Fiscal Consolidation in India : The Way Forward

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Abstract

The magnitude of fiscal deficit has always been a cause of concern for policy makers in India. The first step towards fiscal consolidation in India began with implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 and Fiscal Regulatory Legislation (FSL). Further, the Twelfth Finance Commission proposed incentives for State Governments in order to bring in fiscal discipline at the state level. This paper examined the long term profile and impact of high fiscal deficit, consequent debt to GDP ratio, and the need for fiscal consolidation in India. It also presented the reasons behind non- attainment of the fiscal targets set under the FRBM bill. The paper aimed to contribute to the policy debate on fiscal consolidation in India.

Key words : fiscal policy, fiscal deficit, fiscal sustainability, public debt

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Persistent high fiscal deficit has been a cause of concern for policy makers in India. Post the 1991 crisis, the government has been targeting a reduction in fiscal deficit every year. Persistent high fiscal deficit could pose an inflationary risk, affects savings, lowers the growth of the economy, affects the sovereign rating of the country, and makes the economy less attractive to foreign investors. Moreover, persistent high level of fiscal deficit indicates that a larger share of public resources is expended towards debt servicing ; thereby, leaving much less for capital expenditure.

High fiscal deficit also crowds out private-sector investment. The private sector has proven to be efficient and profitable ; thus, the diversion of resources to the public sector results in slowing down of growth. The composition of fiscal deficit is equally important. A high proportion of revenue deficit implies that the borrowed resources are being utilized for financing current consumption. For ensuring long-term sustainable growth, it is essential to balance the revenue expenditure and to divert the funds towards investment purposes.

India felt the need for a fiscal bill like Fiscal Responsibility and Budget Management to facilitate the fiscal consolidation envisaged by the government. Globally, there are countries (like the U.S. (Gramm- Rudmann-Hollings Act), FRA of New Zealand, EU (Maastricht Treaty)) that have introduced Bills to facilitate fiscal consolidation in these countries.

India adopted a rule-based fiscal framework, the Fiscal Responsibility and Budget Management Act (FRBMA) in the year 2003. The Act sets procedural and numerical rules only for the Central government. Its stated objective is to ensure inter-generational equity in fiscal management, achieve fiscal sustainability to ensure long-term

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macro-economic stability, and bring in transparency in fiscal operations of the Central government. To introduce fiscal prudence at the level of states, the states were encouraged to introduce their own fiscal responsibility laws (FRLs). States, introducing FRLs, were given incentives in the form of conditional debt restructuring and interest rate relief by The Twelfth Finance Commission (TFC).

During the period of 2003-04 to 2007-08, the Central government's fiscal deficit declined substantially, helping the Central government, achieve a year in advance, the medium term target as set by the Act. This was also followed by a reduction in the Central government's current deficit to 1.2% of the GDP. However, significant slippage with respect to the 2008-09 targets was experienced, challenging the effectiveness of FRBMA.

This paper aims to discuss the fiscal performance of the Central Government during 2003 to 2014 and provide a roadmap to facilitate strengthening its fiscal performance. The Section I discusses the multiple factors that compelled the introduction of the FRBM Bill 2000. The Section II presents a critical appraisal of the provisions of the FRBMA 2003. The next section illustrates the fiscal performance of the Central Government in two time periods, that is, during 2003-04 to 2007-08 and 2008-09 to 2013-14. In the last section, we attempt to provide policy implications for further strengthening the fiscal performance of the government.

Section I

The Reasons for Introducing FRBMA 2003

It is imperative to discuss the fiscal background that led to the introduction of the FRBMA. The efficacy of expansionary fiscal policy has been seriously questioned in several studies (Favaro & Lahiri, 2004). The studies during 1990s have focused mainly on the worsening level of fiscal deficit, the strategy for its reduction, and sound expenditure management (Shome, 2002).

During the second half of the 1990s, government finances in India worsened continuously, resulting into large and inflexible fiscal imbalances. The deterioration was the result of the combined effect of significant reform-induced losses in revenue (namely from reductions in customs and excise duty rates), poor tax performance due to a narrow tax base, and low tax buoyancy on one hand and on the other hand, the government's inability to contain current public spending (Poirson, 2006). Please see Figure 2.

Both the Centre and the State governments contributed to the fiscal deterioration in India due to implementation of the civil service wage increases recommended by the Fifth Pay Commission. This led to widening of deficits, especially at the state level. Persistent primary deficits led to a sharp accumulation of debt. In 2003-04, at 9% of GDP, India had one of the largest general government deficits in the world, and its debt reached more than 87% of the GDP (Topalava & Nyberg, 2010).

High level of fiscal deficits (Figure 1), by raising the real interest rates, crowd our private investment, especially in the context of the Government borrowing being predominantly used to finance revenue deficits. India's fiscal and debt indicators were comparable to or worse than that of Argentina, Brazil, and Turkey, who have faced a serious macroeconomic crisis. Ahluwalia (2002) concluded that India was not vulnerable to any crisis because of built up of foreign exchange reserves, capital controls, flexible exchange rate system, and widespread public ownership of banks. The public debt though had reached unsustainable levels. Please refer to Figure 3 to see India's debt-GDP ratio from 1990-91 to 2014-15.

Another study observed that if India did not have a Central Government deficit of some 6% of the GDP, the gross rate of capital formation could have risen from 24% of the GDP to 30% of GDP, which could have added nearly 1% to annual economic growth (Feldstein, 2004).

Figure 1. Gross Fiscal Deficit and Primary Deficit to GDP in India

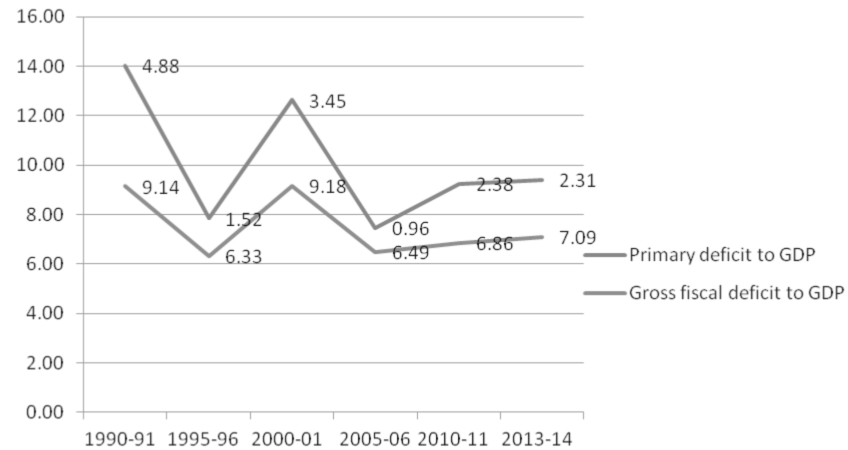


Figure 2. India's Tax/GDP Ratio

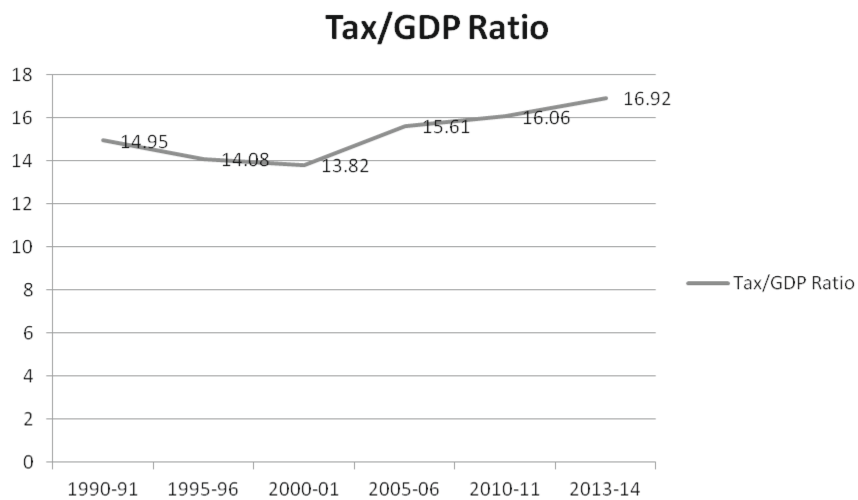
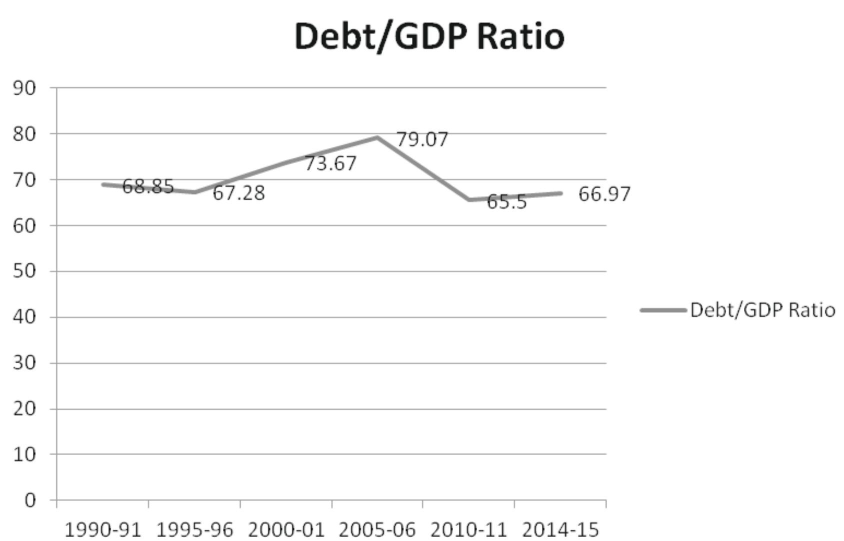


Figure 3. India's Debt/GDP Ratio



Fiscal Responsibility and Budgetary Management Act, 2003

A committee on Fiscal Responsibility Legislation was constituted in 2000 to evaluate various aspects of the Indian financial system and come up with draft legislation on fiscal responsibility. The FRBM Bill was introduced by the then Finance Minister of India, Mr. Yashwant Sinha in December 2000. The most significant aspect of the Bill was its thrust on the fiscal management principles and setting medium term targets for the key fiscal parameters. The fiscal management principles put forth the elimination of revenue and fiscal deficits and building up of adequate revenue surplus in a time-bound manner. In 2003, the Parliament passed the Fiscal Responsibility and Budgetary Management Act, and it got implemented at the Central Government level.

The key provisions of the bill are listed here:

(1) Reduce revenue deficit by 1.5% or more of the estimated GDP at the end of each financial year beginning on the 1st day of April 2001 and eliminating revenue deficit by March 2006.

(2) Reduce fiscal deficit by 1.5% or more of the estimated GDP at the end of each financial year beginning on the 1st day of April 2001 and reduce the fiscal deficit to 2% of the estimated GDP by March 2006.

(3) Ensure that within a period of 10 financial years (i.e. from 2001 to 2011), the total liabilities (including external debt at current prices) should not exceed 50% of the estimated value of GDP for that year.

(4) Prohibition of direct borrowings by the Central Government from the RBI, after 3 years of enactment of the Bill, except by way of advances to meet temporary cash needs in certain circumstances (FRBM Bill, 2000), that is, from the financial year beginning on April 1, 2004, the Central Government is barred from making primary issues to the Reserve Bank of India.

(5) The annual finance bill (budget) to be presented along with three statements, which should form the basis of the budget (a) Medium Term Fiscal Policy Statement, (b) the Fiscal Policy Strategy Statement, and (c) the Macroeconomic Framework Statement.

The medium term fiscal policy statement shall set-forth a three-year rolling target for prescribed fiscal indicators ; shall include an assessment of sustainability relating to the balance between revenue receipts and revenue expenditure and the use of capital receipts for generating productive assets.

Though the Bill contributed in bringing in fiscal discipline till 2004-05, the Government had to stall FRBM implementation in 2005-06. The Union Budget of 2006-07 announced a resumption of the FRBM process in which revenue augmentation and expenditure re-orientation were the main planks. The Twelfth Finance Commission had provisions wherein the State Governments were given incentives if they enacted their own fiscal responsibility legislation. The Twelth Finance Commission, in order to address the rising debt burden of States, recommended a general scheme of debt relief and a loan write off scheme.

The Thirteenth Finance Commission also had provisions wherein the State Governments were forced to comply with fiscal discipline. Non compliance would withdraw lower lending rates offered to states on loans from the National Small Savings Fund (NSSF). The states, on an average, borrow around 6-8% of their gross fiscal deficits from the NSSF.

The Fourteenth Finance Commission has taken some bold steps like increasing the tax share of State Government to 42%, setting up of a fiscal council to make the Centre accountable, and doing away with direct transfers to States under centrally sponsored schemes. It also adopted the conventional concept of revenue deficit, that is, the gap between all revenue receipts and revenue expenditure for setting the fiscal targets.

Section II

Review of Literature

The Bill was enacted in 2003 with stated objectives to make budgetary operations sustainable and to further inter-generational equity in fiscal management, macro-economic stability, and economic growth. Later, with every finance commission, the provisions have been amended to bring in desired outcomes, mainly fiscal consolidation.

Rakshit (2001) highlighted the need to assess the efficacy of the fiscal consolidation programme chalked down in the FRBM Bill as it would have a far-reaching effect on the Indian economy. He discussed how far the provisions of the bill were in consonance with its objectives of inter-generational equity, macroeconomic stability, and growth.He further opined that the bill should have provided some scope for anti-cyclical variations in revenue and fiscal deficits. In an effort to reduce revenue deficit or generating revenue surplus, the government may tend to scale down expenditure on education, health, and other social services.

Mishra (2001) studied the various provisions made in the draft FRMB Act. In her opinion, a distinction between structural and cyclical components of fiscal deficit is essential. The FRA targets fiscal deficit - GDP ratio while it should target structural deficit - GDP ratio, for otherwise, its policy actions may lead to an increase in the amplitude of cycles experienced by the economy.

Karnik (2002) studied the provisions of the Bill and welcomed the step. The paper found that the whole purpose of the Bill is to offer a credible commitment that the government is serious about redressing the fiscal balance. The commitment would have been credible only if the Government was willing to be penalized for not being able to meet the provisions of the Bill. However, with the elimination of all targets related to gross fiscal deficit and revenue deficit, the Government would not contravene any provision of the Bill and hence cannot be penalized.

Bagchi (2006) studied the effects of reduction in deficit on the social sector services. The findings suggested that an exclusive focus on deficit reduction has had an adverse fall out for public spending on health and education in several states, forcing a shrinkage of the public sector's involvement in the social sector.

Lalwani (2009) found that the post FRMB phase was characterized by rising share of revenue expenditure and a falling share of capital expenditure. Though the requirement in FRMB was if the gross fiscal deficit as a percent of GDP stabiles at 3% with zero revenue deficit, the share of capital expenditure in GDP stabilizes at 3%. In 2009-10, the budget allocations on welfare improving schemes was a mere 8.88% of the total expenditure of the Government ; thus, the deficit was primarily due to interest payments and higher pay scales on account of the Sixth Pay Commission.

Sethi (2009) studied the six least-developed states, and found that in order to meet the targets set in the Twelfth Finance Commission, the examined states cut down expenditure in the social sectors where progress is most crucial to lift them out of their least-developed status.

Simone and Topalova (2009) identified the following as the main weaknesses of the Bill:

(i) Absence of well-defined accounting definitions for target fiscal indicators,

(ii) Insufficient transparency in budget preparation,

(iii) Focus on deficit type targets,

(iv) Lack of expenditure rules and a debt target,

(v) Absence of well-defined sanctions for non - compliance,

(vi) Widely defined escape clauses,

(vii) No independent assessment of compliance with the FRBMA.

Gajbhiye, Hajra, and Rakhe (2008) worked on the recommendations to the Thirteenth Finance Commission (THFC). They suggested that there should be an emphasis on quality of fiscal correction. The authors suggested that the Commission should consider widening the shareable pool of central tax and include service tax. In the context of fiscal restructuring, the THFC may emphasize the criticality of quality of fiscal adjustment for higher capital outlays and enhancement of infrastructure and social sector spending with beneficial impact on growth and employment. Second, in the process of fiscal transfers, the THFC may opt to include the efforts to increase non-tax revenue as a criterion for horizontal devolution and may consider giving due weight to the need to enhance social sector expenditure as a criterion for horizontal sharing. Third, THFC may consider more purpose-specific grants, which would enable enhancement in the level of human development across the states on the lines of the Canadian and Australian federations. The THFC may also revisit the idea of "matching grants" in view of its stringent nature. Fourth, the THFC may consider abolishing the post- devolution non-plan revenue deficit grant in view of the elimination of revenue deficit in the post-FRL phase.

Dholakia (2015) studied the recommendations made by the Fourteenth Finance Commission. Some positives like increase in the tax share going to State Governments & setting up of Fiscal council to make Centre accountable were welcomed. The discontinuation of practice of giving special weight to a fiscal Discipline Index was an unwelcome development. The study indicated that the provisions of the revenue deficit and untied grants is likely to encourage fiscal profligacy among several states.

The varied literature review brings out that there have been few studies conducted on the FRBM Act, its provisions, its limitations, and its effectiveness in bringing about fiscal correction. These studies have focused on the various steps undertaken to improve fiscal consolidation in India. The present study will focus on assessing the performance of both the Central Government & State Government till 2014. This study has not focused on the various provisions and Finance Commissions' implementations, but rather suggests a concept of public sector borrowing requirements (PSBR) as it is not enough to control fiscal deficit, and the borrowing requirements of the public sector must start declining in order to reduce the public debt.

Section III

Assessment of the Performance by State & Central Governments

The enactment of FRBM legislation and consequent decline in fiscal deficit to 4.5 % as percent of GDP in 2004-05 from 7.8% in 1990-91 is seen as a remarkable achievement. This improvement in fiscal deficit could be attributed to three major policy decisions taken by the Government as highlighted by Dr. Narendra Jadhav (Jadhav, n.d.) The policy changes have been enlisted below:

(1) The change in the accounting treatment of small savings consequent upon creation of National Small Savings Fund in April 1999.

(2) Withdrawal of budgetary support in the form of Plan Loans from the States from 2005-06. This has been recommended in the Twelfth Finance Commission. Thus, the burden of raising resources from the market will shift to State Governments.

(3) Non- recognition of disinvestment proceeds as budgetary receipts since 2005-06.

Up until 2007-08, after the introduction of the FRBMA & FRL legislation, there were improvements in the headline fiscal indicators (Please refer to Table 1). In 2007-08, there was an increase in revenues generated from ₹ 43.49 crores in 2006-07 to ₹ 58.06 crores in 2007-08. The same declined in 2008-09 to ₹ 54.06 crores. On the

Table 1. Major Indicators of Deficit (₹ Billion)

Year	Gross fiscal deficit	Gross Primary deficit	Revenue deficit
2003-04	1232.73	-8.15	982.61
2004-05	1257.94	-11.40	783.38
2005-06	1464.35	138.05	923.0
2006-07	1425.73	-76.99	802.22
2007-08	1269.12	-441.18	525.69
2008-09	3369.92	1447.88	2535.39
2009-10	4184.82	2053.89	3389.98
2010-11	3735.91	1395.69	2522.52
2011-12	5159.9	2428.4	3943.48
2012-13	4901.9	1770.2	3642.82
2013-14	5245.39	1444.73	3702.88
2014-15	5311.77	1041.66	3783.48

Source: Reserve Bank of India, Handbook of Statistics (2015).

other hand, the expenditure saw a quick rise from ₹ 57.74 crores to ₹ 70.75 crores in 2007-08 to ₹ 87.78 crores in 2008-09. Thus, the improvement in fiscal situation just before the financial crisis of 2008 was short lived. The reasons for meeting up with targets until 2007-08 were increased tax revenue due to rapid growth, strong corporate profits, and improvement in tax administration. Secondly, increased use of subsidy related bonds to meet current spending needs led to the reduction in current spending (Simone & Topalova, 2009).

The deterioration in fiscal deficit since 2008-09 could be attributed to the financial crisis of 2008. Nonetheless, there were internal factors which were also responsible for the slippage. Few factors like introduction of a number of costly schemes such as agricultural debt write off, expansion of NREGA scheme, implementation of Sixth Pay Commission led to manifold increase in expenditure, and thus, deficit.

The Government can, instead of just focusing on the reduction of fiscal deficit, look at public sector borrowing requirements (PSBR). PSBR is defined as the sum of central fiscal deficit (central fiscal dis-savings), the combined state fiscal deficit (state fiscal dis-savings), plus the savings of the PSUs. In India, the calculation of savings of PSU's is complicated since there are around 290 PSUs at the Central level and over 1,000 at the State level. The net savings of the PSUs requires detailed data from each enterprise. Almost one-third of the PSUs at the Central level run losses, while overall, the PSUs turn in a profit. PSBR gives a consolidated picture of the public accounts. Instead of focusing on Centre fiscal deficit or State fiscal deficit, few countries like Brazil and the UK concentrate on the consolidated fiscal deficit. In India, with the implementation of GST & provisions in the Fourteenth Finance Commission, a greater share of revenues will be shared with State Governments. It is imperative that we look at the consolidated public accounts.

Section IV

The Way Forward

Many countries have adopted fiscal rules in order to focus on bringing fiscal discipline. As noted by Wyplosz (2012), while fiscal rules like FRBMA are neither necessary nor sufficient to achieve fiscal discipline, evidence suggests that "they can and do help". One may look at introducing more flexible fiscal rules that could take into account macroeconomic policies and comprehensive tax reforms. An implementation of GST would help in raising revenues to finance social expenditure. The FRBMA had escape clauses and limited accountability in the event of missed targets. Tighter escape clauses should be introduced. There should be clear guidelines on triggers and their interpretation. Loosely defined clauses allow for misuse. There is also a need to introduce a cap on expenditure growth to complement new target on fiscal deficit. Setting up of a fiscal council is welcomed because with multiple objectives to be achieved by fiscal rules, it's necessary to set up institutional arrangements like fiscal councils.

Reduction in fiscal deficit can be achieved by implementing few measures such as :

(1) Simplifying the tax structure to discourage and control generation of black income. The White paper on Black Economy in India describes that one of the major reasons for the generation of black income is high taxation in the country. The introduction of the Benami Transactions Prohibition Bill 2015 by the Finance Minister Mr. Arun Jaitley is a step towards the same.

(2) Improving tax elasticity, through expansion of coverage, by bringing in progressivity in the whole system and removal of various exemptions in income tax.

(3) Accepting the significance of tax evasion as a major factor leading to less tax collection and identifying and resolving reasons encouraging tax evasion.

(4) The Parliament has passed the GST Bill which will help to increase the revenue by at least 2-3%. The debate is how this increase will be distributed amongst State & Central Governments. This will be discussed in the GST council set up by the Finance Ministry.

(5) Broad-basing direct taxes, that is, improving the tax base.

(6) A more efficient tax administration.

(7) A sound expenditure management through better budgeting techniques and stressing on expenditure prioritization.

(8) Improving the quality of government spending or restructuring of government expenditure as India's level of government spending is less as compared internationally. One way of achieving this could be introducing broad-based social security.

(9) Ensuring that the growth of government expenditure is below the revenue growth and thereby, increasing saving and private investment.

(10) Further reducing the total outlays on subsidies and improving the administration of food and agricultural subsidies. Similarly, improving the delivery mechanism of food grains, so that it reaches the targeted beneficiaries.

Findings and Conclusion

In India, Finance Commissions are responsible for implementation of the various reforms which may facilitate fiscal consolidation. There is a continuous debate on the share of the State & Central Governments. Yes, with implementation of GST, the ambiguity shall reduce. Reduction in fiscal deficit in a year cannot be taken as a measure for fiscal consolidation. In India, it has happened that fiscal deficit has reduced, but the public sector borrowing requirements have not reduced enough. In countries like the UK, the Government uses a concept like public sector borrowing requirements to gauge the health of public accounts. It is a broader concept which helps to gauge the borrowing requirements vis- a- vis spending by the public sector as a whole.

Limitations of the Study and Scope for Further Research

There are constraints on data compilation in India, which does impact the findings. Efforts should be made to compile accounts of all PSUs (Centre owned & State owned) in order to understand the correct position of each of them. This will also facilitate in understanding how much the Government should borrow for investment in infrastructure. In India, the net savings of the non-departmental PSUs and of autonomous institutions is reported in the National Accounts by the Central Statistics Office (CSO).

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