

**Role of Fiscal Responsibility and Budget  
Management Act in Restoring Fiscal Balance in  
India**

**A Thesis Submitted for the Degree of  
Doctor of Philosophy  
in Economics**

**By**

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2010**

*Dedicated to My Beloved Parents.....*

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## **DECLARATION**

I hereby declare that the work embodied in this dissertation entitled “**Role of Fiscal Responsibility and Budget Management Act in Restoring Fiscal Balance in India**” carried out under the supervision of **Prof. J V M Sarma** is an original research work carried by me within the full period prescribed under Ph.D. ordinances of the University of Hyderabad.

I declare to the best of my knowledge that no part of the thesis was earlier submitted for the award of research degree of any University or Institute.

Place: Hyderabad  
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## ***ABBREVIATION***

BoP: Balance of Payments

CE: Capital Expenditure

CT: Central Transfer

CSS: Centrally Sponsored Schemes

DCRF: Debt Consolidation and Relief Facility

EFC: Eleventh Finance Commission

FRF: Fiscal Reform Facility

FCs: Finance Commissions

FR: Fiscal Responsibility

FPRs: Fiscal Policy Rules

FRBMA: Fiscal Responsibility and Budget Management Act

FRFs: Fiscal Reform Facilities

FRLs: Fiscal Responsibility Laws

GDP: Gross Domestic Product

GFD: Gross Fiscal Deficit

GSDP: Gross State Domestic Product

GDFC: Gross Domestic Product at Factor Cost

GDMP: Gross Domestic Product at market price

GOI: Government of India

IMF: International Monetary Fund

IP: Interest Payments

MOU: Memoranda of Understanding

MSS: Market Stabilisation Scheme

MTFRPs: Medium Term Fiscal Reform Programs

NPRD: Non-Plan Revenue Deficit

NSSF: National Small Saving Fund

OLS: Ordinary Least Square

OD: Outstanding Debt

OWTR: Own Tax Revenue

OWNTR: Own Non Tax Revenue

PC: Planning Commission

PD: Primary Deficit

PSUs: Power Sector Utilities

RBI: Reserve Bank of India

RD: Revenue Deficit

RE: Revenue Expenditure

SPUs: State Power Utilities

SNG: Sub National Government

TDS: Tax Deduction at Source

TIN: Tax Information Network

TFC: Tenth Finance Commission

TWFC: Twelfth Finance Commission

VAT: Value Added Tax

WMA: Ways and Means Advance

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## **Chapter-I**

### **Background, Issues and Objectives of the Study**

#### **1.1. Introduction**

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

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

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

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

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

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

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

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

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

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

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

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crowding out of private investment, and reduce income redistribution from wage earner to interest earner (Kopits and Symansky, 1998).

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

### **1.2. Rationale for Fiscal Responsibility in India**

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

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

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a welcome downward shift since 2002-03 declining to 0.2 per cent for 2007-08. Due to the global economic crisis it is again estimated to up to 5.5 per cent for 2009-10(BE).

Persisting fiscal imbalance in India has been a major macro-economic concern to policy makers. More and more revenue deficit implies preemption of private saving for government current consumption which tends to crowd out private investment without corresponding increase in capital spending by the government. It is also recognized that since the 1990s primary deficit has turned negative, implying that states are borrowing to meet their current expenditure or significant part of the fiscal deficit is due to the burden of the serving the past debt. It is obvious that, it is not the problem of growing deficit, which deserves concern, but the composition of this deficit and the way it is being financed because the impact of fiscal deficit depends on it (Mohanty, 2004).

### **1.3. India's Efforts towards Achieving Fiscal Responsibility**

India has been tackling the fiscal deterioration by adopting fiscal reform mechanism to improve fiscal responsibility. In the last decade India has enacted mechanisms to bind government to fiscal rectitude through formal legal or even constitutional devices.

In 2000-01 the finance ministry issued guide lines to state for Medium Term Fiscal Reform Programs (MTFRPs). The MTFRP had dual aim of reducing wasteful expenditure (cutting low priority spending) and improving tax collection or improving the efficiency of the tax administration. The MTFRPs required states to make time bound reform in four areas like, fiscal, power, and public sector and budgetary. The main objectives of MTFRPs were to bring the consolidated fiscal deficit to sustainable levels by 2005 and to bring down debt-GDP ratio as well as interest payment MTFRPs could not achieve its target rather during this time period fiscal situation deteriorated. There was a design failure in prescribing a uniform 5 per cent point improvement in the ratio for all states. If states started off with larger base year deficits, it became relatively easier for them to make huge improvements.

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On April 2000 the Eleventh Finance Commission (EFC)<sup>1</sup> recommended, an incentive fund in the form of Fiscal Reform Facility (FRF). EFC recommended releasing 15 per cent grant to the states by linking with improvement in fiscal performance. Under FRF, Government of India prescribed a single monitor able indicator for the purpose of making releases from the incentive funds. The indicator expected each state to achieve a minimum improvement of 5 per cent in revenue deficit/ surplus as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-2000.

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

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

Thirteenth Finance Commission has recommended two debt relief measures to be extended to all states. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to states contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9 per cent. The Commission has also recommended that structural reforms should be brought in the

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<sup>1</sup> The Finance Commission is a constitutional body established under article 280 of the Indian Constitution every five years with the primary purpose of determining the sharing of centrally collected tax proceeds between the central and state governments and the distribution of grants-in-aid of revenues across states. The terms of reference of the Finance Commissions can be expanded by order of parliament.

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NSSF to make it more market linked. The second debt relief recommended by the Commission is write-off of Central loans to states. All the above mentioned debt relief is available to states only if they amend/legislate FRBM Acts in accordance with the recommendations of the Commission. The Commission has also recommended that the states will be eligible for the states Specific Grants only if they comply with this condition.

In 2003 the central government of India enacted FRBM Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macro economic variable. In terms of Fiscal Responsibility and Budget Management (FRBM) Act centre's fiscal deficit was required to be reduced to 3 per cent of GDP and revenue deficit to be eliminated by 2008-09. The rules under the Act further require the central government to reduce the revenue deficit by an amount equivalent to 0.5 per cent or more of GDP at the end of each year beginning with 2004-05. The fiscal deficit is to be reduced by 0.3 per cent or more of GDP at the end of each financial year beginning with 2004-05. Similarly, acting in response to the debt relief package recommended by TWFC in return for fiscal correction, almost every state except West Bengal and Sikkim has enacted Fiscal Responsibility Acts. States government accepted similar obligations of reducing fiscal deficit to 3 per cent of Gross States Domestic Product (GSDP) and eliminating revenue deficits by 2008-09. The case for fiscal responsibility, both at the centre and in the states, was made on the argument that fiscal consolidation is an essential condition for accelerating growth.

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

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

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

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### **1.4. Objectives of the Study**

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

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

### **1.5. Approach and Methodology of the Study**

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

The effectiveness and suitability of the recent FRBM Act has been found by analyzing provision and rules under taken by FRBM Act. In order to study the impact of FRBM Act

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on fiscal indicator, the performance of major fiscal indicators trend such as, Gross Fiscal Deficit to GDP ratio, Revenue Deficit to GDP ratio, Primary deficit to GDP ratio, Tax to GDP ratio, Revenue expenditure to GDP ratio, capital expenditure to GDP ratio and Total Outstanding Liabilities to GDP ratio trend have been analyzed before and after the FRBM Act, both at the central as well as at state level.

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

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

$$Y - r > 0 \quad (1)$$

$$r = (IP) / (OD)_{t-1} \quad (2)$$

Where,

Y= Trend growth rate of GDP at current Market price

r = Average Interest Rate, IP= Interest Payment, OD = Outstanding Debt, t = Time Period ( $r < g$ ).

### 1.6. Data and Period of Study

The data for the study have been collected from the secondary sources. Indicator such as GDP (at market price), Population, Gross Fiscal Deficit, Revenue Deficit and Primary Deficit has been taken from *Handbook of Statistics on the Indian Economy*, which is published by Reserve Bank of India. For state level analysis data has been taken from *State Finances: A study of Budget*, which is also published by Reserve Bank of India. The yearly data have been taken for the period of 1980-81 to 2008-09.

### **1.7. Justification of the Study**

The study tries to find out the rationale of rules based fiscal policy in India and their appropriateness. The effectiveness and suitability of FRBM Act is still a debatable issue. There exists a lot of literature on measuring the effectiveness of rules based fiscal policy in different countries. But there are very few studies in the context of India. That is what provides the motivation for the present study. The present study tries to analyze how the fiscal policy rules have been designed in different countries and how they are different from India. It also does a critical review of the performance of fiscal indicators taken under fiscal Responsibility and Budget Management Act and their appropriateness.

### **1.8. Organisation of the Thesis**

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

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

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

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

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

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

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

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

Finally, the eighth chapter summarizes the study, concludes and suggests for improving the fiscal monitoring mechanism in India.

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## Chapter-II

### Review of Literature

#### 2.1. Introduction

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

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

#### 2.2. Studies Relating to Rationale of Fiscal Policy Rules

International Monetary Fund (2006) focuses that sound and sustainable government finances play an important role in promoting macroeconomic stability and growth. High

quality fiscal adjustment can also mobilize domestic savings, increase the efficiency of resource allocation, and help meet development goals. Loose fiscal policy, on the other hand, can lead to inflation, crowding out, uncertainty, and volatility, all of which hamper growth. Successful fiscal adjustments durably and efficiently improve the fiscal position while minimizing any welfare costs. Success depends on a range of factors, especially, the timing and speed, size, and quality of adjustment. Adjustment will be more successful when well coordinated with monetary policy. The exact amount of fiscal adjustment needed depends on individual country circumstances, objectives. Fiscal adjustment is needed for countries which face macro-stability constraints. The success of fiscal adjustment, in particular, the growth response, depends on the quality and durability of the specific measures that underpin it. Government expenditures that are productive and a tax system that is efficient and broad based contribute to growth and development, and measures that are perceived as durable allay concerns about debt sustainability and alter people's behavior. Fiscal responsibility laws, transparency, and good governance, can also play an important role in achieving high quality, durable, adjustment. There is also some evidence to suggest that emerging market economies with lower subsidies and transfers or higher revenues are more likely to sustain consolidations. Similarly, developing countries that cut selected current spending while protecting capital expenditures tend to experience longer lasting adjustment. For countries with low revenue-to-GDP ratios (as in most developing countries), revenue increases can also lengthen the duration of fiscal consolidation. For the success of fiscal responsibility law Institutions should be sufficiently developed to support the requirements included in the framework. Public finance management systems, in particular, should be sufficiently advanced to credibly implement the procedural and fiscal rules and to enforce them. They require broad political consensus to be successful and are not a substitute for political commitment. While the adoption of fiscal responsibility laws can potentially serve as a catalyst for meaningful reforms promoting fiscal prudence, experience suggests that broad support for fiscal prudence is a pre-condition for their success. Designing the framework takes time and should be geared toward addressing country-specific weaknesses in fiscal management that lie at the root of poor fiscal outcomes. These requirements may not be met in countries facing large macroeconomic imbalances or

political instability. They should cover a broad definition of government. Those targeting a broader coverage of the public sector tend to be more successful than those using a narrow indicator. In countries with a weak track record of policy implementation, procedural rules may work better than numeric rules. Under these circumstances, fiscal discipline can be promoted through increased transparency and accountability. If including numeric fiscal rules, these should be carefully designed. Numerical rules can potentially be helpful, for instance, in containing a deficit bias, but are not in themselves the solution to structural fiscal problems. Numeric fiscal rules could even foster creative accounting and low-quality measures. Fiscal rules should be: (1) well defined regarding the specific fiscal indicator to be targeted, the institutional coverage and, if any, escape clauses; (2) simple and transparent, to serve as an effective instrument of communication of government policy objectives; and (3) monitorable, so that noncompliance can be easily detected and addressed. Their credibility ultimately depends on the government's track record and on political and social consensus. Enforcement mechanisms should be credible and effective. Escape clauses should be reduced to a minimum to ensure the credibility of the process. They should enhance transparency. Countries with poor transparency and budget procedures are also unlikely to monitor effectively a meaningful quantitative fiscal target or enforce accountability.

Heller (2002) provides a perspective on how the IMF assesses a 'sound fiscal policy' focusing principally on industrial and emerging market economies. It observes six central criteria: the short term fiscal policy stance, with greater emphasis on automatic stabilizers than discretionary fiscal policy, relevance of medium and sometimes long term issues: fiscal sustainability capacity for aggregate fiscal policy implementation (including political economy factors) structural content of fiscal policy (tax efficiency and public expenditure quality) and institutional governance and process issues associated with budget implementation and revenue collection. Greater emphasis could be placed on adequate margin to deal with uncertain long term challenges. What constitutes a sound fiscal policy in one country will differ from that in another. Automatic stabilizers should be allowed to operate high tax burden is not conducive to increasing labour supply and could become a constraint on economic growth. Meeting a more stringent

expenditure target while accommodating higher spending in priority areas would require a critical review of other areas, including social spending where spending is relatively high by international standards. Short term fiscal policy stance should consider not only the position of central government, but also sub federal level, extra budgetary agencies and public sector enterprises. Aggregate expenditure policy should be set according to medium term targets, rather than allowing them to higher (lower) in weak (boom) period. Having sets its fiscal policy objectives; Government should have a demonstrated capacity-analytically, legislatively and institutionally to coordinate, manage and implement aggregate fiscal policy to achieve them. IMF recognizes institutional rules can play an important role in achievement of broad fiscal policy objective. IMF emphasizes on structural content of fiscal policies. Importance is given to macroeconomic aggregates. Efficiency and effectiveness of public expenditure programme should improve and dead weight losses associated with mobilization of tax revenue should minimize. IMF had a bias towards expenditure reductions rather than tax increases, particularly for more advanced economies with already high tax rate burden. Emphasis should be given to minimize the adverse allocative effects and to instill an investment and growth supportive environment. Excessively high margin tax rates should be reduced and broadening of tax base and tax neutrality should be emphasized. IMF emphasizes the importance of high quality; transparent budget process, good governance and a well manage expenditure and revenue administration. Sound fiscal policy should be supported by an efficient system for managing public expenditure and collecting revenues.

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

Drazen (2004) highlights a number of conceptual issues in the political economy of fiscal rules. This paper gives significant insight into why rules often don't work – they don't address the cause of fiscal bias; they attach no real costs to deviating from the rules; they attach no real cost to changing the rules. It also suggested some different kinds of costs that may help enforce rules. Both perspectives should be helpful in thinking how rules should be designed. This paper concerned the more basic question of what problems a fiscal rule is meant to address and how a rule can address these problems. This in turn

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

Eslava (2006) reviews the recent literature on the political economy of fiscal policy. Three lines of argumentation and their empirical implications have been considered:

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

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

Rao and Nath (2000) explain fiscal adjustment in India is essentially crisis driven. Once the immediate compulsions were met, not much steam was left to make real changes. Since the attempt has been only to create an illusion of fiscal adjustment, fiscal consolidation has remained an elusive goal. Illusion of reforms has been created by placing emphasis on an inadequate measure of fiscal balance. Even in containing the fiscal deficit, the performance of the government has been dismal, but to show it in better light the scope and definition have been changed from time to time. In terms of comparable fiscal deficit numbers, there is not much to commend the effort to contain the imbalance. On the contrary, emphasis on fiscal deficit has caused distortions, as containment of the fiscal deficit was achieved by crowding out infrastructure investment expenditures at the margin. In terms of achieving fiscal correction in the real sense, the performance of the government during the last decade leaves much to be desired. The revenue deficit rather than showing a decline has increased over the years and this has happened despite reduction in the current transfers to the state governments. Equally worrisome is the sharp decline in capital expenditures and the effects of infrastructure bottlenecks are already visible in the economy. Thus the story of fiscal adjustment in

India is one of choosing the wrong targets, operating the instruments in inappropriate ways and creating an illusion of achieving targets while the reality is entirely different. The government has been concealing deterioration in the fiscal balance by placing emphasis on the fiscal deficit rather than more meaningful summary measures, and frequently changing its definition and method of measurement. Analysis shows that on a comparable basis fiscal deficit reduction has been marginal. On the contrary, other fiscal indicators have shown significant deterioration. Thus the claims about fiscal adjustment are illusory. Fiscal consolidation in India perhaps requires another crisis.

Kopits (2001)<sup>b</sup> assesses the potential usefulness of fiscal policy rules for India, in the light of rapidly growing international experience in this area. As part of this assessment, it explores various design options and institutional arrangements that seem relevant for India, in the context of the Fiscal Responsibility and Budget Management Bill. India's public deficit bias and indebtedness cannot be sustained much longer, especially with stepped-up external liberalization. Thus, there is a strong case for adopting fiscal responsibility legislation that involves: a high degree of transparency; well-designed fiscal policy rules at the national and sub-national levels of government; short-run contingency measures and a multiyear macro-budgetary process; an institutional framework for implementation of rules; and appropriate preparation and sequencing, including the phase-in of supporting structural reforms. As illustrated by international experience, all of these components are critical for the success of fiscal policy rules in India. The bill recently submitted to parliament goes a long way toward incorporating many of these elements. However, the bill leaves considerable scope, partly through delegated legislation, to strengthen provisions on the balanced-budget requirements and the public debt limit that are open to interpretation. An important step in this regard would consist of shifting to accrual accounting, which implies redefinition of the balanced budget rules in terms of operating balance. More important, the bill is silent on an area that has yet to be addressed, namely, the modalities of fiscal responsibility at sub national levels of government. In fact, a major challenge in India will be to extend fiscal policy rules to sub national levels, while preserving a sufficient degree of regional or local autonomy. There are some institutional issues especially, those with significant and

complex political economy implications on which it is difficult to formulate specific recommendations. Lessons for India from the experience of other countries, for example, on the statutory instrument, the authority of arbitration, or on the sanctions for noncompliance, are mixed. On transparency, however, the lessons are unequivocal: clarity in institutional arrangements (intergovernmental fiscal relations, relations between the government and the so-called public accounts, relations between the government and public utilities), in fiscal reporting (including timely, accurate and comprehensive financial statements) and in accounting (in particular through accruals-based treatment). To ensure the success of the rules, their implementation needs to be preceded by a concerted outreach campaign, broad legislative consensus, and an adequate convergence path, all of which are beginning to be tackled in the context of the bill.

Khatri and Kochar (2002) discuss the lead up to the current fiscal situation in India; compare India's key fiscal indicators with those of other emerging markets, and draws lessons for India from the successful fiscal adjustments of other countries. India's deficit and debt levels are high by international standards and are broadly accepted to be unsustainable. Revenue to GDP in India is significantly lower than that of other emerging markets (while expenditure is comparable), suggesting much scope to pursue improvements in revenue collection. Factors such as the size and composition of the adjustment, and a high initial debt level are associated with these successful fiscal adjustments. Concerted effort to substantially reduce fiscal deficits is required. Increasing deficits, a growing debt stock and a narrowing of the growth-interest rate differential imply that the conditions for fiscal sustainability have further worsened. The current level of the primary deficit, if left unchecked, implies a growing and unsustainable debt stock. Further, the international comparisons show that India's revenue to GDP ratio is particularly low. Thus while reductions in the public sector wage bill, inefficient expenditure and government subsidies are essential, the key challenge appears to be on the revenue side to get agriculture into the tax net, to increase the taxation of services, and to raise the number of tax payers, particularly high income tax payers. As in other countries, many groups in India will oppose deficit reduction, but the literature on the political economy of fiscal adjustment provides some grounds for optimism. While that

literature indicates that consolidation may be more difficult to pursue for a coalition government, as is in power in India, there is no evidence of a systematic electoral penalty or decline in popularity for fiscally prudent governments. The need for ensuring corrective action in a “depoliticized” framework of fiscal rules prompted the push for Fiscal Responsibility legislation. The draft legislation specified target rates for reduction of the central government deficit and revenue deficit, and a target debt to GDP ratio. Whatever form the bill eventually takes, it will be important that its medium term objective is to achieve a sustainable fiscal situation. This will be difficult to achieve unless two essential features of the draft bill committing to a rules based reduction in deficits and the ultimate target of a zero revenue (current) balance are retained in the final legislation.

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

However, it is moot if 2 per cent level of borrowing will be sufficient to meet the development needs of the economy

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

is unlikely to grow out of its debt problem in spite of today's low interest rates. To the contrary, a fiscal adjustment is needed to underpin faster growth.

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

eliminating the revenue account deficits is only a misnomer. India needs a policy for fiscal prudence but FRBM in its present form is not the answer.

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

Builter and Patel (2005) explain in India overall net public debt burden does not give cause for immediate alarm. The reasons India has remained fundamentally solvent despite the sustained fiscal deficits of the past twenty years are fast nominal GDP growth and financial repression. Capital formation is a key driver of the growth of potential output. With India's continuing widespread capital controls and persistently small inward foreign direct investment, the volume of capital formation in the country is constrained by domestic saving. Depressed by the continuing large public sector deficits, the national

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

Kochhar (2006) examine both the evolutions of fiscal imbalances and key developments in major macroeconomic variables in order to assess the macroeconomic impact of the growing fiscal imbalances. Keeping in view the persistent fiscal imbalance and indebtedness, arguably, the fiscal situation is the single biggest threat to macroeconomic

stability. The rising fiscal imbalances and debt reflects a weakening in revenue mobilization, persistent deficit at Centre and State level and narrowing of the gap between real interest rate and growth rate. The author interestingly finds that on account of high fiscal imbalance there were hidden costs on the economy in terms of the foregone potential for even higher economic growth than that has recently been experienced. The large and increasing fiscal deficit led to a crowding out of productive public expenditure and constrained the scope for further structural reforms and liberalization and rooms for macroeconomic policy maneuver adversely impacting the growth prospects. In order to avoid the crisis, the author feels that there is strong need of revenue mobilization efforts and reorientation of expenditure away from subsidies and towards physical and social infrastructure projects. India's medium term economic prospects, among others depend critically on progress with the closely intertwined tasks of fiscal consolidation and structural reforms. The rising level of fiscal imbalances and resultant high level of debt may create a vicious circle inducing a fall in the ratio of private to total credit, rising inflation and falling economic growth.

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

Singh and Srinivasan (2006) assess India's current fiscal situation, its likely future evolution and impacts on the economy. The authors examine possible reforms of macroeconomic policy and broader institutional reforms that will bear on the

macroeconomic situation. The authors also take into account the factors such as political feasibility of possible reforms. They also examine both medium and longer run scenarios, fiscal sustainability and adjustment going beyond conventional government budget deficits, to include off-budget liabilities, both actual and contingent. They concludes that some short run fiscal adjustments are clearly necessary to avoid any possibility of a crisis, but at the same time more fundamental adjustments in the tax system, the structure of the expenditure and the financial sector must be on the agenda for reforms.

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

Srivastav (2008) discusses the rationale of fiscal policy rules arising from both political economy literature and conventional public finance literature. He reviewed the international experience regarding fiscal policy and fiscal transparency rules. He analyzes states FRBMAs and related experiences. Empirical evidence supports at least in an international setting the predictions of models based on opportunistic manipulation of

fiscal policy. First debt accumulation is related to the degree of transparency of the budget. Second while, there appear to be electoral increase in fiscal deficits and government expenditures, these are limited to countries where voters are less successful in monitoring fiscal outcomes. There are some shortcomings in center's FRBMA. Many countries are going for defining fiscal deficit targets in countercyclical intervention can be strengthened by having reliable forecasting models for anticipating downturns. This should be done after the debt GDP ratio has fallen significantly. It can also be undertaken earlier if the household sector's savings in financial for increases and a private investment is not able to absorb it. It is best to stick with revenue deficit target. This is specified in the Act rather the rules in center's FRBMA. It can also make better economic sense for government not to use up available saving for current or consumption expenditure. There is an improvement in the deficit indicators comparing the levels relative to GDP before and after the FRBMA. The improvement was not only the result of following the targets until 2007-08 but also because of steady improvement in the growth rate. In fact, very largely the fiscal improvement was responsible for the increase in growth rate. In particular, the improvement in the revenue deficit was responsible for an increase in the savings ratio for about 4 percent point.

Rajaraman (2006) focuses on the factors underlying the continued weak fiscal position during the previous one and half decades as well as the prospects of recent fiscal reforms. The author identifies that the impact of trade liberalization measures and their associated loss of tariff revenue remained the major factor underlying the weakened fiscal position since the early 1990s. Unlike other countries which undertook tariff rate reductions, India did not compensate the loss of revenue by a commensurate increase in domestic taxes. The author is of the view that buoyant growth in India is essential for fiscal reforms to be possible and this requires that the kinds of physical and social infrastructure should go up in both quality and quantity. The author finds two strands to the fiscal imbalance path in India. First, high interest rates on public debt which started rising sharply in the 1980s and details the political economy pressure that fuelled this rise. Second, non-interest fiscal indicators which worsened sharply in 1998 with the real wage hike introduced that year for government employees and pensioners raising the consolidated salary bill

substantially. An econometric exercise investigates whether this event was endogenous to the political economy. The regression equations show an election year response, which has become more marked in the last 30 years. The author recognises the importance of two major reforms, *i.e.*, the reforms of the interest rates guaranteed under the NSSF and passage of the Fiscal Responsibility Legislation.

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

Hausmann and Purfield (2006) provide thought provoking views and find that India's tendency to run large deficit and accumulate debt has deep institutional roots embedded in its highly decentralized democratic system. The paper mainly studies three aspects of fiscal consolidation. First, it accounts for the lack of symptoms of an impending crisis by pointing to some aspects. However, the lack of symptoms is double-edged sword: it makes crisis less likely for any level of debt, but society is less responsive to fiscal imbalances, thus making the eventual problems much larger. Second, it analyses possible implications of the fiscal responsibility legislation on India's imbalances. Third, it studies India's federal system and the role of States in the fiscal adjustment effort. The authors find that India's ability to tolerate high deficit and debt without encountering the types of crises experienced by many other emerging economies is a mixed blessing. It reflects the comparatively large and closed nature of its economy as well as its deep domestic capital market and large, albeit captive, pool of domestic savings. The last has allowed the Government to finance deficits with long term fixed rate debt instruments. The authors recognize the recent institutional reforms based on legal backing. The authors suggest a State level fiscal consolidation plan including those of imposition of borrowing ceiling on States to constrain their deficits and reforms to the system of intergovernmental transfers

to give a more stable and reliable source of revenue. In a federal set up, stable and reliable sources of flow of funds helps in formulating the future strategies at sub national levels governments. For sound fiscal management, however, the efforts should be undertaken by both the Central and State Governments. The federal budgetary systems bring especially difficult challenges.

### **2.5. Studies Relating to Against Fiscal Policy Rules in India**

Patnaik (2006) explains there is no theoretical reason cited for having a fiscal deficit target of 3 per cent. FRBM act has been enacted because it is a sound finance but because international speculators demand it. Fiscal deficit financed itself by generating an excess of domestic saving over private investment exactly equal to itself. If the objective of an economy is, employment generation public expenditure through borrowing finance is useful. On the other hand, a society with egalitarian goals should aim to keep down fiscal deficit, and finance public expenditure through progressive taxation.

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

### **2.6. Studies Relating to Fiscal Policy Design**

Kopits and Symansky (1998) address a number of questions. What are the fiscal policy rules? What are the principal benefits and drawbacks associated with various fiscal rules, particularly compared with alternative approaches to fiscal adjustment? Can fiscal rules contribute to long run sustainability and welfare without sacrificing short run stabilization? If so, what characteristics of fiscal rules make this contribution most effective? Growing interest in fiscal policy rules is in part attributable to the deterioration in fiscal performance, the so called deficit bias, experienced for more than two decades by a large part of the world. A fiscal policy rule is moderated by some attempts to reverse this trend. For a policy rule to be credible, it must involve commitment over a long period of time. Fiscal policy rules tends be more heterogeneous and complex than monetary and

exchange rate rules. They listed some desirable characteristics which any FPR should have. Ideally a, fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient. Binding fiscal policy rules are likely to influence the level and composition of government expenditure and taxation. In addition, fiscal rules have major macro economic consequences for inflation, external indebtedness, and economic growth. For the most part, economic performance under fiscal rules has been mixed. Besides a number of successes, some rules have been ineffective, suspended, or abandoned. In the advanced economies attempts to comply with fiscal rules contributed to a decline in inflation and interest rates, mitigated the crowding out of private investment, and alleviated the external imbalance. In developing economies, in the absence of sufficiently deep internal financial markets, restrictions on bank financing or domestic borrowing were partly accommodated by a substantial buildup in foreign indebtedness. To some extent, the latter was facilitated by the credibility gains associated with implementation of the fiscal rule. Apart from broadly favorable macroeconomic effects, compliance with fiscal rules has led to distortions in the composition of government expenditures or tax increases. On the expenditure side, often the brunt of the adjustment has been borne by cuts in public investment. In some instances, fiscal rules induced a lack of transparency in the budget process, proliferation of creative accounting practices, and recourse to one-off measures. Also distortions in tax structure and administration may have been compounded, along with an increase in the overall tax burden. In his paper a set of stochastic simulations were performed for the group of seven economies, on the basis of shocks derived from historical data, to ascertain the likely effects of various balanced budget rules on the variability of macroeconomic performance. A basic premise underlying these simulations is that if a major source of the variability is irresponsible fiscal policy, then fiscal rules will tend to dampen macroeconomic fluctuations. If, on the other hand, output variability is the result of disturbances due to shocks other than fiscal policy, then fiscal rules will be procyclical and will tend to exacerbate these fluctuations. In general, the source of overall macroeconomic variability is a result of shocks to the behavioral equations of the method. The effect of fiscal rules on output variability is determined by the relative size and

persistence of fiscal policy shocks compared with the size of other underlying shocks, and by their interaction with automatic stabilizers.

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

## 2.7. Studies Relating to Fiscal Policy Design in India

Rangarajan and Rao (2007) explains even if India achieve zero revenue deficits, and use borrowings only for investment expenditure as the golden rule, we still need to restrain fiscal deficits because the budgetary returns on investment are typically lower than the cost of borrowing. From an empirical perspective, it is true that our high fiscal deficits have not, over an extended period, had an adverse economic impact by way of higher inflation or interest rates. But this apparent paradox is the result of a fortuitous combination of circumstances. The economic reforms launched in 1991 – notably, the abolition of industrial licensing, degeneration of industries and trade liberalization – had unleashed competitive forces resulting in higher investment as well as higher efficiency in production leading to an increase in production capacity which ran ahead of demand. It was because of this sluggish private investment demand that we escaped higher interest rates despite higher fiscal deficits. It is argued that internationally fiscal rules do not target revenue deficits; they focus instead on the fiscal deficit and on the primary deficit . The case for focusing on the primary deficit is simply that interest costs on accumulated debt are outside the scope of government control and while they may vary with interest rate changes, this variation does not reflect the quality of fiscal control. It is not correct to say that the revenue deficit target is not internationally recognized. The UK, for example, has the ‘golden rule’ which mandates the government to restrict borrowing to the extent of capital expenditure. Accordingly, under the golden rule, capital expenditure equals borrowing plus any plough back from surplus on the revenue account. The golden rule is, therefore, similar to our zero revenue deficit targets. In a conceptual sense, of the three variables, fiscal deficit, primary deficit and revenue deficit, it does not matter which two variables we target. It is argued that India too must adopt a similar cyclically adjusted fiscal management. Notwithstanding the appeal of this argument, we would be better off with a fixed target. A cyclically adjusted policy works only when the debt-GDP ratio is already at a sustainable level. Debt sustainability and fiscal deficit are interlinked and should not be viewed on a stand-alone basis. In our case the debt-GDP ratio is above the sustainability level. We need to first bring it down and then stabilize it at that low level. This cannot be achieved unless we maintain a low fiscal deficit over a period. A cyclically adjusted policy can certainly be an option after the adjustment phase is

complete. Cyclical adjustment, of course, presupposes that the economy is subject to economic cycles.

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

Howes and Jha (2004) argue on the basis both of international experience and on the basis of the specific circumstances that India is facing. From the international experience they drew a negative conclusion from international experience with FPRs that they are neither necessary nor sufficient for fiscal adjustment. The argument in favour of introduction of FPRs is India's failure in the last ten years to produce fiscal adjustment in India either at the central level or the state level. In India much-needed fiscal adjustment

would be enhanced by the introduction of legislated fiscal policy rules (FPRs) at the levels of the state as well as that of the central government. India's borrowing regime allows state government's greater freedom except for foreign debt. GOI actual control of states' borrowing behaviour is far below its constitutional limit. Much borrowing by states is formula based, and so not linked at all to a state borrowing capacity. There is no points introducing a FPR covering only the budget, as government will go off budget borrow. Contingent liabilities should be capped, but in addition off budget borrowings where debt serving will fall to the government, should be consolidated with on budget borrowing in setting Targeting revenue deficit in the one hand protect capital spending on the other hand can lead to budgetary distortions. These can already be observed as states, for example, classify their budgetary support to the power sector as equity investments to avoid counting them as revenue expenditures. Another reason for targeting the fiscal rather than the revenue deficit is the need to cap off-budget borrowing, argued for above, much of which finances capital expenditure. With capital expenditures uncapped, states could continue to bankrupt themselves by shifting capital expenditure, and borrowing for the same, off budget. Capital spending in India generates very little revenue for government. It would thus seem that, whether or not a revenue balance target is given, the overall deficit should definitely be capped. While institutional reforms such as the introduction of FPRs cannot substitute for the policies needed to realize fiscal adjustment, they can help catalyze these reforms. Much more analysis and debate is needed for the choice of targets, reporting requirements and sanctions/corrective mechanisms, whatever is done in terms of introducing an FPR, it should only be contemplated by a reforming government, and as part of a reform package. Complementary actions will be needed to make the FPR a success. They are referring here not to the introduction of fiscal reforms, though of course this is crucial, but to complementary institutional measures. Improved forecasting, both inter- and intra-year, will also need to be part of the reform package. States generally have no estimate of their current year's GDP growth, let alone a forecast of the next year's. Tax forecasting models, like economic models, simply don't exist at the state-level in India, though they are taken for granted in states in developed country federations. Expanded capacity

within finance departments will be critical to enable these changes to be introduced, and to cope with the reporting requirements of any FPR.

## **2.8. Studies Relating to International Experience of Fiscal Policy Rule**

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

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

Public expenditure toward more productive uses is important for achieving more sustained fiscal adjustments. In particular, fiscal consolidation achieved through cuts in selected current expenditures, while protecting or increasing capital spending, tends to be more lasting. Revenue increases are also found to be critical to the persistence of fiscal consolidation. There is evidence, though generally weaker, that other variables are important for the duration of fiscal adjustments. For example, high levels of public debt

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

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

Kopits (2001)<sup>a</sup> reexamines the merits for and against fiscal rules. He identifies three broad lessons. First, governments with a strong reputation for fiscal prudence do not need

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

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

Hausmann (2004) observes that emerging market economies would benefit from fiscal rules that aim not only at eliminating deficits and reducing debt ratios but also, more importantly, at containing the risk in the composition of the debt. Managing the debt structure may reduce risk premia and allow rapid fiscal consolidation through self reinforcing reduction in interest rates.

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

## **2.9. Studies Relating to India's experience of Fiscal Policy Rule**

Rakhsith (2005) explains the statements submitted with 2005 year's budget in compliance with the Fiscal Responsibility and Budget Management Act (FRBMA) sets out medium term rolling targets for fiscal indicators; and explain the assumptions and fiscal strategy underlying the targets. The statements contain the usual quota of the ministry's good intentions, e.g., focus on outcome (rather than outlay) of government expenditures; broadening of the tax base; targeting of subsidies; and use of capital expenditure only for purposes of productive investment. However, there is no move towards or awareness of the need for revamping the current system of grossly distortionary and iniquitous system of direct taxes characterized by absence of any estate duty or inheritance tax; extremely liberal treatment of capital gains; and exemption of all dividends from personal income tax and of practically all financial assets from wealth tax. The most serious failing of the ministry's direct tax strategy lies in the absence of any move towards relating taxes to a fairer measure of ability to pay through an

integrated system of personal income tax, capital gains tax, wealth tax and inheritance tax so that scope for evasion is reduced, burden of taxation is equitably shared, and tax collections become GDP elastic. More important perhaps is likely to be the inefficiency resulting from adhering to the distinction between Plan and non-Plan expenditure; absence of any notion regarding optimal allocation of investible resources between PSEs and the government; and treatment of social sector expenditure as current, without any rolling target for its enhancement as a proportion of government expenditure or GDP (so that such expenditure is not squeezed out by the requirement of zero revenue deficit). The most glaring deficiency of the statements however lies in the absence of a coherent macroeconomic framework an absence that has prevented the ministry from appreciating the role of government expenditure, its composition and its alternative modes of financing in a demand deficient and supply constrained economy for purposes. Thus though the ministry recognizes the need for boosting demand at the present juncture of the Indian economy, it fails to recognize that existence of output gap and large foreign exchange reserves provides a golden opportunity of a significant step up in infrastructural and social sector investment for closing the gap, crowding in private investment, raising RBI holding of GOI securities at the expense of forex reserves and GOI bonds held by the public, and hence boosting the economy's growth potential and strengthening government finances both in the short and medium run.

Rao and Jena (2005) examine TWFC did not make any drastic changes in total statutory transfers. Equalization was broadly similar to past. In addition to it a critical evaluation of various recommendations relating to transfers recommended by finance commission has been done and also examined whether the plan is realistic and speculates on the prospects of achieving fiscal balance as laid out in restructuring plan evaluated the basic recommendation relating to tax devolution and grants. The structure of incentives and equity and efficiency implications of recommendations evaluated in. There is a considerable scope for improving tax-GDP ratio by strengthening tax administration and information. The gap filling approach has two important criticisms, which impact on both incentives and equity in the transfer system. The first is the taking the base year numbers-standardized non plan expenditures did not take note of differences in existing level of

services. The poorer states with low resources bases, continued to have low gaps and hence, low levels of transfers relative to their fiscal disability. In other words the relevant base should have been the fiscal capacity and non-plan revenue expenditure needs and not actual revenues and non-plan revenue expenditures. The sprinkling of norms by finance commission in growth rates, maintenance expenditures and public enterprises does not tantamount to estimating revenue capacities and needs. Therefore it is argued that the methodology failed to offset the fiscal disability of poorer states. The effectiveness of debt write-off scheme depends on how important this to each state. An individual state's response to incentive depends on the magnitude of the adjustment it has to make and the volume of gain by responding to the incentive. The former depends on the repayment liability of individual states on central loans from which the write-off was recommended which in turn more productive but which reduces the surplus, it should be accepted. In other words, the additional grants were simply substituted for spending from own revenues and the basic purpose of equalizing expenditure was not served. The appropriate design for this is to have open-ended specific purpose grants with matching requirements. To see the degree of equalization income elasticity of transfer was estimated which assumed that per capita GSDP represents taxable capacity. The estimates showed that ex-ante and ex-post elasticity's are the same in the case of ninth and tenth finance commissions awards for aggregate transfers and it is the ex-post elasticity that was marginally lower in eleventh finance commission. The equalization impact of TWFC broadly similar to those of ninth and tenth but marginally low than that of EFC. The TFC has had to make its recommendation considering the poor state of finances at both the central and state levels. The commission had to work out the fiscal restructuring plan in different fiscal environment.

Srivastav (2006) explains the targets for fiscal responsibility legislations were determined in the light of the experience of the 1990s where government debt and interest payments relative to GDP increased enormously following the award of the Fifth Pay Commission. With an inordinately high level of debt, and corresponding high interest payments liabilities, governments allowed public investment to steadily fall. Further, even high fiscal deficits could not increase primary expenditure of government making it difficult to

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

Mohanty and Singh (2007) explain major logic behind reducing deficits was that deficits lead to inflation. The Union Government has been able to reduce deficits. However, rate of inflation for almost all sections of population increased during FRBM era. While

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

Rao, Sen and Jena (2008) explain despite substantial improvement, the fiscal situation continues to be a matter of concern when off-budget liabilities and other fiscal risks are considered. A closer analysis of fiscal trends at central and state levels reveals that there are significant off- budget liabilities. In other words, the fiscal responsibility legislations have led the central and state governments to indulge in "creative accounting" to show lower deficits by pushing some liabilities outside the budget. The lower interest rates due to the debt swap scheme resulted in the lower debt service payments. Thus, the fiscal adjustment came about mainly through higher revenues. This increase was mainly due to increased revenues from direct taxes and partly due to increase in service tax revenues. State finances started showing steady improvement, thanks to higher growth rate of the economy and larger tax devolution due to buoyancy of central taxes. By 2007-08, the states were well on course to achieve the deficit reduction targets set by the Twelfth Finance Commission (TFC). The progress in the reduction in revenue deficits was also linked to the writing off of the debt repayment to the central government. Within

revenues, 1.6 percentage points improvement were due to higher transfers. The states' own tax revenues increased by 0.6 percentage point and this was achieved through the value added tax (VAT) reform, rationalization of stamp duties coupled with boom in the real estate markets, and a general rise in tax collections arising from relatively higher growth of the secondary sector. On the expenditure side, the adjustment was only one percentage point and half of this was due to lower interest payments. Lower interest rates arising from the debt swap scheme adopted in 2004-05, lower volume of borrowings from the National Small Savings Fund and debt restructuring as per the recommendation of the Twelfth Finance Commission contributed to the improvement. Thus, much of the improvement in state finances has come about due to the higher transfers, but nevertheless, the improvement is likely to sustain in the medium term as revenue from central direct taxes are likely to show high buoyancy with progressive strengthening of the information system and reforms to introduce the GST. General category states performed better than special category states in reducing fiscal deficit, but reverse was the case in revenue deficit. Among the former, the low income states performed better in revenue deficit reduction, but the performance of high income states was better in reducing fiscal deficit. Both high income and low income categories of states brought down fiscal deficits by more than two percentage points, but the latter category states increased their capital outlay by a larger magnitude (3.3 points) than the former (1.5 points). It is seen that while actual revenues were broadly in tune with the targets, the government failed to compress revenue expenditures according to the targets set and not surprisingly failed to achieve the revenue deficit targets. It is also seen that in order to achieve the fiscal deficit target, the government compressed capital expenditure from 2.4 percent of GDP in 2003-04 to 1.1 percent in 2008-09, instead of increasing it as envisaged in the reform scenario. While macroeconomic stability is an extremely important objective, it is necessary to consider whether the Finance Commission should take this as a primary task. Surely, the Commission will have to consider the ability and flexibility of the central government in the macroeconomic management of the economy in formulating its recommendations on tax devolution and grants. It should also consider building in appropriate incentive structure in its recommendations to provide incentive to the states for better fiscal management and penalize those that indulge in laxity. It is

required to take into account a number of considerations, the focus should be on the transfer system. As regards the transfer system itself is concerned, the paper argues that although it may be difficult to make drastic changes in the relative shares of the states, the Commission should give up the gap filling approach.

Simone and Topalova (2009) examine India's experience with fiscal rules with a view to inform the design of a possible successor fiscal framework to the FRBMA. Numerical targets should be supported by structural reform measures for both revenues and expenditures, while the coverage of the fiscal rules should be expanded. During the second half of the 1990s, government finances in India deteriorated continuously, leading to large and intractable fiscal imbalances. Fiscal consolidation was required not only to facilitate sustained long-run growth by minimizing the crowding out of investment and allowing the removal of constraints imposed on the domestic financial system by government's financing needs, but also to create the fiscal space for countercyclical fiscal policy and crisis-related spending. The introduction of FRL coincided with significant improvements in headline fiscal indicators. More than two-thirds of the fiscal adjustment over this time period was due to revenue gains, with improvements in tax performance underpinned by rapid economic growth, strong corporate profits, and improvements in tax administration as measured by effective tax rates. The rest of the adjustment came mostly from declining interest payments. In the absence of expenditure reform, the subsidy bill increased dramatically. These developments undermined the credibility of government's commitment to fiscal discipline and suggest that going forward revenue gains cannot single-handedly carry fiscal adjustment and the sustainability of India's fiscal policy. The fiscal consolidation at the state level was achieved on the back of growing own revenues and higher resource transfers from the central government. The variation in the design of FRLs across India's states allows an examination of whether certain design features of the fiscal rules are correlated with better fiscal performance. Namely, some states have adopted a specific target for their outstanding debt as a share of GSDP for a pre-specified date in the future; some states have adopted some rules on expenditure. Some states require quarterly review of expenditure and receipts against budget estimates, while other requires half-yearly or annual review of compliance. They

constructed indicators of whether the state law includes (i) a debt target or, (ii) expenditure rules, and (iii) whether the performance review is at least half-yearly. They interact these state law design features with the post FRL indicator to examine whether fiscal performance after the introduction of fiscal rules varies with the presence or absence of these features. Among India's states, the disciplining effect of FRLs appears to be stronger if the fiscal rules include a specific debt target or expenditure rules. Expand the coverage of the fiscal accounts and target fiscal indicators. This includes bringing all subsidy-related expenditures above the line and gradually expanding the coverage of the fiscal accounts to include public enterprises that pose fiscal risks and the accounts of special purpose vehicles created for funding government spending such as PPPs, both at the central and sub-national levels. The new FRBMA numerical targets should be supported by a concrete underlying plan of short- and medium-term policy measures for both revenues and expenditures. The plan should be discussed in detail in the policy statements required by the FRBMA. The assumptions underpinning the budget should always include annual forecasts over a medium-term horizon for key macroeconomic variables such as GDP growth, inflation, imports, exports and the exchange rate. Specific expenditure rules on these categories of spending depending on relevance could be included to address this problem while limiting their number to avoid an increase in complexity. Another approach to address these issues is to exclude the specific spending categories concerned from the definition of the expenditure aggregate. However, the cost is opening the door to creative accounting and incentives to push spending to exclude categories. This suggests that some additional complexity cost of the specific rules approach may be preferable. Given the stated central objective of the FRBMA, i.e. ensuring fiscal sustainability, a direct rule on gross public debt should be a logical part of the FRBMA successor.

Herd and Leibfritz (2008) examine various areas of India's fiscal policy, in particular fiscal discipline, the structure of government spending, the tax system and fiscal federalism. It describes reforms over the past decades which, as part of the overall economic reform agenda, helped lifting the Indian economy to a higher growth path. It also discusses where further reforms are desirable to further reduce economic distortions and improve the provision of public services. It finds that after high fiscal deficits have often been

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

### **2.10. Conclusion**

At national level, deficit bias, time inconsistency, pro-cyclical fiscal stance, over borrowing and unsustainable public debt is the major fiscal problems which the economies face. At the sub national level vertical imbalance, free rider common pool, unsustainable debts are the major fiscal problem. A fiscal policy rule is implemented to solve these problems. An appropriate fiscal policy in the long run can promote economic growth and in the short run can bring macro economic stability. The success of fiscal policy rules, in particular, the growth response, depends on the quality and durability of the specific measures that underpin it. Transparency, and good governance, can also play an important role in achieving high quality, durable, adjustment. They should cover a broad definition of government. Those targeting a broader coverage of the public sector

tend to be more successful than those using a narrow indicator. In countries with a weak track record of policy implementation, procedural rules may work better than numeric rules. Under these circumstances, fiscal discipline can be promoted through increased transparency and accountability. If including numeric fiscal rules, these should be carefully designed. Numerical rules can potentially be helpful, for instance, in containing a deficit bias, but are not in themselves the solution to structural fiscal problems. Numeric fiscal rules could even foster creative accounting and low-quality measures.

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## Chapter-III

### Theoretical Base for Fiscal Policy Rules and it's Implication in India

#### 3.1. Introduction

Two stands of literature set out the basic reasons why external constraints on growth of fiscal deficits such as through fiscal policy rules may be required. One line of argument is mainstream approach and the other form of argument is the political economy approach.

**3.2. Mainstream Theoretical Perspectives:** While the views of economists differ, the circumstances under which debt, and its increment, i.e. fiscal deficit become unsustainable. There are three theoretical perspectives, namely, neo-classical, Ricardian and Keynesian. Depending on the circumstances and the relevant theoretical perspectives, fiscal deficit may be bad, indifferent or good. Neo-classical view consider fiscal deficits detrimental to investment and growth, while in Keynesian paradigm, it constitute a key policy prescription and theorist persuaded by Ricardian equivalence assert that fiscal deficits do not really matter except for smoothening the path of adjustment to expenditure or revenue shocks.

**3.2.1. The Neo Classical View:** Neo classical literatures highlight the adverse impact of unsustainable debt and deficits. The usability of fiscal policy as a tool of countercyclical intervention is also compromised when fiscal deficit is high and structural in nature. In the neo classical perspective fiscal deficit will have a detrimental effect on growth if the reduction in government saving (or an increase in government dis-Saving) which is equivalent to revenue deficit is not fully offset by rise in private saving. Besides affecting the overall saving rate, when there is a net fall in the saving rate, there will be pressure on interest rate which may crowd out private investment and therefore adversely affect growth. The neo classical economists assume that markets clear so that full employment of resources is attend. In this paradigm, fiscal deficits raise lifetime consumption by

shifting taxes to future generations. If economies resources are fully employed, increased consumption implies decreased saving in a closed economy. In an open economy, real interest rates and investment may remain unaffected, but the fall in national saving is financed by higher external borrowing accompanied by an appreciation of the domestic currency and fall in exports. In both cases, net national saving falls and consumption rises accompanied by some combination of fall in investment and exports. The neo-classical paradigm assumes that the consumption of each individual is determined as the solution to an inter-temporal optimization problem where, both borrowing and lending are permitted at the market rate of interest. It also assumes that individuals have finite life spans where each consumer belongs to a specific generation and life spans of successive generations overlap.

**3.2.2. Keynesian View:** In the mainstream fiscal literature, the Keynesian views give strong argument for high level of fiscal deficit relative to GDP. Keynesian view argues, particularly when there are unemployed resources, that an increase in autonomous government expenditure, whether investment or consumption, financed by borrowing would cause output to expand through a multiplier process. The traditional Keynesian framework does not distinguish between alternative uses of the fiscal deficit as between government consumption or investment expenditure, nor does it distinguish between alternative sources of financing the fiscal deficit through monetization or external or internal borrowing. Although there is no explicit budget constraint in the analysis by Keynes, subsequent developments that do incorporate the budget constraint show that, as a result, some of the Keynesian conclusion is weakened. Subsequent elaboration of the Keynesian paradigms envisage that the multiplier-based expansion of output leads to a rise in the demand for money, and if money supply is fixed and deficit is bond financed, interest rate would rise partially offsetting the multiplier effect. However, the Keynesians argue that increased aggregate demand enhances the private investment and leads to higher investment at any given rate of interest. The effect of a rise in interest rate may thus be more neutralized by the increased profitability of investment. Keynesian argue that deficits may stimulate saving and investment even if interest rate rises, primarily because of the employment of unutilized resources. However, at full employment, deficit

would lead to crowd out even in the Keynesian paradigm. Unlike loanable funds theory, Keynesian paradigm rules out any direct effect on interest rate of borrowing by the government.

The standard Keynesian argument is that a fiscal contraction has a temporary contractionary effect through an aggregate demand channel, in a model with sticky prices and wages. A standard multiplier effect implies that spending cuts are more recessionary than tax increases.

**3.2.3. Ricardian Equivalence Perspective:** In Ricardian equivalence, fiscal deficits are viewed as neutral in terms of their impact on growth. The financing of budget by deficits amounts only to postponement of taxes. The deficit in any current period is exactly equal to the present value of future taxation that is required to pay off the increment to debt resulting from the deficit. Since government spending must be paid for, whether now or later, the present value of spending must be equal to present value of tax and non tax revenues. If household spending decisions are based on the present value of their incomes that takes into account the present value of their future tax liabilities, fiscal deficits would not have an impact on aggregate demand.

The relevance and applicability of these alternative analytical frameworks depend on the empirical characteristics of a given economy as also the initial conditions. It depends particularly on the saving behaviour of the household sector. If consumers are myopic or liquidity constrained, aggregate consumption becomes very sensitive to changes in disposable incomes, and the Keynesian prescriptions may be more applicable. If individuals are rational, fully informed and motivated by altruistic behaviour, Ricardian equivalence may have some validity. In general it has been argued that short term demand management, Keynesian prescriptions apply and for long term growth the neo classical view should be considered relevant. The critical difference in these alternative perspectives comes from how the saving of private sector is affected by the existence of fiscal deficit of a given order. If fiscal deficits are meant to largely finance revenue deficits, there would be a fall in government savings. To some extent, this fall may be

offset by an increase in the private savings as their wealth in terms of holding government bonds increases with an increase in fiscal deficits. The latter effect is often much smaller than the former effect, and there is a fall in overall saving rate.

### **3.3. Political Economy Literature**

The main argument for fiscal rule is the bias towards budget deficits and towards excess public spending. The attraction of rules is that by constraining policymakers, they will reduce or eliminate the tendency towards budget deficits.

Alesina and Perotti (1995) classified three type of political economy models of fiscal policy such as, model based on fiscal illusion with optimistic and naïve voters, models of debt as a strategic variable and models of distributional conflict.

#### **3.3.1. Models based on Fiscal Illusion with Opportunistic and Naive Voters**

This type of model is in spirit of public choice literature. The key assumptions are that policy makers are opportunistic (that is they are care about electoral prospects and not directly about private agents welfare). There is the electoral motive towards high spending in election years and in this way fiscal deficit increases. In many countries incumbents appear to increase government spending before elections in order to improve their re-election prospects. Fiscal manipulation before elections is especially strong in developing countries. Early theories of fiscal choices based on political considerations highlight the manipulation of government expenditures by policymakers trying to get re-elected (for instance, Buchanan and Wagner, 1977). The basic argument is that voters value public spending but consistently under estimate its costs in terms of the tax burden, especially if those costs are postponed. A classic argument is that individuals favor expenditures, but do not want to pay for them. Wagner (1976) and Buchanan and Wagner (1977) have formalized this point in the notion of a “deficit illusion,” whereby voters do not understand the government’s inter temporal budget. Faced with deficit-financed expenditure, voters overestimate the value of the expenditure side and underestimate the future tax burden. Voters suffer from “fiscal illusion” both in considering the size of government and in analyzing budget deficits. Opportunistic incumbents take advantage of

this misperception, running deficits to win the favor of voters. According to Ricardian equivalence notwithstanding, voters may not grasp fully the mechanics of the intertemporal budget constraint by which today's deficits are inevitably linked to tomorrow taxes and noninterest spending capacity. This lack of understanding has two effects. First a rational policy maker may find it useful to use fiscal expansions as a way to increase reelection chances. Second, voter's myopia and an incumbents' willingness to stay in office may cause undue delays in much needed fiscal adjustments. Voters do not punish politicians for fiscal irresponsible behaviour. Thus voters support policy makers who provide high levels of deficit financed expenditures, and do not favour fiscally conservative politicians. This generates incentives for fiscal irresponsibility. It also generates asymmetric stabilization policies, as policymakers are willing to run deficits to fight a recession but are not willing to run surpluses in good times. Hence, fiscal illusion is not simply an empirical statement about misperceptions about government size, but a hypothesis about how policymakers may succeed in deceiving voters about the true size of government. It is argued that voters measure the size of government by their tax bill and policymakers can disguise taxes so that voters underestimate the true tax bill. One explanation of a persistent deficit is in terms of misperceptions about deficits.

A closely related argument has been made by the literature on political business cycles (Nordhaus, 1975), where the opportunistic manipulation of economic policy is tied to election times. Individuals are assumed to vote on the basis of recent macroeconomic outcomes, and public spending increases and tax cuts are assumed to be expansionary. Policymakers then run deficits before elections to stimulate the economy. Elections are followed by expenditure cuts engineered to "cool down" the economy.

A political process argument concerns bureaucratic behavior. Niskanen (1971) argues that the behavior of bureaucrats may be explained by budget maximization. They try to maximize their budgets since a higher budget translates into both higher salaries and more power. He views bureaucratic behavior as a principal-agent problem under asymmetric information. Fiscal rules are thus meant to try to contain the political pressures that yield such a bias (Drazen, 2002).

Rogoff (1990) and Rogoff and Sibert (1988) argue that not only voters cannot fully understand the government budget, but also that they are repeatedly fooled by the politicians. Voters have only imperfect information about competence level of each politician. They extract information about the incumbent running for reelection from his past fiscal choices. An incumbent who has provided more government programmes is inferred to be more competent, and is thus supported by voters. This creates incentives for politicians to run deficits to finance larger expenditures.

This early literature has been criticized because of the assumption that voters make consistent mistakes (Alesina and Perotti, 1995; Drazen, 2000). The notion of fiscal illusion implies not only that voters cannot fully understand the government budget, but also that they are repeatedly fooled by politicians. The opportunistic political business cycles literature, for instance, exhibits the unsatisfactory feature that voters who have gone through one electoral cycle do not learn from previous experience that pre-election expansions will be followed by contractions. As a result, expansions repeatedly lead voters to support the incumbent, even though there is every reason to expect that they will be followed by a period of poor macroeconomic performance. Alesina and Perotti (1995), Drazen (2000), and others provide empirical evidence to contend that rational and informed voters can not be repeatedly fooled by the opportunistic politician.

One important condition to explain the rational manipulation of fiscal deficits is that voters must be unable to observe all the details of the budgets. If they knew the cost of all projects undertaken by the government, they would clearly infer the incumbent's competence. Shi and Svensson (2006) show that opportunistic deficits may also arise if voters observe all government programmes, but at least some individual remain uninformed about the fiscal balance. In any case, the accumulation of debt arises from opportunistic behaviour of politicians depends on how transparent the budget is: less transparency leads to larger opportunistic deficits (Alt and Lassen, 2006). The ability of voters to understand the government's budget depends on factors such as the government's accounting practices, media development, and the sophistication of voters.

Two empirical implications arise from this literature. First, debt accumulation should be larger in contexts with less budget transparency. Second, electoral periods could be times of high public expenditures and deficits, but only in contexts where fiscal outcomes cannot be transparently observed by voters. There is however a large body of empirical literature that does not support the hypothesis of opportunistic use of deficits during election times. For example, Persson and Tabellini (2003) find no pre-electoral change of government expenditure or surplus in a large sample of both developed and less developed economies. Similar findings are reported by Brender and Drazen (2005a) show that these findings reflect the experience of “new democracies” in the first few years after their transition to democratic regimes. They interpret this finding as an indication that political deficit cycles emerge only in contexts where voters and the media have not yet developed the ability to efficiently monitor fiscal policy. On the other hand, Schuknecht (1994) Shi and Shi and Svensson (2006) find pre-electoral deteriorations of fiscal balances and increases of public expenditure in developing countries. He tested a similar hypothesis by letting the effect of election years on fiscal outcomes vary with a measure of the share of voters who are well informed. They find the negative effect of election times on the deficit is weaker for higher shares of informed voters.

Alt and Lassen (2006) construct an index of fiscal transparency for 19 OECD countries during the 1990s, using survey responses from those countries' budget directors. They study whether the transparency index is systematically related to the levels of deficit and debt in those countries. Their findings suggest that more transparency leads to lower deficits and debt levels, even after controlling for a variety of political and economic factors, and treating transparency as potentially endogenous to fiscal outcomes.

Other studies analyze the effect of budget institutions on debt accumulation. Though not restricted to fiscal transparency, measures of the quality of budget institutions do account for the transparency of procedures relating to both the drafting and the implementation of the budget. For the case of Latin America, Alesina et al. (1999) and Stein et al. (1998) use an index of budget institutions that, besides measuring other important characteristics of the budgetary process, captures transparency by considering the ability of the

government to acquire debt through decentralized agencies. They study the relationship between budget institutions and the government's deficit for 20 Latin American countries during the 1980s and early 1990s, and find that better budget institutions have been related to lower deficits. Similar findings are reported by Von Hagen (1992) for eight European countries. His measure of the quality of institutions includes indicators of budget transparency, based on survey responses by budget officials, as well as on objective measures such as the existence of "special funds" in the budget.

In short, empirical evidence seems to support the main predictions of models based on opportunistic manipulation of fiscal policy. First, debt accumulation is related to the degree of transparency of the budget. Second, while there appear to be electoral increases in fiscal deficits and government expenditures, these are limited to countries where one could argue that voters are less successful in monitoring fiscal outcomes. When the government's fiscal choices are not transparent to the public, however, opportunistic incentives may lead to high deficits because highly valued spending on development projects may be paid for by acquiring debt that is not observed by voters.

There are certain literatures which are not so favorable toward the traditional assumption that voters prefer high-spending governments. The most traditional view of the political effect of fiscal decisions has been that voters penalize fiscal adjustments, either because they are contractionary or because voters derive utility from high expected levels of government spending. Empirical findings suggest both that fiscal adjustments are not necessarily contraction and that incumbents who have adopted loose fiscal policies do not receive greater voter support than fiscally conservative incumbents. If anything, the opposite seems true. Alesina et al. (1998) examine the behavior of various macroeconomic indicators before, during, and after episodes of fiscal adjustment in 19 OECD countries during the 1960-1995 periods. They find that whether or not tight fiscal policies are contractionary depends in turn on whether the adjustment is successful in achieving a persistent deficit reduction. Successful episodes of fiscal adjustment are not followed by deteriorations of the macroeconomic environment, whereas unsuccessful episodes frequently are. A related finding is reported by Gupta et al. (2003), who study a

group of 39 low-income countries during the 1990s and show that strong fiscal balances are associated with high growth, even in the short run. Interestingly, the success of an episode of fiscal adjustment depends on the composition of the adjustment, as well as on the initial level of debt. These studies find that adjustments based on expenditure contractions mainly reductions of transfers and wage Payments are successful; those relying on tax increases are contractionary and fail to achieve persistent deficit reductions. Moreover, fiscal adjustments are more likely to succeed if the initial level of debt is high, a result that is consistent with the models of delayed adjustment we review below. Findings regarding the fiscal preferences of voters are no less surprising. Based on election outcomes and opinion polls for 19 OECD countries, Alesina et al. (1998) find that governments that follow tight policies are no more likely to be replaced than others, nor do they lose popularity. If anything, the opposite holds: after sharp fiscal adjustments based mostly on current spending cuts, the probability that an incumbent remains in power increases. Similarly, various country studies for both developed and developing countries show that the share of votes received by the incumbent's party decreases with the level of government spending and/or the fiscal deficit observed before the election. Findings in this direction are reported by Eslava (2006) and Drazen and Eslava (2005) for Colombia, Brender (2003) for Israel, and Peltzman (1992) for the United States. Voters' fiscal conservatism, however, is not independent of the composition of government spending. Using data on the elections of mayors in Israel, Brender (2003) finds that, although voters penalize election-year increases in deficits, they reward high expenditure in development projects. Eslava (2006) and Drazen and Eslava (2005) show that the share of votes received by an incumbent party in Colombian local elections increases with capital expenditures (including development projects) observed before the election, even though it decreases with the fiscal deficit. Indirect evidence along the same lines is provided by several studies on pre-electoral changes in the composition of government spending, which are likely to reflect incumbents' beliefs about the political effects of their fiscal choices. Schuknecht (1994) finds that, prior to elections, capital expenditures rise as a share of both GDP and overall expenditure in his sample of 35 developing countries. Kneebone and McKenzie (2001) find no pre-electoral increases in aggregate spending for Canadian provinces, but do find that spending in social services, industrial

development, and health actually increase before elections. Very similar findings are reported for Mexico by González (2002), who also finds that other categories of spending, such as current transfers, contract prior to elections. Drazen and Eslava (2005) for Colombia and Khemani (2004) for India, find that, local government expenditures shift from current categories of spending toward investment categories before the elections. In Brender's (2003) study, the negative effect of deficits on incumbents' re-election probabilities became evident only in the latter part of his sample period, after the adoption of modern accounting practices and a greater media effort to monitor fiscal policy. Brender and Drazen (2005b), using a large panel of countries, find that deficits over the previous three years reduce an incumbent's re-election chances, but only in established democracies.

Moreover, review shows the evidence that electoral deficits arise only in the context of relatively young democracies, suggesting that politicians in more developed political environments realize increased deficits will not be rewarded. This evidence suggests that, contrary to conventional wisdom, voters do not prefer high spending governments. They show preferences for high spending on specific items, such as development and infrastructure projects, but seem to be quite aware of the costs of overall high spending. In particular, they support governments that engage in successful and stringent fiscal adjustments when these are necessary, and penalize governments that run large deficits. When the government's fiscal choices are not transparent to the public, however, opportunistic incentives may lead to high deficits because highly valued spending on development projects may be paid for by acquiring debt that is not observed by voters.

### **3.3.2. Models of Debt as a Strategic Variable**

It emphasizes that stock of debt has an effect on policy choices of future government and can therefore be used to constrain its action (Alesina and Tabellini, 1990). In this context, a deficit bias can arise because different political parties, which face electoral uncertainties, have conflicting spending priorities. These factors imply that the current government does not fully internalize the cost of running budget deficit today, because the future spending that is going to be compressed may reflect the priorities of a different

government. This deficit bias is increasing in the degree of political polarization (reflected in the difference between spending priorities) and in the budget of electoral uncertainty. In this class of model, priorities before an election would agree on abandoned budget rule, but after the election the party in power prefers discretion.

### **3.3.3. Models of Distributional Conflict**

A high level of fiscal deficits is the result of distributional conflicts between policymakers or between groups of voters. Two lines of research are considered. First the strategic use of deficits by policy makers who fear be replaced by someone with different fiscal preferences. Second, budget deficits based on the fight of groups of voters with conflicting interests for a common pool of government revenues. In this discussion the argument that distributive conflicts may explain delays in undertaking necessary fiscal adjustments. It shows that how conflict between groups (represented by parties, interest groups, and coalition members) can delay the adoption of necessary policy measures, such as for example, spending cuts or tax increase to stem growth in public indebtedness caused by exogenous factors (Alesina and Drazen, (1991), Drazen and Grilli, (1993)). Delays occur because groups can not agree on burden sharing for the necessary fiscal adjustment. These models predict that fragmented or divided government and polarized societies would have more difficulty implementing fiscal adjustment than single party governments and less polarized societies. Evidence presented in Roubini and Sachs (1989) and Grilli, Masciandaro and Tabellini (1991) for OECD countries and by Poterba (1994) and Alt and Lowry (1994) for US states is consistent with these prediction.

In this regard literatures explain fiscal deficits are the result of conflicts of interests: conflicts between politicians with heterogeneous preferences, or conflict between different social groups over the distribution of resources. Three sub- stands of these literatures are:

- (a) Policymakers strategically use deficits to tie the hands of successors with different preferences.

- (b) The adoption of fiscal adjustment is strategically delayed with distributional consequences
- (c) Common pool problems where the competition among different groups over the distribution of government revenues leads to deficits.

**Distributive Conflicts between Policy Makers:** If different politicians have potentially different fiscal preferences for instance, reflecting the heterogeneous preferences of voters in citizen-candidate framework incumbent officials may have incentives to run deficits to tie the hands of their successors. The argument is based on the fact that current budget deficits impose costs in terms of either lower future public spending or higher future tax collections.

The model has three basic implications: 1) officials from different parties, who are assumed to have heterogeneous preferences, spend on different types of public goods, 2) budget deficits increase with the probability that the government will be replaced, and 3) deficits increase with the level of polarization between the different parties, since greater polarization implies larger differences between the preferences of the incumbent and those of his potential replacement. Alesina and Tabellini (1990) present a model where politicians have heterogeneous preferences in terms of the composition of public spending. An incumbent who faces the risk of being replaced by someone of the opposing “party” has incentives to run a deficit and spend the resources on the types of public goods he prefers. If the incumbent is in fact replaced by an opponent, the cost of the deficit (a future spending contraction) will fall disproportionately on the goods the current incumbent values less.

A related argument arises when politicians differ in their preferences regarding the optimal size of the government (Persson and Svensson, 1989). If policy maker is faced with a large probability of being replaced in office, low-spending incumbents may run deficits (mainly by cutting taxes), thereby increasing government indebtedness in order to force their successors into low expenditure levels. High-spending incumbents would do the opposite. The model thus predicts that conservative incumbents will run deficits when

they expect to be replaced, while liberal incumbents will run surpluses in similar circumstances. The differences between the choices of parties with diverging ideologies should be starker in more polarized contexts, where the preferences of opposing parties are further apart.

The last decade has witnessed several attempts to test the empirical relevance of the theoretical arguments outlined above. There are studies that examine large samples of countries and studies that examine U.S. states; neither has found consistent evidence in favor of either model of strategic use of deficits. Lambertini (2003), for instance, studies two large data panels: U.S. states between 1960 and 1995, and a sample of 16 OECD countries for the 1960-1992 periods. She does not find any significant effect of the probability of being re-elected on the budget surplus, nor differences between different parties in terms of either defense spending or budget surpluses. Similar findings are reported for samples of industrial countries by Grilli et al. (1991) and by Franzese (2000), and for U.S. states by Crain and Tollison (1993).

It has been recently argued, however, that the lack of evidence in support of strategic models of the deficit is due to the use of data on countries or states faced with widely different political, legal, and economic environments (Sutter, 2003; Pettersson-Lidbom, 2001). As it is difficult to appropriately control for these sources of variability, attempts to discover strategic patterns in the deficit data may be affected by the presence of opposing effects not accounted for. Pettersson-Lidbom (2001) tries to overcome this difficulty by examining the patterns of debt accumulation by Swedish local governments between 1974 and 1994. The advantage of these data lies in the fact that Swedish localities are all subject to the same institutional and constitutional framework. The study uses a two-stage procedure, where the first stage fits a probit model on the probability of being defeated in the next election, and introduces several controls. The author finds evidence that supports the Persson-Svensson theory of strategic debts: the amount of debt accumulated by right-wing government increases with its probability of electoral defeat, while the opposite is true for left-wing governments. His finding, in turn, contradicts the

Alesina-Tabellini model, which predicts that debt accumulation by any government should increase with the probability of defeat.

An interesting experimental study also presents evidence that the strategic use of deficits may be masked when widely different subjects are studied. Sutter's (2003) experiment presents pairs of individuals with the decision to allocate a given budget over two time periods, and over two goods in each period. Choices are made by one of the two individuals, and each faces a positive probability in each period of being the one making the choices. The experiment assigns payoffs to each combination of the two goods, defining the preferences of the two agents over the allocation of the budget, as in Alesina and Tabellini (1990). Greater polarization can thus be defined as more heterogeneous preferences between the two individuals. The author presents each pair of individuals with the same experiment in several trials, varying the level of polarization and the probability of "re-electing" the first period decision maker in each trial. He finds that spending in the first period (and thus the "deficit") rises with a higher degree of polarization and a lower probability of re-election, supporting the Alesina-Tabellini model. However, when the experiment is conducted with different pairs of individuals and with only one trial for each pair, there is no systematic effect on the deficit of letting polarization and the probability of re-election vary across pairs. The author concludes that, while deficits are indeed used strategically, this phenomenon is hard to identify in the data if other sources of heterogeneity are not appropriately controlled for.

**Distributive Conflicts between Groups of Voters:** Heterogeneous interests across groups of voters have been put forward as a reason for potentially pervasive deficits. The basic argument was first presented by Weingast et al. (1981) when explaining the fiscal consequences of having geographically disperse interests influence the budget. The problem arises if legislators making budget decisions represent geographic units interested in different government-funded projects, with government revenues being centralized. The benefits of a given government project are then concentrated geographically, while its costs are shared by all districts. The consequence is that each district internalizes the full benefit of specific projects, but only part of the cost, and this

result in over-provision of government projects. The size of the budget, and thus the deficit, increases with the number of districts represented in the government, termed government “fragmentation.”

Similar common-pool problems have been captured by more recent theoretical developments, and have been used to explain the pro-cyclicality of fiscal policy in less developed economies. Tornell and Lane (1998) and Talvi and Végh (1996, 2005) argue that the additional fiscal resources available during booms generate a more intense fight among the different groups for the common pool of resources (a “voracity effect”). As a result, government deficits grow in good times. Alesina and Tabellini (2005), meanwhile, relate procyclicality to voters’ efforts to avoid having the extra revenues generated by the boom be handed out to interest groups fighting for those resources (or appropriated by the government). A central assumption is that there are two fiscal outcomes voters cannot perfectly monitor: the amount of “rents” captured by the incumbent or the interest groups, and the amount of fiscal resources generated by the boom. When a boom is observed, therefore, voters demand more public spending on productive projects to restrain the incumbent’s ability to appropriate any extra resources. Voters’ demands create a deficit bias during good times.

Why would these models be particularly appropriate for less-developed economies (which are the ones exhibiting pro-cyclical fiscal policy)? Two reasons are put forward. First, the greater volatility of the macroeconomic environment exhibited by those economies implies that booms are associated with particularly large and short-lived extra revenues. These characteristics imply large incentives to fight for those extra resources (Talvi and Vegh, 1996). Second, the model in Alesina and Tabellini (2005) suggests that the pro-cyclicality of the deficit is negatively associated with the budget’s transparency, and is positively associated with the level of corruption. In a sample of 87 countries between 1960 and 1999, the authors show that pro-cyclicality and corruption are indeed positively correlated, but only for democracies. These findings are consistent with their theoretical arguments. It remains to be shown that less developed economies have less

transparent budget institutions, or that developing economies only exhibit procyclical fiscal policy when voters face great difficulties understanding the budget.

The bias is stronger the more the decentralized the decision system is because of the existence of common pool problem (every body has pay taxes, but only specific ministries and constituents benefits from the spending). Kontoupoulos and Perotti (1999) present the evidence that countries with a larger number of spending ministers tends to have higher public spending. Fragmentation, it is argued (e.g., Stein *et al* 1998) is positively related to the number of seats representing each district in legislature, the effective number of parties participating in the government, and the lack of power of the government over the legislature. Coalition governments and proportional representation systems are also related to more fragmentation. Spending decisions within a government coalition, implying that control on spending is more difficult the larger the number of parties in the coalition. Empirical findings seem to confirm that electoral systems that results in more political cohesion and stability generate more fiscal discipline. The results are less supportive of a systematic relationship between left-wing or right-wing parties and greater debt accumulation. Stein *et .al* (1998) examine the relationship between different electoral systems and fiscal performance in a sample of 26 Latin American countries for 1990-95. The degree of fragmentation of electoral systems is measured using district magnitude (the number of seats each district holds in the legislature) and the number of effective parties in the legislature (number of parties weighted by their vote share). The power of government over the legislature is measured by the number of legislative seats held by the government's party. Results suggest that electoral systems with more proportionality and a larger number of parties, as well as those with less government power over the legislature, produce larger governments, larger deficits, and more pro cyclical fiscal policies.

The literature that explains fiscal deficits based on distributional conflicts has several testable implications. First, the probability of a fiscal adjustment should increase with the initial level of debt. Second, debt accumulation should be positively related with the number of groups or districts that are effectively represented in the process of choosing

the budget. Government fragmentation should thus generate higher deficits. It should also lead to more procyclical fiscal policy, to the extent that distributional conflicts have been suggested as an explanation of procyclical fiscal outcomes. Furthermore, greater fragmentation should also lead to a fiscal adjustment being less likely. On the other hand, models of the strategic use of deficits suggest that more polarization and greater government turnover should generate larger deficits, possibly contingent upon the ideological orientation of the government. An additional implication is that the accumulation of debt may be related to the ideology of the party in power.

Fragmentation has been suggested to be positively related to the number of seats representing each district in the legislature, the effective number of parties participating in the government, and the lack of power of the government over the legislature (Stein et al., 1998). Coalition governments and proportional representation systems are also related to more fragmentation. Polarization, on the other hand, is usually measured in terms of the frequency of change of the party in power, and parliamentary systems are considered more polarized than presidential ones. It is not clear, however, that measures of “fragmentation” are not also capturing “polarization,” and vice versa. Both concepts refer to the process of fiscal policymaking being more subject to distributive conflicts.

To summarize, the findings seem to generally confirm that electoral systems that result in more political cohesion and stability generate more fiscal discipline. The results are less supportive of a systematic relationship between left-wing or right-wing parties and greater debt accumulation. In short, the studies reviewed above seem to support the hypotheses that more fragmented governments and electoral systems lead to more debt accumulation.

### **3.4. Political Cycles: Some Studies in India**

There have been a number of studies in India that have considered the applicability of political determinants of fiscal decisions. Most of these studies have looked at the state level. Some of the studies discussed below are Khemani (2000), Besley and Burgess (2000), and Chaudhuri and Dasgupta (2006).

Khemani studied the effect of state elections in India on two separate policy instruments available to state governments: fiscal policies, namely taxes and spending, and public service delivery, particularly road construction. The inclusion of public services was innovative. The contrast between the effect of elections on taxes and spending on the one hand, and public service delivery on the other, allows her to distinguish between alternate theories explaining the existence of cycles. The Nordhaus-style model of political cycles to woo uninformed and myopic voters predicts populist spending and tax cuts (leading to deficits) just before elections, followed by post-election contraction. The Rogoff model predicts tax cuts, and increases in government consumption spending at the expense of investment spending.

Her findings may be summarized as follows: on the fiscal side, in the year leading to an election, incumbent state governments lower taxes, not on items of mass consumption but instead on a selective base consisting of manufacturers and producers; they increase spending on the capital account, but reduce spending on the current account which consists of various populist subsidies and salaries. She finds that there is no significant effect of elections on the state deficit. Khemani argues that this pattern of evidence is contrary to both the Nordhaus and Rogoff type models. The electoral effects on the composition of taxes and spending are not consistent with a story of populist politics to woo the mass of uninformed voters. The distinction between capital and current spending is directly counter to Rogoff's prediction.

She finds that state governments significantly increase road construction in the year before elections, without corresponding increases in spending on roads. This election-year increase in the mileage of new roads, even after controlling for spending on roads, indicates that government management of public works improves in election years. The effect on roads is much larger in magnitude than the effect on the fiscal instruments. In her analysis, the cycle is generated by high discounting of the future by politicians in a common agency setting where they are responsive to several different constituencies. She highlights that the big effect of elections is on public service delivery, which requires a

model different from the ones in the received literature that focus on fiscal policy manipulation. There is some evidence for fiscal maneuvering, but it appears to be limited to the extension of political patronage to specific groups, in exchange for support for electioneering.

Besley and Burgess (2000) study the determinants of government responsiveness to its citizens as a key issue in political economy. They develop a model based on the solution of political agency problems. Having a more informed and politically active electorate strengthens incentives for governments to be responsive. This suggests that there is a role both for democratic institutions and the mass media in ensuring that the preferences of citizens are reflected in policy. They show that public food distribution and calamity relief expenditure are greater, controlling for shocks, where governments face greater electoral accountability and where newspaper circulation is highest.

They use data from the sixteen major Indian states for the period 1958 to 1992 to test the implications of the theory. India is home to a large vulnerable population which is regularly buffeted by natural shocks including droughts, floods, earthquakes and cyclones. Over time, measures including public food distribution, calamity relief expenditure and public works projects have been developed to deal with these shocks. In India, popularly elected state governments play a key role in social protection.

They consider two social protection measures: per capita public food distribution and calamity relief expenditure expressed as a share of net state domestic income. Their measures of shocks are food grain production and the real value of crops damaged by floods. They find no impact of state income on public food distribution and the fraction of state income devoted to calamity relief tends to decline with state income. Population density is insignificant in both regressions and urbanization is insignificant in the calamity relief regression. They show that, after controlling for both shock levels and basic economic and political indicators, newspaper circulation is positively and significantly correlated with both food distribution and calamity relief. Thus, those states that have higher levels of media development are also more responsive in terms of public

food distribution and calamity relief expenditure. A one percent increase in newspaper circulation is associated with a 2.4 percent increase in public food distribution and a 5.5 percent increase in the share of public expenditures devoted to calamity relief.

The level of political competitiveness proxied by the electoral margin between the ruling party and its main competitor might also be expected to affect incentives to respond. The fraction of the population classified as scheduled caste/scheduled tribe is a rough measure of polarization in Indian society. They include an election dummy, equal to one if it is an election or pre-election year in a given state. While, not strictly predicted by the theory, it is possible that governments are more responsive near elections if citizens have better memories about recent events.

The results show that, controlling for shocks; electoral turnout rates in Indian states do not exert a direct effect on either levels of public food distribution or calamity relief expenditures. Where ruling parties are more secure due to there being larger electoral margins and less political competition, higher levels public food distribution are seen. This is not the case for calamity relief. They also observe that state governments are more responsive in terms of public food distribution during election and pre-election years. This effect is not present for calamity relief expenditures. Having a higher fraction of scheduled caste/scheduled tribe in the population does not appear to affect average levels of food distribution or calamity relief. The results suggest that for public food distribution, politics matter. Governments who are threatened either due to there being a close competitor or due to the proximity of an election tend to be more responsive.

Chaudhuri and Dasgupta (2006) investigate, using data from the 14 major states of India, whether state governments' fiscal policy choices are tempered by political considerations. Two main conclusions are as follows. First, they show that certain fiscal policies experience electoral cycles: state governments raise less commodity tax revenue, spend less on the current account, and incur larger capital account developmental expenditures in election years than in all other years. Second, it is observed that coalition state

governments raise less own non-tax revenues and spend less on the current account than state governments that are more cohesive in composition.

Srivastava D.K. (2008), examines impact of election year upsurges in fiscal deficit through econometric investigation covering the period from 1950-51 to 2005-06. It seems that in two years around the election time, that is the election year and the year immediately proceeding the election year, the combined impact leads to a rise in the fiscal deficit relative to GDP, on average, of about 1.8 percentage points. Soon after the election years, the fiscal deficit falls, rising again in the next election cycle.

Rajaraman (2006) focuses on the factors underlying the continued weak fiscal position during the previous one and half decades as well as the prospects of recent fiscal reforms. An econometric exercise investigates whether this event was endogenous to the political economy. The regression equations show an election year response, which has become more marked in the last 30 years.

### **3.5. Political Determinants of Fiscal Deficit**

It may be noted that the opportunistic and partisan models are not mutually exclusive in a multi-party setting. Whereas the ruling party may sometimes exhibit opportunistic behaviour, the growth of many regional parties have political bases in partisan motives that are reflected in support for specific regions, castes, economic and social groups, etc. Secondly, while the government may tend to stimulate the economy just prior to elections, opposition parties try to woo the electorate on the basis of promises, if they are voted to power. If they actually do come to power, they tend to stimulate the economy soon after the elections. Even the ruling party promises to undertake more spending if voted back to power. That is why we may, in general, expect higher deficit based spending in the year preceding the elections and the year in which elections are held.

### 3.6. Empirical Measurement of Impact of Election on Fiscal Deficit

#### Research Issues:

Political economy literature explain that there is the electoral motive towards high spending in election years and in this way fiscal deficit increases. Whether election year leads to increase in fiscal deficit can be checked through econometric investigation It is the impact of overall government fiscal deficit and debt that is important for both growth and macroeconomic cycles. We focus on the role of political factors in this time series macro framework covering for the econometric exercises, the period from 1980-81 to 2008-09.

#### Data Period of the Study

The data for the study have been from *Handbook of Statistics on the Indian Economy*, which is a publication of Reserve Bank of India. In this study, the focus is on time series data relating to the combined account of the central and state governments. Elections were held in 1980, 1984, 1989, 1991, 1996, 1998, 1999, 2004 and 2009

#### The Model

The Impact of election year on the fiscal deficit is checked by taking dummy for the one year proceeding to election year as 1 and by taking other years as 0.

$FD/GDP$  (at mkt price) = f {GDPFCG, PG, (Election is taken as a dummy 1 for one year proceeding to election year and 0 is taken for other years)}

Here, GDP= Gross Domestic Product (at market price)

GDFCG = GDP growth rate at Factor Cost

PG = population growth Rate

Election = Election is taken as a dummy 1 for one year proceeding to election year and 0 is taken for other years

FD\_GDP = Gross Fiscal Deficit (Combined Government) / GDP (at market price).

**Table 3.1. Empirical Result of the Impact Election on Gross Fiscal Deficit to GDP Ratio**

Dependent Variable: FD_GDP				
Method: Least Squares				
Sample (adjusted): 1981 2008				
Included observations: 28 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.009444	0.016651	0.567150	0.5761
GDPFCG	-0.001842	0.000641	-2.872069	0.0086
PG	0.020497	0.006141	3.337935	0.0029
ELECTION	0.006961	0.003775	1.844260	0.0781
FD_GDP(-1)	0.665441	0.128343	5.184856	0.0000
R-squared	0.736517	Mean dependent var		0.077248
Adjusted R-squared	0.690694	S.D. dependent var		0.015142
S.E. of regression	0.008421	Akaike info criterion		-6.555707
Sum squared resid	0.001631	Schwarz criterion		-6.317814
Log likelihood	96.77990	F-statistic		16.07308
Durbin-Watson stat	2.402981	Prob(F-statistic)		0.000002

Note: *Election dummy (ELECTION) takes a value 1 in one year preceding election years and 0 in other years.*

From the result we can say that in India election does not have a significant impact on the rising fiscal deficit to GDP ratio where as GDP growth (at factor price) has a negative effect on fiscal deficit to GDP.

### 3.8. Conclusion

A key distortion underlying inadequate fiscal discipline arises from the tendency of government to have shorter horizons than voters. The reason for policy makers' myopia lies in the electoral uncertainty inherent in the democratic process. As elected official focus primarily on the consequences of their own (discretionary) actions while in office, their interest for future policies is lessened due to the risk of losing the next election. Myopia implies a relative neglect for the future tax hikes and primary expenditure cuts inevitably attached to present deficits. A rational government that balance the perceived marginal cost of deficits with marginal gains will thus opt for deficits above those desired by voters. For similar reasons, fiscal adjustment delayed or back loaded, and revenue windfalls in good times are less likely to be saved, pointing once again to an asymmetric cyclical pattern in deficit.

Models based on fiscal illusion with opportunistic and naive voters assumptions are that policy makers are opportunistic (that is they care about electoral prospects and not directly about private agents welfare). There is the electoral motive towards high spending in election years and in this way fiscal deficit increases. From the above model result we can say that election does not have a significant impact on the fiscal deficit in India. While there appear to be electoral increases in fiscal deficits and government expenditures, these are limited to countries where one could argue that voters are less successful in monitoring fiscal outcomes. When the government's fiscal choices are not transparent to the public, however, opportunistic incentives may lead to high deficits because highly valued spending on development projects may be paid for by acquiring debt that is not observed by voters.

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## **Chapter-IV**

### **International Experience of Fiscal Policy Rules**

#### **4.1. Introduction**

The virtue of fiscal discipline has been admired, for at least two millennia, yet, occasionally, departures from discipline have been justified politically most notably, aftermath of great depression. In the 1980s, deficit bias, and its contribution to public indebtedness as well as its adverse repercussions on private investment, prompted some government to introduce medium-term fiscal consolidation to restore macroeconomic stability and fiscal sustainability. More recently, this was increasingly followed by a shift to fiscal policy rules. According to (Peach, 2001), the first law incorporating a provision that can be interpreted as a “fiscal rule” was enacted in 1917 in U.S. Under this law, the Liberty Bond Act established a statutory limit on the gross indebtedness of federal government.

#### **4.2. Evolution of Fiscal Policy Rules at International level**

According to (Kopits, 2001) formal attempts at casting the virtue of fiscal discipline into permanent rules, through constitutional or legal provisions, at various levels of government, span over a century and a half. During this period three fairly distinct waves can be identified. In the first wave sub-national government in some federal system adopted autonomously the golden rule. Under this rules most states in the US since the mid 90th century and several cantons in Switzerland since the 1920s assumed an obligation to maintain current budget balance. In the second wave, after World War II, several industrial countries like Germany, Italy, Japan and Nether Land introduced balanced budget rules. That rules underpinned their stabilization programmes following monetary reforms. Most of these were of golden rule type. Other rules such as those of Indonesia, CFA franc zone in 1960s were assumed to limiting or prohibiting the financing of budget deficits from specified domestic sources like from central banks.

Nevertheless, under all these rules, considerable scope remained for creative accounting and other nontransparent practices that could undermine compliance.

The current wave, starting with New Zealand's Fiscal Responsibility Act of 1994 and after the pioneering introduction of inflation targeting in that country, many industrial and emerging economies introduces fiscal policy rules. Fiscal policy rules in emerging market economies are of recent vintage, mainly since the late 1990s. Most of the existing rules are expressed as benchmarks for a broad performance indicator, such as the government balance (in flow terms) or the public debt (in stock terms), usually as a proportion of GDP. In practically all these countries, fiscal policy rules have been embedded in a rules-based monetary framework. The latter includes an inflation targeting regime (Brazil, Chile, Colombia, Mexico, Peru, Poland), a currency board arrangement (Estonia, and until recently Argentina), or a dollarized regime (Ecuador). In this sense, fiscal rules can be viewed as means to reduce or eliminate fiscal dominance in macroeconomic policy. In contrast to the previous waves, a common denominator of the recent rule is that they are supported by more transparency standard consisting of accounting conventions, timely and regularly reporting requirements and a medium term macro budgetary frameworks. Generally all these elements are enshrined in broad legislation or international treaty, with careful spelled out accountability obligations.

### **4.3. International Experience of Fiscal Policy Rules Design**

Present fiscal policy rules are fairly diverse in both design and implementation. Considering the international experience recent institutional reform can be classified into three board groups: formal deficit and debt rules, expenditure limits and transparency. The main examples of this approach are European countries bound by the Maastricht Treaty as supplemented by the stability and Growth Pact. The U.K since 1997 has operated a Golden Rule whereby borrowing is done only to finance capital spending and the limit on net debt is 40 per cent of GDP over a cycle In Continental Europe (EMU stability and Growth Pact, Switzerland) and emerging economies (Argentina, Brazil, Colombia, Peru and India) rely far more on a set of numerical reference values (target or limits) on performance indicators. Rules on budget vary, in a few cases as numerical

limits on the overall deficit (Argentina, Peru, India), or a floor for the overall surplus (1 percent of GDP in Chile). Observance of a current-balance rule, also called the “golden rule” (Brazil, Mexico, India, Venezuela), can prevent a crowding-out of much needed public investment. In some countries, the budget-balance rule is accompanied by additional limits on total government expenditures (Venezuela), primary (non interest) outlays (Argentina, Ecuador, Peru), interest payments (Colombia), and the wage bill (Brazil, Colombia), in order to contain the fastest growing components of fiscal imbalance.

Several countries have deficit and debt rules at sub national level. In the U.S, all but two states have laws requiring balanced budgets and limiting the states to raise debt. Nine provinces and territories of Canada have fiscal rules with balanced budgets requiring them to take on debt only for the purpose of financing investment projects. Canada has also focused on instituting a rigorous expenditure review process. Debt ceiling can serve as a useful adjunct to deficit rules. In practice debt ceiling have been driven not by calculations based on theory, but run by concern about reducing high debt level and are thus generally chosen on the basis of experience of the individual countries.

The U.S places relatively greater emphasis on expenditure and deficit rules. Expenditure rule typically emphasize ceiling on specific areas of expenditures like discretionary expenditure as opposed to non discretionary expenditure and in some cases with respect particular programmes.

Anglo-Saxon countries place primary emphasis on transparency (Australia, Canadian provinces, New Zealand, U.K). The key elements in this approach are an explicit legal basis, elaboration of guiding principles of fiscal policy, requirement that objectives are clearly stated, and emphasis on the need for long term focus to fiscal policy, and fiscal reporting to public. The U.K, U.S, and New Zealand have enacted legislations for transparency with require statements providing the objectives for deficits and debt.

In some countries, under the budget-balance rule, escape clauses are provided in the form of a contingency fund (also called stabilization or countercyclical fund) and/or a multiyear definition of the rule in order to accommodate shocks or cyclical fluctuations in activity. The countercyclical contingency fund is intended to release resources to finance a cyclically induced deficit or to withdraw them from a cyclically generated surplus (Argentina, Estonia, and Peru). More directly, the rule may be defined in terms of structural or cyclically adjusted balance (Chile). A multi-year or medium-term balanced-budget requirement (Ecuador, Venezuela), which allows not only for the operation of automatic stabilizers but also for some countercyclical discretionary action, performs a similar function. To cushion the budget from output changes, some countries (Ecuador) specify ex-ante the real growth of primary expenditure in terms of a constant rate, broadly in line with trend or potential GDP growth. Either in conjunction with a budget-balance rule, or simply with the goal of securing medium to long-term fiscal sustainability, several countries have established for a targets for the phased reduction of the debt-GDP (Poland) or debt-revenue ratio (Brazil). The debt-ratio target or ceiling usually presupposes, either implicitly or explicitly (Brazil), an annual operational target in terms of a minimum primary surplus.

Generally, the institutional coverage of rules depends on the degree of fiscal decentralization and autonomy of various levels of government. In a relatively centralized fiscal system the rules are imposed only on the central government (Chile, Peru) without much loss of control. However, in federal systems, rules must encompass at the national and sub-national levels of government. Depending on the degree of sub-national autonomy, uniform rules are imposed top-down on all sub national governments (Brazil, Colombia, Mexico, Poland) or differentiated rules are voluntarily self-imposed from the bottom-up by some sub national governments (Argentina, India). Fiscal policy rules can be specified in a constitutional provision (Mexico, Poland), high-level legislation (Brazil), or ordinary legislation (India) that applies to governments over successive electoral cycles.

Whatever the statutory form, at present most policy rules are supported by institutional arrangements encompassing the budget process (possibly in a rolling medium-term budget framework), accounting conventions, periodic reporting, projection requirements, and penalties for noncompliance. Also, there is an assignment of responsibilities for implementation versus monitoring and audit the latter usually to be undertaken by an independent authority. Legal sanctions for noncompliance (treated as a criminal offense in Brazil) may exist as well, though typically these remain untested in the courts. Rarely, in the case of top-down sub national government rules (Colombia), deviation from the rule is subject to financial penalties. However, in most countries, noncompliance, especially by the national government, is punished with loss of reputation toward the electorate or financial markets.

#### **4.4. International Experiences of Fiscal Policy Rules in Selected Countries**

##### **(A) Legislative Fiscal Policy Rules**

##### **(i) Deficit, Expenditure and Debt Rules**

**United States:** In United States during 1950-75, the public debt to GDP ratio declined continuously, while the budget deficit remained low. In 1975, public expenditure began to increase rapidly, mainly due to expanding entitlement programmes. Initially, the deficits were partly covered by growing tax revenues, as high inflation moved individual into higher income tax brackets. However, the introduction of inflation indexing in the tax code, tax relief introduced through the Economic Recovery Tax of 1981. Increase in defense spending, and an adverse cyclical position resulted in substantial increase in public deficit, which reached more than 6 per cent of GDP in 1983. After the mid-1980s, the deficit was reduced due to stronger economic activity and legislative initiatives. In the mid 1990s mild recession resulted in a new increase in the budget deficit. The public debt to GDP ratio rose from approximately 25 per cent in the early 1970s to just fewer than 45 per cent in the early 1990s.

To bind governments to fiscal rectitude the United States has long experience with fiscal rules. Rules were introduced through a series of laws enacted since the mid-1980s. The Balanced Budget and Emergency Deficit control Act of 1985, known as Graman –

Rudman- Hollings I specified declining annual targets for the budget deficit, ending with budgetary equilibrium in 1991. The targets were to be enforced by uniform percentage reduction in selected mandatory and most discretionary spending programme. This was ruled unconstitutional because its implementation violated the separation of powers. In 1990, because of unexpected expenditures arising from war with Iraq and major flood, and faced with prospect of substantial expenditure cuts, the president and the congress, agreed to postpone balancing the budget until 1993. This was followed in 1987 by the Balanced Budget and Emergency Deficit control Reaffirmation Act, also known as Graman–Rudman-Hollings II, which revised the deficit targets established by in 1985 and extended them through 1993. This triggered a change in fiscal framework, which the 1990 Budget Enforcement Act reflects.

The goal of Graman–Rudman-Hollings I and II was to increase fiscal discipline by reducing the public deficit and to control the increase in the public debt. The Graman–Rudman-Hollings laws did not produce the targeted decline in deficit because of mistakes in establishing the potential rate of growth of GDP and flaws in the determination of targets. As a result, the sequestrations required to achieve the goals proved to be unworkably large. In 1990, as part of a major deficit reduction package the congress approved the Budget Enforcement Act of 1990, which replaced the deficit targets with expenditure ceilings or caps and established for the period 1990-95 a Pay As You Go system (PAYGO) for revenues and direct spending. Direct spending included entitlement programmes established through legislation. For these programmes, outlays were determined not by annual appropriations but by eligibility criteria and benefits formulas specified to each. Under PAYGO system, all changes in taxes and direct spending had to be deficit neutral over one and five year horizons. In 1993, the Omnibus Budget Reconciliation Act extended the provision of the 1990 law until 1998.

The Budget Enforcement Act of 1997 extended again the provisions of the 1990 law until 2002. Budget Enforcement Act (1990 and 1997) shared the objective of controlling the fiscal deficit and the public debt, but changed the fiscal framework used to achieves the goal. The Budget Enforcement Act of 1990 and its subsequent modification in 1993 and

1997 established more realistic targets, so fiscal restraint was more easily maintained. Nonetheless, an important part of the improvement in fiscal accounts during 1990s was due to the favorable position of the U.S.

**Sweden:** Fiscal rules in Sweden came after a period of high fiscal deficits and a substantial increase in public debt to GDP ratio in the early 1990s. This fiscal deterioration caused due to the severe recession and banking crisis. In 1994 fiscal deficit became 10.5 per cent of GDP and a ratio of public expenditure to GDP of about 65 per cent. Gross public debt as a proportion of GDP almost doubled between 1990 and 1994, reaching almost 75 per cent of GDP. Government reacted by introducing fiscal consolidation programme in 1994-95 and approved fiscal policy rules in 1996 which was implemented in 1997.

The rules aimed at achieving the government long term goal of budget surplus of 2 per cent GDP over the cycle to prepare the public finances for population aging. This goal was intended to need no further tax increases. Budgetary planning is made on a rolling three year basis based on economic forecasts viewed by both the parliament and the government. The basic fiscal targets were a binding nominal ceiling for central government expenditure and the general government net borrowing. The spring fiscal policy bill contained the government's forecast for revenues and expenditures and the allocation of total spending among 27 expenditure areas. The latter were excluded as being beyond public sector control. As a result, the expenditure ceiling covers approximately two-third of total expenditure. In the budget bill of 1997, when the expenditure ceilings were first set, the budgetary margins for the period 1997-99 were established at 1.5, 2.0 and 2.5 per cent of total expenditures, respectively. In practice, the margins had been used to finance discretionary increase in public expenditure.

The government had to inform the parliament of substantial deviations from expenditure ceilings, including reasons for such deviations. Any overrun had to be financed by reducing other areas of spending, through differences between ex ante and ex post outcomes were not formally sanctioned. In the case of limited expenditure over runs, a

borrowing possibility was allowed, but the amount borrowed was automatically deducted from the budget appropriation of the following year. National Audit office carried out annual audits and efficiency audits. The annual audits examined whether an agency's annual reports gives a true picture of financial situation and performance, while the efficiency audits concentrated on how government activity was carried out.

Even though the rules have been in place only since 1997, it is clear that results are positive. Although favorable economic growth has also contributed to this outcome, government expenditure as a percentage of GDP decreased to below 53 per cent of GDP in 2002 from around 60 per cent in 1996. The fiscal balance has shown steady surpluses since 1998.

**Switzerland:** Upto 1980s public debt to GDP ratio was substantially low in Switzerland. In the first half of 1990s the Swiss economy experiences a protracted recession. As a result of this the growth rate of GDP reduced from 1.8 per cent in 1970-90 to zero percent in 1990-96. This also resulted in heavy spending and deficit. The public debt GDP ratio increased from 31 per cent in 1990 to a peak of 54.5 per cent in 1998, especially because of an increase in the debt of federal government.

In 1998, constitution amended to establish the obligation to balance the federal budget by 2001 implemented a fiscal rule. In order to achieve the goal, the authorities cut military spending, rail road budget and increased social security payments. The recovery of the economy in 1999-2000 allowed Swiss government to balance the budget one year earlier.

In 2000, the Swiss government proposed another, constitutional that introduced rules to control the fiscal accounts of federal government. It aims at preventing structural deficit in the federal budget and allowing scope for countercyclical fiscal policy. It imposed a ceiling on federal government expenditure.

The introduction of the rule in a period of structural deficit has made compliance difficult in particular, as sharp adjustment was required to abide by the rule. Technical

implementation problem emerged. Another problem with Swiss rule is that it covers only the relatively small federal budget.

**Netherlands:** has a long history of carefully planned fiscal policy. In 1960s, the Dutch government adopted a structural fiscal policy based on the principle that the budget deficit should be constant as a proportion of trend GDP. The system performed well until the early 1970s, when unrealistic forecasts about trend GDP increased expenditure far beyond actual revenues, resulting in a substantial increase in fiscal deficit. By 1982, the general government deficit was around 7 per cent of GDP. As a result of this situation, the government abandoned the previous fiscal policy and adopted a multi year deficit reduction target. The new policy, however, was strongly procyclical, and the deficit reduction path had to be frequently revised. Despite these drawbacks, the fiscal deficit returned to more sustainable level.

In 1994, trend based fiscal policy established. It aimed at transparent and orderly decision making in budgetary process, increasing efficiency and improving financial control of public sector activities, reducing the ratio of structural sector spending to GDP, and permitting a more effective use of public budget as a countercyclical tool in order to stabilize GDP around its potential. Finally the fiscal framework was intended to strengthen the budgetary process. The budgetary framework of 1994 established a specific expenditure ceiling for central government spending like social security, and health care on a four year basis. In 2002 the rule became more tightened and transfer was allowed only in exceptional circumstances.

Under the budget framework established by two Kok administrations, Dutch public accounts improved substantially; and both public spending and the tax burden were reduced. The fiscal deficit of 4.2 percent of GDP in 1995 became a surplus of 1.5 per cent of GDP in 2000. The gross public debt to GDP ratio was reduced to 56.1 per cent in 2000 from more than 75 per cent in 1995. A favorable position in business cycle also contributed to these outcomes and by 2002 a deficit had reemerged. The use of a cautious economic scenario and unexpectedly strong economic growth produced large revenue

windfalls during the second Kok administration, which should have resulted in large tax cuts according to the rules. In order not to further stimulate the economy, tax cuts remained below what would be implied by rules for distribution of the revenues windfalls. The spending rules, on the other hand, remained binding.

**Indonesia:** Fiscal policy rules in Indonesia introduced in the mid 1960s in the wake of an external payments crisis and high inflation. Under this policy there was prohibition on domestic government borrowing. The coverage excludes certain off-budget operations, particularly those financed with oil export receipts or borrowing from abroad.

**Poland:** The central government in Poland is bound by two rules. The nominal deficit in the approved annual budget can not be exceeded without going back to parliament, and the national public debt has a constitutional limit of 60 per cent of GDP. Special prudential measures are triggered when public debt exceeds 50 per cent of GDP. Specifically, the deficits of sub-national governments must be lowered, the council of ministers must submit a fiscal consolidation plan to parliament, and issuing of new state guarantees is limited.

**(ii) Transparency Rule:**

**New Zealand:** Fiscal management of New Zealand was orderly during the 1960s and early 1970s. Government expenditure was around 30 per cent of GDP and the public budget was close to balance. However, during the most of the 1970s and 1980s, tax revenues lagged spending growth, with the latter being led by increasing transfers, higher debt services caused by persistent fiscal deficits, and higher interest rates following financial liberalization. By the early 1990s, government spending had reached 40 per cent of GDP. Debt peaked at 74.5 per cent of GDP in 1987, from level of around 40 per cent of GDP in the mid- 1970s. As a consequence of the poor fiscal performance, New Zealand's debt rating was downgraded in the early 1990s, increasing the cost of financing the continuing fiscal imbalances.

In this context, the authorities began a process of institutional reform. Fiscal Responsibility Control Act became effective in July 1994. It aimed at improving fiscal policy by specifying principles of responsible fiscal management and strengthening reporting requirement to achieve more transparent decision making by the government. The law intended to increase accountability by promoting a more informed public debate about fiscal policy, and it facilitated the independent assessment of fiscal policies. Provision of Fiscal Responsibility Control Act established five principles of responsible management. First, to reduce public debt by achieving operating surpluses every year until prudent level are reached. Second, to maintain public debt at prudent levels by ensuring that on an average, total operating expenses do not exceed total operating revenues over a reasonable period of time. Third, to achieve levels of public sector net worth that can provide a buffer against adverse shocks. Fourth, to take reasonable steps in order to manage the risks which public sector is facing. Fifth to pursue policies that is consistent with reasonable predictability.

In addition to these principles, an annual budgetary policy statement and a fiscal strategy report to be published. The budgetary policy statement must include the government broad strategic priorities for the upcoming budget, its fiscal intention for the next three years, and its long term fiscal policy objectives. The government must also make clear the consistency of its plans and objectives with the principles of responsible fiscal management set out in the act. In turn, the fiscal strategy reports analyzes the consistency between the economic and fiscal projections included in the budget and government's short term fiscal plans set out in the most recently published budget policy statement. Three year economic and fiscal update to be published depending upon the circumstances, 14 to 42 days prior to any general election. The reports are to be made using generally accepted accounting practice on an accrual basis. In the case of difference between ex ante and ex post outcomes no formal sanctions are established. The government can depart from the principles, but reasons for the departure and when and how it expects to return to them must be stated explicitly.

In addition non legislated fiscal practices concerning expenditure management have been introduced. These involve giving spending department's fixed nominal baselines, which can be adjusted demand driven changes. Until fiscal year 2002-03, any changes or new initiatives within the three year parliamentary cycle had to be met from a fund called fiscal provision, which limited the amount available for new spending. In the 2002 budget this set of practices was replaced by an explicit medium-term framework, which became operational in 2003-04. The medium-term objective was to achieve an average operating surplus over cycle sufficient to cover contribution to New Zealand Superannuation Fund (covering old age pensions) and ensure that gross public debt remains below 30 per cent of GDP. Short-term operating and investment expenditure plans will have to be consistent with these objectives and regularly adjusted in line with fiscal outlook.

New Zealand's fiscal position improved substantially during the 1990s, but the direct contribution of the present fiscal framework has to be weighted against cyclical improvements. Nevertheless, most estimates indicate a clear shift toward lower structural public deficits during the second half of the 1990s. Further more, by requiring all levels of government to be explicit about their short term intentions and long term objectives; the Fiscal Responsibility Control Act establishes a more transparent framework for annual budget decision.

**South Africa:** Since 1994 the fiscal situation had deteriorated sharply in the run-up to the 1994 elections and the political transition it entailed. Government debt was rising fast and the associated interest burden had risen to more than 5 per cent of GDP. So serious was the situation that all parties to the political negotiations of 1993 countersigned a standby facility for the government with the IMF, with the hope that policy credibility might be acquired in this way with a view to stabilising domestic and international markets dealing in South African assets.

In 1999 Public Finance Management Act was Implemented which legislated the need for regular financial reporting, sound expenditure controls and a strengthened system of

supervision and audit. Public finance Management Act, 1999 incorporates many salutary features of responsible fiscal management such as budget disclosure of intentions regarding borrowing and other forms of public liability during current and future financial years, provision of giving projections of multi-year budget to parliament with key macro economic projections, borrowing power limited to budget deficit. Ministers' responsibility regarding guarantees, to be defrayed in the first instance from the funds budgeted for the department issuing the guarantee, percentage limits for re appropriations and unbudgeted expenditure etc.

Together with the multi-year budgeting approach adopted from December 1997 onwards with the publication of the Medium Term Budget Policy Statement (MTBPS) and the Medium Term Expenditure Framework (MTEF) the South African fiscal authorities have taken considerable strides towards the use of targets, monitoring and the transparency often associated with modern fiscal rules

The non-interest government expenditure was successfully contained relative to output growth until 2000-01, but has since been allowed to expand faster than output. Interest payments remained stubbornly high relative to total expenditure until late 1990s following which the debt-GDP ratio started on a sustained downward trend in the year 2000 Total (domestic and foreign) debt declined from a maximum of 50 per cent of GDP in 1995 to 35 per cent in 2006. Finally, government revenue has been growing even more rapidly than the accelerated GDP growth of recent years.

**(iii) Growth and Stability Pact Fiscal Policy Rules:**

**Maastricht Treaty of European Union:** high and persistent budget deficits, rising stock of public debt; a tendency to run a pro-cyclical policy which, instead of smoothing the business cycle, contributed to accentuate its swings. All these factors led European Union to implement Maastricht Treaty in 1992. The main goal of the Maastricht Treaty in terms of fiscal policy is to ensure fiscal discipline in member countries in order to prevent fiscal crises that would negatively affect other countries.

Under the Treaty, fiscal discipline is to be judged on the basis of two main criteria: (1) whether the government deficit as a percentage of GDP exceeds the reference value of 3 per cent of GDP; and (2) whether the ratio of gross government debt to GDP exceeds the reference value of 60 per cent of GDP. Exceptions may be made with respect to the deficit criterion if the ratio of the deficit to GDP has declined significantly and is close to the reference value, or if the excess is only temporary and the ratio remains close to the reference value. Exceptions may be made with respect to the debt criterion if the debt-to-GDP ratio is diminishing at an acceptable pace. The Maastricht Treaty provisions were strengthened by the Stability and Growth Pact (SGP), which ensures that countries sustain their commitment to fiscal prudence once they have joined the EMU. The SGP was adopted in 1997 and took effect when the euro was launched on January 1, 1999. In addition to the Treaty's debt and deficit rules, the SGP requires that member states set medium-term objectives of budgetary positions close to balance or in surplus, in order to provide sufficient flexibility to allow the operation of automatic fiscal stabilizers while remaining within the 3 per cent deficit limit. The SGP also provides for increased monitoring, with an annual review of the stability programmes of countries participating in the euro area (and convergence programmes of those not participating in the euro area). The programmes set out medium-term targets and the adjustment path toward the targets. The Council of EU-member Finance Ministers (ECOFIN) assesses and delivers an opinion on each programme, based on the recommendation of the European Commission. In addition, the Council and Commission regularly monitor the implementation of the programmes and can recommend corrective action if a significant divergence from the medium-term budgetary objective or the adjustment path is identified. In the case of an excessive deficit in a country participating in the euro area, a course of remedial action will be proposed, which must be implemented within ten months. Otherwise, the country may be subject to sanctions in the form of a mandatory non-interest bearing deposit, which varies in size with the magnitude of the excessive deficit, up to a maximum of 0.5 per cent of GDP. If the excessive deficit is eliminated within two years, the deposit will be returned to the country. If it is not eliminated within that time frame, the deposit will become a fine.

Recently, ECOFIN approved the European Commission's suggested changes in the interpretation of the SGP. The changes neither alter the existing reference levels for debt and deficits, nor eliminate the pact's requirement that budgetary balances be close to balance or better. Rather, the reforms refine the interpretation of these requirements, allowing greater flexibility to promote growth, while at the same time reinforcing rules to ensure the soundness and sustainability of public finances in preparation for population ageing. In practical terms, this implies an increased focus on the level of debt and cyclically-adjusted budget balances, likely resulting in some exceptions to the "close to balance" requirement. Generally speaking, the changes aim to provide greater fiscal flexibility to countries with low levels of debt while increasing controls on countries with high debt levels. By 1998, eleven of the fifteen EU member states had met the convergence criteria and agreed to participate in EMU. The Maastricht Treaty fiscal criteria are generally credited with having accelerated fiscal consolidation in the EU countries. For example, France faced a fiscal crisis in the early 1990s, with the total government deficit peaking at 6 per cent of GDP in 1993. However, the fiscal situation improved significantly over the following years, largely due to discretionary policy undertaken by the government in order to comply with the Maastricht Treaty. By 1998, the deficit was under 3 per cent, consistent with the convergence criteria. All member states budget deficits declined substantially since 1993, the year which marked the entry into force of the Maastricht Treaty and in which the euro area registered the historically high deficit ratio of 5.5% of GDP. However, in some countries, public debt started to decrease only when primary surpluses became high enough to compensate the snow-ball effect.

**Germany:** In Germany, a constitutional rule was introduced in 1969 which required a balanced, but allowed borrowing for investment expenditure (golden rule). In addition, some states' constitutions included golden rule. The size of government and public debt in Germany grew rapidly after 1970s. Further more fiscal policy was often conducted in a pro-cyclical fashion. In Germany, the federal government and many of the regional governments were constitutionally obligated to adhere to the "golden rule" that borrowing should only finance capital expenditure. However, the rule has imposed little

budgetary discipline because it was usually applied *ex ante* rather than *ex post*. In addition, investment at the federal level was broadly defined, including financial as well as non financial assets and excluding privatization and depreciation. It excluded special funds and can be suspended if the government determines that economy was not operating at the “national equilibrium”. However, rules to deal with spending overruns were not specified. The new draft of Article 51 came into force in January 1, 2005. It specified that all level of governments will be responsible for avoiding the excessive deficit procedure and proclaimed the overall aim of deficit reduction to meet the close-to-balance target of Stability Growth Pact (SGP). More recently German stability programmes have undertaken to keep annual nominal spending growth at below 2 percent at the level of the general government.

**Italy:** In Italy, no fiscal rule exist other than Stability Growth Pact (SGP). In 1999 Italy introduced Internal Stability Pact (ISP) requiring regional and local governments to reduce their deficits and debt. Deficit was defined as the difference between total revenues net of state transfers and total expenditure net of investment and interest payments. The sanctions were not credible because they could result in excessive penalties for sub national governments. In 1999, only half of the fiscal consolidation projected in the ISP was achieved. The pact was therefore modified in late 1999. First a more ambitious target was set for sub national government for 2000. Second, overall balance was defined to include receipts from the sale of real estate assets as part of public revenues. Third, sub national governments meeting the objectives of the ISP would be granted a reduction in the interest on their outstanding debts to the Cassa Depositi Prestiti. For 2000, it appears that local governments compiled with these revised targets, while the regions breached their deficit ceilings. For the year 2001, it was established that the targeted balance could not worsen by more than 3 per cent from 1999. Successive ISP modifications were adopted to constrain the increase in planned current spending by Ordinary Statue Regions and municipalities in 2002 and with the budget law for 2003 for example, establishing that municipality’ deficits should be no worse than 2001 level.

**Spain:** In 1991, the central and regional governments agreed to the so called Budget Consolidation Scenarios (BCSs) for 1992-96. Based on bilateral negotiations, this agreement specified the maximum deficit and debt for each region. These programmes were publicly announced and became the main coordination tool for budgetary and debt policies of the central and regional governments. Because of the 1992-96 recessions, no region compiled, but the scenario represented a turning point in the evolution of regional debt (Vinuela, 2001). The BCS were revised in March 1995, following revision of the convergence program in July 1994, and again in 1998 with the approval of the first stability program. While the former agreements were respected, the deficit and debt levels specified in the previous agreement are unknown to public, and no transparent sanctioning mechanism exists. Therefore, it is impossible to assess compliance. The Law of Budgetary Stability, first implemented in 2003, required that all levels of government formulate, approve and execute a budget in balance or in surplus. It strengthened reporting requirements, especially at the regional level. This law was expected to ensure that decentralized public finances would not jeopardize the central government's consolidation objective, as well as greater transparency of each region's contributions.

**Belgium:** Cooperation agreements under the national Stability program set permissible fiscal targets for the federal and other level of government. In 1994, the federal government and the communities and regions reached a first cooperation agreement. Subsequent intergovernmental agreements covered 1996-99, 1999-2002, and 2001-05. These agreements established permissible Entity I and Entity II deficit targets according to the recommendations of the High Council of Finance, Which was also in charge of monitoring and reporting on compliance. The corporation agreement did not include formal sanctioning procedures for deviations from permissible deficits. However, the federal government could restrict the borrowing of communities and regions for upto two years upon recommendation of High Council of Finance once regions involved had been consulted.

**Austria:** In 1995, the federal, state, and local governments agreed to achieve budget balance primarily through expenditure reduction. During subsequent negotiations on the

intergovernmental transfer system in 1997, they agreed on the maximum deficit that each will incur. The federal government was assigned a deficit of 2.7 per cent and the Lander and local government were assigned 0.3 per cent of GDP. In the 1998 Austrian Stability Pact, all levels agreed to internally allocate the Maastricht Treaty deficit limit mainly on the basis of population. This internal stability pact established proportional contribution of the federal government and Lander to the sanction payment in the case of an excessive deficit. Local governments in any Lander collectively share the responsibility for the deficit; their contribution to sanction payments would be deducted from their sanction payments would be allowed to partially assign their permissible deficit to other entities. No sanctions were established for noncompliance with the deficit ceiling. In 2000, the domestic stability pact was amended through 2004. Landers targeted an average budget surplus over the period of no less than 0.75 per cent of GDP, with allowable temporary overruns of 0.1 per cent of GDP. The monitoring and enforcement system included fines subject to unanimous decision of all interested parties.

**(iv) Sub-national Fiscal Policy Rules:**

**Argentina:** Prior to 1991 the provinces borrowed heavily, largely from their own provincial banks, which then went to the central bank to discount loans, effectively giving provinces a share in the seigniorage and inflation tax. These banks provided more than 60 per cent of the credit needs of the provincial government at low or zero interest rates. But the central bank charter, which was revised in September 1992, ended the access of provinces to seigniorage and inflation tax. The 1991 convertibility plan fixed the dollar exchange rate of the Argentine currency. This eliminated the possibility of central bank financing of government deficits, and thus impose a relatively hard budget constraint on the public sector. Moreover, by time of stabilization in 1991, a combination of hyper inflation and centre-state negotiations left the provinces with virtually no debt to the federal government. Since then, total provincial debt has declined as a share of GDP and provincial revenues. In 1999 Argentina Fiscal Solvency Act was introduced. It was applied only to the central government. It established a path for reduction of federal budget deficit leading to its elimination by 2005. Besides establishing numeric limits for the central government's fiscal deficit, it limited the growth of expenditures, stipulated

the adoption of pluri-annual budgeting, created a Countercyclical Fiscal Fund, and implemented transparency measures regarding public finances the features favored by the recent literature on fiscal rules. The Law required reaching fiscal balance no later than 2003 and set nominal ceilings for the national-level non-financial public sector deficit between 1999 and 2002. But they were broken in every year.

Although the national law did not include conditions for sub-national governments, it invited the provinces to pass similar laws of their own, and several did. The provisions of the laws differ across provinces, as did the degree to which they were adhered to, even before the economic crisis in 2001. All the provincial FRLs had limits on the deficit or overall debt, and most have both (Braun and Tomassi, 2003). In 2001 the FRLs stopped working because of the extreme mismatch between the national government's fiscal and monetary policies in the context of a fixed exchange rate. Although the federal government's FRL lacked enforcement power, the more fundamental problem was the government's many legally inflexible spending obligations, most notably debt service and provincial transfers. Federal-provincial agreements in 2000 had set nominal peso (= US dollar) floors on transfers to the provinces that would last several years during a transition to a long-term arrangement of moving-average calculations that were more favorable to the federal government. Unfortunately the recessions of 2001 and thereafter reduced revenues to the point that the federal government could not make the promised transfers and defaulted on those and other obligations, paying them with debt that circulated as money (Gonzalez, Rosenblatt and Webb, 2003). Even with stronger enforcement procedures on paper, the FRL could not have solved the problem.

The provincial FRLs also had shortcomings that would have been problematic even if the collapse at the top had not come first. They lacked enforcement power and a critical mass of states had not passed them. The *Compromiso Federal* of 2000 did not have contingencies to assure fiscal sustainability in down-side scenarios of growth. It arranged to share benefits of growth but not to share the cost of recession. All the governments were benefiting from the public asset of a stable currency and using it to access credit markets, but they failed to appreciate the fragility of the asset and the need to coordinate

efforts ex ante controls to avoid overusing it. The attachment of co-participaciones at Banco de la Nacion looked so much like a federal guarantee of the provincial debt that most lenders did not fear ex post consequences, and there were no ex ante constraints from their side.

**Brazil:** Brazil states have a history of running deficits, and then seeking and obtaining federal bail outs. After three decades of sub-national debt crisis, a new Fiscal Responsibility Law (FRL) was introduced in 2000 to make break with the past. It was probably the most comprehensive and toughest in the history of FPRs. It applied to all levels of government (union, states, federal districts and municipalities) and to all three branches (executive, legislative, and judicial). It aimed at maintaining current balance, limiting all personal expenditure, including pensions, under 60 per cent and limiting the ratio of debt to current revenue within the limits set for each year by the President. In addition, the law prescribed detail rules for offsetting any unanticipated increase in expenditures and any increase in tax preferences, for granting guarantees and for own financing of any increase in public pension benefits.

The fiscal performance of Brazil's Sub-National Governments (SNGs) improved markedly over the last few years. The average ratio of debt to net revenue declined from 3.8 in 1998 to 1.9 in 2001 (Alfonso, 2002). At the end of 2000, 10 states still had deficit ratios above the FRL target; by the end of 2001 only six were out of compliance. They adjusted personnel expenditure, including public pensions, even faster; of the 18 states that were out of compliance with FRL targets in 2000, 13 managed to comply by the end of 2001. (BNDES, 10 May 2002) Adjustment by SNGs continued in 2002 and 2003. How much of this is due to the FRL one cannot specify a fraction, because the states as a group seem to have jumped from a bad equilibrium to a relatively good one.

**Peru:** In Peru, the law on Fiscal Prudence and Transparency, enacted in December 1999, declared as a general principle that the government should adhere to balanced or surplus position over the medium term. While coverage that extended practically to the entire general government, the rules resemble closely those of Argentina. Specifically, the law

obliged the authorities (a) to maintain overall balance, subject to ceiling equivalent to 1 per cent of GDP and (b) to limit the annual nominal growth of primary expenditure to 2 per cent above the annual rate of inflation. The rules could be waived in the event of national emergency or international crisis: on evidence of contraction of GDP, the deficit would be allowed rise to 2 per cent of GDP. Also, the Law provided for a stabilization fund, constituted from a portion of excess revenues and privatization receipts, to be drawn to compensate for a cyclical shortfall. Any net accumulation above 3 per cent of GDP would be used for retiring public debt.

Although the initial law improved transparency and helped reduce national-level deficits, it had two main problems: first, it did not keep national government deficits within the legal limits, and second it did not make provisions for the sub-national governments. In April 2003 the government passed a new law, making several amendments intended to rectify these problems. Their success depended on enforcement, the first steps for which was the issuance of regulations. The new law made four key improvements for fiscal prudence at the national level. A new clause prohibited any administrative or legal norm that interfered with the correct execution of the Marco Macroeconómico Multianual (MMM), called for in the original law, especially with respect to the fiscal deficit targets. In election years, the government may only spend up to 60 per cent of the annual spending allocation in the first 7 months and could only use 40 per cent of the annual limit on the deficit in the first semester. Quarterly monitoring of the fiscal performance was required and, in case of revenue shortfall, adequate remedies to revenues and/or expenditures started in the next quarter. If the fiscal deficit limits were relaxed, as under circumstances allowed in the law, then the transition to return to the regular rules was better specified. The new law made five key provisions for the SNGs:

- 1) Each regional government must prepare and published an annual development plan that was consistent with the national MMM (including the size of fiscal deficit).
- 2) All SNGs had to keep a non-negative primary balance on average in the last 3 years in office.

- 3) The overall public-sector deficit limit in the law applied to the sub-national as well as national levels an important ex ante constraint. Regulation needed to define the procedure for translating the aggregate fiscal limit into an allocation of borrowing limits for each of the governments, national and sub-national.
- 4) The FRL had set some ex ante constraints for sub-national borrowing; SNGs could only borrow internationally with the guarantee of the national government. The guarantee for any loan required compliance with the Annual Debt Law and demonstration of the capacity to pay, which provisions gave the national government the authority to veto SN borrowing.
- 5) If an SNG violated the targets in the law, the national government must withhold some transfers to make the required payments of debt an important ex post consequence, if well enforced.

Peru is decentralizing quickly, as have other countries, but it is unique in the passage of an FRL so early in the process, even before the sub-national governments are fully defined or established. It is still too soon to know the results, but if the FRL is well enforced, it will help establish a culture of fiscal prudence in these new governments (Webb, Steven 2004).

**Mexico:** Mexico has no FRL at the national level. Many states have laws, or traditions, regarding the build-up of deficits or surpluses (rainy-day funds), but none has what we call an FRL. Nonetheless, new institutions of SN fiscal discipline have emerged in Mexico since the late 1990s, which seemed to be achieving by other means some objectives of FRLs. To avoid a recurrence of the fiscal crisis, each state had to agree to a fiscal adjustment program designed in the Secretariat of Finance (SHCP), which monitored compliance prior to disbursement of the annual tranches of assistance, set a precedent of fiscal consequences, and brought most states to a good financial situation by the end of the 1990s. The indexed debt that the banks were force to accept helped them avert total ruin and collapse of the system, but illiquidity of the assets and low return inflicted some penalty on the borrowers as well. The government also ended its policy of formally guaranteeing sub-national debt, although as a transition it agreed to accept and

execute contractual mandates by which the borrowers pledged their revenue-sharing transfers as collateral for the debt service. By 1999, the federal government saw the need for change toward a more traditional hard-budget constraint for SNGs and so brought in a whole new system, starting in 2000. The new borrowing framework had four key elements: 1. Giving commercial and development banks ex ante signals about the riskiness of state debt, by making the debt subject to the same borrower concentration limits as other debt and by requiring that capital-risk weighting reflect riskiness, based on international credit ratings. 2. Giving strong incentives for borrowers to publish their fiscal and financial information. 3. Eliminating discretionary transfers from the federal government, at least those at the discretion of the executive. 4. Ending SHCP's role as fideicomiso for collateralizing debt with participaciones. Lenders and the SN borrowers typically organize their own fideicomisos for this purpose, and the absence of direct federal government involvement aims to reduce the administrative ease and thus the likelihood of any bailouts.

Although Mexico does not have a national FRL, state governments have incentives now to make their budgets and balance sheets attractive to voters, credit rating agencies, and lenders taking the sort of measures that an FRL might demand. Nonetheless, the FRL features for transparency and medium-term fiscal management would benefit the federal as well as sub-national governments in Mexico (Webb, Steven; 2004).

**Colombia:** passed Law 617 in 2000, which functioned in many ways as a Sub-national FRL. It is also still too early to tell whether the law brings about a structural change in fiscal outcomes, but the provisions appear to move in the right direction: 1) Primary current expenditure may not exceed non earmarked current revenues, and should not exceed a fixed percentage, depending on the state or municipality category; governments must make across the board cuts whenever effective non-earmarked current revenues are lower than budgeted. 2) Expenditure for state legislatures is limited. 3) State and municipal central administrations are not allowed to make transfers to their public entities. 4) Strict limits apply to creation of new municipalities, and municipalities proven non-viable have to merge. 5) When sub-national governments do not comply with the

limits imposed by the Law, they have to adopt a fiscal-rescue program to regain viability within the next two years. 6) To promote transparency, there is an extensive list of characteristics and requirements for the election of governors, majors, legislators and their relatives.

In June 2003 the government passed a Fiscal Responsibility Law, labeled as such and applying to the national as well as the sub-national governments. It specified a process for setting budget targets and linking them to target ranges for debts and deficits. Regulations for the law build on the current practice of publishing quarterly fiscal results, defining deficits on the basis of cash revenue and accrual of spending obligations, and defining debt to include floating debt. The FRL had set a target to eliminate *reservas presupuestales* in two years. The other part of floating debt, *cuentas por pagar*, was counted as regular debt and thus controlled by the fiscal/financial plan. To help with fiscal discipline at all levels, the FRL prohibited the national government from lending to an SNG or guaranteeing its debt if it was in violation of *Ley 617 of 2000* or *Ley 357 of 1997*, or if it is in arrears on any debt service to the national government. Indeed, a sub-national government with those fiscal violations could not legally borrow from anyone. To discourage electoral cycles in fiscal policy, the FRL also prohibited any government from committing future spending (*vigencias futuras*) or increasing personnel spending in an election year. For the sub-national governments there were additional restraints on deficits: eliminating the intermediate category in *Ley 357* (thus putting tight fiscal restraints immediately on SNGs that show signs of problems), and required that departments and large municipalities get satisfactory credit ratings from international rating agencies before they borrow. While some of these legal measures needed further refinement, such as through their regulations, they represented important advances as long as they are enforced well.

The strategy for fiscal control in the proposed FRL differed between the national and Sub-national levels, because of the different constitutional constraints they faced on fiscal policy. For the sub-national governments the Constitution specified most of their revenue, via transfers, and gave them little leeway to raise more own revenue, so the

proposed FRL strengthened the ex ante restraints on sub-national deficits to complement the existing restraints on sub-national spending, mostly in *Ley 617*. For the national government, where most of the fiscal problems had centered, the FRL increased transparency but still does not give the Ministry of Finance a hard budget constraint with which to enforce fiscal discipline in the face of special-interest demands, including those coming through SNGs on behalf of teachers and others. The Constitution, debt obligations, pensions, and other legal entitlements specified almost all outlays for the national government, so the FRL focused on limiting the deficits so that the adjustment will have to concentrate on the tax side and thus eventually motivate political restraint on spending. Control over spending would improve only if less spending was legally pre-committed to special interests and if the new budget law (drafted in 2003, to be discussed and ) gave the Ministry of Finance the authority in case of a revenue shortfall to curtail spending in order to meet the fiscal balance in the approved budget. The draft did not make this provision, however, and the FRL alone cannot control the national deficits (Webb, Steven; 2004).

**Denmark:** emphasized on expenditure restrained in 2004. It adopted a cooperative approach to policy coordination, whereby the central and sub-national governments negotiated fiscal targets, which then become binding. Starting from 2003, the counties became legally bound to comply with the budget targets (negotiated with the central government and expressed in nominal terms), but expenditure overruns at the local level remain an issue. A broader reform of governance at the sub-national level involving a drastic reduction in the number of municipalities was agreed. It will come into force in 2007. Cyclically adjusted primary fiscal balance improved by about 2.9 percent of GDP over 2004–05. Expenditure restraint accounted for approximately half of the improvement. Tax revenues exceeded expectations, largely owing to rising oil and gas prices, in spite of a reduction in personal income tax rates in 2004, and a "tax freeze" in effect since 2002. Caps on expenditure growth in real terms led to a gradual reduction in the expenditure-to-GDP ratio. Recent fiscal consolidations in Denmark and New Zealand were facilitated by the previous successful consolidations of the 1990s, which laid the

foundations of medium-term budgeting, incorporation of long-term fiscal projections, and improved expenditure control.

**(B) Non Legislated Fiscal Policy Rule**

**United Kingdom:** The United Kingdom's fiscal policy was highly volatile during 1970s, with deficits averaging around 3.3 per cent of GDP from 1979 to 1996 and reaching over 4 per cent of GDP in 1997. When the authorities attempted to control the budget deficit, fiscal policy turned pro-cyclical, with the main burden of the adjustments falling on public investment. The bias against capital investment resulted in underinvestment in public assets and in formation below in other G-7 countries. In this context, in 1997 the authorities introduced a new framework, including measures to ensure a clear separation between monetary and fiscal policy. In U.K the fiscal framework introduced in 1997, the code for fiscal stability was set of principles and guidelines that received statutory backing through the finance Act of 1998. Thus, it also tided the future governments. The fiscal frame work intended to achieve efficiency and effectiveness of taxation and spending, it also aimed at supporting monetary policy. It intended to ensure sound public finances and fair allocation of taxation both within and across generations. It avoided unsustainable increase in public debt by balancing current expenditures with current revenues over the cycle. In this way, the new framework removed bias against capital spending.

The code of fiscal stability was based on three pillars: a set of principles, fiscal rules, and specific reporting and auditing guide lines that received. There were five principles of the code fiscal stability. The first one was transparency in the setting of objectives and implementation of fiscal policy and in the publication of public accounts. The second one was stability in the fiscal policy making process and in how fiscal policy affects the economy. Third one was responsibility in the management of public finances. The fourth one was fairness, including a fair treatment among different generation. The fifth one was efficiency in the design and implementation of policy and managing both sides of public sector balance sheet.

Two general rules accorded with these principles. The first, the golden rule specified that the government will borrow only to invest. The second, the sustainable investment rule, established that the public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

The code also specified reporting and auditing requirements. It mandated a financial statement and budget reports to disclose the key budget decisions and the short term and fiscal outlook; an economic and fiscal strategy report outlining the government's long term goals, its strategies for the future, and progress towards meeting its fiscal objectives; and debt management plans. Furthermore, the government had to publish its economic and fiscal projection, including estimates of the cyclically adjusted fiscal position and long term projection. It had to assess the sustainability of policies, including disclosure and quantification, where possible, of decisions and circumstances that could have a material impact on the economic and fiscal outlook.

To support fiscal framework all spending department had departmental expenditure limits, which will be set in nominal terms for three years on a two years rolling basis. The expenditure limits were only adjusted if inflation forecasts differ significantly from the original projection. Unspent funds could be carried over to the next year, but over runs were not allowed. Departmental expenditure limits covered most non cyclical primary expenditure, approximately half of total expenditure and they included central government transfers to local governments. Current and capital expenditures were treated separately in order to be consistent with golden rule established in code.

Following the introduction of the new framework, fiscal accounts improved markedly, with the public debt to GDP ratio declining from 43.7 per cent in 1996 to 31.5 per cent in 2001. At the same time, the general balance switched from a deficit of 4.4 per cent of GDP in 1996 to 0.9 per cent of GDP in 2001. Over the same period the structural balance also improved, suggesting the part of fiscal improvement was not attributable to the positive position of the U.K economy in the business cycle. Although fiscal balances weakened in 2002, they remained consistent with the fiscal rules. The public debt to GDP

ratio edged up to 31.9 per cent in 2002, and the general government balance deteriorated by about 2 percentage points. Meanwhile, the structural balance turned from a surplus of 0.5 per cent in 2001 to a deficit of 1.2 per cent in 2002, reflecting mainly an increased spending on education, health, and transportation, and a loss of corporate tax revenues.

**Australia Fiscal Policy Rules:** Poor fiscal performance over more than two decades, which led to marked build up in public debt, prompted the Australian authorities to adopt Budget Honesty Act enacted in 1998. Under it government must laid out its short-term fiscal objectives and targets, as well as its medium strategy in each annual budget.

The act established general principles for formulating sound fiscal policy. Fiscal strategy was based on following principles. First, financial risks must be managed prudently, including the general government debt maintained at prudent levels. Second, fiscal policy should help achieve adequate national saving and moderate cyclical fluctuations in economic activity, taking in to account the economic risks and impact of those risks on fiscal position. Third, spending and taxing policies should be consistent with a reasonable degree of stability and predictability in the level of tax burden. Fourth, the integrity of tax system should be maintained. And fifth, policy decisions should be fair from an intergenerational point of view.

Government was required to release a fiscal strategy statement at or before the first budget. The statement was intended to increase public awareness of fiscal strategy and to establish a bench mark for evaluating its conduct. Additionally, the act required government to release reports of Budget Economic and Fiscal Outlook, Mid year Economic and Fiscal Outlook and Final Budget Outcome. The treasurer also had to publicly release an intergenerational report every five years that assesses the sustainability of government policies for next 40 years, including the financial implications of demographic change. To increase the transparency of the budget process in election years, the government had to publish a pre-election Economic and Fiscal Outlook. Budget Honesty Act did not specify particular numerical targets, but it requires

government to set operational targets on three year basis and publish them in fiscal strategy statement.

The new framework contribute to a significant turn around in the federal fiscal position, which shifted from a deficit of about 4 per cent of GDP (on a cash basis) in 1992-93 to a surplus of 2 per cent of GDP in 1999-00. Spending has increased only slightly, and tax burden has remained constant. Moreover, transparency has improved through the new reporting requirements established in the act.

**Canada:** In Canada, federal government debt fluctuated around 35-40 per cent of GDP in the 1980s; but the decline in economic growth during the early 1990s led to dramatic increase in the deficit, which reached around 6 per cent of GDP in 1993. By 1994, debt reached 70 per cent of GDP. The authorities responded through legislated spending restrained beginning in 1992.

The Fiscal Spending control act of 1992 established a nominal expenditure limit for 1992-96. In addition since 1994 the government introduced several policy rules that were not formally legislated.

The main objectives of the act were to control public expenditure growth, reduce fiscal imbalances, and stop the increase in public debt. The non-legislated policy rules were directed at minimizing the use of overly optimistic economic assumptions for budgeting, reducing public debt to cope with population-aging costs, increasing the planning horizon for public sector activities, and improving the transparency of public operations.

The Fiscal Spending control act set nominal limits on programme spending from 1991 to 1995. "Programme spending" included all public expenditures except those associated with the service of debts, payments of employment insurance, expenditures related to farmer protection act, and expenditures arising from emergencies and payments in satisfaction of court judgment against government. The expenditure limits were legislated and thus legally binding: therefore the government was not permitted to present a budget

proposal inconsistent with established expenditure. Overspending in one year could be offset in the following two years, including the financial year stipulated in the law. Additionally, spending could be increased in a year with unexpected revenues, or if spending during the previous year had not reached the limit. Two year rolling deficit targets were adopted with the goal of balancing the budget and, as part of pre-budget consultation process, mid year fiscal updates describing deficit target and revised economic assumptions began to be published. In 1995 a contingency reserve was set up to finance forecasting errors and unpredictable events. In 1998, the government committed itself to a debt repayment plan implying balanced budgets the following two years.

In 2000, Government added a new element to debt repayment plan in addition to setting aside a contingency reserve each fall it announces whether more of that years' surplus than anticipated in budget would be devoted to debt reduction. In the future, the effect of "prudent assumption" on budget projections would be identified explicitly in order to facilitate the evaluation of fiscal strategy. This implies that the public budgets starts by establishing the degree of economic prudence required to cushion pressures on government finances, such as higher than-expected interest rates or lower than forecast growth. This helps to ensure that the government meets it's to balanced growth.

The Fiscal Spending control act was successful. Actual spending remained within limits in all year except 1993, when overspending offset under spending in the preceding fiscal year. Furthermore, the deficit of 5 per cent of GDP in 1995 became a surplus of 1 per cent of GDP by 1999. Although this improvement partially is cyclical, most of it reflects structural gains. Additionally, the ratio of net public debt to GDP was reduced from around 70 per cent in 1995 to 52 per cent in 2000.

**Japan:** Japan had a legislated fiscal rule since 1947, which prescribes that bond issuance be limited to raising funds for financing public works. The rule covered only the general account budget of the central government, which represented only about 25 per cent of the central government's total budget. However, since 1975, deficit-financing bonds had

been issued on a regular basis in addition to construction bonds, which were exclusively for public works. Moreover, the distinction between construction and deficit-financing bonds became less clear as construction bonds were issued to cover more and more spending categories. As such, the fiscal rule had not proven to be a binding constraint since 1975. In order to address the deficit which had persisted through the early to mid-1990s, especially in light of future ageing-related pressures, the government engaged in fiscal tightening and passed the Fiscal Structural Reform Law in 1997. The legislation provided that the sum of the central and local government deficits as a percentage of GDP should be reduced to 3 per cent or less by 2003 (from around 6 per cent in 1997). Furthermore, it provided that the amount of deficit-financing bonds should be reduced every fiscal year and issuance of such bonds should cease by 2003. The legislation also required that numerical limits be set for expenditures in each major programme from 1998 to 2000. Finally, it specified that the sum of taxes, payroll contributions and the deficit should not exceed 50 per cent of GDP. However, the fiscal tightening initiated in 1997 was too much for the economy to bear. Under pressure from the Asian economic crisis and the failure of some major Japanese financial institutions, the economy fell into recession. In response, the government revised the Fiscal Structural Reform Law in May 1998 to introduce more flexibility, and then formally suspended its application in November 1998. Since that time, the government has followed expansionary policies and the general government gross debt-to-GDP ratio has skyrocketed, reached 133 per cent in 2001. Again in 2003 a new Fiscal policy rules proposed from 2003. It was defined in terms of current balance- government limited borrowing capital expenditure only.

**Chile:** Chile did not impose specific rules requiring fiscal balance until 2000, but other long-standing institutional factors played useful roles in maintaining discipline. These included giving more power to the finance ministry than to other ministries; prohibiting the central bank from extending credit to the government; and preventing lower levels of government from borrowing, thereby eliminating sub-national free-rider problems. As net debt declined, its composition became more stable. Most debt is now denominated in local currency and inflation indexed, although un-indexed instruments are being increasingly promoted. Long-term instruments pay a real return of about 3 percent,

similar to the yield in industrial countries. The public sector has positive net foreign assets, since official reserves exceed foreign currency debt; short-term external debt is less than 2 per cent of GDP. Since 2000, the government has committed to an annual target for the central government structural balance, adjusted for cyclical effects and copper-price movements, thus allowing automatic stabilizers to work. This is central to the design of each year's budget. The target currently aims for a surplus of 1 per cent of GDP. To further boost credibility, an expert committee determines the methodology used to calculate the structural balance. Challenges remain, however, to sustaining a strong fiscal performance. The structural budget target has been introduced at a time of cyclical weakening in the overall budget position. Preserving sound policies will require distinguishing temporary from permanent shocks in real time, a notoriously difficult task. An important challenge will be to ensure that any errors in estimating the structural balance average out over time.

#### **4.5. Conclusion**

A review of the experiences of various countries as well as sub-national levels of government suggests that fiscal rules can be useful tools for fiscal retrenchment, if properly designed. Fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient at the both national and sub national levels other wise it may in fact worse than useless, as it invites "creative fiscal accounting."

Countries experience both with and without fiscal rules shows that fiscal rule fiscal rules may be helpful in achieving fiscal success and may even be necessary in certain countries, but they are clearly not necessary in all countries. Governments with a strong reputation for fiscal prudence do not need to be constrained by rules. Countries that lack such a reputation, fiscal rules can indeed provide a useful policy framework that is conducive to stability and growth.

In nineties many counties around the world were able to achieve fiscal consolidation, attaining primary surpluses. Widespread reforms including debt ceilings and deficit targets have strengthened fiscal frame works. Expenditures rules and transparency in the

fiscal management has also been emphasized in these fiscal frameworks. Evolution of these fiscal consolidation efforts have identified certain factors that account for reliable and durable adjustments. Accordingly, fiscal consolidation is more likely to be successful when based on cuts in expenditures, particularly when undertaken by countries with high level of debt widespread reform in fiscal frame work require institutional reforms aimed at achieving and maintaining fiscal consolidation, while leaving room for fiscal policy to respond to business cycle through automatic stabilizers and policy actions. The main criticism of the deficit rules in general and balanced budget rules in particular is that they are irrelevant and therefore tends to be pro-cyclical. This is a more important consideration for national governments as compared to sub national governments. For this reason the deficit rules in national government have increasing been defined in terms of a cyclical adjusted deficit measure or an average over the economic cycle. Thus the rules allow the operation of domestic stabilization and to some extent also provide room for discretionary policy with in the cycle.

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## Chapter-V

### Evolution of Fiscal Policy Rules in India

#### 5.1. Introduction

In India fiscal policy rule is not a new concept. For more than fifty years since the inception of the constitution, government debt and borrowing programmes for the central as well as the state governments in India were managed without any explicit targets or rules except for the constitutional provisions under articles 292 and 293. Apart from this India has been tackling the fiscal deterioration by adopting fiscal reform mechanism to improve fiscal responsibility. In the last decade India has enacted mechanisms to bind government to fiscal rectitude through formal legal or even constitutional devices.

#### 5.2. Constitutional Provisions on Public Debt

Dr. Ambedkar highlighted the importance of Parliamentary Legislation in Constituent Assembly debates on articles 292 and 293 and expressed the hope that “Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the union”. He referred to the need for an “Annual Debt Act”<sup>1</sup>. Article 292 of the constitution of India contemplates limiting government borrowing through a parliament law. It mandates “borrowing by government of India- the executive power of the union extends to borrowing upon the security of the consolidated fund of India within such limits. Under Article 266 any disbursement from the consolidated fund of India mandatorily requires parliamentary approval. Similarly article 293 provides that the legislation of a state can fix limits on borrowing by a state as well as limits on guarantee given by it. Further under this article the central government may make loans to state provided the limit on central government borrowing under article 292 is not exceeded.

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<sup>1</sup> In the constituent assembly debates article 292 of the constitution was referred to as article 268. Dr. Ambedkar had observed “that the borrowing power of the executive shall be subject to such limitations as Parliament may by law prescribe. If parliament does not make a law it is certainly the fault of Parliament and I should have thought it very difficult to imagine any future Parliament which will not pay sufficient or serious attention to this matter and enact a law. Under the article 268 even concede that there might be an Annual Debt Act made by Parliament prescribing or limiting the power of the executive as to how much they can borrow within that year.”

Clause 3 of article 293 provides that if any central loan is outstanding with a state or a loan in respect of which guarantees given by the central government is outstanding, and then a state may not raise any loan without the consent of the government of India. Therefore, Parliament has a vital role in regulating borrowing and other liabilities that are likely to affect the parliament's effective control on future outflows from consolidated fund by way of debt serving and redemption, which is expenditure charged on consolidated fund. The issue of fixing borrowing limits by the parliament no doubt rose time to time. Estimates Committee in 1957-58, and in some of the subsequent reports of Estimates Committee and Public Accounts Committee raised the issue of fixing borrowing limits. Despite this, no legislative action took place to fix on borrowing.

**Shortcoming:** Article 292 of the constitution covers only the Public Debt. This is forming part of consolidated fund of India, as this alone can be deemed to be "borrowing upon the consolidated fund of India". Other liabilities forming part of the Public Account such as post office saving deposits, deposits under small saving certificates and provident funds are not recorded as "borrowing upon the security of consolidated fund of India" (IMF, 2001).

The term fiscal deficit was not part of the budgetary parlance until late eighties. It was only when towards the end of the nineties that interest payment began to account for a large portion of central government and a good amount of revenue sources that issues of sustainability of debt and solvency of borrowing governments gained prominence (Srivastava, 2008).

### **5.3. RBI Attempts towards Controlling Borrowing**

In September 1994 an agreement (without legislated sanction) was signed between the central government and the RBI to phase out the system of ad-hoc treasury bills by 1997-98. Adhoc treasury bills facilitated automatic monetization of the budget deficit. The borrowing gap after all other financing instruments got exhausted. On November 8, 1997, Dr. Rangarajan, the Governor of the RBI, in his inaugural address at the first Conference of the State Finance Secretaries convened by RBI, had flagged the issues that needed to

be focused upon in management of state finances. These included alternative methods for borrowing by the state, statutory ceiling on debt, setting up of consolidated sinking fund and the issuance of state government guarantees.

**Shortcoming:** This, in itself did not preclude the RBI from participating in primary issues of central government securities or operating in the secondary markets for central government debt, but it left these decisions to RBI discretion. While the central government's automatic access to stabilized RBI financing has ended, and reliance on RBI financing by the central government has diminished over recent years, there are no formal limits on overall RBI lending to government. This leaved the RBI free to purchase government securities that are not sold to banks and public financial institution under the central government market borrowing program, and to subsequently sell them through open market operations as part of its monetary and public debt management. The central government also has access to ways and means advances from the RBI. The RBI no longer provides exchange rate or other guarantees (IMF, 2001).

#### **5.4. Provision of Extend Ways and Means Act and Finance Act to Control Borrowing**

Eleventh Finance Commission (EFC) recommended Extended Ways and Means Advance (EWMA) and additional open market borrowings in order to give the incentive for better performance. Fiscal reform programme linked assistance, by way of Extended Ways and Means Advance (EWMA) and additional open market borrowings. The scope and dimension of these facilities were decided by the central government, bearing in mind their macro-economic implications and the centre's fiscal position. The facilities were linked to the monitor able fiscal reform programme drawn up by the state. Eleven States signed confidential Memoranda of Understanding (MoU) with the central government in 1999-00, which promised fiscal reforms in return for advances of tax shares (Government of India, 2000).

**Shortcoming:** The incentive given under this EWMA was not enough encouraging for better fiscal performance.

### **5.5. Debt-Swap Scheme**

Government of India (GOI) formulated a Debt Swap Scheme realising the mounting burden of interest payments on the states, and to supplement their efforts towards fiscal management. The scheme was in operation from 2002-03 to 2004-05. The scheme capitalized on the current low interest regime, to enable states to prepay expensive loans contracted from GOI, with low coupon bearing small savings an open market loans. The scheme covered outstanding high cost loans with interest rate of 13 per cent and above. An amount of Rs 106076 crore was prepaid to GOI by the States from small savings loans and open market borrowings.

These additional recoveries enabled the centre to repay some of its high cost debt to NSSF. The central government used the proceeds of debt swap to effect prepayment of its debt to the National Small Saving Fund (NSSF) at lower interest rate. This had the effect of bringing down centre's overall debt as well as its effective interest rate. During 2002-03, the state Governments swapped Rs 13766 crore had with 20 per cent of small saving share and additional market borrowings. During 2003-04, according to provisional data, loan amounting to Rs 46211 crore had been swapped with 30 per cent of small saving share and additional market borrowings. During 2004-05 additional debt swap amounted to Rs 433887. There has been a fall in centre's liabilities relative to GDP because of the redemption of special securities issued to the NSSF based on the debt swap programme for the state

**Shortcoming of the Debt-Swap Scheme:** The debt-swap scheme was only a small step in the direction of dealing with the unsustainable deficit faced by the States. It covered only 15 per cent of their total debt. Here, again, the scheme merely aimed at reducing the cost of servicing the debt, and not extinguishing it. Though there was a benefits of Debt-Swap Scheme in terms of reducing pressure on the state by way of lower interest rate but it lead to loss of revenue for centre as the high cost loan were brought to lower level (Government of India, 2005).

### **5.6. Debt-Relief Scheme of Tenth Finance Commission**

Tenth Finance Commission recommended debt relief scheme in two parts, namely, (i) specific relief for state with high fiscal stress (ii) a scheme for general debt relief for all states. The second one was linked to fiscal performance. Improvement of fiscal management was measured by comparing the ratio revenue receipt (including devolution and grants from centre) with the total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. The performance of each state was measured against its own performance. Twice the excess of the ratio over the average ratio of fiscal improvement during the preceding three year was recommended for relief on loans contracted during the period 1989-95 and failing due for repayment after 31<sup>st</sup> march 1995. The relief was admissible only to the extent of 10 per cent of the amount due for repayment from loan in any year. Tenth Finance Commission took specific relief for all special category state, and three other states, Orissa, Bihar and Uttar Pradesh, which were characterized by high fiscal stress as indicated by average interest payments to revenue expenditure exceeding 17 per cent during 1989-90 to 1993-94. For these state Tenth Finance Commission recommended writing off of 5 per cent of repayment due with respect to fresh central loans given during 1989-95 and outstanding on 31<sup>st</sup> march 1995. The actual relief sanctioned to state was Rs 212 crore during the period 1995-2000 compared to the relief of Rs 565.51 crore estimated by Tenth Finance Commission (Government of India, 2005).

**Shortcoming:** Though the improvement of fiscal management was measured by comparing the ratio revenue receipt (including devolution and grants from centre) with the total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. So when the devolution and grants from centre was increasing the revenue receipt to total revenue expenditure ratio was showing an improvement but it was not an actual improvement of fiscal management of state.

### **5.7. Debt-Relief Scheme of EFC**

Eleventh Finance Commission (EFC) did not consider any special debt relief for the fiscally stressed states, but continued general debt relief of Tenth Finance Commission.

EFC enhanced general incentive from 10 per cent to 25 per cent. In addition to it instead factors of two, a factors of five was applied on the ratio of fiscal improvement in terms of revenue receipts to total revenue expenditure. In the calculation of revenue receipts, the revenue deficit grants recommended by EFC under article 275 were excluded. This relief was to be available in respect of fresh loans granted during 1995-2000 and outstanding on March 2000. The actual relief sanctioned to state was Rs 131.77 crore till September 2004, compared to the relief of Rs 600 to 700 crore estimated by EFC ( Government of India, 2005).

**Shortcoming:** Though under EFC in the calculation of revenue receipts, the revenue deficit grants recommended by EFC under article 275 were excluded still devolution from centre remained as a part of revenue receipts. So when the devolution from centre was increasing the revenue receipt to total revenue expenditure ratio was showing an improvement but it was not an actual improvement of fiscal management of state.

#### **5.8. Debt Relief Scheme under Twelfth Finance Commission (TWFC)**

Twelfth Finance Commission also recommended for debt relief scheme but, it also recommended that each state has to enact Fiscal Responsibility Law (FRL) with a target to eliminate revenue deficit and reducing fiscal deficit by 2008-09. Enacting FRL became a precondition for availing debt relief. A debt write off scheme became linked with the reduction of revenue deficit of the state. The quantum of repayment was linked to the absolute amount by which the revenue deficit is reduced in each successive year during award period. Fiscal performance measured with reference to the revenue deficit/ revenue surplus as worked out in absolute numbers by taking an average of three years, viz, 2001-02 (Actual), 2002-03(Actual) and 200-04 (RE). This average was taken as the base year for 2003-04. For state which were in revenue surplus, as per the base year figure, and continued to remain so in subsequent years till the end of award periods the installment of repayment due on central loans was written off in each years from 2005-06 onwards so long as revenue surplus of the state did not go below the base year level in absolute terms. In the year the revenue surplus was less than that in the base year figure no write off was permitted. In a year if the reduction in revenue deficit was more than the

minimum required for debt write-off the entire repayment due in that year, the excess was carried forward fully to the next year, provided the revenue deficit continued to follow a down ward trend in the next year and was lower than the base year figure (Government of India, 2005). TWFC also recommended a stricter borrowing ceiling with the center setting global ceilings on borrowing and only lending to fiscally weak states.

**Shortcoming of the TWFC Debt-Relief Scheme:** The scheme of debt-write off linked to revenue deficit reduction recommended by the TWFC favored state with low base year revenue deficit. The relatively better of state received large benefits from debt write-off scheme, though they had relatively lower revenue deficit. Thus, the state with larger deficit gained less in terms of debt write-off in terms of the overall transfers they received. This did not induce them to undertake the fiscal adjustment. It encouraged creative accounting while preparing budget. The recommendation of the TWFC particularly for backward state allowing them to directly access the market, made debt stressed and difficult for the backward state to raise loans from market due to their lower credit worthiness and higher risk perception of lending agency. Placing borrowing limits based on capacity to service debts and uniform target for fiscal deficit reduction accentuated regional imbalances. The scheme of debt write off which was recommended by the TWFC commission guided more by the need for fiscal consolidation rather than providing relief to debt stressed poor state (Rao and Jena, 2005).

Debt Swap Scheme and the Debt Consolidation and Relief Facility (DCRF) recommended by the Eleventh and Twelfth Finance Commission, respectively. However, it may be noted that interest payments on special securities issued to NSSF, which was kept out of the purview of DCRF, constituted more than half the total interest payments obligations in a number of state such as Maharashtra (57.9 per cent) and Gujarat (55.1 per cent), and it accounted for more than 40 per cent in other state such as West Bengal (49.1 per cent), Goa (47.4 per cent), Karnataka (45.4 per cent), Punjab (44.7 per cent), Haryana (44.1 per cent) and Chhattisgarh (43.3 per cent) in 2008-09 (RE). Further, interest payments on market loans constituted more than one-fourth of the total interest payments in some state such as Andhra Pradesh, Kerala, Goa, Tamil Nadu, Rajasthan and Uttar

Pradesh in 2008-09 (RE). Despite the initiation of DCRF, interest payment on account of loans from the centre is quite high in state such as Orissa (29.4 per cent), Madhya Pradesh (16.7 per cent), Karnataka (16.3 per cent) Bihar (16.1 per cent) and Chhattisgarh (15.7 per cent) in 2008-09 (RE) as compared to state like Punjab (0.9 per cent), Maharashtra (5.5 per cent), Haryana (7.0 per cent), Goa (7.6 per cent) and Tamil Nadu (8.6 per cent). As per the recommendations of the TWFC, the state need not compulsorily avail of the loan portion of the Normal Central Assistance. Considering this problem Thirteenth Finance Commission did a little modification in Debt Consolidation and Relief Facility (DCRF) (Government of India, 2010).

### **5.9. Debt Consolidation and Relief Facility (DCRF) under Thirteenth Finance Commission**

The Commission has recommended two debt relief measures to be extended to all state. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to state contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9 per cent. The implication of this relief during the award period is estimated by the Commission to be Rs. 13517 crore. The financial implication over the entire period till the maturity of the last loan covered in this relief measure is estimated to be Rs. 28360 crore. The Commission has also recommended that structural reforms should be brought in the NSSF to make it more market linked. The second debt relief recommended by the Commission is write-off of central loans to state that are administered by central ministries other than Ministry of Finance outstanding as at the end of 2009-10. The amount of loans outstanding as at the end of 2007-08 was Rs. 4506 crore as noted by the Commission. The Commission has also recommended that any further loans under Centrally Sponsored Schemes should be completely avoided. The Commission has also recommended extension of the debt consolidation facility recommended by the Twelfth Finance Commission to state that have not yet availed this benefit.

All the above mentioned debt relief is available to state only if they amend/legislate FRBM Acts in accordance with the recommendations of the Commission. The

Commission has also recommended that the state will be eligible for the state specific grants only if they comply with this condition (Government of India, 2010).

#### **5.10. Eleventh Finance Commission Provision of Fiscal Reform Facility (FRF) to State**

On April 2000, Eleventh Finance Commission drew a monitor able fiscal reform programme, aimed at reduction of revenue deficit of the state. It recommended the manner in which the grants to the state to cover the assessed deficit in their non plan revenue account may be linked to progresses in implementing programme. EFC identified growth of tax revenue, growth of non tax revenue, growth of non-plan revenue expenditure on salaries and allowances, interest payments and reduction of subsidies as the five indicators as a measure of the fiscal performance of the state and recommended weights for each. As recommended by EFC, an incentive fund in the form of Fiscal Reform Facility (FRF) was set up by Ministry of Finance leaving 85 per cent of the revenue deficit grant recommended by EFC to be released to the state without linking it with performance. The remaining 15 per cent was linked with improvement in fiscal performance. While introducing the scheme of FRF, Government of India prescribed a single monitorable indicator for the purpose of making releases from the incentive funds. The indicator expected each state to achieve a minimum improvement of 5 per cent in revenue deficit/surplus as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-2000. The revenue deficit was to be inclusive of contingent liabilities and subsidies due to public sector enterprises (Government of India, 2000).

**Shortcoming of FRF:** Only a minor portion of the grants of non plan revenue account was linked to fiscal performance so it did not give any incentive to state towards fiscal responsibility.

### 5.11. Medium Term Fiscal Reform Programs (MTFRPs)

In 2000-01 the finance ministry issued guide lines to state for Medium Term Fiscal Reform Programs (MTFRPs). The MTFRP had dual aim of reducing wasteful expenditure (cutting low priority spending) and improving tax collection or improving the efficiency of the tax administration. The MTFRPs required the state to make time bound reform in four areas like, fiscal, power and public sector and budgetary. The main objective of MTFRPs were to bring the consolidated fiscal deficit to sustainable levels by 2005 and to bring down debt-GDP ratio as well as interest payment to revenue expenditure rate over the medium term. The MTFRPs finalized for nine states, namely Nagaland, Andhra Pradesh, Karnataka, Orissa, Kerala, Arunachal Pradesh, West Bengal, Himanchal Pradesh and Manipur. Despite the operation of Fiscal Reform Facilities (FRFs) state achieved 6.23 per cent reductions in RD/RR ratio by 2002-03 as against the targeted 15 per cent reduction over the base year 1999-00. In 2003-04, the position deteriorated by 1.89 per cent. The aggregate fiscal deficit of state actually increased from 2.35 per cent of GDP in 1993-94 to 3.5 per cent in 2004-05. Similarly state revenue deficit increased marginally from 0.45 per cent of GDP in 1993-94 to 1 per cent of GDP in 2004-05. The out standing debt to GDP ratio of state increased substantially from 21.79 per cent of GDP in 1993-94 to 31.15 per cent in 2002-03. FRF did not play a significant role in bringing about an improvement in state fiscal position in past five years. On the basis of performance five states classified as consistently improving (Kerala, U.P, Goa, Sikkim and Chhatisgarh). Some state classified as consistently deteriorating (Gujrat, H.P, Uttarachhal and Jharkhand). Twelve states showed initial improvements and then deteriorated (W.B, Rajastan, Punjab, Bihar, T.N, Manipur, M.P, Assam, Haryana, Karnataka, Tripura and Meghalaya). The remaining state were initially deteriorating and then improved such as, Maharastra, J&K, A.P, Mizoram, Nagaland, Arunachal Pradesh and Orissa) (Government of India, 2005).

**Shortcoming of MTFRPs:** There were certain reasons, why MTFRPS could not achieve its target. There was a design failure in prescribing a uniform 5 per cent improvement in the ratio for all state. If state start off with larger base year deficits, it was relatively easier for them to make huge improvements. In the initial years MTFRPs target were set in

terms of revenue deficit as a per cent of total revenues of state and when transfer to state declined, the ratio went up. The single monitorable factor was needed to be removed. The definition of revenue deficit was not uniform for all state. The size of fund, which was promised to be given to a state, as an incentive for achieving targeted reduction in fiscal deficit was insignificant, so could not give sufficient incentive to state to restore fiscal balance (Rao and Jena, 2005). The Twelfth Finance Commission (TFC) and Thirteenth Finance Commission recognized this problem and it recommended for linking the debt write off to improvement in revenue deficit. It has a lot merit as there is a direct link to absolute in the revenue deficit. The debt relief will be available, only if state enacts appropriate legislations to bring down the revenue deficit to zero and commit to reducing the fiscal deficit in a phased manner. MTFRPs was an important development in managing state finances, as the state started thinking about fiscal matters on a medium term frame work.

#### **5.12. Restructuring the System of Fiscal Transfer towards Fiscal Responsibility Under various Finance Commissions in the process of Tax Devolution**

Even though the system of transfer is always guided by equalization and efficiency criteria, but still an objective for providing incentive to state towards achieving fiscal discipline has been always taken care of by different Finance Commissions (FCs). The critical aspect of the recommendations of the 12th and 13th FCs has been to link resource transfers to enhance the fiscal prudence on the part of the state, in general, and the enactment of Fiscal Responsibility Legislations by the state, in particular. The increase in transfers recommended through tax devolution and grants are expected to facilitate the state to undertake fiscal correction even while undertaking social and infrastructure expenditure required moving on an accelerated growth path.

In the tax devolution process time to time different Finance Commissions have taken certain criteria and have assigned them certain weights, considering the urgency of fiscal consolidation.

**Table 5.1: Criteria and Relative Weights for Tax Devolution under Various Finance Commissions**

Criterion	Weight (%)	Weight (%)	Weight (%)	Weight (%)
	10th FC	11th FC	12th FC	13 <sup>th</sup> FC
Population (1971 census)	20	10	25	25
Distance	50	0	0	0
Income (distance method)		62.5	50	10
Area	5	7.5	10	0
Index of infrastructure	5	7.5	0	0
Tax effort	10	5	7.5	0
Fiscal discipline		7.5	7.5	17.5
Fiscal Capacity Distance	0	0	0	47.5

**(a) Tax Effort:** Tenth Finance Commission (TFC) for the first time took tax effort as criteria for tax devolution to state. It worked as an incentive among the state to raise tax potential capacity. Tax effort was measured by the ratio of per capita own tax revenue of a state to its per capita income. It was weighted by the inverse of per capita income. It ensured that if a poorer state exploited its tax base as much as a richer state, it got an additional consideration in the formula. TFC gave 10 per cent weight to tax effort criteria. Eleventh Finance Commission (EFC) also recommended this criterion but it reduced the weight of inverse of per capita income from 1 per cent to 0.5 per cent. EFC gave 5 per cent weight to tax effort criteria. Twelfth Finance Commission (TWFC) also took tax effort criteria for tax devolution and it also raised the weight to 7.5 per cent considering the urgency of fiscal consolidation (Government of India, 2005). Thirteenth Finance Commission dropped this criterion for tax devolution (Government of India, 2010).

**(b) Fiscal Discipline:** Eleventh Finance Commission for the first time introduced the fiscal discipline criteria for tax devolution. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the state. The ratio so computed was used to measure the improvement in the index of fiscal discipline in reference period in comparison to a base period. TWFC also recommended fiscal discipline criteria for tax devolution to state. Fiscal discipline criteria got the relative weight age of 7.5 per cent in both the Eleventh and Twelfth Finance Commission. Twelfth Finance Commission had worked out the index with the reference period of 2000-01 to 2002-03 and the base

period of 1993-94 to 1995-96. These criteria provided an incentive for better fiscal management. Thirteenth Finance Commission have retained this criterion and have worked out the index of fiscal discipline with 2005-06 to 2007-08 as reference years and 2001-02 to 2003-04 as the base years. The own revenue receipts of a state include own tax revenues and thus, the criterion of fiscal discipline also captures the tax effort of state. Thirteenth Finance Commission has, therefore, dropped the use of tax effort as a separate criterion. Twelfth Finance Commission assigned a weight of 7.5 per cent each to fiscal discipline and tax effort. Thus, the combined weight assigned by Twelfth Finance Commission to these two criteria was 15 per cent. There is a strong case to incentives state following fiscal prudence, particularly in the context of the need to return to the path of fiscal correction. Thirteenth Finance Commission, therefore, assigned a weight of 17.5 per cent to fiscal discipline. Under this criterion, if all state improved their respective ratios of own revenue to total revenue expenditure, then the state with relatively higher improvement than the average receives higher transfers. Similarly, if the ratio has deteriorated in all state, then state with lower deterioration than the average receives higher transfers (Government of India, 2005).

**Shortcoming of the Transfer System:** Although the Finance Commission has earned appreciation as a useful fiscal institution for a federation, the transfer system that has been operating on the ground is marked by features that are widely perceived to be not very conducive to fiscal discipline among state. Multiplicity of transfer channels with little effective coordination among them and mediation of capital transfers (loans from the centre) without adequate regard for the repaying capacity of the recipient governments are the major road block on the way of achieving fiscal discipline. The allocation of the other component of the FC's transfers (share of central taxes, which accounts for the bulk of the “statutory transfers”) is decided on the basis of formulae which are also believed to have generated wrong signals for fiscal discipline. However, the emphasis is on equity rather than efficiency. While the transfer formulae also contain weights for efficiency (“tax effort”, fiscal self-reliance etc.) their effects are often perceived to be weak and subdued by equity factors. Even though criteria like tax effort, fiscal discipline has been taken in the tax devolution process under different FCs to

achieve fiscal consolidation; it could not act as an incentive to the state for going towards fiscal stability. These criteria are mainly based on efficiency without considering equity. Though these criteria constitute only a minor portion of the total devolution process, it could not have any significant effect on the efficiency or on the equity among the state. Even the Thirteenth Finance Commission have taken Fiscal Discipline criteria and has given the weight of 17.5 per cent, in the tax devolution process to achieve fiscal consolidation, under the presumption that it will act as an incentive to the state for going towards fiscal stability. Though this criterion constitutes only a minor portion of the total devolution process, it will not have any significant effect on the efficiency or on the equity among the state (Rao and Jena, 2005).

The conflict between equity and efficiency in the transfer formulae is often overplayed as both can be taken care of simultaneously if the revenue gaps of the state are assessed normatively. However, for practical reasons, application of norms has not proceeded far and it may not be unfair to say that the persistence of gap filling approach in the FC's transfers noted above continues to generate perverse incentives for fiscal indiscipline among state. With such a transfer system, the states have found it profitable to undertake expenditure commitments exceeding their available revenues on the expectation that the gap would ultimately be made up by the FC. The design of statutory transfers thus has tended to create a bias towards improvident budgeting by "legitimizing incipient deficits" caused by inadequate revenue effort and imprudent expenditure decisions of the past.

Contrary to the scheme of inter Governmental transfer that was apparently contemplated in the Indian Constitution with FC as the chief mediator, central funds are transferred to state in India through other channels as well, of which Plan transfers constitute the main component. Some transfers are made directly by central ministries for implementing Centrally Sponsored Schemes (CSS). Initially, central assistance for the state plans used to be project-specific. In 1969, this system was replaced by the Gadgil formula whereby support for state plans was extended out of central budget in the form of grant and loan with the share of individual state determined largely on the basis of population, and, in part, with reference to relative income levels. Some weight was given to tax effort but its

effect was submerged by the other factors. An element of discretion was provided in the form of weight age for special factors.

There is lack of effective coordination between FC and PC. As a result, it was possible for a state to underplay its resource availability before the FC but present a different picture before the PC to obtain approval for its Plan of a size unwarranted by available funds. In the pursuit of national objectives like literacy program, the Centrally Sponsored Schemes (CSS) under the 'Plan' which are implemented through the state but are not all funded fully by the centre adding to their expenditure commitment. Often they carry a matching component, casting an additional burden on the state budgets and distorting their priorities. Finally, resources transferred to state in the form of loans are made up largely of 'plan loans'. These are the on-lending by the centre from its own borrowing constituting the largest component of funds flowing from the centre to the state as loans. These, together with the system of state' borrowing from the market mediated by the Centre at uniform rates of interest and maturity, taking no account of the debt sustainability of individual state or their varying creditworthiness, constituted a potent source of budgetary instability of state. Unless the distortions in the fiscal federal system are removed, any attempts at fiscal correction at the state level are doomed to failure (Anand, Sen and Bagchi, 2001).

### **5.13. Restructuring the System of Fiscal Transfer towards Fiscal Responsibility Under Planning Commissions Transfer to State**

Planning commission transfers financial assistance to the state on basis of Gadgil formula in the fourth and fifth five year plan. Under Gadgil formula basically population, percapita income, tax efforts, on going irrigation and power projects and special problems were taken as the bases for financial transfers. Under these formula tax efforts was taken as indicator to achieve fiscal responsibility but though it constitute only 10 per cent of total financial assistance it could not achieve its objective. For 1991-92 annual plans some modification took place in formula and in the modified formula population, percapita income, financial arrangement and special development problems taken as the bases for financial transfers. Under these formula financial arrangement was taken as the

base to achieve fiscal responsibility but though it constitute only 5 per cent of total financial assistance it could not achieve its objective. Again in eight five year plan some modification took place financial assistance to the state was made on the basis of Mukherjee formula. Under this formula basically population, percapita income, performance and special development programmes was taken as the bases for financial transfers. Performance base was given 7.5 per cent weight of total assistance. It took tax effort, financial management; progress in the form of national objectives as the indicator of performance base. Though this performance base constitutes only a minor portion of the total transfer, it did not have any significant effect on the efficiency or on equity among the state.

In the case of plan assistance for general (non-special) category state, 30 per cent of plan assistance was given as grant and 70 per cent as loan. In the case of special category state 10 per cent of plan assistance was given as grant and 90 per cent as loan. Interest rate charged by the central government on the plan loan to State, which has been, in the past sometimes 300 to 400 basis points higher than the cost of funds to centre. Plan grant are not interest free grants. While at least two-thirds of the Plan expenditure have always been debt-financed (since 1974-75), in 1998-99, borrowings of the State meant for Plan Financing reached an unprecedented high of 139 per cent of Plan expenditure

**Shortcoming:** Several features of plan financing and plan transfers tended to generate imbalance in the revenue budget of the state, of which the following deserve mention: 1) Approval of state Plans by the Planning Commission in terms of the 'outlay' without specification of its revenue and capital components. 2) The practice of the PC to approve large state Plans even when a state failed to achieve the targets set in the preceding year by a large margin. 3) Plan, non-Plan dichotomy in budget accounting with the revenue component of a Plan project shown under 'Plan' for the given Plan period but under 'non-Plan account' thereafter. This added to the state's 'committed' expenditure. It also provided a built-in incentive to launch new programs involving substantial expenditure on current account without regard for the consequence for future budgets.

#### **5.14. Non Plan Revenue Grant by Thirteenth Finance Commission**

It has been argued that Non-Plan Revenue Deficit (NPRD) grants risk moral hazard by providing an incentive to state to run non-plan revenue deficits. In Thirteenth Commission's award there has been a significant reduction in the volume and state-wise incidence of NPRD grants, which is to be expected, given the structural improvements in the fiscal position of much state, including special category state. In the latter case, in recognition of the effort made to exit NPRD, Thirteenth Commission, deemed it appropriate to acknowledge such achievement with a performance incentive. Therefore, the need for NPRD grants diminishes as structural fiscal reforms are implemented and economic performance improves (Government of India, 2010).

#### **5.15. Budgetary Reforms towards Fiscal Responsibility**

A system of performance budgeting by Ministries handling development programmes was introduced in 1969 following the recommendations of the Administrative Reforms Commission. For long, a need has been felt to address certain weaknesses that have crept into the performance budgeting. This outcome budget will be major steps toward accountability and in this way it may bring fiscal accountability. Ministries present performance Budget that specifies results to be achieved by major programs. Actual performance is accessed in ministries' Annual Reports. The Planning Commission has a Program Evaluation Organization that carries out evaluation of plan projects.

**Shortcoming:** There is little incentive for Ministries to carry out evaluation of plan projects and this practice is not widespread. Evaluations have not had much impact on subsequent budgets (IMF, 2001). There is lack of clear one to one relationship between the financial and the performance budgets and inadequate target setting the physical terms for ensuring year are the major weaknesses that have crept in to performance budgeting framework.

#### **5.16. Fiscal Responsibility and Budget Management Act**

Even though fiscal reform has been done time to time to improve fiscal responsibility piece meal reform became successful. Widespread deterioration in fiscal position with

associated impact on fiscal sustainability, macro economic vulnerability and economic growth led an emerging, consensus about the urgent need for imposing statutory ceilings on central government's borrowings, debt and deficits. Therefore, in 2003 the central government of India enacted FRBM Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macro economic variable. FRBM act aims at intergenerational equity, macro economic stability, fiscal sustainability and fiscal solvency, eliminating deficit bias, fiscal transparency, fiscal accountability, autonomy of monetary policy and including limits on access of government to central bank credit. The Fiscal Responsibility and Budget Management (FRBM) Act mandates the centre to reduce fiscal deficit to 3 per cent of GDP and to completely eliminate revenue deficit by 2008-09. Similarly, acting in response to the debt relief package recommended by TWFC in return for fiscal correction, almost every state except West Bengal and Sikkim have enacted fiscal responsibility acts accepting similar obligations - fiscal deficit of 3 per cent of Gross State Domestic Product (GSDP) and zero revenue deficits by 2008-09.

The FRBM Act implemented with the debatable issues of: how to meet these objectives without eroding supremacy of Parliament itself in matters relating to fiscal management; and with suitable flexibility needed to meet emerging situations. The Parliamentary system and federal nature of polity would add to the complexities in the design and implementation of legislation (Reddy, 2000).

**Institutional Issues:** The more important institutional issues would perhaps be: (a) whether there is a need to bring about FR through a new constitutional provision, or a mere law, and if it is the latter, whether it should be linked to the existing constitutional provisions on ceilings on debt and guarantees; (b) whether the FR would be passed by Parliament to cover only the centre or whether it should be made applicable to all state in addition, by obtaining necessary authorisations, or whether it should leave the matter to the concerned state with or without some persuasion or through a model law by centre; (c) whether the law should be so designed as to avoid or limit judicial interpretation and jurisdiction; (d) whether the convention of secrecy of budgetary process is consistent with the most significant aspect of FR, namely transparency. It can be argued that, except

where anticipatory actions are possible, such as specific tax-measures, secrecy is not warranted and indeed secrecy of budget process stifles transparency of not only annual exercise, but also medium-term, and perhaps intra-year measures. There are universally recognised fiscal policy rules, and legislation incorporates one or several specific targets or ceilings or conditionalities or even prohibitions. There are broadly three types of rules, balanced-budget or deficit rules; borrowing rules and debt or reserve rules. Of direct relevance to the RBI is a borrowing rule that prohibits or limits borrowing by Government from a central bank. The FR has to balance between a credible rule, quantitatively determined and need for flexibility in fiscal management. Yet another aspect relates to the time frame within which these rules can be implemented. It is possible to visualise milestones, on these rules, incorporated into the legislation or enabling provisions made in FR to fix milestones from time to time.

**Accounting Issues:** Significant operational issues relate to accounting principles and practices. These would include budget coverage, adoption of accrual system to some degree, projections or medium term parameters, explanations for short-term deviations, valuation of assets at market value or foreign currency liabilities at current rate of exchange, contingent liabilities accounting and providing there for, etc.

**Fiscal Management Issues:** Illustratively, fiscal management issues in our country comprise: (a) the fact that a significant part of liabilities is not covered by assets even as per current valuation methods; (b) a significant part of current expenditure is “charged”; (c) there is passive growth of salaries, pensions, dearness allowance etc.; (d) there are also vertical and horizontal issues. If FR is imposed rigidly on centre there can be impact on state and differential impact among state, (e) the overhang of the past makes corrections possible only over the medium term, and hence need for delineation of transition path from the current situation to full-fledged fiscal responsibility.

**Procedural Issues:** The most important procedural issue relates to defining a trigger for what constitutes noncompliance with fiscal responsibility, warranting corrective action, and if so what are the corrective actions. At one extreme, there may just be reputation risk, while at the other extreme; there could be automatic revenue enhancement, or

expenditure containment. Apart from defining trigger and options of automatic sequestration or revenue surcharges, since the budget is annual, the tracking of intra-year situation becomes critical. This is particularly relevant in view of the acute intra-year mismatches observed between receipts and expenditures both at centre and state. The penalty for non-compliance should be built into the process, recognising that repudiation through revision of law itself is not impossible, since this was done by Parliament in several cases. Further, a view has to be taken on who should be the monitoring authority or authorities to track and disclose degree of compliance Comptroller and Auditor General, Parliamentary Committee or Oversight Committee of eminent experts. Whether and how budget documentation needs to be altered and intra-year reporting documentation introduced (say every quarter) to Parliament would also have to be considered. In particular, a case is made out by some experts for periodical reporting directly to public, with remarks of Oversight Committee of experts in addition to reporting and accountability to Parliament.

Another issue is whether Oversight Committee, without prejudice to Parliamentary Committee, should indulge in a pre-budget review or only post-budget review, and whether it should be concerned with intra-year reviews. There is, in cases of some countries, personal accountability, of say the Minister for the estimates and adherence to it. It has to be seen whether such accountability is feasible in India. Finally, there are a set of issues relating to the RBI. Recognising that the ultimate fiscal authority is with Parliament and that cannot be constrained except by self imposition, should FR bar automatic monetisation by the RBI or prescribe rules for it and should the RBI be banned from participating in primary issues of Government stock and finally should FR promote effectiveness of monetary policy by divesting it of its role as Public Debt Manager.

**Procedural Coordination with State:** Inevitably, there would be need for coordination in many areas of fiscal management, between centre and state. This could conveniently extend to even procedures relating to tax administration, which may be desirable irrespective of a view on FR. Let us take an example. States have recently agreed to adopt uniform floor rates of tax in respect of sales tax. This is only the first step towards having

uniform rates of taxation. However, neither uniform floor rates nor uniform rates of tax would be meaningful unless there is a standard and universally accepted classification of goods. The customs and Excise Departments of Government of India adopted the Harmonized System of Nomenclature at the eight-digit classification, though not the twelve digit classification currently in use in Europe. Perhaps, central government should urge all the state to adopt a standard and universally accepted classification of goods for effective coordination of revenue administration. Government of India may have to consider several such initiatives to ensure what may be termed as sound all-India fiscal management.

### **5.17. Conclusion**

In India, among the reform tasks the most challenging one involves re-examination of fiscal relations between the central and state governments, with a view to restoring vertical balance and paving the way to fiscal responsibility. In other words, it is necessary to adopt a mechanism of inter governmental relations with strong incentives for expenditure control and revenue-raising at the sub national level. Failure to develop such a mechanism carries the risk that sub national governments will continue to incur sizable deficits and rely on costly bailouts. Other structural reforms that should help adherence to fiscal rules include downsizing the government's work force, further rationalization of subsidies, and elimination or streamlining of quasi- fiscal operations.

Part of fiscal mess that exists now is due to the confusion persisting around the federal sharing. Fiscal responsibility can not be planned from the above; Subject this condition, state autonomy should not be affected by the system of central transfers. Policies such as adoption of gap filling approach by finance commission, the policy of the planning extending loan assistance to the state in accordance to a set of entitlement form with no reference to borrowing or repayment capacity or the existing level of public debt and the policy of pay revision of government servant regardless of payment capacity of governments of different state. Mere implementation of FRBM Act can not solve the problem an institutional reform is required in order to achieve the FRBM Act objectives.

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## Chapter-VI

### Design Issues under Fiscal Responsibility and Budget Management Act in India

#### 6.1. Introduction

Fiscal responsibility laws aim to impose durable fiscal discipline and overcome the problem of “deficit bias”. Such laws attempt to impose an underlying constraint, of varying degrees of formality, on fiscal policy and often on those that make it. Fiscal responsibility laws can entail numeric rules, such as a balanced budget, or impose procedures focusing on enhancing transparency and accountability. They typically require that the government commit to a monitorable fiscal policy strategy or to specific fiscal targets. Some contain well-defined sanctions for non-compliance. Fiscal responsibility laws generally include explicit escape clauses that suspend their application during exceptional circumstances, such as natural disasters or severe recessions. They can also define fiscal targets in terms of multi-year horizons or structurally adjusted indicators.

Fiscal rules vary considerably across countries in terms of the target variable, institutional coverage, and method of implementation. The country specific context, experiences and environments have a bearing on the nature of the rules. While there are no fixed rules for the design of FPR, Kopits and Symansky (1998) list some desirable characteristics which any FPR should have. Ideally a, fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient.

- (i) Fiscal rules should be well defined as to the indicator to be constrained, the institutional coverage, and specific escape clause in order to avoid ambiguities and ineffective enforcement. A rule defined in terms of the overall balance is preferable to one aimed at current balance (requiring balance current revenue and current expenditure), as investment expenditure suffer from both conceptual and

measurement weakness. Also limitation in the institutional coverage of the Government budget excluding off budget operations and the cost of quasi fiscal activities of public enterprises are an inevitable linkages.

(ii) An essential characteristic of a durable fiscal rule is transparency in Government operation, including accounting, forecasting and institutional arrangements. Opaque fiscal policy intentions and resource to creative accounting or miss presentation of the true magnitude and timing of future obligations, usually in the commitments and contingent liabilities are likely to undermine the rule.

(iii) Fiscal rules should be adequate with respect to the proximate goal. For example if the goal is to reduce inflation rate and the extraction of revenue from seignior age. The rule should restrict government access to central bank financing. However, if, the objective is to avoid a buildup of external debt, then the constraint should be imposed on the budget balance as a whole. Alternatively, sustainability of public debt-GDP ratio would require a rule expressed as a maximum and non increasing debt ratio or, more precisely a minimum primary surplus in proportion to GDP, that is equivalent to or larger than the projected difference between the interest rate and the growth in the economy.

(iv) A closely related criterion for a set of fiscal rules to be consistent internally, as well as with other macro economic policies or policy rules.

(v) Rules should be characterized by simplicity to enhance their appeal to the legislature and to public. It should be simple for general public to follow.

(vi) Rules should be flexible to accommodate exogenous shocks beyond the control of authorities.

(vii) A fiscal rule should be enforceable depending, on the constitutional and legal status by the chosen authority in the country concern.

Most rules can not last for long unless they are supported by efficient policy.

## **6.2. Fiscal Policy Rules Designed at National Level**

Against the fiscal background and after three years of discussion, India enacted the FRBMA in August 2003. At central level under the FRBMA the stated objective are to ensure inter-generational equity in fiscal management, achieve fiscal sustainability

necessary for long-term macro-economic stability, and improve the transparency of central government fiscal operations. Similar to most Fiscal Responsibility Laws (FRLs) around the world, the FRBMA establishes the broad framework for conducting fiscal policy by setting out both procedural as well as numerical rules<sup>1</sup>.

Under FRBMA the principles of fiscal responsibility have been defined in relation to deficit, borrowing and debt and deliberated on the choice, coverage and targets of fiscal indicators. Under deficit principles a group of deficit indicators, viz, Revenue Deficit and Gross Fiscal Deficit have been identified and targeted. FRBM Act under its rates set the target for eliminating revenue deficit by 2008-09 and reducing fiscal deficit to 3 per cent of GDP by 2008-09. To achieve the target of revenue deficit and fiscal deficit the central government has to reduce revenue deficit by an amount equivalent to 0.5 per cent and fiscal deficit by 0.3 per cent or more of GDP at the end of each financial year, beginning with financial year 2004-05. Under borrowing related principles, government borrowing from Reserve bank has been prohibited. It may borrow from it by Way and Means of Advances (WMA) to meet temporary excess cash disbursement over cash receipts. Under the debt related principles, a limit on debt stock has been prescribed. In India, the FRBM Act sets a limit of 50 per cent of GDP on total liabilities of the central government. The central government shall not give guarantees to an amount exceeding 0.5 per cent of GDP in any financial year, beginning with financial year 2004-05. The central government should not assume additional liabilities (excluding external debt at current exchange rate) in excess of 9 per cent of GDP for the financial year 2004-05 and in each subsequent year, the limit of 9 per cent of GDP has to be progressively reduced by at least one per cent of GDP. The FRBM Act is operationally effective because it seeks year to year ceiling rather than a medium term ceiling.

**Institutional Framework:** Fiscal policy rules statutory basis differ from country to country. Although usually the rules are enshrined in a law or in the constitution, in a few

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<sup>1</sup> Procedural rules refer to those that define attributes and interaction of participants in the budget process aiming to enhance transparency, accountability and fiscal management. Numerical rules instead are defined on the basis of overall indicators of fiscal policy such as fiscal balances, debt, revenue, and expenditure.

cases they may be found in administrative or policy guidelines. In India statutory instrument is legislation, mainly under the authority of Articles 292 and 293 of the constitution to set limits on borrowing or extending guarantees. An additional institutional issue touches the authority responsible for the surveillance and enforcement of rules, as well as the associated transparency requirements. In India by principle the government is accountable to parliament; the actual surveillance authority could exercise (on behalf of parliament) by the comptroller and Auditor General, whose functions are specified under Act 148 of the constitution. Ministry of finance reports to parliament any deviations from obligations under the rules and to propose remedial action.

**Transparency:** The FRA adopt certain improvements in fiscal reporting in order to take care of quasi-fiscal operations and ensuring better fiscal transparency. The central government takes suitable measures to ensure greater transparency in its fiscal operations in the public interest and minimize as far as practicable, secrecy in the preparation of the annual financial Statement and demand for grants. In order to ensure greater transparency in fiscal operation in the public interest, the central government at the time of presenting the annual financial Statements and demands for grant has to make disclosure of any significant change in accounting standards, policies and practices affecting or likely to affect the computation of prescribed fiscal indicators, Statement of receivables and guarantees and a Statement of assets.

**Fiscal Policy Statement to be laid before Parliament:** The central government has to lay the Statement on medium-term fiscal policy Statement, the macro economic frame work Statement and the fiscal policy Statement in each financial year. The medium-term fiscal policy statement has to set forth a three year rolling target for four fiscal indicators viz, revenue deficit as per cent of GDP, fiscal deficit as per cent of GDP, tax revenue as percentage of GDP, total outstanding liabilities of the central government as percentage of GDP. The medium-term fiscal policy Statement has to include an assessment of sustainability relating to the balance between revenue receipt and expenditure. Ministry of Finance shall review, every quarter; the trends in receipts and expenditure in relation to the budget and place before both houses. It has to also include an assessment of

sustainability relating to the use of capital receipts including market borrowing for generating productive assets. The fiscal policy strategy Statement shall contain the policies of central government for the ensuing financial year relating to taxation, expenditure, market borrowings and other liabilities, lending and investment, pricing of administered goods and services, securities and description of other activities such as underwriting and guarantees which have potential budgetary implications. It has to also contain the key fiscal measures and rationale for any major deviation in fiscal measures pertaining to taxation, subsidy, expenditure, administered pricing and borrowings. An evaluation as to how the current policies of the central government are in conformity with the fiscal management principles has to be in it. Fiscal policy strategy Statement will contain the intra year bench marks for assessing the trends in receipts and expenditure relating annual targets and budget estimates. It has to contain the strategic priorities of the central government for ensuring financial year in the fiscal area. The macroeconomic framework statement has to contain an assessment relating to the Gross Domestic Product (GDP), the fiscal balance of the union government (revenue balance and gross fiscal balance) and the external sector balance of the economy reflected in the current account balance of the balance of payments.

**Enforceability:** FRA is in terms of compliance at stages of both budget approval (ex-ante) and budget execution (ex-post). Further ex-ante compliance in terms of actual performance is contemplated not only ex-post (end of year performance), but also contemporaries (intra year).

**Exclusion Clause:** An escape or exclusion clause, in non performance of the contract if a certain specified condition occurs. In the context of FRL for government, government can deviate from the pre specified fiscal targets such as revenue deficit and fiscal deficit if there are unforeseen demands on the finances of the Government arising out of internal disturbances or natural calamity or such exceptional grounds as the government specify.

### **6.3. Fiscal Policy Rules at State Level**

Following the footsteps of the central government and the recommendations of the Twelfth Finance Commission<sup>2</sup>, all state governments, except Sikkim and West Bengal, have enacted Fiscal Responsibility Laws (FRLs). Karnataka was the first state to enact the FRL in September 2002 followed by Tamil Nadu (May, 2003), Kerala (August, 2003) and Punjab (October, 2003). Following the recommendations of the TFC, twenty-two more states have enacted the FRLs. Although there are variations across states in the choice of target and the time frame for achieving the target, most of the FRLs stipulated for eliminating of RD by March 31, 2009 and reducing GFD as per cent of Gross State Domestic Product (GSDP) to 3 per cent by March 31, 2010, in line with the targets prescribed by the TFC. The fiscal targets are expressed either as ratio of output or ratio of Total Revenue Receipts (TRR). Tamil Nadu, Rajasthan, Himachal Pradesh, Goa and Punjab have enacted fiscal responsibility law and have used revenue receipts as denominator for revenue deficit. Karnataka, Kerala, Assam, Gujrat, Chhattisgarh, Madhya Pradesh, Tripura, Andhra Pradesh, ManiPur, Nagaland, Uttaranchal, Bihar, Jammu and Kashmir, Mizoram, Jharkhand and UP have, however not out lined the trajectory of revenue deficit and have simply aimed at eliminating RD within a specified period. In addition, several states have imposed limits on guarantees and targeted to reduce their liabilities. They aim at limiting yearly issuance of guarantees to 0.5 per cent of GDP; reduce total liabilities to 50 per cent of GDP, and abstain from borrowing from the Reserve Bank of India (RBI, 2005).

### **6.4. FPR Options for Federation**

At a theoretical level, sub national governments could adopt either a coordinated approach or an autonomous approach in enacting fiscal legislation (Kopits, 2001). Under the coordinated approach (i.e, top-down approach), all sub- national governments are

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<sup>2</sup> The Twelfth Finance Commission (2004) recommendations aimed to alleviate states' fiscal distress by (i) raising the share of central government revenue (from 29.5 to 30.5 percent) and the amount of grants received by states, (ii) conditional debt restructuring and interest rate relief, provided that the states pass and implement FRLs targeting revenue balance by 2008/09 and a 3 percent of GDP overall deficit by 2009/10, (iii) a stricter borrowing ceiling with the center setting global ceilings on borrowing and only lending to fiscally weak states.

subject to uniform rules under the surveillance of a central authority, and each sub national government seeks to establish collective credibility for overall macro economic policy. For the most part, this top-down approach is introduced against the background of past bailouts or under some form of implicit or explicit guarantees to rescue sub-national governments in distress. Coordination also becomes necessary in federations (or confederations) where lower levels of government are responsible for the bulk of fiscal activity, with considerable potential spillovers from the misbehavior of one or several government on the collective risk premium of the federation. It is for this reason that all Brazilian states and German Lander are required to follow the golden rule. Similarly, lacking a credible EU wide no-bailout clause, each EU member country is required by the Stability and Growth Pact to keep its general government accounts close to balance or in surplus over the medium run, subject to the deficit limit of 3 per cent of GDP. Under the autonomous approach (a bottom-up approach), the initiative for adopting fiscal rules arises from individual sub-national governments. Following this bottom-up approach, in Canada, Switzerland and the United States, many sub national governments have adopted the golden rule, enforced with varying degrees of stringency, while others retained discretionary policymaking. By and large, in these countries, sub national governments face directly the financial markets to meet their borrowing requirements, and there is rarely a precedent of bailouts of insolvent sub national governments by the national government.

It can be argued that constitution provides Government of India (GOI) with the authority to introduce coordinated FPR into India, though under the Indian constitution, the Government of India enjoys extensive power over state borrowing. Article 293 empowers the states to borrow upon the security of their respective consolidated funds. These borrowing powers, are however subject to the following conditions: (i) external borrowing is barred (ii) limits may be imposed by state legislature on borrowing; and (iii) if the central government has advanced or guaranteed a loan to a state which remains outstanding, no fresh loan can be raised by that state without the consent, conditional or otherwise, of the central government, A coordinated approach can bind the centre as well as states indebted to GOI. The fact is that India's borrowing regime allows state

government's greater freedom except for foreign debt. GOI actual control over states' borrowing behaviour is far below its constitutional limit. Much borrowing by states is formula based, and so not linked at all to a state borrowing capacity. This applies to the block loans that a state is entitled to borrow from the GOI in accordance with the modified Gadgil formula (based largely on population and income), and the loans raised through Small Saving Schemes (80 per cent of net collections in a state). Access to market borrowing is determined by RBI in consultation with the planning commission and appears to be based on historical precedent (with typical annual increase of about 10 per cent). Public Account, Ways and Means Advance (WMA) and Overdrafts facilities which are provided by RBI is linked to state revenue levels. Guaranties and Public Sector enterprises are the major sources of financing that relax the borrowing constraint. For GOI to move from a practice of low level control of state debt to a legislative coordinated FPR would imply a massive increase in central control. This is unlikely to pass the test of political feasibility given India's federal traditions and the increasing assertiveness of the states. Even if the centre were to fully exercise its constitutional powers it would still only control a portion of state debt. A substantial amount of state level borrowing is from the "public accounts". These public accounts funds do not belong to the government and have to be paid some time or the other to the persons and authorities that deposited them. The central government operates several Small Saving Schemes through public accounts. The net collection in Small Savings Schemes and Public Provident Fund (PPF) in post offices and banks in a state are shared with the states in the form of loans. Though borrowing from the public account is not regarded as borrowing against the consolidated fund of the states, it is subject under Article 293 to be controlled. The central government does not have full control over the borrowing by the states through small saving schemes. Any increase in small saving mobilization results in an automatic increase in cash inflows to the states through accepted sharing formula. The RBI provides WMA to the states banking to help them tide over temporary mismatches in the cash flow of their receipts and payments. Many states use WMA and overdrafts as a resource for financing their fiscal deficit. Such advances are repayable. Another problem against coordinated approach is that, state government guarantees are not subject by the constitution to central control. Changes in the contingent liabilities or outstanding amount of guarantees are not

part of the fiscal deficit. But such guarantees act as a substitute for government expenditure. A public sector enterprise of doubtful commercial viability is given a guarantee to raise fund from the market instead of a grant or loan from budget. According to Article 293(1) of the constitution, the state governments of India can give guarantees upon the security of the consolidated fund of states. In addition to using guarantees to create contingent liabilities to assist their public enterprises to borrow more and at lower cost, state governments have also started to issue guarantees to create actual, but off-budget government liabilities which substitute directly for government on-budget borrowing. Government is able to issue guarantees for special purpose vehicles, the proceeds from which either substitute for government investments or indeed are transformed to general government revenues. Debt-serving for such liabilities is then fully met by the budget in later years. Considering all these things it can be concluded that coordinated approach to FPRs is likely to be non-starter in India, as it is highly unlikely that GOI would either want to or be able to claim for itself a greatly enhanced role in determining state borrowing levels. Autonomous route was envisaged by the framers of India's constitution. Article 292, on GOI borrowing and Article 293, on state borrowing, are written in very similar language. Article 292 envisages central legislature control over central borrowing and Article 293 state legislative control over state borrowing. Considering all these arguments India has adopted the autonomous approach under which, initiative for adopting fiscal rules arises from individual sub-national governments (Howes and Jha, (2002); Hausman and Purfield (2004); Lahiri,(2000)).

The enactment of fiscal rules has been drawing serious debate and several doubts are expressed as to the, rationale of focusing on only three fiscal indicators (fiscal deficit, revenue deficit and accumulated debt) and setting of rather rigid limits by the FRBM and state level Fiscal Responsibility Laws (FRLs). Doubts also exist on the feasibility of adhering to the limits and target imposed in the context of present federal fiscal arrangements in the country.

## **6.5. Rationale of the Indicator taken under FRBM Act**

### **(a) Rationale of Targeting Fiscal Deficit:**

Fiscal deficit as a proportion of GDP has emerged as a key indicator to measure the fiscal health of a country. Fiscal Deficit is measured as the difference between aggregate disbursements and revenue and non debt capital receipts. Fiscal deficit summarizes in a way the total range of public finances covering expenditure and revenue. Therefore a limit on fiscal deficit is required but mere limiting of its size alone may not yield the required result. The impact of fiscal deficit depends upon the composition of the fiscal deficit and the way it is being financed. Continued high fiscal deficit are concern for several reasons. First this disempowers the government fiscal stance by preempting larger share of public resources for debt servicing there by leaving that much less for desirable expenditure such as physical infrastructure (e.g. roads, power) and social infrastructure (eg education and health). This leads to declining ratio of capital expenditure to total expenditure as seen over the period 1990-91 to 2002-03 in the case of India. Continued Fiscal deficit impact on interest and inflation rates depending on how the deficits are financed. If the government borrows in the domestic market, it puts pressure on the interest rate. If the government finances the deficit by creating high power money, it fuels inflation. In India's case since deficits are financed by open market borrowing, albeit through a preferential SLR window, the risk is largely of government borrowing leading to higher interest rate.

The argument that fiscal deficit crowds out private investment and pushes up interest rate holds true under certain given conditions. When fiscal deficit represents a claim on private savings in excess of what private sector's investments plans warrant, there would occur crowding out of private investment, demand for goods as well as for credit would be pushed up in excess of supply and pressures generated thereby for higher interest rates, higher inflation and bigger current account deficit on the external front. If the fiscal deficit represents, in contrast, efficient investment in capital assets that would increase the economy's productivity, the effect on the economy can scarcely be negative. Therefore, running a fiscal deficit is not per se dangerous. There is feeling that the government should increase its capital expenditure beyond current level since public

investment is believed to crowd in private investment. Fiscal deficit may be necessary even desirable in some situation. The issue is not whether or not there should be a fiscal deficit, but its appropriate level.

Basically two factors are relevant in determining appropriate level of fiscal deficit, the private savings of the economy and second the ratio of Government revenue to GDP. A higher level of private savings and higher ratio of government revenues to GDP can permit higher fiscal deficit, without producing an adverse impact of 'crowding out' and keeping the interest payments as a proportion of revenues within limits. However, even in relation to private household savings, what is relevant is private saving in the form of financial assets which is the excess of total saving of the household sector over its investment. Apart from level of savings and the ratio of revenue to GDP it is also a function of existing stock of debt and debt serving burden, the rate of interest, the external payments situations, the degree of capital control and importantly the use to which the borrowed resources are put.

Among the most contentious issues is the sanctity of a 3 per cent target of fiscal deficit each for the centre and the states. An economy should determine its fiscal deficit according to the economic situation rather than it should be prefixed. However under FRBM Act there is always scope for deviating from 3 per cent fiscal deficit under exclusion clause in exceptional situation of the economy. The question has been always raised whether there is a rationale for this or is it just a number pulled out of thin air is a question. Determining an appropriate level of fiscal deficit is a complex problem. There is an enormous amount of public finance literature on fiscal deficits but virtually no paper is there that gives a template for determining the appropriate fiscal deficit. It is this backdrop which has triggered the criticism that the 3 per cent target has no justification and that it has simply been copied from the Maastricht Treaty which mandates the members of the European Union to maintain a 3 per cent fiscal deficit over an economic cycle. Pattnaik, (2006) argues that there is no theoretical reason cited for having a fiscal deficit target of 3 per cent FRBM act has been enacted not because it is a sound finance but because international speculators demand it. Fiscal deficit financed itself by

generating an excess of domestic saving over private investment exactly equal to itself. If the objective of an economy is, employment generation public expenditure through borrowing finance is useful. On the other hand, a society with egalitarian goals should aim to keep down fiscal deficit, and finance public expenditure through progressive taxation (Pattnaik, 2006).

Rangarajan and Rao (2007) argue that Twelfth Finance Commission provided a detailed rationale for the fiscal deficit target of 6 per cent for the centre and states combined. The Commission argued as follows. The Maastricht Treaty allows its members a 3 per cent fiscal deficit. Undoubtedly, the higher savings rate in India will allow a higher level of fiscal deficit relative of GDP to be maintained. Household sector in India has excess savings over its investments of the order of 10 per cent to 11 per cent of GDP. Add to this foreign savings by way of current account deficit of the order of 1.5 per cent-2 per cent of GDP yielding savings of the order of 13 per cent of GDP available to be appropriated by the public sector and the corporate sector-for investment. Up to 5 per cent of this will go to the corporate sector and 8 per cent to the combined public sector. Of the latter about 2 per cent will go to the non-departmental undertakings leaving 6 per cent for the government to be apportioned equally between the centre and the states. Thus, a combined fiscal deficit of 6 per cent of GDP is consistent with the existing ratio of the savings of the household sector in financial assets relative to GDP and prudent levels of current account deficit, and the demand on these by the private corporate sector and non-departmental public enterprises. Secondly, the 6 per cent deficit target (for the centre and states taken together) was defined with respect to maintaining a 12 per cent growth in nominal terms. If India successfully achieves a 9 per cent growth rate in real terms with 5 percent inflation rate, India may need to consider uplifting the fiscal deficit target. However, this could be done after the debt-GDP ratio has fallen significantly. It can also be undertaken earlier if the household sector's savings in financial for increases and private investment is not able to absorb it.

The target for fiscal deficit also needs to be informed by the debt dynamics such as the ratios of debt to GDP and interest payments to revenue. The debt dynamics are such that

unrestrained fiscal deficits will put India on a vicious cycle of higher debt relative to GDP and a larger portion of the revenues being preempted for interest payments. It is important to restrain fiscal deficit in order to first bring down and then stabilize the debt-GDP and interest payments to revenues at reasonable levels. Apart from all these argument the most important point is FRBM Act also have an exclusion clause for fiscal deficit under certain situation and the economy can deviate from pre specified 3per cent fiscal deficit.

**(b) Rationale of Targeting Revenue Deficit:**

The more worrisome in Indian situation is the presence of revenue deficits. Revenue deficit means the difference between revenue expenditure and revenue receipts which indicates increase in liabilities of the government without corresponding increase in assets of that government. Such expenditure of borrowed resources makes additional borrowing inevitable in subsequent periods for the servicing of the original borrowing and sets off a vicious circle of borrowing. It means that centre and states are using up a significant proportion of borrowed funds not for capital investment that will yield future income but for current consumption like payment of salaries, pensions and subsidies. Revenue deficit exacerbate inter temporal equity concerns as they give the pleasure of spending to current generation while pressuring on the pain of debt serving to latter generation. Hence, emphasis on eliminating revenue deficit is required. But, eliminating revenue deficit requires reducing revenue expenditure drastically which is not always feasible. Interest obligations take away around 30 per cent of total expenditure. Similarly, expenditure on defense is not to be compromised. So, if government tries to reduce expenditure it may do so in crucial sector like social services. It is also argued that several items expenditure that has been traditionally classified as revenue (current) expenditure are in the nature of capital expenditure, designed to generate future income steams. Thus although there can be little doubt regarding the desirability of zero revenue deficits, care must be taken that expenditures that bestow widespread benefits (such as social sector) but which are not backed by powerful interest groups are not axed.

The revenue deficit is the difference between current revenue and current expenditures. It indicates the extent of government dis-savings. Targeting revenue deficit could help safeguard investment at times of fiscal consolidation, while leaving net worth of the government unaffected and promoting intergenerational equity. But focusing exclusively on the current balance is risky. Focusing on the revenue deficit may invite creative accounting, with a view to classifying current expenditure as capital.

The issue in the debate has been the need to target revenue deficit as part of fiscal responsibility. It is argued that internationally fiscal rules do not target revenue deficits; they focus instead on the fiscal deficit and on the primary deficit (i.e. fiscal deficit excluding interest payments) as the relevant control variables. It is not correct to say that the revenue deficit target is not internationally recognized. The U.K, for example, has the 'golden rule' which mandates the government to restrict borrowing to the extent of capital expenditure. Accordingly, under the golden rule, capital expenditure equals borrowing plus any plough back from surplus on the revenue account. The golden rule is, therefore, similar to our zero revenue deficit targets. Several other countries too have mandated discipline on maintaining a balance on the current account of the budget. Revenue deficit is not restrained in many countries because do not have a concept of revenue deficit. Even in India, revenue deficits were a phenomenon that started life only in the early 1980s. Second, in a conceptual sense, of the three variables, fiscal deficit, primary deficit and revenue deficit, it does not matter which two variables we target. As long as India targets any two variables, the third variable is determined too. Illustratively, it is possible to calibrate a primary deficit target corresponding to a zero revenue deficit and shift targeting from revenue deficit to primary deficit. In that sense what matters is the quantum of adjustment required to be made and not which two variables are targeted (Rangarajan and Rao, 2007).

The primary balance is the revenue minus non interest (primary) expenditure. It is an indicator of fiscal "effort," in that interest payments are predetermined by the size of previous deficits. The case for focusing on the primary deficit is simply that, interest costs on accumulated debt are outside the scope of government control and while they

may vary with interest rate changes, this variation does not reflect the quality of fiscal control. The primary balance is a critical variable for debt sustainability analysis. The debt-stabilizing primary balance is the primary balance necessary to keep the debt-to-GDP ratio stable. In the case of India it has not been targeted. On the choice of the deficit indicator Primary Deficit (PD) is not taken as a target because it is derived from Gross Fiscal Deficit (GFD) and is not easy to understand. The increases in GFD and PD are mostly attributable to the persistent growth in Revenue Deficit (RD) in recent times and therefore, elimination of RD has been identified as the focal area of fiscal reforms. However, elimination of RD can at best be used as a supplementary target to a fiscal deficit cap to prevent crowding out of capital expenditure. Hence, to set the deficit rule in terms of RD and GFD rather than PD is justified (RBI, 2005).

The argument is between targeting the fiscal and the revenue deficit. It could be argued that only the fiscal deficit should be targeted or just the revenue deficit. Targeting revenue deficit in the one hand protects capital spending on the other hand can lead to budgetary distortions. These can already be observed as states, for example, classify their budgetary support to the power sector as equity investments to avoid counting them as revenue expenditures. Another reason for targeting the fiscal rather than the revenue deficit is the need to cap off-budget borrowing, much of which finances capital expenditure. With capital expenditures uncapped, states could continue to bankrupt themselves by shifting capital expenditure, and borrowing for the same, off budget. Moreover, golden rules work on an assumption that capital projects can pay for themselves, and hence justify the borrowing involved. But in the Indian context, this is far from the case. In fact, most capital spending in India generates very little revenue for government. The power, irrigation, rural water supply, and roads projects which typically dominate capital spending at the state level are usually generating very little revenue for government. To the extent that a revenue surplus is not created, an annual revenue balance requirement is too strict as it means that the only fiscal response to recession can be on the capital side. It would thus seem that, whether or not a revenue balance target is given, the overall deficit should definitely be capped; but arguments for a revenue deficit cap in addition to a fiscal deficit cap are not particularly strong, apart from its undoubted popular support.

**(c) Rationale of Targeting Debt-GDP ratio:**

A major objective of fiscal policy rule is to reduce public debt and stabilize it at a prudent level. Borrowing may need to be constrained because of longer-term debt sustainability concerns. A fiscal rule that establishes a medium term limit on the gross debt-GDP ratio can provide a broad gauge of fiscal decency, whereas a rule that seeks to set year to year debt ceilings is unlikely to be credible or operationally effective. Since measures of public indebtedness (especially as a proportion of GDP) are usually exposed to valuation changes and other factors beyond the control of the authorities, they are difficult to treat as an annual operational target.

It is difficult to calculate true extent of the states' debt burden as states engaged in off-budget activity. The level of outstanding guarantees grew by over 40 percent between 1993 and 2000, outstripping the growth in official state level debt. Fiscal activities are also conducted off-budget through various State-owned Financial Corporations (SFCs) and utilities with adverse consequences for their financial health. These off-budget sources of fiscal activity are contingent liabilities that could result in future claims on states' budgets.

There is a need to go beyond the budget in setting FPR targets. There is a need to incorporate off-budget borrowing and the power sector deficit. Some states now incur more capital expenditure financed by off-budget borrowing than they do on the budget. Since there is an extensive use of off-budget borrowing at the state level, any FPR which did not tackle this issue would be creating a huge loophole for the states to walk through. As regards debt rule, the RBI Group noted that different states adopt different definitions for the total liabilities in their budgets and felt that they would need to broaden their definition to capture the entire range of liabilities that should ideally emerge out of the budget. The definition of liabilities needed to include not only the total liabilities under the Consolidated Fund of the state but also all the items under the Public Account of the state. Given the need to comply with budgetary targets in terms of the prescribed debt rule, state governments might have the tendency to go for off-budget borrowings. The

Group felt that in order to bring such borrowings 'above board', fiscal rules should also cover off-budget borrowings. Accordingly, it was felt that borrowings by the Public Sector Undertakings and Special Purpose Vehicles and other equivalent instruments including guarantees where the liability for repayment of principal and/or interest is on the state government would also be treated as borrowings of the Government for the purpose of computation of total liabilities. Under the borrowing rule, devolvement arising out of state guarantees should be included. States have yet to enact the legislation for a ceiling on outstanding guarantees. A limit on annual incremental risk-weighted state Government guarantees in the model Fiscal Responsibility Bill (FRB) is needed to be incorporated (RBI, 2005).

#### **(d) Denominator for the Fiscal Deficit**

Expressing the fiscal target variable as a ratio of output is a conventional approach for countries, but not so for states – typically, either a revenue balance is assumed (so the question of denominator does not arise) or ratios of revenue are used as target (for example, in Salta, Argentina, the ratio of debt/revenue is targeted). India's statistical data has given rise to increasing concerns, and state-level output data has long been thought to be suspect. Recent changes in gross State Domestic Product (GSDP) growth rates caused by the change in base from 1980-81 to 1993-94 and then revisions using the 1993-94 base have only added fuel to the skeptics' fire. There are longer data lags at the state level than the all-India one, and obviously there are difficulties in estimating the high levels of inter-state trade. The lack of independence of state statistical units could even give rise to scope for data manipulation. Finally, it can be argued that ratios of revenue are easier to understand than ratios of output. Government of India's Fiscal Reform Facility, which provides additional grant financing to states which can demonstrate successful fiscal adjustment, avoids reliance on GSDP data by targeting the ratio of revenue deficit to revenue receipts. For all the difficulties in using GSDP, its use might still be acceptable bearing in mind that the aim of the FPR legislation is to set targets, and that, within any year, fiscal targets would be translated into nominal values and tracked accordingly. Alternatively, revenue can be used as the denominator, or nominal (absolute) values can be chosen as targets. Both options could be considered. It should be noted that revenue

receipts are also subject to estimation problems. Revised revenue estimates, on which judgments about compliance would initially be made, are highly susceptible to manipulation. Rules would also be needed concerning the calculation of revenue receipts to avoid their inflation via book-entries and one-off adjustments both of which can be substantial.

The members of RBI Group debated on the pros and conditions of GSDP (which is the conventional approach) vis-à-vis revenue receipts and finally agreed to adopt total revenue receipts (TRR) as the denominator for revenue deficit and Gross State Domestic Product (GSDP) as the denominator for gross fiscal deficit. This would also be consistent with the approach adopted by most states that have enacted Fiscal Responsibility Law. In case of those states whose GSDP are subject to wide fluctuations, it was suggested that they could opt for trend GSDP (RBI, 2005).

**(e) Rationale of Cyclically Adjusted Fiscal Deficit Target rather than a Fixed Annual Target**

The main criticism of the deficit rules in general and balanced budget rules in particular is that they are irrelevant and therefore tends to be pro-cyclical. This is a more important consideration for national governments as compared to sub national governments. For this reason the deficit rules in national government have increasingly been defined in terms of a cyclical adjusted deficit measure or an average over the economic cycle. Thus the rules allow the operation of domestic stabilization and to some extent also provide room for discretionary policy within the cycle.

The cyclically-adjusted balance seeks to measure the fiscal position net of the impact of output effects on the budget. It is obtained by removing the cyclical component of the budget from the nominal fiscal balance. The cyclical component in turn depends on two factors: the size of the output gap, and the output elasticity of the budget (which is determined by the extent individual budgetary items react to fluctuations in output, as well as by the size of the budget). Budgetary targets are seldom framed in cyclically-adjusted terms. This reflects in part the relative complexity of the techniques used to

estimate output gaps and budgetary elasticities. But while there are a number of difficulties regarding the computation of cyclically-adjusted balances, a variety of measures can be undertaken to address them, and cyclically-adjusted balances can play a useful role as a reference for policy design and implementation. Budgetary targets are seldom framed in cyclically-adjusted terms. This reflects in part the relative complexity of the techniques used to estimate output gaps and budgetary

Reflecting the efficacy of a countercyclical fiscal policy, both the E.U and the U.K have cyclically adjusted fiscal deficit targets. This means that during an upturn the economy builds up credit by running a surplus and encashes the credit by incurring a deficit during a downturn so that over the economic cycle the target deficit is maintained. It is argued that India too must adopt a similar cyclically adjusted fiscal management. Notwithstanding the appeal of this argument, India would be better off with a fixed target. A cyclically adjusted policy works only when the debt-GDP ratio is already at a sustainable level. Debt sustainability and fiscal deficit are interlinked and should not be viewed on a stand-alone basis. A fiscal deficit of 8 per cent when the debt-GDP ratio is 100per cent has sustainability implications quite different from an 8per cent deficit when the debt-GDP ratio is 50 per cent. In India case the debt-GDP ratio is above the sustainability level. India needs to first bring it down and then stabilize it at that low level. This cannot be achieved unless a low fiscal deficit over a period is maintained. A cyclically adjusted policy can certainly be an option after the adjustment phase is complete. Cyclical adjustment, of course, presupposes that the economy is subject to economic cycles (Rangarajan and Rao, 2007).

#### **6.6. The Main Weaknesses in the Fiscal Policy Design in India**

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

**(2) Insufficient transparency in budget preparation:** Numerical targets have not been supported by comprehensive expenditure reform plans. In addition, the assumptions

underpinning the budget do not always include annual forecasts for key macroeconomic variables, and the discussion of fiscal risks<sup>3</sup> is limited.

**(3) Focus on a current balance target:** This allows weaknesses in budget classification to be exploited, by misclassifying current expenditures as capital expenditures. Targeting the current balance may also bias spending against education and health, which have a large current expenditure component. In addition, international experience illustrates that deficit type targets such as the current balance are more likely to reduce incentives for fiscal savings in good times, and to force adjustment in bad times (i.e. procyclicality).

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

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

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

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<sup>3</sup> Fiscal risks, defined as the possibility of deviations in fiscal variables from what is expected, are generated from different sources such as unexpected fluctuations in traditional macroeconomic variables including real growth, exchange rates, interest rates, commodity prices as well as unexpected contingent liabilities stemming from banking crises, natural disasters, state owned enterprises, subnational government bailouts, legal claims, government guarantees and public-private partnerships

## **6.7. Conclusion**

For sustaining and accelerating economic growth, achieving FRBM target is necessary but not a sufficient condition. Numerical rules can potentially be helpful, for instance, in containing a deficit bias, but are not in themselves the solution to structural fiscal problems. Numeric fiscal rules could even foster creative accounting and low-quality measures. Attention is required not only to achieve the target in quantitative terms but also to the quality adjustment. It means to improve both allocative and technical efficiency of public expenditure. Stand alone deficit is insufficient unless the level of revenue and expenditure is unspecified. Given the fiscal deficit is the gap between government's revenue and expenditure, a given level of deficit can be achieved at different level of revenue and expenditure. It is important the level is maintained sufficiently high as we target a specified fiscal deficit. India which is with a weak track record of policy implementation, procedural rules may work better than numeric rules. Under these circumstances, procedural rules could be in many cases beneficial, promoting fiscal discipline through increased transparency and accountability. The effectiveness of fiscal policy rules hinges on transparency in institutional structure and functions, that is, in the relations within the public sector, as well as the relations between the government and private sector entities.

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## APENDIX-1

### Fiscal Policy Rules in India's State level

**1. Karnataka Fiscal Responsibility Law (September 2002):** Aims at Phasing out Revenue Deficit and reducing Fiscal Deficit to 3 per cent of GSDP by 2006. Karnataka has also set a limit on total liabilities at 25 per cent of GSDP by 2015 and on guarantees within prescribed ceiling under the Karnataka Government Guarantees Act. The act specifies budget management through medium term fiscal plan, compliance through half-yearly review and enhancement of transparency. The MTFP would include four years rolling targets for the prescribed fiscal targets, assessment of the sustainability and evaluation of performance prescribed indicators. Half yearly review of revenue receipts and revenue expenditure in relation to budget will be done. The review report will reflect clearly on deviations from the budget targets and remedial measures. Target of GFD or RD may exceed the limits on unforeseen grounds due to national security or natural calamities. Certain fiscal management principles and measures for fiscal transparency will be taken care off.

Karnataka Government has gone through various institutional and fiscal reform in it's various budget before for going towards fiscal sustainability, like it implemented VAT ( in April 2005), new pension Scheme (in 20006), implemented ceiling on guarantees (in April 1999) and also implemented Guarantee reduction fund (in march 2000).

**2. Kerala Fiscal Responsibility Law (August 2003):** Aims at Phasing out Revenue Deficit and reducing Fiscal Deficit to 2 per cent of GSDP by 2007. Kerala ceiling on government guarantees Act provides for an upper limit on outstanding guarantees at Rs 14,000cr, no separate provision on guarantees has been made in Kerala fiscal responsibility legislation. MTFP would review periodically the progress of public expenditure with reference to fiscal target and evaluation of the current trend to budgetary allocations. The Act provides for setting up for public expenditure review committee. It would submit a review report giving full account each item where the

deviations from the fiscal target have occurred during the previous year. Measure to ensure greater transparency in its fiscal operation.

**3. Tamil Nadu Fiscal Responsibility Law (May 2003):** aims at containing GFD at 3.0 per cent of GSDP and revenue deficit to revenue receipts by at least 5 per cent by 2008. The act also caps outstanding guarantees 100 per cent of revenue receipts in the preceding year or at 10 per cent of GSDP, whichever is lower. The MTFP would objective evaluation of fiscal indicators, medium term fiscal objectives, and strategic priorities for ensuring years. It will also do an evaluation of economic trends and future prospects. The Act provides for medium term fiscal plan, external body will review of performance and measure for transparency. Target of GFD or RD may exceed the limits on unforeseen grounds due to national security or natural calamities. Half yearly review of revenue receipts and revenue expenditure in relation to budget will be done and the review report will reflect clearly on deviations from the budget targets and remedial measures. Tamil Nadu FRL also aims at improving the measure to ensure greater transparency in its fiscal operation.

**4. Punjab Fiscal Responsibility Law (October 2003):** contains the rate of growth of GFD 2 per cent per annum in nominal terms till GFD is below 3 per cent of GSDP and stipulates reduction in the ratio of revenue deficit to revenue receipts by at least 5 percentage points each year until revenue balance achieved. The act also set a limit on debt to 40 per cent of GSDP by 2007 and caps outstanding guarantees on long term debt to 80 per cent of revenue receipts of the previous year. The MTFP would include three years rolling targets for the prescribed fiscal targets, assessment of the sustainability and evaluation of performance prescribed indicators Evaluation of economic trends and future prospects. The Act provides for medium term fiscal plan, quarterly review of receipts, and expenditure in relation to budget estimates. The review report has to reflect clearly on deviations from the budget targets and remedial measures. Target GFD or RD may exceed the limits on unforeseen grounds due to national security or natural calamities. Punjab FRL also aims at improving the measure to ensure greater transparency in its fiscal operation.

**5. Uttar Pradesh Fiscal Responsibility Law (February 2004):** aims at Phasing out Revenue Deficit and reducing Fiscal Deficit to 3 per cent of GSDP by 2009. Total liabilities would be capped at 25 per cent of GSDP by 2018. Not to give guarantees for any amount exceeding the limit prescribed under any rule or law to make by the government for the purpose. The MTFP would include five years rolling targets for the prescribed fiscal indicators, medium term fiscal objectives, strategic priorities and evaluation of performance prescribed indicators. Half yearly review of revenue receipts and revenue expenditure in relation to budget will be done and the review report will reflect clearly on deviations from the budget targets and remedial measures. Budget to be made more transparent by better disclosure Statements to be included in the budget documents.

**6. Gujarat Fiscal Responsibility Law (March 2005):** aims at phasing out Revenue Deficit by March 2008 and reducing Fiscal Deficit to 3 per cent of GSDP by March 2009. Cap outstanding guarantees within the limit provided in Gujarat state guarantees Act 1963. It aims at restricting ratio of Debt–GSDP to 30 per cent by March 2008. The MTFP would include three years rolling targets for the prescribed fiscal indicators and an assessment of sustainability evaluation of performance of fiscal indicators vis –a- vis targets. It aims at containing medium term fiscal objectives. It also aims at conformity of current policies with fiscal management principles. It gives Strategic priorities in the fiscal matters for the ensuring financial year. Policies pertaining to various fiscal parameters and rational for any major deviation will also take care off. For compliance review of receipts and expenditure relation to budget estimates. Such review shall be placed immediately following the end of second quarter of the financial year. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. It aims at the constitution of public expenditure. Present to the Legislature every yearly pension liabilities worked out on actuarial basis for next ten years Gujarat Fiscal Responsibility Legislations aims to take measures to ensure greater transparency in fiscal operations.

**7. Maharashtra Fiscal Responsibility Law (April 2005):** Shall specify, by rules, target for reduction of GFD. GFD is interpreted as expenditure on interest to revenue receipts. Phasing out Revenue Deficit by March 2009 and generate revenue surplus balance there after. Outstanding debt excluding public account and risk weighted outstanding guarantees not to exceed twice the receipts in the consolidated fund of the state. The MTFP would include three years rolling targets for the prescribed fiscal indicators and an assessment of sustainability evaluation of current policies vis –a- vis fiscal management principles. It also aims at giving strategic priorities in the fiscal matters for the ensuring financial year. Policies pertaining to various fiscal parameters and rational for any major deviation will also be taken care off. For compliance to do quarterly review of receipts and expenditure relation to budget estimates along with remedial measures if required will be done. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. Maharashtra Fiscal Responsibility Legislations aims at to take measures to ensure greater transparency in fiscal operations.

**8. Himachal Pradesh Fiscal Responsibility Law (April 2005):** aims at reducing RD-RR ratio at least by 2 per cent each year until revenue surplus is achieved. Progressively reduce outstanding guarantees on long-term debt, until it can cap outstanding risk weighted guarantees at 80 per cent of total revenue receipts in the preceding year for which actual are available as per financial accounts. The MTFP would include three years rolling targets for the prescribed fiscal indicators and an assessment of sustainability evaluation of performance of fiscal indicators vis –a- vis targets. It will do an assessment of economic trends and future prospects for growth and developments and conformity of current policies with fiscal management principles. it would give strategic priorities in the fiscal matters for the ensuring financial year. For compliance to do half-yearly review of receipts and expenditure relation to budget estimates along with remedial measures if required will be done. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. Himachal Pradesh Fiscal Responsibility Legislations aims to take measures to ensure greater transparency in fiscal operations.

**9. Rajasthan Fiscal Responsibility Law (May 2005):** aims at bringing down GFD to 3 per cent of GSDP following a path of minimum average annual reduction of 0.4 per cent of GSDP. It also aims at eliminating RD by March 2009, with an average annual reduction of 3 per cent in RD-RR ratio. Outstanding debt excluding public account and risk weighted outstanding guarantees not to exceed twice the receipts in the consolidated fund of the state. MTFP would include setting forth fiscal objectives and priorities of the government, assessment of the sustainability, evaluation of performance of fiscal indicators, evaluation of current policies vis-a vis fiscal management principles, strategic priorities in the fiscal matters for the ensuing financial year, policies pertaining to various fiscal parameters and rationale for any major deviation. For compliance to do quarterly review of receipts and expenditure relation to budget estimates along with remedial measures. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. It aims at Constitution of public expenditure Review Committee. Present to the Legislature every yearly pension liabilities worked out on actuarial basis for next ten years. It aims at to take measures to ensure greater transparency in fiscal operations.

**10. Assam Fiscal Responsibility Law (May 2005):** aims at Phasing out Revenue Deficit and reducing Gross Fiscal Deficit to 3 per cent of GSDP by March 2010. Restrict the guarantees to 50 per cent of states own tax and non tax revenue of the previous year or 5 per cent of GSDP of the previous year at current prices which ever is lower. Restrict stock including the Government guarantees to 45 per cent of GSDP of the previous year at current prices by March 2010. Restrict revenue expenditure under annual state plan to one third of the plan outlay. The MTFP would include five years rolling targets for the prescribed fiscal indicators, an assessment of sustainability evaluation of performance of fiscal indicators, medium term fiscal objectives, economic trends and future prospects for growth and developments and conformity of current policies with fiscal management principles. It also gives strategic priorities in the fiscal matters for the ensuring financial year. Policies pertaining to various fiscal parameters and rationale for any major deviation will be taken care off. For compliance to do quarterly review of receipts and expenditure relation to budget estimates along with remedial measures. GFD and RD

may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. It aims at the constitution of public expenditure. To take measures to ensure greater transparency in fiscal operations. Salary and wages will be contained with 60 per cent of the total tax and non tax revenue of the government, including devolutions from the centre but excluding the grants under the annual plan from the planning commission and other developmental grants. Defining of offences and penalty defined under the Act.

**11. Orissa Fiscal Responsibility Law (June 2005):** aims at reduce revenue deficit to nil within a period of five financial years beginning from the initial financial year on the 1st day of April, 2004 and ending on the 31st day of March, 2009. Reduce fiscal deficit to not more than three percent of the estimated gross state domestic product within a period of five financial years beginning from the initial financial year on the 1st day of April, 2004 and ending of the March, 2009. Reduce fiscal deficit by 1.5 percentage of Gross State Domestic Product (GSDP) in each of the financial years beginning on the 1st day of April, 2004 in a manner consistent with the goal set in clause. Generate a primary surplus of over 3 percent of Gross State Domestic Product (GSDP) by the year ending 31st March 2008. Other important monitor able fiscal targets would be - the ratio of salary to state own revenue is to be reduced to 80 percent by the year ending 31st March 2008; the ratio of non interest committed revenue expenditure to State's Own and Mandated Revenue is to be reduced to 55 percent by the year ending 31st March 2008. The ratio of revenue deficit to revenue receipt is to be reduced to 0 percent by the year ending 31st March 2009. In order to bring the debt stock to a sustainable level, interest payment as a percentage of revenue receipt is to be limited to 18 to 25 per cent. The total debt stock should be limited to 300 per cent of the total revenue receipt of the state by the year ending 2007-08.

Orissa Government has gone through various institutional and fiscal reforms for going towards fiscal sustainability, like it implemented VAT (in April, 2005), new pension Scheme (in January 2005), implemented ceiling on guarantees (in November, 2002) and also implemented Guarantee reduction fund (in March, 2002-03).

**12. Tripura Fiscal Responsibility Law (June 2005):** It aims at bringing down GFD to 3 per cent of GSDP by March 2010. Strive to remain revenue surplus by making a balance in revenue receipts and expenditure build up further surplus. Limit the amount of annual incremental risk weighted guarantees to 1.0 per cent of GSDP. It also aims at total liabilities not to exceed 40 per cent of GSDP by March 2010. Medium-term fiscal policy Statement shall set forth a three year rolling target for four fiscal indicators viz revenue deficit as percentage of total revenue receipts, fiscal deficit as percentage of GSDP and total outstanding liabilities as a percentage of GSDP. The medium-term fiscal policy Statement shall include an assessment of sustainability relating to the balance between revenue receipt and expenditure. An evaluation of current policies vis-à-vis fiscal management principles will be done. It will give strategic priorities in the fiscal matters for the ensuring financial year. Policies pertaining to various fiscal parameters and rationale for any major deviation will be taken care off. For compliance to do quarterly review of receipts and expenditure relation to budget estimates along with remedial measures. An independent agency may be entrusted to review the compliance of the provisions of this Act and to present such reviews in Legislature. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. Estimating yearly pension liabilities worked out actuarial basis for next ten years. To take measures to ensure greater transparency in fiscal operations.

**13. Haryana Fiscal Responsibility Law (July 2005):** aims at bringing down GFD to 3 per cent of GSDP. Phasing out Revenue Deficit by March 2008 -09 and generate revenue surplus. It aims at ensuring outstanding liabilities to 28 per cent of GSDP by March 2010. The MTFP would include three years rolling targets for the prescribed fiscal indicators and an assessment of sustainability evaluation of current policies vis -a- vis fiscal management principles. It gives strategic priorities in the fiscal matters for the ensuring financial year. Policies pertaining to various fiscal parameters and rational for any major deviation will be done. For compliance to do half-yearly review of receipts and expenditure relation to budget estimates along with remedial measures if required will be done. GFD and RD may exceed the limits on grounds of unforeseen demands due to

internal disturbances or natural calamities or such other exceptional grounds. Present to the Legislature every yearly pension liabilities worked out on actuarial basis for next ten years Haryana Fiscal Responsibility Legislations aims to take measures to ensure greater transparency in fiscal operations. Set up an independent agency to review periodically the compliance of the provisions of the act.

**14. Madhya Pradesh Fiscal Responsibility Law (August 2005):** It aims at bringing down GFD to 3 per cent of GSDP and to phase out revenue deficit by March 2009. It also aims at generating revenue surplus thereafter. Limit the guarantees not to exceed 80 per cent of the total revenue receipts in the year proceeding the current year. Limit the liabilities not to exceed 40 per cent of the GSDP by 2015. The MTFP would include three years rolling targets for the prescribed fiscal indicators. It will also do an assessment of sustainability relating to the balance between revenue receipts and revenue expenditure. It will do an evaluation of current policies vis-à-vis fiscal management principles. It will give strategic priorities in the fiscal matters for the ensuring financial year. it will do an assessment of policies pertaining to various fiscal parameters and rationale for any major deviation. For compliance to do it half-yearly review of receipts and expenditure relation to budget estimates along with remedial measures if required will be done. An independent agency may be entrusted to review the compliance of the provisions of this Act and to present such reviews in Legislature. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds. Estimating yearly pension liabilities worked out actuarial basis for next ten years. To take measures to ensure greater transparency in fiscal operations.

**15. Manipur Fiscal Responsibility Law (August 2005):** aims at reducing Fiscal Deficit to 3per cent of GSDP, strive to have revenue balance and to remain revenue surplus. Ceiling the outstanding guarantees is done as per the provisions of the Manipur Ceiling on State Government Guarantees Act, 2004. Pursue expenditure policies that would provide impetus to growth, poverty reduction and improvement in human welfare. Follow a recruitment wage policy, in a manner such that the total salary bill relative to

revenue expenditure net of interest payments and pensions does not exceed 35 per cent. The MTFP would include three years rolling targets for the prescribed fiscal indicators. An assessment of sustainability relating to the balance between revenue receipts and revenue expenditure will be done. It also aims at using of capital receipts for generating productive assets. The estimated yearly pension liabilities worked out on actuarial.

**16. Nagaland Fiscal Responsibility Law (August 2005):** aims at reducing Fiscal Deficit to 3 per cent of GSDP by March 2009. Strive to have revenue balance and remain revenue surplus. Limit the amount of annual incremental risk weighted guarantees to 1 per cent of total revenue receipts or 1 per cent of GSDP in the year proceeding the current year, whichever is lower. Total debt stock not exceeds more than 40 per cent of the GSDP by March 2010. Pursue expenditure policies that would provide impetus to growth, poverty reduction and improvement in human welfare. Follow a recruitment and wage policy such that total salary bill relative to revenue expenditure net of interest payments and pensions does not exceed 61 per cent in any financial year. The MTFP would include three years rolling targets for the prescribed fiscal indicators. It also does an assessment of sustainability relating to the balance between revenue receipts and revenue expenditure, the use of capital receipts for generating productive assets. The estimated yearly pension liabilities worked out on actuarial.

**17. Chattisgarh Fiscal Responsibility Law (September 2005):** aims at reducing GFD to 3 per cent of GSDP and to phase out revenue deficit by March 2009. . The MTFP would include three years rolling targets for the prescribed fiscal indicators. An assessment of sustainability relating to the balance between revenue receipts and revenue expenditure will be done. An Evaluation of current policies vis-à-vis fiscal management principles will be done. It will also give strategic priorities in the fiscal matters for the ensuring financial year. Policies pertaining to various fiscal parameters and rationale for any major deviation will also be analyzed. For compliance to do it quarterly review of receipts and expenditure will be done in relation to budget estimates along with remedial measures if required. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional

grounds. Chattisgarh Fiscal Responsibility Legislations aims at to take measures to ensure greater transparency in fiscal operations.

**18. Andhra Pradesh Fiscal Responsibility Law (October 2005):** It came in to force with effect from 2006. It aims at bringing down GFD to 3 per cent of GSDP by March 2010. It also at phasing out revenue deficit by March 2009 and generate revenue surplus thereafter. Limit the amount of annual incremental risk weighted guarantees to 90 per cent of total revenue receipts. It also aims at total liabilities not to exceed 35 per cent of GSDP by March 2010. Medium-term fiscal policy Statement shall set forth a three year rolling target for four fiscal indicators vz revenue deficit as percentage of total revenue receipts, fiscal deficit as percentage of GSDP and total outstanding liabilities as a percentage of GSDP. The medium-term fiscal policy Statement shall include an assessment of sustainability relating to the balance between revenue receipt and expenditure. It will also do an evaluation of current policies vis-à-vis fiscal management principles. Strategic priorities in the fiscal matters for the ensuring financial year will also be analyzed. Policies pertaining to various fiscal parameters and rationale for any major deviation will also be taken care off. For compliance to do quarterly review of receipts and expenditure relation to budget estimates along with remedial measures. An independent agency may be entrusted to review the compliance of the provisions of this Act and to present such reviews in Legislature. GFD and RD may exceed the limits on grounds of unforeseen demands due to internal disturbances or natural calamities or such other exceptional grounds The fiscal policy strategy Statement shall at the time of presenting budget, make disclosure of Statements of selected indicators such as, components of State government liabilities and interest cost of borrowing/ mobilization of deposits, consolidated fund, guarantees given by government, outstanding risk weighted guarantees, guarantee redemption fund and the Statement of asset in. A Statement on claims and commitment made by State government on revenue demand raised but not realized , liability in respect of major work and contracts and giving details of number of employees in government, public sector and aided institutions and related salaries and pensions in. Estimating yearly pension liabilities worked out actuarial basis

for next ten years. Andhra Pradesh Fiscal Responsibility Legislations aims to take measures to ensure greater transparency in fiscal operations.

**19. Uttaraanchal Fiscal Responsibility Law (October 2005):** aims at Phasing out Revenue Deficit and reducing Fiscal Deficit to 3 per cent of GSDP by March 2009. Reduce the ratio in each financial year. Not to give any guarantee for any amount exceeding the limit stipulated under any rule or law of the state government. Total outstanding liabilities not more than 25 per cent of the GSDP by March 2015. Pursue expenditure policies that would provide impetus to growth, poverty reduction and improvement in human welfare. Manage expenditure consistent with the level of revenue generated. While adhering to the fiscal years, the state government will give priority to protect those expenditure heads classified as ‘High Priority Development Expenditure’ in the MTFRP. The MTFRP would include three years the ensuing year relating to taxation, expenditure, borrowing and other liabilities. Half-yearly review of the trend in receipts and expenditure in relation to the budget estimates along with remedial measures to achieve the budget target will be done. Whenever there is a shortfall in revenue or excess of expenditure over targets, appropriate measures to be taken for increasing revenue and/or reducing expenditure. Supplementary estimates will be accompanied by Statement of curtailment of expenditure and/or augmentation of revenue.

**20. Arunachal Pradesh Fiscal Responsibility Law (March 2006):** aims at Phasing out Revenue Deficit by March 2009 and reducing Fiscal Deficit to 3 per cent of GSDP by March 2010. Reduce RD/ GSDP in each financial year. It will be conservative in giving guarantee. Under this, it will pursue expenditure policies that would provide impetus to growth, poverty reduction and improvement in human welfare. Manage expenditure consistent with the level of revenue generated. While adhering to the fiscal years, the state government will give priority to protect those expenditure heads classified as ‘High Priority Development Expenditure’ in the MTFRP. The MTFRP would include four year rolling target for the prescribed fiscal indicators. Assessment of sustainability relating to the balance between revenue receipts and revenue expenditure the use of capital receipts for generating productive assets. The MTFRP shall, inter alia, contain-the strategic

priorities of the Government in the fiscal matters for the ensuing financial year. Medium term fiscal objectives are to do an evaluation of the performance of the prescribed fiscal indicators in the previous year vis-à-vis targets. It also aims at improving the policies of the Government for Measures to ensure greater transparency in the fiscal operations. Disclosure of sufficient information regarding guarantees and changes in the accounting practices. Provisions of this Act as may appear to be necessary for removing the difficulty.

**21. Meghalaya Fiscal Responsibility Law ( March 2006):** aims at phasing out Revenue Deficit by March 2008-9 and reducing Fiscal Deficit to 3 per cent of GSDP by March 2008-09. Restrict issuing of guarantees except on selective basis. Total outstanding liabilities on the consolidated fund not more than 28 per cent of the GSDP. Pursue expenditure policies that would provide impetus to growth, poverty reduction and improvement in human welfare. Manage expenditure in relation to its receipts potential. Efforts will be taken to contain non plan expenditure. Reduce expenditure on wages and salaries of the Government. The MTFP would include three years rolling targets for the prescribed fiscal indicators. Assessment of sustainability relating to the balance between revenue receipts and revenue expenditure the use of capital receipts for generating productive assets. It will also estimate yearly pension liabilities for the next ten years on the basis of trend growth rate. Measure proposed in the course of the financial year, which may lead to an increase in revenue deficit, shall be accompanied by a Statement of remedial measures, proposed to neutralize such increase or loss. The Minister of Finance shall make a Statement in both the Houses of Legislature if there is a deviation owing to unforeseen circumstances in meeting the obligations cast on the state government under this Act and the remedial measures. Disclosure of sufficient information to allow public scrutiny on the conduct of fiscal policy and the state of public finances will be taken care off. Government or the authorities exercising delegated financial powers shall first issue administrative approval or financial sanction before awarding any work or starting construction. Each department shall maintain a register of works and order of supplies and liabilities. Appointments will be done only against sanctioned posts. Such provisions are not inconsistent with the provisions of this Act as may appear to be necessary for

removing the difficulty. Minimize the fiscal risk associated with management of PSUs and utilities through a review of performance. It aims at bringing an annual Statement on state's economy and related fiscal strategy. A special report will give details of number of employees in Government, public sector undertakings, aided institutions and related salaries.

**22. Bihar Fiscal Responsibility Law (2006):** aims at phasing out Revenue Deficit by March 2008-9 onwards and reducing Fiscal Deficit to 3 per cent of GSDP by March 2008-09. Lay down norms for prioritization of capital expenditure; pursue expenditure policies that would provide impetus to economic growth, poverty reduction and improvement in human welfare. The MTFP would include three years rolling targets for the prescribed fiscal indicators. Assessment of sustainability relating to the balance between revenue receipts and revenue expenditure the use of capital receipts, including borrowings for generating productive assets. The estimated yearly pension liabilities worked out on actuarial basis for the next ten years. Quarterly review of the trend in receipts and expenditure in relation to the budget estimates will be done. The state government may set up an agency independent of the state government to review periodically the compliance of the provisions of the Act and table such reviews in the Houses of the state legislature. The state government will take appropriate measures if there is any shortfall in revenue or excess of expenditure over the intra year targets mentioned in the Fiscal Policy Strategy Statement or the rules under this Act. A Statement in both Houses for any measure proposed in the course of the financial year, which may lead to an increase in revenue deficit, shall be accompanied by a Statement of remedial measures, proposed to neutralize such increase or loss. The Minister of Finance shall make a Statement in both the Houses of Legislature if there is a deviation owing to unforeseen circumstances in meeting the obligations cast on the state affecting or likely to affect the computation of fiscal indicators. Disclosure of details of borrowings by way of WMA/ OD availed from RBI. Disclosure of the number of employees in Government, public sector, aided institutions and related salaries will be done. Whenever the state undertakes to repay principal and/or interest of any separate legal entity, it has to reflect such liability as the borrowings of the state. GFD and RD may exceed the limits on

grounds of unforeseen demands due to national security or natural calamities. Pursue policies to raise non-tax revenue with due regard to cost recovery and equity. The state government may, by notification in the Official Gazette, make rules for carrying out the provisions of this Act. If any difficulty arises in giving effect to the provisions of this Act, the state government may, by order published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty.

**23. Goa Fiscal Responsibility Law (May 2006):** aims at reducing GFD to 3 per cent of GSDP by March 2009. Reduce GFD/ GSDP by 0.5 per cent in each financial year beginning April 2006. Nil by March 2009. Reduce RD/RR by 1.5 per cent in each financial year from April 2006. Cap the total outstanding guarantees within the specified limit under the Goa State Guarantees Act, 1993. Outstanding liabilities will not more than 30 per cent of the GSDP by March 2009. Ratio of IP/RR will not to exceed 20 per cent by March 2009. Manage expenditure consistent with the level of revenue generated. Assessment of sustainability relating to the balance between revenue receipts and revenue expenditure will be done. It aims at using the capital receipts for generating productive assets. The MTFP shall, inter alia, contain- Medium term fiscal objectives. An evaluation of the performance of the prescribed fiscal indicators in the previous year vis-à-vis targets will be done. There will be policies of the Government for the ensuing year relating to taxation expenditure, borrowing and other liabilities. Goa Fiscal Responsibility Legislations aims to take Measures to ensure greater transparency in the fiscal operations. Disclosure of significant changes in the accounting standards, policies and practices will be done. Disclosure of sufficient information regarding contingent liabilities created by guarantee will also be done to avoid recourse to overdraft from RBI.

**23. Jammu and Kashmir Fiscal Responsibility Law (August 2006):** aims at reducing GFD by 3 per cent of GSDP by March 2010, and reduce GFD/GSDP by 0.5 per cent in each financial year beginning with April 2006. It also aims at maintaining revenue surplus. It aims to initiate steps to strengthen revenue surplus. It also aims at limiting the amount of annual incremental risk weighted guarantees to 75 per cent of the total revenue

receipts (TRR) in the year proceeding the current year or at 7.5 per cent of GSDP in the year proceeding the current year, whichever is lower. The total outstanding liabilities shall not exceed 55 per cent of estimated GSDP in 2010. It aims at annual reduction in the outstanding liabilities / GSDP ratio by 500 basis points every year. Pursue expenditure policies that would provide impetus to economic growth, poverty reduction and improvement in human welfare. Lay down norms for prioritization of capital expenditure. The MTFP would include three years rolling targets for the prescribed fiscal indicators. Assessment of sustainability relating to the balance between the revenue receipts and revenue expenditure, the use of capital assets for generating productive assets and the estimated yearly pension liabilities worked out on actuarial basis for the next ten years. For Compliance quarterly review of the trend in receipts and expenditure in relation to budget estimates is done. It aims at set up an independent agency to review the compliance provisions of the Act. Whenever there is a shortfall in revenue or excess of expenditure over targets, appropriate. It aims at measures to be taken for increasing revenue and/or reducing expenditure. A Statement in both Houses of the Legislative Assembly for any measure proposed in the course of the financial year, which may lead to an increase in revenue deficit, which shall be accompanied by a Statement of remedial measures, proposed to neutralise such increase or loss. Estimated yearly pension liabilities worked out on actuarial basis for the next ten years. If the above is not possible for the first 3 years, then forecasts based on trend growth rates may be made. Jammu and Kashmir Fiscal Responsibility Legislations aims at to take measures to ensure greater transparency in fiscal operations. It aims at Disclosing of significant changes in the accounting standards, policies and practices and details of WMA/OD from RBI, whenever the state undertakes to repay principal and/or interest of any separate legal entity; it has to reflect such liability as the borrowing of the state. RD and GFD may exceed the limits specified under this Act due to ground/s of unforeseen demands on the finances. Pursue policies to raise non-tax revenue with due regard to cost recovery and equity. The state government may, by notification in the official Gazette, make rules for carrying out the provisions of this Act. If any difficulty arises in giving effect to the provisions of this Act, the state government may, by order published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as may

appear to be necessary for removing the difficulty. Reduce pre-devolution non-plan revenue deficit by an amount equivalent to one percentage point as compared to the previous financial year beginning from April 1, 2006 so as to bring it down by 20 per cent of GSDP by March 31, 2010 and to maintain the level thereafter.

**24. Mizoram Fiscal Responsibility Law (October 2006):** Aims at reducing fiscal deficit to 3 per cent of GSDP by March 2009. Reduce GFD/GSDP by such percentage points in each financial year so as to achieve 3 per cent of GSDP in March 2009. It aims at to make revenue deficit nil by March 31, 2009. Risk weighted outstanding guarantees in a year shall not exceed twice that of the estimated receipts in the consolidated fund of the state at the close of the financial year. Total outstanding debt, excluding public account, in a year shall not exceed twice that of the estimated receipts in the consolidated fund of the state at the close of the financial year. Pursue expenditure policies that would provide impetus to economic growth, poverty reduction and improvement in human welfare. Lay down norms for prioritization of capital expenditure. The Government may, by notification in the Official Gazette, appoint a committee to be called the Public Expenditure Review Committee. Assessment of sustainability relating to the balance between the revenue receipts and revenue expenditure, the use of capital assets for generating productive assets and the estimated yearly pension liabilities worked out on actuarial basis for the next ten years. Half yearly review of the trend in receipts and expenditure in relation to budget estimates will be done. Estimated yearly pension liabilities worked out on actuarial basis for the next ten years. If the above is not possible for the first 3 years, then forecasts based on trend growth rates may be made. Mizoram Fiscal Responsibility Legislations aims at to take measures to ensure greater transparency in fiscal operations. It aims at Disclosing of significant changes in the accounting standards, policies and practices and details of WMA/OD from RBI. Due to ground/s of unforeseen demands on the finances, RD and GFD may exceed the limits specified under this Act Pursue policies to raise non-tax revenue with due regard to cost recovery and equity. The state government may, by notification in the official Gazette, make rules for carrying out the provisions of this Act. If any difficulty arises in giving effect to the provisions of this Act, the state government may, by order published in the Official

Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty. Bring out special Statement along with the annual budget giving in detail, number of employees in Government, public sector and aided institutions and related salary.

**26. Jharkhand: Fiscal Responsibility Law (May 2007):** Aims at reducing fiscal deficit to 3 per cent of GSDP by March 2009. Reduce GFD/GSDP by such percentage points in each financial year so as to achieve 3 per cent of GSDP in March 2009. It aims to make revenue deficit nil by March 31, 2009. The total debt stock should be limited to 300 per cent of the TRR of the state by 2007-08. In order to bring the debt stock to a sustainable level, interest payments (IP) to revenue receipts (RR) ratio is to be limited to 18 to 25 per cent. Pursue expenditure policies that would provide impetus to economic growth and poverty reduction. Management of expenditure consistent with the level of revenue generated. The MTFP would include three years rolling targets for the prescribed fiscal indicators with specification of underlying assumptions. Assessment of sustainability relating to the balance between the revenue receipts and revenue expenditure, the use of capital assets for generating productive assets and the medium term fiscal objectives of the state government. It will do the evaluation of performance of the prescribed fiscal indicators in the previous year *vis-à-vis* the targets set out earlier and the likely performance in the current financial year as per the revised estimates. It will give the strategic priorities of the state government in the fiscal area for the current financial year in form of a Fiscal Policy Strategy. The policies of the state government for the current financial year relating to expenditure, borrowings and other liabilities, lending and investments and description of other activities, such as guarantees and activities of Public Sector Undertakings which have potential budgetary implications. Review of the trend in receipts and expenditure in relation to budget estimates. Whenever there is a shortfall in revenue or excess of expenditure over targets, appropriate measures to be taken for increasing revenue and/or reducing expenditure. Supplementary estimates will be accompanied by Statement of curtailment of expenditure and/or augmentation of revenue. No liability shall be created outside the budget provision in a financial year without the approval of Government in Finance Department. In the case of natural

calamity, Government shall identify the net fiscal cost of the calamity and such cost would provide ceiling for extent of non-compliance to the specified limits. Estimated yearly pension liabilities worked out on realistic basis for the next ten years. Jharkhand: Fiscal Responsibility Legislations to take measures to ensure greater transparency in fiscal operations. It aims at the Disclosure of significant changes in the accounting standards, policies and practices. The Statement indicating the institution-wise state government guarantees given, default by these organizations in discharging debt servicing liabilities and contingent liability created in the state government account on account of default of these organizations shall be placed in the Jharkhand Legislative Assembly. The state government shall publish full information on the level of its debt and financial assets. The information on debt shall disclose maturity profile and interest rate. RD and GFD may exceed the limits specified under this Act due to ground/s of unforeseen demands on the finances. Pursue policies to raise non-tax revenue with due regard to cost recovery and equity. The state government may, by notification in the official Gazette, make rules for carrying out the provisions of this Act. If any difficulty arises in giving effect to the provisions of this Act, the state government may, by order published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty. Generate a primary surplus of over 3 per cent of GSDP by 2008. It aims at the ratio of salaries to state's own revenue to be reduced to 80 per cent by 2008. It also aims at the ratio of non-interest committed revenue expenditure to state's own and mandated revenue to be reduced to 55 per cent by 2008.

## Design issues under Fiscal Responsibility and Budget Management Act in India

### Fiscal Responsibility Law of States

Item/State	Year of Enactment	Gross Fiscal Deficit (GFD)	Revenue Deficit (RD)	Guarantees	Liabilities
<b>Karnataka</b>	September 2002	Not more than 3 % of GSDP by 2006	Nil by 2006.	Limit the guarantees within Prescribed ceiling under The Government Guarantees Act.	Total liabilities not to exceed 25 % of GSDP by 2015.
<b>Kerala</b>	August 2002	GFD to decline to 2% of GSDP by 2007.	Nil by 2007.	-	-
<b>Tamil Nadu</b>	May 2003	GFD not more than 3.0 % of GSDP by 2008.	Ratio of RD to RR not to exceed 5 % by 2008.	Cap total outstanding guarantees to 100 per cent of the total revenue receipts in the receding year or at 10 per cent of GSDP, whichever is lower.(ii) Cap risk weighted guarantees to 75 per cent of the total revenue receipts in the preceding year or at 7.5 per cent of GSDP, whichever is lower.	-
<b>Punjab</b>	October 2003	Contain rate of growth of GFD to 2% per annum in nominal terms, till GFD is below 3% of GSDP.	Reduce RD as per cent of RR by at least 5 percentage points each year until revenue balance is achieved.	Cap outstanding Guarantees on long-term debt to 80% of revenue receipts of the previous year and guarantees on short term debt to be given only for working capital or food credit.	Debt / GSDP ratio not to exceed 40% by 2007.
<b>Uttar Pradesh</b>	February 2004	Not more than 3% of GSDP by 2009.		Not to give guarantee for any amount exceeding the limit prescribed under any rule or law to be made by the Govt for the purpose.	Debt / GSDP ratio not to exceed 25% by 2018.
<b>Maharashtra</b>	March 2005	Limiting the annual incremental borrowings to not more than half the trend growth rate of revenue receipts.		Amount of risk weighted guarantees issued in a year shall not exceed 1.5 per cent of the expected revenue receipts and to classify the guarantee obligations according to risk of devolvement.	Restriction on borrowing by regulating salary expenditure, ceiling on expenditure on grant-in aid Institutions and ceiling on subsidies.
<b>Manipur</b>	August, 2005	3 per cent of GSDP.	Strive to have Revenue balance and remain revenue surplus	Limit the amount of outstanding guarantees as per the Manipur Government Guarantees Act, 2004	-
<b>Nagaland</b>	August, 2005	3 per cent of GSDP. by March 2009	Strive to have Revenue balance and remain revenue surplus.	Limit the amount of annual incremental risk weighted guarantees to 1 per cent of total revenue receipts or 1 per cent of GSDP in the year preceding the current year, whichever is lower.	Total debt stock not exceed more than 40 per cent of the GSDP by March 2010.
<b>Uttaranchal</b>	October, 2005	3 per cent of GSDP by March 2009. Reduce the ratio in each financial year.	Nil by March 2009. Reduce the ratio in each financial year	Not to give any guarantee for any amount exceeding the limit stipulated under any rule or law of the State Government.	Total outstanding liabilities not more than 25 per cent of the GSDP by March 2015.

## Design issues under Fiscal Responsibility and Budget Management Act in India

Item/State	Year of Enactment	Gross Fiscal Deficit (GFD)	Revenue Deficit (RD)	Guarantees	Liabilities
<b>Arunachal Pradesh</b>	March, 2006	3 per cent of GSDP by March 2010.	Nil by March 2009. Reduce RD/ GSDP in each financial year.	Will be conservative in giving guarantee.	-
<b>Meghalaya</b>	March, 2006	3 per cent of GSDP by 2008-09.	Nil by 2008-09.	Restrict issuing of guarantees except on selective basis.	Total outstanding liabilities on the consolidated fund not more than 28 per cent of the GSDP.
<b>Bihar</b>	April, 2006	3 per cent of GSDP from 2008-09 onwards.	Nil by 2008-09	-	-
<b>Goa</b>	May, 2006	3 per cent of GSDP by March 2009. Reduce GFD/GSDP by 0.5 per cent in each financial year beginning April 2006.	Nil by March 2009. Reduce RD/RR by 1.5 per cent in each financial year from April 200	Cap the total outstanding Guarantees within the specified limit under the Goa State Guarantees Act, 1993.	Total outstanding liabilities not more than 30 per cent of the GSDP by March 2009. Ratio of IP/RR not to exceed 20 per cent by March 2009.
<b>Jammu and Kashmir</b>	August 2006	3 per cent of GSDP by March 2010. Reduce GFD/GSDP by 0.5 per cent in each financial year beginning April 2006.	Maintain revenue surplus. Initiate steps to strengthen revenue surplus.	Limit the amount of annual incremental risk weighted guarantees to 75 per cent of the total revenue receipts (TRR) in the year preceding the current year or at 7.5 per cent of GSDP in the year preceding the current year, whichever is lower.	The total outstanding liabilities shall not exceed 55 per cent of estimated GSDP in 2010. Annual reduction in the outstanding liabilities / GSDP ratio by 500 basis points every year.
<b>Mizoram</b>	October 2006	3 per cent of GSDP by March 2009. Reduce. FD/GSDP by such percentage in each financial year so as to achieve 3 per cent of GSDP in March 2009.	Nil by March 31, 2009.	Risk weighted outstanding guarantees in a year shall not exceed twice that of the estimated receipts in the consolidated fund of the State at the close of the financial year.	Total outstanding debt, excluding public account, in a year shall not exceed twice that of the estimated receipts in the consolidated fund of the State at the close of the financial year.
<b>Jharkhand</b>	May 2007	3 per cent of GSDP by March 2009. reduce GFD/GSDP by such percentage points in each financial year so as to achieve 3 per cent of GSDP in March 2009.	Nil by March 31, 2009.	-	The total debt stock should be limited to 300 per cent of the TRR of the State by 2007-08. In order to bring the debt tock to a sustainable level, interest payments (IP) to revenue receipts (RR) ratio is to be limited to 18 to 25 per cent.

*Source: RBI States finances; Study of Budget, (various issues)*

## **Chapter – VII**

### **Impact of Fiscal Responsibility Budget Management Act on Major Fiscal Indicators in India**

#### **7.1. Introduction**

Binding fiscal policy rules are likely to influence the level and composition of government expenditure and taxation. In addition, fiscal rules have major macroeconomic consequences for inflation, external indebtedness, and economic growth. From the international experience we can say that for most part, economic performance under fiscal rules has been mixed. In most European Union (EU) member countries, attempts to comply with fiscal rules contributed to a decline in inflation and interest rates, mitigated the crowding out of private investment, and alleviated the external imbalance. In developing economies, in the absence of sufficiently deep internal financial markets, restriction on bank financing or domestic borrowing were partly accommodated by a substantial buildup in foreign indebtedness. To some extent, the latter was facilitated by the credibility gain associated with implementation of the fiscal rule.

Apart from broadly favorable macroeconomic effects, compliance with fiscal rules has led to distortions in the composition of government expenditures or led to tax increases. On the expenditure side, often the brunt of adjustment has been borne by cuts in public investment. In some instance, fiscal rules induced a lack of transparency in the budget process (for example accumulation of payment arrears), proliferation of creative accounting practices, and recourse to one off measures (such as financing from privatization receipts). Also distortion in tax structure and administration (for example, advancing tax payments) may have been compounded, with an increase in overall tax burden (Kopits and Symansky, 1998).

In the case of India, sharp deterioration in the fiscal health at centre as well at the state level during the last decade became a cause for serious concern. FRBM act has been

implemented to reverse the deteriorating fiscal situation. In this chapter basically we will analyze whether the FRBM Act has been successful in achieving its target and in what way it has been able to bring the adjustment and will also examine the effect of FRBM on major fiscal indicators through a quantitative method.

## **7.2. Trends in Central Government Major Deficit Indicators before the Implementation of FRBM Act**

Basically there are three major indicators of fiscal imbalance fiscal deficit, revenue deficit and primary deficit. Revenue deficit indicates the extent to which current receipts are not able to cover revenue expenditure necessitating borrowing to finance current, not asset building expenditure. It represents government consumption expenditure that requires to be financed by capital receipts. These capital receipts, apart from small portion of non debt capital receipt, consist of net borrowing, which is called fiscal deficit. The primary deficit is equal to fiscal deficit, which represent net inflow of borrowed funds, minus interest payments, which represent outflow of borrowed funds in the form of transfer payments. The ratio of revenue deficit to fiscal indicates the extent to which the borrowing is used for current expenditure.

The fiscal deficit of the central government, as a proportion of GDP, declined from 6.6 per cent in 1990-91 to 4.1 per cent in 1996-97, but this progress could not sustained and in 2001-02 it increased to 6.18 per cent. After that, there is a fall in fiscal deficit relative to GDP. A similar profile is observed in the case of revenue deficit, which after declining from 3.3 per cent of GDP in 1990-91 to 2.4 per cent in 1996-97, rose steadily to 4.4 per cent in 2001-02. Further, increase in the ratio of fiscal deficit to GDP during this period was also associated with an increase in the proportion of revenue deficit, which increased from 49.4 of fiscal deficit in 1990-91 to 79.7 per cent in 2003-04.

It can also be observed that fiscal deficit was being driven more and more by deficits on revenue account. More and more revenue deficit imply pre-emption of private saving for government current consumption which tends to crowd out private investment without corresponding increase in capital spending by the government.

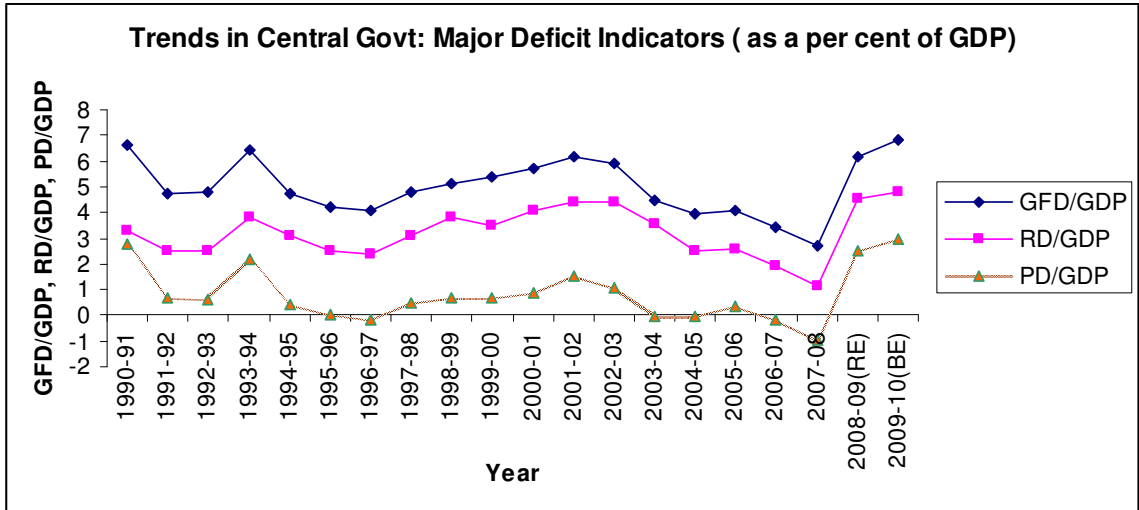
**Table -7.1: Central Government Major Deficit Indicators (as a per cent of GDP)**

Year	GFD/GDP	RD/GDP	PD/GDP	RD as per cent of FD
1990-91	6.6	3.3	2.8	50
1991-92	4.7	2.5	0.7	53
1992-93	4.8	2.5	0.6	52
1993-94	6.4	3.8	2.2	59
1994-95	4.7	3.1	0.4	66
1995-96	4.2	2.5	0	60
1996-97	4.1	2.4	-0.2	59
1997-98	4.8	3.1	0.5	65
1998-99	5.1	3.8	0.7	75
1999-00	5.4	3.5	0.7	65
2000-01	5.7	4.1	0.9	72
2001-02	6.2	4.4	1.5	71
2002-03	5.9	4.4	1.1	75
<b>Enactment of FRBM Act</b>				
2003-04	4.48	3.57	-0.03	79.71
2004-05	3.98	2.49	-0.05	62.57
2005-06	4.08	2.57	0.38	63.03
2006-07	3.45	1.94	-0.19	56.27
2007-08	2.69	1.11	-0.93	41.42
2008-09(RE)	6.14	4.53	2.51	73.83
2009-10(BE)	6.85	4.83	3.0	70.51

RE: Revised Estimates. BE: Budget Estimates. Source: Hand book of Statistics on Indian Economy, RBI Annual policy Statement and RBI bulletin, (various issues)

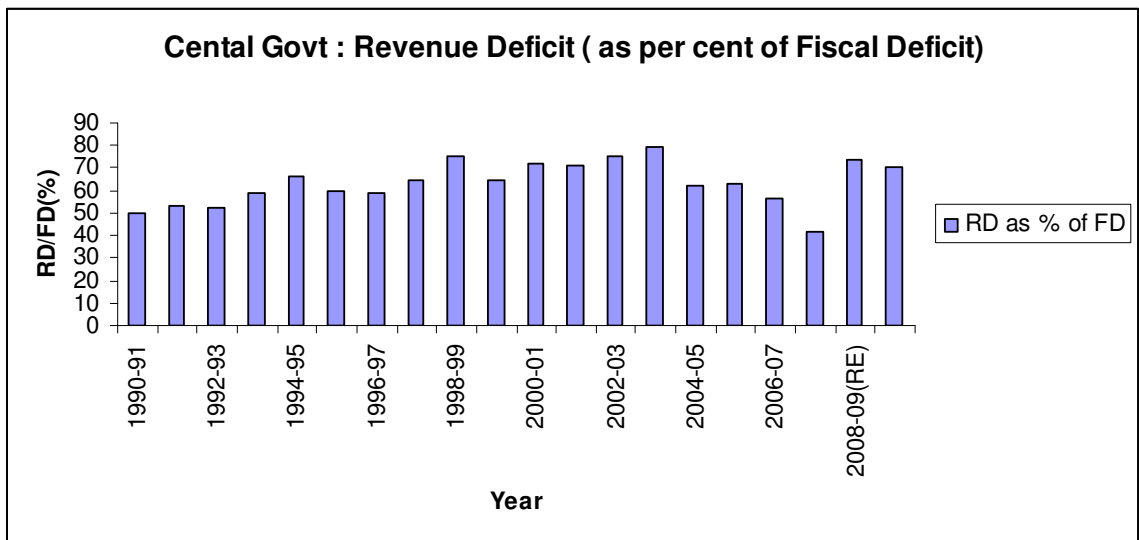
It is also recognized that in nineties primary deficit turned negative. It means that government was borrowing to meet their current expenditure exclusive of interest payment or significant part of the fiscal deficit was due to the burden of the serving the past debt. The main reason given for fiscal deterioration after mid nineties were the fall in central tax GDP ratio, substantial increase in the level of salary and pension payment (particularly in state in the wake of the recommendation of fifth central pay commission) and erosion in the buoyancy of central indirect taxes. Downward rigidities of current expenditure combined with inelastic tax structure were a constraint for achieving fiscal balances.

**Chart-7.1, Central Government: Trends in Major Deficit Indicator (as a per cent of GDP)**



The ratio of revenue deficit to fiscal deficit, which indicates the extent to which borrowings are used to meet current expenditure, increased from 50 per cent in 1990 to 75 per cent by 2002-03. It is quite clear from the table-7.1 that, fiscal deficit rose on account of expanding revenue deficit. The impact of growing revenue deficit on fiscal deficit is captured in terms of the ratio of revenue deficit to fiscal deficit.

**Chart-7.2 Central Government: Revenue Deficit / Fiscal Deficit (as per cent)**



### **7.3. Trends in Central Government Major Deficit Indicators after the Implementation of FRBM Act**

After the implementation of FRBM Act the fiscal situation seems to have improved both in terms of fiscal deficit as well as in revenue deficit. In the era of fiscal consolidation the revenue deficit of the centre declined to 1.11 per cent of GDP in 2007-08, its lowest level since 1990-91. In 2008-09, there was a total reversal of fiscal correction with the revenue deficit reaching a level of 4.53 per cent of GDP. The Union Budget for 2009-10, which was formulated against the backdrop of the global downturn and subdued domestic demand, envisaged a revenue deficit of 4.83 per cent of GDP. The fiscal deficit of the centre declined from 4.48 per cent of GDP in 2003-04 to 2.69 per cent in 2007-08, the lowest since 1990-91. There was a reversal of the declining trend in 2008-09, with the fiscal deficit ballooning to 6.14 per cent of GDP. For 2009-10, it has been budgeted at 6.85 per cent of GDP. The reversal of fiscal correction was on account of the fiscal stimulus measures. Pay revision, farm debt waiver and additional expenditure on food and fertiliser subsidies have added substantially to the fiscal burden. Apart from this much of the deterioration in fiscal indicators observed in 2008-09 was on account of these additional expenditure commitments. The deficit on account of reduction in tax revenue due to economic slowdown as well as the tax cuts in excise and service taxes effected as part of the fiscal stimulus at about 1 per cent of GDP. The fiscal deficit figures of 2009-10 (BE) do not take into account the off-budget bonds issued to the oil marketing and fertiliser companies amounting to Rs. 95,942 crore or 1.8 per cent of GDP in 2008-09. The primary balance which turned into a marginal surplus in 2003-04 continued to remain in surplus till 2007-08 with the exception of 2005-06. The year 2008-09 witnessed a sharp increase in primary deficit to 2.51 per cent of GDP. It is budgeted at 3 per cent of GDP in 2009-10, the highest in the post-reform period. Primary deficits add to the debt-GDP ratio unless GDP growth is higher than the interest rate on public debt.

The ratio of revenue deficit to fiscal deficit, which indicates the extent to which borrowings are used to meet current expenditure, declined from nearly 80 per cent in 2003-04 to 41.42 per cent by 2007-08. However, this proportion went back to nearly 74

per cent in 2008-09 (RE). Thus, a review of the fiscal situation reveals that all fiscal indicators, after registering an improvement in the years following the enactment of the FRBMA, have witnessed sharp deterioration in 2008-09 and 2009-10.

#### 7.4. Central Government Trends in Expenditures before the Implementation of FRBM Act

The total expenditure of central government comprises of revenue and capital expenditure. Revenue expenditure as a per cent of GDP declined from 12.9 per cent in 1990-91 to 11.6 per cent in 1996-97 and rose there after to 13.8 per cent in 2002-03.

**Table -7.2: Central Government: Major Expenditures: (as per cent of GDP)**

Year	Rev EXP/GDP	Cap Exp/ GDP	Total Exp/GDP	Int. Pay/GDP	Subsidies/GDP
1990-91	12.93	5.59	18.52	3.78	2.14
1991-92	12.6	4.46	17.06	4.07	1.88
1992-93	13.76	4.44	18.2	4.61	1.78
1993-94	12.59	3.92	16.51	4.28	1.35
1994-95	12.06	3.81	15.87	4.35	1.17
1995-96	11.77	3.23	15.01	4.21	1.07
1996-97	11.62	3.08	14.69	4.35	1.13
1997-98	11.84	3.4	15.24	4.31	1.22
1998-99	12.43	3.61	16.04	4.47	1.36
1999-00	12.86	2.53	15.39	4.66	1.26
2000-01	13.3	2.29	15.58	4.75	1.28
2001-02	13.21	2.67	15.88	4.71	1.37
2002-03	13.75	3.02	16.77	4.77	1.7
2003-04	13.14	3.96	17.11	4.50	1.6
2004-05	12.20	3.62	15.82	4.03	1.4
2005-06	12.26	1.85	14.11	3.70	1.2
2006-07	12.46	1.67	14.13	3.64	1.3
2007-08	12.58	2.50	15.09	3.62	1.4
2008-09(RE)	15.10	1.83	16.93	3.62	2.43
2009-10(BE)	15.32	2.11	17.43	3.85	2.11

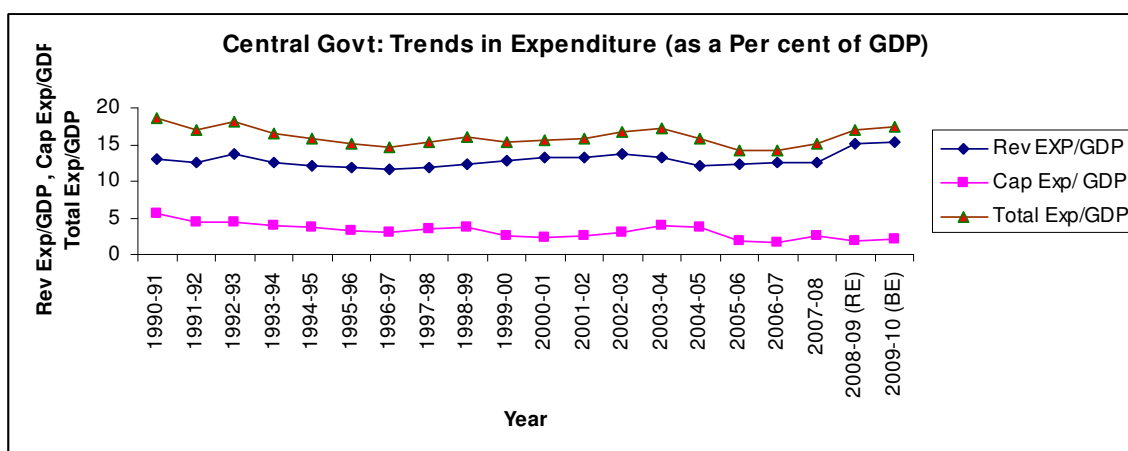
RE: Revised Estimates. BE: Budget Estimates

Source: RBI Annual policy Statement, Hand book of statistics on Indian Economy (various issues), Government of India (2005), "Report of the Twelfth Finance Commission" Ministry of Finance, Government. of India and Government. Of India (2010), "Report of the Thirteenth Finance Commission" Ministry of Finance, Government. Of India

The quality of expenditure, witnessed deterioration over the years as the share of capital expenditure declined from 5.6 per cent of GDP in 1990-91 to 3.0 per cent in 2002-03.

Expenditure on interest payments on the other hand has increased from 3.8 per cent of GDP in 1990-91 to 4.5 per cent of GDP in 2003-04. Interest payments, subsidies, pension and defense expenditure account for 60 per cent to 65 per cent of revenue expenditure (Government of India, 2005). Persistent deficit have resulted in a continuous increase in debt and increasing debt has led to growing proportion of the revenue resources getting spend on interest payments. The rise in interest payments became particularly sharp after liberalization of interest rates and reduction in the Statutory Liquidity Ratio (SLR) of bank (Lahiri, 2000). An interest payment became the largest component of revenue expenditure. Interest payments was accounting for about 35 per cent of revenue expenditure in 2002-03. As proportion of centre revenue receipts, it accounted for about 51 per cent of centre revenue receipts in 2002-03. In recent years, with lower nominal interest rates, the average cost of market borrowing witnessed a declining trend since 2000-01 (Government. of India, 2005).

**Chart -7.3 Central Government Trends in Expenditures (as a per cent of GDP)**



### 7.5. Central Government Trends in Expenditures after the Implementation of FRBM Act

After registering a significant fall from 17.11 per cent of GDP in 2003-04 to 14.13 per cent of GDP in 2006-07, total expenditure of the central government rose to a level of 16.93 per cent of GDP in 2008-09. The fall in the ratio of total expenditure to GDP came mostly from a reduction in capital expenditure. Capital expenditure of the centre, which

declined from 3.96 per cent of GDP in 2003-04 to 1.67 per cent of GDP in 2006-07, rose to 2.50 per cent of GDP in 2007-08. Thereafter, capital expenditure declined to about 2 per cent of GDP in 2008-09. Expenditure on interest payments, defence, pay and allowances and subsidies are the main components of the centre's revenue expenditure, accounting for about 63 per cent of the total. While the proportion of expenditure on interest payments to GDP has shown a marginal decline because of the low interest rate regime, expenditure on defense has remained at more than 2 per cent of GDP in almost all the years since 2003-04. Expenditure on pay and allowances of central government employees excluding defense personnel, after moderating from 1.21 per cent of GDP in 2003-04 to 0.97 per cent of GDP in 2007-08, jumped to 1.33 per cent of GDP in 2008-09 and is estimated to go up even further to 1.50 per cent in 2009-10, the highest since 2000-01. The increase in the ratio of pay and allowances is mainly due to the implementation of the recommendations of the Sixth Central Pay Commission (CPC) and payment of 40 per cent of the arrears in 2008-09 and 60 per cent in 2009-10. Expenditure on pay and allowances may moderate in the coming years with the tapering off of the effect of payment of arrears. Expenditure on explicit subsidies is the third largest item of revenue expenditure after interest payments and defense. Food and fertiliser subsidies are the main explicit subsidies provided by the centre. Explicit subsidies as a proportion GDP, after moderating from 2004-05 to 2007-08, have been rising since then due to the firming up of commodity prices, particularly those of food, fuel and fertilizer (Government of India, 2010).

#### **7.6. Central Government Trends in Gross Tax Revenues before the Implementation Of FRBM Act**

In 1990s liberalization had an adverse impact on tax revenue by reducing tariff rate, custom duties and excise duty (by giving concession to private industry to give them incentive). It also gave concession on direct tax to give incentive to save and invest. In the process of fiscal consolidation among the direct tax both the personal and corporate income taxes, were rationalized. The numbers of rate categories as well as the marginal income tax rates were substantially reduced. The main central commodity taxes, union excise duties and custom duties also went under salient changes. In the case of customs duties, there was drastic reduction in the tariff rates across the rate categories.

**Table -7.3: Central Government major taxes (as a per cent of GDP)**

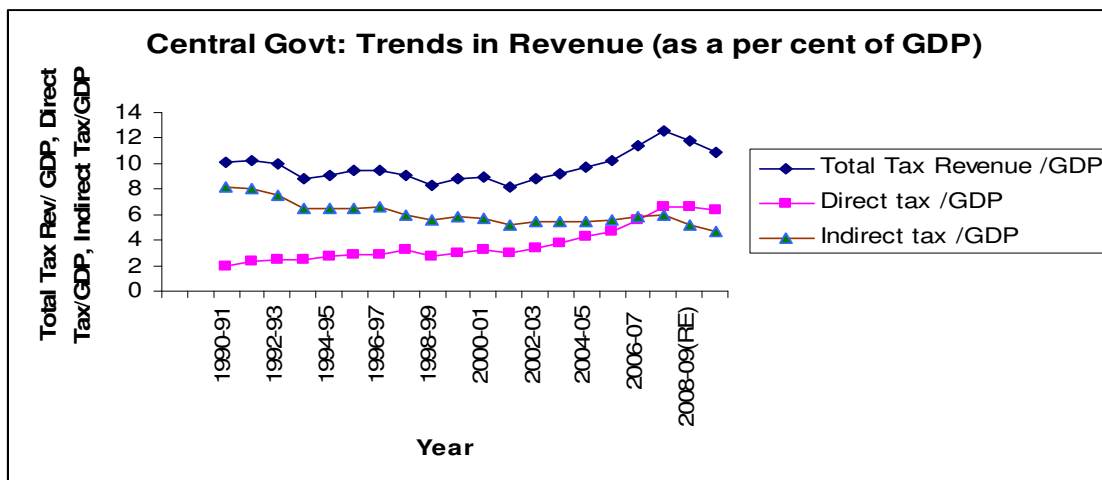
Year	Total Tax Revenue /GDP	Direct tax /GDP	of Which		Indirect tax /GDP	of which	
			Personal Income tax/GDP	Corporation tax/GDP		Excise duties/ GDP	Customs duties/GDP
1990-91	10.1	1.9	0.95	0.94	8.2	4.31	3.63
1991-92	10.3	2.3	1.03	1.2	8	4.3	3.41
1992-93	10	2.4	1.06	1.19	7.5	4.13	3.18
1993-94	8.8	2.4	1.06	1.17	6.5	3.69	2.58
1994-95	9.1	2.7	1.19	1.36	6.5	3.69	2.65
1995-96	9.4	2.8	1.31	1.39	6.5	3.38	3.01
1996-97	9.4	2.8	1.33	1.36	6.6	3.29	3.13
1997-98	9.1	3.2	1.12	1.31	6	3.15	2.64
1998-99	8.3	2.7	1.16	1.41	5.6	3.06	2.34
1999-00	8.8	3	1.32	1.58	5.8	3.2	2.5
2000-01	9	3.2	1.52	1.71	5.7	3.28	2.28
2001-02	8.2	3	1.4	1.6	5.2	3.18	1.76
2002-03	8.8	3.4	1.49	1.9	5.4	3.33	1.82
2003-04	9.23	3.81	1.50	2.31	5.42	3.30	1.77
2004-05	9.68	4.22	1.56	2.63	5.47	3.15	1.83
2005-06	10.21	4.61	1.56	2.82	5.60	3.10	1.81
2006-07	11.47	5.57	1.82	3.50	5.89	2.85	2.09
2007-08	12.56	6.61	2.17	4.08	5.95	2.62	2.20
2008-09 (RE)	11.80	6.55	2.03	4.17	5.25	2.04	2.03
2009-10 (BE)	10.95	6.32	1.82	4.38	4.63	1.82	1.67

RE: Revised Estimates. BE: Budget Estimates, Source: RBI Annual policy Statement (various issues), Handbook of statistics on Indian Economy, (various issues)

In the case of union excise duties, the principle of taxing the value added was adopted, first in the form of Modified VAT (MODVAT) and latter as Central VAT (CENTVAT). The impact of these reforms on direct tax and indirect tax was diametrically opposite. While the direct taxes showed, even with the lower rates a rising tax GDP ratio, this ratio for indirect tax was sliding down. In spite of rationalization of direct tax both personal and corporate income taxes, the fall in the indirect tax to GDP ratio could not be compensated by rise in direct tax. The tax-GDP ratio of centre declined from 10.1 per cent in 1990-91 to 8.8 per cent in 2002-03. The major contribution to this decline was custom duty. This was basically due to the drastic reduction in tariff rates. This custom duty relative to GDP halved from 3.6 per cent in 1990-91 to 1.8 per cent in 2002-03. There was an average reduction in tax rate of union excise duty without a compensatory rise in tax base. Though, the service sector is expanding more now and contributing more

than 50 per cent of GDP but, the collection from service tax remains at levels below 0.5 per cent of GDP.

**Chart -7.4: Central Governments: Trends in Tax Revenues (as a per cent of GDP)**



### 7.7. Central Government Trends in Gross Tax Revenues after the Implementation of FRBM Act

After the enactment of FRBM Act there is a slight improvement observed in the total tax revenue trends. Higher GDP growth coupled with better tax administration and introduction of new taxes such as the ‘fringe benefit tax’, has resulted in higher growth of tax revenues, particularly from 2004-05. The high buoyancy of direct tax revenues may be attributed substantially to improvement in tax compliance following the institution of the Tax Information Network (TIN) and its implementation by the National Securities Depository Ltd (NSDL). With the setting up of the TIN in January 2004, tax compliance has gone up significantly. The gross tax-GDP ratio went up by over three per cent in a span of four years, from 9.23 per cent in 2003-04 to 12.56 per cent in 2007-08. The entire improvement came from the buoyancy of direct taxes, more particularly from corporation tax, reflecting the increasing profitability of the Indian corporate sector. In fact, indirect tax-GDP ratio has remained stagnant between 5 per cent and 6 per cent since the late nineties. As a result of the higher growth of direct taxes, there has also been a shift in the composition of gross tax revenues of the centre. For the first time in the history of public finances of the country, direct taxes have overtaken indirect tax collections in the year 2007-08. This is a healthy development as direct taxes are more progressive than indirect

taxes. From less than 20 per cent share in total tax revenues in 1990-91, the share of direct taxes has increased to over 55 per cent in 2008-09. Within direct taxes, the share of corporation tax has increased from 24.99 per cent of gross tax revenue in 2003-04 to 35.35 per cent in 2008-09, an increase of over 10 per cent. The share of income tax in gross tax revenue of the centre witnessed a marginal increase from 16.27 per cent to 17.20 per cent in the same period. In the case of indirect taxes, while the share of custom duties in gross tax revenue declined marginally by nearly two per cents between 2003-04 and 2008-09, the share of Union excise duties witnessed a sharp decline of over 18 per cent. The sharp decline in the share of Union excise duties was largely on account of rate cuts, and in recent years, on account of the slowdown in the growth of the manufacturing sector. The share of indirect taxes would have fallen further but for the buoyant revenue from service tax. Service tax improved its share from 3.10 per cent in 2003-04 to 10.35 per cent in 2008-09. The increase in the share of service tax was on account of an increase in both coverage as well as tax rates.

### **7.8. Central Government Debt Indicators before the Implementation of FRBM Act**

The debt-to-GDP ratio of the central Governments in India has been on upward trends since the early 1990s. The rise has been particularly pronounced during the 1980s. The magnitude of debt to GDP ratio has also increased over the periods (Lahiri and Kanan, 2002). The total outstanding liabilities show an increasing trend from 55.22 per cent of GDP in 1990-91 to 63.33 per cent of GDP in 2004-05. The composition of central government debt reveals that the debt is mostly internal in nature. The proportion of government financed externally is small. While, internal liabilities showed an increasing trend during 1990-91 to 2004-05, the external liabilities showed a declining trend. In India consequently, there was an accumulation of a huge stock of debt. The growing size of liabilities eventually generated a considerable debt-service burden and rising interest payments.

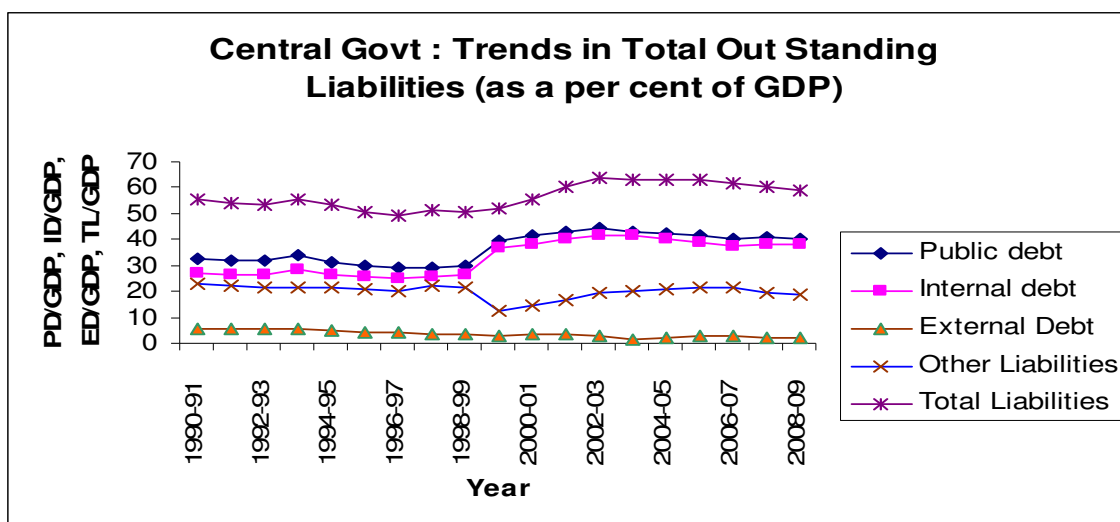
**Table -7.4: Central Government major debt indicators (as a per cent of GDP)**

Year	Public debt	Internal debt	External Debt	Other Liabilities	Total Liabilities
1990-91	32.57	27.04	5.53	22.65	55.22
1991-92	32.03	26.38	5.64	22.14	54.17
1992-93	32.07	26.46	5.62	21.33	53.41
1993-94	33.85	28.38	5.47	21.36	55.21
1994-95	31.25	26.23	5.01	21.78	53.03
1995-96	30.13	25.83	4.30	20.73	50.87
1996-97	28.92	24.99	3.93	20.09	49.01
1997-98	29.10	25.47	3.62	21.87	50.96
1998-99	29.52	26.25	3.27	21.41	50.93
1999-00	39.58	36.59	2.99	12.72	52.31
2000-01	41.37	38.23	3.14	14.22	55.58
2001-02	43.20	40.06	3.14	16.75	59.96
2002-03	44.01	41.58	2.43	19.51	63.52
2003-04	43.12	41.45	1.67	19.92	63.05
2004-05	42.45	40.51	1.93	20.88	63.33
2005-06	41.37	38.75	2.63	21.64	63.01
2006-07	39.90	37.42	2.49	21.58	61.48
2007-08	40.66	38.29	2.37	19.41	60.07
2008-09	40.14	37.85	2.29	18.79	58.93

Source: RBI Hand book of Statistics on Indian Economy (2009) \*GDP means GDP at market price.

\*Here Total liabilities comprising (i) public debt (ii) other liabilities, Public debt comprising External debt and internal liabilities debt, other liabilities include (i) National Small Saving Funds (ii) State Provident Fund (iii) Other accounts such as special deposits (iv) Reserve funds.

**Chart-7.5 Central Government: Trends in Total outstanding Debt to GDP (as a per cent of GDP).**



### **7.9. Central Government Debt Indicators after the Implementation of FRBM Act**

The outstanding liabilities of the central government, after reaching 63.33 per cent of GDP in 2004-05, started declining consistently. This was because of the growth of nominal GDP remaining higher than interest rate. This decline occurred even though a new component had been added to internal debt in 2004-05, which is not reflected in the fiscal deficit. The Government of India introduced the Market Stabilisation Scheme (MSS) in consultation with the RBI in April 2004. Under the scheme, the Government of India raises money through the issue of dated securities/treasury bills to absorb excess liquidity in the market on account of foreign inflows. The amount so raised was to be kept in a separate account with the RBI and was not meant to meet the expenditure needs of the government. Despite a sharp increase in the fiscal deficit in the years 2008-09 and 2009-10, a marginal decline in the ratio of outstanding debt to GDP is projected even in these two years. Among the components of outstanding debt, there is an increase in the share of internal debt. Because of the developments unfolding since the global crisis, the centre increased its net market borrowings sharply, from Rs. 1, 31,768 crore in 2007-08 to Rs. 2, 61,972 crore in 2008-09 and further to Rs. 3, 97,957 crore in the budget estimates for 2009-10. Following the global downturn, the Memorandum of Understanding (MoU) signed with the RBI was amended in February 2009 to allow a part of the amount in the MSS account to be transferred to the Consolidated Fund of India as part of the government's normal market borrowing programme. Following this, an amount of Rs. 12,000 crore was transferred from the MSS account to the Consolidated Fund of the centre in March 2009.

### **7.10. Debt Sustainability at Centre**

The Domar stability condition has been defined as:

$$Y-r > 0 \quad (1)$$

$$r = (IP)_{t-1} / (OD)_{t-1} \quad (2)$$

Where,

Y= Trend growth rate of GDP at current Market price

$r$  = Average Interest Rate

IP= Interest Payment

OD = Outstanding Debt

$t$  = Time Period

Equation (1) and (2) imply that the debt/GDP ratio ( $d/y$ ) is stable if the nominal GDP growth ( $g$ ) exceeds the nominal interest rate ( $r$ ) on government debt. According to the Domar stability condition, larger the gap between the interest rate and growth rate the higher will be the  $d/y$ . Thus, to stabilize debt/GDP ratio ( $d/y$ ), rate of interest should be lower than the output growth ( $r < g$ ).

In this study the Domar stability condition has been tested in respect to market related borrowings rates and administered interest rates for the centre.

Here, Debt refers to Internal Total Outstanding Liabilities including Internal and external liabilities.

GDP means GDP at current market price.

$R(C)$  = average interest rate

$R(ML)C$  = weighted average of market borrowing rate.

The movements in the average interest rates vis- a-vis nominal GDP growth reflect that the Domar stability condition has not been fulfilled for many of the years since 1980s. This is because sizable proportion of domestic debt has been contracted at administered interest at higher level. In recent year, however the rates on market related borrowing have come down and are lower than the nominal GDP growth rate. This development confirms weak sustainability.

**Table -7.5: Domar condition of Debt Sustainability at Centre**

Year	Y	R (C)	R(ML)C
1981-82	17.50	6.29	7.29
1982-83	11.86	6.80	8.36
1983-84	16.45	6.52	9.29
1984-85	12.04	7.20	9.98
1985-86	12.86	7.60	11.08
1986-87	11.90	7.74	11.38
1987-88	13.67	7.81	11.25
1988-89	18.63	8.41	11.4
1989-90	14.88	8.94	11.49
1990-91	16.80	9.32	11.41
1991-92	14.94	9.85	11.78
1992-93	14.95	10.28	12.46
1993-94	15.04	10.70	12.63
1994-95	17.32	10.95	11.9
1995-96	17.33	10.97	13.75
1996-97	15.67	11.56	13.69
1997-98	10.77	11.58	12.01
1998-99	14.67	11.96	11.86
1999-00	11.47	12.39	11.77
2000-01	7.70	12.22	10.95
2001-02	8.40	12.19	9.44
2002-03	7.71	11.64	7.34
2003-04	12.22	11.39	5.71
2004-05	14.33	11.07	6.11
2005-06	13.89	10.23	7.34
2006-07	15.12	10.21	7.89
2007-08	14.39	10.39	8.12
2008-09	12.67	10.13	N.A

Source: *Hand book of Statistics on Indian Economy, RBI (2009)*

### **7.11. Central Government Finances Adjustment after the implementation of FRBM Act**

After the implantation of FRBM act the major deficit indicator of the central government has come down. From this we can not conclude that the FRBM act has been effective in India because before giving any occlusion we have to analyze how India has been able to bring adjustment and whether this adjustment is sustainable. Many economists have argued that the improvement in the deficit indicators or fiscal deficit to GDP ratio has come down until now due to the steady improvement in growth rate (Srivastava, 2008).

**Table-7.6: Adjustment in central Government Finances, 2003-04 to 2009-10 (as per cent of GDP)**

Indicators	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9(RE)	2009/10(BE)
1. Revenue Receipts (a+b)	9.6	9.7	9.7	10.5	11.47	10.56	10.49
(a) Tax Revenue (net of States Share)	6.8	7.1	7.5	8.5	9.3	8.76	8.10
(b) Non Tax revenue	2.8	2.6	2.2	2.0	2.2	1.8	2.4
2. Revenue Expenditure	13.1	12.2	12.3	12.4	12.6	15.1	15.3
(a) Interest Payments	4.5	4	3.7	3.6	3.6	3.6	3.8
(b) Major Subsidies	1.61	1.46	1.32	1.38	1.50	2.43	1.90
3. Revenue Deficit (2-1)	3.6	2.5	2.6	1.9	1.1	4.53	4.83
4. Capital Expenditure	3.96	3.62	1.85	1.67	2.50	1.83	2.11
5. Total Expenditure (2+4)	17.1	15.8	14.11	14.13	15.1	16.93	17.43
6. Fiscal Deficit	4.5	4	4.1	3.5	2.7	6.14	6.85
8. Primary Deficit	-0.03	-0.05	-0.38	-0.19	-0.93	2.5	3.00
9. Outstanding Liabilities	63.05	63.33	63.13	61.23	60.07	58.93	59.68

Source: *Economic Survey, (2008-09) & Government of India (2010) "Report of The Thirteenth Finance commission", 2010-2015, Ministry of Finance, June, New Delhi*

Economist also argued that in 2008 although the fiscal deficit target was over achieved and it was estimated to be 2.5 per cent of GDP. This did not take into account the off budget borrowing by the government. If off budget liabilities would have been taken into account then the deficit would have been much higher (Simone and Topalova, 2008).

By looking into the data we can say that basically the central government has been successful in achieving fiscal balance by curtailing its expenditure especially by curtailing capital expenditure more rather than revenue expenditure.

### **7.12. Trends in Aggregate States' Government Major Deficit Indicators before the Implementation of Fiscal Responsibility Law (FRL)**

Fiscal imbalances have grown sharply across the states since 1980s. Although there was some evidence of fiscal consolidation on part of most states during the early 1990s, this improvement could not sustain thereafter. However, since 1997-98, the imbalance has worsened coinciding with pay revisions of state government employees. As a proportion of GDP gross fiscal deficit of states after declining from 3.3 per cent in 1990-91 to 2.4 per cent in 1993-94 increased consistently in the latter years.

**Table-7.7: States Government Aggregate: Deficit major Indicators (as a of GDP)**

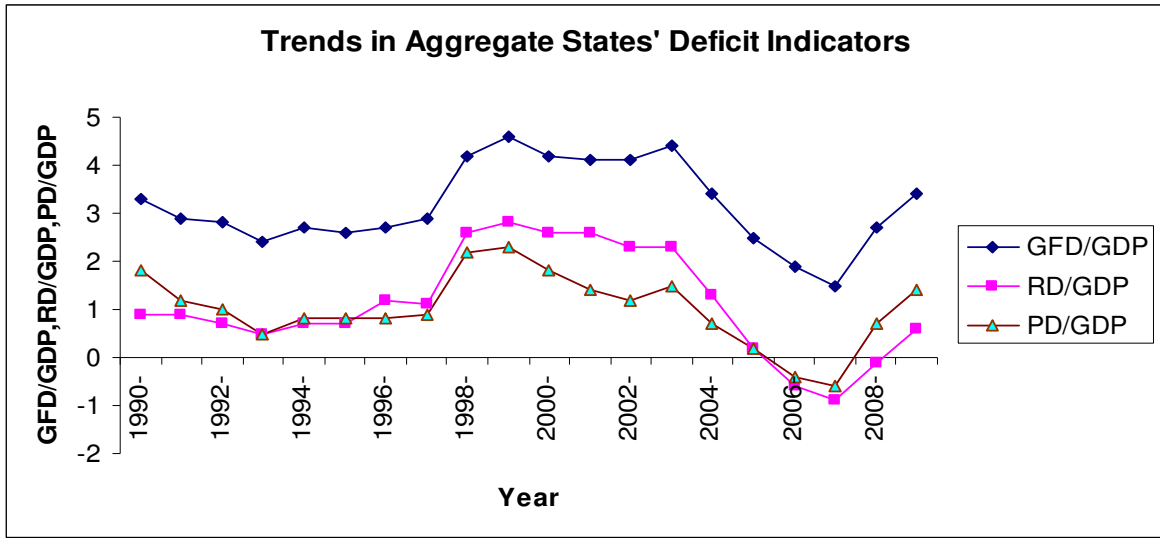
year	GFD/GDP	RD/GDP	PD/GDP	Rev def/ Fiscal def (per cent)
1990-91	3.3	0.9	1.8	27.2
1991-92	2.9	0.9	1.2	31.03
1992-93	2.8	0.7	1	25
1993-94	2.4	0.5	0.5	20.8
1994-95	2.7	0.7	0.8	25.9
1995-96	2.6	0.7	0.8	26.9
1996-97	2.7	1.2	0.8	44.4
1997-98	2.9	1.1	0.9	37.9
1998-99	4.2	2.6	2.2	61.9
1999-00	4.6	2.8	2.3	60.9
2000-01	4.2	2.6	1.8	61.9
2001-02	4.1	2.6	1.4	63.4
2002-03	4.1	2.3	1.2	56.1
2003-04	4.4	2.3	1.5	52.3
2004-05	3.40	1.25	0.65	36.77
2005-06	2.56	0.19	0.20	7.52
2006-07	1.69	-0.71	-0.6	-41.98
2007-08	1.51	-0.94	-0.61	-62.46
2008-09(RE)	2.64	-0.27	0.68	-10.22
2009-10(BE)	3.23	0.50	1.28	15.47

RE: Revised Estimates. BE: Budget Estimates

Source: RBI States finances; Study of Budget, (various issues)

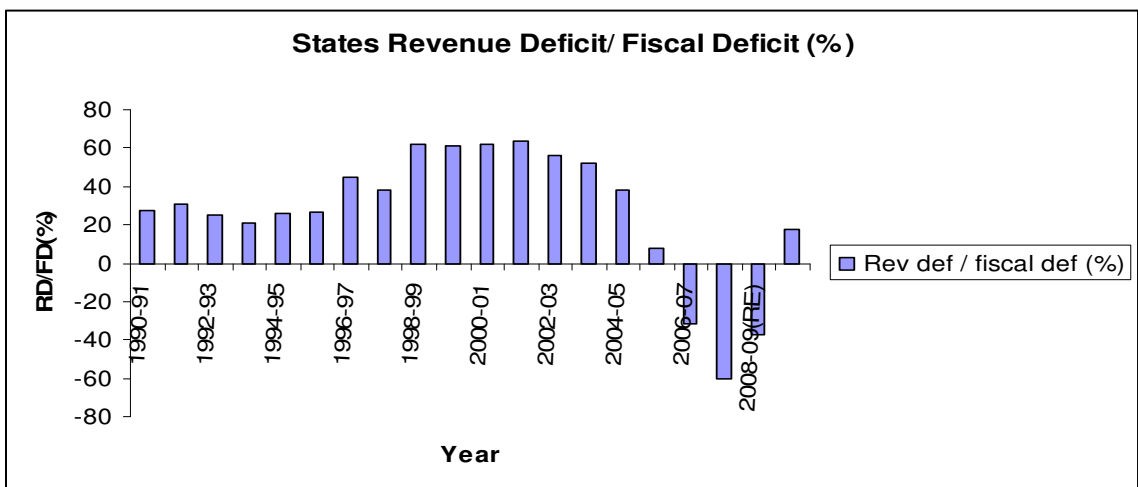
The six years from 1997-98 to 2002-03 was the worst in the history of state finances. The fiscal deficit which was around 3 per cent of GDP until 1997-98, increased sharply to 4.2 per cent in 1998-99. It further reached a peak at 4.6 per cent of GDP in 1999-2000. After that it showed sign of slight improvement continuously till 2002-03, but again despite various fiscal correction measures, it was 4.5 per cent in 2003-04. Attempts to curb fiscal deficits have caused a sharp decline in the quality of deficits as well. Revenue deficit for states as a whole which remained below one per cent of GDP during 1990-91 to 1995-96 reached a peak level of 2.8 per cent of GDP in 1999-2000. It is quiet obvious that increase in revenue deficit led to increase in fiscal deficit also.

**Chart-7.6: Aggregate States': Trends in Major Deficit Indicators (as a per cent of GDP)**



It is quite apparent from the chart-7.7 that the ratio of revenue deficits to fiscal deficit was averaging only 25 per cent in the first six years of nineties. The ratio started rising and reached over 60 per cent in 1998-99 and stayed at over 60 per cent for four years continuously. Fiscal deficit rose on account of expanding revenue deficit.

**Chart-7.7: Aggregate States': Revenue deficit/ fiscal deficit (as per cent)**



It only meant that the states were borrowing largely to fund their revenue deficits and not for any capital expenditure. Primary deficit, despite small fluctuation remained almost

same over a decade's period i.e during 1990-91 to 2000-01 and in subsequent budget it showed a declining trend. Fiscal imbalances in the states are structural in nature.

### **7.13. Trends in Aggregate States' Government Major Deficit Indicators after the Implementation of Fiscal Responsibility Law (FRL)**

In the recent period after the Implementation of FRL, a significant development in respect of state finances is observed. The major fiscal indicators of the state governments have witnessed significant improvement in the recent years. Continuing the fiscal correction and consolidation process, in 2007-08 there was a surplus in the revenue account after a gap of two decades. The ratio of Gross Fiscal Deficit (GFD) of the states to Gross Domestic Product (GDP) was lower at 1.51 per cent of GDP in 2007-08, where as revenue deficit became -0.94 per cent of GDP and primary deficit -0.61 per cent of GDP. Assessment of fiscal performance indicates that, states' government reached their Revenue Deficit (RD) and GFD targets well ahead of the stipulated time schedule under their FRL.

As part of its countercyclical measures in the wake of the global economic downturn, the centre had raised the market borrowing limit of states by Rs. 30,000 crore in 2008-09 and allowed them to exceed their fiscal deficit target by 0.50 per cent to 3.5 per cent of GSDP in 2008-09. The fiscal deficit target was further raised to 4 per cent of GSDP in 2009-10. The target for elimination of the revenue deficit was shifted by a year to 2009-10. The revised estimates of 2008-09 and budget estimates for 2009-10 indicate deterioration in the aggregate finances of states owing to lower growth of own revenues and transfers from the centre on one hand, and increase in revenue expenditure on the other. The revenue surplus of states declined from 0.94 per cent of GDP in 2007-08 to 0.27 per cent in 2008- 09 (RE). Fiscal deficit increased by 1.13 per cent to 2.64 per cent of GDP in 2008-09. The revenue account of states is estimated to turn into a deficit of 0.50 per cent of GDP in 2009-10 (BE) after registering a surplus in the preceding three years. The aggregate fiscal deficit of states is budgeted to increase further to 3.23 per cent of GDP in 2009-10, close to the level obtaining in 2004-05. The primary balance of states, which

remained in surplus in 2006-07 and 2007-08, turned into a deficit of 0.68 per cent and 1.28 per cent of GDP in 2008-09 (RE) and 2009-10 (BE), respectively.

#### 7.14. Aggregate States' Revenue Receipt Trend before the Implementation of FRL

Total Receipts consists of revenue receipts and capital receipts. Revenue receipts consists of tax receipts and non tax receipts Again tax receipts consists of own tax revenue and share in central taxes. Non tax revenue consists of non tax revenue and grants from the centre. States own aggregate revenues receipts divided in own tax and own non tax. States authority to raise direct taxes is limited to agriculture income tax and profession tax. States have larger space in indirect tax field with power to tax goods at the point of sale (except in the course of inter state sale and import-export) and duties of excise on liquor and intoxicants being with them. In terms of wealth and assets taxation, states have authority to tax properties and land.

**Table- 7.8: Revenue Receipts of the States' Government (as a per cent of GDP)**

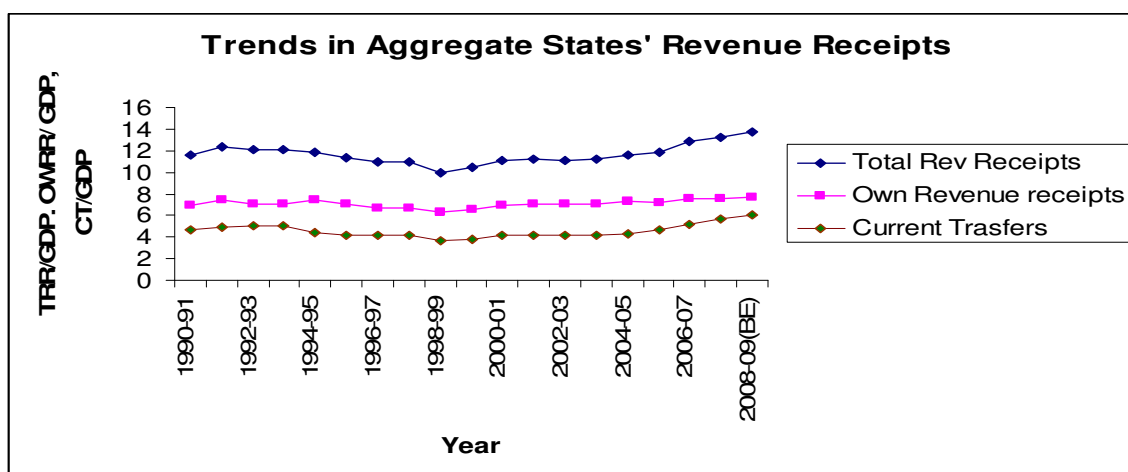
Year	Own Tax	Own Non Tax	Own Rev	Share in Centre Tax	Grant from Centre	Current Transfer	Total Rev Receipt
1	2	3	4=(2+3)	5	6	7=(5+6)	8=(4+7)
1990-91	5.3	1.6	6.9	2.5	2.2	4.7	11.6
1991-92	5.5	1.9	7.4	2.6	2.3	4.9	12.3
1992-93	5.3	1.7	7	2.7	2.4	5.1	12.1
1993-94	5.3	1.8	7.1	2.6	2.4	5	12.1
1994-95	5.3	2.1	7.4	2.4	2	4.4	11.8
1995-96	5.2	1.9	7.1	2.4	1.8	4.2	11.3
1996-97	5	1.7	6.7	2.5	1.7	4.2	10.9
1997-98	5.1	1.6	6.7	2.6	1.6	4.2	10.9
1998-99	4.9	1.4	6.3	2.3	1.3	3.6	9.9
1999-00	5.1	1.5	6.6	2.3	1.5	3.8	10.4
2000-01	5.4	1.5	6.9	2.4	1.8	4.2	11.1
2001-02	5.4	1.4	6.8	2.3	1.9	4.2	11.2
2002-03	5.6	1.4	7	2.3	1.8	4.1	11.1
2003-04	5.6	1.4	7	2.4	1.8	4.2	11.2
2004-05	5.8	1.5	7.3	2.5	1.8	4.3	11.49
2005-06	5.9	1.3	7.2	2.6	2.1	4.7	11.9
2006-07	6.1	1.6	7.7	2.9	2.27	5.2	12.9
2007-08	6.1	1.6	7.7	3.2	2.29	5.5	13.2
2008-9(RE)	6.2	1.5	7.7	3.26	2.9	6.16	13.87
2009-10(BE)	6.3	1.3	7.6	3.17	2.83	6	13.6

Source: RBI States faineances; Study of Budge, 2008-09 and 2009-10

The total revenue receipts to GDP ratio declined from 11.6 per cent in 1990-91 to 9.9 per cent in 1998-99 after that it showed a little improvement. In the case of own non tax revenues, there was a down ward slide. It fell from 1.6 per cent of GDP in 1993-94 to 1.2 per cent in 2001-02. The ratio of own tax revenues to GDP for all states fell from 5.3 per cent in 1993-94 to 4.9 per cent in 1998-99 and was at 5.1 per cent in 1999-00. There was a substantial improvement in 2000-01 as most states agreed to the implementation of floor rates in sales tax and to reduce and rationalize various exemptions. In 2002-03, the states own tax revenue as per cent of GDP improved to 5.5 per cent.

Among the states total receipts the slowest growing item was the transfers from the centre (10 per cent). The current transfer from centre came down from 4.7 per cent of GDP in 1990-91 to 3.6 per cent of GDP in 1998-99 in 2001-02. It increased significantly to 4.2 per cent of GDP. In the case of non finance commission's transfers, the fall was even more significant. In 1993-94 non finance commission transfers accounted for about 2 per cent of GDP. It fell to below 1.3 per cent in the period 2002-03. The finance commission's transfer relative to GDP was lowest in 1998-99 and 1999-00 it, was at 2.4 per cent and 2.5 per cent respectively. The fall in transfers was mainly on account of non finance commission transfer.

**Chart-7.8 Aggregate States': Trends in Revenue Receipts (as a per cent of GDP)**



### **7.15. Aggregate States Revenue Receipt Trend after the implementation of FRL**

There was significant improvement in total revenue receipts of states by 1.71 per cent of GDP, between 2004-05 and 2007-08. While all the components of revenue receipts contributed to this improvement, the primary contributors were transfers from the centre followed by own tax revenues. There was improvement in all the components of revenue receipts of states between 2004-05 and 2007-08. Own tax revenues as a proportion of GDP improved from 5.78 per cent in 2004-05 to 6.07 in 2007-08 which is the highest so far. Non-tax revenues improved, albeit sluggishly, from 1.47 per cent to 1.63 per cent in the same period. Share in central taxes, which had improved considerably following the recommendations of Eleventh Finance Commission, further improved in the award period of Twelfth Finance Commission. Share in central taxes as a per cent of GDP went up from 2.49 per cent in 2004-05 to 3.22 per cent in 2007-08. Aggregate fiscal improvement at the level of the states was mainly revenue-led, particularly through transfers from the centre. Central transfers to states will be much higher than those reported in if the benefit of the DCRF recommended by Twelfth Finance Commission is taken into account. Under the Debt Swap Scheme and the Debt Consolidation and Relief Facility (DCRF). DCRF, central loans amounting to Rs. 1,13,601 crore have been consolidated and an amount of Rs. 18,717 crore has been written off by the end of 2008-09. Interest relief obtained by states amounted to Rs. 15,689 crore in the four-year period 2005-09. Among the other components of revenue receipts, improvement in plan and non-plan grants was 0.26 and 0.28 per cent of GDP, respectively between 2004-05 and 2007-08. Taking all the components together, the revenue receipts of all states increased from 11.49 per cent in 2004-05 to 13.20 per cent of GDP in 2007-08.

### **7.16. Aggregate States' Expenditure trends before the Implementation of FRLs**

In contrast to the trend in revenue receipts, almost all expenditure categories have shown faster growth. These increases were particularly sharp in the case of interest payments and pensions. As far as interest payments were concerned, it rose from about 1.82 per

cent in 1993-94 to 2.96 per cent in 2002-03. In the case of pension also, there was a sharp rise from 0.691 per cent of GDP in 1993-94 to 1.24 per cent of GDP in 2002-03.

**Table-7.9: Aggregate States' Expenditure (as a per cent of GDP)**

Year	Total Rev Exp	Interest Payments	Pension	Plan Rev EXP	Non Plan Rev Exp
1993-94	11.41	1.82	0.61	2.22	10.19
1994-95	11.96	1.92	0.63	2.06	9.91
1995-96	11.63	1.83	0.66	2.01	9.63
1996-97	12.02	1.87	0.72	2.1	9.93
1997-98	12.03	2.01	0.77	1.93	10.1
1998-99	12.41	2.07	0.93	1.99	10.43
1999-00	13.08	2.3	1.16	1.87	11.21
2000-01	13.65	2.48	1.24	1.91	11.74
2001-02	13.31	2.68	1.26	1.85	11.46
2002-03	13.06	2.8	1.24	1.81	11.24
2003-04	13.5	2.78	-	2	11.5
2004-05	12.74	2.75	1.18	1.89	10.85
2005-06	12.18	2.36	1.14	1.94	10.24
2006-07	12.21	2.29	1.13	2.17	10.04
2007-08	12.26	2.12	1.19	2.39	9.88

Source: Government. of India (2005), "Report of the Twelfth Finance Commission" Ministry of Finance and Government. Of India (2010), "Report of the Thirteenth Finance Commission," Ministry of Finance

The plan revenue expenditure came down from 2.22 per cent of GDP in 1993-94 to 1.81 per cent of GDP in 2002-03. It was on account of interest payments and pension that the total revenue expenditure showed a rising trends and it has increased from 11.41 per cent of GDP in 1993-94 to 13.06 per cent of GDP in 2002-03.

### **7.17. Aggregate States' Expenditure trends after the implementation of FRL**

In contrast to growth in revenue receipts, all the components of revenue expenditure, with the exception of plan revenue expenditure, have exhibited a declining trend in the period 2004-05 to 2007-08 Total revenue expenditure as a per cent of GDP declined from 12.74 per cent in 2004-05 to 12.26 per cent in 2007-08. Within total revenue expenditure, while non-plan expenditure witnessed a sharp decline from 10.85 per cent to 9.88 per cent, plan expenditure increased from 1.89 per cent to 2.39 per cent in the same period. During this period, revenue expenditure declined by 0.47 per cent of GDP largely on account of

decline in interest payments by 0.63 per cent of GDP. Interest payments moderated from 2.75 per cent of GDP in 2004-05 to 2.12 per cent in 2007-08. This decline can be attributed to the interest relief obtained by states from the Debt Consolidated Relief Fund, amounting to Rs. 15,689 crore over the period 2005-09. The debt swap scheme, which was operational during 2002-05 also contributed to the reduction in interest payments. An amount of Rs. 1,02,034 crore of high-cost debt was swapped under the scheme, resulting in savings in interest payments for states. It may, however, be difficult to sustain the reduction in revenue expenditure because of the pay revisions. A number of states have revised pay scales of employees in the light of the recommendations of the Sixth CPC. Karnataka and Kerala revised their pay scales in 2007 and 2004, respectively. The increase in plan revenue expenditure of states is on account of increased transfers through centrally Sponsored Schemes.

Aggregate capital expenditure of states registered improvement in the period 2004-05 to 2007-08 following reduction in revenue expenditure and the surplus on revenue account in the years 2006-07 and 2007-08. Between 2004-05 and 2007-08, the aggregate capital expenditure of states went up by 0.59 per cent of GDP.

Subsidy for the power sector is the largest component of state government subsidies. Most of the State Power Utilities (SPUs) have negative financial flows. As SPUs are fully owned by state Governments, the financial performance of these entities has a direct bearing on state finances. State Governments' support to SPUs mainly consists of direct subsidies, subventions, contribution to equity, direct loans and extending guarantees to loans raised. According to a study sponsored by the Commission, the aggregate impact of the support to SPUs on state finances amounted to about Rs. 30,000 crore in 2007-08. Outstanding guarantees extended by states on the loans raised by PSUs amounted to Rs. 1,12,723 crore and constituted 60 per cent of the total outstanding guarantees of all states at the end of March 2008. As per the information received from states, dividend and interest payments by PSUs amounted to Rs. 167.41 crore and Rs. 1684.97 crore, respectively in 2007-08. While dividend amounted to 0.18 per cent of equity, interest payments amounted to 0.99 per cent of the outstanding loans. These per cent are

abysmally low and nowhere near the desired levels of 5 returns on equity and 7 interest on outstanding loans suggested by Twelfth Finance Commission (Government of India, 2010).

### 7.18. Aggregate States' Outstanding liabilities before the implementation of FRLs

The structural weaknesses of the state finances manifested in large and persistent RD resulting in high GFD and large accumulation of debt and a concomitant increase in debt service burden. Between 1991 and 2004, the consolidated debt-GDP ratio of states increased by 10.7 per cent to 33.2 per cent. Outstanding debt of the states comprises internal debt (mainly market borrowings, special securities issued to NSSF loans from banks and financial institutions, and WMA and OD from the Reserve Bank), loans from the centre, public accounts liabilities (including small savings, state provident funds, reserve funds and deposits and advances), and contingency fund.

**Table-7.10: Outstanding Liabilities of States' Government (as per cent of GDP)**

Year	Total Liabilities	Total Internal Debt	Loan and Advances from Centre
1990-91	22.50	3.38	12.91
1991-92	22.46	3.55	12.67
1992-93	22.37	3.57	12.17
1993-94	21.71	3.57	11.68
1994-95	21.37	3.53	11.34
1995-96	21.05	3.68	10.85
1996-97	20.90	3.72	10.60
1997-98	21.86	3.88	11.04
1998-99	23.03	4.41	11.36
1999-00	26.43	6.47	11.80
2000-01	28.26	8.64	11.35
2001-02	30.31	10.93	10.95
2002-03	32.04	13.60	10.15
2003-04	33.16	17.31	7.01
2004-05	32.68	18.89	5.08
2005-06	32.56	19.48	4.38
2006-07	30.29	18.41	3.57
2007-08	28.31	17.69	3.19
2008-09	27.27	17.36	2.96

Source: *Hand book of Statistics on Indian Economy, RBI, (various Issues), RBI States finances: A Study of Budget, (various Issues)*

The composition of outstanding liabilities of the state governments shows a sharp decline in the share of loans from the centre with an upsurge in the share of loans from NSSF, market borrowings and loans from banks and other financial institutions. Loans from NSSF will remain the dominant component (31.2 per cent) of outstanding liabilities during 2008-09 (BE), though its share has come down since 2007. This will be followed by market borrowing at 25.0 per cent in 2008-09 (BE), which stood at 19.3 per cent in 2006-07 (Accounts). On the other hand, loans from the centre, which formed 57.4 per cent of outstanding debt in 1991 declined substantially and are budgeted to contribute only 10.8 per cent during 2008-09 (BE). The share of public accounts in total liabilities has remained in the range of 25- 30 per cent.

**Table-7.11: Composition of Outstanding Liabilities of State Governments**

	1991	2000	2005	2006	2007	2008(RE)	2009(BE)
Total Liabilities (1 to 4)	100	100	100	100	100	100	100
1. Internal Debt	15	24.8	57.8	59.8	61.1	62.5	63.7
(i) market Loans	12.2	14.8	20.7	19.6	19.3	22.4	25
(ii) Special Securities issued by NSSF		5	27.4	31.3	33.8	32.3	31.2
(iii) Loans from Banks and Fls	2	3.4	6.6	6.2	5.8	6	6
2. Loan and Advances from Centre	57.4	45.2	15.6	13.4	11.7	11.3	10.8
3. Public Account(I to iii)	26.8	29.9	26.6	26.6	27.2	16.2	25.4
(i) Small Savings States, PF	13.2	15.8	14.2	13.8	13.6	13.8	13.5
(ii) Reserve Funds	3.7	3.9	5.1	5.4	5.6	4.6	4.3
(iii) Deposits and Advances	10	10.2	7.3	7.4	7.9	7.8	7.5
4. Contingency Fund	0.8	0.3	0.1	0.1	0.1	0.1	0.1

Source: States finances: Study of Budget, RBI, 2008-09

### 7.19. Aggregate States' Outstanding liabilities after the implementation of FRLs

The Twelfth Finance Commission recommended a target of 30.8 per cent for debt-GDP ratio and 15.0 per cent for IP/RR ratio to be achieved by 2009-10. The debt relief mechanism prescribed by the TFC, incentives by adherence to rule-based fiscal regime helped to contain the magnitude of outstanding liabilities. From the peak level of 33.2 per cent at end-March 2004, the debt- GDP ratio of state governments came down to 28.3 per cent in 2007-08 (RE) and is budgeted at 27.4 per cent in 2008-09(BE).

**7.20. Debt sustainability at State level**

According to the Domar to stabilize debt/GDP ratio ( $d/y$ ), rate of interest should be lower than the output growth.

**Table-7.12: Debt sustainability at State level**

Year	Y	R(S)	R(ML)S
1981-82	17.50	5.38	7
1982-83	11.86	5.39	7.5
1983-84	16.45	5.31	8.58
1984-85	12.04	5.71	9
1985-86	12.86	5.79	9.75
1986-87	11.90	6.68	11
1987-88	13.67	7.01	11
1988-89	18.63	7.31	11.5
1989-90	14.88	7.66	11.5
1990-91	16.80	7.88	11.5
1991-92	14.94	8.54	11.84
1992-93	14.95	8.98	13
1993-94	15.04	9.38	13.5
1994-95	17.32	10.33	12.5
1995-96	17.33	10.06	14
1996-97	15.67	10.12	13.82
1997-98	10.77	10.34	12.82
1998-99	14.67	10.61	12.35
1999-00	11.47	11.07	11.89
2000-01	7.70	9.88	10.99
2001-02	8.40	10.37	9.2
2002-03	7.71	9.99	7.49
2003-04	12.22	10.22	6.13
2004-05	14.33	9.46	6.45
2005-06	13.89	8.16	7.63
2006-07	15.12	7.98	8.1
2007-08	14.39	8.22	8.25
2008-09	12.67	8.11	N.A

Source: Hand book of Statistics on Indian economy, RBI (various issues)

\*GDP means GDP at market price. \*Here Debt refers to out standing liabilities comprising (i) internal debt (viz, open market loans, loans from banks/ financial institutions, special securities issued to NSSF, WMA/OD from RBI), (ii) loans and advances from Centre and (iii) small savings, State provident funds, (iii) reserves funds, deposits and advances and contingency fund

Here, R(S) =average interest rate, R(ML)S = weighted average of market borrowing rate

Y= Trend GDP growth rate.

The movements in the average interest rates vis- a-vis nominal GDP growth reflect that the Domar stability condition has not been fulfilled for many of the years since 1980s. This is because sizable proportion of domestic debt has been contracted at administered interest at higher level. In recent year, however the rates on market related borrowing have come down and are lower than the nominal GDP growth rate. These developments conforms weak sustainability.

### 7.21. States' Government Aggregate Fiscal Adjustment after the Implementation of FRL

Some of the economist argue that fiscal consolidation at the state level was achieved on the back of growing own revenues and higher resource transfers from the centre. More than three-quarters of the 2 per cent of GDP decline in the states' aggregate fiscal deficit was due to an increase in state revenue, increased transfers from the central government, namely through shared taxes and grants, and accounted for the bulk of the increase in revenue (Kishore and Prasad, 2007).

**Table-7.13: States' Government Aggregate: Fiscal Adjustment 2003/04-2008/09**

	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9 (BE)	2009/10 (RE)
I. Total Revenue	11.2	11.5	11.99	12.9	13.2	13.87	13.6
A. State own Revenue	7	7.25	7.24	7.73	7.70	7.70	7.60
i) State Own Tax	5.6	5.8	5.9	6.1	6.07	6.21	6.27
ii) State Own Non Tax	1.4	1.47	1.3	1.62	1.63	1.50	1.33
B. Transfers from Centre	4.1	4.2	4.7	5.2	5.5	6.16	6
i) Tax Share	2.4	2.5	2.65	2.9	3.2	3.26	3.17
2 Grant in Aid	1.7	1.7	2.1	2.27	2.29	2.9	2.83
II Revenue Expenditure	13.5	12.7	12.2	12.2	12.3	13.6	14.09
III Capital Expenditure		1.88	2.14	2.32	2.47	2.8	2.6
IV Revenue Deficit	2.3	1.2	0.19	-0.77	-0.94	-0.27	0.5
V Gross Fiscal Deficit	4.4	3.4	2.56	1.69	1.51	2.64	3.23
VI Primary Deficit	1.5	0.65	0.2	-0.6	-0.61	0.68	1.28
VII State Government Outstanding Liabilities	33.2	32.7	32.6	30.2	27.8	27.27	
VIII State Government Outstanding Guaranties	7.5	8	6.5	5.5	3.7		

Source: Economic survey 2008-09, Government of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15 New Delhi

From the table 7.13 we can conclude that the aggregate states' fiscal consolidation masks a relatively modest fiscal adjustment that can be attributed purely to states' own fiscal efforts. Thus, the fiscal adjustment came about mainly through higher revenues. This increase was mainly due to increased revenues from direct taxes and partly due to increase in service tax revenues. State finances started showing steady improvement, thanks to higher growth rate of the economy and larger tax devolution due to buoyancy of central taxes. The states' own tax revenues increased by 0.6 per cent and this was achieved through the Value Added Tax (VAT) reform, rationalization of stamp duties coupled with boom in the real estate markets, and a general rise in tax collections arising from relatively higher growth of the secondary sector. The gain in own tax revenue of 0.4 per cent of GDP (reflecting the implementation of VAT by the majority of states during this time period as well as measures to improve tax administration) was partially eroded by a marginal decline in non-tax revenue (Government of India, 2010).

On the expenditure side, the adjustment was only one per cent and half of this was due to lower interest payments. Lower interest rates arising from the debt swap scheme adopted in 2004-05, lower volume of borrowings from the National Small Savings Fund and debt restructuring as per the recommendation of the Twelfth Finance Commission contributed to the improvement. Thus, much of the improvement in state finances has come about due to the higher transfers, but nevertheless, the improvement is likely to sustain in the medium term as revenue from central direct taxes are likely to show high buoyancy with progressive strengthening of the information system and reforms to introduce the Goods Service Tax (Government of India, 2010).

## **7.22. Inter-State Comparison: Counter of Fiscal Imbalance before the Implementation of FRL**

### **(a) General Category States: Revenue Deficit / Gross State Domestic Product**

The Aggregate revenue account of the state went in to deficit in 1987-88. During the nineties, some of the individual states were still in surplus. Among the general category states Andhra Pradesh went in to revenue deficit in 1994-95. Gujarat and Haryana in 1995-96, and Goa also went in to revenue deficit in 1997-98. During 1993-96 the largest revenue deficit on an average was in Orissa at 2.0 per cent of GSDP followed by Punjab, Uttar Pradesh, and west Bengal. The deficit of these states rose persistently. In the period 2000-03, there was no state of the general category which was showing revenue surplus. The magnitudes of their revenue deficits were higher and their relative position had also changed. During 2000-03 the highest revenue deficit relative to GSDP was that of West Bengal at 5.5 per cent followed by Orissa, Punjab and Bihar. Within in the time period of 1993-96 to 2000-03 the largest deterioration in the revenue deficit to GSDP ratio was that for West Bengal followed by Orissa, Rajasthan and Punjab. Thus revenue deficit became high relative GSDP for high income states like Punjab, middle income states like West Bengal, and low income states like Orissa. States like Bihar and Haryana did not show any perceptible deterioration during this period (Government. of India, (2005).

During 2000-03 Bihar, Punjab, Orissa and West Bengal were the states whose revenue deficit to GSDP was highest within 4.6 per cent to 5.4 per cent in 2000-03. During 2000-03 the lowest revenue deficit relative to GSDP between -2.5 per cent to 1.3 per cent was that of Chhattisgarh, Haryana, Jharkhand and Delhi (RBI State Finances: A Study of Budget 2005-06). Among general category state during 2003-06 revenue deficit became highest within 4.3 per cent to 4.7 per cent of GSDP in the states like West Bengal followed by Uttar Pradesh Kerala, and Punjab. The revenue deficit became lowest between -0.7 percent to 0.0 per cent of GSDP in the states like Haryan, Chhattisgarh, Bihar and Karnataka (State Finances: A study of Budget, RBI, 2007).

## Impact of Fiscal Responsibility and Budget Management Act on Major Fiscal Indicators in India

RANGE	Revenue Deficit/ GSDP of general category States 2000-03
RANGE: -2.5 to 1.3	Chhattisgarh, Haryana, Jharkhand, Delhi
RANGE: 2.1 to 2.6	Andhra Pradesh, Goa, Karnataka, Madhya Pradesh Tamil Nadu,
RANGE: 3.2 to 4.5	Gujarat, Kerala, Maharashtra Rajasthan, Uttar Pradesh
RANGE: 4.6 to 5.4	Bihar, Punjab, Orissa, West Bengal

*Source: States finance: A Study of Budget s RBI 2005-06*

RANGE	Revenue Deficit/ GSDP of general category States 2003-06
RANGE: -0.7 to 0.0	Karnataka, Bihar, Chhattisgarh,, Haryana
RANGE: 0.1 to 1.0	Tamil Nadu, Goa, Orissa, Andhra Pradesh, Madhya Pradesh
RANGE: 1.6 to 2.0	Gujarat, Jharkhand, Rajasthan, Maharashtra,.
RANGE: 3.1 to 4.0	Punjab, Kerala, Uttar Pradesh, West Bengal

*Source: States finances: A Study of Budget, RBI ,2007-08*

In 2005-06 among general category states Delhi, Karnataka and Chhattisgarh achieved revenue surplus. Among states that posed revenue surplus in 2005-06 Delhi topped the list followed by Karnataka and Chatisgarh (RBI State Finances: A Study of Budget, 2007).

**Table-7.14: General Category States: Revenue Deficit / GSDP**

States	2004-05	2005-06	2006-07	2007-08
A.P	1.22	0.33	-1.04	-0.05
Bihar	-1.47	-0.1	-2.52	-4.42
Chhattisgarh	-0.33	-2.51	-4.13	-3.97
Goa	1.07	0.16	-0.97	-1.01
Gujrat	2.13	0.18	-0.7	-0.7
Haryana	0.28	-1.14	-1.26	-1.51
Jharkhand	0.61	0.05	-1.51	-1.72
Karnataka	-1.09	-1.38	-2.21	-1.75
Kerala	3.33	2.52	1.85	2.33
M.P	-1.6	-0.03	-2.6	-3.57
Maharashtra	2.59	0.88	-0.16	-2.56
Orissa	0.73	-0.61	-2.48	-4.11
Punjab	3.48	1.13	-1.64	2.78
Rajasthan	1.83	0.51	-0.43	-0.99
T.N	0.35	-0.85	-1.01	-1
U.P	2.84	0.45	-1.57	-1
W.B	3.94	3.15	3.06	2.63

*Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi*

In 2004-05, among the general category states, revenue accounts of only four states Bihar, Chhattisgarh, Karnataka and Madhya Pradesh were in surplus. By 2007-08, revenue accounts of all states, with the exception of Kerala, Punjab and West Bengal, turned surplus. Thus, in most general category states, elimination of the revenue deficit was achieved one year ahead of the target year of 2008-09 prescribed by Twelfth Finance Commission (Government of India, 2010).

**(b) Gross Fiscal Deficit / Gross State Domestic Product of General Category States**

Among general category state during 1993-96 fiscal deficit was highest in Orissa followed by Rajasthan, Punjab, Uttar Pradesh, West Bengal, and Andhra Pradesh. During 2000-03, West Bengal had the highest fiscal deficit state among the general category states followed by Rajasthan, Orissa and Bihar where the fiscal deficit was between 6.3 per cent to 8.9 per cent of GSDP (State Finances: A Study of Budget 2005-06). In the state like West Bengal followed by Gujrat and Rajasthan largest fiscal deterioration occurred during this two time period of 1993-96 to 2000-03 (Government of India, 2005), Among general category state during 2000-03 fiscal deficit was lowest between 2.1 per cent to 3.7 per cent of GSDP in the States like Chhattisgarh, Haryana, Tamil Nadu and NCT Delhi.

RANGE	Fiscal Deficit/ GSDP of general category States 2000-03.
RANGE: 2.1 to 3.7	Chhattisgarh, Haryana, Tamil Nadu, NCT Delhi,
RANGE: 4.0 to 4.8	Andhra Pradesh, Jharkhand, Karnataka Madhya Pradesh, Maharashtra
RANGE: 5.0 to 6.2	Goa, Gujarat, Kerala, Punjab, Uttar Pradesh,
RANGE: 6.3 to 8.9	Bihar, Orissa, Rajasthan ,West Bengal

Source: States finances: A Study of Budget, RBI ,2005-06

RANGE	Fiscal Deficit/ GSDP of general category States 2003-06.
RANGE: 1.9 to 3.1	Haryana, Tamil Nadu, Karnataka, Orissa
RANGE: 3.2 to 4.4	Chhattisgarh, Punjab, Andhra Pradesh ,Gujarat
RANGE: 4.7 to 5.4	Kerala, Bihar, Maharashtra, Goa, West Bengal
RANGE: 5.5 to 7.7	Rajasthan ,Jharkhand, Uttar Pradesh, Madhya Pradesh

Source: States finances: A Study of Budget, RBI, 2007-08

During 2003-06 Haryana, Tamil Nadu, Karnataka and Orissa were the state with lowest Gross Fiscal Deficit between 1.9 to 3.1 per cent of Gross State Domestic Product. During this time period, Madhya Pradesh was the state with highest fiscal deficit to GSDP ration followed by Uttar Pradesh, Jharkhand and Rajasthan who lied within the range of 5.5 per cent to 7.7 per cent of fiscal deficit to GSDP ratio (RBI State finances; A Study of Budget, 2007).

In 2005-06 five states Delhi, Haryana, Orissa, Karnataka and Tamil Nadu achieved a Gross Fiscal Deficit of below 3 per cent of Gross State Domestic Product. Orissa state did a tremendous improvement in the Gross Fiscal Deficit.

**Table-7.15: General Category States: Fiscal Deficit / GSDP**

States	2004-05	2005-06	2006-07	2007-08
A.P	3.89	3.52	2.1	2.81
Bihar	1.7	4.62	3.05	1.62
Chhattisgarh	2.75	0.79	-0.06	0.17
Goa	4.8	4.51	3.36	3.29
Gujrat	4.6	2.85	2.22	1.56
Haryana	1.29	0.27	-0.93	0.86
Jharkhand	4.32	10.18	1.45	2.79
Karnataka	2.4	2.19	2.49	2.48
Kerala	4.04	3.36	2.68	3.76
M.P	6.05	3.93	2.15	1.95
Maharashtra	4.81	4.02	2.27	-0.49
Orissa	1.91	0.35	-0.9	-1.31
Punjab	4.22	2.42	0.5	3.35
Rajasthan	5.24	3.98	2.67	2.05
T.N	2.75	0.98	1.51	1.27
U.P	5.27	3.6	3.08	4.01
W.B	5.11	4.09	4.19	3.69

*Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi*

There was also significant quantum correction after FRL. Eleven of the 17 general category states had fiscal deficits exceeding 3 per cent of GSDP in 2004-05. This number came down to just five in 2007-08. These five states were Goa, Kerala, Punjab, Uttar Pradesh and West Bengal. Thus, fiscal correction achieved much before 2008-09, the target year for containing the fiscal deficit at 3 per cent of GSDP (Government of India, 2010).

**(C) Debt-GSDP Ratios of General Category States**

Among the general category states, Orissa had the highest debt-GSDP ratio at 63.7 per cent during 2000-03 followed by Uttar Pradesh 47 per cent, Punjab Rajasthan and West Bengal (Government. of India (2005). During the period 2003-06 Rajasthan, Orissa, Goa, Bihar, Uttar Pradesh were the state with highest Debt-GSDP ratio between the range of 52 per cent to 76.6 per cent. This implies in this period Goa debt-GSDP ratio has deteriorated. During 2003-06 Haryana Karnataka Chhattisgarh and Tamil Nadu were the state with lowest debt/ GSDP between the ranges of 29 per cent to 30.2 per cent.

RANGE	Debt /GSDP of General Category States 2000-03
RANGE: 13.4 to 24.9	Karnataka, Maharashtra, Tamil Nadu, Delhi,
RANGE: 26.3 to 32.2	Andhra Pradesh, Goa, Gujarat, Haryana
RANGE: 35.6 to 41.2	Madhya Pradesh, Kerala Uttar Pradesh, West Bengal
RANGE: 42.8 to 75.5	Bihar, Orissa, Punjab, Rajasthan

*Source: States finances: A Study of Budget, RBI, 2005-06,*

RANGE	Debt /GSDP of General Category States 2003-06
RANGE: 29.0 to 30.2	Haryana Karnataka Chhattisgarh, Tamil Nadu
RANGE: 30.5 to 42.3	Jharkhand, Kerala, Maharashtra Gujarat,
RANGE: 42.5 to 51.6	Madhya Pradesh, Andhra Pradesh West Bengal, Punjab
RANGE: 52.0 to 76.6	Rajasthan, Orissa, Goa, Bihar, Uttar Pradesh

*Source: States finances: A Study of Budget, RBI ,2007-08*

There was reduction in the debt-GSDP ratio of the general category states by over 5 per cent of GSDP in 2007-08 over 2004-05. In seven out of the seventeen general category states, debt-GSDP ratio exceeded 40 per cent in 2004-05 as compared to the group average of 39.18 per cent. By 2007-08, the number of such states came down to four, viz., Bihar, Rajasthan, Uttar Pradesh and West Bengal. Among these, Uttar Pradesh, and West Bengal fiscal deficit exceeded 3 per cent of GSDP. Bihar, though a revenue surplus state, had the highest debt-GSDP ratio in 2004-05. All the states except Goa and Jharkhand managed to bring about reduction in their debt-GSDP ratio. Twelfth Finance Commission recommended that the debt-GSDP ratio to bring down to 28 percent over a period of time so as to be consistent with the fiscal deficit target, but it could be achieved by very few states.

**Table7. 16: General Category States: Debt-GSDP**

States	2004-05	2005-06	2006-07	2007-08
A.P	35.3	33.7	32.18	31.16
Bihar	58.02	58.01	49.61	48.49
Chhattisgarh	27.31	24.11	22	18.95
Goa	24.11	22	18.95	38.27
Gujrat	37.59	37.02	34.56	31.44
Haryana	25.91	25.4	22.63	19.73
Jharkhand	26.33	31.55	30.55	31.1
Karnataka	31.32	31.1	30.98	27.94
Kerala	39.63	38.45	36.61	35.78
M.P	41.23	42.27	41.56	38.81
Maharashtra	30.91	32.11	30.34	26.7
Orissa	50.53	48.98	43.3	37.29
Punjab	46.89	45.25	39.97	39.47
Rajasthan	51.28	51.28	47.93	46.29
T.N	27.25	27.15	25.25	22.14
U.P	53.28	53.21	51.96	50.6
W.B	50.01	47.88	44.35	42.82

Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

#### (d) Own Tax Revenue of General Category States

During 2000-03 Karnataka, Kerala, Haryana and Tamil Nadu were the states with highest Own Tax Revenue within 8.2 per cent to 9.0 per cent of GSDP. In the same time period Bihar, Chhattisgarh, Jharkhand, and West Bengal were the state with lowest Own Tax Revenue between 4.2 per cent to 5.5 per cent of GSDP. During 2003-06 Haryana, Karnataka, Goa and Tamil Nadu, were the states with highest Own Tax Revenue within 8.9 per cent to 10.5 per cent of GSDP. In the same time period West Bengal, Bihar, Jharkhand, Uttar Pradesh and Orissa were the state with Own Tax Revenue within 4.7 per cent to 7.0 per cent of GSDP. During 2003-06 Goa Own Tax Revenue increased in comparison to 2000-2003. Haryana, Karnataka, Tamil Nadu and Chhattisgarh had better fiscal performance due to high Own Tax Revenue in both the period. States like West Bengal, Bihar, Orissa and Jharkhand were fiscally weak State due to low Own Tax Revenue.

RANGE	Own Tax Revenue (OTR) /GSDP of General Category States 2000-03.
RANGE: 8.2 to 9.0	Karnataka, Kerala, Haryana, Tamil Nadu
RANGE: 7.2 to 8.0	Andhra Pradesh, Gujarat, Maharashtra, Punjab, Delhi
RANGE: 5.9 to 7.0	Goa, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh
RANGE: 4.2 to 5.5	Bihar, Chhattisgarh, Jharkhand, West Bengal,

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	Own Tax Revenue (OTR) /GSDP of General Category States 2003-06.
RANGE: 8.9 to 10.5	Haryana, Karnataka, Goa, Tamil Nadu
RANGE: 7.9 to 8.7	Andhra Pradesh, Kerala, Punjab, Chhattisgarh, Maharashtra
RANGE: 7.1 to 7.6	Gujarat, Rajasthan, Madhya Pradesh
RANGE: 4.7 to 7.0	West Bengal, Bihar, Jharkhand, Uttar Pradesh, Orissa

*Source: States finance: A Study of Budget RBI,, 2007-08*

An improvement is found in own tax revenues of all general category states with the exception of Haryana and West Bengal between the time period of 2004-05 to 2007-08.

**Table 7.17: General Category States: Own Tax Revenue / GSDP**

States	2004-05	2005-06	2006-07	2007-08
A.P	7.72	8.14	8.89	9.21
Bihar	4.57	4.44	4.08	4.84
Chhattisgarh	7.2	7.36	7.85	7.34
Goa	7.46	8.21	8.89	8.27
Gujrat	6.85	7.14	7.25	7.13
Haryana	7.95	8.53	8.64	7.87
Jharkhand	4.64	5.01	5.09	5
Karnataka	10.73	11.09	12.38	12.07
Kerala	8.13	7.86	8.38	8.42
M.P	7.25	7.84	8.17	8.43
Maharashtra	7.9	7.66	7.87	8.22
Orissa	5.85	6.37	6.65	6.64
Punjab	7.13	8.19	7.31	7.2
Rajasthan	7.18	7.63	7.82	7.97
T.N	9.57	10.16	10.57	10.2
U.P	6.36	6.74	7.37	7.25
W.B	4.76	4.43	4.29	4.25

*Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi*

The improvement in tax-GSDP ratio is found highest in Andhra Pradesh followed by Karnataka, Madhya Pradesh and Uttar Pradesh. The tax-GSDP ratios in the first two

states were relatively higher in 2004-05 as compared to the average for general category states. Karnataka stood out with the highest tax-GSDP ratio of 12.07 per cent in 2007-08 as compared to the average of 7.89 per cent for the general category states as a whole. The improvement in states with low tax-GSDP ratios has been relatively less. While Bihar, with the lowest tax-GSDP ratio of 4.57 per cent in 2004-05, improved its ratio marginally in 2007-08, the ratio in respect of West Bengal slipped by 0.51 per cent to 4.24 in the same period.

**(e) Own Non Tax Revenue of General Category States**

During 2000-03 Goa, Gujarat, Haryana and Punjab were the states with highest Own Non Tax Revenue between 2.7 per cent to 12.3 per cent of GSDP. In the same time period Bihar, Kerala, Uttar Pradesh and West Bengal, were the state with lowest Own Non Tax Revenue between 0.6 to 1.0 per cent of GSDP.

RANGE	Own Non Tax Revenue (OTR) /GSDP of General Category States 2000-03.
RANGE: 2.7 to 12.3	Goa, Gujarat, Haryana, Punjab
RANGE: 1.9 to 2.1	Andhra Pradesh, Chhattisgarh, Madhya Pradesh, Jharkhand, Maharashtra
RANGE: 1.1 to 1.9	Delhi, Karnataka Orissa Rajasthan, Tamil Nadu
RANGE: 0.6 to 1.0	Bihar, Kerala, Uttar Pradesh, West Bengal,

*Source: State Finances: A study of Budget, RBI, 2005-06*

RANGE	Own Non Tax Revenue (OTR) /GSDP of General Category States 2003-06.
RANGE: 2.9 to 7.5	Jharkhand, Punjab, Chhattisgarh, Goa
RANGE: 2.2 to 2.8	Orissa, Madhya Pradesh, Karnataka, Haryana,
RANGE: 1.2 to 2.0	Maharashtra, Gujarat, Tamil Nadu, Rajasthan, Andhra Pradesh
RANGE: 0.5 to 1.1	West Bengal , Kerala, Bihar, Uttar Pradesh,

*Source: State Finances: A study of Budget, RBI, 2007-08*

During 2003-06 Jharkhand, Punjab, Chhattisgarh and Goa became the states with highest Own Non Tax Revenue between 2.9 per cent to 7.5 per cent of GSDP. In the same time period West Bengal, Kerala, Bihar and Uttar Pradesh, became the state with lowest Own

Non Tax Revenue within 0.5 per cent to 1.1 per cent of GSDP. During 2003-06 Gujrat Own Non Tax Revenue decreased comparison to 2000-03.

In contrast to the trend observed in own tax revenues, only a few state Governments showed improvement in own non-tax-GSDP ratio during 2006-07 (RE) over 2003-06 (Average). As a result, the median value of non-tax-GSDP ratio increased only marginally from 2.0 per cent to 2.1 per cent. While Goa (6.1 per cent) and Punjab (5.1 per cent) continued to have high own non-tax-GSDP ratio, states like Bihar, West Bengal and Kerala had the ratio at less than 1.0 per cent. The low level of non tax revenue is partly due to low cost recovery (i.e.,ratio of non-tax receipts to non-plan revenue expenditure) from sectors such as education, medical and public health and family welfare, irrigation, power and roads. There is a wide variation across the states in terms of cost recovery (RBI State finances: A Study of Budget, 2007).

#### (f) Central Transfer to GSDP of General Category States

During 2000-03 Bihar, Madhya Pradesh Orissa and Jharkhand were the states with highest central Transfer within 7.0 per cent to 15.1 per cent of GSDP. In the same time period Haryana, Maharashtra Punjab, Delhi was the state with lowest central transfer within 0.7 per cent to 1.9 per cent of GSDP.

RANGE	Central Transfer (CT) /GSDP of General Category States 2000-03
RANGE: 7.0 to 5.1	Bihar , Madhya Pradesh, Orissa, Jharkhand
RANGE: 4.3 to 6.9	Andhra Pradesh, Chhattisgarh, Rajasthan, Uttar Pradesh, West Bengal
RANGE: 2.2 to 4.0	Goa, Gujarat, Karnataka, Kerala, Tamil Nadu
RANGE: 0.7 to 1.9	Haryana, Maharashtra, Punjab, Delhi

*Source: State Finances: A study of Budget, RBI, 2005-06*

RANGE	Central Transfer (CT) /GSDP of General Category States 2003-06
RANGE: : 8.2 to 20.7	Uttar Pradesh, Bihar, Jharkhand, Orissa
RANGE: 4.7 to 7.3	Andhra Pradesh, Rajasthan, Chhattisgarh, Madhya Pradesh
RANGE: 3.6 to 4.5	Kerala , West Bengal, Karnataka, Maharashtra, Tamil Nadu
RANGE: 1.8 to 2.5	Haryana, Gujarat, Goa, Punjab

*Source: State Finances: A study of Budget, RBI, 2007-08*

During 2003-06 Uttar Pradesh, Bihar, Jharkhand and Orissa became the states with highest central transfer within 8.2 per cent to 20.7 per cent of GSDP. In the same time period

Haryana, Gujarat, Goa, Punjab was the state with low central transfer within 1.8 per cent to 2.5 per cent of GSDP. According to 2006-07 (RE) current transfers (i.e., shareable central taxes and grants-in-aid) as a ratio to GSDP were high for states like Bihar, Orissa, Jharkhand, Chhattisgarh, Madhya Pradesh, Rajasthan and Uttar Pradesh, reflecting the principle of horizontal equity in such fiscal transfers.

**(g) Capital Outlay/GSDP of General Category States**

During 2000-03 Bihar, Goa, Orissa and Jharkhand were the states with highest capital outlays between 2.2 per cent to 3.1 per cent of GSDP. In the same time period Kerala, Tamil Nadu, West Bengal and Delhi were the state with lowest capital outlays within 0.7 per cent to 1.2 per cent of GSDP. During 2003-06 Uttar Pradesh, Jharkhand, Goa and Madhya Pradesh became the states with highest capita outlays within 3.4 per cent to 4.5 per cent of GSDP. In the same time period West Bengal, Kerala, Punjab and Haryana, were the state with lowest Capita Outlays within 0.7 per cent to 1.7 per cent of GSDP.

RANGE	Capital Outlay (CO) /GSDP of General Category States 2000-03.
RANGE: 2.2 to 3.1	Bihar, Goa, Orissa, Jharkhand
RANGE: 1.9 to 2.1	Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh, Rajasthan
RANGE: 1.3 to 1.9	Chhattisgarh, Haryana, Maharashtra, Punjab, Uttar Pradesh
RANGE: 0.7 to 1.2	Kerala, Tamil Nadu, West Bengal, Delhi

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	Capital Outlay (CO) /GSDP of General Category States 2003-06.
RANGE: 3.4 to 4.5	Uttar Pradesh, Jharkhand, Goa, Madhya Pradesh
RANGE: 3.0 to 3.2	Karnataka, Rajasthan, Bihar, Chhattisgarh
RANGE: 2.2 to 2.8	Tamil Nadu, Gujarat, Maharashtra, Andhra Pradesh , ,
RANGE: 0.7 to 1.7	West Bengal , Kerala, Punjab, Haryana, Orissa

*Source: States finances: A Study of Budget, RBI, 2007-08*

During 2003-06 Orissa Capita Outlays declined in comparison to first period so, by reducing its capital outlays it became able to reduce its deficit. Haryana had better fiscal performance in both the period due to low Capital Outlays. Uttar Pradesh capita outlays improved during 2003-06 in comparison to 2000-03.

**Table 7.18: General Category States: Capital Expenditure/GSDP**

States	2004-05	2005-06	2006-07	2007-08
A.P	2.57	3.25	3.68	4.09
Bihar	1.65	2.6	5.27	5.8
Chhattisgarh	2.85	2.72	3.42	4.09
Goa	3.71	4.35	4.31	4.19
Gujrat	2.17	3.17	3.08	2.22
Haryana	1.52	1.92	2.32	1.36
Jharkhand	2.6	3.34	2.33	3.72
Karnataka	3.12	3.47	4.54	4.02
Kerala	0.62	0.66	0.63	0.91
M.P	4.61	5.69	4.03	4.79
Maharashtra	2.03	2.3	1.98	1.99
Orissa	1.48	1.32	1.59	2.73
Punjab	0.78	1.38	2.1	1.58
Rajasthan	2.97	3.32	3.24	3.93
T.N	2.26	1.77	2.27	2.57
U.P	2.29	3.11	4.48	4.92
W.B	0.88	0.7	0.74	0.87

Source: Government of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

Even though Jharkhand has high deficit it's Capita Outlays in both the period was high. Bihar, Chhattisgarh, Jharkhand, Uttar Pradesh, Madhya Pradesh, Goa and Karnataka continued to maintain higher proportion of capital outlay in terms of GSDP (above 4), while Haryana, Kerala and West Bengal continued to have low capital outlay-GSDP ratio (below 2 per cent) (RBI State finances: A Study of Budget, 2007).

An overall improvement is found in the capital expenditure of general category states from 2.12 per cent of GSDP in 2004-05 to 2.94 per cent of GSDP in 2007-08. Only Maharashtra and West Bengal witnessed a marginal reduction in their capital expenditure-GSDP ratios between 2004-05 and 2007-08. The improvement is found significant in the poorer states of Bihar and Uttar Pradesh.

#### **(h) Revenue Expenditure of General Category States**

The general category states witnessed a marginal reduction of 0.20 per cent of GSDP in their revenue expenditure in 2007-08 over the 2004-05 level.

**Table 7.19: General Category States: Revenue Expenditure/GSDP**

States	2004-05	2005-06	2006-07	2007-08
A.P	14.88	14.79	15.39	17.27
Bihar	19.99	22.15	20.8	22.41
Chhattisgarh	15.85	13.54	13.7	14.15
Goa	16.92	16.4	17	16.9
Gujrat	12.85	11.59	11.48	10.93
Haryana	12.18	11.88	12.94	11.88
Jharkhand	13.59	15.43	14.46	15.58
Karnataka	16.64	16.69	17.76	17.36
Kerala	15.57	14.81	14.62	15.33
M.P	16.8	17.68	17.44	17.97
Maharashtra	13.18	11.93	12.05	11.2
Orissa	17.32	17.32	17.3	17.16
Punjab	17.65	16.59	15.03	16.77
Rajasthan	16.97	16.6	16.81	17.48
T.N	14.41	13.94	14.57	14.8
U.P	18.09	16.66	17.85	18.94
W.B	13.49	13.26	12.53	12.39

Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

Reduction in revenue expenditure as a per cent of GSDP was observed in nine of the seventeen states. Andhra Pradesh, Bihar and Jharkhand stand out for witnessing a significant increase in their revenue expenditure, ranging from 1.99 per cent to 2.42 per cent of GSDP between 2004-05 and 2007-08. Reduction in interest burden following the DCRF seems to have aided the states in their effort to reduce revenue expenditure.

#### (i) Development Expenditure/GSDP of General Category States

During 2000-03 Bihar, Goa, Gujarat and Orissa were the states with highest developmental expenditure that lied between the ranges of 14.2 per cent to 17.6 per cent of GSDP. In the same time period Kerala, Punjab West Bengal and Delhi were the state with lowest developmental expenditure within 8.4 per cent to 9.9 per cent of GSDP. During 2003-06 Madhya Pradesh, Goa, Jharkhand and Bihar, were the states with highest developmental expenditure within 16.5 per cent to 18.9 per cent of GSDP. In the same time period West Bengal, Kerala, Punjab, Maharashtra and Haryana were the state with lowest developmental expenditure between. During this period Orissa, Gujrat and Andhra Pradesh developmental expenditure has declined in comparison to first period so by reducing developmental expenditure they became successful in achieving little better

fiscal performance. Whereas states like Jharkhand and Bihar became fiscally weak due to high developmental expenditure. Even though, states like Kerala and West Bengal always had low developmental expenditure still they became fiscally weak.

RANGE	Development Expenditure/GSDP of General Category States 2000-03
RANGE: 14.2to 17.6	Bihar, Goa, Gujarat, Orissa,
RANGE: 12.6 to 13.8	Andhra Pradesh, Jharkhand, Karnataka, Madhya Pradesh, Rajasthan
RANGE: 9.9 to 10.5	Chhattisgarh, Haryana, Maharashtra, Tamil Nadu, Uttar Pradesh
RANGE: 8.4 to 9.9	Kerala, Punjab, West Bengal, Delhi

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	Development Expenditure/GSDP of General Category States 2003-06.
RANGE: 16.5 to 18.9	Madhya Pradesh, Goa, Jharkhand Bihar,
RANGE: 13.7 to 14.8	Rajasthan, Uttar Pradesh, Chhattisgarh
RANGE: 10.5 to 12.7	Gujarat, Orissa, Karnataka, Tamil Nadu, Andhra Pradesh,
RANGE: 7.6 to 10.0	West Bengal, Kerala, Punjab, Maharashtra, Haryana

*Source: States finances: A Study of Budget, RBI 2007-08*

All states except Gujarat, Maharashtra, Madhya Pradesh and Goa witnessed increase in developmental expenditure (DEV)-GSDP ratio in 2006-07 (RE) over 2003-06 (Average) with the median value of DEV-GSDP rose from 12.7 to 14.4 over the period. Relatively underdeveloped states such as Bihar (29.2 per cent ), Jharkhand (22.1 per cent ) and Chhattisgarh (20.2 per cent) ranked the highest in terms of developmental expenditure-GSDP ratio, whereas West Bengal (8.0 per cent) and Maharashtra (9.8 per cent) had the lowest ranking (RBI State finances: A Study of Budget, 2007).

#### **(j) Non Development Expenditure/GSDP of General Category States**

During 2000-03 Chhattisgarh, Gujarat, Jharkhand, Delhi were the states with lowest non developmental expenditure within 3.4 per cent to 5.8 per cent of GSDP. In the same time period Bihar, Goa, Orissa and Punjab were the state with highest non developmental expenditure within 10.8 per cent to 12.7 per cent of GSDP. During 2003-06 Gujarat, Haryana, Chhattisgarh and Maharashtra became the states with lowest non developmental expenditure within 5.5 per cent to 5.7 per cent of GSDP. In the same time period Kerala,

Bihar, Punjab, Uttar Pradesh and Orissa were the state with highest non developmental expenditure within 7.9 per cent to 14.1 per cent of GSDP. Haryana and Chhattisgarh performed better fiscal performance due to low non developmental expenditure in both the period while, Bihar, Orissa and Punjab performed fiscally weak due to high non developmental expenditure.

RANGE	Non Development Expenditure/GSDP of General Category States 2000-03.
RANGE: 3.4 to 5.8	Chhattisgarh, Gujarat, Jharkhand, Delhi
RANGE: 5.9 to 6.4	Andhra Pradesh, Haryana, Karnataka, Maharashtra, Tamil Nadu
RANGE: 6.6 to 8.6	Kerala, Madhya Pradesh, Rajasthan, Uttar Pradesh, West Bengal,
RANGE: 10.8 to 12.7	Bihar, Goa, Orissa, Punjab,

*Source: States finance: A Study of Budget, RBI, 2005-06*

RANGE	Non Development Expenditure/GSDP of General category States 2003-06.
RANGE: 5.5 to 5.7	Gujarat, Haryana, Chhattisgarh, Maharashtra
RANGE: 6.3 to 7.1	Andhra Pradesh, Tamil Nadu, Karnataka, Madhya Pradesh,
RANGE: : 7.3 to 7.6	Goa, West Bengal, Jharkhand, Rajasthan
RANGE: 7.9 to 14.1	Kerala, Bihar, Punjab, Uttar Pradesh, Orissa,

*Source: States finance: A Study of Budget, RBI, 2007-08*

The median value of non-developmental expenditure as ratio to GSDP declined from 7.3 per cent to 6.7 per cent in 2006-07 (RE) over 2003-06 (Average). The ratio of non developmental expenditure to GSDP was high in case of Bihar, Orissa and Punjab (above 10 per cent), while the ratio was lowest for Gujarat and Haryana (less than 5 per cent) in 2006-07 (RE) (RBI State finances: A Study of Budget, 2007).

#### **(k) Social Service Expenditure/GSDP of General Category States**

During 2000-03 Bihar, Jharkhand, Orissa and Rajasthan were the states with highest social service expenditure within 9.0 per cent to 12.7 per cent of GSDP. In the same time period Haryana, Maharashtra, Punjab and Delhi were the state with lowest social service expenditure within 4.7 per cent to 5.9 per cent of GSDP. During 2003-06 Rajasthan, Bihar, Chhattisgarh, and Jharkhand were the states with highest social service expenditure within 8.7 per cent to 12.8 per cent of GSDP. In the same time period

Punjab, Haryana, West Bengal, Gujarat and Maharashtra were the state with lowest social service expenditure within 4.2 per cent to 5.6 per cent of GSDP.

RANGE	SSE /GSDP of General Category States 2000-03.
RANGE: 9.0 to 12.7	Bihar, Jharkhand, Orissa, Rajasthan
RANGE: 7.0 to 8.5	Andhra Pradesh, Goa, Gujarat, Madhya Pradesh, Kerala
RANGE: 6.0 to 7.0	Chhattisgarh, Karnataka, Tamil Nadu, Uttar Pradesh, , West Bengal
RANGE: 4.7 to 5.9	Haryana, Maharashtra, Punjab, Delhi

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	SSE /GSDP of General Category States 2003-06.
RANGE: 8.7 to 12.8	Rajasthan , Bihar, Chhattisgarh, Jharkhand
RANGE: 7.0 to 8.1	Uttar Pradesh, Madhya Pradesh, Goa, Orissa
RANGE: : 6.6 to 6.9	Karnataka, Kerala, Tamil Nadu, Andhra Pradesh
RANGE: 4.2 to 5.6	Punjab, Haryana, West Bengal, Gujarat, Maharashtra

*Source: States finances: A Study of Budget, RBI ,2007-08*

During this period Andhra Pradesh and Gujrat Social service expenditure declined in comparison to first period so by reducing its social service expenditure they could able performe little better fiscal performance. Low Social service expenditure is also one of the reasons for Haryana better fiscal performance in both the period. Chattisgarh social service expenditure has improved in the second period in comparison to first period. Even though Bihar and Jharkhand had low fiscal performance their social service expenditure in both the period was better in comparison to other state.

All states except Goa and Gujarat showed substantial improvement in respect of social sector expenditures (i.e., social services, rural development, food storage and warehousing) under both revenue and capital accounts as a ratio to GSDP during 2006-07 (RE) over that of 2003-06 (Average) with the median value improving from 6.9 per cent to 8.0 per cent. Amongst all the states, Bihar (18.7 per cent), Jharkhand (13.8 per cent) and Chhattisgarh (13.5 per cent) continued to have higher level of social sector expenditure (in terms of GSDP). On the other hand, Haryana (4.8 per cent ), Punjab (5.1 per cent ), Gujarat (5.3 per cent ), Maharashtra (6.0 per cent ) and West Bengal (5.6 per

cent) had lower level of social sector expenditure-GSDP ratio (RBI State finances: A Study of Budget, 2007).

**(I) Revenue Deficit /Gross State Domestic Product of Special Category States**

During the period 2000-03 the special category states, Arunachala Pradesh, Meghalaya, and Skkim continued to show a surplus (Government. of India 2005). During 2000-03, Mizoram, Manipur and Himachal Pradesh became the states with highest revenue deficit within 3.5 per cent to 10.3 per cent of GSDP. The states having lowest Revenue Deficit between the ranges of -13.6 to -0.8 of GSDP were Arunachal Pradesh, Meghalaya and Sikkim.

RANGE-	RD/GSDP of Special Category States 2000-03
RANGE: -13.6 to -0.8	Arunachal Pradesh, Meghalaya, Sikkim,
RANGE: : 0.2 to 0.4	Jammu and Kashmir Nagaland,
RANGE: : 0.7 to 2.0	Assam, Tripura , Uttaranchal
RANGE: 3.5 to 10.3	Himachal Pradesh, Manipur, Mizoram

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	RD/GSDP of Special Category States 2003-06
RANGE: -11.4 to -5.6	Sikkim, Nagaland Jammu and Kashmir
RANGE: -4.5 to -3.2	Arunachal Pradesh, Tripura, Mizoram Manipur
RANGE: -0.7 to -0.3	Meghalaya, Assam
RANGE: 3.1 to 4.8	Uttarakhand, ,Himachal Pradesh

*Source: States finances: A Study of Budget, RBI, 2007-08*

Among special category state during 2003-06 revenue deficit became highest between 3.1 per cent to 4.8 per cent of GSDP in the states like Uttarakhand and Himachal Pradesh, The revenue deficit became lowest between -11.4 per cent to 5.6 per cent of GSDP is in the states like Sikkim, Nagaland, Jammu and Kashmir.

In the special category, five states were in revenue deficit in 2004-05, but by 2006-07, the revenue accounts of all turned surplus and remained so in 2007-08. The revenue surplus in many of the special category states was of a higher magnitude relative to their respective GSDPs as compared to those in the general category. The higher revenue surplus in these states is indicative of the higher revenue account transfers to these states.

Central transfers account for over 70 per cent of the revenue receipts of special category states (Government. of India, 2010).

**Table 7.20: Special Category States: Revenue Deficit/GSDP**

States	2004-05	2005-06	2006-07	2007-08
ARP	0.27	-6.23	-20.44	-20.44
Assam	0.56	-2.61	-3.47	-3.66
H.P	5.02	-0.36	-0.67	-2.66
J&K	-2.32	-0.36	-0.67	-2.66
Manipur	-2.00	-7.98	-8.39	-21.31
Meghalaya	0.86	-1.15	-3.37	-2.47
Mizoram	-4.33	-2.43	-8.43	-3.99
Nagaland	-2.9	-3.65	-8.62	-5.89
Sikkim	-10.54	-10.75	-11.06	-14.91
Tripura	-4.75	-6.74	-8.27	-8.04
Uttarakhand	4.01	0.28	-3.02	-1.87

Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

**(m) Fiscal Deficit /Gross State Domestic Product of Special Category States**

During 2003-06 among the special category states the states with highest Gross Fiscal Deficit between the ranges of 3.1 per cent to 4.8 per cent of GSDP were Himachal Pradesh and Uttarakhand. The states having lowest Revenue Deficit between the ranges of -11.4 per cent to -5.6 per cent of GSDP were Sikkim Nagaland and Jammu & Kashmir. Among special category state during 2003-06 fiscal deficits was highest between 11.4 per cent of GSDP in the States like, Mizoram and Arunachal Pradesh. The fiscal deficit was lowest between the rage of 1.8 per cent to 3.0 per cent of GSDP in the States like Nagaland, Assam and Tripura.

RANGE	GFD/GSDP of Special Category States 2000-03
RANGE: 3.6 to 4.1	Assam, Sikkim, Uttaranchal
RANGE: 5.3 to 8.3	Meghalaya, Tripura
RANGE: 8.6 to 9.6	Jammu and Kashmir, Manipur, Nagaland
RANGE: 11.7 to 20.2	Arunachal Pradesh, Himachal Pradesh, Mizoram

Source: States finances: A Study of Budget, RBI, 2005-06

RANGE	GFD/GSDP of Special Category States 2003-06
RANGE: 1.8 to 3.0	Nagaland, Assam, Tripura
RANGE: 3.9 to 8.1	Jammu and Kashmir, Meghalaya, Sikkim
RANGE: 8.2 to 8.7	Manipur, Uttarakhand, Himachal Pradesh
RANGE: 11.4	Mizoram, Arunachal Pradesh

Source: States finances: A Study of Budget, RBI, 2007-08

Among the eleven special category states, only four (Jammu & Kashmir, Mizoram, Nagaland and Uttarakhand) had fiscal deficits exceeding 3 per cent of GSDP in 2007-08, as compared to 10 per cent in 2004-05. Fiscal correction in special category states is characterised by large year-to-year variations, both within and across states, because of the low and fluctuating nature of GSDP in these states.

**Table 7.21: Special Category States: Fiscal Deficit/GSDP**

States	2004-05	2005-06	2006-07	2007-08
ARP	13.54	8.8	-3.14	0.24
Assam	3.92	-0.62	-1.12	-1.12
H.P	7.85	2.83	3.25	1.73
J&K	6.86	9.96	6.65	8.38
Manipur	9.84	5.36	8.89	-1.79
Meghalaya	5.39	2.83	3.25	1.73
Mizoram	9.59	14.71	6.4	11.91
Nagaland	4.08	5.41	2.44	5.52
Sikkim	11.58	8.13	4.68	2.73
Tripura	1.17	-1.28	0.14	-2.75
Uttarakhand	7.18	2.98	5.12	-4.07

*Source: Government of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi*

#### (n) Debt-GSDP Ratios of Special Category States

Debt-GSDP ratios are comparatively high for the Special category states in view of higher GFD-GSDP ratios. The IP-RR ratio for the Special category states is; however, much lower than the non-Special Category states. In the case of special category state during 1993-96 the highest debt-GSDP state was J& K with 58 per cent, followed by Sikkim with 53.7 per cent.

RANGE	Debt /GSDP of GSDP of Special Category States 2000-03
RANGE: 30.8 to 43.2	Assam, Meghalaya, Tripura
RANGE: 51.8 to 57.3	Arunachal Pradesh, Nagaland
RANGE: 57.3 to 58.8	Jammu & Kashmir, Manipur
RANGE: 63.4 to 75.2	Himachal Pradesh, Mizoram, Sikkim

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	Debt /GSDP of GSDP of Special Category States 2003-06.
RANGE: : 39.1 to 46.5	Assam, Nagaland, Meghalaya
RANGE: 48.1 to 76.2	Uttarakhand, Tripura, Sikkim
RANGE: 77.9 to 79.8	Arunachal Pradesh Himachal Pradesh, Jammu and Kashmir
RANGE: 81.5 to 107.8	Manipur, Mizoram,

Source: *States finances: A Study of Budget, RBI, 2007-08*

During 2000-03, Mizoram had the highest debt- GSDP ratio with 85 per cent, followed by Sikkim with 63.2 per cent, Himachal Pradesh with 56 per cent, Jammu & Kashmir with 54.8 per cent and Arunachal Pradesh (Government. of India, 2005). During 2003-06 Manipur and Mizoram were the state with highest debt-GSDP ratio between 81.5 to 107.8 per cent, while Assam, Nagaland, Meghalaya were the state with lowest debt-GSDP ratio between 39.1 per cent to 46.5 per cent.

Even though the aggregate debt-GSDP ratio of the special category states in 2007-08 is found lower as compared to the 2004-05 level, the debt position of six of the eleven states, which registered a revenue surplus in all three years since 2005-06, worsened by 2007-08. The debt-GSDP ratio of special category states continues to remain at a much higher level than that of the general category states. Low levels and fluctuating nature of GSDP growth partly explains the high debt-GSDP ratios in some of these states (Government of India, 2010).

**Table 7.22: Special Category States: Debt /GSDP**

States	2004-05	2005-06	2006-07	2007-08
ARP	62.29	80.09	69.73	68.13
Assam	33.4	32.22	31.13	29.87
H.P	71.68	68.44	63.73	60.73
J&K	58.47	63.27	64.04	67.17
Manipur	67.48	77.09	78.37	79.4
Meghalaya	37.43	40.61	39.68	41.3
Mizoram	110.44	109.48	103.7	102.74
Nagaland	52.62	56.3	55.71	54
Sikkim	69.1	73.82	71.7	76.33
Tripura	50.4	47.06	44.79	42.08
Uttarakhand	115.79	112.11	103.21	94.13

Source: *Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi*

**(0) Own Tax Revenue of Special Category States**

The own tax revenue as ratio to GSDP is typically low for the Special category states in comparison to general category States. During 2000-03 Himachal Pradesh, Sikkim and Uttaranchal were the States with highest Own Tax Revenue within 5.6 per cent to 7.8 per cent of GSDP. In the same time Arunachal Pradesh Mizoram and Nagaland were the state with lowest Own Tax Revenue within 1.1 per cent to 1.5 per cent of GSDP.

RANGE	Own Tax Revenue (OTR) /GSDP of Special Category States 2000-03.
RANGE: 5.6 to 7.8	Himachal Pradesh, Sikkim, Uttaranchal
RANGE: 3.3 to 5.1	Assam, Jammu and Kashmir, Meghalaya
RANGE: 1.7 to 2.5	Manipur, Tripura
RANGE: 1.1 to 1.5	Arunachal Pradesh, Mizoram, Nagaland

*Source: States finances: A Study of Budget, RBI 2005-06*

RANGE	Own Tax Revenue (OTR) /GSDP of Special Category States 2003-06.
RANGE: 6.7 to 8.0	Sikkim, Uttarakhand, Jammu and Kashmir
RANGE: 4.0 to 6.1	Himachal Pradesh, Assam, Meghalaya
RANGE: 1.9 to 3.1	Tripura, Manipur, Arunachal Pradesh
RANGE: 1.4 to 1.5	Mizoram, Nagaland

*Source: RBI States finances: A Study of Budget, 2007-08*

During 2003-06 Sikkim, Uttarakhand, Jammu and Kashmir became the states with highest Own Tax Revenue within 6.7 per cent to 8.0 per cent of GSDP. In the same time period Mizoram and Nagaland were the state with Own Tax Revenue within 1.4 per cent to 1.5 per cent of GSDP.

All special category States improved their tax-GSDP ratios in 2007-08 relative to 2004-05, with the exception of Assam. There was considerable improvement in Own Tax Revenues in the states of Jammu & Kashmir and Uttarakhand. States in the special category improved their overall tax-GSDP ratio by 0.8 per centage point of GSDP in 2007-08 over 2004-05, which was higher than the aggregate improvement of 0.53 per cent of GSDP achieved by general category states.

**Table 7.23: Special Category States: Own Tax Revenue /GSDP**

States	2004-05	2005-06	2006-07	2007-08
AP	1.76	2.13	2.3	2.45
Assam	5.16	5.59	5.46	4.77
H.P	5.43	5.88	5.84	6.12
J&K	5.57	6.13	6.2	8.05
Manipur	1.78	1.88	2.28	2.59
Meghalaya	3.58	4	4.38	4.2
Mizoram	1.61	2.04	2.27	2.36
Nagaland	1.46	1.86	1.86	1.83
Sikkim	5.48	5.43	6.12	6.36
Tripura	2.89	3.15	3.32	3.29
Uttarakhand	6.09	6.82	8.46	8.05

Source: Government of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

**(p) Own Non Tax Revenue of Special Category States**

During 2000-03 Arunachal Pradesh Mizoram, and Sikkim were the states with highest Own Non Tax Revenue between 2.5 to 83.0 per cent of GSDP. In the same time period Himachal Pradesh, Manipur and Nagaland were the state with lowest Own Non Tax Revenue between 1.1 to 1.3 per cent of GSDP. During 2003-06 Sikkim, Mizoram and Arunachal Pradesh became the states with highest Own Non Tax Revenue within 3.0 per cent to 53.8 per cent of GSDP. In the same time period Manipur and Nagaland became the state with lowest Own Non Tax Revenue within 1.3 per cent to 1.6 per cent of GSDP.

RANGE	Own Non Tax Revenue (ONTR) /GSDP of Special Category States 2000-03.
RANGE: 2.5 to 83.0	Arunachal Pradesh, Mizoram, Sikkim
RANGE : 1.7 to 2.3	Assam, Jammu and Kashmir, Meghalaya
RANGE: 1.5 to 1.6	Tripura, Uttaranchal
RANGE: 1.1 to 1.3	Himachal Pradesh, Manipur, Nagaland

Source: States finances: A Study of Budget, RBI, 2005-06

RANGE	Own Non Tax Revenue (ONTR) /GSDP of Special Category States 2003-06.
RANGE: 3.0 to 53.8	Sikkim, Mizoram, Arunachal Pradesh
RANGE: 2.6 to 2.8	Jammu and Kashmir, Assam, Meghalaya, Himachal Pradesh,
RANGE: 1.8 to 2.5	Uttarakhand, Tripura
RANGE: 1.4 to 1.6	Manipur, Nagaland

Source: States finances: A Study of Budget, RB, 2007-08:

The own non- tax revenue to GSDP ratio of the Special Category states showed an increase in 2006-07 (RE) over 2003-06. The ratio became exceptionally high in the case of Sikkim in both the periods, on account of revenue generated from state lotteries. The state-wise cost recovery (i.e., ratio of non-tax receipts to non-plan revenue expenditure) in terms of education, health, irrigation, power and roads indicates that the cost recovery from these socio-economic services provided by the state governments is low across the states. There is, therefore, a need to enhance cost recovery by way of levying appropriate user charges on these services, which would, however, require improvement in quality in service delivery ( RBI state Finances: A study of Budget, 2007).

**(q) Central Transfer to GSDP of General Category States**

Special category states have higher dependency on the centre, as reflected in comparatively higher central transfer GSDP ratio in comparison to general category states. During 2000-03 Arunachal Pradesh, Mizoram and Sikkim were the states with highest central transfer within 45.3 per cent to 55.0 per cent of GSDP. In the same time period Assam, Himachal Pradesh and Uttaranchal were the state with lowest central transfer between 10.3 to 16.5 per cent of GSDP. During 2003-06 Arunachal Pradesh, Sikkim, Mizoram became the states with highest central transfer within 49.8 per cent to 54.0 per cent of GSDP. In the same time period Assam and Uttarakhand became the state with low central transfer within 11.3 per cent to 13.8 per cent of GSDP.

RANGE	Central Transfer (CT)/GSDP of General Category States 2000-03.
RANGE: 45.3 to 55.0	Arunachal Pradesh Mizoram, Sikkim
RANGE: 31.7 to 33.7	Jammu and Kashmir, Manipur, Nagaland
RANGE: 23.8 to 25.3	Meghalaya, Tripura
RANGE: 10.3 to 16.5	Assam, Himachal Pradesh, Uttaranchal

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	Central Transfer (CT)/GSDP of General Category States 2003-06.
RANGE: 49.8 to 54.0	Arunachal Pradesh, Sikkim, Mizoram
RANGE: 35.2 to 40.9	Manipur, Nagaland, Jammu and Kashmir
RANGE: 16.1 to 27.0	Tripura, Meghalaya, Himachal Pradesh
RANGE: 11.3 to 13.8	Assam, Uttarakhand

*Source: States finances: A Study of Budget, RBI, 2007-08:*

Even though the median value of central transfer to GSDP ratio declined marginally from 35.2 per cent during 2003-06 (Average) to 34.0 per cent in 2006-07 (RE) the ratio of Central transfers was more than 50 per cent of GSDP in case of Arunachal Pradesh, Sikkim, Mizoram and Manipur in 2006-07 (RE), while the ratio was less than 20 per cent for Himachal Pradesh and Uttarakhand (RBI State finances: A Study of Budget, 2007).

**(r) Capital Outlay/GSDP of non Special Category States**

During 2000-03 Arunachal Pradesh Sikkim and Uttaranchal were the states with highest capita outlays within 10.1 per cent to 17.7 per cent of GSDP. In the same time period Assam, Himachal Pradesh and Meghalaya were the state with lowest capita outlays within 1.6 per cent to 4.8 per cent of GSDP. During 2003-06 Sikkim Mizoram and Arunachal Pradesh were the states with highest capita outlays within 14.0 per cent to 19.5 per cent of GSDP. In the same time period Himachal Pradesh and Assam, became the states with lowest capita outlays within 3.0 per cent to 3.8 per cent of GSDP.

RANGE	Capital Outlay (CO) /GSDP of Special Category States 2000-03.
RANGE: 10.1 to 17.7	Arunachal Pradesh Sikkim, Uttaranchal
RANGE: 8.0 to 9.0	Jammu and Kashmir, Mizoram , Nagaland
RANGE: 5.0 to 7.5	Manipur, Tripura
RANGE: 1.6 to 4.8	Assam, Himachal Pradesh, Meghalaya

*Source: States finances: A Study of Budget, RBI, 2005-06*

RANGE	Capital Outlay (CO) /GSDP of Special Category States 2003-06.
RANGE: 14.0 to 19.5	Sikkim Mizoram, Arunachal Pradesh,
RANGE: 7.5 to 12.2	Jammu and Kashmir, Manipur, Tripura
RANGE: 4.7 to 7.4	Nagaland, Meghalaya,Uttarakhand
RANGE: 3.0 to 3.8	Himachal Pradesh, Assam,

*Source: States finances: A Study of Budget, RBI, 2007-08*

In 2007-08 while, Manipur became the state with highest capital expenditure to GSDP ratio, Assam became the state with lowest capital expenditure to GSDP ratio.

**Table 7.24: Special Category States: Capital Expenditure /GSDP**

State	2004-05	2005-06	2006-07	2007-08
ARP	13.14	15	17.22	18.82
Assam	4.15	1.88	2.28	2.4
H.P	2.84	3.22	3.91	4.42
J&K	8.99	11.38	8.46	11.69
Manipur	11.41	12.16	16.23	19.42
Meghalaya	4.23	4.1	4.6	5.15
Mizoram	13.43	16.73	15.63	16.55
Nagaland	7.1	9.14	11.13	11.42
Sikkim	22.07	18.89	15.77	17.66
Tripura	7.67	7.92	7.03	8.21
Uttarakhand	4.79	6.52	5.72	6.57

Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

#### (s) Revenue Expenditure/GSDP of Special Category States

There was a marginal increase in the revenue expenditure of special category states during 2004-08. Revenue expenditure-GSDP ratio is much higher at 27.15 per cent in special category states as compared to 14.98 per cent in general category states in 2007-08. Assam, Sikkim and Tripura are the only three states in the special category that reduced their revenue expenditure-GSDP ratios in 2007-08 compared to the 2004-05 levels.

**Table 7.25: Special Category States: Revenue Expenditure/GSDP**

State	2004-05	2005-06	2006-07	2007-08
ARP	52.91	57.15	55.79	56.43
Assam	19.47	18.22	17.97	18.09
H.P	25.11	25.39	26.96	25.93
J&K	34.22	37.38	36.56	38.34
Manipur	36.15	39.57	45.19	40.19
Meghalaya	27.5	26.5	27.41	29.63
Mizoram	56.85	58.87	57.53	58.04
Nagaland	31.51	36.36	34.81	35.76
Sikkim	107.57	96.59	91.2	99.83
Tripura	26.31	25.48	24.14	24.83
Uttarakhand	21.23	21.44	21.8	21.33

Source: Government. of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 2010-15, New Delhi

**(t) Development Expenditure/GSDP of Special Category States**

During 2000-03 Arunachal Pradesh, Mizoram and Sikkim were the states with highest developmental expenditure within 45.7 per cent to 55.8 per cent of GSDP. In the same time period Assam, Himachal Pradesh, and Uttarakhand were the state with lowest developmental expenditure between 13.8 to 23.4 per cent of GSDP. During 2003-06 Arunachal Pradesh, Sikkim and Mizoram were the states with highest developmental expenditure within 48.2 per cent to 54.9 per cent of GSDP. In the same time Uttarakhand and Assam became the state with lowest developmental expenditure between: 17.4 per cent to 19.8 per cent of GSDP.

RANGE	Development Expenditure/GSDP of Special Category States 2000-03
RANGE: 45.7 to 55.8	Arunachal Pradesh, Mizoram, Sikkim
RANGE: 26.8 to 28.1	Jammu and Kashmir, Manipur, Nagaland
RANGE: 24.0 to 24.7	Meghalaya, Tripura
RANGE: 13.8 to 23.4	Assam , Himachal Pradesh, Uttarakhand

Source: *States finances: A Study of Budget, RBI, 2005-06*

RANGE	Development Expenditure/GSDP of Special Category States 2003-06.
RANGE: 48.2 to 54.9	Arunachal Pradesh, Sikkim Mizoram
RANGE: 23.3 to 34.5	Manipur Nagaland, Jammu and Kashmir
RANGE: 19.9 to 23.	Meghalaya, Tripura Himachal Pradesh
RANGE: 17.4 to 19.8	Uttarakhand, Assam

Source: *States finances: A Study of Budget RBI, 2007-08*

**(u) Non Development Expenditure/GSDP of Special Category States**

During 2000-03 Assam, Meghalaya and Uttarakhand were the states with lowest non developmental expenditure within 6.1 per cent to 11.1 per cent of GSDP. In the same time period Jammu and Kashmir, Mizoram and Sikkim were the state with highest non developmental expenditure within 18.0 per cent to 18.7 per cent of GSDP. During 2003-06 Assam, Uttarakhand and Meghalaya became the states with lowest non developmental expenditure within 8.8 per cent to 11.3 per cent of GSDP. In the same time period Mizoram and Sikkim became the state with highest non developmental expenditure lies within 19 per cent to 65 per cent of GSDP.

RANGE	Non Development Expenditure/GSDP of Special Category States 2000-03
RANGE: 6.1 to 11.1	Assam, Meghalaya, Uttarakhand
RANGE: 12.6 to 12.9	Himachal Pradesh, Tripura
RANGE: 18.0 to 18.7	Arunachal Pradesh Manipur Nagaland
RANGE: 19.0 to 29.2	Jammu and Kashmir, Mizoram, Sikkim

Source: States finances: A Study of Budget, RBI, 2005-06

RANGE	Non Development Expenditure/GSDP of Special Category States 2003-06.
RANGE: : 8.8 to 11.3	Assam, Uttarakhand, Meghalaya
RANGE: 12.7 to 16.5	Tripura, Nagaland, Himachal Pradesh
RANGE: 18.1 to 18.6	Arunachal Pradesh, Manipur Jammu and Kashmir
RANGE: 19.0 to 29.2	Mizoram, Sikkim

Source: States finances: A Study of Budget, RBI, 2007-08

#### (v) Social Service Expenditure/GSDP of General Category States

During 2000-03 Arunachal Pradesh Mizoram and Sikkim were the states with highest social service expenditure within 20.0 per cent to 29.2 per cent of GSDP. In the same time period Assam, Himachal Pradesh and Uttarakhand were the state with lowest social service expenditure within 8.5 per cent to 13.3 per cent of GSDP.

RANGE	Social Service Expenditure/GSDP of Special Category States 2000-03
RANGE: 20.0 to 29.2	Arunachal Pradesh, Mizoram, Sikkim
RANGE: 14.3 to 16.2	Manipur, Meghalaya, Tripura
RANGE: 13.7 to 14.0	Jammu and Kashmir, Nagaland
RANGE: 8.5 to 13.3	Assam, Himachal Pradesh, Uttarakhand

Source: States finances: A Study of Budget, RBI, 2005-06

RANGE	Social Service Expenditure/GSDP of Special Category States 2003-06.
RANGE: 24.7 to 29.9	Sikkim, Mizoram Arunachal Pradesh
RANGE: 13.6 to 19.4	Manipur, Meghalaya, Jammu and Kashmir
RANGE: 12.0 to 13.3	Tripura, Nagaland, Himachal Pradesh
RANGE: 9.9 to 11.3	Assam, Uttarakhand

Source: States finances: A Study of Budget, RBI, 2007-08

During 2003-06 Sikkim, Mizoram and Arunachal Pradesh became the states with highest social service expenditure within 24.7 per cent to 29.9 per cent of GSDP. In the same

time period Assam and Uttarakhand became the state with lowest social service expenditure within 9.9 per cent to 11.3 per cent of GSDP

### 7.23 Empirical Measurement of Impact of FRBM Act on Fiscal Deficit

**Research Issue:** FRBM was implemented to bring fiscal balance. Here an attempt has been done to examine whether the enactment of FRBM has brought the fiscal balance in terms of reduction in Fiscal Deficit to GDP ratio.

**Data and period of the Study:** We have taken the data from Hand book of Statistics on India Economy 2009, Reserve Bank of India, Government of India. The period under consideration is from 1980-81 to 2008-09.

#### Model Design

Here simple Ordinary Least Square method has been applied to examine the impact of FRBM Act on fiscal balance.

$FD/GDP = f \{ GDFC, PG, FRBM \text{ (dummy as 1 for years which has FRBM other years 0)} \}$

**Table 7.26: Empirical result of the measurement of FRBM Act on Fiscal Deficit to GDP ratio**

Dependent Variable: FD_GDP				
Method: Least Squares				
Sample (adjusted): 1981 2008				
Included observations: 28 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.022764	0.030075	0.756905	0.4568
GDPFCG	-0.001477	0.000651	-2.269374	0.0329
PG	0.013107	0.013434	0.975692	0.3394
FRBM	-0.004358	0.008335	-0.522797	0.6061
FD_GDP(-1)	0.650711	0.136409	4.770293	0.0001
R-squared	0.701105	Mean dependent var	0.077248	
Adjusted R-squared	0.649123	S.D. dependent var	0.015142	
S.E. of regression	0.008969	Akaike info criterion	-6.429602	
Sum squared resid	0.001850	Schwarz criterion	-6.191708	
Log likelihood	95.01442	F-statistic	13.48752	
Durbin-Watson stat	2.266538	Prob(F-statistic)	0.000008	

Note: FRBM dummy (FRBM) taken as 1 for years which has FRBM other years 0

Here, GDP= Gross Domestic Product at Market Price

GDFCG = GDP growth rate at Factor Cost

PG = population growth Rate

FRBM (here FRBM dummy is taken as 1 for year which have FRBM and 0 is for other years)}

FD\_GDP = Gross Fiscal Deficit (Combined Government) / GDP (at market price).

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

#### **7.24. Conclusion**

No doubt FRBM Act is an important development in managing centre and state finances. After the implementation of FRBM Act central government major fiscal deficit indicators showing a declining trend. The improvement at central level is due to slight improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that among expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there is not much changes. Fiscal Policy Rules should also take care of capital expenditure as it is a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment. Resumption of the path of fiscal correction is crucial to achieving a sustainable fiscal situation at the centre. Though softening of international oil prices has provided some relief, reverting to the high growth path and a strategy to exit from the expansionary fiscal stance put in place as a countercyclical measure will hold the key to fiscal correction.

The enactment of Fiscal Responsibility Law (FRL) in 26 states has resulted in significant fiscal correction. In aggregate, these states have reached their expenditure and debt

targets ahead of schedule. Revenue buoyancy, both due to improve own tax revenues of the states and due to the derived benefit of high central tax buoyancies (through share in central taxes) has mainly been responsible for the fiscal correction. Another encouraging feature is that, in the aggregate, the states have been able to reduce their debt to Gross State Domestic Product (GSDP) ratio to less than 30 per cent. There was considerable improvement in the aggregate finances of states following higher growth of own tax revenues and increased transfers from the centre. The revenue account of states turned surplus in 2006-07 and continued to remain in surplus in 2007-08. This is ahead of the target date of 2008-09 recommended by Twelfth Finance Commission. The process of fiscal consolidation in states was helped in no small measure by the enactment of FRBMA by most states by bringing in rule based management of public finances.

An issue that has gathered substantial interest in the wake of fiscal correction at the state Government level in line with TFC recommendations and their FRL is the need to ensure that the correction is not at the cost of reduction in either quantity or quality of expenditure. In this context, it may be mentioned that in the post-FRL period, there was marginal reduction in revenue expenditure as a ratio to GDP. States have also not been able to step up the developmental component of expenditure, though capital outlay as a ratio to GDP has shown an upward trend. To conclude, the improvement in state finances during the recent years owes a great extent to the various fiscal reforms, *viz.*, implementation of FRLs, introduction of VAT, imposition of new taxes and measures to improve tax administration, measures aimed at limiting non-development expenditure, etc. The larger devolution and transfer of resources from the central government backed by strong macroeconomic growth also aided the fiscal correction and consolidation process at the state government level. Reduction in interest payment is also another reason for fiscal improvement. Subsidies by states to power and irrigation sectors, both explicit and implicit, are a big drag on the finances of states. The performance of state level PSUs continues to remain poor. One noteworthy development was the increase in the aggregate capital expenditure of states following reduction in revenue expenditure and the surplus on the revenue account. The expected reduction in the growth of own

revenue receipts and central transfers, along with increasing expenditure commitments on account of pay revisions are likely to pose a threat to the fiscal correction achieved so far. The state governments may pursue their efforts for improving revenue collection from non-tax resources, ensuring the quantity and quality of major expenditure heads, reducing recourse to borrowed funds for financing expenditure and enhancing devolution of resources to the local Government level. The state governments may have to design post-FRL architecture after assessing their performance under the rule-based framework. There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing, by state level public sector undertakings and power sector deficit. Contingent liabilities should be capped, but in addition off budget borrowing, where debt serving will fall to government, should be consolidated with on budget borrowing.

Inter state comparison of fiscal adjustment shows that general category states performed better than special category states in reducing fiscal deficit, but reverse were the case in revenue deficit. Among the former, the low income states performed better in revenue deficit reduction, but the performance of high income states was better in reducing fiscal deficit. Both high income and low income categories of states brought down fiscal deficits by more than two per cent but the latter category states increased their capital outlay by a larger magnitude than the former. In the general category there are wide variations across states in the extent of correction achieved through improvement in own revenue and compression of revenue expenditure. However, in the majority of states, the correction is revenue-led, with major corrections coming from central transfers. There was no revenue expenditure compression in special category states, with the exception of Assam, Sikkim and Tripura. As in the case of the general category states, transfers from the centre have played a major role in fiscal correction

A number of developments, particularly the slowdown of the economy and its adverse impact on revenue growth, increasing commodity prices, anti-recessionary measures, farm loan waiver and implementation of the recommendations of the Sixth Central Pay Commission, have resulted in a worsening, going beyond the reversal of the fiscal

correction achieved till 2007-08. Despite deterioration in all fiscal indicators in 2008-09 and 2009-10, the debt-GDP ratio remained stable or even declined marginally. This was because of the growth of nominal GDP remaining higher than the average nominal interest rate. Though the tax-GDP ratio has come down in 2008-09, it is still higher than the level reached in 2004-05. The fall in the aggregate tax-GDP ratio in 2008-09 would have been sharper but for buoyant revenues from corporation tax and service tax. There has been a continuous increase in the tax-GDP ratios of these taxes till 2008-09. While the tax-GDP ratio in respect of corporation tax is expected to be maintained even in 2009-10, that of service tax is expected to witness a marginal fall. With buoyant revenues from corporation tax, revenue from direct taxes has, for the first time, overtaken that from indirect taxes in 2007-08. Total expenditure of the centre relative to GDP witnessed a significant contraction between 2003-04 and 2006-07, after which it started rising again, despite moderation in capital expenditure. Rising revenue expenditure, particularly in 2008-09 and 2009-10, contributed to growth in total expenditure. Within revenue expenditure there was sharp increase in expenditure on pay and allowances, as well as subsidies. In recent years, off-budget liabilities of the centre have assumed alarming proportions. In 2008-09, off-budget bonds issued to oil marketing and fertiliser companies amounted to Rs. 95,942 crore or 1.80 per cent of GDP.

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

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## **Chapter-VIII**

### **Summary and Conclusion**

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

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

Persisting fiscal imbalance in India has been a major macro-economic concern to policy makers. More and more revenue deficit implies preemption of private saving for

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

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

At national level, deficit bias, time inconsistency, pro-cyclical fiscal stance, over borrowing and unsustainable public debt is the major fiscal problems which the economies face. At the sub national level vertical imbalance, free rider common pool, unsustainable debts are the major fiscal problem. A fiscal policy rule is implemented to solve these problems. An appropriate fiscal policy in the long run can promote economic growth and in the short run can bring macro economic stability. The success of fiscal policy rules, in particular, the growth response, depends on the quality and durability of the specific measures that underpin it. Transparency, and good governance, can also play an important role in achieving high quality, durable, adjustment. They should cover a broad definition of government. Those targeting a broader coverage of the public sector

tend to be more successful than those using a narrow indicator. In countries with a weak track record of policy implementation, procedural rules may work better than numeric rules. Under these circumstances, fiscal discipline can be promoted through increased transparency and accountability.

In India, among the reform tasks the most challenging one involves re-examination of fiscal relations between the Central and State governments, with a view to restoring vertical balance and paving the way to fiscal responsibility and introduction of rules at the sub-national level. In other words, it is necessary to adopt a mechanism of intergovernmental relations with strong incentives for expenditure control and revenue-raising at the sub-national level the recent agreement on indirect taxation at the State level is a key element in this regard. Failure to develop such a mechanism carries the risk that sub national governments will continue to incur sizable deficits and rely on costly bailouts. Other structural reforms that should help adherence to fiscal rules include downsizing the government's work force, further rationalization of subsidies, and elimination or streamlining of quasi- fiscal operations.

Even though fiscal reform has been done time to time to improve fiscal responsibility piece meal reform became successful. Widespread deterioration in fiscal position with associated impact on fiscal sustainability, macro economic vulnerability and economic growth led an emerging, consensus about the urgent need for imposing statutory ceilings on central government's borrowings, debt and deficits. Therefore, in 2003 the central government of India enacted FRBM Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macro economic variable. FRBM act aims at intergenerational equity, macro economic stability, fiscal sustainability and fiscal solvency, eliminating deficit bias, fiscal transparency, fiscal accountability, autonomy of monetary policy and including limits on access of Government to central bank credit. Following the central government almost every State has already enacted fiscal responsibility Legislations except West Bengal and Sikkim. There are certain design failures in the FRBM Act which may act as an obstacle in achieving its objective.

No doubt FRBM Act is an important development in managing Centre and States finances. Recently after the implementation of FRBM Act Central Government major fiscal deficit indicators showing a declining trend. This improvement in fiscal deficit indicators at the both central level is due to improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that at central level among expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there are not much changes. Fiscal Policy Rules should also take capital expenditure as a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment.

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

The improvement in States finances during the recent years owes a great extent to the various fiscal reforms, *viz.*, implementation of FRLs, introduction of VAT, imposition of new taxes and measures to improve tax administration, measures aimed at limiting non-development expenditure, etc. The larger devolution and transfer of resources from the Central Government backed by strong macroeconomic growth also aided the fiscal correction and consolidation process at the States Government level. The States Governments may pursue their efforts for improving revenue collection from non-tax resources, ensuring the quantity and quality of major expenditure heads, reducing recourse to borrowed funds for financing expenditure and enhancing devolution of resources to the local Government level. The States Governments may have to design post-FRL architecture after assessing their performance under the rule-based framework.

There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing, by States level public sector undertakings and power sector deficit. Contingent liabilities should be capped, but in addition off budget borrowing, where debt serving will fall to government, should be consolidated with on budget borrowing.

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

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

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

- (1) Absence of clear accounting definitions for target fiscal indicator:** This has allowed creative accounting as reflected by the issuance of off-budget bonds to finance subsidies, which have thus been excluded from the definition of the FRBMA-relevant deficit variable.
- (2) Insufficient transparency in budget preparation:** Numerical targets have not been supported by comprehensive expenditure reform plans. In addition, the assumptions underpinning the budget do not always include annual forecasts for key macroeconomic variables, and the discussion of fiscal risks is limited.

**(3) Focus on a current balance target:** This allows weaknesses in budget classification to be exploited, by misclassifying current expenditures as capital expenditures. Targeting the current balance may also bias spending against education and health, which have a large current expenditure component. In addition, international experience illustrates that deficit type targets such as the current balance are more likely to reduce incentives for fiscal savings in good times, and to force adjustment in bad times (i.e. procyclicality).

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

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

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

## **The Way Forward**

### **A. Reforming the FRBMA:**

**1. In terms of target variables:** (i) include an explicit national medium-term debt target and define a path to achieve it; (ii) discuss with state the setting of state debt targets consistent with such path, for example, based on net revenue as in Brazil; (iii) on the basis of the desired debt path and a revenue projection based on a prudent trend growth assumption, derive annual nominal primary expenditure growth rules on the basis of the

government's flow budget constraint; and (iv) consider including specific rules to protect capital spending if there is a concern that it may be cut excessively during adjustment. These changes will put the medium-term focus of fiscal policy squarely on debt sustainability, tackle the deficit bias at its very core (expenditure overruns), and reduce the tendency to pro-cyclical responses of fiscal balance targets by allowing automatic stabilizers to operate.

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

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

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

**5. In terms of correction of deviations and enforcement:** (i) reduce the size of deviations that trigger corrective actions; (ii) introduce automatic and time bound mechanisms to correct deviations from targets that prioritize areas of spending that would

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

**6. To reduce opportunities for creative accounting and biased forecasts:** define precisely the accounting framework and definitions for target fiscal indicators. Adopting an international standards budget classification (such as GFSM (2001)) and reforming the chart of accounts to be fully consistent with it could be useful in curbing possibilities for creative accounting. (ii) Empower an independent scorekeeper. Consider expanding the role of existing independent agencies that monitor government funds (e.g., Controller Accountant General and Controller Auditor General) before creating a new one for this purpose. The autonomous scorekeeper could be in charge of: (a) providing and assessing compliance with standardized accounting standards for all levels of government; (b) preparing objective and timely reports that allow to verify compliance with the FRBMA and other budgetary rules and targets. With these functions, the score keeper would have a role similar to that of EUROSTAT in the European Union. (iii) Expand the coverage of the fiscal accounts and target fiscal indicators. This includes bringing all subsidy-related expenditures above the line and gradually expanding the coverage of the fiscal accounts to include public enterprises that pose fiscal risks and the accounts of special purpose vehicles created for funding government spending such as PPPs, both at the central and sub-national levels.

**7. To focus medium-term fiscal policy on debt sustainability, consider using debt and expenditure growth targets:** This approach would tackle the deficit bias at its core, and allow room for macroeconomic stabilization through automatic stabilizers. This could be achieved by: (i) Setting a medium-term debt target and debt reduction path to achieve it. Given the stated central objective of the FRBMA, i.e. ensuring fiscal sustainability, a direct rule on gross public debt should be a logical part of the FRBMA successor. Setting the exact debt level target requires judgment about sustainable debt levels and India's debt tolerance. As India continues its gradual integration with global financial markets, the judgment should also be informed by the debt levels observed in other emerging markets following sound fiscal policies. While theory does not provide a clear rationale for any specific debt target level in general, recent research suggests that emerging markets tend to have less debt tolerance than advanced economies. The debt target level should also be prudently defined to allow some room for discretionary countercyclical fiscal policy if automatic stabilizers were not sufficient.

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

**9. Combine fiscal rule reforms with other strategies to promote fiscal discipline:** In particular, continue to strengthen financial market control mechanisms as well as cooperative arrangements across government levels and pursue reforms to the intergovernmental fiscal relations system. To strengthen these arrangements: (i) Provide the conditions necessary for an effective market-based control mechanisms for fiscal discipline. An important step in this regard would be to gradually eliminate the

availability of large non-market based and captive sources of financing such as a statutory liquidity requirement for banks to hold state issued paper, compulsory investment by the National Small Savings fund in state paper and borrowing from the state employees' pension fund. Establishing a firm commitment to a no-bailout policy will also strengthen the incentives for discipline faced by local authorities. (ii) Explore further possibilities for cooperative approaches to promote fiscal discipline. Arrangements enhancing cooperation between the center and regional governments such as the bi-annual conference of State Finance Secretaries could be transformed into a forum where both the center and the states could discuss sub-national FRL reforms and facilitate discussions on borrowing ceilings consistent with national objectives.(iii) Persevere with intergovernmental fiscal reforms in particular to reduce states' dependence on central transfers, simplify the transfer system, and review the design of the transfer system on the basis of needs and fiscal capacity of the different states.

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

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## ***Abstract***

*Growing interest in fiscal policy rule is in part attributable to the deterioration in fiscal performance, the so called deficit bias, experienced for more than two decades by a large part of the world. Fiscal policy rule is moderated by some attempts to reverse this trend. Kopits and Symansky (1998) defined, a fiscal policy rule as a permanent constraint on fiscal policy expressed in terms of a summary indicator of fiscal performance, such as the budget deficit, borrowing, debt or a major component thereof. The need for fiscal adjustment may be seen in the context of the impact of the fiscal policy on stabilization and growth objectives, the sustainability of the fiscal policy stance, and the linkages between fiscal and other policy instruments. Loose fiscal policy, especially when financed by printing money, can lead to high and volatile inflation. When the government borrows to finance a looser fiscal position, the greater demand for loanable funds can reduce private investment (and other interest-sensitive components of private spending) by raising interest rates. Under a floating exchange rate, higher interest rates will also tend to attract foreign capital, leading to an appreciation of the exchange rate, which will also crowd out exports. Loose fiscal policy may not be sustainable. For example, continuously rising debt levels creates uncertainty (regarding inflation, a disorderly depreciation, price and foreign trade restrictions, or large tax increases). These states of affairs reduce private investment as they cause investors to wait and see. Loose fiscal policy may also make the economic environment more volatile (e.g., by recurrent, and ill-timed, bursts of fiscal contraction and expansion), which can weaken investment by increasing risk and focusing investment on the short run. Fiscal adjustment can help mitigate cyclicity (recurrent recessions and booms), reduce large external current account imbalances, and contain inflation. In capital account crisis, fiscal adjustment can restore confidence, ease financing constraints, and support the growth.*

*Fiscal adjustment may be needed to facilitate external adjustment, especially to reduce excessive current account deficits or surpluses. A successful fiscal adjustment durably and efficiently improves the fiscal position while minimising any welfare costs. Success depends on a range of factors especially, the timing, speed, size, and quality of adjustment. Accordingly, fiscal policy rules – if well designed and properly implemented – are viewed as potentially useful techniques for emerging market economies exposed to macroeconomic volatility and high capital mobility.*

*The fiscal position of both India's central and state government worsened significantly since the fiscal consolidation achieved after the 1991 balance of payments crisis. The remarkable downward inflexibility was demonstrated by fiscal deficit and stubborn upward movement was exhibited by revenue and primary deficit. The rising fiscal imbalance may lead to macro economic instability heavy borrowing and balance of payments (BoPs) crisis. The most adverse impact of fiscal deficit is its adverse impact on public expenditure in areas of education, health, infrastructure, social security and welfare because of acute fiscal stress involved in their government. More and more revenue deficit imply pre-emption of private saving for government current consumption which tends to crowd out private investment without corresponding increase in capital spending by the government.*

*India has been tackling the fiscal deterioration by adopting fiscal reform to improve fiscal responsibility. Widespread deterioration in fiscal position with associated impact on fiscal sustainability, macro economic vulnerability and economic growth led an emerging, consensus about the urgent need for imposing statutory ceilings on Central Government's borrowings, debt and deficits. Therefore, in 2003 the Central Government of India enacted FRBM Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macroeconomic variable. Now all the major States have enacted Fiscal Responsibility Legislations except West Bengal and Sikkim. This study broadly attempts to analyse the role of Fiscal Responsibility and Budget Management Act in restoring fiscal balance in India.*

*The study analyses the need for fiscal rules and constraints in India. The study aims at finding out the major factor behind rising fiscal imbalance in India and to examine whether there is an electoral motive towards high fiscal deficit to GDP ratio or not. It makes a review how Fiscal Policy Rules (FPRs) are designed in different countries. It analyzes the success and failure of FPRs in achieving fiscal discipline through different mechanism. It also analyzes the effectiveness of various measures undertaken at the central and state level to inculcate fiscal discipline in the fiscal management. It makes an attempt to do a critical in depth reviews of the Fiscal Responsibility and Budget Management Act and make an attempt at examining effectiveness and suitability of FRBM act through a quantitative analysis. It also makes an attempt to suggest improvements in the fiscal monitoring mechanism in India.*

*FRBM Act is an important development in managing centre and state finances. Recently after the implementation of FRBM Act; Central Government major fiscal deficit indicators show a declining trend. This improvement in fiscal deficit indicators at the central level is due to improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that among the central level expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there are not many changes. Fiscal Policy Rules should also take capital expenditure as a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment.*

*The improvement in State finances during the recent years owes a great extent to the various fiscal reforms, viz., implementation of Fiscal Responsibility Laws, introduction of VAT, imposition of new taxes and measures to improve tax administration, measures aimed at limiting non-development expenditure, etc. The larger devolution and transfer of resources from the Central Government backed by strong macroeconomic growth also aided the fiscal correction and consolidation process at the State Government level. The State Governments may pursue their efforts for improving revenue collection from non-tax resources, ensuring the quantity and quality of major expenditure heads, reducing recourse to borrowed funds for financing expenditure and enhancing devolution of resources to the local Government level. The State Governments may have to design post-FRL architecture after assessing their performance under the rule-based framework.*

*There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing, by state level public sector undertakings and power sector deficit. Contingent liabilities should be capped, but in addition off budget borrowing, where debt servicing will fall to government, should be consolidated with on budget borrowing.*

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

*My empirical show that FRBM act does not have a significant effect on the Gross Fiscal Deficit (GFD) to GDP ratio where as GDP (at factor cost) growth rate has a significant negative effect on the GFD to GDP ratio. Population growth does not have a significant effect on Gross Fiscal deficit to GDP ratio.*

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

**Synopsis**

**Of Ph.D. Thesis Titled**

**Role of Fiscal Responsibility and Budget Management  
Act in Restoring Fiscal Balance in India**

*To be submitted by*

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## **Introduction**

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

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

Loose fiscal policy, especially when financed by printing money, can lead to high and volatile inflation. When the government borrows to finance a looser fiscal position, the greater demand for loanable funds can reduce private investment (and other interest-sensitive components of private spending) by raising interest rates. Under a floating exchange rate, higher interest rates will also tend to attract foreign capital, leading to an appreciation of the exchange rate, which will also crowd out exports. Loose fiscal policy may not be sustainable. It leads to continuously rising debt levels creates uncertainty (regarding inflation, a disorderly depreciation, price and foreign trade restrictions, or large tax increases). These states of affairs reduce private investment as they cause investors to wait and see. Fiscal adjustment can help mitigate cyclicalities (recurrent recessions and booms), reduce large external current account imbalances, and contain inflation. In capital account crisis, fiscal adjustment can restore confidence, ease financing constraints, and support growth.

Previously, a history of fiscal indiscipline had often yielded high inflation, depleted foreign exchange reserves, a private sector starved of credit, a flight from domestic currency, foreign exchange rationing, and an overvalued exchange rate. In these circumstances, rapid reduction of the fiscal deficit became an imperative. In the past decade, several advanced economies have shifted from discretion-based to rules-based fiscal policies often reacting to the deterioration of their public finances. This shift has taken place in countries such as New Zealand, Australia, and United Kingdom, but perhaps most visibly in the European Union (EU) in support of monetary unification. In emerging market economies, the adoption of fiscal policy rules has been much more recent and limited mainly to Latin America. In some instances, the rules were introduced following a financial crisis; in others they were adopted to reduce vulnerability to a potential crisis. Often the immediate motivation has been to reverse the buildup of public debt, to restore fiscal sustainability and, more generally, to enhance the credibility of macroeconomic management. In addition, in some regions, mainly Central and Eastern Europe, rules are increasingly viewed as an anchor in the convergence to a broader monetary union (Kopits, 2001<sup>a</sup>).

### **Rationale for Fiscal Responsibility in India**

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

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

Persisting fiscal imbalance in India has been a major macro-economic concern to policy makers. More and more revenue deficit implies preemption of private saving for government current consumption which tends to crowd out private investment without corresponding increase in capital spending by the government. It is also recognized that since the 1990s primary deficit has turned negative, implying that states are borrowing to meet their current expenditure or significant part of the fiscal deficit is due to the burden of the serving the past debt. It is obvious that, it is not the problem of growing deficit, which deserves concern, but the composition of this deficit and the way it is being financed because the impact of fiscal deficit depends on it (Mohanty, 2004).

India has been tackling the fiscal deterioration by adopting fiscal reform mechanism to improve fiscal responsibility. In the last decade India has enacted mechanisms to bind government to fiscal rectitude through formal legal or even constitutional devices.

In 2000-01 the Finance Ministry issued guidelines to state for Medium Term Fiscal Reform Programs (MTFRPs). The MTFRP had dual aim of reducing wasteful expenditure (cutting low priority spending) and improving tax collection or improving the efficiency of the tax administration. The MTFRPs required states to make time bound reform in four areas like, fiscal, power, and public sector and budgetary. The main

objectives of MTFRPs were to bring the consolidated fiscal deficit to sustainable levels by 2005 and to bring down debt-GDP ratio as well as interest payment. MTFRPs could not achieve its target rather during this time period fiscal situation deteriorated. There was a design failure in prescribing a uniform 5 per cent point improvement in the ratio for all states. If states started off with larger base year deficits, it became relatively easier for them to make huge improvements.

On April 2000 the Eleventh Finance Commission (EFC) <sup>1</sup> recommended, an incentive fund in the form of Fiscal Reform Facility (FRF). EFC recommended releasing 15 per cent grant to the states by linking with improvement in fiscal performance. Under FRF, Government of India prescribed a single monitor able indicator for the purpose of making releases from the incentive funds. The indicator expected each state to achieve a minimum improvement of 5 per cent in revenue deficit/surplus as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-2000.

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

Twelfth Finance Commission (TWFC) recommended for debt write off scheme to enhance the fiscal prudence on the part of the States, but it also recommended that each State has to enact Fiscal Responsibility Law with a target to eliminate revenue deficit and reducing fiscal deficit. A debt write off scheme became linked with the reduction of revenue deficit of the states. The quantum of repayment was linked to the absolute

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<sup>1</sup> The Finance Commission is a constitutional body established under article 280 of the Indian Constitution every five years with the primary purpose of determining the sharing of centrally collected tax proceeds between the central and state governments and the distribution of grants-in-aid of revenues across states. The terms of reference of the Finance Commissions can be expanded by order of parliament.

amount by which the revenue deficit was reduced in each successive year during award period.

Thirteenth Finance Commission has recommended two debt relief measures to be extended to all states. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to states contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9 per cent. The Commission has also recommended that structural reforms should be brought in the NSSF to make it more market linked. The second debt relief recommended by the Commission is write-off of central loans to states. All the above mentioned debt relief is available to states only if they amend/legislate FRBM Acts in accordance with the recommendations of the Commission. The Commission has also recommended that the states will be eligible for the states Specific Grants only if they comply with this condition.

Even though time to time initiative has been taken to achieve fiscal responsibility piece meal reform became successful. Widespread deterioration in fiscal position with associated impact on fiscal sustainability, macro economic vulnerability and economic growth led an emerging, consensus about the urgent need for imposing statutory ceilings on central government's borrowings, debt and deficits. Therefore, in 2003 the central government of India enacted FRBM Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macro economic variable. In terms of Fiscal Responsibility and Budget Management (FRBM) Act centre's fiscal deficit was required to be reduced to 3 per cent of GDP and revenue deficit to be eliminated by 2008-09. The rules under the Act further require the central government to reduce the revenue deficit by an amount equivalent to 0.5 per cent or more of GDP at the end of each year beginning with 2004-05. The fiscal deficit is to be reduced by 0.3 percent or more of GDP at the end of each financial year beginning with 2004-05. Similarly, acting in response to the debt relief package recommended by TWFC in return for fiscal correction, almost every state except West Bengal and Sikkim has enacted Fiscal Responsibility Acts. States government accepted similar obligations of reducing fiscal

deficit to 3 per cent of Gross States Domestic Product (GSDP) and eliminating revenue deficits by 2008-09. The case for fiscal responsibility, both at the centre and in the states, was made on the argument that fiscal consolidation is an essential condition for accelerating growth.

However, there are always doubts remain about how far Fiscal Policy Rule will be helpful in attaining the primary objectives, as distinguished from the intermediate ones of reducing deficit and debt. Some of the developmental economist argues that limiting fiscal deficit to 3 per cent may be too restrictive though it may affect development expenditure or social expenditure (Ghosh and Sekhar, 2005). They also argue that if the fiscal deficit is dominantly in the form of capital expenditure, it contributes to future growth through demand and supply linkages. Infraction can create so much demand in the economy that private investment may crowd in to supplement autonomous investment. There is nothing wrong in maintaining large fiscal deficit if restoring to public debt is made only to meet investment requirements as long as their social rate of return is higher than the rate of interest. Deficit per se is not bad as the Indian economy is a demand-constrained economy (Mohanty, 2004). There is no theoretical reason cited for having a fiscal deficit target of 3 per cent. FRBM Act has been enacted not because it is a sound finance but because international speculators demand it. Fiscal deficit financed itself by generating an excess of domestic saving over private investment exactly equal to itself. If the objective of an economy is, employment generation then, the public expenditure through borrowing finance is useful. On the other hand, a society with egalitarian goals should aim to keep down fiscal deficit, and finance public expenditure through progressive taxation (Patnaik, 2006).

The most important argument in favour of introduction of FPR is the failure in the last ten years to produce fiscal adjustment in India both at central level and state level. India's public deficit bias and indebtedness can not be sustained much longer with stepped-up external liberalization. Thus there is a strong case for adopting Fiscal Responsibility Legislation that involves a high degree of transparency, well designed fiscal policy rules at national and sub national levels of government (Kopits, 2001). On account of high

fiscal imbalance there are hidden costs on the Indian economy in terms of the foregone potential for even higher economic growth than that has recently been experienced. The large and increasing fiscal deficit led to a crowding out of productive public expenditure and constrained the scope for further structural reforms and liberalization and rooms for macroeconomic policy maneuver adversely impact the growth prospects. In order to avoid the crisis, there is a strong need of revenue mobilization efforts and reorientation of expenditure away from subsidies and towards physical and social infrastructure projects. India's medium term economic prospects, among others depend critically on progress with the closely intertwined tasks of fiscal consolidation and structural reforms. The rising level of fiscal imbalances and resultant high level of debt may create a vicious circle inducing a fall in the ratio of private to total credit, rising inflation and falling economic growth (Kochhar, 2006).

### **Objectives of the Study**

In the light of the above background the objectives of the present study are:

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

## **Data and Period of Study**

The data for the study have been collected from the secondary sources. Indicator such as GDP (at market price), Population, Gross Fiscal Deficit, Revenue Deficit and Primary Deficit has been taken from *Handbook of Statistics on the Indian Economy*, which is a publication of Reserve Bank of India. For state level analysis data has been taken from *State Finances: A study of Budget*, which is a publication of Reserve Bank of India. The yearly data have been taken for the period of 1980-81 to 2008-09.

## **Approach and Methodology of the Study**

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

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

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

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

$$Y-r > 0 \quad (1)$$

$$r = (IP)_t / (OD)_{t-1} \quad (2)$$

Where,

$Y$  = Trend growth rate of GDP at current Market price

$r$  = Average Interest Rate,  $IP$  = Interest Payment,  $OD$  = Outstanding Debt,  $t$  = Time Period  
( $r < g$ ).

## **Organisation of the Thesis**

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

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

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

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

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

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

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

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

Finally, the eighth chapter summarizes the study, concludes and suggests for improving the fiscal monitoring mechanism in India.

## **Major Findings**

No doubt FRBM Act is an important development in managing centre and states finances. Recently after the implementation of FRBM Act central government major fiscal deficit indicators are showing a declining trend. This improvement in fiscal deficit indicators at the both central level is due to improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that at central level among expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there are not much changes. Fiscal Policy Rules should also take capital expenditure as a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment.

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

The improvement in states finances during the recent years owes a great extent to the various fiscal reforms, *viz.*, implementation of FRLs, introduction of VAT, imposition of new taxes and measures to improve tax administration, measures aimed at limiting non-development expenditure, etc. The larger devolution and transfer of resources from the Central Government backed by strong macroeconomic growth also aided the fiscal correction and consolidation process at the states government level. The states governments may pursue their efforts for improving revenue collection from non-tax resources, ensuring the quantity and quality of major expenditure heads, reducing recourse to borrowed funds for financing expenditure and enhancing devolution of resources to the local government level. The states governments may have to design post-

FRL architecture after assessing their performance under the rule-based framework. There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing, by states level public sector undertakings and power sector deficit. Contingent liabilities should be capped, but in addition off budget borrowing, where debt serving will fall to government, should be consolidated with on budget borrowing.

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

My Empirical analysis show that FRBM act does not have a significant effect on the Gross Fiscal deficit (GFD) to GDP ratio where as GDP (at factor cost) growth rate has a significant negative effect on the GFD to GDP ratio. Population growth does not have a significant effect on Gross Fiscal deficit to GDP ratio.

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

expenditure framework needs to be strengthened by clearly distinguishing between current and capital spending and by placing more emphasis on performance audit.

**The main weaknesses in the Fiscal Responsibility and Budget Management Act design in India are:**

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

**(2) Insufficient transparency in budget preparation:** Numerical targets have not been supported by comprehensive expenditure reform plans. In addition, the assumptions underpinning the budget do not always include annual forecasts for key macroeconomic variables, and the discussion of fiscal risks is limited.

**(3) Focus on a current balance target:** This allows weaknesses in budget classification to be exploited, by misclassifying current expenditures as capital expenditures. Targeting the current balance may also bias spending against education and health, which have a large current expenditure component. In addition, international experience illustrates that deficit type targets such as the current balance are more likely to reduce incentives for fiscal savings in good times, and to force adjustment in bad times (i.e. pro-cyclicality).

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

**(5) Absence of well-defined sanctions for non-compliance:** There are no explicit automatic penalties for missing fiscal targets and/or not following budget procedures. International experience shows that institutional sanctions (e.g., withholding of transfers, borrowing restrictions, and fines) and/or personal sanctions (e.g., fines,

dismissal, and penal prosecution) are likely to be needed especially in countries with a history of weak fiscal discipline.

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

## **The Way Forward**

### **A. Reforming the FRBMA:**

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

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

**3. In terms of procedure and transparency:** (i) explicitly provide a plan of measures and reforms that support the achievement of targets (e.g., subsidy reform); (ii)

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

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

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

**6. To reduce opportunities for creative accounting and biased forecasts:** define precisely the accounting framework and definitions for target fiscal indicators. Adopting

an international standards budget classification (such as GFSM (2001)) and reforming the chart of accounts to be fully consistent with it could be useful in curbing possibilities for creative accounting. (ii) Empower an independent scorekeeper. Consider expanding the role of existing independent agencies that monitor government funds (e.g., Controller Accountant General and Controller Auditor General) before creating a new one for this purpose. The autonomous scorekeeper could be in charge of: (a) providing and assessing compliance with standardized accounting standards for all levels of government; (b) preparing objective and timely reports that allow to verify compliance with the FRBMA and other budgetary rules and targets. With these functions, the score keeper would have a role similar to that of EUROSTAT in the European Union. (iii) Expand the coverage of the fiscal accounts and target fiscal indicators. This includes bringing all subsidy-related expenditures above the line and gradually expanding the coverage of the fiscal accounts to include public enterprises that pose fiscal risks and the accounts of special purpose vehicles created for funding government spending such as PPPs, both at the central and subnational levels.

**7. To focus medium-term fiscal policy on debt sustainability, consider using debt and expenditure growth targets:** This approach would tackle the deficit bias at its core, and allow room for macroeconomic stabilization through automatic stabilizers. This could be achieved by: (i) setting a medium-term debt target and debt reduction path to achieve it. Given the stated central objective of the FRBMA, i.e. ensuring fiscal sustainability, a direct rule on gross public debt should be a logical part of the FRBMA successor. Setting the exact debt level target requires judgment about sustainable debt levels and India's debt tolerance. As India continues its gradual integration with global financial markets, the judgment should also be informed by the debt levels observed in other emerging markets following sound fiscal policies. While theory does not provide a clear rationale for any specific debt target level in general, recent research suggests that emerging markets tend to have less debt tolerance than advanced economies. The debt target level should also be prudently defined to allow some room for discretionary countercyclical fiscal policy if automatic stabilizers were not sufficient.

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

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

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