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Chapter

INDIA'S FISCAL POLICY

In a system of indicative planning, reliance on fiscal policy as an instrument of development is considerable. The Planning Commission had stated in the Seventh Five Year Plan, "Through it (fiscal policy), the Government creates and sustains the public economy consisting of the provision of public services and public investment; at the same time it is an instrument for reallocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability."[1] *Thus fiscal policy has a multidimensional role. It particularly aims at improving the growth performance of the economy and ensuring social justice to the people. However, when fiscal policy is not used discreetly, it is likely to create a fiscal mess as it has happened in this country. A fiscal imbalance requires immediate corrective measures because a large fiscal deficit is non-sustainable.* In the 1990s, world over it became fashionable to argue that legal restraints on government fiscal behaviour are necessary to prevent it from pursuing an irresponsible fiscal policy.

This chapter while discussing India's fiscal policy will address the following issues:

- Objectives of fiscal policy in India
- Fiscal imbalance and deficit finance
- Fiscal imbalance and the new fiscal approach
- Fiscal Responsibility and Budget Management Act.

OBJECTIVES OF FISCAL POLICY IN INDIA

Fiscal policy in India always had two major objectives, namely *improving the growth performance of the economy and ensuring social justice to the people.*

Growth Performance of the Economy

Fiscal policy influences growth performance of an economy mainly in two ways. In the first place, it affects growth by influencing the mobilisation of resources for development. Secondly, it exercises its influence by improving the efficiency of resource allocation.

1. Fiscal policy and resource mobilisation. India has done well in terms of tax effort. In 1950-51 when the planning process was initiated the tax-GDP ratio was as low as 6.3 per cent. Since then, it rose steadily for four decades and stood at 15.8 per cent in 1991-92. During the liberalisation phase of 1990s the tax-GDP ratio declined to 13.3 per cent in 1998-99 due to sharp reduction in tax rate. However, during the last few years, tax-GDP ratio has risen again and was 17.2 per cent of GDP in 2015-16. For a poor country like India, which started its development effort with a very low per capita income and has recorded an extremely modest rate of growth for a considerable period of planning, this record in mobilising tax revenue is not bad by any standard. In India, all the major direct taxes, such as personal income tax and corporation tax have recorded buoyancy greater than unity. However, in recent years, buoyancy of Union excise duty and customs duty has been low. Obviously this has not enabled as much mobilisation of resources through taxation as one would normally expect in the conditions prevailing in India. For example, there are many tax exemptions and concessions, agricultural incomes are out of the tax net, and there is a vast black economy.

In Arun Kumar's opinion "If the entire black economy is converted into white, India's growth would get boosted to 10 per cent, all educated youth would get jobs. The additional tax collection of about ₹ 3 lakh crore would leave a fiscal surplus."[2] But this is not an easy proposition because it would require stringent measures against the most influential sections of the society, such as the corporate sector, business community, stock brokers, land mafia, professionals, bureaucrats and politicians.

Apart from tax revenue *other important aspects of resource mobilisation are generation of non-tax revenues, restricting of current government expenditure and raising of surpluses of public sector enterprises. Each of these need careful analysis for assessing the government's effort in respect of resource mobilisation.* However, for want of space, we shall focus on trends in overall public savings which can be justifiably considered as an appropriate index of resource mobilisation effort.

Since the Fourth Five Year Plan, the Planning Commission has been explicitly laying down targets for public savings rate for the terminal year of the respective

Five Year Plan. On comparing the actual rates with these targeted rates, one is inevitably led to the conclusion that public savings performance has fallen markedly below planned levels in the past three decades. In 1980-81, the rate of public savings relative to GDP was 4.0 per cent which in any case was very low.

Over the period 1998-99 to 2002-03, the rate of public savings relative to GDP was negative. Though it turned positive thereafter, it was only 1.3 per cent of GDP in 2003-04 and 1.2 per cent of GDP in 2011-12 (according to the new series with base year 2011-12, the rate of public savings was 1.5 per cent of GDP in 2011-12 and 1.2 per cent of GDP in 2014-15). The unsatisfactory performance of public savings is attributable to both weakness in mobilising revenues and a rapid growth in government expenditures. Another factor which explains the lacklustre public savings performance is failure of public sector enterprises to generate adequate surpluses. At the Central level, the ratio of PAT (profit after tax) to capital employed was below 5 per cent in a number of years. At the State level, the performance of the public sector enterprises is far more disappointing. Both the State Electricity Boards and the State Road Transport Undertakings have been incurring heavy losses for quite some time.

2. Fiscal policy and allocational efficiency. Fiscal Policy also influences growth performance of an economy through its effects on the allocation of resources. ***An efficient and rational allocation of resources will obviously be helpful in raising the rate of economic growth.*** Therefore, if fiscal policy favourably affects the efficiency of resource allocation, then in the process, growth performance of the economy is bound to improve. An indifferent fiscal policy adversely affecting the efficiency of resource allocation on the contrary retards the productive activity and thereby results in lower rate of economic growth.

Among the various instruments of fiscal policy, perhaps tax policy is the most important determinant of the efficiency of resource use. Therefore, we shall examine if over the years it has not exercised any negative effects on the productive activity. ***During the first four decades of economic planning, the reliance on commodity taxation had increased and it accounted for around 84 per cent of the tax revenue of the Central government in 1990-91. However, during the period of economic reforms, the trend was reversed and the ratio of indirect tax revenue to total tax revenue declined to 45 per cent in 2014-15.***

Among the indirect taxes, the preponderant role has been played by customs and excise duties at the Central government level and the sales tax at the State government level. These taxes have been generally levied mainly on revenue-raising considerations and have sometimes resulted in efficiency losses. The case of customs duties is particularly mentioned to prove this point. In recent years, a number of studies have revealed that the structure of customs duties along with restrictive controls has provided effective protection to a number of industries, and as a result there has been unnecessary loss of efficiency in resource use.

Recently in the light of the recommendations of the Chelliah Committee, some corrective measures have been undertaken and by lowering down the import duties unwarranted protection to the industries has been withdrawn. The policy of levying taxes on inputs in the past had led to the problem of "cascading" of tax and interest costs and distorted the incentive structure for investment and production. It has also adversely affected the competitiveness of exports. By rationalising the excise duties structure in recent years, an attempt has been made to rectify the situation.

Since the beginning of economic planning there has been proliferation of non-departmental public enterprises. Investment in them over the various plan periods has been massive, yet they have failed to generate the expected amount of surpluses. This has raised serious doubts about their efficiency level. These enterprises have been set up to realise objectives other than the maximisation of private profit. Therefore, it would be wrong to evaluate their performance on this criterion. Nevertheless, the studies at the enterprise, sub-sector and sectoral levels suggest that the efficiency of resource use in public sector enterprises is not altogether satisfactory.

In India, a sizeable black economy exists which poses serious problems for the allocative dimensions of fiscal policy. Shankar Acharya states, "To begin with, widespread tax evasion blunts the allocative signals of the tax system. When, in the case of a large number of manufacturers and traders, the tax dues are believed to be the end product of a complicated interaction between the tax statutes, the evasion opportunities, the enforcement machinery and its susceptibility to corruption, it is idle to pretend that only the first of these factors, namely, the tax laws, is solely responsible for the resource allocation implications of tax system."[3] There is now considerable evidence which suggests that corporate enterprises and other business firms in arriving at decisions on investment, production and sale consider not only the tax laws but also the possibilities of avoiding tax burden through legal and illegal methods. ***The presence of a large black economy which generates income equalling 40 per cent of GDP also vitiates the allocative impact of the fiscal policy on the expenditure side.*** The widespread leakages from government expenditure programmes adversely affect the efficiency of public expenditure which means

that in practice the actual return from public expenditure is far less than the anticipated return.

Fiscal Policy and Equity

It is often doubted whether India's fiscal policy conforms to the principle of equity. During the first four decades of economic planning, the share of direct taxes in total tax revenue had fallen from 40 per cent to 16 per cent. However, during the 1990s the trend was reversed and thus in 2014-15 direct taxes accounted for 55 per cent of the total tax revenue of the Central government. Many economists have argued that direct taxes are generally progressive. However, the progressivity is reduced substantially because of large number of exemptions and concessions provided under the direct tax laws. Moreover, there is large-scale tax evasion often with the connivance of bureaucracy and the ruling class. It is an acknowledged fact that there is a large undisclosed income in the country on which no tax is paid. This income is mostly in the hands of industrialists, traders, land mafia, professionals, bureaucrats and politicians. Therefore, the sharpness of progression in nominal rates does not guarantee that the principle of equity in direct taxation will not be violated. As far as indirect taxes are concerned, they are generally believed to be regressive.

For assessing the equity implications of the fiscal policy, it is also necessary to analyse as to who benefits from public expenditure. For India so far no comprehensive study has been made on this aspect of the fiscal policy. Taking a partial view some economists have recently argued that the poverty alleviation programmes reflect the intentions of the government. However, this way of looking at the issue is not correct. The fact of the matter is that the benefit of most of the government expenditure has hardly reached the poorest of the poor. After all who does not know that poor rarely benefit from expenditures on defence, public administration, higher education and urban based medical facilities. Even the benefit of most development expenditure rarely trickles down to reach the poorest of the poor. Therefore, the equity implications of the public expenditure are clear; the poor have benefited the least from them.

THE FISCAL IMBALANCE AND DEFICIT FINANCE

Upto the mid 1980s fiscal imbalance was seen in terms of the overall budget deficit measured by the gap between the expenditure and the receipts under the revenue and capital accounts taken together. ***This gap was sought to be filled by deficit financing which in India is defined as borrowings from the Reserve Bank of India against the issue of Treasury Bills and running down of accumulated cash balances.*** When government borrows from the Reserve Bank of India, it merely transfers its securities to the Bank who, on the basis of these securities, issues more notes and puts them into circulation on behalf of the government. ***This amounts to creation of money.***

Rationale for Deficit Financing

In a developing economy when the government fails to mobilise adequate resources for the public sector plan from domestic as well as external sources, recourse to deficit financing becomes necessary. Alternatively, the government can cut the size of the plan itself and that in turn will slash the demand for investible funds. It will, however, have serious repercussions on growth. Therefore, a developing country often has to make a difficult choice between two regrettable necessities, *viz.*, a lower growth rate and an inflationary price rise. Obviously, of the two, price rise is a lesser evil and is thus to be preferred to a lower growth rate. According to the planners, over the years India has been facing precisely this problem. Pramit Chaudhuri rejects this contention. He asserts that the government did not make adequate efforts to mobilise resources from domestic sources even at a time when "there was an excess supply of saving from within the private sector."[4] In fact the failure of the government to raise adequate resources is largely on account of its inability to use its powers of taxation systematically.

To sum up, ***the need for deficit financing in this country arises on the one hand from the failure of the government to mobilise the desired volume of surplus for the public sector plans and on the other, from its rapidly growing expenditures (mostly on unproductive non-developmental activities).***

Consequences of Deficit Financing

Deficit financing can play a useful role during the phase of depression in a developed economy. During this phase, the level of expenditure falls down to a very low level and the banks and the general public are in no mood to undertake the risk of investment. They prefer to accumulate idle cash balances instead. The machinery and capital equipment are all there, what lacks is the incentive to produce due to deficiency in aggregate demand. If the government pumps in additional purchasing power in the economy (through deficit financing), the level of effective demand is likely to increase. To meet this demand, the machinery and capital equipment lying hitherto unused will be pressed into operation. The level of production will, accordingly, increase. If this increase is able to match the increase in the aggregate spending level, inflationary tendencies will not be generated.

Conditions in underdeveloped countries are different. This is on account of the fact that in these countries, the capital equipment does not exist but has to be built up. Thus, while newly created money (as a result of deficit financing) leads to an immediate increase in the purchasing power in the hands of the people, the production of goods does not increase simultaneously. In fact, there is likely to be a considerable time-lag in the generation of extra purchasing power and the availability of additional consumer goods. In the meantime, the level of prices increases. According to Meier and Baldwin, ***capital accumulation in developing countries through deficit financing is likely to generate inflation because in these countries "the propensity to consume is high, there are many market imperfections, there is little excess capacity in plant and equipment, and the elasticities of food supplies are low."***[5]

Because of the general poverty of the masses, their levels of food consumption are very low. Therefore, their first temptation is to spend more on food consequent upon an increase in income. However, it is difficult to increase the supply of food items in the short run (even in the long run an increase in their supply requires strenuous efforts in the form of implementing land reforms, adopting new agricultural techniques, etc.). Therefore, demand for food items is likely to be pushed up to a far higher level as compared to their supply resulting in a rise in their prices. In the developing countries, prices of food items work as a 'signal' for the prices of other goods and they also start rising. The high propensity to consume compounds the inflationary impact of deficit financing as a substantial proportion of the increased income is spent on consumption. Because of market imperfections, the composition of total output and the productive structure of the economy remain much more fixed over time in an underdeveloped country as compared to a developed country. This makes for low elasticity of supply of output.

If additional resources generated through deficit financing are utilised for the production of consumption goods, the inflationary impact is likely to be restricted as the additionally created money supply will be matched by an increased amount of consumption goods. Examples of programmes wherein increased expenditure is not likely to result in inflation are small-scale enterprises, distribution of new-high yielding varieties of seeds, fertilisers, etc., to farmers, minor irrigation schemes, etc. However, the important task before developing countries is not to increase the output of consumption goods but to build up costly capital equipment, lay down railway tracks, improve communication facilities, build up huge hydroelectric and thermal power plants, etc. Therefore, the extra money created through deficit financing is likely to be spent on financing these projects. As a result, there is no likelihood of an increase in consumer goods in the near future and inflation would almost inevitably result.

While supporting deficit financing in underdeveloped countries, some economists have argued that because of large-scale unemployment in these countries, deficit financing is not likely to be inflationary since increase in money supply will result in absorption of the unemployed and increased output of goods and services. However, though applicable in developed countries, this argument does not hold in underdeveloped countries as there is little excess capacity in farms and factories in the latter to match unemployment. As pointed out in an ECAFE document, "It is precisely because there are bottlenecks, such as a shortage of capital or skill, in the productive system that resources are unemployed in an underdeveloped economy."[6]

According to some economists, even if deficit financing tends to be inflationary it carries no danger as long as the inflationary pressures are mild. In fact, a mild inflationary situation affords incentives to the producers who, in the expectation of increasing profits, are likely to raise the level of production and, in the process, utilise idle capital and labour resources of the economy.

THE FISCAL IMBALANCE AND THE NEW FISCAL APPROACH

On account of growing burden of non-development expenditure, the fiscal situation deteriorated throughout the 1980s and assumed crisis proportions by the beginning of 1991-92. Throughout the 1980s all the major indicators of fiscal imbalance largely reflected that it was on the rise. The process of macroeconomic stabilisation undertaken within a neo-liberal framework brought about a shift in the approach towards the measurement of fiscal imbalance. Following the US budgetary practices the concept of ***fiscal deficit*** has come into use. ***It is measured by the difference between total government expenditure over government revenue and grants and thus reflects the total resource gap.*** This measure of deficit has been adopted by the IMF as the principal policy target in evaluating the performance of countries seeking assistance.[7]

Some other indicators used to measure fiscal imbalance are the ***revenue deficit*** and the ***primary deficit***. ***The revenue deficit is defined as the difference between revenue expenditure (i.e., those government expenditures which do not result in capital formation) and current revenues. The primary deficit is the fiscal deficit less interest payments.***

The Fiscal Imbalance and Fiscal Correction

The trends in various indicators of fiscal imbalance since 1980-81 are given in Table 53.1. From this table, it is clear that between 1980-81 and 1990-91 the revenue deficit of the Central government rose substantially. The revenue deficit rose from 1.5 per cent of GDP in 1980-81 to 3.3 per cent in 1990-91. This fact unambiguously suggests that the fiscal situation was under mounting pressure throughout the decade long period from 1980-81 to 1990-91. In this period the gross fiscal deficit of the Central government rose alarmingly. From 5.6 per cent of GDP in 1980-81, it rose to 7.6 per cent in 1990-91.

Such a fiscal situation was unsustainable and required immediate corrective measures. Accordingly, the regular Budget for 1991-92 which was presented to Parliament on July 24, 1991, announced some major steps to correct the fiscal imbalance. Though the burden of achieving reduction in fiscal deficit fell heavily on expenditure side, the Budget contained some proposals for raising additional revenue. After the Budget for 1991-92 was passed, the Government imposed a 5 per cent cut on the expenditure provisions contained in the sanctioned Budget estimates for 1991-92 of all Ministries/Departments.

These measures enabled the government at the Centre to reduce fiscal deficit from about 7.6 per cent of GDP in 1990-91 to 5.4 per cent of GDP in 1991-92 and 4.7 per cent of GDP in 1996-97. Fiscal deficit rose to 5.7 per cent of GDP in 1997-98 and stood at 6.0 per cent of GDP in 2001-02.

Since 1997-98 two factors contributed to increasing fiscal deficit. ***First,*** reduction in tax rates adversely affected tax revenue. ***Second,*** non-development expenditure continued increasing due to casual approach of the government. There was, however, a steady decline in fiscal deficit-GDP ratio subsequently as a result of the enactment of Fiscal Reforms and Budget Management (FRBM) Act in 2004. The fiscal deficit of the Central government declined to 3.3 per cent of GDP in 2006-07 and further to 2.5 per cent of GDP in 2007-08 as a result of substantial effort at fiscal correction. The target for fiscal deficit was kept at 2.5 per cent of GDP for the financial year 2008-09. However, because of slowdown in the economy in the latter half of this year, there was a fall in tax collections. At the same time, the government had to increase expenditures substantially in a bid to generate demand in the economy. As a result, fiscal deficit increased considerably to 6.0 per cent of GDP — the highest in the last seven years.[8] The fiscal deficit rose further to 6.5 per cent of GDP in 2009-10. It declined thereafter and stood at 3.9 per cent in 2015-16 and 3.5 per cent in 2016-17. The Union Budget for 2017-18 projects a further decline by 0.3 percentage points, *i.e.*, Centre's fiscal deficit in 2017-18 is projected at 3.2 per cent of GDP. According to the Reserve Bank, "adherence to fiscal consolidation path is contingent upon efficient resource mobilisation – broadening the tax base and rationalising exemptions reflect the Government's intent in this direction. The stance ***of fiscal policy in 2016-17 will face a challenging trade-off sustaining public investment within the straitjacket of shrinking fiscal headroom".***[9]

Interest payments. Interest payments which contributed most to the fiscal imbalance have continued to rise. According to Raja J. Chelliah, "the net interest payments by the government can be reduced by bringing down the gross interest payments or by increasing the income from the government's investments. It does not seem feasible to increase the latter. It is, therefore, necessary to find ways of reducing the gross interest payments by the government."[10] Chelliah is right in his assertion that the government must find ways to reduce interest payments, but the government seems to be complacent about it. This is clear from the fact that interest payments of the Central government rose from ₹ 26,596 crore in 1991-92 to ₹ 59,478 crore in 1996-97 and to ₹ 4,42,620 crore in 2015-16. Presently the government has no other option except to effect reduction in the existing stock of debt. ***Since it is now possible to retire a part of the external debt due to comfortable position of foreign exchange reserves, debt reduction need not be confined to internal debt. The resources for liquidating a part of the internal debt can be raised by disinvesting in public enterprises and selling a part of vast real estate that the government owns in the country.***

Non-interest expenditure. In India, although there is some scope for raising tax revenue, the liberalisation approach of the government would deter it from doing so. Therefore, ***if fiscal deficit is to be brought down the growth of all the major categories of non-interest expenditure has to be slowed down considerably. In some cases it is both desirable and feasible to effect reduction in the expenditure. From this point of view experts now particularly mention subsidies, capital assistance to non-viable and inefficient enterprises, government's consumption expenditure related to staff and defence expenditure.***

Major subsidies provided by the Centre are on food, fertilisers and petroleum. Although the government has time and again expressed its resolve to cut down the burden of subsidies, they have actually increased over time. The major subsidies added upto ₹ 12,158 crore in 1990-91. They are estimated to have risen to as high as ₹ 2,32,705 crore in 2016-17 (₹ 27,532 crore petroleum subsidy, ₹ 1,35,173 crore food subsidy, and ₹ 70,000 crore fertiliser subsidy).[11] It may be noted here that these subsidies do not

Table 53.1

Central Government Deficit
(per cent of GDP at Current Market Prices)

Years/Period	Revenue Deficit	Gross Fiscal Deficit	Primary Deficit
1980-81	1.4	5.6	3.8
1985-86	2.0	7.6	5.0
1990-91	3.2	7.6	4.0
1991-92	2.4	5.4	1.4
1992-93	2.4	5.2	1.2
1995-96	2.4	4.9	0.8
1996-97	2.3	4.7	0.5
1997-98	3.0	5.7	1.5
2000-01	3.9	5.5	0.9
2001-02	4.2	6.0	1.4
2002-03	4.2	5.7	1.1
2005-06	2.5	4.0	0.4
2006-07	1.9	3.3	−0.2
2007-08	1.0	2.5	−0.9
2008-09	4.5	6.0	2.6
2009-10	5.2	6.5	3.2
2010-11	3.2	4.8	1.8
2011-12	4.5	5.9	2.8
2012-13	3.7	4.9	1.8
2013-14	3.2	4.5	1.1
2014-15	2.9	4.1	0.9
2015-16	2.5	3.9	0.7
2016-17	2.1	3.5	0.3

Sources: (*i*) Reserve Bank of India, *Handbook of Statistics on the Indian Economy* 2015-16 (Mumbai, 2016), Table 240, p. 378 and (*ii*) *Business Standard,* February 2, 2017, p. 10.

include the compensation through the issue of special securities to Oil Marketing companies towards the estimated under-recoveries on account of domestic LPG and PDS Kerosene and special securities issued to Food Corporation of India and fertiliser units. If these subsidies are also included, the burden would rise further by a substantial amount.

The government has reduced budgetary support to the plan investment by public enterprises. In future, non-viable public enterprises should be closed down and other loss making enterprises should be advised to revise their pricing policies to wipe out their losses. Regarding the government's consumption expenditure related to staff, there seems to be no choice except to reduce it. Over the years, the government has over-extended itself and there is now considerable overstaffing in government departments. The government will have to find ways and means to shed the surplus staff. Meanwhile, austerity measures must be imposed on all government personnel.

Themes of the 'New Fiscal Policy'

In the broad framework of the economic liberalisation approach of the post-1991 reform period, the major themes of the fiscal policy have been concretised in this country. There is broad agreement on these themes and they can be summarised as follows.

"1. A systematic effort to ***simplify*** both the tax structure and the tax laws;
2. A deliberate shift to a regime of ***reasonable direct tax rates, combined with better administration and enforcement,*** to improve compliance and raise revenues;
3. The fostering of a ***stable and predictable*** tax policy environment;
4. Greater recognition and ***weight given to the resource allocation and equity consequences of taxation;***
5. More reliance on ***non-discretionary fiscal and financial instruments*** in managing the economy, as compared to ad hoc, discretionary physical controls;
6. Concerted efforts to ***improve tax administration*** and reduce the scope for arbitrary harassment;
7. Growing appreciation of the ***links between fiscal and monetary policy***;
8. Fresh initiative to ***strengthen methods*** of expenditure control."[12]

FISCAL RESPONSIBILITY IN INDIA

In the 1990s, with the resurgence of the neo-classical ideology, balanced budget received axiomatic acceptability

at the international level. Since most governments failed to pursue this policy voluntarily, it was suggested that the fiscal balance should be restored by imposing legal responsibility on the government. The fashion of legal restraints on government fiscal behaviour was set by the United States, where in the mid-1980s the Balanced Budget and Emerging Deficit Control Act (Gramm-Rudman-Hollings Act) required a steady decline in the federal government's deficit to zero within a stipulated and fairly short time-frame. Such a legal binding on government in fiscal matters is extreme by any standard. Nevertheless, besides the USA, some other countries have opted for such an extreme measure and a few other countries preferred to pursue balanced budget policies without legal stipulation. India opted for the legal course in 2000 after having failed to restore fiscal balance for about a decade.

The Fiscal Responsibility and Budget Management (FRBM) Act

The Committee on Fiscal Responsibility Legislation was constituted on January 17, 2000 to look into various aspects of fiscal system and recommend a draft legislation on fiscal responsibility of the government. It was announced in the Budget for 2000-01 that the government intended to create a strong institutional mechanism embodied in Fiscal Responsibility Act to restore fiscal discipline at the level of the Central government. Accordingly, the Fiscal Responsibility and Budget Management (FRBM) Bill 2000 was introduced in Lok Sabha in December 2000. The Preamble to the Bill states its objectives as: "To provide for the responsibility of the Central government to ensure inter-generational equity in fiscal management and long-term macroeconomic stability by achieving sufficient revenue surplus, eliminating fiscal deficit and removing fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on the Central government borrowings, debt and deficits, greater transparency in fiscal operations of the Central government and conducting fiscal policy in medium-term framework and for matters connected therewith or incidental thereto."

The FRBM Bill was totally undemocratic in its approach as it denied freedom to future governments in respect of fiscal management. The aim of the FRBM Bill was to bind future governments to a pre-specified fiscal policy framework which is an entirely anti-democratic measure. The Bill was referred to a select Committee of Parliament which after serious deliberations decided to reject it. The Parliamentary Standing Committee that had studied the original Bill made certain recommendations to dilute various provisions in the Bill. The diluted version of the original Fiscal Responsibility and Budget Management Bill was passed by the UPA government immediately after assuming power in July 2004.

Box 53.1

Fiscal Imbalance and the New Fiscal Approach

Central Government's Fiscal Imbalance

- Revenue deficit – 2.5 per cent of GDP in 2015-16 and 2.1 per cent of GDP in 2016-17.
- Gross fiscal deficit – 3.9 per cent of GDP in 2015-16 and 3.5 per cent of GDP in 2016-17.
- Primary deficit – 0.7 per cent of GDP in 2015-16 and 0.3 per cent of GDP in 2016-17.
- Revenue expenditure – 11.4 per cent of GDP in 2015-16.
- Capital expenditure – 1.7 per cent of GDP in 2015-16.
- Interest payments – 3.3 per cent of GDP in 2015-16.
- Major subsidies – 1.9 per cent of GDP in 2015-16.

Central and State Governments' Combined Fiscal Imbalance

- Revenue deficit – 3.3 per cent of GDP in 2014-15 and 3.0 per cent of GDP in 2015-16 (BE*).
- Gross fiscal defict – 7.0 per cent of GDP in 2014-15 and 6.5 per cent of GDP in 2015-16 (BE*).

Neo-classical ideology emphasises balanced budget approach.

For restoring fiscal soundness – The Central government introduced FRBM Bill in Lok Sabha in 2000: FRBM Act passed in 2004.

FRBM Act anti-democratic.

FRBM Act mandates the Central government:

1. Revenue deficit to fall to zero by 2009
2. Fiscal deficit to be reduced to 3 per cent of GDP by March 2009.

Because of slowdown in the economy since the latter half of the financial year 2008-09, these deadlines laid down in the FRBM Act have been postponed.

* Budget estimates

The FRBM Act which became effective from July 5, 2004 mandated the Central Government to eliminate revenue deficit by March 2009 and subsequently build up a revenue surplus. The Act also mandated the Central government to reduce fiscal deficit to an amount equivalent to 3 per cent of GDP by March 2009.

The rules made under FRBM Act specify the annual targets for reduction of fiscal and revenue deficits. The rules also prescribe the formats for medium term fiscal policy statement, the fiscal policy strategy statement and the macroeconomic framework statement to be presented to Parliament along with the annual financial statement. For formulating annual targets and drawing up the framework for fiscal policies a Task Force headed by Vijay Kelkar was constituted by the Central Government. The Task Force estimated that under the reform scenario, tax-GDP ratio of the Centre would rise from 9.2 per cent in 2003-04 to 13.2 per cent in 2008-09. The expenditure-GDP ratio was expected to come down to 14.3 per cent by 2008-09 from 15.4 per cent in 2003-04.

The FRBM Act provides for greater transparency in fiscal operations, quarterly review of fiscal situation and regulating direct borrowing from the RBI in a bid to check borrowing and control expenditure to effect fiscal discipline. The original version of the FRBM Bill had prohibited direct borrowing from the RBI after three years of the passage of the bill except to meet temporary needs. The present FRBM legislation has done away with this provision.

The FRBM legislation has now made it mandatory for the Finance Minister to make an annual statement to Parliament on the fiscal situation besides explaining any deviation in meeting the fiscal obligations cast on the Centre. The legislation provides for responsibility of the Central government to ensure inter-generational equity in financial management and long-term macroeconomic stability by achieving sufficient revenue surplus.

Appraisal of the FRBM Legislation

The Fiscal Responsibility and Budget Management legislation is an attempt on the part of the Central government to commit itself and tie hands of future governments in order to ensure fiscal discipline. The desirability of fiscal discipline is generally accepted, yet there are serious misgivings about the coverage of the legislation and its chosen targets.

1. Misgivings about the revenue deficit target. There is broad consensus that the revenue deficit is to be brought down to zero. In the past, despite general agreement on this issue successive Central governments had failed to reduce revenue deficit during the 1990s. In fact, the revenue deficit of the Central government was 3.6 per cent of the GDP in 2003-04 as against 2.4 per cent in 1996-97. This appalling situation developed on account of two reasons. First, Central tax revenue (net) to GDP ratio declined from 7.6 per cent in 1990-91 to 6.8 per cent in 2003-04. Second, interest payments, revenue subsidies, defence expenditure and other non-plan expenditures rose substantially. If restrictions are imposed on the government to reduce revenue deficit, the real possibility is that the government may cut down social sector spending — especially on basic health and basic education — very severely.[13]

The problem with basic health and basic education is that there is no lobby to push the government for these services. Ajit Karnik states, "In the absence of such a lobby, there is the danger that in the endeavour to attain the target of zero RD (revenue deficit), the government may squeeze social sector spending still further."[14] This will surely be disastrous for large sections of the Indian population.

2. Low levels of capital expenditure. One of the major defects of government finances during the post-reform period has been the declining capital expenditure-GDP ratio. The capital expenditure-GDP ratio which was 5.6 per cent of GDP in 1990-91 fell to 2.7 per cent in 2001-02. After registering some increase in 2003-04 and 2004-05 (it was 3.5 per cent in 2004-05), it fell to just 1.6 per cent in 2006-07 and stood at 1.7 per cent of GDP in 2015-16.

3. Neglect of equity and economic growth. Under the Fiscal Responsibility and Budget Management legislation, the dice is heavily loaded against investments in not only human resources development, but also infrastructure because of the view that on account of their large externalities, a major part of the return on such investments would not directly contribute to the government revenue. One of the major omissions of the FRBM legislation "thus consists in the absence of any targets for time-bound, minimum improvements in these areas which are crucial for both equity and economic growth."[15]

4. Lack of seriousness about financing public expenditure. The Fiscal Responsibility and Budget Management legislation does not address the problem of financing public expenditure in a serious manner. During the 1990s the tax-GDP ratio declined significantly. Hence, the need to raise this ratio should have received top priority under the legislation. But this was not to be. There is no target under the legislation for the tax-GDP ratio. As a matter of fact, a large number of tax concessions continue to be given most of which cannot be justified. The problem of financing public expenditure is callously dealt with by imposing a restriction on the Central government to borrow from the RBI to finance government expenditure, current or capital. This forces the government to incur enormously high interest cost on all its debt.

The legislation could have provided for raising tax-GDP ratio by making improvements in tax administration and collections and measures to rein in tax evasion. However, this aspect received virtually no attention in the legislation. Moreover, the legislation does not seem to recognise that borrowing from the central bank on a moderate scale for financing government investment serves useful purpose in an economy like ours. As a matter of fact, it has an important role to play in promoting the basic objectives of economic growth and equity and minimising the adverse effects of debt and deficits.

5. Flawed assumptions of the FRBM legislation. The FRBM legislation is based on the following assumptions:

(*i*) Lower fiscal deficits lead to higher and more sustained growth.

(*ii*) Large fiscal deficits necessarily lead to higher inflation.

(*iii*) Large fiscal deficit increases external vulnerability of the economy.

C.P. Chandrasekhar and Jayati Ghosh reject these assumptions as they are not tenable. They examine each of these assumptions and point out their unsustainability. Commenting on the first assumption that lower fiscal deficits lead to higher and more sustained growth, they remark, "This need not be the case, since if the deficit is dominantly in the form of capital expenditure, it contributes to future growth through demand and supply linkages. Also, since there is a strong positive correlation between public and private investment, ...more such public spending would stimulate more overall investment and thus growth."[16]

Rejecting the validity of the second assumption, C.P. Chandrasekhar and Jayati Ghosh argue that inflation is caused by the *ex ante* (planned) excess of aggregate demand over aggregate supply, which may come from public or private sectors. Therefore, fiscal deficit must not be blamed all the time for higher inflation. In India, the rate of inflation had fallen during the late 1990s despite fiscal deficit hovering around 5.9 per cent of the GDP.

The third assumption is also incorrect. The external vulnerability depends more on capital and trade account convertibility and the perception of international finance rather than fiscal discipline. Therefore, capital flight may begin at a time when fiscal deficit is low. The higher fiscal deficit may not necessarily cause external crisis. In this country we have managed to build large foreign exchange reserves despite the fact that the fiscal deficit has not come down.

Having convincingly shown that the assumptions of the Fiscal Responsibility and Budget Management legislation are theoretically incorrect, C.P. Chandrasekhar and Jayati Ghosh conclude that the restraining measures under the FRBM Bill (now FRBM Act) "are both unwarranted and unnecessary, and if implemented they would actually be substantially detrimental to the material interest of most of the Indian people. This is because such measures would not only force deflation on the economy, but also involve reductions in public expenditure to meet these very severe criteria, so that public expenditure which is important and necessary for growth and welfare would not be made."[17]

As already stated earlier, because of slowdown in the economy during the second half of the financial year 2008-09, tax collections in this year fell. At the same time, the government was obliged to undertake massive expenditure programmes to raise demand to boost the economy. As a result, target deadlines under the FRBM Act have been ignored. In fact, fiscal deficit in 2008-09 was as high as 6.0 per cent of GDP which rose further to 6.5 per cent of GDP in 2009-10. This is the position when 'oil bonds' issued to oil-marketing companies and 'fertiliser bonds' issued to fertiliser companies are not included in the calculation of fiscal deficit. If these 'off-budget liabilities' are also included, figure for fiscal deficit would be much higher. For example, the Prime Minister's Economic Advisory Council reported in end-July 2008 that "total off-budget liabilities of the Centre could exceed 5 per cent of GDP".[18] This is over and above the Central fiscal deficit of 6 per cent of GDP in 2008-09. Accordingly, the 'true' fiscal deficit of the Centre in 2008-09 probably exceeded 10 per cent of GDP. Although the government claims that fiscal deficit of the Centre fell from 6.5 per cent of GDP in 2009-10 to 3.9 per cent in 2015-16 and 3.5 per cent in 2016-17, many economists have maintained that these figures have been arrived at by 'statistical manipulation' and 'accounting jugglery'. According to these economists, the actual deficits of the Central government are much more than the figures indicate.

Another matter of concern is that the combined fiscal deficit of the States has seen a rise in recent period – from 1.93 per cent of GDP in 2011-12 to 2.46 per cent in 2015-16 and 2.8 per cent in 2016-17. Three factors are likely to make the threat to the health of State finances even more serious. One, the key reasons for an increase in the fiscal deficit at the State level are lower growth in revenue and a faster rise in expenditure. These, in turn, make the task of bridging the gap more onerous. Two, the impact of the Seventh Pay Commission's recommendations on the States is not yet fully evident. As more and more States increase wages in tune with the recommendations of the Commission, the State's fiscal deficit for the next couple of years is likely to worsen. Finally, the launch of the goods and services tax (GST) will introduce an element of uncertainty to the flow of tax revenue to State governments'

coffers. Until the new tax regime is fully rolled out and clarity emerges on the anticipated revenue loss as a consequence, the combined fiscal deficit of the States is likely to take a hit.[10]

Fiscal Responsibility and Budget Management (FRBM) Committee

The government appointed a five-member Committee in May 2016 under the chairmanship of N.K. Singh to review the Fiscal Responsibility and Budget Management (FRBM) Act and to examine a changed format including FRBM targets. The Committee was an outcome of intense debate on FRBM implementation. There was difference of opinion about the need for adopting a fixed FRBM target like fiscal deficit. Some economists argue that the FRBM target which is usually expressed in terms of fiscal deficit, need not be followed during the time when the government has to spend more to fight recession and support economic growth. Some other economists believe that a target oriented fiscal deficit (as under FRBM) is necessary to ensure fiscal discipline. During Budget Speech in 2016, the Finance Minister expressed this debate thus: "There is now a school of thought which believes that instead of fixed numbers as fiscal deficit targets, it may be better to have a fiscal deficit range as the target, which would give necessary policy space to the government to deal with dynamic situations. There is also a suggestion that fiscal expansion or contraction should be aligned with credit contraction or expansion, respectively, in the economy".

Terms of Reference of N.K. Singh Committee. The terms of reference of N.K. Singh Committee were as under:

1. Review of the running of FRBM Act in the past and suggest changes to meet contingencies. The Committee was asked to review the working of the FRBM Act during the last 12 years. It was also asked to suggest the way forward, keeping in view the broad objective of fiscal consolidation and prudence and the changes required in the context of the uncertainty and volatility in the global economy.

2. Examining various associated facts. The Committee was asked to look into the various aspects and factors that have to be considered while determining the FRBM target.

3. Examining the feasibility of flexible fiscal deficit target. The Committee was required to look into the possibility of a 'fiscal deficit range' or flexible fiscal deficit target instead of a fixed target (for example, 3 per cent of GDP at present).

4. Aligning fiscal activities with credit cycle. The Committee was asked to suggest whether the government need to align or adjust its fiscal expansion/contraction with credit expansion/contraction in the economy.

Report Submitted by the Committee. The Committee submitted its report to the Finance Minister on January 23, 2017 and is being examined by the government. The Report has four volumes. The first volume addresses the issue of fiscal policy and roadmap, international experience and the Committee's recommendations on it. The second volume refers to views of international organisations like OECD, World Bank, ILO which made presentations before the panel. The third volume deals with Centre-State issues. The fourth volume includes views of domain experts, both national and international, and what they believe an appropriate fiscal policy would be.

The Report of the N.K. Singh Committee was made public on April 11, 2017. It has suggested a new fiscal framework that has recommended ***bringing down the debt-to-GDP ratio to 60 per cent by 2023*** (40 per cent for the Centre and 20 per cent for States). Since the States are already meeting this target (see Table 52.3 of Chapter 52 in this context), this means that the entire burden for reducing the debt to the recommended limit will have to be borne by the Centre.

The Committee has also recommended that ***the Central government should target a fiscal deficit of 3 per cent of GDP in years upto March 31, 2020 and to 2.5 per cent of GDP by 2022-23.*** It, however, suggested 'escape clause' in case of over-riding consideration of national security, acts of war, calamities of national proportion and collapse of agriculture severely affecting farm output and incomes. Also, 'far-reaching structural reforms in the economy with unanticipated fiscal implications' too can trigger deviation from the targets. However, the deviations from the stipulated fiscal deficit target shall not exceed 0.5 percentage points in a year. The Committee has also recommended that the revenue deficit should also be brought down in phases to touch the level of 0.8 per cent of GDP in 2022-23.

Another important recommendation of the N.K. Singh Committee is that ***the Centre should replace the existing FRBM Act, 2003, with a new law and also set up a Fiscal Council.***

NOTES

1. Government of India, Planning Commission, *Seventh Five Year Plan* 1985-90, Vol. I (Delhi, 1985), p. 68.
2. Prabhakar Sinha, "Changing Colours: How Black Turns into White", *Sunday Times of India* (New Delhi), March 13, 2005, p. 10.
3. Shankar Acharya, "India's Fiscal Policy", in Robert Lucas and Gustav F. Papanek (eds.), *The Indian Economy — Recent Development and Future Prospects* (Delhi, 1988), p. 294.