History and Evolution of the FRBM Act: Issues and Challenges*

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Contents

1 Introduction

This paper reviews the history and evolution of the Fiscal Responsibility and Budget Management (FRBM) process in India. Active thinking on institutionalizing fiscal responsibility legislation commenced in the year 2000 when the then Indian Finance Secretary, Dr. EAS Sarma, chaired a ten-member committee to study various aspects of the Centre's fiscal architecture. They prepared a draft fiscal responsibility legislation which was subsequently amended by the parliamentary standing committee on finance. The FRBM Act was then passed by parliament in 2003 and FRBM rules were enacted soon after that.

In this chapter, we take account of observations by successive Finance Commissions on how the FRBM Act and budget management procedures could be better implemented. We evaluate the performance of the FRBM Act both in terms of numerical targets and compliance with procedural rules. Finally, we look at broader issues and challenges going forward that should provide an intellectual backdrop to thinking about FRBM design and implementation. We discuss issues pertinent to the size of the government, the rationale behind the level of fiscal targets, the utility and importance of "the golden rule", the level of the fiscal deficit ceiling, and the scope and definition of escape clauses.

It is worth noting that the issue of fiscal responsibility was on the radar of the architects of the Indian constitution. Thus, Article 292 states *"the executive powers of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees with such limits, if any, as may be so fixed".* Speaking in the Constituent Assembly, Dr. BR Ambedkar said, *"from all points of view, this Article is sufficient to cover all contingencies and I have no doubt about it that we hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the Union. I go further and say that I not only hope but expect that Parliament will discharge its duties under this Article".*

Since independence, successive Estimate and Public Accounts Committees of Parliament repeatedly urged the government to fix the borrowing limits of the central government. The RBI, especially in the early 1990s, also repeatedly urged the government in its annual reports, to place restrictions on central government deficits and consider a ceiling on public debt. The Ministry of Finance, however, tended to the view that the enactment of law under Article 292 was permissive, not mandatory, and asserted the operational difficulty of fixing fiscal deficit targets given lags in the availability of GDP numbers. This viewpoint changed only in the year 2000 when the urgent need

Figure 1: Liabilities of Centre and State

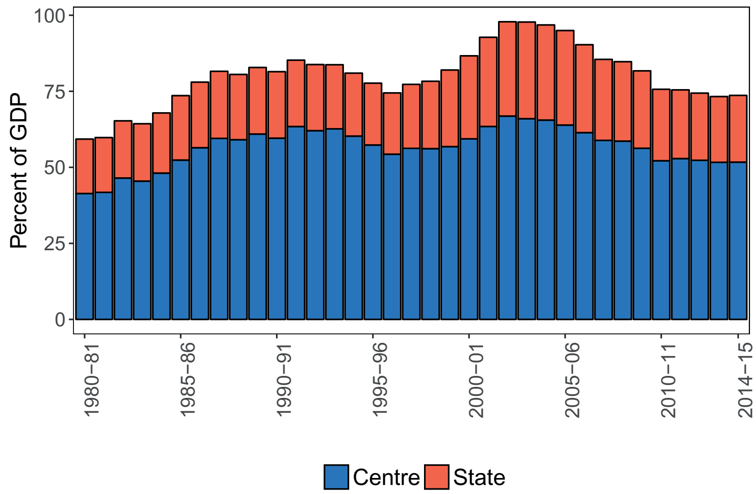


Figure 2: Year-on-Year change in Total Liabilities

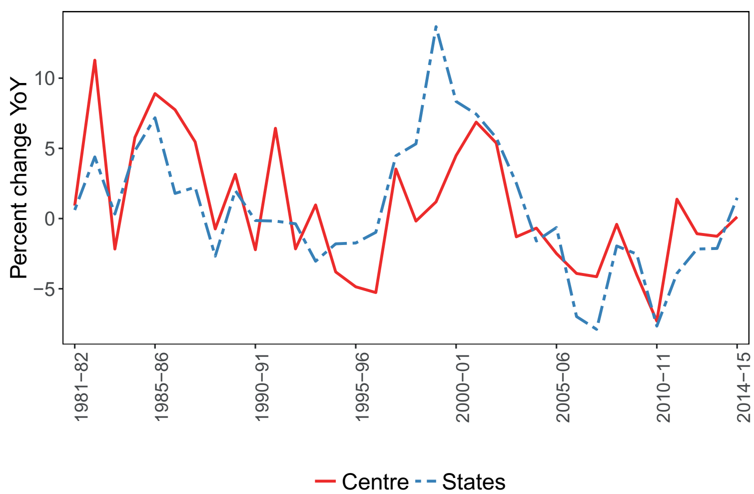
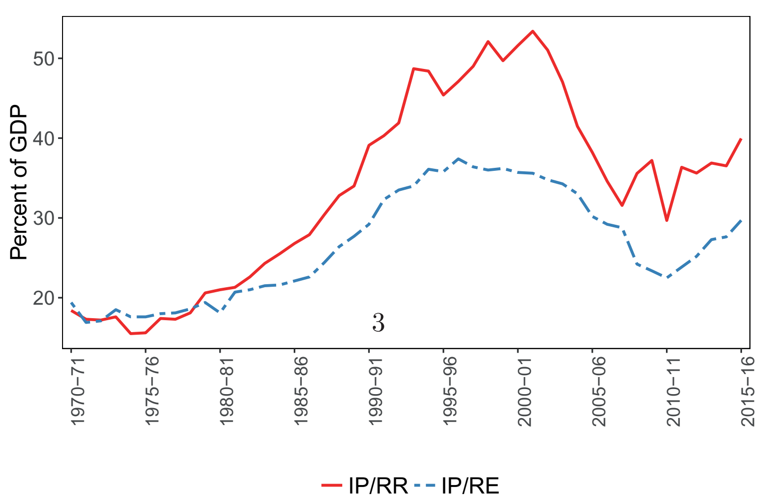


Figure 3: Mounting Interest Burden



to maintain stability and predictability in central government public finances became a part of government policy.

Before proceeding to a detailed examination of the evolution of the FRBM Act, we highlight some long-term trends in general government public finances. From Figure 1, it is clear that general government debt slowly increased from 1980-81 through till 1990-91. Structural reforms brought buoyancy and automatic discipline in the first half of the 1990s, moderating the debt to GDP ratio of the general government. However, from 1996-97, the steep increase in the public debt of both the centre and the states clearly called for institutional correction. As can be seen from Figure 2, this period marked an unprecedented rise in the year-on-year growth of total liabilities, which is normally the vantage from which finance ministries look at this problem. Another source of concern to ministries of finance is the extent to which interest payments consume revenue receipts and form a proportion of total revenue expenditure. As we can see in Figure 3, both these trends were rather alarming in the late 1990s.

There was, therefore, compelling operational evidence that a change in policy stance on the part of the Ministry of Finance was urgently necessary, which led to the commencement of the FRBM process at the level of the then finance secretary.

2 The E.A.S. Sarma Committee (2000)

The deterioration in Central Government finances peaked in the late 1990s, following a number of exogenous shocks to public spending such as unanticipated expenditure on national defence, elections, Odisha's super cyclone, and the residual impact of the Fifth Pay Commission. In 2000-01, the total liabilities of the Union and State Governments stood at 59.3 and 27.3 percent of GDP respectively. Given the persistently deteriorating financial position, the Finance Minister, while presenting the 2000-01 Budget announced several measures that would help "put our fiscal house in order." He emphasized on the need for a roadmap to downsize the Government and design an institutional framework to conduct medium-term fiscal management embodied in a Fiscal Responsibility Act (FRA).

To study the various aspects of the Centre's fiscal architecture and prepare a draft legislation on fiscal responsibility (FRL), a ten-member Committee was set up on January 17th, 2000, with the Finance Secretary, Dr. E.A.S. Sarma as its Chairman. The Committee submitted its recommendations as well as a draft FRL to the Finance Minister on July 4, 2000.

The Committee took a broad approach. Although fiscal responsibility, imposed by prescribing explicit numerical fiscal targets, was an integral part of the proposed legislation, it also stressed on issues of budget management, preparation, presentation, and transparency. The proposed legislation was therefore christened the Fiscal Responsibility and Budget Management Act[1]. This section methodizes the recommendations of the Committee into the two rubrics of fiscal responsibility and budget management principles and discusses these individually.

2.1 Principles of Fiscal Responsibility

The Committee identified three categories of indicators for numerical fiscal targets with specific time frames: (i) deficit, (ii) debt, and (iii) borrowing. Such normative ceilings would also facilitate casting the legislation within the scope of Article 292 of the Constitution.

2.1.1 Deficit Ceilings

Seven deficit indicators were considered[2], but for simplicity and focused attention, the Committee recommended ceilings for only two– fiscal and revenue deficit. It sought to discourage excessive deficit for accumulating capital assets by mandating a progressive reduction in the fiscal deficit by 0.33 percent of GDP at the end of each financial year so as to reduce the fiscal deficit to no more than 3 percent of GDP in five years, ending on March 31st, 2006. The Committee also prescribed the complete elimination of revenue deficit over this period, through annual reductions of 0.5 percent of GDP, and build up an "adequate" revenue surplus after that. This would ensure the observance of the 'golden rule'. In addition to limits on the deficit, the proposed legislation also constrained the Government by limiting guarantees to half percent of GDP in any given financial year.

The Committee did not commission any formal study to determine the suitability or optimality of the level of the fiscal deficit target of 3 percent of GDP. It was also not borrowed from the EU's Maastricht criteria as is commonly believed (Buiter and Patel (2006)). The deficit limit of 3 percent in the Stability and Growth Pact pertains to general government deficit. Comparisons to the FRBM's limit on Central Government deficit are specious.

[1] The name of the proposed legislation was, in part, inspired by the case of New Zealand where issues of budget management were addressed in the Public Finance Act (1989) which preceded the Fiscal Responsibility Act (1994).

[2] These included revenue deficit, monetised deficit, gross fiscal deficit, net fiscal deficit, gross primary deficit, net primary deficit, and the government sector fiscal deficit.

In fact, the FRBM Act's target of 3 percent fiscal deficit, which was adopted by consensus by the Committee, was not based on any formal economic or debt sustainability analysis. It was adopted, as the Committee felt that a 3 percent fiscal deficit will be sufficient to force the government to shed non-productive expenditure, reduce public debt, and create space for investments in productive assets. Subsequently, the Twelfth Finance Commission, and in particular the technical paper by Rangarajan and Srivastava (2004) attempted to rationalise the 3 percent target. Using simple fiscal arithmetic, they surmised that with household savings at 10 percent of GDP and a current account deficit of 1.5 percent of GDP, a combined fiscal deficit of the Centre and the States of 6 percent would be required to ensure investment of 4 percent and 1.5 percent of GDP by the private corporate and public enterprises respectively. The 6 percent general government deficit was apportioned equally between the States and the Centre (See Section 6.2.2 below for details).

2.1.2 Debt Ceiling

For the Union Government, the committee recommended for a debt-to-GDP ratio of 50 percent of GDP in a period of 10 years commencing on April 1, 2001[3].

2.1.3 Borrowing from the Reserve Bank of India

The Committee also considered (i) the regulation of RBI's credit to the Government of India and (ii) freeing the central bank from its public debt management function as essential parts of fiscal responsibility. The first part involved limiting RBI's credit to the Government in order to discourage the latter from resorting to inflation tax. This would prevent the Centre from exploiting the output-inflation trade-off, in the short-run, by pressurising the RBI to extend credit, even if it is at the cost of the central bank's core functions of monetary policy and price stability. The proposed FRBMA proscribed Central Government borrowing from the RBI except through the Ways and Means Advances repayable within the same financial year to meet short-term mismatches between cash receipts and expenditures. The second part involved enhancing the RBI's autonomy by separating its debt management and monetary policy arms and freeing it from the conflict of interest that underlies its multiple functions. However, the proposed FRBMA was silent on this issue.

[3] Debt was defined as the total liabilities of the Government of India, including external debt at current exchange rates at the end of a financial year. The Sarma Committee did not provide any analytical rationale for the 50 percent debt limit.

2.2 Escape Clause for Numerical Targets

To allow for sufficient flexibility in fiscal management in the event of an unforeseen macroeconomic shock, the proposed FRBMA included an escape clause. This allowed the Government to breach the numerical targets on the grounds of unforeseen demands on the finances of the Central Government due to well-defined events: national security and national calamity. It also mandated that the government should immediately submit any such grounds before both Houses of Parliament. Notably, the Bill did not provide for an escape clause for the debt ceiling, possibly because of its long-term time frame.

2.3 Principles of Budget Management

Although today the FRBMA is most commonly associated with its numerical ceilings on fiscal indicators, the initial emphasis of the Sarma Committee was on issues of budget management such as a medium-term outlook to budgeting, transparency and monitoring mechanisms, and accounting reforms rather than prescribing numerical trajectories for deficit indicators. It must be mentioned, however, that two members of the committee- the Controller General of Accounts (CGA) and the representative of the Comptroller and Auditor General of India (CAG) were particularly hostile to this approach. Their status-quoist disposition on matters of budget management stemmed from the view that extant institutions, particularly the Constitution, already address these concerns sufficiently. Indeed, these institutions were against the very idea of legislating a fresh FRA, as ceilings on borrowings could be prescribed under Article 292 of the Constitution.

2.3.1 Accounting Reforms

The Committee recognized that the present cash-based accounting system fails to adequately account for contingent liabilities, liabilities arising out of unpaid bills, and unrealised tax revenues. Moreover, all transactions are reported at their historical values, which do not take into account adjustments due to depreciation, inflation, and exchange rate fluctuations, thereby failing to reflect the true economic and fiscal position of the Government.

Though the Committee took a favourable view towards accrual accounting and greater disclosures of contingent liabilities and saw these matters as essential to fiscal responsibility, the CGA and the representative of the CAG disagreed. They stressed that "accounting reforms should be de-linked from fiscal responsibility legislation" and felt that the proposed changes in the accounting system were "neither desirable nor feasible at this stage". In particular, they believed that shifting to accrual accounting would entail a full-blown overhaul of the accounting system with complicating implications for the State Governments as they base their accounting practices on the Centre.

Thus, they stressed that such reforms should be separately examined while discussing Article 150 of the Constitution which allows the Government to choose its desired accounting system on the advice of the CAG. Moreover, they stated that the Register of Liabilities which is maintained by each Department and Ministry under the General Financial Rules as well as their extant management information systems (MIS) are sufficient to generate reports on contingent liabilities, liabilities arising out of incomplete projects, and outstanding revenue arrears.

2.3.2 Transparency

The Committee placed particular importance on the openness of the Government about its fiscal plans and projections. It provided for three fiscal policy statements in the proposed FRBM Act. The first was a Medium-Term Fiscal Policy Statement that would contain three-year rolling targets for fiscal indicators. The document would also comment on the sustainability of the balance between revenue receipts and revenue expenditure, as well as on the utilisation of capital receipts for generating productive assets. The second document, the Fiscal Policy Strategy Statement, would delineate the Government's policies on fiscal matters such as taxation, expenditure, market borrowings etc. as well as activities such as guarantees and underwriting that may have indirect, yet significant budgetary implications. The third document was the Macroeconomic Framework and its scope was left open for future consideration.

In addition to these documents, the draft FRBMA also outlined certain measures for transparency. These primarily sought to discourage creative accounting by the Government by requiring it to disclose information in all outstanding contractual liabilities, revenue demands raised but not realised, contingent liabilities etc.

2.3.3 Enforcement Mechanisms and Compliance

The Sarma Committee identified two preconditions for the enforceability of an FRA. These consisted of (i) defining clear triggers that determine what constitutes non-compliance and (ii) conducting intra-year budget monitoring to enable the identification of intra-year triggers and the formulation of intra-year corrective actions.

To bolster the reporting and monitoring of the fiscal conduct of the Government, the Committee made a case for a Fiscal Management Review Committee (FRMC). The primary remit of the FRMC would be to conduct ex-post reviews of government budgets. Additionally, the FRMC may be tasked with intra-year reviews, particularly in light of the trend of unusually large supplementary grants that induce large differences between budget estimates, revised estimates, and actuals, and thus, undermine the budget-making process itself.

However, similar to its views on accounting reforms, the CAG held that the existence of Parliamentary and Constitutional institutions such as the Public Accounts Committee, the Estimates Committee, and the CAG itself, obviate the need for a separate FRMC. In fact, it went so far as to state that the setting up of the FMRC will go against the basic structure of the Constitution and also *"encroach upon the prerogative of the Finance Minister... to inform and explain to the Parliament the conduct of fiscal policies and budget management".* It felt that rather than duplicating the work of these institutions, the Government should ensure effective action in cognizance of the periodic recommendations by these institutions, e.g. the various Audit Reports of the CAG that comment on the government's fiscal performance, particularly the Union Civil Audit. Moreover, the CAG noted that the constitution of an FMRC may not be considered by the Committee as *"international experience in the form of Fiscal Management Review Committees to ensure compliance with fiscal responsibility legislation was also not examined during the deliberations of the Committee".* Lastly, the CAG claimed that no such institution exists in the few democratic countries that have enacted FRAs and were discussed by the Sarma Committee even though the Sarma Committee did indeed discuss several such countries, e.g. Japan, Germany, Netherlands, and the United States[4].

The Sarma Committee's final view was that an FMRC would "supplement rather than supplant" existing institutions and hence improve the Government's compliance with the FRBMA. Despite the CAG's dissent, it was included in the draft FRBMA, but its inclusion was short-lived.

The draft legislation recommended by the Sarma Committee went through three notable amendments by the Union Cabinet before being tabled in the Lok Sabha on December 20th, 2000. First, the cabinet reduced the fiscal deficit target from 3 percent to 2 percent of GDP which consequently required the Government to reduce its fiscal deficit by 0.5 percent of GDP per year as opposed to the earlier annual reduction of 0.33 percent. Second, the amended Bill deleted all references pertaining to the Fiscal Management Review Committee. Third, in addition to the three annual FRBM Statements outlined by the Sarma Committee, the final Bill additionally required the Finance Minister to

[4]See Annexure 1 of the Sarma Committee Report (2000) and Debrun and Kinda (2014).

conduct quarterly reviews of receipts and expenditure and place the same before the Parliament. These intra-year reviews would trigger sequestration of expenditure by the Government in the event of intra-year shortfalls of revenues or an excess of expenditure[5]. The FRBM Bill was subsequently referred to the Standing Committee on Finance on July 24, 2000.

3 The Report of the Standing Committee on Finance on the FRBM Bill (2000) and the shaping of the FRBM Act (2003)

The Standing Committee on Finance deliberated on the FRBM Bill for 16 months and its recommendations fundamentally altered two key features of the Bill. After accepting both of these recommendations, the Parliament passed the FRBM Act on August 23, 2003. First, The Standing Committee was not in favour of statutory numerical ceilings on key fiscal indicators as it felt that they imposed undue rigidity on the functioning of the Government and may further reduce allocations for development and poverty alleviation. Moreover, it was also concerned with the possibility of litigation on account of non-compliance with the provisions of the Act. It held that economic decision making should not become the subject matter of judicial scrutiny[6]. It thus recommended the deletion of the numerical ceilings on revenue and fiscal deficit, debt, and guarantees and relegated these to the associated rules that the Central Government is empowered to formulate under Clause 8 of the Bill. All of these recommendations, except one, were reflected in final Act. The exception was that of retaining the target of the elimination of revenue deficit in the Act itself. Its annual reduction path, however, was relegated to the FRBM rules.

Second, the Standing Committee felt that the definition of the escape clause in the FRBM Bill was too restrictive. The Bill provided for infractions of the numerical ceilings on the grounds of national calamities and natural disasters. However, the Committee felt that these may not be the only exigent circumstances that may require the Government to spend beyond the FRBM-prescribed limits and that the escape clause should be more flexible. The FRBM Bill was subsequently amended to reflect the Committee's

[5]This clause did not apply to expenditure charged on the Consolidated Fund of India under Clause (3) of Article 112 of the Constitution. This mainly includes emoluments and allowances of the President and other constitutional offices.

[6]In this respect, the Standing Committee sought the opinion of the Law Secretary, who stated that though the possibility of such litigation cannot be ruled out, it is highly unlikely given the provisions of sub-clause (3) of clause 7 of the FRBM Bill, which gives Parliament the control, supervision and monitoring of any deviations from the numerical targets stated in the Act.

concerns. The scope of the escape clause was broadened to allow for the numerical ceilings to be breached *"on the grounds of national security, national calamity,* ***or such other exceptional grounds as the Central Government may specify****' [emphasis added].*

The departures between the Sarma Committee's draft FRBM Bill and the FRBM Act passed by Parliament in 2003 reveals that FRBM Act was weakened in two important dimensions. First, the FRBM Act lacked the strong legislative oversight provided for in the Sarma Committee's Bill. As stated earlier, the Sarma Committee felt that without numerical ceilings in the Act, the legislation would lack credibility. The relegation of the targets for fiscal deficit, debt, and guarantees, from the Act to the FRBM rules, made them potentially vulnerable to political vicissitudes. Stripped of their legal backing, these targets could now be modified merely by passing a notification in the Gazette of India. The next section discusses the impact of this amendment.

Second, the amendment in the definition of the escape clause (first proviso to Section (4) of the Bill) was a significant blow to the credibility of the FRBM Act. One of the key lessons from the international experience with fiscal rules is that a vague and loosely defined escape clause may render the rule ineffective[7]. Good escape clauses should specify only a limited number of clearly defined and measurable circumstances that may be used as grounds for breaching the fiscal rules. The proviso in the final FRBM Act, however, left it open for the Central Government to specify any such exceptional grounds. This latitude afforded to the Government was exercised by it in 2008-09 when the FRBM targets were overshot. The final FRBM Act also differed from the original Bill in that the escape clause (first proviso of Section 4 (2)) was also extended to Section 5 (1) of the Act which stated that the Central Government shall not borrow from the Reserve Bank.

4 Observations by Successive Finance Commissions

Finance Commissions (FC) routinely undertake a review of the finances of the state and central governments. In doing so, the past three FCs have commented at length on the Central and State fiscal responsibility legislation. This section details the observations of successive FCs viz. the Centre's FRBM Act (for a discussion on FC recommendations on State fiscal responsibility legislation, see Roy and Kotia (2016)).

While welcoming implementation of the FRBM Act by the Central Government, the

[7] See for instance Kopits (2001) and Schaechter et al. (2012).

12th FC noted that it is vital that the revenue and fiscal deficit targets of the Act and the Rules are not modified and that the Centre sets an example for the States. The terms of reference of the Thirteenth FC required it to review the fiscal consolidation roadmap of the general government. In this context, the 13th FC made several observations and recommendations about the Centre's FRBM Act.

First, it recommended making the FRBM process more transparent and comprehensive. It noted that the annual nature of the extant budget process is not conducive for the effective implementation of a fiscal responsibility legislation such as the FRBM Act. It recommended that the central government revise its medium-term fiscal policy statement to include a more detailed Medium Term Fiscal Plan (MTFP) with a detailed break-up of the rolling targets for various revenue and expenditure heads. To enhance transparency, the Commission reported that some stakeholders such as the RBI, the Planning Commission, and the States pointed out that the practice of off-budget borrowing by the Centre is a violation of the FRBM Act in that such borrowings are not captured by the revenue or fiscal deficits reported in the Union Budget. In this regard, the 13th FC recommended that in addition to the ceiling of 0.5 percent of GDP on the flow of guarantees, the FRBM Act must also prescribe a ceiling for the stock of guarantees at five percent of GDP. Furthermore, details of contingent liabilities, especially those arising out of stipulated annuity payments for public-private partnerships, should be published in the Union Budget.

Second, the Commission emphasized on the need to make the FRBM Act better suited to adapt to exogenous shocks and in doing so, achieve its core function of macroeconomic stabilisation. In this regard it recommended that (1) the MTFP must provide details of the values of the parameters underlying revenue and expenditure projections and thus facilitating evidence-based policy; (2) the escape clause should be tightened so as to allow relaxations of FRBM targets only in times of specific exogenous shocks such as agro-climatic events, global recession, oil price fluctuations etc; (3) the cost of a fiscal stimulus during a slowdown should be borne by the Centre and not the States. Third, the 13th FC recommended the setting up of an independent Committee to review and monitor the implementation of the FRBM Act.

In a departure from the past, the Fourteenth Finance Commission was explicitly required to make suggestions to amend existing FRBM Acts currently in force by the Centre and States. In its review, the 14th FC made three important observations. First, it recommended doing away with the concept of effective revenue deficit. It stated that *"The artificial carving out of the revenue account deficit into effective revenue deficit to bring out that portion of grants which is intended to create capital asset at the recipient level leads to an accounting problem and raises the moral hazard issue of creative bud-*

geting". It thus recommended that the Union Government make an amendment to the FRBM Act and omit the definition of effective revenue deficit from 1st April 2015.

Second, like its predecessor, the 14th FC recommended that an independent fiscal council should be established to undertake an ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. Finally, the 14th FC recommended that Union Government may replace the existing FRBM Act by a Debt Ceiling and Fiscal Responsibility Legislation, specifically invoking Article 292 in its preamble. This would enhance the law's legitimacy and sanctity.

5 Evaluating the Performance of the FRBM Act

Given the above background, we now discuss the working and implementation of the FRBM Act over the past 12 years. Although the FRBM Act received the assent of the President on August 26, 2003, it was only notified by the newly elected UPA government on July 5th, 2004[8]. The FRBM rules as well as the report of the Kelkar Task Force, both published in July 2004 guided the implementation of the Act. The Government assimilated the numerical and procedural provisions of the law in the budget process in 2004-05. There were two aspects of this integration. First, the Government's fiscal consolidation strategy was now anchored by FRBMA's numerical targets on fiscal and revenue deficits, guarantees, and the accretion of additional liabilities. Second, three additional documents, a medium-term fiscal policy statement, a fiscal policy strategy statement, and a macroeconomic framework statement, were presented along with the Union Budget every year. In 2012 a medium-term expenditure framework was also added to this list.

5.1 Numerical Targets

Though the FRBM Act presently prescribes only three numerical targets, namely for fiscal, revenue, and effective revenue deficit, the associated FRBM rules also specify an initial annual limit on debt accumulation and a limit on the accretion of guarantees. The compliance with the deficit targets can be assessed in three phases as follows.

[8] It is interesting that in its short history, the FRBM Act saw four Finance Ministers. The FRBM Bill was introduced by Yashwant Sinha in 2000. The Act was passed during the tenure of Jaswant Singh. It was subsequently notified by P Chidambram, and its suspension in 2008-09 was at the hands of Pranab Mukherjee.

1. **FRBM I:** 2004-05 to 2007-08
2. **Suspension:** 2008-09 to 2012-13
3. **FRBM II:** 2013-14 to present

5.1.1 FRBM I

Figures 4 and 5 show the central government's compliance with the deficit targets. For fiscal deficit, the FRBM rules had prescribed a final target of 3 percent of GDP that was to be achieved by 31st March 2009 through annual reductions of 0.3 percent of GDP[9]. In the first phase of implementation, the Government did well to adhere to the prescribed path of consolidation. The fiscal deficit declined from 4.34 percent in 2003-04 to 2.54 percent of GDP in 2007-08, achieving the target of 3 percent of GDP one year in advance. However, the Global Financial Crisis (GFC) in Q3 2008, as well as the impending 2009 general elections caused severe fiscal disturbances. Though the budgeted fiscal deficit for 2008-09 was 2.5 percent of GDP, the revised estimate published in the interim budget of 2009-10 was 6 percent of GDP[10], marking a significant deviation from the FRBM roadmap. Announcing the temporary suspension (which would eventually extend to as long as five years) of the deficit targets in the FRBM Act, the then Finance Minister, Pranab Mukherjee, in his 2009-10 (Interim) budget speech stated that *"Extraordinary economic circumstances merit extraordinary measures. Now is the time for such measures. Our Government decided to relax the FRBM targets, in order to provide much-needed demand boost to counter the situation created by the global financial meltdown".*

Subsequently, after the 2009 general elections, the Finance Minister, in his 2009-10 (final) budget speech, attributed the entire difference of Rs. 1,86,000 crores (3.5 percent of GDP) between the fiscal deficits of 2007-08 and 2008-09 to the 'fiscal stimulus' provided to buttress the GFC. However, this statement was inaccurate for two reasons. First, as documented in detail by Buiter and Patel (2010) and Simone and Topalova (2009), expenditure slippages had started well before the financial crisis hit the global economy in the third quarter of 2008-09, possibly in anticipation of the upcoming 2009 general elections. These infractions primarily consisted of populist spending policies on account of a farm debt waiver, the abrupt expansion of the MNREGA from 200 to over 600 districts, large subsidies on account of oil, food, and fertilizers, and the

[9] Originally the deadline for all targets was 2008, it was later postponed to 2009 by an amendment to the FRBM Act.

[10] Mid-Term Fiscal Policy Statement, Union Budget, Government of India, 2008-09 and 2009-10 (Interim).

Figure 4: FRBM Compliance:Fiscal Deficit

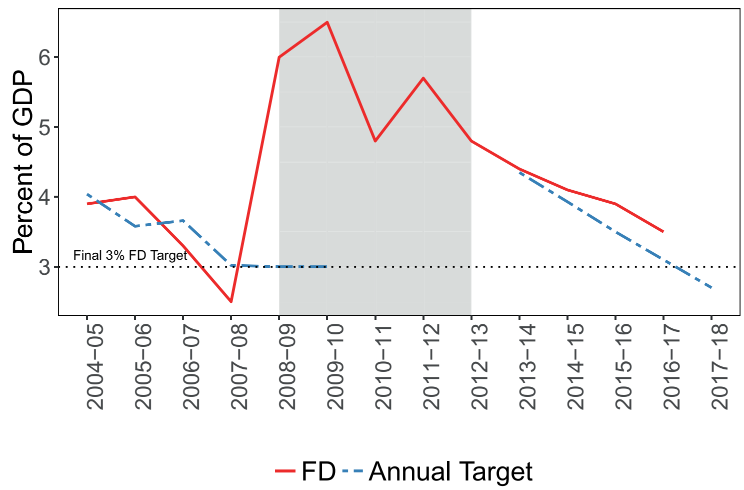


Figure 5: FRBM Compliance:Revenue Deficit

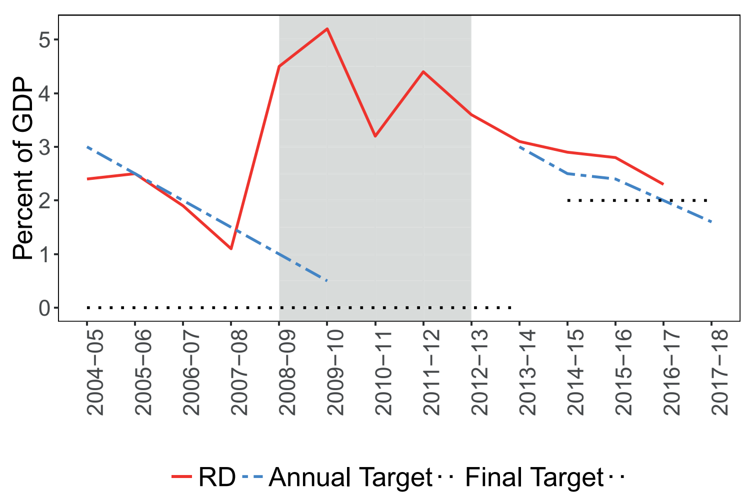
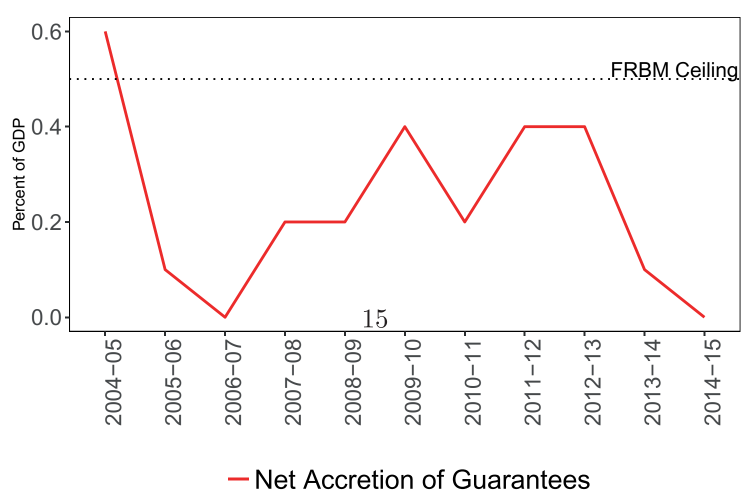


Figure 6: FRBM Compliance:Guarantees



implementation of the recommendations of the 6th Pay Commission. Thus, a significant part of the fiscal deterioration may be attributable to the election cycle in addition to the economic cycle.

Second, the figure of 3.5 percent of GDP understated the magnitude of the deterioration in the fiscal deficit between 2008-09 and 2009-10. As the Finance Ministe, himself stated in his 2010-11 budget speech, the Centre's fiscal deficit in 2008-09, inclusive of the off-budget expenditures of oil and fertilizer bonds was, in fact, 7.8 percent, rather than the budgeted 6 percent of GDP. This meant that the total deterioration in the fiscal deficit in 2008-09 alone was a dramatic 5.3 percent of GDP. Sadly, 2008-09 was not an anomalous year. Buiter and Patel (2010) estimate that off-budget bonds issued in 2006-07 added up to as much as 1.5 percent of GDP. Since such bonds were off-budget, the true measure of fiscal deficit in 2006-07 was 4.8 percent of GDP rather than the budgeted 3.3 percent. Indeed, this leads them to the gloomy conclusion that *"It should be apparent that after 2004-05, not only has there been no fiscal consolidation once off-budget expenditure is included, but indicators have mostly deteriorated."*

For revenue deficit, the FRBM rules had prescribed a final target of nil that was to be achieved by 31st March, 2009 through annual reductions of 0.5 percent of GDP. Oddly enough, given that the revenue deficit in 2003-04 was 3.5 percent of GDP, the prescribed roadmap was inadequate to eliminate the revenue deficit by the said deadline. Notwithstanding this aberration, the annual reductions in revenue deficit complied with the target of 0.5 percent in all but one year in the first phase. In 2005-06, the additional fiscal burden due to the recommendations of the Twelfth Finance Commission caused the government to fall short of meeting the annual reduction of 0.5 percent in the revenue deficit that year[11]. As required by the FRBM Act, the Finance Minister explained this deviation in parliament. Like fiscal deficit, however, revenue deficit also ballooned considerably in 2008-09, from the budgeted 1 percent to the revised 4.4 percent of GDP. Accounting for the off-budget bonds brought the number to an unprecedented 6.3 percent of GDP (Buiter and Patel (2010)).

As Figure 6 illustrates, the limit on the accretion of guarantees was comfortably met in most years across the three phases of the FRBM Act.

Notwithstanding the off-budget borrowings by the central government during the

[11]This deviation was stated by the Finance Minister in a statement to Parliament as required by Section 7 of the FRBM Act. The Finance Minister stated that the reason for this one-time breach of the FRBM annual reduction targets is due to the fact that the TFC recommendations do not fully factor in the expenditure commitments of the Central Government arising out of the National Common Minimum Programme. However, he assured the House of the Government's commitment to adhere to the target of elimination of revenue deficit by 2008-09.

first phase of the FRBM Act, several studies have attributed the fiscal consolidation in this period to high GDP growth and tax buoyancy. Simone and Topalova (2009) estimate that two-thirds of the fiscal adjustment in this period was due to revenue gains. Dholakia et al. (2011) and the 2009 Review of the Economy, published by the Economic Advisory Council to the Prime Minister state that much of the improvements in the financial position of the central government arose due to revenue buoyancy. The basis of these claims lay in the unprecedented growth in GDP that translated into sharp increases in tax receipts.

Phase I of the FRBM Act was indeed a very conducive period for fiscal consolidation. Figure 7 shows that nominal GDP grew sharply and consistently in the pre-crisis noughties. Consequently, the nominal year-on-year growth rate of both direct and indirect central taxes (net of transfers to States) also grew consistently since 2001-02. These dynamics translated into a considerable rise in the net central tax to GDP ratio, particularly the net central direct tax to GDP ratio, which more than doubled between 2001-02 and 2007-08 (see Figure 8). However, as seen in Figure 9, even the expenditure to GDP ratio declined in this period. Furthermore, the decomposition of the annual change in the fiscal deficit reveals more nuanced characteristics of the fiscal consolidation in Phase I.

To re-evaluate the claims of revenue dependency of the fiscal correction during Phase I, Figure 10 decomposes the annual movements in the fiscal deficit into changes in total revenue and total expenditure. It decomposes the year-on-year change in the fiscal deficit as follows.

$$\Delta\left(\frac{FD_t}{GDP_t}\right) = \Delta\left(\frac{Exp_t}{GDP_t}\right) - \Delta\left(\frac{Rev_t}{GDP_t}\right)$$

In panel (a) for example, both the revenue to GDP as well as the expenditure to GDP ratios fell in 2004-05. A fall in revenues exerts an upward, and a fall in expenditures exerts a downward pressure on the deficit. For instance, the drop in the fiscal deficit to GDP ratio of 0.46 percent in 2004-05 is due to the fact that the decline in revenues (0.77 percent) was less than the decline in expenditures (-1.23 percent). Figure 10 (b) on the other hand reports the proportional contributions of revenue and expenditure to the dynamics of fiscal deficit. It shows the percent that each component contributes to changes in the fiscal deficit in each year. In 2004-05, about 62 percent of the total change in the fiscal deficit was due to lower expenditures whereas falling revenues contributed the residual 38 percent. Analogously, Figures 10 (c) and 10 (d) calculate the nominal and proportional contributions of components of revenue and expenditure.

Figure 7: Year-on-Year Growth Rate of Nominal GDP

Figure 8: Central Government Tax Collection Net of Devolution to States

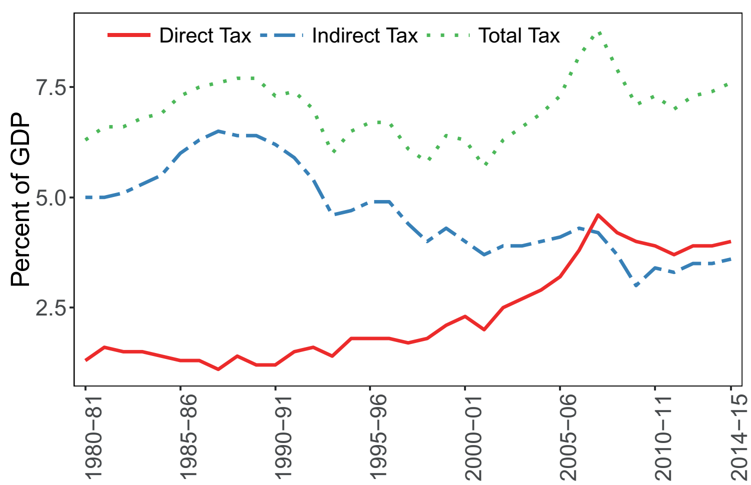


Figure 9: Expenditure-GDP Ratios

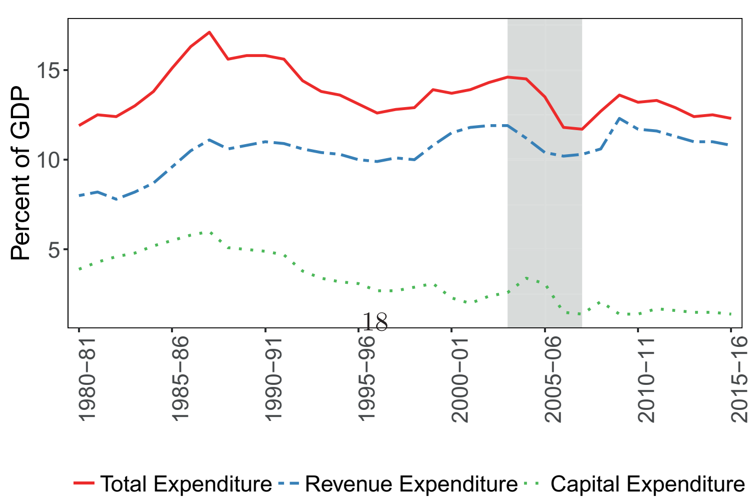


Figure 10: Decomposition of the Fiscal Deficit

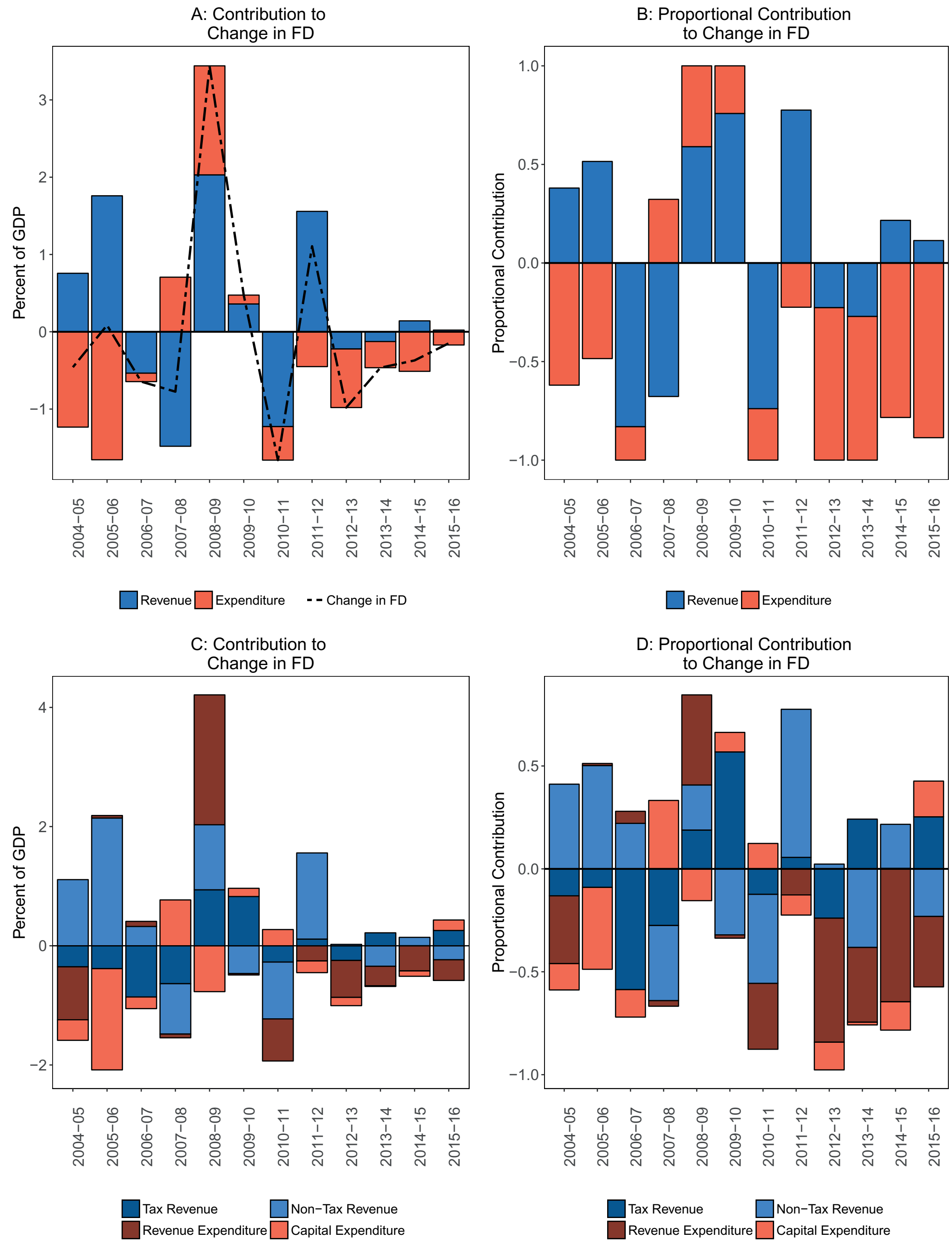
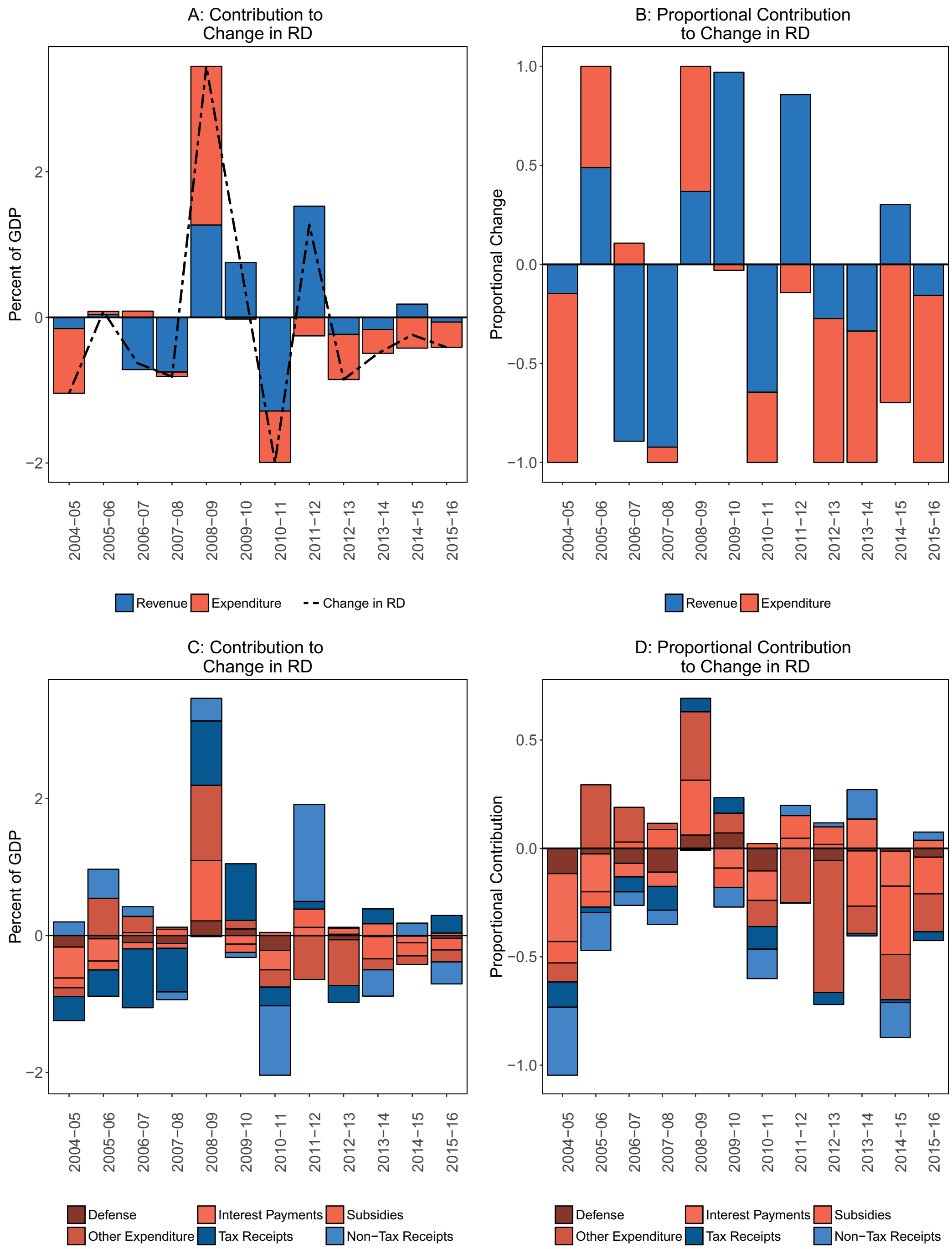


Figure 11: Decomposition of the Revenue Deficit



In the first two years after the implementation of the FRBM Act, revenues declined as a percent of GDP, and the entire reduction in the fiscal deficit of 0.46 and 0 percent of GDP in 2004-05 and 2005-06 respectively, was due to an even greater decline in the expenditure-GDP ratio. In the following two years, however, the revenue to GDP ratio grew considerably, aiding the decline in the fiscal deficit of 0.65 and 0.77 percent of GDP respectively. Therefore, during the four-year period of the initial implementation of the FRBM Act, it was a fairly even mix of revenue buoyancy and expenditure curtailment that led to fiscal consolidation.

Panel 10 (b) reveals that the positive impact of the rising tax revenues to GDP ratio throughout the first phase was overshadowed by a considerable decline in non-tax revenue to GDP ratio, particularly in 2004-05 and 2005-06[12]. These years also saw a decline in the expenditure-GDP ratio with both revenue and capital expenditure falling as a percent of GDP in 2004-05 and 2005-06. A similar picture emerges for the revenue deficit (see Figure 11).

A more wide-ranging analysis of the Government's compliance with the numerical provisions of the FRBM Act can be conducted by comparing ex-post fiscal outcomes to the projections made by the Task force to implement the FRBM Act, constituted in 2004, with Dr. Vijay Kelkar as its Chairman. The Task Force drew a medium-term fiscal plan for the period of 2005-06 to 2008-09. The plan had two parts. The first involved making a set of 'baseline' projections, whereby a detailed medium-term (3-year) forecasting effort was undertaken. The baseline projections assumed that the coming 3-year period will be similar to recent years in terms of progress on policy administration. The next step consisted of devising policy proposals which close the gaps (if any) between the baseline projections and the requirements of the FRBM Act. The Task Force had cast such proposals for tax and expenditure reforms in a macroeconomic perspective that could help devise the most effective trajectory to meet FRBM targets[13].

[12]Interest receipts from the States had gone down considerably due to the introduction of the Debt Swap Scheme by the Government of India to supplement efforts of the States towards fiscal consolidation. Interest receipts declined further due to the recommendations of the Twelfth Finance Commission that enabled States to reschedule outstanding Central Loans under the condition that they enact Fiscal Responsibility Legislation (See the Receipts Budget 2005-06 and 2006-07 for details).

[13]The Task force delved into a detailed strategy for tax reforms with the aims of widening the tax base, enhancing the equity of the tax system, and exploring a shift to consumption taxes to increase efficiency. Its major proposals in this regard were:

1. To Introduce a Goods and Services Tax at both the level of the Centre and the States. It stressed on the need for the Centre and the States to come to an agreement on this fundamental issue.
2. To reach ASEAN rates of customs, and to have the minimal rate dispersion. Towards this, the Task Force proposed a shift to a three-rate structure consisting of 5 per cent, 8 per cent and 10 per cent.
3. To simplify and remove exemptions, rationalise incentives for savings and to broaden the base of income tax.

Figure 12 compares the actual performance of revenue and expenditure with those that the Task Force projected for the period 2004-05 to 2008-09. The projections are based on the assumption of the implementation of the tax and expenditure reforms recommended by the task force. Not surprisingly, the actual tax revenues during this period were substantially lower than the projections, as many of the proposed tax reforms could not be implemented in time. Revenue expenditure as a percent of GDP was more or less in line with the projections until it rose sharply by over two percentage points during the crisis. Interestingly, for most of this period, capital expenditure remained far lower than the levels projected by the Task Force.

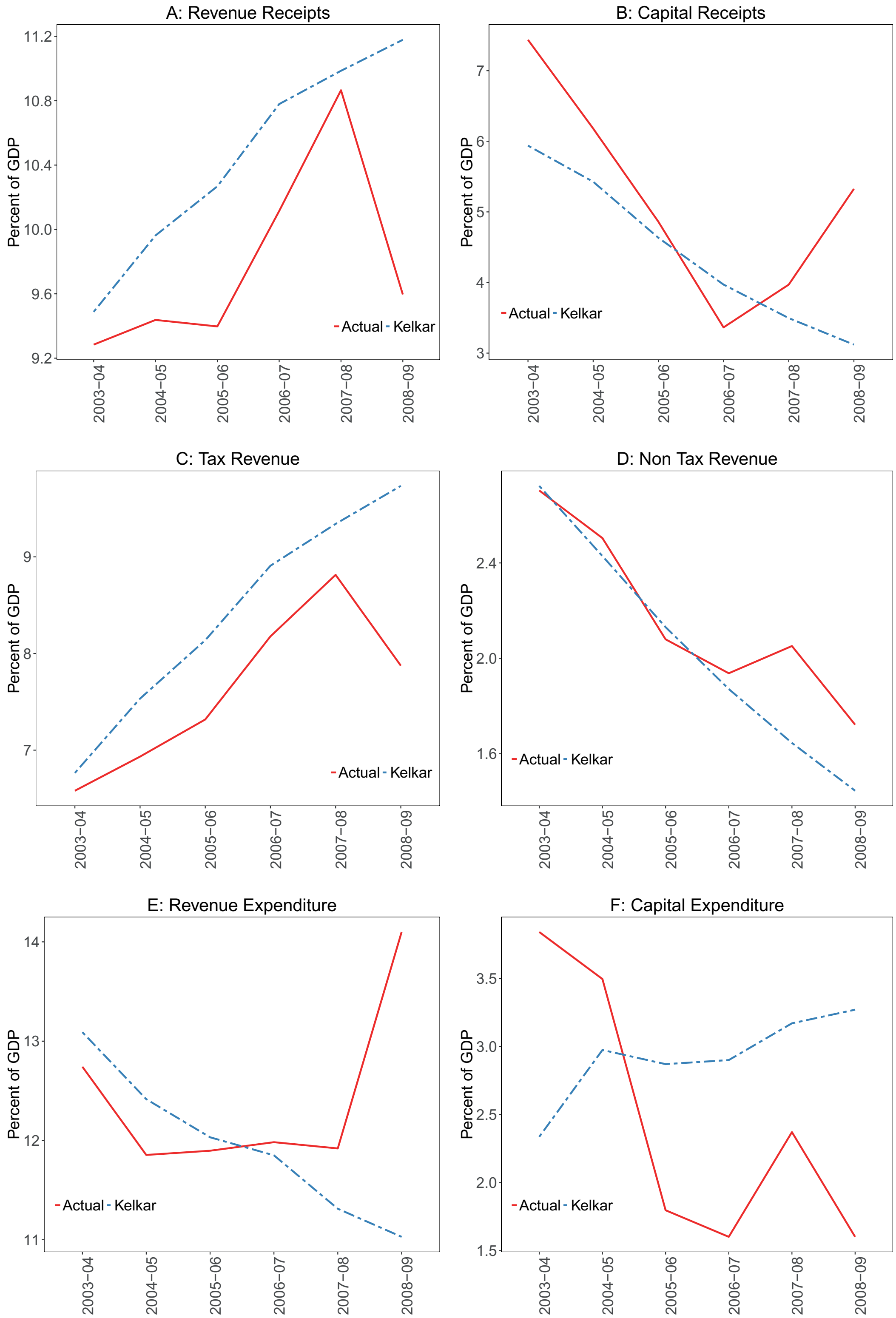
5.1.2 The Suspension Phase

We now discuss the suspension phase of the FRBM Act from 2008-09 to 2012-13. As discussed above, due to the ill-fated synchronization of the election and economic cycles towards the end of Phase I, the fiscal indicators of the Government deteriorated dramatically on account of populist spending as well as the three economic stimuli that was injected in 2008-09 and 2009-10. Figure 10 (a) shows that the ratios of revenue and expenditure to GDP simultaneously deteriorated for two consecutive years. On the expenditure side, capital expenditure to GDP ratio decreased by 0.76 percent but was overshadowed by the stupendous rise of over 2 percent in the revenue expenditure to GDP ratio. On the revenue side, the ratios of tax and non-tax revenue to GDP fell by equal proportions. It is noteworthy, however, that though the FRBM Act was brought back only in 2013, the proliferation in revenue expenditure had been curtailed since as early as 2009-10. Figure 11 shows that the revenue expenditure to GDP ratio has declined in each year since the infractions of 2008-09, primarily on account of lower subsidy bills and other non-defence revenue expenditures.

Unlike international best practice, neither the escape clause (the first proviso to Section 4 of the FRBM Act) of the FRBM Act nor the associated FRBM Rules mandate a clearly defined correction path that would facilitate fiscal consolidation following a breach in the adherence to the numerical targets. This was reflected in the following, rather vague statement by the Finance Minister, in his 2009-10 budget speech: *"I in-*

4. To carry out three reforms in the corporate income tax:
    - Bring the depreciation rates into alignment with the low inflation rates and low interest rates which now prevail in India.
    - Remove the structure of exemptions in the light of the reduction in tax rates over the last two decades.
    - Close the gap between the peak rate for personal income tax and the corporate tax rate.

Figure 12: Kelkar Task Force Projections vs. Actuals



tend to... return to the FRBM target for fiscal deficit at the earliest and as soon as the negative effects of the global crisis on the Indian economy have been overcome." Therefore, amidst considerable uncertainty about the government's plans of returning to the FRBMA roadmap, the two deficit rules remained in abeyance for five years.

5.1.3 FRBM II

It was not until the budget speech of 2012-13 that Finance Minister Pranab Mukherjee announced his intention to re-operationalize the FRBM Act. The Finance Act, 2012 introduced several amendments to the Act. A new target of zero "effective revenue deficit" was introduced, that sought to eliminate revenue deficit excluding grants for the creation of capital assets by 2015. Consequently, the target for revenue deficit was raised to 2 percent of GDP. The amendment also announced that a new statement called the medium-term expenditure framework would publish three-year rolling target for expenditure indicators. Moreover, to enhance the monitoring and enforcement of the law, an amendment to Section 7 empowered the Central Government to entrust the Comptroller and Auditor General of India to conduct periodic reviews of the implementation of the legislation.

However, in his second budget, to create fiscal space for public expenditure, Finance Minister Arun Jaitley amended the Act yet again, further postponing the deadlines for meeting the numerical targets from 2015 to 2018. The Government is presently on track to meeting its fiscal targets by 31st March, 2018. However, for the first time in over five years, the Government of India has resorted to off-budget borrowings in the 2016-17 budget. The rationale provided for such borrowing is to *"give a further boost to public investment in Infrastructure"*. As Table 1 details, a total of Rs. 31,300 crores have been mobilized through the issuance of bonds by public sector enterprises under selected ministries[14]. As discussed in previous sections, the mobilization of such off-budget resources undermines the numerical targets in the FRBM Act and should be discouraged.

5.2 Compliance with Procedural Rules

Apart from adherence to numerical fiscal targets, we assess the FRBM Act's compliance viz. the various procedural rules provided under the Act. By procedural rules, we mean explicit measures to improve the monitoring and enforcement of the Act. We discuss two

[14] See Union Budget 2016-17, Expenditure Budget Volume I, pg. 44-45 for details.

Table 1: Off-Budget Borrowings in the 2016-17 Budget (Rs. Crores)

Ministry	**Agency**	**Amount**
Power	Power Finance Corporation/Rural Electrification Corporation	5000
New and Renewable Energy	Indian Renewable Energy Development Agency	4000
Road Transport & Highways	National Highway Authority of India	15000
Shipping	Inland Water Transport Corporation of India	1000
Agriculture	National Bank for Agriculture and Rural Development	6300
Total		**31300**

such measures, (1) the statutory basis for the legislation and (2) measures to enhance transparency.

5.2.1 Statutory Basis

The repeated amendments to the FRBM Act are a cause of concern. Medium and long-term compliance and credibility is difficult to achieve if the Government can repeatedly postpone its fiscal targets without sufficient cost. To understand the lacunae in the legal support for the numerical targets, we assess the non-compliance of the FRBMA targets at a procedural level. This approach requires segmenting the numerical ceilings into three parts, namely (1) the level of the target, (2) the deadline by which the target has to be achieved, and (3) annual reduction in the deficit indicators that the law specifies (see tables 2 and 3).

Table 2: Legal Basis of Attributes of Numerical Rules

Rule	**Level of Target**	**Deadline**	**Annual Reduction**
Fiscal Deficit	Rules	Act	Rules
Revenue Deficit	Act	Act	Rules
Guarantees	Rules	-	Rules

Table 3: Specifics of the Numerical Rules

Rule	**Level of Target**	**Deadline**	**Annual Reduction**
Fiscal Deficit	3%	31st March, 2008	0.30%
Revenue Deficit	Nil	31st March, 2008	0.50%
Guarantees	0.5% each year	-	-

Note: As stated in previous sections, the specifics of the numerical rules were amended several times. This table reflects the provisions of the original FRBM Act, 2003.

In the original Bill, all the three attributes were a part of the legislation in that they were specified under specific sections of the FRBM Bill. However, as discussed above, the Standing Committee on Finance relegated the level of the fiscal deficit target as well as magnitude of the annual reductions in the fiscal and revenue deficits to the associated FRBM rules. Many experts (see Lahiri (2015) for instance) advocate for bringing the fiscal targets back into the Act as a means to achieve better compliance. However, the experience of the implementation of the FRBM Act in the past 12 years reveals that this may be far from a panacea.

It is crucial to note that though the level of the targets, as well as the annual reduction path, may have been relegated to the rules, the deadlines by which the final targets are to be met have remained a part of the Act itself. Thus, any deviation from the FRBM roadmap that will postpone the achievement of the deficit targets *necessitates an amendment to the Act*. Such a deviation cannot be managed merely by amending the FRBM rules.

Consider the possible ways in which the central government may wriggle out of its ex-ante commitment to the FRBM roadmap.

1. It may make use of the liberally-defined proviso (escape clause) to Section 4 of the Act that prescribes fiscal and revenue deficit limits. The Finance Minister Pranab Mukherjee resorted to this method in 2009-10.

2. It may change the level of the targets itself by amending the FRBM rules. This does not require an amendment to the Act as the targets are specified only in the rules.

3. It may amend the Act and postpone the deadline by which it is required to meet the level of the said targets.

It is pertinent to note that option two has *never* been exercised and is unlikely to be exercised in future. During FRBM I and II phases, the government has always resorted to option 3, that requires an amendment to the Act. To claim that FRBMA has lacked compliance because its flesh was relegated to the rules is suspect, as none of the delays in FRBMA targets were effected by amending the rules in the first place[15]. Thus, the requirement of amending the Act hardly constrains the conduct of Government. In fact, given the populist trends prevalent today, it is hard to think that any political party would protest an expansion of the government budget, beyond the FRBM roadmap.

[15] The sole exception to this trend was the change in the annual target paths of fiscal and revenue deficit in 2015. However, even this change was preceded by an amendment to the Act in the same year.

Therefore, moving the level of the target or the annual reduction paths from the associated rules back to the Act is not likely to raise the cost of reneging on an ex-ante budget commitment.

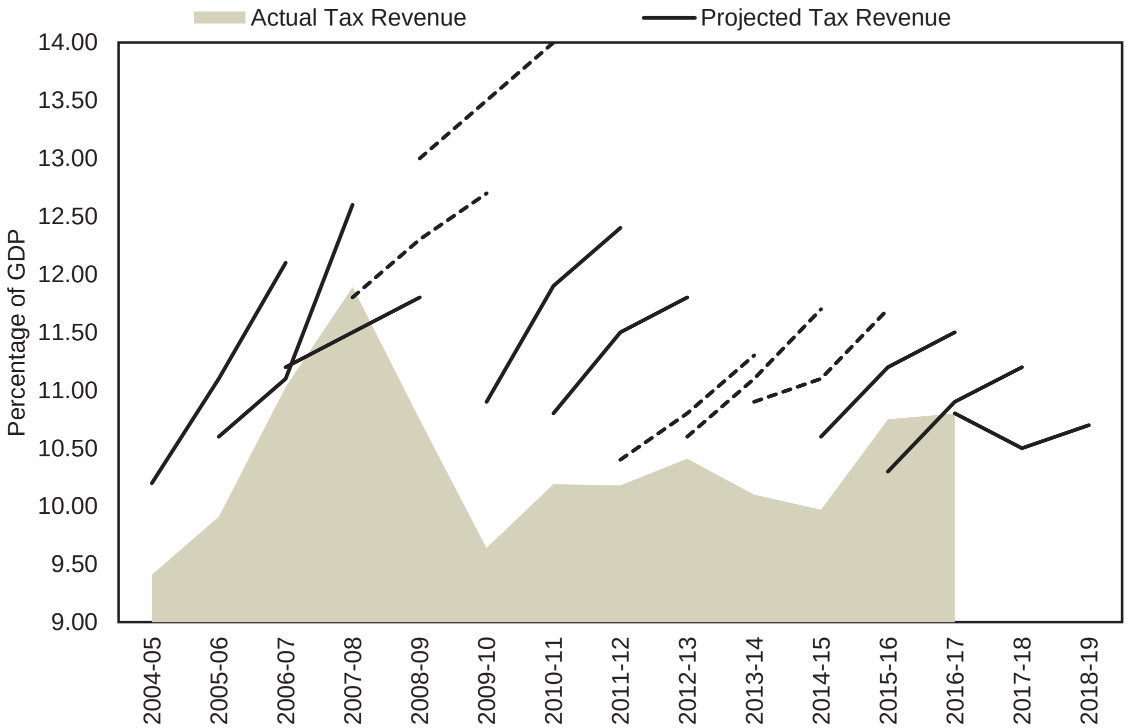
5.2.2 Enhancing Transparency

The improvement of budget management practices was of first importance to the framers of the FRBM Bill. Increasing the transparency of the budget-making process was regarded as a crucial step towards this endeavour. The aim was to make budget projections more accurate so that they reflect the true current financial position of the Union. Furthermore, relevant budget documents would provide explicit details of the underlying assumptions behind such projections. This additional clarity would then enhance the reputation cost of making over-optimistic assumptions that lead to unrealistic projections.

Section 2.3.2 above talks about specific FRBM provisions in this regard. Did they work? To answer this question, we study one such provision in the FRBM Act, namely the Medium Term Fiscal Policy Statement (MTFP). The MTFP statement publishes three-year rolling targets for five indicators. These include fiscal deficit, revenue deficit, effective revenue deficit, debt to GDP ratio, and gross tax revenue. For e.g. the 2010 MTFP statement lays out the Budget Estimates for 2010 and makes projections for 2011 and 2012. Thus, for each year, we have three data points. For 2012, for instance, we have a projection from 2010 (we call this T2), a projection from 2011 (we call this T1) and a BE estimate from 2012 itself. For each year starting from 2006-07, which is the first year for which T2, T1, and BE are available, Figure 13 plots the discrepancy between the three data points for each year. We find that RD and FD are underestimated in all the years. Tax revenues are always overestimated and almost never underestimated. Debt is also usually underestimated, but the projections are more accurate than those for the deficit indicators.

Figure 14 presents another way to look at the same data for tax revenues. It plots the rolling targets for tax revenue in each year. These are the upward sloping line segments, indicating that the MTFP Statement has *always* predicted that tax revenues will rise as a share of GDP. This is true even for the crisis years. The shaded area charts the actual evolution of the gross tax to GDP ratio, which presents a more sobering outlook. Comparing the actual data to the projections reveals that *even when the tax to GDP ratio was, in fact, falling (the shaded area corresponding to the dashed target lines), the MTPF continued to project that they would rise in successive years.* This is not just a matter of committing an error in forecasting; the MTFP statement seems to be erring even on assessing the *direction of the trajectory* of tax revenues.

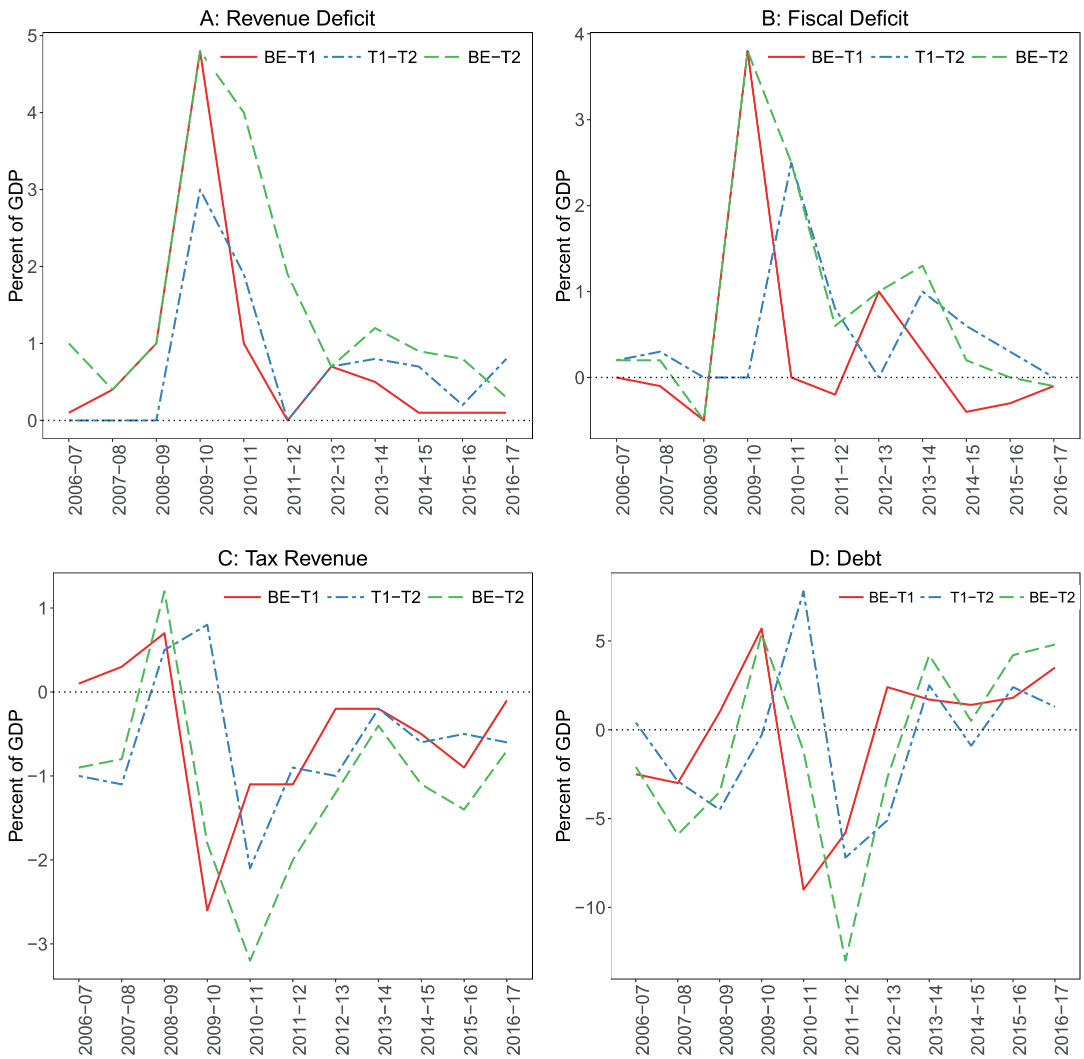
Figure 14: Direction of the Trajectory of Tax Revenues



6 Issues and Challenges

In this section, we look at important issues that are pertinent to the FRBM Act but have received little attention in recent academic or policy literature in India. First, we study the FRBM Act as ultimately imposing a restriction on the total size of the general government by limiting the extent and nature of government borrowing. It would be an egregious error to assume that the government could simply increase its total size by increasing the tax-GDP ratio as long as borrowing limits were fixed. If there is a consensus on the overall medium-term size of the government, then an increase in the tax-GDP ratio could be deployed to expand its fiscal space, however, if the size of the general government equals or exceeds the desired level, then, an increase in the tax to GDP ratio should be used to reduce debt. In an emerging economy, this is an important medium-term question.

Figure 13: Medium Term Fiscal Statement: Forecast Errors



Second, we study the rationale behind the 'Golden Rule' and the evolution of India's revenue expenditure and deficit. The golden rule states that governments should not borrow to consume in the medium-term. This is at the heart of the existing restrictions placed on the revenue deficit. It is important to examine the evolution of this aggregate and its implication for fiscal responsibility.

Third, we assess the rationale behind the level of the numerical targets in the FRBM Act. In setting fiscal deficit ceilings, it is important to understand the theoretical basis for such ceilings, and this is of particular interest in India where the 12th FC has used a savings based analysis to inform its recommendations in this regard. Finally, since the FRBM process involves a discussion of escape clauses, it is important to list the broad principles underlying such clauses and their application in other countries.

6.1 The Size of the Government

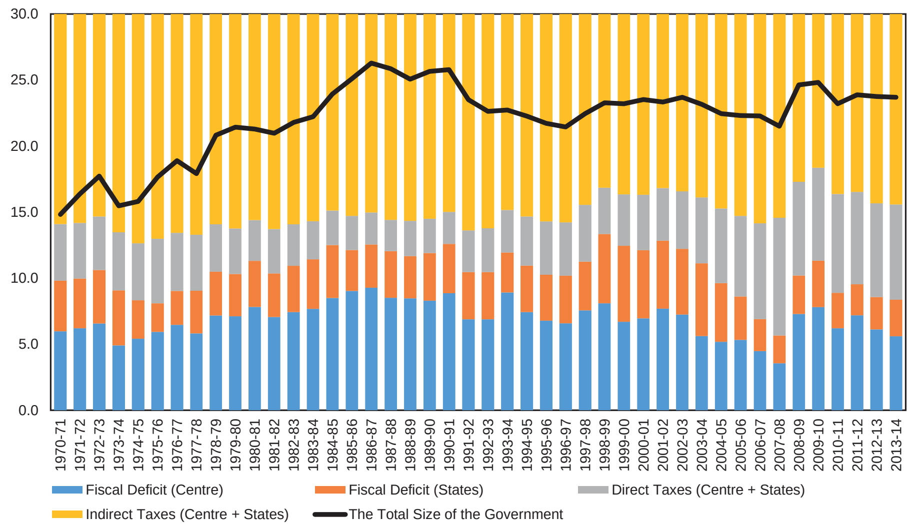
I sit on a man's back, choking him and making him carry me, and yet assure myself and others that I am very sorry for him and wish to lighten his load by all possible means – except by getting off his back.
– Leo Tolstoy

What is the proper size of the government? What are the causes and economic consequences of a growing government? These questions have long been the focus of public choice theorists and practitioners. In this section, we trace the evolution of the size of the government in India and compare it with that in the rest of the world.

We define the size of the government as the sum of the total tax revenues collected by the States and the Centre and the general government net lending. Figure 15 shows the evolution of the size of the government as well as its decomposition for the Indian economy. It rose almost uninterrupted from about 16 percent in 1970-71 to over 25 percent of GDP in the late 1980s and early 1990s. This was followed by a slight moderation in the 1990s, led primarily by a modest reduction in the Centre's fiscal deficit as well as excise tax collections by the Centre and States. The crisis years stand out, with a sudden increase in the size of the government. The modest fall in direct and indirect tax collections was overshadowed by the sharp rise in the combined fiscal deficit which more than doubled from 4.1 percent in 2007-08 to 8.4 percent of GDP in 2008-09.

The data suggests that the general government accounts for almost a quarter of the GDP. Is this just right, too small or too big? This important policy question has been long ignored. A policy stance on this matter must appreciate the economic consequences of the growth of government. The first of these is the impact of government activity

Figure 15: The Size of the Government (percent of GDP)



on the overall productivity of the economy. Public investment in health, education, and physical infrastructure can increase the productivity of the factors of production. However, government activity can also have detrimental effects. First, higher taxes might induce lower work effort and savings by households and firms. Second, it may crowd out private sector investment and production[16]. These considerations suggest an inverted-U relationship between government activity and economic productivity– government activity augments the productivity of the economy at low levels, but as it rises, the marginal increase in productivity declines until it ultimately turns negative at very high levels of government activity. Olson, Sarna, and Swamy (2000) show for a sample of developing countries that both the size of the government and the quality of its institutions matter. This is pertinent in the Indian context as the "capacity of the State" has often been brought into question.

The second consequence of the size of the government is the welfare cost of taxation. Commodity taxes distort an agent's pattern of consumption and income taxes distort an agent's choice between labour and leisure. It is well known that the welfare losses that arise as a result of these distortions can become relatively large when the government attempts to maximize its revenue from taxation, and are a rising function of the market power enjoyed by the firms who bear the tax. Browning (1987) estimates the marginal welfare loss of income tax in the United States at 32 to 47 percent.

[16] For further discussion and references to the literature, see Hansson and Henrekson (1994).

Of course, fiscal policy must take cognizance of the size of the government. At the same time, as Chowdhury and Islam (2010) point out in the case of optimal debt, policy makers should guard against succumbing to the allure of the seeming accuracy of estimates of the 'optimal' size of the government. As in the case of optimal debt, comparing the size the government of different countries provides a reasonable back-of the-envelope benchmark

Figure 16 plots the size of the government of over 80 countries as well as the average of a number of country groups. The data represents 5-year averages. For example, the data for 1995 is the average for the period 1990-95 for each county or grouping. The first thing to note is that advanced countries have much larger governments (see the points for EU, advanced economies (AEs) and the G7). The emerging markets (EMs) and most low-income groups tend to have smaller governments. India has the smallest government amongst the BRIC countries. In this background, it is important to enunciate a clear policy stance on this crucial issue.

6.2 The Rationale Behind the Level of Fiscal Targets

What is the appropriate level of fiscal targets that the FRBM Act should prescribe? We discuss this and related questions in this section, focusing on the two FRBM fiscal indicators, i.e. revenue and fiscal deficit.

6.2.1 The Golden Rule

In the case of the revenue deficit, the "golden rule" prescribes that revenue or current budget should be in balance or in surplus. This is particularly challenging to achieve given that a large proportion of revenue expenditure goes into servicing the existing debt stock, and therefore rigid in the short run.

Furthermore, revenue expenditures such as wages and subsidies are politically difficult to curtail. The E.A.S. Sarma Committee consequently stressed that without the Golden Rule, fiscal consolidation might lead to a disproportionately large compression of capital assets. Thus, the golden rule was seen as a means of maintaining the "quality of fiscal correction"[17].

[17]See page 9 of the Report of the Committee on Fiscal Responsibility Legislation, Ministry of Finance, Department of Economic Affairs.

Figure 16: The Size of the Government: International Comparison

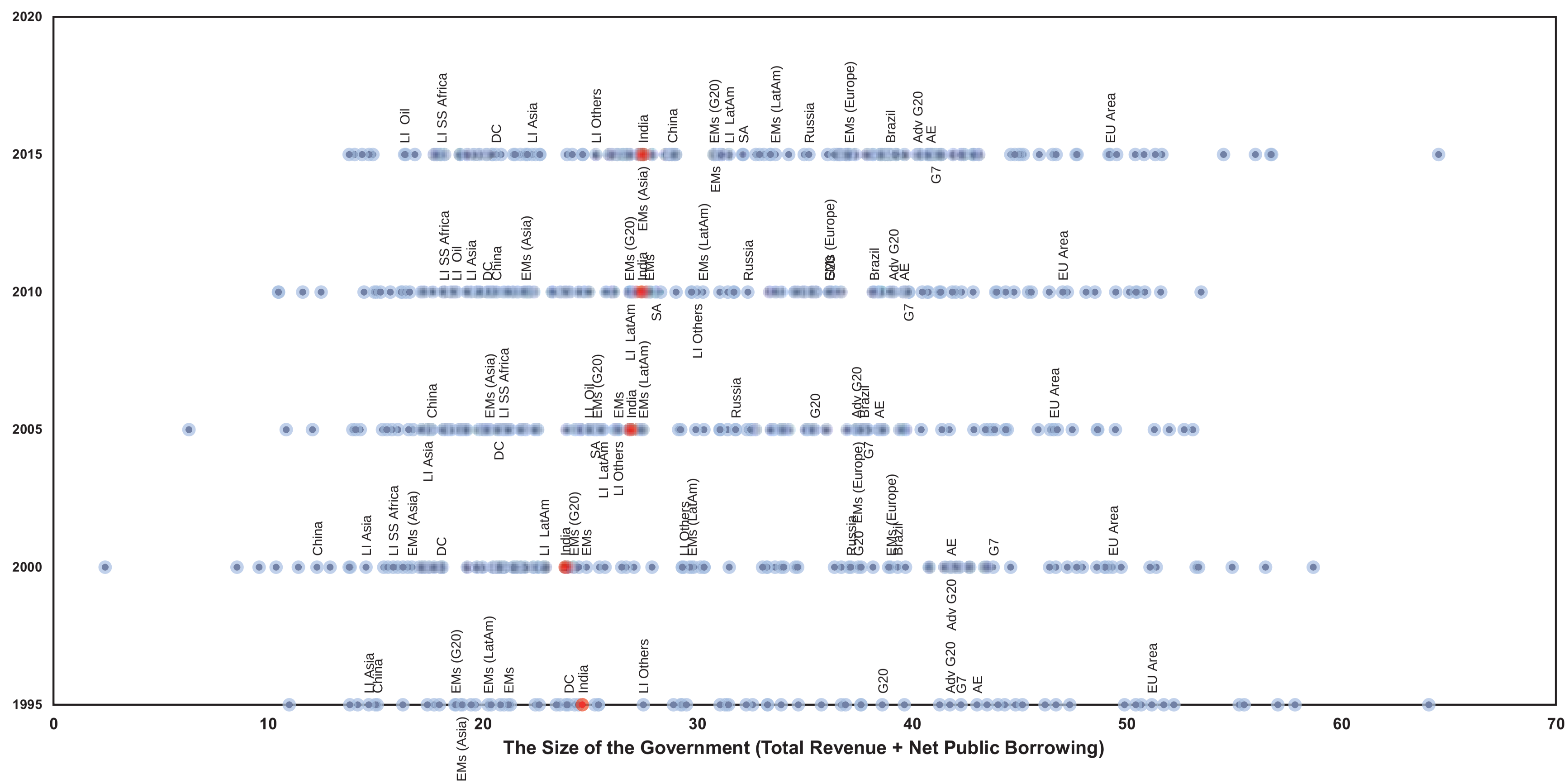


Figure 17 shows that persistent revenue deficit is a relatively recent phenomenon. The Centre's revenue account was in surplus or balanced till the late 1970s. Since the 1980s however, the Centre's revenue account has consistently been in deficit, reaching a high of over 5.5 percent of GDP in the late 1990s. The early 2000s saw a sharp fall in the revenue deficit of the centre owing largely to the implementation of the FRBM Act and a favourable growth environment. This, however, was completely reversed following the financial crisis. A gradual correction is under way at present. A similar pattern is observed for the States. Notably, however, unlike the Centre, the states as a whole now meet the golden rule.

Figure 18 reveals that this deterioration in the combined revenue account was in large part due to significant expenditure slippages. In the two decades following the mid-1970s, there were very few years in which the combined revenue expenditure as a percent of GDP declined. In fact, for almost half of this period, it rose by more than 0.5 percent of GDP, year on year. Thus, revenue expenditure as a percent of GDP has almost doubled in the past four decades. This is primarily on account of interest payments which rose from 1.26 percent of GDP in 1970-71 to as high as 4.64 percent of GDP in 2002-03. Subsidies have also added to the burden, particularly in the last decade (see Figure 19).

In 2012, the FRBM Act was amended to include a ceiling for a newfangled fiscal indicator, namely the 'effective revenue deficit' (ERD). ERD is defined as the difference between the revenue deficit and grants for the creation of capital assets. These grants refer to the grants-in-aid extended by the Centre to any entity that may be categorized as a 'scheme implementing agency' (i.e. a State government or local autonomous bodies) specifically for the creation of capital assets that would be owned directly by them. The amendment also made provisions for the inclusion of the detailed break-up of grants for the creation of capital assets in the Medium-Term Expenditure Framework Statement to keep within the transparency clauses of the Act. The amendment prescribed the elimination of the effective revenue deficit while the target for revenue deficit was raised to 2 percent of the GDP.

ERD has been controversial. For instance, in its report, the Fourteenth Finance Commission held that *"The artificial carving out of the revenue account deficit into effective revenue deficit to bring out that portion of grants which is intended to create capital asset at the recipient level leads to an accounting problem and raises the moral hazard issue of creative budgeting".* Lahiri (2015) raises similar concerns. Others have also criticized the inadequate fiscal reporting of the assets expected to be created by the scheme implementing agencies, raising concerns of creative budgeting and window-dressing.

Figure 17: Revenue Deficit as Percent of GDP

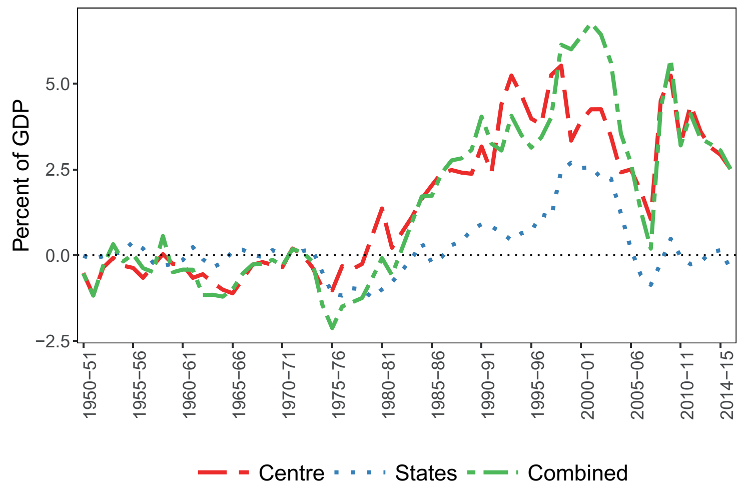


Figure 18: Decomposition of the Y-o-Y percent Change in the Combined Revenue Deficit of the States and the Centre

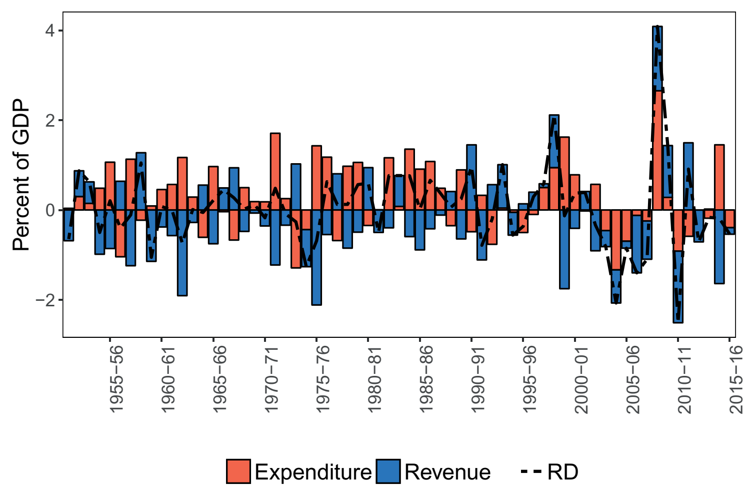
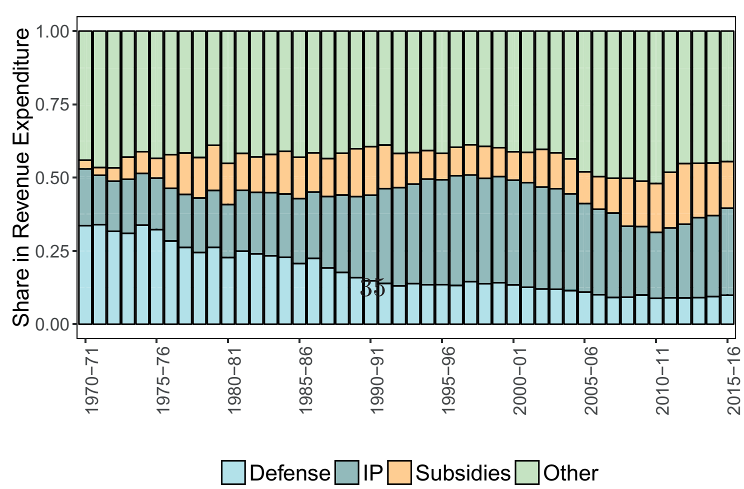


Figure 19: Revenue Expenditure and its Decomposition



In this background, the concept of an ERD, which is at odds with the principle of the golden rule must be reassessed. The Centre must lay out a road map for the elimination of its revenue deficit or at least specify the maximum revenue deficit over the medium term.

6.2.2 The Level of the Fiscal Deficit Ceiling

Arriving at the appropriate level of the fiscal deficit target calls for a more involved analysis. As the previous sections illustrate, the extant 3 percent ceiling on the fiscal deficit was more a product of subjective assessment by the Sarma Committee than any formal analysis of budget arithmetic. However, the literature does identify formal methods that may be used to arrive at the level of fiscal rules. We discuss two of these below.

1. **The Arithmetic of Fiscal Rules à la Kopits (2001)**

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Kopits (2001a) arrives at operational targets of fiscal deficit (overall balance) that are consistent with a gradual reduction in the public debt to a prudent level within a given number of years. At the same time, these targets are sufficiently flexible and accommodate automatic stabilizers.

The inter-temporal budget constraint can be expressed as

$$d_t = \left(\frac{1+i}{1+g}\right) d_{t-1} - b_t$$

where d is the stock of public sector debt as percent of GDP, i is average nominal interest rate on public debt, g is nominal GDP growth rate, and b is primary budget surplus as percent of GDP.

A country may, for instance, want to reduce its public debt over a period of time (say n years), so that

$$d^*_{t+n} < d_t \tag{1}$$

This medium term goal is met within a period of n years by annual reductions of x in the debt to GDP ratio, and operationalised by means of a rule for primary surplus

$$b_t^* = \underbrace{(i-g)d_{t-1}}_{\text{Debt Servicing}} + x \tag{2}$$

This operational target can be defined in reference to trend growth.

$$b_t^* = \underbrace{r_t(1+\alpha GAP_t)}_{\text{Revenue Cyclicality}} - \underbrace{c_t(1-\beta GAP_t)}_{\text{Expenditure Cyclicality}} + k_t \tag{3}$$

where r = government revenue, c = primary current expenditure, k = capital expenditure, α and β are revenue and expenditure elasticities with respect to output gap. GAP is the difference between trend GDP and actual GDP.

Thus, when output is below potential (i.e. $GAP_t > 0$), the rule allows for the primary surplus to be smaller than the target primary surplus, i.e. $b_t < b_t^*$. Whereas, when output is above potential (i.e. $GAP_t < 0$), it is required that $b_t \geqslant b_t^*$. Note that *ceteris paribus*, if GDP growth is above (below) trend then d_t will fall (rise) and remain unchanged if the economy is on its trend growth path. Rule (2) implies that if the target reduction in the debt ratio is set equal to the growth rate ($x = gd_{t-1}$) we get

$$b_t^* = id_{t-1} \tag{4}$$

i.e, the primary surplus equals the interest payments on debt, which implies overall balance (i.e., a fiscal deficit of nil).

The above budget arithmetic was used in setting the general government fiscal targets in the Stability and Growth Pact in the EU. Kopits (2001b) notes that a 1 percent decline in output is estimated to result, on average, in a 0.6 percent budget deficit in the EU. Therefore, the 3 percent deficit reference value under EMU is consistent with a 5 percent below-trend deviation in GDP. However, a waiver from the reference value can be invoked in the event of a 2 percent contraction in GDP– which provides for a sufficient margin from potential growth of about 2 percent for most EU members.

2. **Savings Arithmetic à la Rangarajan and Srivastava (2004)**

Using standard equations of debt dynamics, Rangarajan and Srivastava derive the following conditions for the stabilization of debt and fiscal deficit respectively[18].

$$b^* = p\left(\frac{1+g}{g-i}\right) \tag{5}$$

$$f^* = \left(\frac{p \cdot g}{g-i}\right) \tag{6}$$

where b^* denotes the long-term equilibrium value of the debt to GDP ratio, p is the primary deficit to GDP ratio, g denotes nominal GDP growth rate and f^* is the long-term equilibrium value of the fiscal deficit to GDP ratio. Using 5 and 6 they arrive at

$$b^* = f^* \frac{(1+g)}{g} \tag{7}$$

Given the fiscal deficit ceiling of 3 percent in the FRBM Act, they derive the following implications from the above formulations. First, the debt to GDP ratio will eventually stabilize at 28 percent. Moreover, a primary deficit may be sustained as long as nominal GDP growth out-paces the nominal interest rate. In particular, if nominal growth and interest rates are assumed at 12 and 7 percent respectively, then a primary deficit of 1.25 percent of GDP is consistent with equation (7).

The Twelfth Finance Commission used this analysis to recommend a combined fiscal deficit of the Centre and States of 6 percent of GDP. Given that household savings are of the order of 10 percent of GDP and assuming a current account deficit of 1.5 percent of GDP, the Commission held that a 6 percent combined fiscal deficit would be adequate to provide an absorption of 4 percent of savings by the private corporate sector and 1.5 percent by non-departmental public enterprises. Equation 5 implies that a combined fiscal deficit of 6 percent would imply that overall debt on the combined account would stabilise at 56 percent of GDP.

[18] See the Report of the Twelfth Finance Commission, pp 69-71, Section IV of Rangarajan and Srivastava (2004) for details.

6.3 Well Defined Escape Clauses

Numerical fiscal rules are not a panacea in themselves. They must be complemented with a set of procedural rules as well as measures to enhance transparency in the Government's fiscal conduct. Strengthening of these supporting fiscal frameworks is important to ensure the monitoring and enforcement of such rules. One key feature of this supporting framework is that of having a well-defined escape clause that may allow the government to breach targets in the event of some unforeseen macroeconomic shock such as a natural disaster or economic recession. Thus, escape clauses help provide flexibility in a strictly rules-based fiscal architecture.

Some of the broad principles that should go behind the design and construct of escape clauses are:

1. **Limited applicability:** The range of factors for which exercising an escape clause will be permitted should be limited. Therefore, escape clauses should be applicable only in the event of rare occurrences that would justify flouting the set numerical targets.

2. **Clearly specified:** The guidelines that define the events for which exercising an escape clause is to be permitted should be clearly enunciated and there should not be any room for interpretation. This will protect from escape clauses being implemented in order to justify a deficit bias.

3. **Post-deviation correction mechanisms:** The path back to fiscal consolidation must be clearly defined once an escape clause has been enacted. The treatment of the accumulated deviation, for example, higher public debt or a larger fiscal deficit must be enunciated in well defined correction mechanisms.

In order for escape clauses to be effective, however, they need to be well-specified. This is difficult because if potential trigger events were explicitly defined, it would dilute the idea of attaching flexibility to rules and likely suffer from the problem of exclusion. However, nebulous definitions create room for interpretations. For example, pre-2009 German fiscal rules allowed for deviations from the consolidation path in case of "a disturbance of the macroeconomic equilibrium", which was frequently used to justify exceeding the deficit ceiling. In India, the escape clause allows for deviations in case exceptional circumstances "as the government may specify". The Swiss and Spanish fiscal rules mention "exceptional circumstances" are adequate to adopt escape clauses usually justified by events such as natural disasters or recessions etc. In Switzerland the event has to be approved by a super-majority in the Parliament. Both countries are, however, equipped with a medium term correction plan within their fiscal framework in case escape clauses are adopted.

Botswana, Chile and Norway have had notable success with resource fund implementation. However, many countries such as Mongolia, Nigeria, Ecuador, Chad and Papua New Guinea faltered because of weak enforcement. Therefore, it is imperative that rules be defined clearly such that loopholes cannot be exploited to breach targets and justify suspension. In most of these resource rich countries, fiscal rules are linked to non-resource fiscal behavior. But they are usually coupled with nebulously defined escape clauses. This allows governments to suspend rules and breach limits. Institutional weaknesses also highlight the problem of lacklustre enforcement mechanisms.

In this context, of particular importance is the flexibility that the escape clause affords over the cycle of commodity process. Emerging Economies often experience procyclical foreign capital inflows. This creates vulnerability in the domestic markets. In order to cushion from such exogenous blows, several EMEs have well specified fiscal rules with respect to windfall gain/loss because of swings in commodity prices in international markets. Table 4 gives a snapshot of escape clauses in different countries that are calibrated, in different forms, to the volatility in commodity prices. Though the country discussed are all commodity-exporters, similar escape clauses could be a useful tool for commodity-importers such as India.

Table 4: Escape Clauses Calibrated to Commodity Prices

Country	**Escape Clause**	**Description of Rules**
Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon	No	Supranational rules as adopted by CEMAC. Oil revenue is replaced with its three year moving average while calculating basic structural fiscal balance. They also specify that non-oil fiscal balance in per cent of non-oil GDP should be in balance or surplus.
Ecuador	No	BBR (2003-09) annual reduction in non-oil deficit until a balanced budget is achieved
Mexico	Yes. If non-oil revenues are below their potential due to a negative output gap, there can be a deficit equivalent to the shortfall. (2006)	BBR (since 2006): Balanced budget on a cash basis established in the FRL. It applies to the federal public sector which includes the central government, social security, and key public enterprises (e.g., the oil company PEMEX and the electricity company CFE). It includes a reference price for oil that is set by a formula and also a system of four stabilization funds, including an oil stabilization fund. Starting with the 2009 fiscal year, the definition was changed to exclude the investment outlays of the state-owned oil company Pemex from the balanced-budget rule. This change reflects general reforms aimed at boosting investment in oil projects and the inclusion of all Pemex's investment projects as budgetary investment. The escape clause was used in 2010, 2011 and 2012. The 2006 Law includes sanctions for non-compliance. An escape clause establishes that under exceptional circumstances there can be a deficit envisaged in the budget. The escape clause was used in 2010, 2011 and 2012.
Russia	Yes (2013,14)	National rules: ER (effective from 2013): Parliament adopted in mid-December 2012 a new oil-price based fiscal rule. The rule sets a ceiling on expenditures (oil revenue at the "base" oil price, plus all non-oil revenues, plus a net borrowing limit of 1 per cent of GDP). Oil revenues above the base oil price need to be saved in the Reserve Fund until it reaches 7 per cent of GDP (though there are some allowable exceptions to this under the law).
	NA	Once the Reserve Fund reaches this threshold, at least half of excess oil revenues should go to the National Wealth Fund, while the remaining resources would be channelled to the budget to finance infrastructure and other priority projects. Starting in 2013, the rule will use a 5-year backward-looking average of oil prices as the base, which will gradually increase to a 10-year average by 2018, to avoid abruptly moving to a very low base oil price.
		BBR (2007-09): The BBR was approved in 2007 and became effective in 2008. Under the BBR, Russia's legal fiscal framework relied on the non-oil balance as a key fiscal indicator. The budget included a long-term non-oil deficit target of 4.7 per cent of GDP. This was suspended in April 2009 as a result of the global financial crisis, and formally abolished in 2012.

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