is needed for the choice of targets, reporting requirements and sanctions/corrective mechanisms, whatever is done in terms of introducing an FPR, it should only be contemplalted by a reforming government, and as part of a reform package. Complementary actions will be needed to make the FPR a success. They are referring here not to the introduction of fiscal reforms, though of course this is crucial, but to complementary institutional measures. Improved forecasting, both inter- and intra-year, will also need to be part of the reform package. States gene rally have no estimate of their current year’s GDP growth, let alone a forecast of the next year’s. Tax forecasting models, like economic models, simply don’t exist at the state-level in India, though they are taken for granted in states in developed country federations. Expanded capacity
within finance departments will be critical to enable these changes to be introduced, and to cope with the reporting requirements of any FPR.


Alesina and Perotti (1996) study how the composition of fiscal adjustments influences their likelihood of “success,” defined as a long lasting deficit reduction, and their macroeconomic consequences. They identified two types of fiscal adjustments for OECD countries. Type 1 adjustments rely primarily on spending cuts; the components of spending which receive the largest cuts are transfer programs and government employment and wages. Furthermore, in these adjustments taxes on households are kept constant, or even reduced. Type 2 adjustments rely primarily on tax increases, particularly on households and spending cuts in public investment. They have shown that Type 1 adjustments are more permanent and expansionary, while Type 2 tend to be reversed by further deteriorations of the budget and have worse macroeconomic consequences.

Gupta, Baldacci, Clements, and Tiongson (2003) examine the factors affecting the persistence of fiscal consolidation in 25 emerging market countries during 1980–2001. It proposes a new approach for defining spells of fiscal consolidation. The results indicate that the probability of ending a fiscal adjustment is affected by the legacy of previous fiscal failures, the size of the deficit, the composition of spending, and level of total revenues. There is also some evidence that the initial debt stock, exchange rate developments, inflation, and the unemployment rate have an impact on the persistence of adjustments.

Public expenditure toward more productive uses is important for achieving more sustained fiscal adjustments. In particular, fiscal consolidation achieved through cuts in selected current expenditures, while protecting or increasing capital spending, tends to be more lasting. Revenue increases are also found to be critical to the persistence of fiscal consolidation. There is evidence, though generally weaker, that other variables are important for the duration of fiscal adjustments. For example, high levels of public debt
exert pressure to implement fiscal reforms and maintain a tight fiscal policy. Exchange rate depreciations and oil price increases are significantly associated with the probability of sustaining fiscal adjustments. Finally, both poor governance and high unemployment are obstacles to achieving sustained fiscal adjustments. These results have several policy implications for emerging market countries. Strong institutions and a good policy track record are critical to achieve this sustainability. Countries with a history of “stop and go” fiscal adjustments are less likely than other countries to stay the course and achieve durable fiscal consolidation. Fiscal deficit reductions should be based on cuts in wasteful spending and revenue mobilization efforts. This can be achieved if across-the-board expenditure reductions are avoided and important expenditure programs (e.g., investment in infrastructure) are protected. Furthermore, revenue increases which, can be achieved by broadening the tax base, removing exemptions, and combating tax evasion, as well as by higher tax rates are associated with more durable fiscal adjustments. Enhancing revenue collection also helps minimize fiscal vulnerability stemming from low and volatile revenue bases. This contributes to reducing the probability of liquidity crises and risks of default, which may short circuit both growth and fiscal adjustment.

Dabán et. al, (2003) study the design of rules-based fiscal frameworks in France, Germany, Italy, and Spain the four largest economies in the euro area They argue that, to avoid procyclicality, the four countries would benefit from incorporating spending rules on deficit and debt targets. Their paper advocates binding spending rules consistent with medium-term debt targets while allowing cyclical revenue fluctuations to affect the budget balance. Dabán and others review implementation issues and suggest that fiscal rules be embedded in medium-term macroeconomic frameworks, applied to the general government, and use comprehensive expenditure targets. On real versus nominal rules, their paper points out that nominal rule may be preferable in countries where cyclical stabilization is a priority, while real rules may be more appropriate when there are automatic indexation clauses for significant expenditures (e.g., entitlements)

Kopits (2001) reexamines the merits for and against fiscal rules. He identifies three broad lessons. First, governments with a strong reputation for fiscal prudence do not need
to be constrained by rules. Second, in countries that lack such a reputation, fiscal rules can indeed provide a useful policy framework that is conducive to stability and growth. Third, to enhance their usefulness, fiscal rules need to meet the Kopits-Symansky criteria (Ideally a fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient) at the both national and subnational levels. Kopits [2001] argued that a fiscal rule is in fact worse than useless, as it invites “creative fiscal accounting,” which introduces fiscal distortions that would not be present in the absence of rules.

Kopits (2004) draws several lessons for policymakers from the contributed essays: (1) in emerging market countries, just as in advanced economies, fiscal rules need the support of the electorate; (2) as a corollary, although in principle it is preferable to enshrine fiscal rules in the constitution or in a high-level law, informal rules might be equally effective as long as they are backed by broad public consensus; (3) macroeconomic policy rules can be viable only if underpinned by strong procedural rules, including good practices in transparency and accountability; (4) markets have far lower tolerance for relatively high public debt-to-GDP ratios in emerging market countries than in advanced economies; (5) in emerging market countries, fiscal rules must be designed to take into account significant macroeconomic volatility; (6) as an alternative, particularly for economies with nonrenewable resources, a commodity stabilization fund that complements limits on the budget deficit and expenditure can cushion pressures stemming from wide fluctuations in the terms of trade; (7) fiscal decentralization requires considerable care in the design and enforcement of rules; and (8) for fiscal policy rules to be credible, initiating key long-term structural reforms early on is indispensable.

Hausmann (2004) observes that emerging market economies would benefit from fiscal rules that aim not only at eliminating deficits and reducing debt ratios but also, more importantly, at containing the risk in the composition of the debt. Managing the debt structure may reduce risk premia and allow rapid fiscal consolidation through self-reinforcing reduction in interest rates.
Webb (2004) discusses fiscal responsibility laws in Latin America, with special attention to their provisions for fiscal discipline by sub-national governments. It discusses why and when such laws might be useful to help resolve the coordination problem in getting diverse governments to avoid overusing the common national credit market and to help individual governments make a time consistent commitment for fiscal prudence. It examines the cases of Brazil, Colombia, Peru, and Argentina, as well as the case of Mexico where other types of laws and regulations aim to achieve the same objectives of solidifying incentives for fiscal discipline at all levels of government. Fiscal responsibility laws are found to be useful in some cases, although the experience is not long enough to be certain, but they are clearly not necessary in every case, nor always sufficient to assure fiscal stability. While there is much that FRLs might do, the evidence of their effects is meager, as only a few countries have actually tried them, and only recently. Although political consensus for fiscal prudence is clearly a necessary condition to launch a successful FRL, The effectiveness of an FRL obviously depends on how well it can be enforced. Countries with weak enforcement mechanisms for an FRL are also likely to have weaknesses in other sub-national fiscal constraints.

2.9. Studies Relating to India’s experience of Fiscal Policy Rule

Rakhsith (2005) explains the statements submitted with 2005 year’s budget in compliance with the Fiscal Responsibility and Budget Management Act (FRBMA) sets out medium term rolling targets for fiscal indicators; and explain the assumptions and fiscal strategy underlying the targets. The statements contain the usual quota of the ministry’s good intentions, e.g., focus on outcome (rather than outlay) of government expenditures; broadening of the tax base; targeting of subsidies; and use of capital expenditure only for purposes of productive investment. However, there is no move towards or awareness of the need for revamping the current system of grossly distortionary and iniquitous system of direct taxes characterized by absence of any estate duty or inheritance tax; extremely liberal treatment of capital gains; and exemption of all dividends from personal income tax and of practically all financial assets from wealth tax. The most serious failing of the ministry’s direct tax strategy lies in the absence of any move towards relating taxes to a fairer measure of ability to pay through an
integrated system of personal income tax, capital gains tax, wealth tax and inheritance tax so that scope for evasion is reduced, burden of taxation is equitably shared, and tax collections become GDP elastic. More important perhaps is likely to be the inefficiency resulting from adhering to the distinction between Plan and non-Plan expenditure; absence of any notion regarding optimal allocation of investible resources between PSEs and the government; and treatment of social sector expenditure as current, without any rolling target for its enhancement as a proportion of government expenditure or GDP (so that such expenditure is not squeezed out by the requirement of zero revenue deficit). The most glaring deficiency of the statements however lies in the absence of a coherent macroeconomic framework an absence that has prevented the ministry from appreciating the role of government expenditure, its composition and its alternative modes of financing in a demand deficient and supply constrained economy for purposes. Thus though the ministry recognizes the need for boosting demand at the present juncture of the Indian economy, it fails to recognize that existence of output gap and large foreign exchange reserves provides a golden opportunity of a significant step up in infrastructural and social sector investment for closing the gap, crowding in private investment, raising RBI holding of GOI securities at the expense of forex reserves and GOI bonds held by the public, and hence boosting the economy’s growth potential and strengthening government finances both in the short and medium run.

Rao and Jena (2005) examine TWFC did not make any drastic changes in total statutory transfers. Equalization was broadly similar to past. In addition to it a critical evaluation of various recommendations relating to transfers recommended by finance commission has been done and also examined whether the plan is realistic and speculates on the prospects of achieving fiscal balance as laid out in restructuring plan evaluated the basic recommendation relating to tax devolution and grants. The structure of incentives and equity and efficiency implications of recommendations evaluated in. There is a considerable scope for improving tax-GDP ratio by strengthening tax administration and information. The gap filling approach has two important criticisms, which impact on both incentives and equity in the transfer system. The first is the taking the base year numbers-standardized non plan expenditures did not take note of differences in existing level of
services. The poorer states with low resources bases, continued to have low gaps and hence, low levels of transfers relative to their fiscal disability. In other words the relevant base should have been the fiscal capacity and non-plan revenue expenditure needs and not actual revenues and non-plan revenue expenditures. The sprinkling of norms by finance commission in growth rates, maintenance expenditures and public enterprises does not tantamount to estimating revenue capacities and needs. Therefore it is argued that the methodology failed to offset the fiscal disability of poorer states. The effectiveness of debt write-off scheme depends on how important this to each state. An individual state’s response to incentive depends on the magnitude of the adjustment it has to make and the volume of gain by responding to the incentive. The former depends on the repayment liability of individual states on central loans from which the write-off was recommended which in turn more productive but which reduces the surplus, it should be accepted. In other words, the additional grants were simply substituted for spending from own revenues and the basic purpose of equalizing expenditure was not served. The appropriate design for this is to have open-ended specific purpose grants with matching requirements. To see the degree of equalization income elasticity of transfer was estimated which assumed that per capita GSDP represents taxable capacity. The estimates showed that ex-ante and ex-post elasticity’s are the same in the case of ninth and tenth finance commissions awards for aggregate transfers and it is the ex-post elasticity that was marginally lower in eleventh finance commission. The equalization impact of TWFC broadly similar to those of ninth and tenth but marginally low than that of EFC. The TFC has had to make its recommendation considering the poor state of finances at both the central and state levels. The commission had to work out the fiscal restructuring plan in different fiscal environment.

Srivastav (2006) explains the targets for fiscal responsibility legislations were determined in the light of the experience of the 1990s where government debt and interest payments relative to GDP increased enormously following the award of the Fifth Pay Commission. With an inordinately high level of debt, and corresponding high interest payments liabilities, governments allowed public investment to steadily fall. Further, even high fiscal deficits could not increase primary expenditure of government making it difficult to
launch any countercyclical intervention even when India faced inordinately low growth rates in the first three years of this decade. With recent fiscal correction, as fiscal deficits were lowered, interest payments fell, revenue deficit fell and government savings increased. With the interest rates remaining moderate, after the inordinate rise in the late 1990s and improvement in household saving and investment, growth rates improved and the debt-GDP ratio started falling after 2004-05. With fiscal correction continuing and in conjunction with improvement in private investment, the highest ever growth rates at about 8 per cent have been experienced for four years at a stretch. There is a clear one-to-one relationship between the combined revenue deficit of central and sub-national governments and the net saving of government administration and departmental enterprises. The improvement on account of revenue deficit alone has enabled a rise in the saving rate of 4 percentage points during 2001-02 to 2004-05. As fiscal correction continues, the falling interest payments relative to GDP release revenue plan resources, which is a particular need for augmenting the social services. The falling revenue deficit leads to releasing a larger share of the fiscal deficit for plan capital expenditure. There are some shortcomings in the center’s FRBM Act. It is useful to define fiscal deficit targets in countercyclical terms as is done in many countries. The application of countercyclical intervention can be strengthened by having reliable forecasting models for anticipating downturns. If we successfully achieve a 9 per cent growth with 5 per cent inflation rate, we will eventually need to uplift the fiscal deficit target because the existing targets were derived with respect to a nominal growth rate of 12 per cent. However, this should be done after the debt-GDP ratio has fallen to levels consistent with the fiscal deficit target. It can be undertaken earlier if the level of the household sector’s savings in the financial form as a percentage of GDP increases above 11 per cent on a sustained basis and private investment is not able to absorb it. It is best to adhere to the revenue deficit target. This is specified in the FRBM Act rather than the rules. It also makes better economic sense for the government not to use up available savings for current or consumption expenditure.

Mohanty and Singh (2007) explain major logic behind reducing deficits was that deficits lead to inflation. The Union Government has been able to reduce deficits. However, rate of inflation for almost all sections of population increased during FRBM era. While
deficits declined substantially in the post FRBM era, the interest payments did not show a substantial decline. However, the interest payments incurred by States registered a substantial increase. Impact of FRBM on Development Expenditure of the Government the Union Government’s development expenditure as proportion of GDP declined in the post FRBM era. However, in case of states, it has registered a marginal increase indicating that in a high interest rate regime, states have been more sincere than the Union Government towards their development needs. An Act like FRBM has led them to a fiscal crisis situation through increased interest burden. An analysis of revenue account of the development expenditure by states shows that in almost all sectors of development, there has been a decline in the FRBM era. In case of education, health sector, and in agriculture there is a decline. Overall Social sectors, it declined from 4.5 per cent of GDP to 4.1 per cent of GDP during the period. While interest payments are mounting, the expenditure on capital investments is declining in India. The situation has worsened in the FRBM regime Central Government’s total expenditure as a proportion of GDP has declined There has been a substantial decline in the total non plan grants to states as a proportion of GDP during recent years.

Rao, Sen and Jena (2008) explain despite substantial improvement, the fiscal situation continues to be a matter of concern when off-budget liabilities and other fiscal risks are considered. A closer analysis of fiscal trends at central and state levels reveals that there are significant off-budget liabilities. In other words, the fiscal responsibility legislations have led the central and state governments to indulge in “creative accounting” to show lower deficits by pushing some liabilities outside the budget. The lower interest rates due to the debt swap scheme resulted in the lower debt service payments. Thus, the fiscal adjustment came about mainly through higher revenues. This increase was mainly due to increased revenues from direct taxes and partly due to increase in service tax revenues. State finances started showing steady improvement, thanks to higher growth rate of the economy and larger tax devolution due to buoyancy of central taxes. By 2007-08, the states were well on course to achieve the deficit reduction targets set by the Twelfth Finance Commission (TFC). The progress in the reduction in revenue deficits was also linked to the writing off of the debt repayment to the central government. Within
revenues, 1.6 percentage points improvement were due to higher transfers. The states’ own tax revenues increased by 0.6 percentage point and this was achieved through the value added tax (VAT) reform, rationalization of stamp duties coupled with boom in the real estate markets, and a general rise in tax collections arising from relatively higher growth of the secondary sector. On the expenditure side, the adjustment was only one percentage point and half of this was due to lower interest payments. Lower interest rates arising from the debt swap scheme adopted in 2004-05, lower volume of borrowings from the National Small Savings Fund and debt restructuring as per the recommendation of the Twelfth Finance Commission contributed to the improvement. Thus, much of the improvement in state finances has come about due to the higher transfers, but nevertheless, the improvement is likely to sustain in the medium term as revenue from central direct taxes are likely to show high buoyancy with progressive strengthening of the information system and reforms to introduce the GST. General category states performed better than special category states in reducing fiscal deficit, but reverse was the case in revenue deficit. Among the former, the low income states performed better in revenue deficit reduction, but the performance of high income states was better in reducing fiscal deficit. Both high income and low income categories of states brought down fiscal deficits by more than two percentage points, but the latter category states increased their capital outlay by a larger magnitude (3.3 points) than the former (1.5 points). It is seen that while actual revenues were broadly in tune with the targets, the government failed to compress revenue expenditures according to the targets set and not surprisingly failed to achieve the revenue deficit targets. It is also seen that in order to achieve the fiscal deficit target, the government compressed capital expenditure from 2.4 percent of GDP in 2003-04 to 1.1 percent in 2008-09, instead of increasing it as envisaged in the reform scenario. While macroeconomic stability is an extremely important objective, it is necessary to consider whether the Finance Commission should take this as a primary task. Surely, the Commission will have to consider the ability and flexibility of the central government in the macroeconomic management of the economy in formulating its recommendations on tax devolution and grants. It should also consider building in appropriate incentive structure in its recommendations to provide incentive to the states for better fiscal management and penalize those that indulge in laxity. It is
required to take into account a number of considerations, the focus should be on the transfer system. As regards the transfer system itself is concerned, the paper argues that although it may be difficult to make drastic changes in the relative shares of the states, the Commission should give up the gap filling approach.

Simone and Topalova (2009) examine India’s experience with fiscal rules with a view to inform the design of a possible successor fiscal framework to the FRBMA. Numerical targets should be supported by structural reform measures for both revenues and expenditures, while the coverage of the fiscal rules should be expanded. During the second half of the 1990s, government finances in India deteriorated continuously, leading to large and intractable fiscal imbalances. Fiscal consolidation was required not only to facilitate sustained long-run growth by minimizing the crowding out of investment and allowing the removal of constraints imposed on the domestic financial system by government’s financing needs, but also to create the fiscal space for countercyclical fiscal policy and crisis-related spending. The introduction of FRL coincided with significant improvements in headline fiscal indicators. More than two-thirds of the fiscal adjustment over this time period was due to revenue gains, with improvements in tax performance underpinned by rapid economic growth, strong corporate profits, and improvements in tax administration as measured by effective tax rates. The rest of the adjustment came mostly from declining interest payments. In the absence of expenditure reform, the subsidy bill increased dramatically. These developments undermined the credibility of government’s commitment to fiscal discipline and suggest that going forward revenue gains cannot single-handedly carry fiscal adjustment and the sustainability of India’s fiscal policy. The fiscal consolidation at the state level was achieved on the back of growing own revenues and higher resource transfers from the central government. The variation in the design of FRLs across India’s states allows an examination of whether certain design features of the fiscal rules are correlated with better fiscal performance. Namely, some states have adopted a specific target for their outstanding debt as a share of GSDP for a pre-specified date in the future; some states have adopted some rules on expenditure. Some states require quarterly review of expenditure and receipts against budget estimates, while other requires half-yearly or annual review of compliance. They
constructed indicators of whether the state law includes (i) a debt target or, (ii) expenditure rules, and (iii) whether the performance review is at least half-yearly. They interact these state law design features with the post FRL indicator to examine whether fiscal performance after the introduction of fiscal rules varies with the presence or absence of these features. Among India’s states, the disciplining effect of FRLs appears to be stronger if the fiscal rules include a specific debt target or expenditure rules. 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. The new FRBMA numerical targets should be supported by a concrete underlying plan of short- and medium-term policy measures for both revenues and expenditures. The plan should be discussed in detail in the policy statements required by the FRBMA. The assumptions underpinning the budget should always include annual forecasts over a medium-term horizon for key macroeconomic variables such as GDP growth, inflation, imports, exports and the exchange rate. Specific expenditure rules on these categories of spending depending on relevance could be included to address this problem while limiting their number to avoid an increase in complexity. Another approach to address these issues is to exclude the specific spending categories concerned from the definition of the expenditure aggregate. However, the cost is opening the door to creative accounting and incentives to push spending to exclude categories. This suggests that some additional complexity cost of the specific rules approach may be preferable. 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.

Herd and Leibfritz (2008) examine various areas of India’s fiscal policy, in particular fiscal discipline, the structure of government spending, the tax system and fiscal federalism. It describes reforms over the past decades which, as part of the overall economic reform agenda, helped lifting the Indian economy to a higher growth path. It also discusses where further reforms are desirable to further reduce economic distortions and improve the provision of public services. It finds that after high fiscal deficits have often been
recorded during the past two decades, after the adoption of the Fiscal Responsibility and Budget Management Act in 2003, fiscal discipline has significantly improved. As to government spending, it argues that, given the large share which is used to subsidize commercial undertakings, agriculture and food distribution, there is much room to improve the quality of spending and to target it better to improving infrastructure and reducing poverty. It describes the tax system which has undergone major reforms since the early 1990s. Nonetheless, there are still many exemptions and loopholes which suggest that a broadening of the tax bases would allow further reductions in tax rates and make the system simpler, fairer and more efficient. The paper also suggests that reforms of indirect taxes should focus on creating a common market within India so that goods can move between states without border controls. Finally, on fiscal federalism it finds that India’s federal structure has led to a well-developed system of tax-sharing and transfers, both through constitutionally empowered bodies and delivered through the annual budget. While overall, India’s fiscal federalism has worked well moving resources towards the poorest states, it has become very complex and there are still some features which weaken fiscal discipline of the states. Furthermore, a major drawback is the lack of an effective local government system, most notably in rural areas and strengthening the local level would be important for improving accountability and responsiveness to citizens.

2.10. Conclusion

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. If including numeric fiscal rules, these should be carefully designed. Numerical rules can potentially be helpful, for instance, in containing a deficit bias, but are not in themselves the solution to structural fiscal problems. Numeric fiscal rules could even foster creative accounting and low-quality measures.
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