FRBM REVIEW COMMITTEE REPORT

VOLUME – I

RESPONSIBLE GROWTH

A DEBT AND FISCAL FRAMEWORK FOR 21ST CENTURY INDIA

FRBM Review Committee

JANUARY, 2017

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Dated 19th January, 2017

LETTER OF TRANSMITTAL

We are greatly privileged to submit the report of the Fiscal Responsibility & Budget Management Act (FRBM) Review Committee constituted by the Government of India on 17th of May, 2016. The Committee has intensively consulted with a wide-range of stakeholders. It has received the benefit of advice from eminent national, international organisations and domain experts. The Ministries of the Government of India particularly, the Ministry of Finance as well as the State Governments have greatly enriched our understanding of the nuances and complexities involved in crafting a fiscal policy framework which combines the virtue of growth with macro-economic stability.

We believe this report will enhance the broad understanding of fiscal related issues and enable policy action that is best designed to serve the needs of our large and rapidly growing economy.

To facilitate such policy action, we are also enclosing with this Report a Draft Debt Management and Fiscal Responsibility Bill, 2017 along with its attendant Rules. A key feature of this draft Bill is that, in accordance with international best practices, it has been drafted in plain English to ensure it is intelligible to the economist and the ordinary reader alike.

We sincerely thank the Government for having entrusted this endeavour to us.

n.K. Sink

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Acknowledgements

The fiscal affairs of a government unlike a private company are of direct concern to its citizens and to international parties which interact with it. The Committee has been conscious of this from the beginning of its deliberations and we have, therefore, many debts to acknowledge.

The Committee acknowledges with gratitude the valuable time spared by the Hon'ble President of India, Shri Pranab Mukherjee for an enriching interaction with the Committee members and furthering their understanding of this complex issue. It is equally grateful to Shri Arun Jaitley, Finance Minister for his continuing support and guidance.

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Dr. Subhash Chandra Pandey, Additional Secretary and Financial Advisor, Department of Industrial Policy & Promotion (DIPP) and Dr. Prachi Mishra, Specialist Advisor and Head Strategic Research Unit, Reserve Bank of India, have travelled the journey on which the Committee has embarked from the very beginning, and have closely interacted with us and provided valuable technical, analytical and intellectual inputs. Our work has been enriched in substance and focus due to their efforts.

From the private sector, Mr. Sajjid Z. Chinoy contributed to our understanding of many issues especially highlighting the best international practice and the interplay between fiscal and monetary policy as did Mr. Neelkant Mishra, in particular, on the working of the informal sector. Mr. Chetan Ahya, Mr. Ashish Gupta and Mr. Kush Shah also made contributions to the Committee's work. The Committee is grateful to Mr. S. Gurumurthy for giving us access to his papers and analysis of fiscal issues.

Work on Fiscal Responsibility and Budget Management (FRBM) has a long history and we are grateful to Dr. E.A.S. Sarma, the architect of the first FRBM Act and Dr. Y.V. Reddy, former governor of Reserve Bank of India, for giving us a grounded historical context of the key policy issues and architectural framework of the FRBM.

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The Committee was also fortunate to receive contributions from international domain experts. Mr. Martin Wolf wrote a paper with his views on the subject and spared time to interact with the Committee by video-conference. Prof. Fransesco Giovazzi and Prof. Michael Boskin also provided two important papers which brought international experience to the Indian context.

At the institutional level, the National Institute of Public Finance & Policy (NIPFP) and Indian council for Research on International Economic Relations (ICRIER) gave immeasurable support to the Committee's work and have also contributed two expert papers. The NIPFP, in particular, was generous with its time and expert advice which shaped the Committee's thinking on multiple issues, particularly on State level fiscal responsibility.

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The Government of India and the state governments have been generous with their time. We would especially like to place on record, the invaluable support provided by the budget division of the Ministry of Finance headed by Shri Prashant Goyal, Joint Secretary (Budget) and Secretary to this Committee, and Shri Naresh Mohan Jha, Director (Budget). We were also fortunate to have extensive interaction with the office of CAG who was kind enough to assign Shri L. Siddharth Singh, Director in the office of CAG to work with us.

The Committee had wide ranging interactions with various Secretaries of the Ministries of Government of India which contributed in shaping the Committee's thinking and enriched their understanding immeasurably. The Committee also acknowledges the support provided by NITI Aayog for an effective interaction with the State Governments. We are particularly grateful to the Chief Secretaries and Finance Secretaries of State Governments for their valuable interaction and submissions to the Committee.

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The Chairman's office served as a catalyst for logistical support and organising the programme and meetings of the Committee. The office was ably led by Shri S.R. Raja, Under Secretary who coordinated the working of the Chairman's office and interactions with all the stakeholders with the valuable support of Shri R.K. Hirani, Shri S. Gopalakrishnan and Shri Vijayraj Singh, Consultants. It also acknowledges the services of Shri Sunil Choudhari, Deputy Director (FRBM), Shri Naresh Agarwal, Section Officer (FRBM), Shri Ananya Kotia, NIPFP, Ms. Neha Arya, Observer Research Foundation (ORF), Shri Awtar Mehta, Private Secretary to the Chairman, Shri Ram Swrup Meena, Assistant Section Officer and other supporting staff for the smooth functioning of the Committee.

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The Committee was also privileged to interact with former Chief Economic Advisors and Finance secretaries and we thank them for making their time available.

Institutions like FRBM are built and nurtured through co-operative efforts and the co-operation that the Committee has received from such diverse stakeholders reflects the underlying strength of the Indian democratic process.

CHAPTER 1 INTRODUCTION

CHAPTER 1

Introduction

The maxim that "you cannot spend your way to prosperity" is now widely accepted. Fiscal policies must therefore be embedded in caution than exuberance. In restraint than profligacy. Over the years, altered thinking on development priorities is increasingly cognizant of four factors.

First, in a large, populous and vibrant democracy, the Indian perspective on the role of the State is a more nuanced one. In the initial period following our independence, paucity of foreign exchange and inadequacy of food supplies inhibited the pursuit of more broad based development objectives. Scarcity of capital, a nascent private sector, and tardy implementation capabilities resulted in a highly regulated and controlled economy. The outcomes were modest rates of growth and periodic balance of payments crises, financed through foreign aid and access to multilateral funds. Over time, this became a self limiting strategy. Financing public outlays through increased borrowings resulted in high fiscal deficits and severe economic crises. This corrected marginally in the 80s but more substantially in the 90s making macroeconomic stabilisation a central objective. It must however be recognised that even in a country like India with multiple development compulsions the approach to fiscal policies has evolved over time. We have moved away from discretionary fiscal policy to a more rules based approach.

Second, there is no denying that given the large absolute number of poor, the need for substantial infrastructure up-gradation, improving social sector outcomes (particularly education), there continues to be high expectations from the State. Electoral campaigns in India now invariably focus on development outcomes. They increasingly devote attention to the obligation of State and the social compact. Incumbent governments which have improved governance, the quality of life, and physical and social infrastructure have a somewhat higher probability of returning to power. Creating an enabling environment or a regulatory framework which enables private enterprise to flourish has not been part of our electoral psyche. There is a distinct asymmetry between what is relevant in a country like India and the priority of the more advanced economies where promoting private enterprise and investment is an important ingredient of electoral campaigns. In India this is missing and the obligations and expectations of the State centre around improved governance, and higher public outlays. In a Parliamentary democracy this casts an onerous obligation on the State. This remains the case even as private enterprise and entrepreneurial talent have diversified in multiple ways.

Third, fiscal policies need to increasingly balance between compulsions of growth and macroeconomic stabilisation. These are not easy choices to make. They need to balance the dynamics of growth with fiscal prudence essential for macroeconomic stability. The attempt of this Committee has been to seek a symmetry in fostering growth within the framework of macroeconomic stabilisation.

Fourth, tackling jobless growth and accelerating job creation is now a centrepiece policy priority. This is particularly true in an economy like India where demographic compulsions necessitate creation of a million jobs a month and the bulk of employment continues to be within the informal sector. Unfortunately, new technological changes are increasingly labour displacing and productivity improvements are linked with these technological innovations. The challenge, therefore, is not only job creation but quality jobs which do not cripple the competitiveness of the economy.

The efficacy of enhanced public outlays in imparting fresh growth momentum and improving physical and social infrastructure assumes high implementational efficiency. Both the experience and outcomes have been mixed. The broader issue is whether private investments can piggy back on enhanced public outlays? The Public Private Partnership (PPP) as a preferred growth strategy is contingent on multiple factors. The PPPs have been less successful than originally conceived. Issues of dispute resolution, assignments of risks, pitfalls of crony capitalism and securing a regulatory framework which enables optimisation of productivity gains have remained problematic. Fiscal prudence on the other hand has created space for private investment and when blended with sustainable levels of public outlays can have indisputable benefits. However, in a country like India where the incidence of poverty remains exceptionally high, the reliability and quality of infrastructure is weak, and there is a need to improve outcomes on health and education, the morally compelling case for enhanced public outlays can hardly be over stated. Fiscal policies must be cognizant of these obligations. A cohesive social compact enjoins on the State to fulfil these legitimate aspirations. However, sustained long-term growth is inherently contingent on the pursuit of macroeconomic stabilisation policies.

With many economies around the world in fiscal consolidation mode, there is an ongoing and intense debate worldwide about the effects of fiscal policy on economic activity. Keynesian economists believe that fiscal policy can help governments manage the economy to ensure full employment. The argument is that when private economic activity is not creating enough demand in the economy to create full employment, fiscal policy can be used to increase demand and therefore stimulate enough economic activity to create more jobs, especially in emerging and developing economies with infrastructure needs, and lack of adequate incentive for markets to produce public goods. The evidence regarding the effectiveness of activist fiscal policy, and in particular, discretionary fiscal policy, however, is mixed and limited. In emerging economies, it remains challenging to deliver discretionary fiscal measures quickly, make them well targeted, and most importantly, once put in place, to withdraw them sufficiently quickly to preserve fiscal sustainability. The effects of fiscal stimulus are constrained in emerging markets also because of credibility issues. Increases in risk premiums can reduce fiscal multipliers sharply, and can even render them negative. Conversely, fiscal prudence can increase credibility, and create confidence among investors, especially among foreign investors who are becoming more important in an increasingly financially integrated world.

In the "rules versus discretion" debate that has constantly dominated the discourse in many emerging markets, experience suggests that given the compulsions of Parliamentary democracy in many countries, the rules based approach has multiple advantages. Unfettered discretion has often resulted in unsustainable macroeconomic policies and has led to recurring economic crises. Unsustainable levels of borrowing and the resulting volatility in growth rate reduces credibility and confidence of the investor community. Those emerging markets that have been governed by incentive-compatible, rules-based frameworks, tend to experience better macroeconomic outcomes.

India's own recent experience illustrates this starkly. The years in which India adhered to the first FRBM framework were also the years characterized by strong growth, low inflation and no glaring external and internal imbalances. In contrast, the years in which it went off the FRBM framework – post the global

financial crisis in 2008 – and did not adhere to the envisaged path of fiscal consolidation, were also the years characterized by the most macroeconomic instability, pushing the economy to the brink during the "taper tantrum" crisis of 2013. The same is true of monetary policy. The move to headline CPI inflation targeting was accompanied by a dramatic fall in inflation, although several factors also contributed significantly.

Yet, we need to adopt "smart rules" that facilitate constrained discretion. One of the shortcomings of the first FRBM Act was that there was no mechanism in place in the revenue-buoyant boom years of 2003-2007 – to create "fiscal space" that could be used later for spending on productive activities. Instead, when the global financial crisis hit in 2008, the resulting fiscal expansion took the deficit very far away from the original target. In particular, there were no carefully-defined "escape clauses" that capped the expansion which turned out to be excessive. All these institutional shortcomings contributed to the macroeconomic uncertainty that built up between 2010 and 2013, culminating in the mini-BoP crisis around the taper tantrum. So it's important to have "rules", but they need to be "smart" rules.

This is the larger backdrop of the report: a recognition of the government's widely acknowledged track record and hard work in bringing about macroeconomic stability, which needs to be supported going forward; and at the same time a recognition that fiscal thinking has evolved around the world. It is against this backdrop that the Committee set about to evaluate the first FRBM – what worked and what didn't - and then set about to propose a "next generation" fiscal framework that tries to enhance credibility, and transparency, build institutions, and create some degree of flexibility to external shocks.

Backdrop: the first FRBM

As alluded to above, periods of macroeconomic instability in India have invariably been pre-dated by fiscal adventurism. In the 1980s, for example, the combined fiscal deficit had widened to 8.6 % in 1984-85 and breached 9% of GDP in the ensuing years. While there are many explanations for the 1991 crisis, including the breakup of the Soviet Union, the Kuwait war affecting remittance flows, the increase in petroleum prices; an indisputable proximate cause was the unsustainable fiscal deficit in the years preceding the 1991 crisis. Following the crisis, fiscal corrections were made coupled with other sector specific structural reforms. A combination of these macro policies and other reforms stabilized the economy. It unleashed the entrepreneurial instincts of the private sector and with progressive dilution of financial sector repression, it enhanced competitive efficiency and our economic performance.

However, somewhat later in the 1990s, fiscal deficits again rose sharply to over 10%. This time the government acted with alacrity and introduced the Fiscal Responsibility and Budget Management Bill in Parliament in the year 2000. Alas, this languished till its final enactment on the 26th of August, 2003. The FRBM Act proposed that the central and state deficit would each be progressively reduced to reach 3% of GDP. It was felt that instead of corrections through executive action, adherence to fiscal norms were more likely if they were embedded in a legal framework. Importantly, the Act did not borrow the 3% limit from the European Union's (EU) fiscal rules as is commonly believed. The fiscal deficit target of 3 percent was, in fact, adopted with two considerations in mind -a) consistency with the forecast trend of household financial savings and b) the target being considered sufficient for reducing the stock of outstanding government liabilities to the level of 50 per cent of the GDP within 10 years.

The FRBM Act did make a significant difference. Fiscal deficits came down impressively in subsequent years. However, there was a "pause button" on the FRBM law post the global financial crisis, and many of the earlier gains were eroded. This significantly impeded credibility, and it was only in September 2012 that a path towards fiscal consolidation was recalibrated. That said, the sense was still that the FRBM Act -- though it has its shortcomings that this Committee aims to fix - created the right incentives to ensure responsible policymaking. Chapter 2 (Historical Perspective), provides in greater detail, the historical background leading to the enactment of the FRBM Act, 2003, and also traces the evolution of our thinking on fiscal policies since then.

Why a new FRBM?

India is in a very different place than it was in 2003, when it adopted the first FRBM Law. India is increasingly getting financially integrated with the world economy. Capital flows have increased dramatically over the last five decades (gross capital flows increased 81 times since 1970); but the real takeoff happened since the early 2000s. In particular, portfolio flows have increased sharply. Although there still exists separate investment caps on sub-accounts of foreign institutional investors (FIIs), foreign holdings in government and corporate bonds currently stand at US\$ 22.5 bn and US\$ 23.7 bn respectively (compared to, for example, US\$ 8.5 bn and US\$ 15bn in 2011). Increased international financial integration has coincided with domestic financial sector reforms. Policy induced frictions, e.g. on account of the Statutory Liquidity Ratio (SLR) imposed on banks to hold a minimum fraction of their deposits in the form of government bonds, have also come down from 30% in the late 1990s to 21.5% recently. In fact, the de facto SLR requirement is even lower at 11.5%. This is because 11% of the total investment in SLR securities can be included in the Liquidity Coverage Ratio (LCR) envisaged as a form of prudential regulation under Basel III, and are therefore no longer captive. This has direct and important implications for the fiscal framework, as the extent of automatic financing of high fiscal deficits by banks through financial repression has reduced, and is likely to decline further in the future, and intensify the challenges on the fiscal front going forward.

More recently, in an extraordinary and unanticipated domestic development, the Government of India, withdrew the legal tender status of Rs. 500 and Rs. 1000 banknotes. The intervention was carried out to tackle the problem of counterfeit currency, which is increasingly being channeled towards funding terrorism and other illegal activities, and to effectively nullify black money hoarded in cash. Some early high frequency indicators such as the Purchasing Managers' Index (PMI), and auto sales, especially of two-wheelers and commercial vehicles, are suggestive of a negative effect on demand in the month following the intervention, although non-oil non-gold imports, a commonly used proxy for domestic demand, have held up till now. Anecdotal evidence also suggests that there have been disruptions in supply chains due to the withdrawal of high-value currency notes. These are likely to be transient. However, over a longer period, as the parallel economy moves to "white", the move is anticipated to lead to an increase in accounted income, and have a positive impact on tax collections by the government. Moreover, the expectation is that over the medium-term, more and more households would be induced to move from cash to digital forms of payments, which would reduce transaction costs, and lead to gains in efficiency for the economy.

At the same time, the global backdrop has also changed substantially. The prolonged global slowdown – characterized by some economists as a secular stagnation - developments in China, uncertainties in the

Eurozone, demographic imbalances in several countries (like the aging population of Japan) significant debt burdens, low inflation, and the pursuit of unconventional monetary policy by many central banks under pressure to restore growth and achieve their inflation targets, have made the international environment increasingly challenging. More recently, the results of the US presidential election, the anticipation of expansionary fiscal policies and reflation, continued tightening of monetary policy by the Federal Reserve, and the perception of increased protectionism in the United States going forward, have all made the global environment highly uncertain. These external challenges also come at a time when India has become increasingly globalized. Trade as percentage of GDP has increased significantly even in the last decade necessitating policymaking to become far more cognizant of global events. There is no doubt that domestic policies must reckon with an increasingly challenging, uncertain, and volatile exogenous environment.

Simultaneously, however, the thinking on fiscal rules globally has changed (as discussed more fully in Chapter 3, ("International Experience"). Most countries have multiple fiscal rules. Furthermore, where practicable, these rules have provisions to allow fiscal space for exogenous shocks. Finally, they are complemented by independent fiscal councils, escape clauses, and automatic correction mechanisms - to impart transparency, flexibility and credibility to the framework.

The Committee's Mandate

It is against this backdrop that the Honorable Finance Minister indicated in the Union Budget of 2016-17 that:

"The FRBM Act has been under implementation for more than a decade. Hope Central and State Governments have made significant gains from the implementation of this Act. There is now a school of though, which believes that instead of fixed numbers as Fiscal Deficit targets, it may be better to have a Fiscal Deficit range as the target, which would give necessary policy space to the Government to deal with dynamic situations. There is also a suggestion that fiscal expansion or contraction should be aligned with credit contraction or expansion respectively, in the economy. While remaining committed to fiscal prudence and consolidation, a time has come to review the working of the FRBM Act, especially in the context of the uncertainty and volatility, which may have become the new norms of global economy. I therefore propose to constitute a Committee to review the implementations of the FRBM Act and give its recommendations on the way forward"

In pursuance of these budget announcements, this Committee was constituted on the 17th of May, 2016 with a wide ranging Terms of Reference which *inter alia* included the following:

1. To review the working of the FRBM Act over last 12 years and to suggest the way forward, keeping in view the broad objective of fiscal consolidation and prudence and the changes required in the context of the uncertainty and volatility in the global economy;

2. To look into various aspects, factors, considerations going into determining the FRBM targets;

3. To examine the need and feasibility of having a 'fiscal deficit range' as the target in place of the existing fixed numbers (percentage of GDP) as fiscal deficit target; if so, the specific recommendations of the Committee thereon; and

4. To examine the need and feasibility of aligning the fiscal expansion or contraction with credit contraction or expansion respectively in the economy.

The Consultation Process

The Committee while formulating their work procedure has undertaken extensive consultations with multiple stakeholders to address the aforesaid Terms of Reference. In seeking best international practice, extensive interactions were held with multilateral institutions like the World Bank, International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), International Labour Organization (ILO), the European Union (EU) and the Asian Development Bank (ADB). The Committee held extensive discussions with all relevant central ministries and government organizations. Discussions were also held with Chief Secretaries and Finance Secretaries of the States. The Comptroller and Auditor General (CAG) made a number of useful suggestions in their fruitful interactions with the Committee. During its visit to Mumbai, fruitful interactions were held with the Reserve Bank of India, leading banks and financial institutions, Non Banking Financial Companies (NBFC) and the Life Insurance Corporation of India (LIC). Finally, the Committee also had consultations with key international credit rating agencies to understand the process and methodology underlying their ratings, and in particular the role of fiscal policy and debt in shaping country ratings. The Committee was also fortunate to receive several papers, presentations, and responses by many domain experts which have enriched its understanding of the complex issues involved.

A 21st Century Debt and Fiscal Paradigm

Debt is the new anchor

Based on extensive internal and external consultations, cross-country experience, and several rounds of discussions and deliberations within the Committee, the Committee recommends a move to public debt to GDP ratio as a medium-term anchor for fiscal policy in India. The recommendation is based on several arguments discussed in detail in Chapter 4 (A 21st Century Debt & Fiscal Paradigm).

The Committee believes that a transparent and predictable policy framework is one that is rule-based. Central to a credible framework is the concept of an anchor. An anchor ties down the final goal of policy, and the expectations of economic agents adjust accordingly. By acting as a constraint on policy discretion, an anchor dis-incentivizes time inconsistency, including due to pressures from interest groups. There are four key economic arguments that form the basis for moving to debt. First, the standard government solvency constraint suggests debt to be the ultimate objective of fiscal policy. Second, there was broad consensus that a debt ceiling combined with fiscal deficit as an operational target can jointly provide a robust fiscal framework for India. Third, India, with a public debt close to 70% of GDP, currently stands out as among the most indebted countries amongst the relevant peer group of emerging markets. Finally, public debt exemplifies an important factor in the assessments of rating agencies. In addition to these economic arguments, a non-economic, albeit powerful and convincing rationale for moving to debt as the anchor put forth by several members of the committee, and considered to be particularly relevant in the Indian ethos, was that "debt", and "debt repayments" are concepts that can be communicated easily to the public, and are also embedded in the psyche of the ordinary citizen.

There are also two common myths regarding public debt, which were dispelled by several members of the Committee. First, a common perception seems to be that countries like India with a high domestic debt burden but a small fraction of external debt should not worry about public debt. One reason for this perception is the belief that governments can never default on domestic debt as they can always print money

and inflate away their debt. However, it was recognized that, in practice, high inflation could be costly as well. Moreover, domestic defaults do occur, and evidence suggests that these can be costlier than external defaults. In fact, there are ongoing discussions in Basel to attach risk-weights to sovereign paper – irrespective of whether the borrowing is from domestic or external sources. A second commonly perceived wisdom is that debt to GDP ratio has been on a declining trend in India, therefore, it should not constitute a source of concern going forward. The Committee agreed that in the Indian case, rather than fiscal prudence, it is in fact, a favorable interest rate growth differential arising from high growth rates and relatively low interest rates that has facilitated the consolidation of debt. A negative interest growth differential, however, cannot be a long-run equilibrium, and may not persist over time. The trend has already begun to slope upwards, which may make it difficult to sustain India's debt in the long run. Moreover, while India's debt ratios have improved over time, its incremental debt to GDP ratio, which is equal to its fiscal deficit, remains one of the highest among emerging markets.

Several different approaches were employed to determine an appropriate or prudent debt ceiling for India. For example, a debt threshold was calibrated by estimating the level of debt to GDP at which debt has a negative effect on economic growth. A second approach relied on the concept of "debt intolerance", which refers to levels of debt where emerging markets have difficulty accessing capital markets. Based on this approach, the maximum threshold that will keep India from dropping to a more debt intolerant club was estimated. An alternative methodology we employed distinguished between an "anchor" and a "cliff" for public debt. A cliff is a level of debt beyond which a country goes into debt distress, the government's solvency or liquidity is put into question, and the government loses control over its debt dynamics. An anchor, on the other hand, is defined as a level such that there is a low probability of reaching the "cliff" over a given horizon if negative shocks occur. The idea is that the guardrail of fiscal policy needs to be set far enough from the cliff such that there is a sufficient buffer when countries are subject to macro and fiscal shocks.

Although every approach has limitations, taken together with cross country evidence and assessment methodology of rating agencies, they may suggest a ceiling of around 60% of GDP for general government debt in India. A 60% of GDP debt ceiling would still be above the average for emerging markets, but it would provide sufficient space for greater private investment and higher growth, offer a sufficient buffer when the country is subject to macro and fiscal shocks, make available some headroom for future contingent liabilities, and would also be a level of debt that is sustainable under plausible assumptions on primary balances and interest-growth differentials.

Our analysis also suggests a ceiling of around 40% for the central government debt. A ceiling of 40% GDP for the centre is based on calibrating a level beyond which additional borrowing would crowd out space for productive investment and social spending, and have an adverse effect on economic growth. The Committee considered the balance of 20% of GDP as a prudent ceiling for the states. Currently, the level of debt stock is much higher for the centre compared to the states (49.4% and 21% respectively). Therefore, while the proposed framework envisages consolidating the centre's debt stock from 49.4% to below 40%, states are assumed to stay at roughly the same level.

With Fiscal Deficit as the Operational Target

A medium-term debt ceiling is not sufficient by itself, and needs to be combined with a key operational target, which the Committee recommends to be the fiscal deficit. A debt sustainability analysis (DSA) conducted for the central government suggests that a debt ceiling of 40% of GDP for the central government

can be attained in the next 5-6 years if the government sticks to the fiscal path envisaged under the present FRBM; and even sooner if the government follows a stricter path. However, a relaxation of the target would delay attaining the debt ceiling, especially if the relaxation leads to a loss in credibility, and higher costs of borrowing. Each scenario entails costs and benefits. Similar to the present FRBM, the Committee relied on a savings-based argument to arrive at a path for the operational target. Based on the latest data from the CSO and the RBI, net household financial savings were reported at 7.6% of GDP in FY15. Further, India's external borrowing needs, proxied by its sustainable current deficit India in the medium-term, are estimated at roughly 2.3% of GDP. Therefore, a total of around 10% of GDP of household savings and external borrowing would be available for the public and private sectors in the medium-term, which the Committee assumed to be allocated equally between the two. This would lead to a combined fiscal deficit of the centre and the states of 5% of GDP, and at the same time ensure an investment of 5% of GDP. The 5% general government deficit, divided equally between the centre and the states, would imply a 2.5% deficit for the centre in the medium-term.

The Committee relied on two additional lines of thinking to recommend a fiscal deficit of 3% of GDP during FY18, FY19, and FY20. First, the Committee believes that the cost to credibility of deviating from a path of fiscal deficit agreed on by two successive governments can potentially be substantial. Second, India's own past experience when it has deviated from a path of fiscal prudence guided its recommendation. An unsustainable fiscal deficit was an indisputable cause of the BoP crisis in 1991; and post global financial crisis, the years when India did not adhere to the envisaged path of fiscal consolidation, were also associated with macroeconomic instability, leading to the "taper tantrum" crisis of 2013.

To summarize, after intense discussions, debate, and several internal presentations, and taking into account the tradeoffs, the Committee recommends a path of medium-term consolidation, where the fiscal deficit is envisaged to be on a glide path, to be reduced to 2.5% of GDP, consistent with reducing the centre's debt to 40% by FY23. In the recommended scenario, fiscal deficit is assumed at 3.5% in FY17, decline to 3.0% in FY18-FY20, 2.8% in FY21, 2.6% in FY22, and 2.5% in FY23, and thereafter.

In addition to a path for the headline fiscal balance, the Committee, in line with the present FRBM and the Medium Term Fiscal Policy Statement (MTFP) in the Union budget, also recommends that the central government reduces its revenue deficit to GDP ratio steadily by 0.25 percentage points each year, to reach 0.8% by FY23, from a projected value of 2.3% in FY17. A path for revenue deficit has been included based on several discussions within the Committee and with outside experts including policy makers who find revenue deficit as a useful goalpost in their day-to-day policy making process. The distinction between revenue and capital accounts is, in fact, rooted in the history of budget making process, and even in the Constitution of India. The revenue deficit broadly measures the extent of borrowings to be used for revenue expenditures. The Committee believes that borrowings for expenditures that are of a recurrent nature, and that need to be incurred every year, may not be desirable, and should be tax-financed – the idea underlying the so called 'golden rule'. The envisaged path of revenue deficit implies that the revenue to fiscal deficit ratio would reduce steadily to 32%, from its current level of 66%, and from a high of 80% in early 2000s, and leave sufficient room for increased capital spending to maximize growth. The envisaged path is less ambitious, albeit more realistic, than the MTFP statement presented in the FY17 budget, which assumes a 1 percentage point of GDP reduction in revenue deficit over the next two years.

The Committee also debated the implications of a change in the assumptions underlying the DSA for the framework we are proposing. What if nominal GDP growth is higher, *ceteris paribus*? What would that imply for the debt ceiling, and for the path of fiscal deficit? It was recognized that the *ceteris paribus* assumption may not be very realistic – as typically interest rates would also be higher in a growing economy, perhaps due to policy responses, but also due to increased demand for credit. Hence the interest-growth differential [r-g], which matters for debt dynamics, may not be very different as higher values of r and g would go together.

Overall, there was broad agreement that the key elements of the proposed fiscal framework - a medium-term debt ceiling, and a fiscal deficit path consistent with achieving that ceiling - should not be altered even if the assumptions underlying the DSA change. The government should stick to the envisaged fiscal deficit path and if needed, re-calibrate its path of primary deficit depending on shocks or changing assumptions relating to key parameters like nominal GDP growth, or interest rates. If additional fiscal space becomes available, it should be spent on productive activities. On the contrary, if there is reduced fiscal room, government can use the opportunity to reduce spending on unproductive activities e.g. on subsidies.

One disadvantage of headline fiscal balance rules is that they do not have counter-cyclical properties. For example, when growth - and therefore revenues - are above potential, policymakers should ideally be reducing fiscal deficits, and thereby creating fiscal space that can be used in downturns. However, adhering to a fiscal deficit target necessarily results in those extra revenues being spent. Similarly, during downturns, as automatic stabilizers work, one would want the fiscal deficit to expand, but that is precluded by adherence to a headline deficit rule, thereby making fiscal policy pro-cyclical. There is widespread evidence that fiscal policy in emerging markets tends to be procyclical rather than counter-cyclical, in part because of political incentives to run large deficits in good times when financing is available. To overcome these problems, some countries adopt "cyclically-adjusted deficits", which has the benefit that, by construction, they have economic stabilization properties by explicitly accounting for the state of the business cycle. Another option which countries are increasingly adopting are "expenditure rules" which set limits on total/primary/current spending and can be specified as either a limit on the ratio to GDP/revenue or nominal or real growth. The Committee discussed these issues at length, but there was unanimous agreement that operationalizing cyclically adjusted deficits or ceilings on expenditures may not be practical in the Indian context at this point of time. As institutions develop, with data constraints and concerns relating to enforcement waning, future reviews of the fiscal framework could consider more sophisticated rules that address the important issue of counter-cyclicality. However, the Committee is cognizant of the need to provide flexibility in the case of exogenous shocks. Specifying "escape clauses", as well as an additional clause that introduces increased prudence in good times, addresses this issue (more on this below).

Fiscal Council, Escape Clauses, and Buoyancy

In order to build institutions, the Committee recommends setting up an independent Fiscal Council. We foresee the Council will serve both an ex-ante role – providing independent forecasts on key macro variables like real and nominal GDP growth, tax buoyancy, commodity prices – as well as an ex-post monitoring role, and also serve as the institution to advise on triggering the escape clause and also specify a path of return.

In addition, as alluded to above, next generation frameworks are characterized by institutional development and some degree of fiscal flexibility to respond to shocks. The latter is incorporated under an "escape clause" wherein temporary and moderate deviations from the baseline fiscal path are permitted under exceptional circumstances and in reaction to external shocks. This is commonplace in most modern fiscal frameworks as a means to ensure that fiscal policy does not exacerbate the initial shock. To ensure that these "escape" clauses are not mis-used, the Committee has ensured that:

- They have been defined very narrowly and specifically, unlike the first FRBM wherein the definition of "exceptional circumstance" is defined very opaquely and is liable to mis-use,
- They are constrained by the quantum of the deviation, and
- A path of returning to the baseline is specified.

In particular, the Committee proposes escape clauses for:

- Over-riding consideration of national security, acts of war, calamities of national proportion and collapse of agriculture severely affecting farm output and incomes.
- Far-reaching structural reforms in the economy with unanticipated fiscal implications.
- Sharp decline in real output growth of at least 3 percentage points below the average for the previous four quarters.
- The deviation from the stipulated fiscal deficit target shall not exceed 0.5 percentage points in a year. (One of the members, Dr. Urjit Patel, however, is in favour of 0.3 percentage points).

The Escape Clauses can be invoked:

- (a) by the Government after formal consultations and advice of the Fiscal Council.
- (b) provided it is accompanied by a clear commitment to return to the original fiscal target in the ensuing fiscal year.

Buoyancy

The Committee also felt that the policy responses to sharp changes in ouptut growth should be symmetric. If there is a sharp increase in real output growth of at least 3 percentage points above the average for the previous four quarters, fiscal deficit must fall by at least 0.5 percentage points below target. Similar to the escape clause, the buoyancy clause can be invoked by the Government, after formal consultations and advice of the Fiscal Council.

Chapters 7 ("Fiscal Council") and 8 ("Escape Clauses"), lay out in more details the constitution and functioning of a Fiscal Council, and the proposed escape clauses, respectively.

Alternative proposals discussed by the Committee

Several alternative strategies were also deliberated within the Committee. First, as specified by the ToR, the Committee examined the need and feasibility of having a 'fiscal deficit range' as the operational target instead of fixed numbers proposed in our framework. The Committee, however, unanimously ruled this out for three reasons. First, consultation with domain experts, particularly in the context of Parliamentary democracies, suggests that a range for the fiscal deficit more often than not tends to get operationalized at the upper end of the range. Second, some amount of flexibility is automatically built in the proposed

framework, if fiscal deficit targets are fixed to one decimal, which allows for some space for changes within the decimal point. Finally, the Committee agreed that fixed targets rather than a range can make fiscal policy more predictable, and therefore enhance investor confidence.

As required by the ToR, the Committee also debated at length on the need and feasibility for explicitly aligning fiscal policies with credit behavior in the economy. In order to address this ToR, Chapter 6 ("Anatomy of Credit") examines closely the behavior of credit, and its linkages with investment and output, especially in the context of the recent slowdown of credit in India. We document that there has been a significant slowdown in credit growth in India since the global financial crisis. Importantly, the movements in credit have mirrored those in investment and output. The report argues that the credit slowdown over the last few years can be explained by several factors viz. weak firm performance and stressed corporate balance sheets resulting from a combination of domestic and global factors leading to subdued demand for credit; stressed balance sheets of banks resulting in weak supply; and substitution by corporates away from bank towards non-bank sources of credit. Overall, the findings in the report, however, do not suggest any need or feasibility for explicitly aligning FRBM rules with credit behavior in the economy.

Finally, another option considered by the Committee was to use "primary balance" (defined as total government revenue minus non-interest costs) as the principal quantifiable objective of fiscal policy with zero general government primary balance as the medium-term target, and to also have primary balance as an operational target, with a glide path and a fixed annual reduction in primary deficit. The Committee could not be persuaded to pursue this approach based on practicality in its implementation, tenuous economic logic and mis-alignment with best international practices. A decline in primary deficit is neither necessary nor sufficient for debt ratios to decline. In fact, for States, a gentle glide path for primary deficit could make debt to GDP explosive with questionable debt sustainability. Besides, the share of interest payments in the centre's fiscal deficit is as large as 92% and can scarcely be excluded from Government's fiscal stance. Further, India as a member of the G20 is bound by acceptable international rules and standards, and no other large country has a permanent fiscal rule based on primary balance embedded in their legislation. Most importantly, while debt is a concept embedded in the psyche of an average citizen that can be easily communicated to the public, primary balance as a concept cannot be easily understood even by the academic community, much less an ordinary citizen.

Interaction Between Centre and States

Given India's vibrant federal structure, increased devolution of resources from the Centre to the States under the 14th Finance Commission, and the fact that total state expenditures (as a percent of GSDP) is now even greater than the Centre, state finances have become a crucial lynchpin in India's fiscal framework.

Chapter 5, ("State Level Fiscal Responsibility Legislation"), therefore, deals with the interaction of central and state finances. Many state governments have adopted state-level fiscal laws and sought to adhere to a 3% fiscal deficit target for States under the previous FRBM. The chapter argues for at least a continuation of the present practice. However, the Committee recognizes that the quality of compliance has sharply deteriorated through an increase in contingent liabilities such as the debt of the power utilities which are to be explicitly taken over by the state governments under the Ujjwal DISCOM Assurance Yojana (UDAY) scheme, irregularities in food credit accounts of state governments with commercial banks, off-balance-sheet expenditures and accounting engineering to evade the stated target. These deviations need

to be discouraged and a combination of penalties and incentives needs to be imaginatively crafted for enabling the States to better conform to prescribed fiscal norms. On the whole, states must partner the central government in pursuit of the overall debt trajectory of seeking a 60% debt to GDP ratio. This would be in the ratio of 40/20, namely, 40% for the central government, and 20% for the states. The detailed guidelines and modalities for the states to achieve 20% (from the current level of 21%) can be considered going forward by the Fifteenth Finance Commission.

Congruence of Fiscal and Monetary Policy

Finally, we deal with the importance of establishing congruity between monetary and fiscal policy. While it is difficult to provide a mechanical linkage, it is axiomatic that both monetary and fiscal policies must act in tandem to ensure growth and macroeconomic stability. There are several channels of interplay between monetary and fiscal policies – e.g., the effect of both monetary and fiscal policies on aggregate demand, the effect of monetary policies on public sector debt dynamics, the effect of distortionary taxation on central bank policies, the effect of inflation on the budget, and on government borrowing rates, due to changes in inflation risk premia. The explicit institutional frameworks that govern monetary and fiscal policies, say Inflation Targeting (IT) regimes and Fiscal Rules (FRs), can also interact with each other. Although there are no established international best practices, the available evidence appears to suggest that the combination of FR and IT, and in particular, FR before IT, is associated with better macroeconomic and fiscal outcomes. This is what India has done in practice.

The Monetary Policy Committee and the recent amendments to the RBI Act enjoin the RBI to secure a central target of 4% inflation. Against this public and legislative commitment, a profligate fiscal policy would force the RBI to tighten monetary policy to levels perhaps higher than what may be optimal. For example, the dramatic fiscal expansion post the global financial crisis contributed to the surge in inflation and forced the RBI to sharply raise interest rates. Price stability mandate is now enshrined in the RBI act, with the operational target being decided, and to be reviewed jointly, by the government and the RBI. Given that the target has already been agreed on with the government, it is, in effect, the responsibility of both the government and the RBI to achieve the target, and explain any deviations from it. Indeed, the experience in India conforms that fiscal and monetary policies have generally acted as complements. For example, low real interest rates were correlated with an expansionary fiscal policy immediately after the Global Financial Crisis (GFC), while higher interest rates coincided with fiscal consolidation thereafter.

Putting it All Together

The Committee believes that this report seeks to align our fiscal regime to the best international practices suitable to the needs of a large growing economy. In the end, growth must remain the central objective of overall economic policy. A rapidly growing economy is the only medium we know to improve the quality of life and address poverty. However, to ensure macroeconomic stability and intergenerational equity, we must strive for responsible growth. That is why the report is titled "Responsible Growth: A Debt & Fiscal Framework for 21st Century India".

To conclude, Mahatma Gandhi had said that "*economics that hurts the moral well being of an individual or a nation are immoral and therefore sinful*". Rising expenditure financed through unsustainable borrowings and high public indebtedness hurts the moral well-being of a nation. That is why "responsible" growth is our compelling obligation and necessity. While concluding a debate on borrowing under Article 268 of the Constitution, Dr. B.R. Ambedkar had said "we hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the Union. I go further and say that I not only hope but I expect that the Parliament will discharge its duties under this Article". The enactment of this Debt & Fiscal Responsibility Act and the supporting legislative changes can indeed achieve the fulfillment of Ambedkar's vision and commitment given during the debate in the Constituent Assembly.

The accompanying volumes include papers and presentations from the wide-range of stake-holders that the Committee interacted with. Specifically, the attached Volume II includes presentations from international organizations. Volume III includes papers and presentations from consultations with the Centre and States, and Volume IV includes papers and presentations from "domain experts" who interacted with the Committee and guided its thinking.

CHAPTER 2 HISTORICAL PERSPECTIVE

CHAPTER 2

Historical Perspective

Introduction

The FRBM Act, 2003 is a law enacted under Article 292 of the Constitution (read with Article 283) empowering the government to borrow upon the security of the Consolidated Fund of India 'within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed'. Article 293 stipulates restrictions on the power of State governments to borrow. Extracts from the animated and illuminating debate on government borrowings in the Constituent Assembly are enclosed with this chapter.

The statutory regulation of public debt had been repeatedly recommended by the Estimates Committee, the Public Accounts Committee, and the Reserve Bank of India (RBI) since 1957. But it had not been accepted by the government contending that the extent of government borrowings, including 'deficit financing' (if any) were clearly indicated in Budget documents and therefore had the tacit approval of the Parliament.

Noting that the enactment of law under Article 292 was permissive – not mandatory – the government had also argued that explicit limits to be imposed by law on government borrowings would have to cover both market borrowings as well as 'deficit financing' and thus would have to be sufficiently high. While wide limits would provide no real checks, it said that narrowing them would be impracticable and further that Public Accounts liabilities are not explicitly covered by Article 292.

Against this background, an initiative was taken in the Ministry of Finance¹ to study international legislative practice in controlling public debt and deficits to suggest a draft 'Public Debt and Guarantee Limitation Act' for India. The draft sought the elimination of the revenue deficit within five years, a steady reduction in the fiscal deficit, capping the growth rate of the stock of liabilities at the growth rate of net tax revenue receipts, the elimination of asset-liability mismatches on a book value basis within 10 years and capping outstanding guarantees to 10 percent of outstanding liabilities.

These provisions not only capped public debt using endogenous budgetary variables (book value of physical and financial assets) but also mandated revenue generation to recoup the progressive use of borrowings for consumption resorted to in the past and the eventual use of borrowed funds for creation of productive assets. The use of such endogenous variables rather than exogenous variables like GDP was suggested to make the caps flexible and operational. To bring Public Account liabilities within the ambit of the proposed law, Article 292 was to be supplemented by Article 283 with stipulated changes in accounting to formalize use of cash surplus in the Public Account to bridge the cash deficits in the Consolidated Fund. The draft also included 'escape clauses', allowing the obligations to be relaxed through a Presidential Proclamation of 'a grave natural calamity' or when a proclamation of emergency (grave threats to internal or external security) under Article 352 was in force. Since fiscal transparency was perceived as the ultimate enforcement tool in a democracy, the draft law also stipulated annual disclosures in the nature of reporting on public sector borrowing requirements and general government debt relating to States, public sector enterprises and parastatal entities.

¹ Paper on "Legislative regulation of debt, deficit and guarantees in India", 1999 authored by S. C. Pandey, Director(Budget)

In 1999, there was acute fiscal stress. During 1994-99, the average fiscal deficit of the Union was over 6 percent of GDP. The total liabilities of the Union increased from ₹6,30,071 crore in 1994-95 to ₹10,12,486 crore in 1998-99. If the external debt were to be revalued at current exchange rates, *i.e.*, at the rates prevalent on March 31, 1999, total Central government liabilities would have been about 50 percent of GDP, almost as high as they were in the crisis years of the early 1990s. Even so, the assessment of public debt would be incomplete because the liabilities of the State governments also need to be considered for fair international comparison. At the end of 1998-99, total Central government liabilities were ₹875,625 crore (at historical rates of exchange for external debt) whereas its total assets at book value (cumulative capital expenditure at historical cost plus outstanding loans) stood at ₹528,399 crore. The gap represented cumulative debt incurred to finance revenue expenditures. The average cost of borrowing being significantly higher than the average rate of return from investments compounded the problem by continually widening this mismatch. The rising interest burden became a matter of deep concern. Policy reforms in debt management since 1991 led to a sharp increase in the interest burden on the budget- the Union Government consciously chose to resort to borrowing from the open market to finance fiscal deficits and to move away from the monetization of deficits through constant rollovers of Treasury Bills issued at rates far below the market rate. Also, controls on investments of Insurance/Pension/Provident Funds etc. and statutory preemptions of investible funds of banks were whittled down substantially to reduce financial repression through captive sources of financing deficits.

Sarma Committ ee on Fiscal Responsi bility Legislati on (2000) Considering the above-mentioned study report and draft law and taking note of the prevailing fiscal stress, the Finance Minister constituted a committee on January 17, 2000 (Chairman: Dr. E.A.S. Sarma, then Secretary, Economic Affairs) to study all cognate aspects and prepare a draft legislation. The Committee submitted its Report on July 4, 2000. It identified three categories of indicators for numerical fiscal targets with specific time frames: (i) revenue and fiscal deficits; (ii) total liabilities/debt; and (iii) borrowing from the RBI. Eight deficit indicators were considered but for simplicity and focused attention, the Committee recommended ceilings for only two – fiscal and revenue deficits. It sought to discourage excessive deficit for accumulating capital assets by mandating a progressive reduction in the fiscal deficit by 0.33 percent of GDP at the end of each financial year so as to reduce to the fiscal deficit to no more than 3 percent of GDP in five years ending on March 31, 2006. The Committee also recommended the complete

elimination of the revenue deficit in five years ending on March 31, 2006 through annual reductions of 0.5 percent of GDP, and to build up an adequate revenue surplus thereafter. This would ensure the observance of the 'golden rule', *i.e.*, revenue surpluses would be used for the purpose of discharging liabilities in excess of assets. In addition to limits on the deficit, the proposed legislation also limited guarantees to 0.5 percent of GDP in any given financial year. The committee also advocated a debt-GDP ratio of 50 percent in a period of 10 years commencing on April 1, 2001².

A brief digression on the rationale underlying the level of the fiscal deficit target enshrined in the FRBM Bill may be worthwhile. It must be clarified at the outset that the Committee did not borrow from the

² Debt was defined as the total liabilities of the Government of India, including external debt at current exchange rates at the end of a financial year.

European Union's (EU's) fiscal rules³ as is commonly believed (Buiter and Patel 2010)⁴. The deficit limit of 3 percent in the EU's Stability and Growth Pact (SGP) pertained to the general government deficit and as such, comparisons with the FRBM's limit on the Central government's deficit alone is specious. The gross fiscal deficit (GFD) target of 3 percent was adopted by consensus by the Committee on the twin considerations of (a) it being consistent with forecast of trend household financial savings, and (b) the target being considered sufficient for reducing the stock of outstanding Central government liabilities to the level of 50 percent of GDP within 10 years. Combined with the revenue deficit reduction target, the GFD target was intended to help shed non-productive expenditure, raise revenues and create space for investments on productive assets.

It also needs to be borne in mind that the debt/deficit targets (3 percent GFD and 50 percent Debt/GDP ratio) were contemplated at a time when the Central government was actively pursuing 'borrow-and-lend' financial intermediation operations for the States. The share of annual lending to States, which was as high as 1.5 percent of GDP in 1995-96, has shrunk to less than 0.10 percent of GDP in 2014-15. The disintermediation of loans to States (except for routing of external assistance) from 2005-06 as recommended by the 12th Finance Commission opened up significant fiscal space for the Centre.

The 12th Finance Commission and, in particular, a technical paper submitted to it (Rangarajan and Srivastava 2004) explicitly linked the 3 percent GFD target to household financial savings while prescribing fiscal consolidation targets for States. Given household savings of 10 percent of GDP and a current account deficit of 1.5 percent of GDP, a combined fiscal deficit of the Centre and the States of 6 percent was envisaged to be required to ensure investment of 4 percent of GDP and 1.5 percent of GDP by the private corporate and public enterprises, respectively. The 6 percent general government deficit was apportioned equally between the States and the Centre.

In order to allow for sufficient flexibility in fiscal management in the event of an unforeseen macroeconomic shock, the proposed law included an escape clause which allowed the Government to deviate on grounds of unforeseen demands on the finances of the Central Government due to well-defined events: national security and national calamity. It also mandated that the grounds for breaching the targets shall immediately be placed before both Houses of Parliament.

Fiscal dominance of monetary policy was a recurrent theme in the Sarma Committee deliberations. The Committee recommended curtailing government's direct borrowing from the RBI except through the short-term ways and means advances so as to discourage the government from resorting to the inflation tax by monetizing deficits. This would prevent the Centre from exploiting the output-inflation trade-off in the short-run at the cost of the central bank's price stability goal of monetary policy.

The FRBMA is commonly associated with numerical ceilings on fiscal indicators. Yet, the Sarma Committee had equally emphasized improvement in the quality of budget management through a medium-term outlook to budgeting, transparency and monitoring mechanisms, and accounting reforms, which

³Stability and Growth Pact (SGP) is an agreement among the 28 Member States of the European Union to facilitate and maintain the stability of the Economic and Monetary union (EMU).

⁴It is illuminating to study the logic behind the EU's three percent general government deficit limit. Kopits (2001). The SGP's rationale is to maintain an overall fiscal balance or surplus over the economic cycle, subject to a pre-set deficit limit of 3 percent of GDP. Historical estimates suggest that a one percent decline in output result in a 0.6 percent rise in the deficit in the EU. Therefore, a 3 percent deficit reference point allows for a 5 percent below-trend deviation in GDP.

formed part of the FRBM enforcement mechanism to bring in civil society suasion and to discourage financial engineering to game the compliance system.

The Committee recommended by majority view the introduction of accrual accounting as the cash-based accounting system did not recognize either the hidden liabilities arising out of unpaid bills or the potential gains from unrealized revenues. Moreover, in a cash-based system, all financial transactions are reported at their historical book value, which do not take into account adjustments due to depreciation, inflation, and exchange rate fluctuations, thereby failing to reflect the true economic and fiscal position of the Government. The representatives of the Controller General of Accounts (CGA) and the Comptroller and Auditor General (CAG) dissented, stating that it was "neither desirable nor feasible at this stage" as it would entail a full-blown overhaul of the accounting system with complicating implications for the State Governments. Such reforms should be separately examined under Article 150 of the Constitution. They argued that the system of year-end revaluation of external loans at current exchange rates was already in practice, a Register of Liabilities was required to be maintained under the General Financial Rules and there were other departmental management information system (MIS) to report on arrears of tax revenues and other such items which the Committee recommended to be reported. The government did not accept these recommendations until they were echoed by the 12th Finance Commission in 2005, ironically at the behest of the CAG. The government accepted them in principle but no significant progress has been made in their implementation.

The Sarma Committee had given particular importance to the openness of the government on issues of its fiscal projections. It provided for a mandatory laying down of certain additional statements before the Parliament along with the Budget, namely, (a) a Medium-Term Fiscal Policy Statement containing three-year rolling targets for fiscal indicators with commentary on the sustainability of the balance between revenue receipts and revenue expenditure as well as on the utilization of capital receipts for generating productive assets; (b) the Fiscal Policy Strategy Statement delineating the government's policies on fiscal matters such as taxation, expenditure, market borrowings *etc.*, as well as activities such as guarantees and underwriting that may have indirect, yet significant budgetary implications; and (c) a Macroeconomic Framework to highlight interaction of the Budget with the larger economy. The draft law also outlined certain measures for transparency by way of mandatory disclosures on outstanding contractual liabilities, revenue demands raised but not realized contingent liabilities *etc.*, to discourage creative accounting.

The Committee recommended setting up a Fiscal Management Review Committee (FMRC) under the FRBM Act to oversee the implementation of the Act and to conduct reviews of the fiscal situation. As part of the compliance mechanism, clear triggers were to be put in place *ex ante* to determine what constituted non-compliance during intra-year budget reviews as well as specified corrective actions, including cutbacks in budget allocations.

The representative of the CAG dissented on this recommendation stating that the reporting by the FMRC to Parliament will "encroach upon the prerogative of the Finance Minister... to inform and explain to the Parliament the conduct of fiscal policies and budget management" as the executive accountability to Parliament could not be divided. Moreover, the existing institutions of the CAG and Parliamentary Committees obviated the need for the FMRC. The FMRC provision was included in the draft law proposed

by the Committee, arguing that the FMRC would "supplement rather than supplant" existing institutions. The government later dropped the provision.

The 13th Finance Commission recommended that the Centre should institute a process of independent review and monitoring of the implementation of the FRBMA. Accordingly, the Act was amended in 2012 to provide for the government entrusting a periodical review of compliance with the provisions of the Act to the CAG. The CAG always had inherent discretion as part of audit mandate to review the implementation of any Act dealing with financial matters, but this amendment made it almost mandatory for the CAG to conduct such reviews annually under the amended FRBM Rules.

Cabinet decision (2000) on Sarma Committee recommen dations The draft legislation recommended by the Sarma Committee went through some notable amendments before the amended draft of the Bill was tabled in the Lok Sabha on December 21, 2000. First, the fiscal deficit target was tightened from 3 percent to 2 percent of GDP, which consequently required the Government to reduce its fiscal deficit by 0.5 percent of GDP per year, as opposed to the earlier annual reduction of 0.33 percent proposed by the Committee. Second, the amended Bill omitted provisions relating to the FMRC (owing to reservations expressed by the CAG) and, instead, stipulated that the Finance Minister should conduct quarterly reviews of the fiscal situation and report the outcome to the Parliament. These intra-year reviews could trigger the sequestration of 'Voted' expenditure.

The government sought early passage of the Bill in the Budget Session of 2001. Notably, the Cabinet also approved the voluntary adoption of the obligations sought to be imposed on the Government which started preparing for the Budget 2001-02 on that basis. (In the Union Budget for 2001-02, deficits were computed exactly as per the definition given in the proposed FRBM Bill so as not to understate the growth in the government's liabilities). The FRBM Bill, 2000 was referred to the Department Related Parliamentary Standing Committee (DRPSC) which felt that the provisions of the Bill were too burdensome on the government and recommended whittling down of key features.

Report of the Standing Committee on Finance on the FRBM Bill (2000) The DRPSC felt that 'numerical ceilings and the time frame set for attaining the said levels induce excessive rigidity into the decision making, depriving the government of the flexibility needed to respond to the exigencies in an appropriate manner, to serve the national interest best'. It, therefore, recommended that all stipulations relating to numerical ceilings as well as the time-frame set for reduction in revenue and fiscal deficits, the amount of guarantees and the total liabilities of the government be deleted from the Bill. Instead, it said, the legislation should merely stipulate that the revenue and fiscal deficits may be kept or maintained at prudent levels, to be defined and incorporated under the Rules. Thus, the fiscal deficit target of 2 percent of GDP was removed from the Act, relegated to the Rules, and notified as 3 percent of GDP in the 2004 FRBM Rules. Similarly, the liability reduction target of capping the total liabilities (including external

debt at current exchange rates) at 50 percent of GDP within 10 years was removed and then further diluted in the Rules.

In partial non-acceptance of the DRPSC recommendations, the government retained the revenue deficit elimination target in the Act but shifted the annual reduction path to the Rules. The numerical ceilings and

time frames constituted in a way the core of the proposed legislation. Their relegation to the reduced status of Rules was a major dilution. For any special relaxation, the government could always go to the Parliament with appropriate justification and seek amendment in the law rather than taking a blanket relaxation ahead of the need. Parliamentary intervention could have ensured informed discussion on how to raise resources, how to weed out low priority expenditures and how to share costs with the States.

The DRPSC felt that the definition of the escape clause in the FRBM Bill was too restrictive. The Bill had provided for infractions of the numerical ceilings on the grounds of national calamities and natural disasters. DRPSC sought greater flexibility by incorporating 'matters of urgent public importance' in the escape clause. Similarly, the DRPSC sought to expand the escape clause by removing restrictions on borrowings from the RBI as it feared that a blanket ban on borrowing from the RBI might lead to higher market borrowings by the government, which would cause a rise in the interest burden and adversely affect economic development.

The move towards market-related yields on gilts was well established as part of on-going economic reforms since the early 1990s. The objective was to force the government to pay the real cost of funds. Any artificial reduction in market-borrowing by recourse to the RBI or through controls on investments by banks, financial institutions, trust funds *etc.* Restrictions on direct borrowing from the RBI were meant to reduce fiscal dominance of monetary policy and monetization of government deficits. However, the DRPSC was disinclined to bind the government even though the Bill provided for a three-year grace period to enable the government to develop a deep and wide market in government securities.

DRPSC did not agree to the proposed measures to enforce compliance by way of cuts in allocations in case mid-year deficits rose above pre-specified levels and suggested that whenever there was either a shortfall in revenue or excess of expenditure over specified levels during any financial year, prior approval of the Parliament should be taken before curtailing the allocations.

The FRBM Bill had provided for protection of actions taken in good faith by stipulating that 'no suit, prosecution or other legal proceedings shall lie against the government or any officer of the government for anything which is in good faith done or intended to be done under this Act or the rules or regulations made thereunder'. The DRPSC was concerned with the possibility of litigation in the event of deviation/failure of the government in meeting the obligations, thereby making the process of economic decisions the subject matter of judicial scrutiny. To address these concerns, another clause was added to oust the jurisdiction of civil courts alone as the constitutionally protected writ jurisdiction of superior courts could not be curtailed through an Act. The final Act stipulated that 'no civil court shall have jurisdiction to question the legality of any action taken by or any decision of the Central government under the Act.' But an increased awareness in civil society about any perceived fiscal irresponsibility of the government can lead to judicial interventions even without FRBM Act as the courts also consider public interest litigations (PILs) on matters regulated not only by laws but also through administrative/policy decisions. However, the courts may be more disinclined to interfere if they are satisfied that a credible mechanism exists to deal with the cognate matters.

Presidential assent (2003) and coming into force of the Act (2004) The Bill was further diluted to reflect the DRPSC's concerns by enlarging the scope of the escape clause to allow for numerical ceilings to be breached not merely on grounds of national security or national calamity as per the original Bill but also on '*such other exceptional grounds as the Central Government may specify*'. This loosely worded escape clause would later be used by the government in 2008-09 to breach the FRBM targets. Thus, the original Bill proposed by the Sarma Committee substantially lost its bite through successive amendments.

The amended Bill received the assent of the President on August 26, 2003 with the date of enforcement of the Act being left to the discretion of the government. The Act and the Rules made under the Act were brought into force by the newly elected

government on July 5, 2004. In July, 2004, a Task Force led by Dr. Vijay L. Kelkar recommended various measures for implementation of the FRBM Act and substantially, a path of revenue-led fiscal consolidation.

Evaluating the actual implementa tion of the FRBM Act For the revenue deficit, the FRBM rules prescribed a final target of nil that was to be achieved by March 31, 2009 through annual reductions of 0.5 percent of GDP. For the fiscal deficit, the FRBM rules prescribed a final target of 3 percent of GDP to be achieved by March 31, 2009 through minimum annual reductions of 0.3 percent of GDP.

The implementation of the Act involved action on two distinct but inter-related set of action points. The first was compliance with the numerical targets and timelines on certain measurable fiscal indicators. The second lay under the broad category of fiscal

transparency requirements – which was an implicit part of the enforcement mechanism of the Act requiring a set of Statements being presented along with the Budget. The FRBM Act contained only the numerical target for the revenue deficit to which a derived measure of 'effective revenue deficit' was added from 2012-13. The associated FRBM rules specified targets on the fiscal deficit, and limits on the annual accretion to the stock of outstanding liabilities and guarantees. The compliance can be assessed in three phases.



In 2005-06, the government sought to push the 'pause button' on FRBM on account of the additional fiscal burden due to the recommendations of the 12th Finance Commission. The fiscal deficit *apparently* declined from 4.34 percent in 2003-04 to 2.54 percent in 2007-08, achieving the target of 3 percent of GDP one year in advance and the revenue deficit also *apparently* came down from 3.5 percent of GDP in 2003-04 to 1.1 percent of GDP in 2007-08, and closer to the target of nil in 2008-09. But as the CAG would later point out, the deficit figures were under-

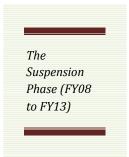
reported and the computation of the deficit was not as per the definition given in the FRBM Act. The 'offbudget' bonds issued to oil companies in 2006-07 alone added up to as much as 1.5 percent of GDP.

This phase also saw some key decisions that would sow the seeds of future fiscal deterioration. Particular mention must be made of the handling of the 12th Finance Commission's recommendation that the Centre should stop financial intermediation for the States. The offloading of Central loans to States from 2005-06 should have been used to accelerate fiscal consolidation as these loans would no longer burden the fiscal deficit of the Centre. However, the government chose to fritter away this vacated fiscal space by filling it

with higher doses of discretionary Plan grants to the States. This enlarged the base over which incremental budgeting year after year ensured a sharp increase in transfers to States post 2005-06.

Several studies have attributed the fiscal consolidation in the first phase to high GDP growth and tax buoyancy. Simone and Topalova (2009) estimate that two-thirds of the fiscal adjustment in this period was due to revenue gains. Dholakia *et al.* (2011) state that much of the improvement in the financial position of the Central government arose due to revenue buoyancy. The basis of these claims lay in unprecedented nominal growth in GDP.

The fact is that Phase I of the FRBM Act was indeed a period conducive for fiscal consolidation. The nominal year-on-year growth rate of both direct and indirect central taxes (net of transfers to States) increased consistently from 2001-02. These dynamics translated into a considerable rise in the net central tax/GDP ratio, particularly the net central direct tax/GDP ratio, which more than doubled between 2001-02 and 2007-08. Even the expenditure to GDP ratio *apparently* declined in this period, partly due to financial disintermediation of Central Plan loans to States (except for EAP) from 2005-06 and exclusion of subsidy claims deferred or paid through bonds.



In 2008-09, there was a reversal of the steady fiscal consolidation being pursued. The budgeted fiscal deficit for 2008-09 was 2.5 percent of GDP, while the revised estimates shown in the interim budget presented in February 2009 was 6 percent of GDP⁵. However, the Centre's actual fiscal deficit in 2008-09, inclusive of the off-budget expenditures of oil and fertilizer bonds, was, in fact, 7.8 percent despite significant under-reporting through deferment of expenditure liabilities.

Thus, the total deterioration in the fiscal deficit in 2008-09 was a dramatic 5.3 percent of GDP. The revenue deficit also ballooned considerably in 2008-09, from the

budgeted 1 percent to the revised 4.4 percent of GDP. Accounting for the off-budget bonds brought the number to an unprecedented 6.3 percent of GDP (Buiter and Patel 2010)⁶. In his review report on FRBM Act submitted to the Parliament recently, the CAG confirmed under-reporting of true revenue and fiscal deficits through exclusion of bonds issued in lieu of subsidies.

Announcing suspension (which would extend to five years) of the deficit targets in the FRBM Act, the Finance Minister in his 2009-10 (Interim) Budget speech stated: "*Extraordinary economic circumstances merit extraordinary measures. Now is the time for such measures. Our Government decided to relax the FRBM targets, in order to provide much needed demand boost to counter the situation created by the global financial meltdown*". He attributed the entire difference of ₹1,86,000 crore (3.5 percent of GDP) between the fiscal deficits of 2007-08 and 2008-09 to the 'fiscal stimulus' provided cushion to the global financial crisis (GFC).

This overlooked some considerations. First, as documented in detail by Buiter and Patel $(2010)^{7}$ and Simone and Topalova $(2009)^{8}$, in anticipation of the upcoming 2009 general elections, expenditure slippages had started well before the financial crisis hit the global economy in the third quarter of 2008-09.

⁵ Mid-Term Fiscal Policy Statement, Union Budget, Government of India, 2008-09 and 2009-10 (Interim).

⁶ Buiter, W. H., and Patel, U. R. (2010). Fiscal rules in India: Are they effective? (No.w15934). National Bureau of Economic Research.

⁷ Buiter, W. H., and Patel, U. R. (2010). Fiscal rules in India: Are they effective? (No.w15934). National Bureau of Economic Research.

⁸ Simone, A. S., and Topalova, P. B. (2009). India's experience with fiscal rules: an evaluation and the way forward. IMF Working Papers, 1-40.

These infractions primarily consisted of populist spending policies on account of a farm debt waiver, the abrupt expansion of the MNREGA from 200 to over 600 districts, large subsidies on account of oil, food, and fertilizers, and the implementation of the recommendations of the 6th Pay Commission. Thus, a significant part of the fiscal deterioration may be attributable to the election cycle.

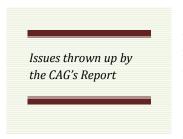
The CAG reported that in February 2009 the government had put on hold temporarily the fiscal consolidation process 'citing the global economic crisis and adverse circumstances'. The 'fiscal stimulus' measures were announced purportedly to offset the impact of the GFC on the Indian economy. The measures included across the board major cuts in indirect taxes and a substantial step-up in government expenditure with relaxed debt ceilings for States as well. These measures were not targeted at any particular sector facing demand contraction. Given the inertia in the economic data gathering system, it is highly unlikely that the government had credible information on which sectors were actually impacted by the GFC and to what extent. India's exports had been growing faster than the overall economy, but the contribution of net exports to India's GDP had been quite marginal. Hence, the measures to boost demand in a supply-constrained situation only fuelled spiraling inflation.

Unlike in international best practices, neither the escape clause (first proviso to Section 4) of the FRBM Act nor the associated FRBM Rules mandate a clearly defined correction path that would facilitate return to fiscal consolidation following a breach in adherence to the fiscal rules. The Finance Minister, in his 2009-10 budget speech: "*I intend to take... return to the FRBM target for fiscal deficit at the earliest and as soon as the negative effects of the global crisis on the Indian economy have been overcome.*" Thus, amidst considerable uncertainty about returning to the FRBMA roadmap, the deficit rules remained in abeyance for a period of five years.



In the budget speech of 2012-13, the FM announced his intention to reoperationalize the FRBM Act and proposed several amendments to the Act in the Finance Bill. These included pushing the deadlines for numerical targets from 2009 to 2015 and introducing a new fiscal indicator, *viz.*, the 'effective revenue deficit' (revenue deficit excluding grants for creation of capital assets). The target for the revenue deficit was raised to 2 percent. The

amendment also announced that a new statement called the medium-term expenditure framework will publish three-year rolling target for expenditure indicators each year to facilitate expenditure management. Moreover, another amendment sought to provide for the CAG conducting periodic reviews of the implementation of the legislation. However, in his second budget, FM again postponed the deadlines for meeting the numerical targets from 2015 to 2018 in order to create fiscal space for public expenditure.



Some of the specific findings of the CAG on the implementation of the FRBM Act show that the focus on the revenue deficit and the gross fiscal deficit in the implementation of the FRBM Act has diverted attention from efficient management of the stock of financial liabilities of the government in general and of small savings operations in particular. The National Small Savings Fund (NSSF) was created in the Public Accounts in April 1999. The cumulative operating loss of NSSF, which was a modest ₹1681.68 crore at the end of 1999-

2000, has steadily increased to ₹90,707.56 crore at the end of 2014-15. The current system allows this

operating deficit to eat into the capital base of NSSF. This deficit is in the nature of loss to be borne by the government on the revenue account. By keeping the annual loss in the operation of NSSF under Public Accounts, the deficit for the relevant year is not reflected fairly. The accumulated loss of NSSF (₹90,707.56 crore) at the end of 2014-15 thus represents the cumulative understatement of the government's annual interest payments and revenue deficits. This undermines both fiscal sustainability and fiscal transparency. Before the NSSF was constituted, small savings receipts mobilized by the Central government and lent onwards to the States were treated as capital expenditure of the Central government and, accordingly, calculated in its gross fiscal deficit. Any shortfall in returns from loans given out of small savings proceeds and the interest paid on small savings were accounted for under the Consolidated Fund of India (CFI) and hence calculated under its revenue deficit. After the constitution of the NSSF in the Public Accounts, however, the income/deficit of NSSF is not being reflected as part of the Union Government's revenue deficit. The 14th Finance Commission had observed that the off-budget nature of NSSF operations renders them outside the regulatory framework of the FRBM Act, raising concerns about fiscal transparency and sustainability. The government has accepted that administrative intervention is required for making good the accumulated losses of NSSF.

During the certification of 'net proceeds' by the CAG, based on the recommendations of the successive Finance Commissions, it was noticed that during the period 1996-97 to 2014-15, the States were entitled to an additional share of ₹81,647.70 crore in Central taxes. The Centre did not attempt to reduce the arrears of States' share, pending receipt of the CAG's certificate. Thus, deficits reported under the FRBM framework were under-reported to the extent of reduction in transfers to the States since 1996-97.

The claims of five central public sector undertakings⁹ amounting to ₹44,941 crore (claims including past years' unpaid bills but excluding last-quarter bills for 2014-15) remained unpaid in respect of food, petroleum and fertilizer subsidies. Every year, some claims of past years would be paid and some of the current year's claims would be deferred on account of various reasons such as non-finalization of accounts by PSUs and non-receipt of audited claims. The deferment of liabilities to subsequent years has a cyclical bearing on the computation of fiscal indicators. Outstanding subsidy claims of the Food Corporation of India have continuously increased during the last five years. For a truer picture of the fiscal situation, some advance/provisional payments even in respect of unaudited claims may perhaps need consideration.

The CAG pointed out that deficits shown in the document titled 'Budget at a Glance' are not being computed exactly as per the definition provided in the FRBM Act, which has led to significant underreporting of actual deficit in some years. Any netting of an item of revenue or capital expenditure that affects the revenue or fiscal deficit is inconsistent with the definition of these deficits under the FRBM Act. Interestingly, the practice of netting non-cash transactions was not adopted in Budget 2001-02 (as required under the FRBM Act) when the Government decided to voluntarily adopt the obligations while the FRBM Bill was awaiting approval by Parliament. The CAG had drawn the attention of the Finance Minister to this practice in October 2007 and also commented on it in the Audit Reports on accounts for the years 2004-05, 2005-06 and 2007-08 to 2009-10. The Minister had clarified in December 2007 that the procedure of depicting net expenditure in the 'Budget at a Glance' (gross expenditure as reported in annual financial

⁹ National Fertilizers Ltd., Fertilizers and Chemicals Travancore Ltd., Madras Fertilizers Ltd., Hindustan Petroleum Corporation Ltd., Food Corporation of India Ltd.

statement minus non-cash outgo items) had been followed over the years for budgeting and accounting of government transactions. Subsequently, however, in his Budget speech on the Union Budget for 2008-09 he acknowledged that significant amount of liabilities of the Government on account of oil, food and fertilizer bonds were currently below the line, though the accounting arrangement was consistent with the past practice. Thus, the fiscal and revenue deficits were understated to that extent.

One-time receipts of ₹16,941 crore from the penal levy paid by the allottees of cancelled coal blocks and spectrum auction helped in containing the revenue deficit in 2014-15. But these do not provide a sustainable base for future inflows.

Cesses are statutory levies whose proceeds are earmarked for utilization for specific purposes. The revenue from the cesses is, therefore, not shared by the Central government with the States. During 2014-15, the CAG commented on non-transfer of ₹ 8,123 crore of such cesses into the funds earmarked for the purpose and being used instead to bridge the current year's revenue/fiscal deficit. The CAG recommended disclosure of the utilization of cesses collected for the intended purpose and unutilized balances in the annual accounts or in the Budget documents. Unless there is a clear account given on what exactly the cesses have financed, the adverse perception of cesses being an instrument to deny States of their share in Central taxes would need to be addressed.

The CAG pointed out that in 2014-15, refunds of ₹1,17,495 crore (including interest on refunds of taxes) were made from gross direct tax collection. Refunds ranged between 12 to 17 percent of the gross direct tax collection during the period 2010-15. Large-scale refunds may point to a systemic bias in tax administration towards the practice of 'tax borrowing' where the tax authorities seek to collect more taxes than due to be refunded next year after meeting the current year's target. This vitiates the integrity of reported deficits.

The net Public Account liabilities were shown in the finance accounts as ₹6,71,010 crore, as against the actual gross outstanding liability of ₹13,41,220 crore, the difference being 5.4 percent of GDP due to netting of some investments and operating losses. The netting of ₹6,70,210 crore was on account of exclusion of investments out of NSSF collections in State Government securities.

The 2012 amendment to the FRBM Act had mandated the government to eliminate the 'effective revenue deficit' (ERD)¹⁰ by 2014-15 with minimum annual reduction of 0.8 percent of GDP and also to reach a revenue deficit of not more than 2 percent of GDP by 2014-15. The target has since been deferred to 2017-18. The CAG pointed out deviations and inconsistencies in the correct accounting classification of grants under the ERD. Grants given by the Central government under schemes like Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) Member of Parliament Local Area Development Scheme (MPLADS) Indira Awas Yojana (IAY) Rajiv Awas Yojana (RAY) *etc.*, were used for expenditure on general community works with no clear ownership, or for assets like houses whose ownership vested in individual beneficiaries. In view of fungibility of resources at the grantee level, the end-use of grants for asset-creation is desirable only if there is credible assurance that it is not leading to mere refinancing or replacement of existing spending on asset creation and that the assets that would have been created but for these grants continue to be actually so created. Since the income stream attached to the grant-financed assets

¹⁰ The effective revenue deficit is the difference between the revenue deficit (as traditionally understood *i.e.*, based on all grants-in-aid being treated as revenue expenditure) and 'grants for creation of capital assets'. The intention was to separately report the grants which were used to finance current expenditure and those used to create capital assets by the recipient grantee entity.

does not belong to the central government, financing them from borrowed funds results in the cost of debt service entirely devolving on the central government. The 14th Finance Commission has recommended that the government should discontinue targeting of the 'effective revenue deficit' as it is not recognized in the standard government accounting.



The combined expenditure of Central and State governments has continued to hover around 28 percent of GDP over the last 25 years. But it has undergone structural changes in composition, with a decline in share of capital expenditure. Fiscal expansion by the Central government from 2005-06 was, to some extent, offset by fiscal contraction by the State governments. The question therefore is: what is the proper size of the general government? What are the causes and economic consequences of a

growing government? These questions have long been the focus of public choice theorists and practitioners. A policy stance on this matter must appreciate the economic consequences of the growth of government. The size of Government rose almost interrupted from about 16 percent of GDP in 1970-71 to over 25 percent of GDP in the late 1980s and early 1990s. This was followed by a slight moderation in the 1990s, led primarily by modest reductions in the Centre's fiscal deficit as well as increases in excise tax collections by the Centre and States. The crisis years stand out, with a sudden increase in the size of government. A modest fall in direct and indirect tax collections was overshadowed by a sharp rise in the combined fiscal deficit, which more than doubled from 4.1 percent in 2007-08 to 8.4 percent of GDP in 2008-09. The advanced economies and the G7 countries have much larger governments that those in emerging economies. Most low-income groups tend to have smaller governments. India has the smallest government amongst the BRICS countries. The issue of desirability and feasibility of resizing the general government is linked to the sustainable revenue base and borrowing capacity of the government.

The initial FRBM targets need revisit when there is major change in the assumptions underlying those targets. The fiscal deficit target needs review to factor (a) change in the net household financial savings and (b) in the profile of government's capital expenditure.

The 3 percent of GDP ceiling on the fiscal deficit recommended by the Sarma Committee was intended to achieve stabilization of the Central government's debt/GDP ratio to 50 percent in 10 years and was consistent with availability of household financial savings, to affordably finance this level of fiscal deficit without increasing dependence on external debt. The fiscal deficit was targeted at 3 percent of GDP at a time when household financial savings were 10 to 12 percent of GDP. Now these savings have reduced to about 7.5 percent of GDP. The continued crowding out by general government has led to increase in the country's external debt on private/corporate account, although external indebtedness in the Central government's books of accounts is modest.

Further, the target for the gross fiscal deficit at 3 percent of GDP was fixed at a time when the centre was extending substantial loans to state governments and the target for centre's GFD presumed continuation of this practice. However, on the recommendation of the 12th Finance Commission, the central government stopped giving Plan loans to states except against external aid. Resultant drop in the centre's lending to states could have led to a sizeable reduction in the centre's fiscal deficit, simply because of a change of budgeting policy rather than from any hard revenue-raising or expenditure cutting exercise. The target set

for the GFD (3 percent of GDP) could have been revised downwards to reflect this fundamental change in the assumptions behind the target.

With the Centre having substantially given up its financial intermediation role (borrowing and lending to CPSUs and States) and with the shifting of asset creation to special purpose vehicles (SPVs) of various hues, the scope of direct capital expenditure by the Central government is largely confined to defence and railways. Even the financing of capital-intensive national highways and industrial corridors is through grants to parastatal. Thus, the very rationale of the original FRBM target of fiscal deficit of 3 percent of GDP only for 'capital expenditure' and lending on government account merits reconsideration. Persistently high level of general-government revenue deficits imply continued financing of revenue expenditure from borrowings, implying further build-up of revenue deficits due to interest payments unmatched by increase in revenues.

Revenue expenditure as percent of GDP has almost doubled in the past four decades. The FRBM Act prescribes the "golden rule" that the revenue budget should be targeted to be in surplus. This is particularly challenging to achieve given that a large proportion of revenue expenditure goes into inescapable payments like interest payments, salaries, pensions and a large number of subsidies. Moreover, prospects of significant improvements in the tax/GDP ratio are limited in the short-run. The Sarma Committee had stressed, however, that, without this golden rule, fiscal consolidation could lead to a disproportionately large compression of capital assets. Persistent revenue deficits are a relatively recent phenomenon. The Centre's revenue account was in surplus or balanced till the late 1970s. Since the 1980s, however, it has consistently been in deficit, reaching a peak of over 5.5 percent of GDP in the late 1990s. The early 2000s saw a sharp fall in the revenue deficit of the centre owing largely to the implementation of the FRBM Act and a favorable growth environment. This, however, was completely reversed from 2008-09 onwards. A gradual correction is underway at present. A similar pattern is observed for the States. The deterioration in the combined revenue account was, in large part, due to significant expenditure slippages. In the two decades following the mid-1970s, there were very few years in which the combined revenue expenditure declined as a proportion to GDP. In fact, for almost half of this period, it rose by more than 0.5 percent of GDP year on year.

There are occasionally large receipts or expenditures of a non-recurring nature. These may spike the deficit and need special explanation and care to ensure that these do not get embedded in the underlying long-term secular trend of receipts and expenditures. Thus, windfall receipts by sale of physical or financial assets or non-recurring receipts like receipts from the auction of telecom spectrum or auction of coal blocks or the Income Disclosure Scheme need to be highlighted while explaining deficit reductions and also the unlikely availability of similar receipts on a regular basis in future needs to be considered.

Successful implementation of VAT and substantial increase in grants to States under the Finance Commission awards since 2005-06 and the phenomenal expansion in Central and Centrally Sponsored Schemes allowed States to conserve their own resources. The sharp increase in direct transfers by the Central government to State and district level implementing agencies has led to relative moderation in the growth of expenditure by the States in these areas and thus the overall general government expenditure as percent of GDP has remained almost stagnant. This partly explains why the Centre's fiscal deficit has increased more than that of States.

The current focus of FRBM implementation on the 'above the line' revenue deficit and gross fiscal deficit deflects attention from inefficient management of the financial liabilities of the government in general and of small savings operations in particular. The accumulated operating deficit in the National Small Savings Fund understates the true state of the revenue deficit, the fiscal deficit and the primary deficit.

The implementation of the Act brings into sharp focus the need of having a well-defined and credible escape clause with a mandatory requirement of a roadmap to return to fiscal consolidation path in case of a breach.

The fiscal deficits of governments will continue to be a matter of concern so long as the economy has limited financial resources. We need to attract foreign capital, preferably equity, to augment the resource pool in the economy and to bring technology. This is what the government is currently doing by liberalizing FDI inflows under the Make-In-India programme. Developing an equity culture through well-regulated capital markets and broadbasing the ownership of PSUs is also on the agenda to reduce general dependence on debt resources to finance major investments.

The FRBM continues to be relevant because we cannot emulate advanced economies where old orthodoxies have been shunned and printing currency to spend is acceptable. Our general government debt is about three times its revenues. Resources are, no doubt, required to exploit the growth potential but with growth must come income augmentation for the government. Prudence requires matching debt with income-earning assets. GDP is the 'asset' from which the government extracts income for debt servicing and hence a proxy for the revenue base. There is a gestation involved in realizing these increased revenues as we need to provide for enough government intervention to reap the limited window of the demographic dividend. We still live in an unequal world and the rules are different for different sovereigns. The systemic central banks of the world continue to pose uncertainty for emerging markets. When the earlier orthodoxy of fiscal discipline gives way to fiscal policy being handed over to monetary authorities to support fiscal expansion and we are hard put to influence the course of financial flows across national borders, dexterous fiscal management is a monumental challenge. We shall discuss in subsequent chapters how to balance the growth-related needs of our resource-starved economy with that of staying on the course of fiscal rectitude for responsible growth. The prospects for fiscal consolidation are bright because of continuing steps being taken to curb black money generation, moving to a cashless economy, broadbasing taxation through GST, boosting savings and growth through financial inclusion, using technology to cut leakages of government benefits and idle cash with parastatals, unlocking the hidden wealth in PSUs and above all, inclusion of hitherto unreported economic activities in the informal sector and thereby boosting the coverage of GDP.

CHAPTER 3 INTERNATIONAL EXPERIENCE

Contents

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Overview

As India embarks on reviewing its FRBM (Fiscal Responsibility and Budget Management) Law, it is important not to reinvent the wheel but instead look at international best practices including what has worked and not worked in other emerging markets. This is particularly important because the global orthodoxy on fiscal rules has changed materially since India enacted its first FRBM Law in 2003.

Back then, fiscal rules were still a relatively new phenomenon for emerging markets. By 2014, however, the number of emerging markets that had adopted fiscal rules had increased dramatically, and even surpassed advanced economies, even after accounting for the European Union. Furthermore, in the early 2000s most emerging markets were governed by a single fiscal rule and, therefore, inevitably faced the trade-off between credibility and flexibility. Countries that adopted a budget balance rule or a debt rule to serve as a fiscal anchor had to accept the fact that these rules did not necessarily have economic stabilization features and, in fact, fiscal policy was often forced to be pro-cyclical. Conversely, during the global financial crisis when, in the pursuit of using fiscal policy as a counter-cyclical tool, countries (including India) were forced to deviate from fiscal rules, often with a significant cost to policy credibility.

These experiences spawned a <u>"second generation fiscal framework</u>" which essentially comprises of four characteristics:

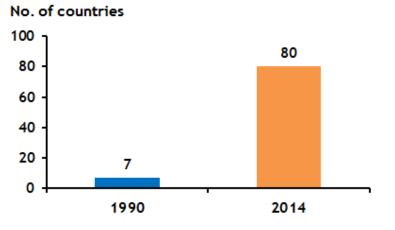
- First, countries typically adopt more than one fiscal rule to avoid the shortcomings of any one rule and better balance credibility (the need to create a fiscal anchor) and flexibility (the need to respond to economic shocks and ensure that fiscal policy is not procyclical). The average number of fiscal rules in emerging markets in 2000 was 1. By 2014, it had almost doubled to 1.7. For countries that have more than one rule, a combination of a debt rule and a deficit rule appears the most common. One challenge with multiple rules, however, is that they could sometimes be internally inconsistent, and complex to monitor, verify and communicate something that Indian policymakers need to guard against.
- Second, countries' preference for flexibility is manifested in two ways. The conventional method particularly in advanced economies is to use cyclically-adjusted or structural deficits. However, computing the state of the business cycle and the quantum of output gaps is particularly challenging in emerging markets, given data constraints and the fact that some emerging markets are constantly undergoing structural transformation. A second method to create flexibility is, therefore, through escape clauses that allow deviations from fiscal rules in the case of exogenous shocks outside the policymaker's control. In theory, these clauses should be narrowly defined and their invocation should be predicated on unambiguous criteria (e.g. a natural disaster; war). In practice, however, countries have used escape clauses even for events that are not completely out of the government's control and have also defined their invocation in an ambiguous manner, potentially diluting credibility. Indian policymakers, therefore, need to ensure that the institutional framework around escape clauses prevents them from being abused or used indiscriminately.
- Third, countries sometimes adopt automatic correction mechanisms which specify in advance (typically encoded in the legislation) how deviations from the rule will be handled. This is now a requirement for EU countries that have signed the "Fiscal Compact" but has not been built into enough fiscal rules. An *ex ante* auto correction mechanism is a visible signal of the policymaker's commitment and supports the credibility of fiscal rules.

• Finally, there been a sharp growth of independent "fiscal councils" in the post crisis period. These councils have an important remit both *ex ante* (forecasting) and *ex post* (monitoring the adherence to fiscal rules; conducting sustainability analysis; invoking escape clauses; and managing automatic correct mechanisms). International experience suggests that fiscal councils can improve fiscal outcomes and forecast accuracy, often materially, especially when they are (a) independent; (b) command a strong media profile; (c) tasked with monitoring fiscal rules; and (iv) involved in forecast assessment.

2. Proliferation of Fiscal Rules

There has been a proliferation of fiscal rules around the world over the last 25 years. As recently as in 1990, only about seven countries had fiscal rules in place, which included the United States, Germany, Indonesia, Japan and Luxemburg. Furthermore, even amongst these economies, at least two caveats apply. First, in some cases, rules only covered the central government, and not necessarily sub-national governments, and therefore were not comprehensive. Second, even as rules were in place, it is not the case that they were necessarily being adhered to.

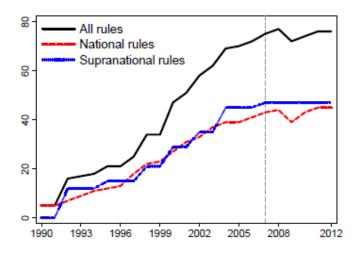
Since then, however, there has been a proliferation of fiscal rules around the world. According to the IMF's Fiscal Rules Database, the number of countries with a fiscal rule – either national or supranational – galloped to over 80 by 2014. As the chart below shows, fiscal rules saw a steady adoption in the decade of the 1990s, and a more aggressive adoption in the decade of the 2000s – around the time India adopted its first FRBM Act. The number of countries with rules then dipped in the global financial crisis, which was understandable, given that many countries held their rules in abeyance to use fiscal policy aggressively to counter the slowdown in their economies. Post crisis, the number of countries with rules began to rise again, as countries tried to return to a path of fiscal discipline and undo the post-crisis expansion. By 2012, the number of countries with fiscal rules – either national or supranational – was, in fact, higher than before the crisis.



Number of countries with fiscal rule

Source: IMF Fiscal Rules Database (2014)

Number of countries adopting a fiscal rule



Source: Schaechter et. al (2012).

2.1 Both National and Supra-national Rules have Risen in Tandem

A natural question to ask is: what prompted the sudden popularity of fiscal rules? To answer this, we need to distinguish between both (i) *national* fiscal rules and *supranational* rules; and (ii) rules adopted by advanced and emerging economies. Both are instructive in informing whether the adoption of fiscal rules was truly widespread, or simply an artifact of some regions adopting supranational rules.

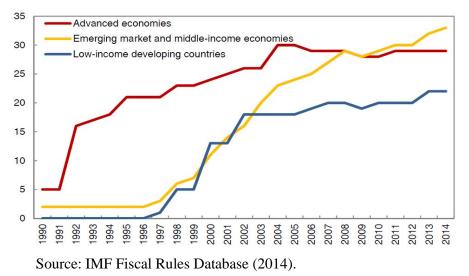
Interestingly, as the chart above demonstrates, there is no discernable difference in the pre-crisis behavior of national versus supranational rules – both rose in tandem in the run-up to the crisis. Post crisis, national rules drove the headline trend – dipping post the 2008 crisis and then re-accelerating to 2012 – such that there were more national rules in place by 2012 than there were in the run-up to the crisis.

2.2 Emerging markets late entrants, but have surpassed advanced economies

When categorizing countries with fiscal rules into (i) advanced economies, (ii) emerging markets and (iii) low-income countries, it is understandable that advanced economies were the first ones off the block. As alluded to above, only five advanced economies had adopted fiscal rules in 1990. By 2004, however, that number has grown almost six-fold to about 30 countries. The majority were member states adopting fiscal rules in the 1990s as part of the Maastricht Treaty in 1992 and the Stability and Growth Pact in 1997. Since 2004, however, the number of advanced economies with fiscal rules has remained flat and, if anything, reduced slightly.

In contrast, emerging markets were late entrants to the process. Only about two emerging markets had fiscal rules as recently as 1996. However, the emerging market universe witnessed exponential growth of fiscal rules during the decade of the 2000s. At the onset of the global financial crisis, the number of emerging market economies with a fiscal rule (~27) was virtually identical to that of advanced economies. Post the global financial crisis, fiscal rules in emerging markets witnessed a slight dip for two years before continuing their secular rise. Many emerging markets – including India – held their rules in temporary abeyance ("hit the pause button") as they aggressively used fiscal policy to counter their domestic

slowdowns. However, just as quickly, some of these countries re-invoked their rules, and the total number of fiscal rules in place by about 2010 was very similar to the pre-crisis high. In India's case, the pause button lasted a bit longer. The initial FRBM Act was paused in 2008 and a new path to returning to the 3 percent of GDP target for the Centre's gross fiscal deficit was re-adopted from September, 2012. That said, by 2014, the number of emerging markets with fiscal rules (~33) had exceeded the number of advanced economies with fiscal rules. A detailed list of emerging markets with fiscal rules is in the Appendix.



Number of Countries Using Fiscal Rules, 1990-2014

2.3 National rules reflected different fiscal motivations

Disparate factors have motivated the adoption of national fiscal rules over the last two decades. Three broad trends and triggers are discernible. First, some countries imposed rules after debt burdens exploded on the back of financial, banking or economic crises. A second motivation was to counter more secular trends of rising deficits and debt, rather than the upshot of episodic events such as economic and financial crisis. A third motivation was to restore fiscal discipline after expansionary fiscal policy during the global financial crisis.

In the early 1990s, for example, countries such as Finland and Sweden adopted rules to counter the explosion in debt on account of the banking and economic crises. The emerging market equivalent was the debt crisis in Latin America that induced countries such as Brazil and Peru to adopt fiscal rules. In other cases, the motivation was very different, with countries such as Belgium imposing fiscal rules to generate the fiscal consolidation needed to qualify for the Euro Area, while economies such as Netherlands and Switzerland undertook rules to arrest a more secular trend of rising fiscal deficits and debt. Finally, several countries introduced or re-imposed fiscal rules after the 2008 crisis to create institutional frameworks to chip away at debt burdens and fiscal deficits, after expansionary fiscal policy was liberally used during the financial crisis.

3. Four broad types of fiscal rules

There appear to be four main types of "fiscal rules" that are adopted around the world, which can be distinguished by the type of fiscal aggregate that they are focused on.

3.1 Debt Rule

One of the most common fiscal rules involves targeting the "debt stock," typically as a percentage of GDP. The reason it is so prevalent is that, ultimately, it is the evolution of debt to GDP that is most closely linked with fiscal sustainability. Therefore, by targeting debt to GDP, policymakers are focused directly on the variable that is associated with fiscal sustainability. Furthermore, it is meant to serve as a signal that the cost of debt service is sustainable over time. Second, it is an transparent and easy-to- communicate metric. Examples of this include the EU, Poland and the Slovak Republic (all of which have a debt ceiling of 60 percent of GDP, and countries like Panama and Kosovo which have a debt ceiling of 40 percent of GDP)

However, focusing on the debt to GDP ratio poses its own challenges. Firstly, by focusing on a stock variable, there is no clear operational guidance on annual fiscal targets for policymakers because, under different assumptions of growth and interest rates, different combinations of the primary/fiscal deficit can converge to the same debt to GDP outcome. Second, the debt to GDP ratio can be impacted by factors outside the policymaker's control – e.g., interest and exchange rates. Furthermore, it can be also be impacted by "below-the-line" items that don't necessarily flow through the budget. So the link between annual primary balances (the variable most directly under the control of policymakers) and the debt to GDP is not always direct. In extreme situations, in fact, focusing on a debt target can cause fiscal policy to become pro-cyclical. For example, a negative shock to GDP causes the debt to GDP to rise. If the debt to GDP ratio was already as its limit/ceiling before the shock, the primary balance would need to increase (or the primary deficit be reduced) to improve debt dynamics, thereby making fiscal policy pro-cyclical. But this is only the case when the debt to GDP ratio is at its ceiling.

3.2 Budget Balance Rules

A second, very common, fiscal rule – and one that underpinned India's first FRBM Act -- is a fiscal deficit or budget balance rule. The benefit of a fiscal deficit/balance rule is that it provides clear operational guidance to policymakers, since it is directly under policymakers' control. Second, it is easy to communicate and monitor. Third, it is very closely linked to debt sustainability – in that it typically controls the evolution of the debt ratio -- though it suffers from some of the same caveats as mentioned above, namely that for a given path of fiscal deficits the debt to GDP ratio could be still be impacted by factors outside the policymakers control. That said, fiscal deficits are most closely linked to debt sustainability.

Perhaps, the biggest disadvantage of headline fiscal balance rules is that they do not have counter-cyclical properties. For example, when growth – and therefore revenues – are above potential, policymakers should ideally be reducing fiscal deficits, and thereby creating fiscal space that can be used in downturns. However, adhering to a fiscal deficit target, necessarily results in those extra revenues being spent. Similarly, during downturns, as automatic stabilizers work, one would want the fiscal deficit to expand, but that is precluded by adherence to a headline deficit rule, thereby making fiscal policy pro-cyclical.

3.2a Structural Budget Balance And "Over-The-Cycle" Rules

To overcome these problems, some countries adopt several variants of budget balance rules. These include cyclically adjusted deficits and over-the-cycle deficits. The benefit of cyclically-adjusted or structural deficit rules is that, by construction, they have economic stabilization properties by explicitly accounting for the state of the business cycle. Operationalizing these rules, however, entails defining a business cycle and

estimating where on the cycle a country is (i.e., estimating the sign and quantum of the output gap). However, given the difficulties of ascertaining what "trend growth" is – particularly in emerging markets that are often undergoing sustained structural transformation and where data constraints are more binding – estimating output gaps is fraught with uncertainty and very often simply a function of the analytical approach that is used. Against this backdrop, focusing on "structural deficits" appears impractical in an emerging market context. Second, structural deficits are harder to communicate and monitor, and lead to significant uncertainty about the eventual quantum of headline deficits and borrowing requirements, thereby having the potential of creating significant market uncertainty

The "over-the-cycle" deficit rule suffers from the same challenge of defining what the cycle is. To the extent, that there is ambiguity about the state of the cycle, it can lead to time-inconsistency problems, and delay adjustment to the end of the cycle.

3.2b Golden Rules

Finally, a "golden rule" – where capital expenditures are excluded from deficit calculations – are meant to protect investment and ensure that "productive" capital expenditures are not constrained by fiscal rules. Any such rule is, however, much less linked to debt sustainability than a headline fiscal deficit rule is. Furthermore, in some cases, the distinction between revenue and capital expenditures is blurred. Expenditures to build schools will clearly fall under capital expenditures: but should recurring payments to teachers that operate in that school be counted as capital or current expenditures and therefore be subject to or exempt from the headline deficit?

3.3 Expenditure Rules

A third grouping of rules are "expenditure rules" which set limits on total/primary/current spending and can be specified as either a limit on the ratio to GDP/revenue or on nominal or real growth. The benefit of such rules is that they (a) directly target the size of government; (b) are relatively easy to communicate and monitor; and (c) have counter-cyclical, albeit asymmetric properties. During boom times, expenditure rules prevent extra revenues from being spent, thereby causing fiscal deficits to reduce and make fiscal policy counter-cyclical. In the face of adverse shocks, however, expenditure rules can constrain deficits from expanding or automatic stabilizers to work on the expenditure side. Furthermore, when implemented in isolation, expenditure rules are not directly linked to a debt sustainability objective, because they place no restrictions on revenues and, therefore, on fiscal deficits. Furthermore, the more expenditure rules are designed to be counter-cyclical (e.g. excluding automatic stabilizers in the rule), the further away they veer from debt sustainably objectives. That said, expenditure rules have been adopted at different points in time in Brazil, Belgium and Sweden, to name a few countries.

3.4 Revenue Rules

Finally, a fourth set of fiscal rules entail placing ceilings or floors on revenues (typically as a percent of GDP) with the aim that ceilings work to ensure that tax burdens are not too high and conversely that floors incentivize tax administration and revenue collections. One of the benefits of such rules is that they can lead to improved revenue generation and tax administration. However, like expenditure rules, they are not correlated with debt sustainability because they place no restrictions on the expenditure side. Furthermore, operationalizing revenue floors or ceilings can be challenging and impractical, given that revenues are

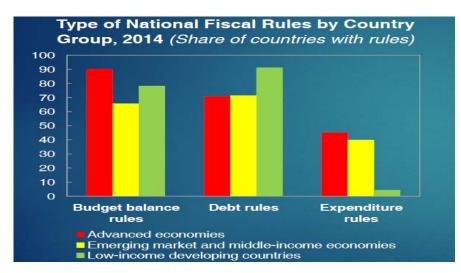
strongly correlated with the state of the business cycle. As a consequence, putting floor/ceilings also ensures that fiscal policy becomes pro-cyclical during downturns/booms, respectively. Finally, like expenditure rules, these are not easy to monitor and communicate and create continuing uncertainty about the eventual fiscal deficit and market borrowings in any given year. Other variants of revenue rules entail determining the use of windfall revenues. Examples of countries that have adopted revenue rules at some point include France, Denmark and Kenya.

Type of rule	Pros	Cons
Debt rule	Direct link to debt sustainability	Not linked to the business cycle
	Easy to communicate and monitor	Can be impacted by non-fiscal flows
		Provides no operational guidance to fiscal
		targets
Budget balance rule	Closely linked to evolution of debt ratios	Does not necessarily provide stabilization benefits;
	Easy to communicate and monitor	can make fiscal policy procyclical
	Provides clear operational targets	
Structural budget	Provides economic stabilization benefits	Data constraints make it hard to assess state
balance rule		of busines cycle in emerging markets
	Linked to evolution of debt	Can be abused because of its opacity
		Difficult to communicate and monitor
Expenditure rule	Provides counter-cyclicality under certain conditions	Not necessarily linked to debt sustainability
	Tries to optimize size of the government	
	Easy to communicate and monitor	Becomes procyclical when hit with adverse shocks
Revenue rule	Tries to optimize size of government	Not necessarily linked to debt sustainability
	Keeps the focus on revenue policy and administration	on
	Help manage windfalls	Can become procyclical under certain conditions

4. **Prevalence of Rules: The Country Experience**

So how prevalent are each of these rules, given their trade-offs? In the case of advanced economies, budget balance rules appear the most common, with 90 percent adhering to a budget balance rule, about 70 percent to a debt rule, and 40 percent to expenditure rules (IMF, 2014). The percentages add up to more than 100 because countries can simultaneously adopt more than one rule.

In the case of emerging markets, debt rules are slightly more common than budget balance rules. About 70 percent of emerging markets have debt rules, 65 percent have budget balance rules, and 40 percent have expenditure rules (IMF, 2014).



Source: IMF Fiscal Rules Database (2014).

5. General Principles Underpinning Fiscal Rules

There is no unique fiscal rule that is always and everywhere applicable. Instead, the fiscal rule that a country adopts very much mirrors the most important objective/constraint that the country faces (sustainability versus stabilization).

Kopis and Symansky (1998) summaries the characteristics of a sound fiscal rule:

- Transparency
- Simple to communicate and monitor
- Coherent with the larger objective
- Mindful of other public policy goals
 - Allow for fiscal stabilization (or, at least, not exacerbate economic volatility)
 - Not discourage structural reforms
 - Disincentivise low-quality adjustments (undue tax hikes, cuts in productive spending)

The aforementioned principles constitute an ideal paradigm that should underpin a fiscal rule. In practice, however, fiscal rules are rarely able to simultaneously achieve all these objectives. Instead, two clear trade-offs are implicit.

- **Balancing "flexibility" with a "fiscal anchor":** Rules that create anchors typically do not have economic stabilisation properties and, very often, can be pro-cyclical (e.g. headline fiscal-deficit/debt rule). Conversely, rules that are created to be counter-cyclical (e.g. an expenditure rule) can often veer away from sustainability objectives and, therefore, not serve as a good fiscal anchor.
- **Balancing "flexibility" with "simplicity".** The ease of monitoring and communicating a rule is an important attribute to anchor market expectations, build public support and verify that policymakers have complied with the rule. However, rules that try and create both a fiscal anchor and achieve economic stabilization properties (i.e. a cyclically-adjusted rule) and thereby mitigate the first trade-off -- are often at the cost of simplicity, transparency and ease of monitoring and communication.

6. Second Generation Fiscal Framework

Recognizing the need to incorporate the principles that underpin a sound fiscal framework and the tradeoffs that are inherent, second generation fiscal frameworks typically comprise of four main characteristics:

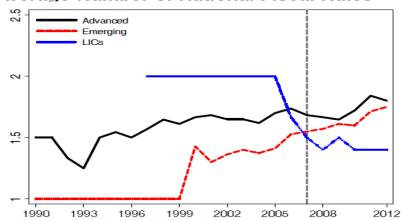
6.1 Using More Than One Rule In Tandem

An increasing number of countries are operating with more than one fiscal rule in order to mitigate the the trade-offs between credibility and flexibility.

As the chart below shows, emerging markets averaged one rule till about 2000, but the average number of rules in emerging markets has now almost doubled to 1.7. Similarly, the number of rules that advanced economies have adopted has also increased from about 1.5 in 1990 to about 1.8 by 2012.

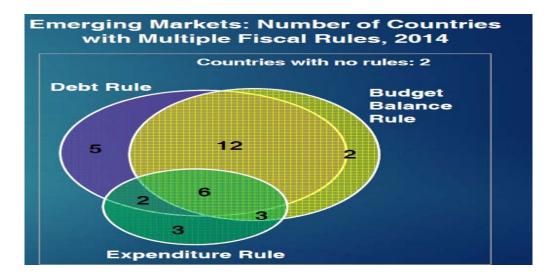
The IMF Fiscal Rules Database (2014) lists 33 emerging markets as having fiscal rules, with 23 having more than one rule in place while 10 countries have one in place. The most common combination is a debt rule and a budget balance rule, which is adopted in 12 emerging markets – or half of the universe that adopts two rules. Three emerging markets have a combination of a budget balance rule and an expenditure rule, and 2 emerging markets have the combination of a debt rule and an expenditure rule. Six emerging markets have all three rules (debt, balance budget and expenditure rule) in tandem, while 10 emerging markets observe only one rule.

That said, as alluded to earlier, having too many rules complicates fiscal policy-making by potentially making the rules internally inconsistent, and thereby forcing policymakers to rank order the rules in case of a conflict. Increasing complexity also poses problems with compliance, monitoring and communication.

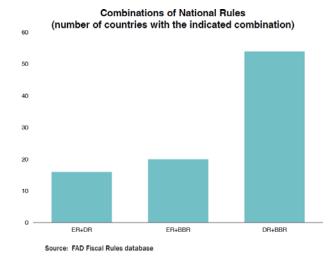


Average Number of National Fiscal Rules

Source: IMF Fiscal Rules database (2014).



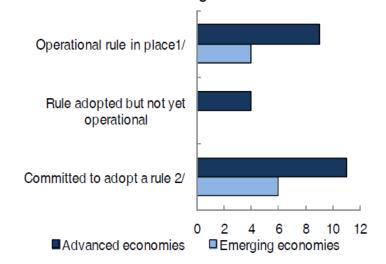
Source: IMF Fiscal Rules database (2014).



6.2 Adopting more flexibility, including through escape clauses

Second, more countries are adopting rules that provide flexibility to react to the vagaries of the business cycle and exogenous shocks, likely reflecting the fact that some countries were hamstrung by fiscal rules that existed at the time of the global financial crisis. While many countries did deviate from their rules during the crisis, such deviations likely came at the expense of credibility. As a consequence, the move to more flexible rules is likely a reaction to that experience, and reflects a desire to create a framework that both provides an anchor and yet allows some flexibility.

One natural manifestation of a rule that entails flexibility is to adopt a cyclically-adjusted (or structural) deficit rule. However, as discussed above, this does not appear feasible in the case of emerging markets, given the difficulties of identifying the state of the business cycle and quantum of the output gaps, resulting in just a few emerging markets going down this route.



Number of Countries with Budget Balance Rules that Account for the Economic Cycle

Sources: Schaechter and others (2012)

Therefore, countries have also introduced flexibility through "escape clauses" that provide flexibility and/or space for deviations from rules when policymakers have to contend with external events outside the government's control.

In theory, well-specified escape clauses and best practices should involve:

- A very limited range of factors outside the government's control that trigger the escape clause (e.g. natural disasters, wars, emergencies)
- A relatively clear and unambiguous threshold of when and whom triggers the escapes clause
- A clear specification of the return path and treatment of accumulated deviations.

In practice, however, countries have used escape clauses even for events that are not completely out of the government's control and also defined their invocation in a more ambiguous manner. The table below lists some examples of escape clauses. As is clear, all but two countries in the list invoke escape clauses in the case of natural disasters, but all countries invoke escape clauses in the case of economic recessions. Further, most invoke these clauses for other events outside the government's control, though these are defined differently in different countries.

Country and Date	Natural disaster	Economic recession	Banking system ballout, guarantee schemes	Change In Government	Change In budget coverage	Other events outside govt. control	Voting mechanism defined	Transition path defined
Brazil (since 2000)	х	х	-	-	-	-	х	-
Colombia (since 2011)	-	х	-	-	-	x	-	-
Germany (since 2010)	x	х	-	-	-	х	х	х
Jamaica (since 2010)	x	х	-	-	-	х	-	-
Mauritius (since 2008)	x	х	-	-	-	x	-	-
Mexico (since 2006)	-	x	-	-	-	-	-	-
Panama (since 2008)	x	х	-	-	-	х	-	х
Peru (since 2000)	x	х	-	-	-	х	-	х
Romania (since 2010)	-	х	-	х	х	х	-	х
Slovakia (since 2012)	x	х	х	-	-	х	-	-
Spain (since 2002)	x	х	-	-	-	х	х	х
Switzerland (since 2003)	x	х	-	-	-	х	х	х
EU member states/ euro area (since 2005) WAEMU (since 2000)	-	x	-	-	-	-	-	x
WALMO (SINCE 2000)		х	-	-	-	-	-	-

Table 5. Fiscal Rules with Escape Clauses

Source: FAD Fiscal Rules Dataset.(2014)

A table in the appendix contains several example of how and why the escape clause is invoked in the country experience.

6.3 Automatic Correction Mechanisms

Automatic correction mechanisms specify in advance (typically encoded in the legislation) how deviations from the rule will be handled. This is now a requirement for EU countries that have signed the "Fiscal Compact". An *ex ante* auto correction mechanism is a visible signal of policymaker's commitment and supports the credibility of fiscal rules.

Some examples of countries that that use automatic correction mechanisms include:

- Germany and Switzerland: deviations from the structural budget balance rule (positive or negative) are stored in a national account; when the accumulated deviation exceeds a threshold, improvements in the structural balance are required within a pre-defined timeframe to undo these deviations (Source: German Federal Ministry of Finance, 2011; Bodmar, 2006)
- Poland and Slovakia: Actions are triggered when certain debt thresholds are reached. These include the Ministry of Finance suggesting to Parliament measures to reverse growth, the Cabinet passing a packet of measures to trim debt and freeze wages, and expenditures being cut automatically at different debt thresholds.

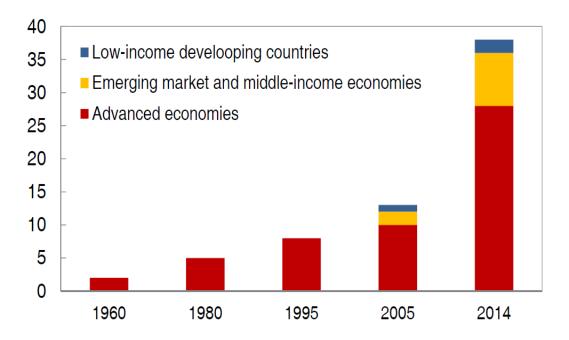
6.4 Independent Fiscal Councils

In recent years, an increasing number of advanced and some emerging economies are using independent bodies ("fiscal councils") to further enhance the credibility of their fiscal rules.

In particular, a fiscal council can be thought of as independent, non-partisan agency – set up either through a statutory or executive mandate to – to publicly assess the government's fiscal performance against its stated objectives.

As the chart below shows, the number of countries that had fiscal councils before 2005 was less than 15. By 2015, it had almost tripled to about 40. Furthermore, 10 emerging markets had established fiscal councils by 2014, versus just about 2 a decade before.

Number of Fiscal Councils has grown sharply post crisis



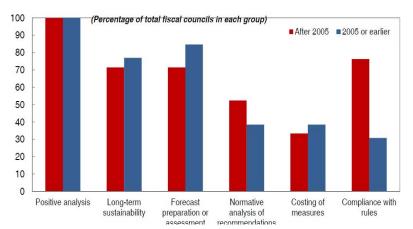
Source: IMF Fiscal Councils Dataset and staff estimates.

Fiscal Councils can serve both *ex ante* and *ex post* functions. A representative list of functions that fiscal councils across the world fulfill include:

- Producing independent forecasts (e.g. GDP growth, tax buoyancy, commodity prices) and/or reviewing the government's forecasts and assumptions (an ex ante function)
- Monitoring governments' fiscal performance including adherence to fiscal rules (an ex post function), triggering escape clauses, and managing the path of automatic correction mechanisms
- Long-term sustainability analysis: conducting a debt sustainability analysis under different assumptions, and vetting the realism of those assumptions
- Independently costing new proposals

As the figure below reveals, positive analysis, long-term sustainability assessments and forecasting are the most frequent missions of fiscal councils. Evaluating compliance with fiscal rules is a feature of more recently established councils.

Functions that Fiscal Councils perform



Source: IMF Fiscal Councils Dataset and staff estimates.

Diversity of Institutional Models Exists

A variety of institutional models exist for the manner and location in which fiscal councils are set up and reside:

- Stand-alone institutions that are typically set up as part of fiscal responsibilities laws
 - Countries that adopt this approach include Germany, Hungary, Ireland, Portugal, Romania, Serbia and the Slovak Republic
- Councils under the legislative branch
 - They include parliamentary budget offices (PBOs) traditionally in presidential political systems (United States, Korea, Mexico); other countries that have adopted this approach include Australia, Canada, Italy, Georgia, Kenya and South Africa

Councils that come under the executive branch •

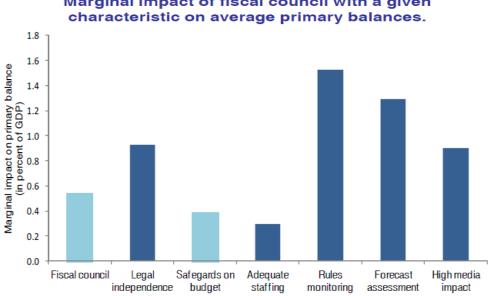
They exist in Belgium, Croatia, Denmark, Japan, Netherlands, Slovenia, the U.K. and Chile 0

Paired with other financial institutions •

They exist in France and Finland. 0

International experience suggests that fiscal councils can improve fiscal outcomes and forecast accuracy, especially when they are (a) independent; (b) have a strong media profile; (c) are tasked with monitoring fiscal rules; and (iv) are involved in forecast assessment.

As the figure below suggests, these attributes are most important when assessing the fiscal impact of councils on average primary balances.



Marginal impact of fiscal council with a given

Curristine (2015)

More generally, the international experience suggests that councils can improve fiscal performance and outcomes if well-designed. This includes:

- The remit and responsibilities of the Council are designed keeping in mind the country specific • context
- A strong and clear legal basis for independence exists •
- Political and operational independence is not compromised •
- **Resources commensurate to the remit are provided** •
- Transparency, accountability and strong media presence exists •

Appendix 1. Escape Clauses: Country Examples

Country	Description of Escape Clauses
Brazil (since 2000)	Real GDP growth below 1 percent over four quarters, and natural disaster but can only be invoked with Congressional approval.
Colombia (since 2011)	In case of extraordinary events threatening the macroeconomic stability of the country, enforcement of the fiscal rule may be temporarily suspended, subject to the favorable opinion of CONFIS (an internal fiscal council headed by the Finance Minister).
Germany (since 2010)	Natural disasters or unusual emergency situation which are outside government control and have major impact on the financial position of the government. Absolute majority of parliament is needed to trigger the escape clause. Parliament must approve an amortization plan with a specified timeframe for reducing the accumulated deviation. Until 2010, escape clause in case of a "distortion of the macroeconomic equilibrium."
Jamaica (since 2010)	The targets may be exceeded on the grounds of national security, national emergency, or such other exceptional grounds, as the Minister may specify in an order subject to affirmative resolution.
Mauritius (since 2008)	Temporary deviations in case of emergencies and large public investment projects.
Mexico (since 2006)	If non-oil revenues are below their potential due to a negative output gap, there can be a deficit equivalent to the shortfall.
Panama (since 2008)	If real GDP grows by less than 1 percent, the non-financial public sector deficit ceiling can be relaxed to 3 percent of GDP in the first year, followed by a gradual transition to the original ceiling (1 percent of GDP) within 3 years.
Peru (since 2000)	If real GDP declines or in case of other emergencies, declared by the Congress at the request of the Executive, the deficit ceiling can be relaxed up to 2.5 percent of GDP. The Executive must specify deficit and expenditure ceilings to be applied during the exception period. In both cases a minimum adjustment of 0.5 percent of GDP is required until the 1 percent deficit ceiling is reached.
Romania (since 2010)	In case of a government change, the new government will announce whether its program is consistent with the Medium-Term Budgetary Framework (MTBF) and if not the Ministry of Finance will prepare a revised MTBF, to be approved by parliament and subject to the review and opinion of the Fiscal Council.
Slovakia (since 2012)	Escape clauses for a major recession, banking system bailout, natural disaster, and international guarantee schemes.
Spain (since 2002)	In case of natural disasters, exceptional slowdown, exceptional budget deficits are accompanied by a medium-term financial plan to correct this situation within the next 3 years (to be approved by a majority vote by the parliament).
Switzerland (since 2003)	The government can approve by supermajority a budget deviating from the budget balance rule in "exceptional circumstances," which are defined in Budget Law as natural disaster, severe recession, and changes in accounting methods.
EU member states/ euro area (since 2005)	An excessive deficit procedure may not be opened when the 3 percent deficit limit is exceeded only temporarily and exceptionally, and the deficit is close to the deficit limit (both conditions need to apply). Deadlines for excessive deficit correction can be extended in case of adverse economic developments.
WAEMU (since 2000)	Temporary and pronounced shortfall of real GDP (at least 3 percentage points below the average of the previous 3 years) and budget revenue (at least 10 percentage points below the average of the previous 3 years average).

Source: National authorities; and IMF staff assessment.

Country	Year	Rule	Country	Year	Rule	Country	Year	Rule
Malaysia	1959	DR	Chile	2001	BBR	Malta	2004	BBR+DR
Indonesia	1967	BBR	Costa Rica	2001	BBR	Pakistan	2005	BBR+DR
Lithuania	1997	DR	Namibia	2001	DR	Mexico	2006	BBR
Antigua & B.	1998	BBR+DR	Eq. Guinea	2002	BBR+DR	Romania	2007	BBR+DR
St. Kitts & N.	1998	BBR+DR	Panama	2002	BBR+DR	Russia	2007	BBR
St. Lucia	1998	BBR+DR	Botswana	2003	ER	Armenia	2008	DR
Poland	1999	DR	Bulgaria	2003	DR	Mauritius	2008	DR
Argentina	2000	ER+BBR	Ecuador	2003	BBR+DR	Croatia	2009	DR
Brazil	2000	ER+DR	Sri Lanka	2003	BBR+DR	Jamaica	2010	BBR+DR
Colombia	2000	ER	Hungary	2004	BBR+DR	Serbia	2011	BBR+DR
Peru	2000	ER+BBR	India	2004	BBR	Georgia	2013	ER+BBR+DF

Appendix 2: Fiscal Rules Initially Adopted by Emerging Markets

Source: IMF Fiscal Rules database (2015).

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CHAPTER 4

A 21ST CENTURY DEBT AND FISCAL PARADIGM

CHAPTER 4

A 21st Century Debt and Fiscal Paradigm

I. Introduction

Why a new fiscal framework?

Why does India need a new fiscal framework? Since the mid 1990s, government finances in India deteriorated continuously. The deterioration was the result of several factors: reform induced losses in revenue (customs and excise), poor tax performance due to narrow tax base, low tax buoyancy; but also government's inability to contain spending. Both the centre and states contributed to this deterioration (Figure 1). The implementation of the 5th Pay Commission recommendations widened the deficits especially at the state-level. In FY02, at 9.6%, India had a record deficit not only based on its own history but also when compared to the rest of the world. Persistent primary deficits also led to an accumulation of debt. Gross debt reached close to 85% of GDP around mid 2000s.

Against this background, a Fiscal Responsibility and Budget Management Act (FRBMA) was enacted in August 2003. The FRBM Act proposed that the central and state deficit would each be progressively reduced to reach 3% of GDP. The fiscal deficit target of 6% was argued as being consistent with household financial savings. It was calculated that a total of roughly 12% of GDP of household savings and external borrowing – comprised of household financial savings of 10% of GDP and a current account deficit of 2% of GDP - would be allocated equally between public and the private sector. This would lead to a combined fiscal deficit for the centre and the states of 6% of GDP, and at the same time also ensure an investment by private corporates (and public enterprises) of 6% of GDP. The 6% general government deficit was divided equally between the centre and the states.

After the enactment of the FRBMA, there was a clear improvement in the fiscal position of the government. The general government deficit declined from a peak of 9.6% in FY02 to 4% in FY08. In fact, the central government deficit declined to 2.5% of GDP in FY08, a year in advance from when the 3% deficit target was to be achieved. The debt to GDP ratio also declined during this period from 83% in FY03 to 71% in FY08. The entire fiscal adjustment during this period came from enhanced revenues, while there was no adjustment on the expenditure side. In fact, there was an increase in quasi-fiscal expenditures, issuance of subsidy related bonds, etc.

The process of fiscal consolidation, was, however, reversed after the global financial crisis. The general government deficit reached 9.3% in FY2010. The central government deficit was at a historical high. Part of this was due to crisis related measures, the slowdown in activity, and the resulting low tax revenues. However, the sharp rise in fiscal deficit can also be attributed to measures unrelated to the crisis, which were planned in any case. For example, the implementation of the 6th Pay Commission recommendations, and the expansion of the Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) in the run-up to the upcoming elections, contributed to the sharp rise in fiscal deficit. Moreover, in the absence of any expenditure reforms, the increase in global commodity prices in the first half of 2008 led to very high subsidy bills. These developments undermined the credibility of the government's commitment to fiscal discipline. Importantly, these developments established that revenue gains by themselves could not single handedly bear the burden of fiscal adjustment and sustainability of India's fiscal policy. Since FY09 there

has been some improvement in the fiscal balances, but not to the levels we witnessed before the crisis.

Given this background and our previous experience with the global financial crisis, it may be timely to review our fiscal framework. Indeed, during the last decade, many countries have sought to improve fiscal management and fiscal outcomes through fiscal rules.

Why debt?

A transparent and predictable policy framework is one that is rule-based. Central to a credible framework is the concept of an anchor. An anchor ties down the final goal of policy, and the expectations of economic agents adjust accordingly. By acting as a constraint on policy discretion, an anchor dis-incentivizes time inconsistency, including due to pressures from interest groups.

Should India move to debt as medium-term anchor for fiscal policy? If so, why? Why not continue with the current framework where we specify a path of fiscal policy, and use fiscal deficit itself as a medium-term target of fiscal policy? In this section, we present six key arguments that may suggest moving to a debt ceiling as a medium-term anchor of fiscal policy.

First, the standard government solvency constraint suggests using debt as the ultimate objective of fiscal policy. The solvency constraint implies that at some point a solvent government has to run primary surpluses; in technical terms, it is called a "No-Ponzi condition", i.e. the present discounted value of the terminal government debt should be equal to or less than zero.

Second, debt and fiscal deficit may not be mutually exclusive choices. Cross-country evidence suggests that fiscal rules must be comprehensive, and a debt ceiling combined with fiscal deficit as an operational target could jointly provide a robust fiscal framework. 68 countries have debt rules, and the number of countries with debt ceilings has increased significantly. Importantly, countries are increasingly adopting multiple rules in order to have a robust fiscal framework (Figure 2).

Third, there seems to be a common perception that countries like India with a high domestic debt burden but a small fraction of external debt should not worry about public debt. One reason for this perception is the belief that governments can never default on domestic debt as they can always print money and inflate away their debt. However, in practice, high inflation could be costly as well. Inflation causes distortions, and governments may find high inflation to be more costly compared to repudiating debt. The potential costs of inflation are likely to be higher, especially in inflation-targeting (IT) regimes like the one recently constituted in India. In an IT regime, if the government tries to inflate away its debt by creating a level of inflation higher than the target, it could lead to a loss in credibility of the central bank and the government. Moreover, defaults on domestic debt do occur frequently e.g. Argentina defaulted thrice on its domestic debt between 1980 and 2001. The output costs of domestic defaults are also high, and in fact can be significantly worse than that of external debt (Reinhart and Rogoff (2008)). In addition to measured defaults, there can be "de facto" defaults as well. Financial repression combined with increasing inflation has also helped India "de facto" default on its debt. Indeed, there are discussions going on in Basel to attach risk-weights to sovereign paper – irrespective of whether the borrowing is from domestic or external sources.

Fourth, another commonly perceived wisdom is that debt/GDP ratio has been on a declining trend in India, therefore, it does not constitute a source of worry going forward. To put this perception in context,

it may be useful to look closely at stylized facts on the evolution of public debt in India. Public debt in India has been in the range of 48% and 83% of GDP between FY81 and FY15. The lowest point of 48% of GDP was achieved back in FY81, it increased since then to reach a peak of 83% of GDP in FY03. Since mid 2000s, public debt has indeed been on a declining trend, and is estimated to reach close to 70% in FY17. As discussed above, India underwent substantial fiscal consolidation after the introduction of the FRBMA in 2003 till FY08. During this consolidation phase, the debt ratio was reduced from 83% in FY03 to 71% of GDP in FY08. Despite a fiscal expansion since FY08, where the gross fiscal deficit increased from 4% in FY08 to around 7% in FY15, debt/GDP ratio continued to decline. This is primarily because during the entire period, it is, in fact, a favorable interest rate growth differential arising from high growth rates and relatively low interest rates that has facilitated the consolidation of debt (Figure 3). However, a negative interest growth differential cannot be a long-run equilibrium, and may not persist over time. For example, the trend has already begun to slope upwards, which may make it difficult to sustain India's debt in the long run.

Fifth, to put the argument of a debt ceiling for India in perspective, it is also important to compare the evolution of India's debt with that in other emerging markets. India stands out as among the most indebted countries in the sample. India's incremental debt (which is identical to its fiscal deficit, see Annex 1 for details) also stands out as among the highest among emerging markets (Figure 4). Therefore, a case can be made for a successor fiscal framework, which is more likely to achieve fiscal discipline, to be centreed around a medium-term debt ceiling.

Finally, public debt is also one of the factors in the assessments of rating agencies. Credit rating agencies include public debt in their fiscal block. India has higher outstanding debt, and higher fiscal deficit, compared to the average of Emerging Markets (EM) peers with similar ratings (Table 1). While small reductions in debt will not move India into a higher rating category, a progressive reduction in debt may be needed even to keep its current rating.

The rest of the chapter is organized as follows. Section II employs several approaches to calculate a debt ceiling for India; Section III calibrates the path of fiscal deficit and debt going forward under different assumptions; Section IV concludes with key policy recommendations.

II. Prudent Ceiling for India's Debt to GDP Ratio

Methodologies

We adopt several methodologies to determine the optimal ceiling for India's public debt to GDP, as its mediumterm anchor for fiscal policy. In what follows, we describe the approaches briefly, and present our findings.

I. Debt and growth

According to this approach, we can calibrate the debt threshold by estimating the level of debt/GDP at which debt has a negative effect on economic growth. In various economic models, reasonable levels of current debt inflows are expected to have a positive effect on growth. There is an incentive for capital scarce countries, especially those with infrastructure gaps like India, to borrow and invest, since the marginal product of capital is higher than the cost of borrowing. But large levels of accumulated debt can also be associated with lower growth. A higher public debt can distort economic activity to service the debt through distortionary taxes, or through cuts in productive spending, which can dampen investment and growth. The

idea translates into a so-called "Laffer curve" for the effect of debt on growth. Along the left or "good" side of the curve, increases in the stock of debt are associated with higher investment and higher growth, while higher debt service is associated with distortionary taxation, and reduced spending on productive investment on the "wrong" side of the curve.

We estimate non-linear regression specifications that allow us to identify a level of debt at which the impact of debt on growth becomes negative. In particular, we employ a quadratic function, which is specified as follows:

$$y_t = \alpha + \beta D_t + \gamma D_t^2 + \delta X_t + \varepsilon_t \tag{1}$$

where y_t represents GDP growth, D_t the debt indicators, and X_t denotes the control variables in a standard growth regression. The specification (1) would support a debt and growth Laffer curve relationship if the estimated coefficient on debt, β , is positive, and the estimated coefficient on debt squared is negative. The peak of the quadratic function identifies the level of debt at which the marginal impact of debt on growth becomes negative.

We also employ a spline specification that can be specified as follows:

$$y_t = \alpha + \beta D_t + \gamma D_t * Dum_{(D > D^*)} + \delta X_t + \varepsilon_t$$
(2)

 $Dum_{(D>D^*)}$ is a dummy that takes a value of 1 if debt is above the threshold D*. The coefficient γ captures whether the effect of debt on growth is significantly different at high levels of debt. We use quarterly data from India between 1999-2013 and estimate specifications (1) and (2). Due to lack of quarterly data on state government debt, we restrict the regression analysis to central government debt. Table 2 presents the results. The dependent variable is the GDP growth rate in all the regressions. Column (1) shows the results from estimating a simple linear regression of GDP growth on Debt/GDP, while columns (2)-(5) present non-linear specifications. Column (1) suggests that debt is negatively associated with growth. Columns (2)-(5) provide evidence for non-linear effects. Increasing debt is associated with positive growth up to a certain point, beyond which the association turns negative. In general, we estimate the turning point with debt/GDP at around 40%. In other words, debt levels greater than approximately 40% of GDP are detrimental for the growth rate of the economy. After this threshold, an increase in debt of 1 percentage point of GDP is associated with a lower GDP growth rate of approximately 0.6-0.7 percentage points. The ceiling of 40% of GDP remains robust to a number of alternative specifications, and time series properties of the key variables. Assuming a debt/GDP ratio of 20% for the states, roughly at their current level, our analysis suggests an optimal general government debt/GDP ceiling of around 60%.

II. Maximum level of sustainable public debt

The second approach starts with the government's inter-temporal budget constraint. This is a standard solvency constraint, which implies that at some point, a solvent government will have to run primary surpluses. In technical terms, this is known as the no-Ponzi condition, which suggests that the present discounted value (PDV) of the terminal government debt should be equal to or less than zero. From the government's inter-temporal budget constraint, and adding to it a simple debt dynamics equation, we can derive a simple relationship between the current debt to GDP ratio and the future primary fiscal balances. The relationship suggests that the sustainable level of debt should be less than or equal to the PDV of the expected future primary surpluses, where the discount factor is given by (r-g), where r is real interest rate on government debt, and g is the real growth rate.

This methodology, however, is not easily adaptable to India as India has historically recorded primary deficits, which would imply a negative value of sustainable debt. Second, even the discount factor, or the difference between real interest and growth rates, has consistently been negative. This is because a number of factors, such as a captive investor base for government securities, as well as capital controls, have kept the cost of government borrowing low. As these conditions are eased, a negative (r-g), which is inconsistent with a long-run equilibrium in any economic model, may cease to exist. Assuming that in the medium to long-term, the government can run a primary surplus of 0.5% of GDP, and the real cost of borrowing for the government is higher than the growth rate by say 0.8 percentage points of GDP, we can arrive at a sustainable level of debt to GDP ratio of 60%. Lower is the long-run primary surplus, and higher is the effective borrowing cost of the government (r-g), lower will be the sustainable level of public debt. For example, if the government runs a long-run primary surplus of 0.3% of GDP, and government's real borrowing cost for the government is higher than the growth rate by surplus of 0.3% of GDP, and government's real borrowing cost for the government is higher than the growth rate by about 1 percentage point, the sustainable level of public debt will only be at 30% of GDP.

III. Comparison with other emerging markets

To put the choice of India's debt ceiling in perspective, it is important to compare the evolution of India's debt with that in other emerging markets. As discussed above, India, whose public debt is estimated at roughly 68% of GDP in FY15, stands out as among the most indebted countries in the sample. It is, however, also true that India has reduced its debt ratio since FY06. But its progress has, in fact, been weak when seen in the context of its impressive growth record, and its high inflation history. For example, Turkey, Peru, Hungary, Israel, Poland, which reduced their debt ratio by more, all achieved it with lower average growth rates over the sample period (Figure 5). Importantly, while India's debt ratios have improved, its incremental debt to GDP ratio, which is equal to its fiscal deficit, remains one of the highest among emerging markets.

IV. Debt intolerance

Our next approach relies on the concept of "debt intolerance". Debt intolerance, a concept first introduced by Reinhart et. al., 2003, refers to levels of debt where emerging markets have difficulty accessing capital markets. It is possible that emerging economies get cut off from external markets even at low levels of external debt, while other highly indebted countries may continue to have market access. Debt intolerance can typically be explained by a few variables, e.g., a country's default and inflation histories. Following methods used in the literature (see for example, Topalova and Nyberg, 2010; Saxegaard, 2014), we estimate the level of public debt at which India can become debt intolerant. We can derive a threshold for safe debt by estimating a relationship between debt intolerance and public debt to GDP ratio, using cross-country data for a sample of 110 countries, over a period covering 2000-2014. Debt intolerance is proxied by the Institutional Investor Rating (IIR). The threshold can be derived in three steps. First, countries are grouped in 3 clubs where the cutoffs are based on the mean and standard deviation of the IIR over the entire sample. Second, we estimate the relationship between countries' IIR and their public debt to GDP ratio. Third, the estimated regression coefficients are applied to derive the predicted debt levels for India, and the maximum threshold that will keep India from dropping to a more debt intolerant club.

India's rating has improved over time, and it has been in the "intermittent-high" club (B1) since 2004. India's IIR has generally moved closely with the average of its EM peers, but has diverged more recently, with India's IIR being lower than that of its peers. Similar to earlier studies, we find that higher debt is associated with lower sovereign rating for countries in clubs B and C. Using the estimated coefficients from the regression, we predict the IIR for India at different levels of general government debt. We find that if India were to reduce its debt to GDP ratio to 60-65% of GDP, it would be in a less debt intolerant club of countries. Allowing for some buffer to account for uncertainties may suggest a level of safe debt of around 60% of GDP (Table 3).

V. Credit Rating Agencies

As discussed above, the stock of public debt and fiscal deficit are also important determinants of sovereign ratings in the models of credit rating agencies (e.g. S&P, Fitch, and Moody's). They appear as an important input in the "Fiscal Assessment" block of their models. Table 4 shows that in comparison to other countries with similar ratings, India reported much higher debt and deficits. On average, EMs with similar ratings reported a debt/GDP ratio of 40%, compared to close to 70% India. For example, Indonesia has a debt ratio of 25%, while Turkey's is close to 38%. A reduction in India's debt and deficits may, therefore, be needed even to remain in its current grade, given the wide difference from its peers. A reduction in India's debt would also be needed to attract a higher rating. For example, the median country with a Fitch sovereign rating of A, has a debt to GDP ratio of 45%.

VI. A Stochastic Approach

Our next approach applies the methodology developed by Debrun, Jarmuzek, and Shabunina (forthcoming) and Celasun, Debrun, and Ostry (2007) to the case of India. The idea underlying this approach is that a debt anchor should be such that there is a low probability of reaching a fiscal "cliff" over a given horizon if negative shocks occur. A fiscal cliff is defined as a level of debt beyond which a country goes into debt distress, the government's solvency or liquidity is put into question, and the government loses control over its debt dynamics. The guardrail of fiscal policy needs to be set far enough from the cliff such that there is a sufficient buffer when countries are subject to macro and fiscal shocks.

In practice, this methodology first involves estimating a threshold or a fiscal cliff. To get a level of debt beyond which debt cannot be stabilized, we consider a hypothetical situation in which (i) the PB hits its policy limit and (ii) the (r-g) is very unfavorable/high (that's what we call call "r-g under stress"). Using the recent experience of Brazil as an example of an emerging market under stress, we can easily observe r-g above 2-3 percent (in Brazil, 10 year government bond yields hover around 12-16 percent, while nominal growth is below 10 percent). Applying this to India, and assuming values of 2% and 2.5% for long-run primary balance and r-g respectively, we arrive at a threshold for the debt/GDP of 85%. Next, three blocks are estimated: (i) *Economic block:* which involves estimating a vector autoregressive model (VAR) to derive (a) estimates of country-specific shocks to macroeconomic variables such as the interest rate, growth, and the exchange rate that a country was subject to in the past; and (b) projections for these variables. (ii)

Fiscal block: which involves estimating a "fiscal reaction function" to derive/calibrate (a) how the primary balance responds to debt; (b) country- specific shocks to the primary balance; and (c) the maximum primary balance that can be achieved; (iii) *Simulation block:* This facilitates the computations by combining the economic and fiscal blocks into a debt equation on the basis of stochastic simulations. Estimation of the three blocks enables us to calculate a debt level that would provide sufficient safety margins to stay beneath the threshold.

Figure 6 shows a fan chart, which describes a range of alternative debt trajectories under different macroeconomic shocks for India. For each sequence of shocks that are drawn from the VAR, we construct a debt path that results from the combination of the debt accumulation equation and the fiscal reaction function. Given that we use the VAR to do 1000 draws, we have 1000 sequences of shocks and thus 1000 debt trajectories. For very bad shocks (low GDP growth/high interest rate for instance), the debt trajectory is high; for favorable shocks, the debt trajectory is low. The solid line in the fan chart is the median. The goal is to choose the initial debt level so that the debt fan chart stays below the threshold with a high probability. This initial debt level is what we call the debt anchor. Starting from this level, future debt can withstand shocks without breaching the debt limit and growing out of control. Figure 6 shows the estimates for India with a 5 percent probability of staying beneath the threshold, which is quite conservative. The time horizon is 6 years (same horizon as WEO projections). In the case of the 85 percent debt limit, to maintain the safety margins with a 95 percent degree of certainty, the exercise suggests that public debt would need to be 60 percent of GDP or less. If we assume a cliff of 80% of GDP, the safe level of debt anchor would be even lower, at 50% of GDP.

VII. Debt Ceilings in Other Countries

An increasing number of countries have been using a debt rule. For example, the number of countries with debt rules has increased from 39 in 2000 to 68 in 2014. About 60% of these countries have been targeting a debt to GDP ratio of 60% (Figure 7).

Summary:

To summarize, this section employed seven different approaches to determine an appropriate or prudent debt ceiling for India. Although every approach may have some limitations, taken together with cross country evidence and assessment methodology of rating agencies, they may suggest a ceiling of around 60% of GDP for general government debt in India. Importantly, the ceiling should be interpreted as a "guardrail", in the sense that debt/GDP should be contained within this ceiling; and a debt/GDP ratio lower than this ceiling would be consistent with all the methodologies presented above. Given that currently India is at debt levels higher than what the analysis suggests is a prudent level, operationally, the debt ceiling can also be interpreted as a medium-term target or objective to guide fiscal policy.

III. How to Get There? A Debt Sustainability Analysis (DSA) for India

Framework

Having established a medium term debt ceiling, the next important question is how would the ceiling be achieved operationally? India's envisaged debt ceiling of 60% of GDP should be achievable under realistic

assumptions on macroeconomic variables and plausible reform scenarios. In this section, we ask the question: under what assumptions can the medium-term ceiling be achieved, and also how many years would it take for India to achieve its medium-term goal. The ceiling would make sense only if it can be attained under plausible macroeconomic scenarios.

We start with a very simple framework to conduct the so-called "debt sustainability analysis". The basic idea underpinning the analysis is as follows: A country can be defined to be solvent if the net present value (NPV) of the income stream (excluding interest payments) is at least as large as NPV of expenditure plus any initial debt. In other words, the inter-temporal budget constraint is met or the No-Ponzi-game condition is satisfied. It can be shown that if debt/GDP ratio is on a stable or declining path, the solvency condition is automatically met (Blanchard and Fischer, 1989). The framework therefore relies on using economic theory and all available information to project public debt/GDP in the medium-term.

The evolution of debt can be described by a simple equation, which expresses total stock of debt in the next period, as a sum of the current debt stock, interest payments on the current debt stock, and less the primary balance. In other words,

(1)
$$D_{t+1} = D_t * (1+r) - PB_{t+1}$$

where r is the nominal interest rate in debt, and PB is the government's primary balance.

Dividing (1) by nominal GDP, and simplifying the equation implies the following equation:

(2)
$$d_{t+1} - d_t = \frac{r}{(1+g)}d_t - \frac{g}{(1+g)}d_t - pb_{t+1}$$

where d denotes the ratio of debt stock to nominal GDP, and g is the growth rate of nominal GDP. In this very simple model, changes in debt/GDP ratios can be projected as a sum of contributions from three factors: (i) interest rate, (ii) growth rate of GDP, and (iii) the primary balance. Intuitively, the idea is that higher the interest rate, the lower the GDP growth rate, and lower the primary balance, higher will be the debt stock going forward.

Debt Sustainability Analysis (DSA) for the Central Government

We start by analyzing the debt dynamics for the central government. The analysis presented above also suggests a ceiling of around 40% for the centre. A ceiling of 40% GDP for the centre is based on calibrating a level beyond which additional borrowing would crowd out space for productive investment and social spending, and have an adverse effect on economic growth. We build six key scenarios under different assumptions on primary deficit, interest rate, and GDP growth, and project the path of India's central government debt going forward. We assume a medium-term debt ceiling of 40% of GDP for the centre, and analyze how long would it take to reach the ceiling under different scenarios. We assume nominal GDP to grow at 11.5% (e.g. a real GDP growth of 7%, and an inflation rate of 4.5%) in all the scenarios. This is also the average growth in nominal GDP over the last five years from FY12-FY17.

Finally, initial debt is taken from the FY17 Budget, and is assumed at 49.4% of GDP. The initial debt assumption is based on the figure for total liabilities of the central government. The total liabilities include

"debt" and other liabilities, and broadly represent public account liabilities, and are currently estimated at ₹ 74,38,481 crores, or 49.4% of GDP (see Annex 5 (i) of Receipts Budget FY17). The total liabilities of the central government include the securities issued by the centre under the Market Stabilization Scheme (MSS) that are used by the RBI for liquidity management operations, and the part of liabilities of the centre under the National Small Savings Fund (NSSF) that are invested in special securities issued by the states. These are of a sizeable magnitude, and they together account for 2.6% of GDP. There are three key arguments for including these in the centre's liabilities. First, irrespective of how these liabilities are used by the centre – to on lend to the states, or to be used by the RBI, these are, in effect, the centre's liabilities. Second, the total liabilities are what appear in key official documents such as the Finance Accounts and the Budget, and can be easily communicated and cross-checked with official documents. Third, the Comptroller and Auditor General, the supreme audit institution in India, does not give any credence to these adjustments, and treats them as centre's liabilities.

Nominal interest rate is projected at 7.3% (except in Scenarios V and VI, where it assumed at 7.8% and 8.3% respectively). The projection is based on the weighted average borrowing cost on outstanding liabilities of the government, which includes market loans and other liabilities. The weighted average yields for central government securities are fairly sticky as the share of fresh issuances is relatively low, so we assume it to stay at 7.3% over time in the baseline. However, if government actions, for example, lead to a loss in credibility, and to large shocks to annual borrowing costs, they can potentially affect weighted average yields, despite the fact that a relatively small fraction of the stock of existing debt may be newly incurred or re-priced. Scenarios V and VI consider these possibilities. The other assumptions, and the resulting evolution of debt and fiscal deficit for the different scenarios are presented below.

I. Present FRBM

Under the "Present FRBM" scenario, central government is assumed to follow an overall fiscal deficit path as envisaged in the present FRBM. Central government fiscal deficit to GDP is projected to take values of 3.5% in FY17, 3.0% in FY18, and is assumed to stay at that level. Simulations based on this scenario suggest that central government debt to GDP ratio would decline to 40% of GDP by FY23.

II. Accelerated Consolidation

What if the government follows a path of fiscal consolidation which is stricter than that envisaged under the current FRBM? Under this scenario, government is assumed to follow a path similar to the present FRBM scenario in the first three years, with a projected fiscal deficit of 3.0% of GDP in FY18-FY20. Fiscal deficit is then projected to decline slowly to 2.8% in FY21, 2.6% in FY22, 2.5% in FY23, and to stay at 2.5% thereafter. Under this scenario, the ceiling of 40% of GDP would be achieved by FY23 (same as under the Present FRBM scenario).

III. Significantly Accelerated Consolidation

We simulate an additional "Significantly Accelerated Consolidation" scenario, where the fiscal deficit declines to 2.5% at a faster pace than assumed under the "Accelerated Consolidation" scenario. Under this scenario, central government is projected to achieve a fiscal deficit of 3%, 2.8%, 2.7%, 2.6%, and 2.5% of GDP respectively during FY18-FY22, and at 2.5% thereafter. Under this scenario, the ceiling of 40% of GDP would be achieved by FY22 (compared to FY23 under the Present FRBM scenario).

IV. Mild Relaxation

What if the centre deviates from its short-term fiscal targets as envisaged under the Present FRBM scenario? In this scenario, we project the centre's overall fiscal deficit to take a value of 3.3% of GDP in FY18, 3.2% of GDP in FY19, 3.1% of GDP in FY20, and it is projected to stay at 3% of GDP from FY21. This scenario envisages a glide path for fiscal deficit, and allows for a deviation of 0.3% of GDP from the target in FY18, 0.2% of GDP in FY19, 0.1% in FY20, and no deviations from FY21 onwards. The simulations for this scenario suggest that the additional fiscal space in FY18-FY20 relative to what was envisaged in the FRBM would delay reaching the ceiling of 40% of GDP by one year to FY24.

V. Significant relaxation

The deviation from the fiscal deficit target in the short-term could also lead to a loss in India's credibility among foreign institutional investors (FIIs), which would reduce the demand for Indian securities, reduce their price, and increase government bond yields. The rise in government bond yields would lead to an increase in the interest burden on new debt, and also for the old debt that is re-priced. How do bond yields react to changes in fiscal deficit and market borrowings? In order to answer this question, we use a simple regression of long-term government bond yields on fiscal deficit/net market borrowings, after controlling for standard determinants of yields such as the inflation rate, forward premia, global financial volatility measured by VIX, etc. Our analysis suggests that, on average, for example, a 0.3 percentage points of GDP increase in fiscal deficit or market borrowing can increase long-term government bond yields by 10 basis points (see Table 5). There have, however, been instances when market reactions have been sharper. For example, a 1.3% of GDP slippage in fiscal deficit in March 2012, steepened the yield curve by 60 bps.

We simulate a scenario, where a deviation from the fiscal target, leads to a rise in interest rates of 50 basis points. A rise in bond yields by 50 basis points following a deviation from the FRBM, would delay reaching the ceiling of 40% of GDP by an additional year to FY25.

VI. Deep relaxation

The deviation from the fiscal deficit target in the short-term can also lead to a larger loss in India's credibility among FIIs, and can increase government bond yields by even more than 50 bps. We simulate an additional scenario, where a deviation from the fiscal target, leads to a larger increase in interest rates of for example, 100 basis points. A rise in bond yields by 100 basis points following a deviation from the FRBM, would delay reaching the ceiling of 40% of GDP by an additional year to FY26.

Table-6a summarizes the evolution of debt under all the six scenarios. A ceiling of 40% can be achieved as soon as FY22. On the other hand, the ceiling could take as long as nine years to achieve if the government relaxes the FRBM, and if that leads to a loss in credibility. The projected path of fiscal deficit/GDP and also a possible path for primary deficit/GDP of the central government under the different scenarios are summarized in Tables-6b and Tables-6c respectively. The key features, and the evolution of central government debt under the six scenarios are also summarized in Box 1. We also do a simple decomposition exercise to understand the contribution of the different drivers of debt dynamics – real GDP growth, inflation, interest rate, and primary deficit. For illustration purposes, Table 7 and Figure 8 present the decomposition under the Accelerated Consolidation scenario. Not surprisingly, central government debt dynamics going forward will predominantly be driven by real GDP growth, while inflation will also play a significant role in driving the debt ratios down. Primary deficits, on the other hand, will play a small role, and interest rates will force the debt/GDP in the opposite direction.

Box 1. How to get there? A debt sustainability analysis for the central government

What possible options could allow the central government to reach a debt ceiling of 40% of GDP? What are the pros and cons of different options? We build six key scenarios to answer these questions.

I. Present FRBM:

- Nominal GDP growth of 11.5% and an interest rate of 7.3% on central government debt.
- Central government debt declines to 40% by FY23.
- Fiscal deficit at 3.5% in FY17, declines to 3% in FY18, and stays at that level.

II. Accelerated Consolidation:

- Nominal GDP growth of 11.5% and an interest rate of 7.3% on central government debt
- Benefit: An increase in India's credibility among FIIs, and lower government bond yields.
- Cost: Reduced fiscal space for social expenditures, implementation of GST, etc.
- Fiscal deficit at 3.5% in FY17, declines to 3.0% in FY18-FY20, 2.8% in FY21, 2.6% in FY22, and 2.5% in FY23.

III. Significantly Accelerated Consolidation:

- Nominal GDP growth of 11.5% and an interest rate of 7.3% on central government debt
- Benefit: Debt to GDP declines to 40% the fastest by FY22.
- Benefit: Stronger increase in credibility relative to the Accelerated Consolidation scenario.
- Cost: Reduced fiscal space for social expenditures, compensation to states for implementation of GST, etc.
- Fiscal deficit at 3.5% in FY17, 3% in FY18, 2.8% in FY19, 2.7% in FY20, 2.6% in FY21, and 2.5% in FY22.

IV. Mild Relaxation:

- Nominal GDP growth of 11.5% and an interest rate of 7.3% on central government debt
- Benefit: Additional fiscal space relative to Present FRBM of 0.5% of GDP (₹ 75,000 crores) spread over 3 years to allow for compensation to states for short-term losses in revenue resulting from implementing of GST, and also for additional spending on infrastructure, social sector, agriculture, or for additional spending in high employment intensive industries through job creation.
- Cost: Additional one year to reach the ceiling relative to the Present FRBM scenario. Central government debt to decline to 40% by FY24.
- Cost: Loss in credibility among foreign investors (more on this in Scenario V).
- Fiscal deficit at 3.5% in FY17, 3.3% in FY18, 3.2% in FY19, and 3.1% in FY20, 3% in FY21, and stays at that level.

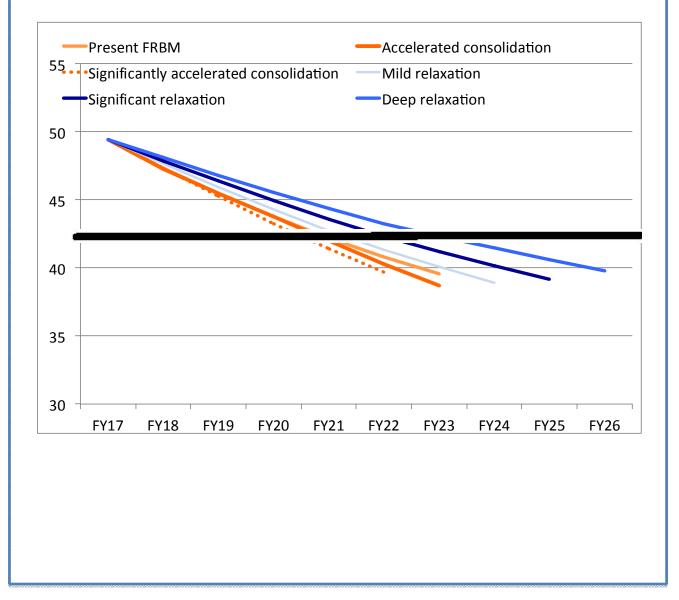
V. Significant Relaxation:

- Nominal GDP growth of 11.5%, interest rates on central government debt rise to 7.8%.
- Benefit: Additional fiscal space over 3 years relative to Mild Relaxation of 0.7% of GDP (₹ 105,000 crores).
- Cost: Additional two years to reach the ceiling relative to the Present FRBM scenario. Central government debt to decline to 40% by FY25.
- Cost: Loss in credibility, rise in interest payments, path of fiscal deficit higher than under the Mild Relaxation scenario
- Fiscal deficit to GDP at 3.5% in FY17, 3.6% in FY18, 3.4% in FY19, and declines close to 3% by FY25.

Box 1 (contd.). How to get there? A debt sustainability analysis for the central government

VI. Deep Relaxation:

- Nominal GDP growth of 11.5%, interest rates on central government debt rise to 8.3%.
- Benefit: Maximum fiscal space compared to all scenarios. Added space over years of 0.4% of GDP (~60,000 crores) relative to Significant Relaxation.
- Cost: Additional three years to reach the ceiling relative to the Present FRBM scenario. Central government debt to declines to 40% by FY26.
- Cost: Sharper loss in credibility, and increase in interest payments, path of fiscal deficit even higher than under the Significant Relaxation scenario
- Fiscal deficit to GDP at 3.5% in FY17, 3.8% in FY18, 3.7% in FY19, 3.6% in FY20, 3.5% in FY21-FY24, 3.4% in FY25-FY26.



Recommended path for the operational target

A central argument for adopting a fiscal deficit target of 3 percent 2003 FRBM Act was based on household savings. We apply a similar argument to derive at a path for the operational target, consistent with achieving the medium-term debt ceiling. Based on the latest data from the CSO and the RBI, net household financial savings were reported at 7.6% of GDP for FY15. Further, India's external borrowing needs can be proxied by its sustainable current deficit India in the medium-term, which is estimated at around 2.3% of GDP.¹ Therefore, a total of 10% of GDP of household savings and external borrowing would be available, which can be assumed to be allocated equally between the public and private sector. This would lead to a combined fiscal deficit of the centre and the states of 5% of GDP, and at the same time ensure an investment of 5% of GDP. The 5% general government deficit, divided equally between the centre and the states, would imply a 2.5% deficit for the centre in the medium-term. Both the "Accelerated Consolidation", and the "Significantly Accelerated Consolidation" path would be consistent with reducing the centre's debt to 40% of GDP, with the fiscal deficit to reach 2.5% of GDP in the next 5 years. However, the Committee was of the view that the "Significantly Accelerated Consolidation" path may be too strict and may result in an unanticipated reduction in fiscal space in the short-term.

In the near term, the Committee recommends to stick to a fiscal deficit of 3% of GDP in FY18-FY20 based on two additional arguments:

(i) The cost to credibility of deviating from a path of fiscal deficit agreed on by two successive governments: As discussed above, a deviation from the fiscal deficit target in the short-term could also lead to a loss in India's credibility among foreign institutional investors (FIIs), which would reduce the demand for Indian government securities, reduce their price, and increase government bond yields. The rise in government bond yields would lead to an increase in interest burden on new debt, and also for the old debt that is re-priced. Given that India is increasingly getting financially integrated with the world economy - with foreign holdings in government and corporate bonds, having increased sharply over the last few years, and the recent decision to allow foreign participation in state government securities – such costs to credibility can be substantial.

(ii) India's own experience in the past when it has deviated from a path of fiscal prudence. Two key examples are: (a) Unsustainable fiscal deficit in the years preceding the 1991 crisis (b) Post the global financial crisis, when India did not adhere to the envisaged path of fiscal consolidation, were also the years characterized by macroeconomic instability, leading to the "taper tantrum" crisis of 2013.

Therefore, based on several discussions within the Committee, the chapter recommends a "Accelerated Consolidation" path, where the fiscal deficit is envisaged to be on a glide path, to be reduced to 2.5% of GDP, consistent with reducing the centre's debt to 40% by FY23. In the recommended scenario, fiscal deficit is assumed at 3.5% in FY17, decline to 3.0% in FY18-FY20, 2.8% in FY21, 2.6% in FY22, and 2.5% in FY23, and thereafter.

¹ See, for example, Rangarajan and Mishra (2013).

What if the assumptions underlying the DSA change?

In all the scenarios presented above, we assumed nominal GDP to grow at 11.5% (e.g. a real GDP growth of 7%, and an inflation rate of 4.5%). In this section we address a valid concern: What if nominal GDP growth is higher, *ceteris paribus*? What would that imply for the debt ceiling, and for the path of fiscal deficit? We analyze this possibility in detail below, but two points to note. First, the ceteris paribus assumption may not be very realistic – as typically interest rates would also be higher in a growing economy, perhaps due to policy responses, but also due to increased demand for credit. Hence [r-g], which matters for the debt dynamics, may not be very different due to higher values of both r and g. At the minimum, the decline in [r-g] may be lower than that explained by an increase in g.

Let us assume the recommended "Accelerated Consolidation" scenario where debt/GDP is reduced to 40% by FY22, fiscal deficit is projected at 3.5% of GDP in FY17, and at 3.0% of GDP in FY18-FY20, 2.8% in FY21, 2.6% in FY22, and 2.5% in FY23 and onwards. What if nominal GDP growth increases, e.g. to 12.5% (say inflation is at 5.5% instead of 4.5% we assumed), *ceteris paribus*? There are two options: Option 1. Government sticks to the Accelerated Consolidation path of fiscal deficit. A favorable debt trajectory and lower interest payments would create additional space for social spending and public investment. Government can increase spending towards productive activities e.g. on infrastructure, run higher primary deficits relative to the Accelerated Consolidation scenario, and debt to GDP would decline to 40% by FY22, a year earlier than under the Accelerated Consolidation scenario. Option 2. Government undershoots the fiscal deficit path envisaged under the Accelerated Consolidation scenario, but sticks to its spending and primary deficit path. Table 9 presents both these options.

In principle, since a debt/GDP ratio of 40% is strictly a "ceiling" for the medium-term, and the fiscal deficit path could be interpreted as the upper bound that the government cannot exceed, either of these options would be consistent with our framework. However, in order to keep the framework simple, as well as to allow for flexibility, we believe that Option 1, where the government sticks to the fiscal deficit path and adjusts its primary balance to be consistent with the fiscal deficit path, might be preferable, and also easy to communicate. However, it is crucial that the additional fiscal space created under Option 1 is spent on productive activities.

Although we have illustrated the example of a higher nominal GDP growth above, a similar analysis can be done for the case when the nominal GDP growth turns out to be lower than expected (say growth is at 6% instead of 7% we assumed). In the event of a lower GDP growth, a less favorable debt trajectory and higher interest payments would reduce the available fiscal space. In this case, the government can use the opportunity to reduce spending on unproductive activities e.g. on subsidies, run lower primary deficits relative to the present FRBM scenario, and stick to the present FRBM path of fiscal deficit.

Overall, adhering to Option 1 essentially implies that the new fiscal framework would entail only two key elements: (i) a medium-term debt ceiling; and (ii) a fiscal deficit path consistent with achieving that ceiling. The two elements together would make the framework more robust (rather than having a single rule), but at the same time would also be simple and easy to communicate. The framework would also "suggest" a path of primary deficit which we have laid out in Table 6c, but this path would simply be suggestive, and the framework would allow flexibility to the government to re-calibrate its path of primary deficit depending on shocks or changing assumptions relating to key parameters like nominal GDP growth, or interest rates. In

other words, in this framework, the overall fiscal balance would take precedence over primary balance as the operational target.

Revenue Deficit

The distinction between revenue and capital accounts is rooted in the history of budget making process, and even in the Constitution of India. The current FRBM Act and subsequent Fiscal Responsibility Law (FRL) frameworks laid out by the government have, therefore, consistently stipulated a revenue deficit target for the central government. This is also reported in the medium-term fiscal policy (MTFP) statement in the Union Budget each year. The rationale for doing so is both analytical and specific to the Indian public finance context. The revenue deficit broadly measures the extent of borrowings used for revenue expenditure, and is a subset of overall fiscal deficit. Theoretically, revenue expenditure is considered to be consumption expenditure (as opposed to capital or investment expenditure). However, as pointed out in the report of the 13th Finance Commission, this classification is actually intended to specify the recurrent nature of such expenditure and not whether it creates future capital assets including human capital assets (see pp 129-130 of the report of the 13th FC). The logic of this is that borrowing for expenditures that are to be incurred year after year is neither desirable nor sustainable; these should be tax-financed. This is the basis of the commonly known as the 'golden rule'.

In the Indian context, revenue deficit has increased sharply relative to overall fiscal deficit. Figure 9 shows that the ratio of revenue to fiscal deficit for the centre rose sharply from 1.3 percent in 1980-81 to almost 80 percent in 2000-01, though it has declined to 66% since then. This appears to represent a "structural" shift in the balance of government spending towards current spending, when, in fact, successive central governments have actually repeatedly asserted their preference for high capital spending, in order to maximize growth. The argument that revenue spending is essential to deliver public services that complement growth (such as health and education) does not hold in this case since these are the principal responsibilities of the states, and the fiscal role of the central government in these areas is limited to providing specific-purpose transfers to the states at its discretion. Following the increase in the vertical devolution of central taxes from 32 to 42 percent of the divisible pool by the Fourteenth Finance Commission, the centre has also scaled back the these specific-purpose transfers to the states. The centre also makes grants to states for capital spending, and it has been argued that these should not be viewed as revenue expenditure per se. For a few years now, this has meant that the centre has reported another number, the "effective revenue deficit", which claims to measure the revenue deficit minus these grants. The Fourteenth Finance Commission has convincingly argued that the practice of reporting effective revenue deficit should be ended due to analytical problems, and that in line with international best practices, revenue deficit should continue to be viewed as the indicator that reports how much central government borrowing is used for consumption or recurrent expenditure.

Based on these arguments, the chapter recommends that the central government reduces its revenue deficit to GDP ratio steadily by roughly 0.25 percentage points each year, to reach 0.8% by FY23, from a projected value of 2.3% in FY17. The envisaged path of revenue deficit implies that the revenue to fiscal deficit ratio would reduce steadily to 32%, from its current level of 66%, and from a high of 80% in early 2000s, and leave sufficient room for increased capital spending to maximize growth. The envisaged path is less ambitious, albeit more realistic, than the MTFP statement presented in the FY17 budget, which assumes a

1 percentage point of GDP reduction in the revenue deficit over the next two years. While the Committee acknowledged the principle of the 'golden rule', it also recognized the difficulties in seperating current and capital expenditures, and the constraints on the central government in its ability to reduce the revenue deficit to zero. For this reason, the Committee did not recommend a zero revenue deficit in the medium-term but rather a continued effort to reduce the revenue deficit so that the revenue deficit to fiscal deficit ratio falls to more reasonable levels.

The recommended path of debt, fiscal deficit, and revenue deficit, are summarized in Table 8.

Rationale for the path of revenue deficit

In order to arrive at a path for revenue deficit, the chapter examines how can the centre reduce its revenue deficit over time. Revenue deficit can be reduced either by raising taxes or by curtailing revenue expenditures. Increasing the central government revenue to GDP ratio from 9.1 percent to 11.5 percent, ceteris paribus, can eliminate revenue deficit. This is a significant, albeit arguably achievable objective, over the medium-term. While growth in tax revenues is always welcome, such growth is uncertain and it would be unreasonable to assume that such increases would either be adequate or fully deployed to reducing the revenue deficit, given other demands on the central government, which is already constrained in its revenue expenditure needs.

The other way in which the revenue deficit can be reduced is by reducing revenue expenditure of the central government. The largest component of revenue expenditure, however, is interest payment on debt that may not be significantly amenable to direct policy actions. While it is true that a reduction in the stock of debt or a reduction in interest rates in the medium-term could reduce interest payments, this effect may not be of an order of magnitude that will significantly impact the government's ability to reduce the revenue deficit. Central government pensions, another significant component of revenue deficit, too, are largely autonomous of government policy action in the medium-term. An important discretionary component of revenue expenditure of the central government is subsidies, but even if these were to be halved from their present levels, the revenue deficit will not be eliminated. Grants to states and union territories, while also discretionary, do involve an agreed policy compact between the centre and the states and therefore reductions in this area of central government spending are, in practice, moderate.

Central government expenditures on salaries and allowances have been remarkably moderate over time, with decadal spikes happening when Pay Commission awards are accepted. Within this category, the highest share is that of defense services; spending on non-defense personnel has been stable as a percent of GDP over time. Expenditure on police and paramilitary personnel is an exception and has seen a sharp increase over the past two decades.² Since these expenditures are a function of national security needs, it would not be advisable for the Committee to regard these as reducible in the medium-term.

Thus, on the expenditure front, while subsidies can be cut and expenditure made more efficient, there are several categories of revenue expenditure that are not amenable to such policy actions, as we have elucidated above. Therefore, the Committee agreed that an elimination of the central government revenue deficit may not be realistic or feasible, even over the medium-term. Nonetheless, the Committee agreed that it is important to continue to benchmark central government revenue deficit targets and to secure reductions in the revenue to GDP ratio given the sharp rise in the revenue to fiscal ratio.

² See Table 2 on pp. 13, pp. 28-29, and Table 10 on pp. 35 in the Report of the 7^{th} Central Pay Commission.

Are states' debt sustainable?

As discussed above, our analysis suggests a ceiling of around 40% for the centre. Given a ceiling of 60% of GDP for the general government, the balance of 20% of GDP can be considered as a prudent ceiling for the states. The current level of debt stock is much higher for the centre compared to the states (49.4% and 21% respectively). Therefore, while the proposed framework envisages consolidating the centre's debt stock from 49.4% to below 40%, states are envisioned to stay at roughly the same level (see below for more details).

While debt ratios for the central government always decline under the different scenarios we simulated in the previous section, the behavior of the states turns out to be strikingly different. We assume a mediumterm debt ceiling of around 20% for the states, in order to achieve an upper limit of close to 60% for the general government. Nominal GDP is assumed to grow at 11.5% as before. Based on data from the RBI on weighted average coupon yields on the outstanding stock of market borrowings, we assume an interest rate of 8.5%, and we project it to decline by roughly ten basis points every year. Finally, initial debt to GDP in FY17 is assumed at 21% of GDP. The figure includes the debt of state power utilities taken over the state governments under the UDAY scheme, but excludes the states' share of NSSF liabilities to avoid double counting as they are already included in the centre's debt figure.³

Under the "Present FRBM" scenario, for example, states are assumed to follow a combined fiscal deficit path as envisaged in the present FRBM. The state government fiscal deficit to GDP is projected to take values of 3.0% in FY17, and is assumed to stay at that level. The evolution of the debt dynamics for the states and the centre (both under the "Present FRBM" scenario) is compared in Figure 10. While the centre's debt ratio is projected to decline, that for states' is actually predicted to increase. This is mainly due to the fact that primary deficit, which is a driving variable in the debt dynamics, is much higher for the states. The centre's primary deficit comprises only 0.3% of GDP while the states recorded higher primary deficits. The central government's overall fiscal deficit is higher than that for the states, but is directed mainly towards making interest payments on existing borrowings. Therefore, states' debt cannot be brought down to 20% under the "Present FRBM" scenario. If states, however, follow a path of fiscal consolidation which is stricter than that envisaged under the present FRBM, only then can the debt be brought down to 20% of GDP over the medium-term. The analysis of fiscal issues relevant to the states and recommendations are discussed in Chapter 5.

Other issues

One disadvantage of headline fiscal balance rules is that they do not have counter-cyclical properties. For example, when growth – and therefore revenues – are above potential, policymakers should ideally be reducing fiscal deficits, and thereby creating fiscal space that can be used in downturns. However, adhering to a fiscal deficit target necessarily results in those extra revenues being spent. Similarly, during downturns, as automatic stabilizers work, one would want the fiscal deficit to expand, but that is precluded by adherence to a headline deficit rule, thereby making fiscal policy pro-cyclical. There is widespread evidence that fiscal policy in emerging markets tends to be procyclical rather than countercyclical, in part because of political incentives to run large deficits in good times when financing is available. To overcome these

³ Although states' liability is treated to be lower for purely accounting purposes, yet in practice, the interest burden on the states' share of NSSF securities will continue to be borne by the states.

problems, some countries adopt "cyclically-adjusted deficits", which has the benefit that, by construction, they have economic stabilization properties by explicitly accounting for the state of the business cycle. Another option which countries are increasingly adopting are "expenditure rules" which set limits on total/primary/current spending and can be specified as either a limit on the ratio to GDP/revenue or nominal or real growth. The Committee, however, unanimously believed that operationalizing cyclically adjusted deficits or ceilings on expenditures, however, may not be very practical in the Indian context at this point of time. As institutions develop, with data constraints and concerns relating to enforcement beginning to wane, India can consider more sophisticated rules that address the important issue of counter-cyclicality.

However, the Committee was cognizant of the need to provide flexibility in the case of large exogenous shocks. Specifying "escape clauses", as well as an additional clause that introduces increased prudence in good times, addresses this issue (Chapter 8 provides more details).

Finally, another issue is the need and feasibility of having a 'fiscal deficit range' as the operational target instead of fixed numbers proposed in our framework. There are several reasons why a fiscal framework with fixed targets may be preferred to a range. First, consultation with domain experts, particularly in the context of Parliamentary democracies, suggests that a range for the fiscal deficit tends to get operationalized at the upper end of the range. Second, some amount of flexibility may be automatically built in the proposed framework, if fiscal deficit targets are fixed to one decimal, which allows for some space for changes within the decimal point. Finally, fixed targets rather than a range can make fiscal policy more predictable, and therefore enhance investor confidence.

VII. Conclusions and summary of recommendations

This chapter employs several approaches, based on theoretical considerations, cross country evidence, as well as estimations and simulations using Indian data, to arrive at a prudent medium-term ceiling for debt. While each approach may not be conclusive on its own, taken together they suggest a debt ceiling of around 60% of GDP. A 60% of GDP debt ceiling would still be above the average for emerging markets, but it would provide sufficient space for higher private investment and higher growth, provide a sufficient buffer when the country is subject to macro and fiscal shocks, provide some headroom for future contingent liabilities, and would also be a level of debt that is sustainable under possible assumptions on long run primary balances and interest-growth differentials.

The debt ceiling would make sense only if it can be attained under plausible scenarios. Our simulations suggest that the ceiling for the central government could be attained in the next 6 years if the government sticks to the fiscal path envisaged under the current FRBM; and even sooner if the government follows a significantly accelerated path of consolidation. However, a relaxation of the target would delay attaining the debt ceiling, especially if the relaxation leads to a loss in credibility, and higher costs of borrowing.

Importantly, a medium-term debt ceiling would not be sufficient by itself. The ceiling would need to be combined with an operational target e.g. the fiscal deficit. The path of this operational target would need to be carefully calibrated in order to achieve the debt ceiling in the medium-term. Such a path would also need to take into account several short-run trade-offs that the government may face. We have presented in this paper several scenarios and paths for the fiscal deficit, which would be consistent with achieving a ceiling of 60% in the medium-term.

The main policy recommendations based on the analysis in this chapter are summarized below:

- 1. Adopt a prudent medium-term ceiling for general government debt of 60% of GDP, to be achieved by FY23.
- 2. Within the overall ceiling specified above, adopt a ceiling of 40% for the centre, and the balance 20% for the states.
- 3. Adopt fiscal deficit as the key operational target consistent with achieving the medium-term debt ceiling.
- 4. A path of fiscal deficit with fixed operational targets rather than a range.
- 5. A path of fiscal deficit to GDP ratio of 3.0% in FY18-FY20, 2.8% in FY21, 2.6% in FY22, and 2.5% in FY23.
- 6. Reduce revenue deficit to GDP ratio steadily by roughly 0.25 percentage points each year, to reach 0.8% by FY23.

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Tables and Figures

Table 1.

Country	Average Debt %: 2010 - 14	Fiscal Deficit %: 2015	Revenue %: 2015	Expenditure %: 2015
India	67.32	-7.17	20.77	27.95
Similary rated EM Peers	39.89	-2.69	27.55	30.71

Source: Debt from WEO by IMF; Fiscal Deficit, Revenue & Expenditure from Global Fiscal Monitor by IMF

Table-2					
Effect of Debt on India' (Quarterly Data)	s GDP growth (Y	(-0-Y)			
Threshold	(1)	(2)	(3) 37.5%	(4) 40%	(5) 42.5%
Debt (% of GDP)	-0.0577 ^{***} (0.001)	0.570 [*] (0.068)			
Debt-squared		-0.00191 ^{**} (0.045)			
Debt			0.0927 (0.230)	0.0343 (0.389)	-0.00481 (0.860)
Debt*Dummy_highDe bt			-0.175** (0.050)	-0.148** (0.015)	-0.147 ^{**} (0.024)
World GDP growth Rate	0.566 ^{***} (0.000)	0.556 ^{***} (0.000)	0.587 ^{***} (0.000)	0.545 ^{***} (0.000)	0.541 ^{***} (0.000)
Bad Rain Dummy	-1.692 ^{***} (0.010)	-1.662 ^{***} (0.009)	-1.552** (0.015)	-1.613*** (0.010)	-1.722 ^{***} (0.006)
Growth Rate of Oil Prices	-0.0352 ^{***} (0.000)	-0.0303*** (0.001)	-0.0291 ^{***} (0.001)	-0.0280 ^{***} (0.001)	-0.0316 ^{***} (0.000)
Volume of Stalled Projects	-0.00805 ^{***} (0.000)	-0.00822*** (0.000)	-0.00835 ^{***} (0.000)	-0.00845 ^{***} (0.000)	-0.00812 ^{***} (0.000)
Real Interest Rate	-0.462 ^{***} (0.000)	-0.401 ^{***} (0.000)	-0.347*** (0.003)	-0.391*** (0.000)	-0.426 ^{***} (0.000)
N R-squared	58 0.555	58 0.589	58 0.588	58 0.605	58 0.598

p-values in parentheses

* p < 0.1, ** p < 0.05, *** p < 0.01

World GDP Growth, Rainfall Dummy and Real Interest Rates are not lagged. All other regressors are lagged by one quarter. Threshold values reported are for debt as percentage of annual GDP. The variable used in regressions however is debt as % of quarterly GDP and coefficients have to be interpreted accordingly.

Debt/GDP	Predicted IIR	Club
20	57.6	Club BI
25	56.9	Club BI
30	56.1	Club Bl
35	55.4	Club Bl
40	54.7	Club Bl
45	53.9	Club Bl
50	53.2	Club Bl
55	52.5	Club Bl
60	51.7	Club Bl
65	51.0	Club Bl
70	50.3	Club BII
75	49.5	Club BII
80	48.8	Club BII
85	48.1	Club BII
90	47.3	Club BII
95	46.6	Club BII
100	45.9	Club BII
105	45.1	Club BII
110	44.4	Club BII
115	43.7	Club BII
120	43.0	Club BII
125	42.2	Club BII
130	41.5	Club BII

Table 3

Source: IMF (2016).

Table 4	ŀ
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Country	Average Debt	Fiscal Balance
INDIA	67.3	-7.2
COLOMBIA	37.6	-2.8
HUNGARY	78.5	-2.2
INDONESIA	24.0	-2.5
MEXICO	44.9	-4.1
PERU	22.1	-2.2
RUSSIA	12.5	-3.5
SOUTH AFRICA	41.0	-4.0
THAILAND	41.4	0.3
TURKEY	37.5	-1.0
URUGUAY	59.3	-3.5
Similary rated EM Peers* -		
Average	39.9	-2.6

Debt and Deficit: India and Similarly Rated EM Peers (% of GDP)

Source: Debt from World Economic Outlook of the IMF; Deficit from Fiscal Monitor of the IMF. * If ranking similar to India as assigned by any of the three rating agencies, S&P, Fitch, and Moody's. Debt is averaged over 2010 - 14; wheres fiscal deficit is reported for 2015.

Determinants of Govt. S (Quarterly Data; post-20		us						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Fiscal Deficit (% of GDP, moving average)	0.152 [*] (0.080)	0.184 [*] (0.072)	0.178 (0.102)	0.174 [*] (0.092)				
Market Borrowings (% of GDP, moving average)					0.228 ^{***} (0.008)	0.249 ^{***} (0.007)	0.264 ^{***} (0.008)	0.284 ^{**} (0.002)
Treasury Bill Yield (91 Days)	0.574 ^{***} (0.000)	0.655^{***} (0.000)	0.646^{***} (0.000)	0.653 ^{***} (0.000)	0.617 ^{***} (0.000)	0.687^{***} (0.000)	0.706 ^{****} (0.000)	0.701**
VIX		0.00582	0.00584	0.00901		0.00695	0.00713	(0.000) 0.0111
Forward Premia (6		(0.675) -0.0744	(0.677) -0.0684	(0.530) -0.0712		(0.577) -0.0667	(0.571) -0.0791	(0.371)
Months)		(0.233)	(0.341)	(0.255)		(0.237)	(0.219)	0.0703 (0.201)
Inflation (WPI)			0.00643 (0.863)				-0.0154 (0.681)	
Non-food Inflation (WPI)				-0.0130 (0.353)				- 0.0266 **
								(0.048)
Observations R^2	65 0.581	65 0.594	65 0.595	65 0.600	63 0.632	63 0.644	63 0.645	63 0.668

Table-5

p-values in parentheses

p < 0.1, p < 0.05, p < 0.01, p < 0.01

Columns (1)-(4) see the effect of fiscal deficit on government security yields, whereas columns (5)-(8) see the effect of market borrowings. Different set of controls are used for robustness. The coefficient on fiscal deficit and market borrowings is positive and significant for all the specifications. This means that market penalizes extra deficit and borrowings through higher bond yields. Also note that the magnitude of coefficients on fiscal deficit are slightly smaller than that on market borrowings. This is intuitive, since market borrowings very highly correlated with fiscal deficit (Correlation co-efficient of 0.67) and generally less than fiscal deficit.

Table-6: Evolution of Fiscal Indicators for Central Government

Evolution of Debt/GDP under Different Scenarios (%)						
	Present FRBM	Accelerated consolidation	Significantly accelerated consolidation	Mild relaxation	Significant relaxation	Deep relaxation
FY17	49.4	49.4	49.4	49.4	49.4	49.4
FY18	47.3	47.3	47.3	47.6	47.9	48.1
FY19	45.5	45.5	45.3	45.9	46.4	46.8
FY20	43.7	43.7	43.3	44.3	44.9	45.6
FY21	42.2	42.0	41.4	42.7	43.5	44.4
FY22	40.8	40.3	39.7	41.3	42.3	43.3
FY23	39.6	38.7		40.1	41.1	42.3
FY24				38.9	40.1	41.5
FY25					39.1	40.6
FY26						39.8

Table-6a: Evolution of Debt/GDP

Table-6b: Evolution of Fiscal Deficit/GDP

Evolution of Fiscal Deficit/GDP under Different Scenarios (%)						
	Present FRBM	Accelerated consolidation	Significantly accelerated consolidation	Mild relaxation	Significant relaxation	Deep relaxation
FY17	3.5	3.5	3.5	3.5	3.5	3.5
FY18	3.0	3.0	3.0	3.3	3.6	3.8
FY19	3.0	3.0	2.8	3.2	3.4	3.7
FY20	3.0	3.0	2.7	3.1	3.3	3.6
FY21	3.0	2.8	2.6	3.0	3.2	3.5
FY22	3.0	2.6	2.5	3.0	3.2	3.5
FY23	3.0	2.5		3.0	3.2	3.5
FY24				3.0	3.2	3.5
FY25					3.1	3.4
FY26						3.4

Evolution of Primary Deficit/GDP under Different Scenarios (%)						
	Present FRBM	Accelerated consolidation	Significantly accelerated consolidation	Mild relaxation	Significant relaxation	Deep relaxation
FY17	0.3	0.3	0.3	0.3	0.3	0.3
FY18	-0.2	-0.3	-0.2	0.1	0.1	0.1
FY19	-0.1	-0.1	-0.3	0.1	0.1	0.1
FY20	0.0	0.0	-0.3	0.1	0.1	0.1
FY21	0.1	-0.1	-0.2	0.1	0.1	0.1
FY22	0.2	-0.1	-0.2	0.2	0.2	0.2
FY23	0.3	-0.1		0.3	0.3	0.3
FY24				0.3	0.3	0.3
FY25					0.3	0.3
FY26						0.3

Table-6: Evolution of Debt/GDP for Central Government (contd.) Table-6c: Evolution of Primary Deficit/GDP

Table-7: Decomposition of the Change in Debt/GDP: Accelerated Consolidation Decomposition of the Change in Debt/GDP. Accelerated Consolidation Scenario

	FY18	FY19	FY20	FY21	FY22	FY23
Change in debt	-2.1	-1.8	-1.7	-1.7	-1.7	-1.6
Interest rate	3.2	3.1	3.0	2.9	2.7	2.6
Growth	-3.1	-3.0	-2.9	-2.7	-2.6	-2.5
Inflation	-2.0	-1.9	-1.8	-1.8	-1.7	-1.6
Primary deficit	-0.3	-0.1	0.0	-0.1	-0.1	-0.1

Table-8: Recommended Path of Debt and Deficit for Central Government:

Recomr	Recommended Path of Debt and Deficits						
	Debt to GDP (%)	Fiscal deficit (% of GDP)	Revenue deficit (% of GDP)				
FY17	49.4	3.5	2.30				
FY18	47.3	3.0	2.05				
FY19	45.5	3.0	1.80				
FY20	43.7	3.0	1.55				
FY21	42.0	2.8	1.30				
FY22	40.3	2.6	1.05				
FY23	38.7	2.5	0.80				

Table-9: Evolution of Fiscal Indicators for Central Government: Alternative Assumptions

Evolutio	Evolution of Debt/GDP under Different Scenarios (%)							
	Accelerated							
	consolidation	Option 1	Option 2					
	GDP growth	GDP growth	GDP growth					
	11.5%	12.5%	12.5%					
FY17	49.4	49.4	49.4					
FY18	47.3	46.9	46.9					
FY19	45.5	44.7	44.7					
FY20	43.7	42.7	42.6					
FY21	42.0	40.7	40.5					
FY22	40.3	38.8	38.5					
FY23	38.7	37.0	36.7					

Table-9a: Evolution of Debt/GDP

Table-9b: Evolution of Fiscal Deficit/GDP

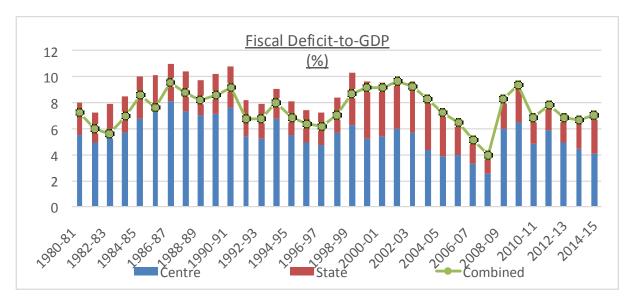
Evolution of Fiscal Deficit/GDP under Different Scenarios (%)									
	Accelerated consolidation GDP growth 11.5%	Option 1 GDP growth 12.5%	Option 2 GDP growth 12.5%						
FY17	3.5	3.5	3.5						
FY18	3.0	3.0	3.0						
FY19	3.0	3.0	3.0						
FY20	3.0	3.0	2.9						
FY21	2.8	2.8	2.7						
FY22	2.6	2.6	2.5						
FY23	2.5	2.5	2.4						

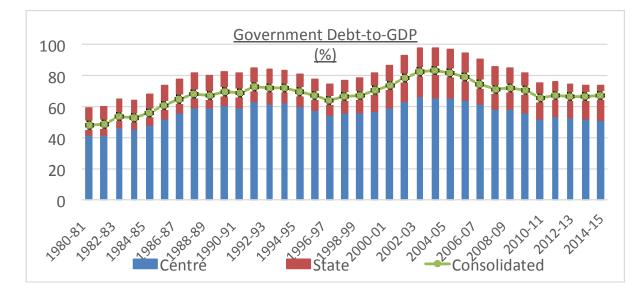
Table-9: Evolution of Fiscal Indicators for Central Government: Alternative Assumptions (contd.)

Evolution of Primary Deficit/GDP under Different Scenarios (%)										
	Accelerated consolidation GDP growth 11.5%	Option 1 GDP growth 12.5%	Option 2 GDP growth 12.5%							
FY17	0.3	0.3	0.3							
FY18	-0.3	-0.3	-0.3							
FY19	-0.1	-0.1	-0.1							
FY20	0.0	0.1	0.0							
FY21	-0.1	0.0	-0.1							
FY22	-0.1	0.0	-0.1							
FY23	-0.1	0.0	-0.1							

Table-9c: Evolution of Primary Deficit/GDP

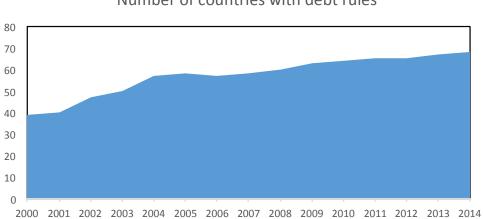




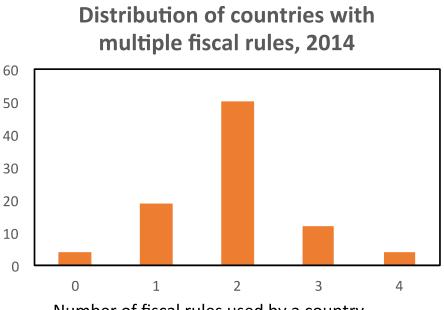


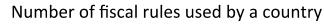
Sources: DBIE, RBI.

Figure 2

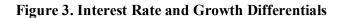


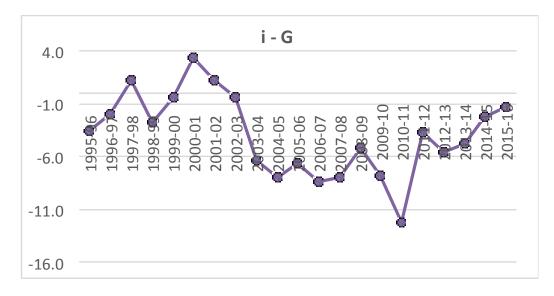
Number of countries with debt rules

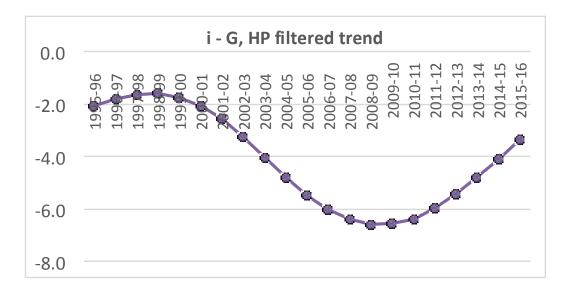




Source: IMF (2016).

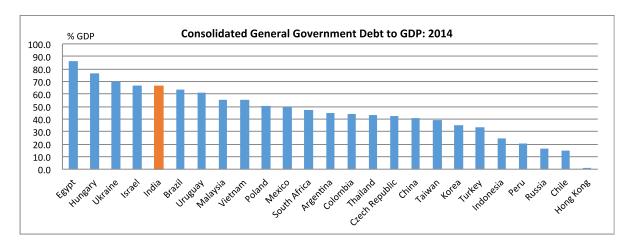


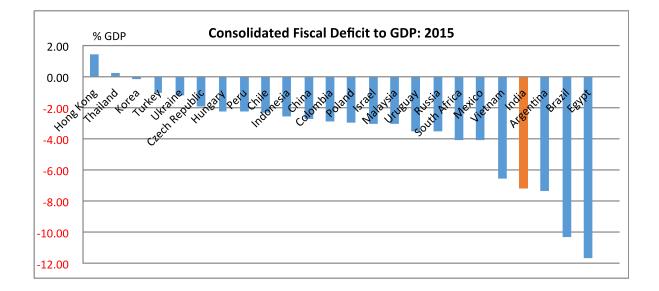




Notes - i is the yield on 10 year G-Sec, G is the growth in Nominal GDP. Sources: Bloomberg, CSO.

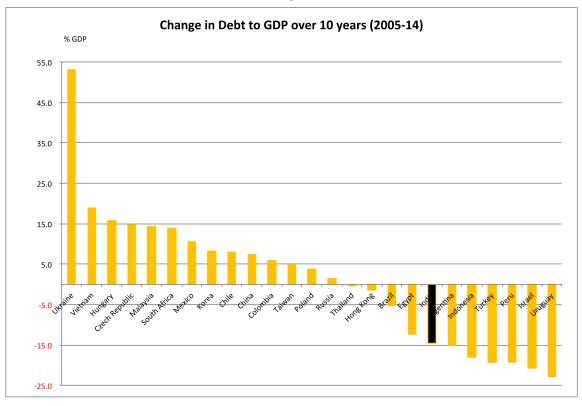
Figure 4	ŀ
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Source: General Government Debt from the World Economic Outlook, IMF. Fiscal Deficit from Global Fiscal Monitor, IMF.

Figure 5



Source: General Government Debt from World Economic Outlook, IMF.

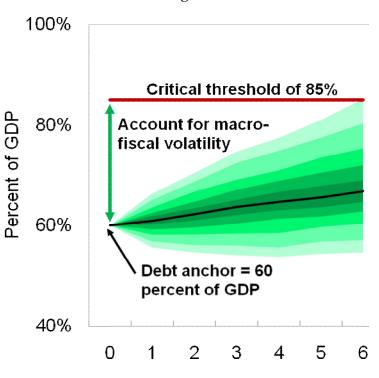
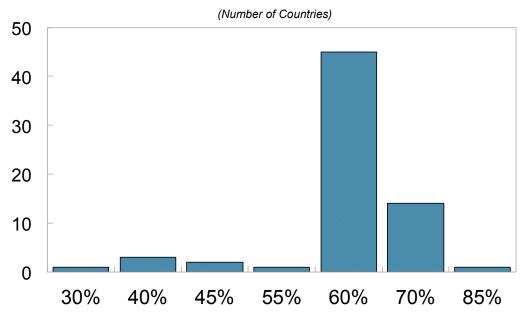


Figure 6.

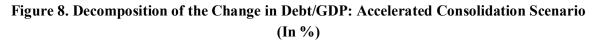
Source. IMF (2016).

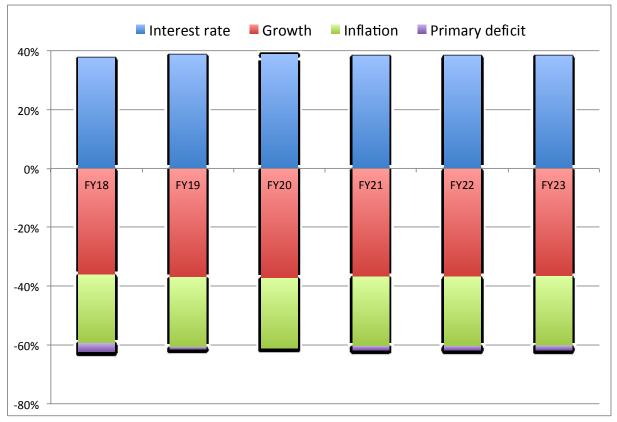
Figure 7.

Distribution of Public Debt Ceilings (in percent of GDP)



Sources: IMF Fiscal rule dataset





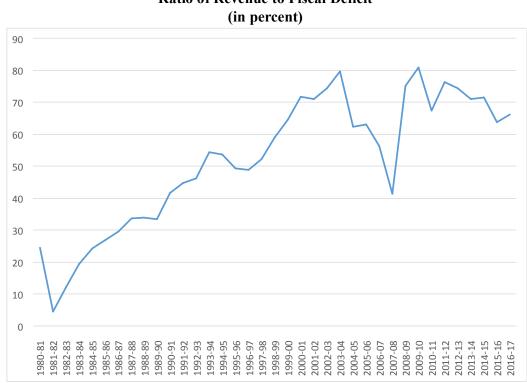


Figure 9. **Ratio of Revenue to Fiscal Deficit**

Source. Handbook of Statistics on the Indian Economy, Table 99. Key Deficit Indicators of the Central Government.

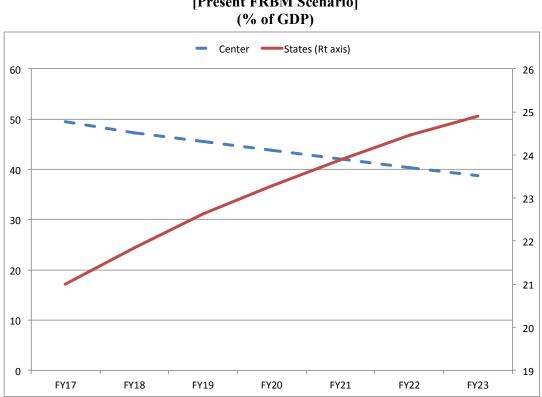


Figure 10. Debt Dynamics: Centre vs States [Present FRBM Scenario]

(1)
$$D_{t+1} = D_t * (1 + r) - PB_{t+1}$$

(2) $D_{t+1} = D_t + (r^*D_t - PB_{t+1})$
(3) $D_{t+1} = D_t + FD_{t+1}$
(4) $D_{t+1} - D_t = FD_{t+1}$
(5) $\frac{(D_{t+1} - D_t)}{Y_{t+1}} = \frac{FD_{t+1}}{Y_{t+1}}$

CHAPTER 5 PARTNERING THE STATES

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1. Introduction

This committee is enjoined in its terms of reference to look at the different considerations going into the making of FRBM targets and to provide its views on the expected impact of its recommendations, inter alia, on the general government deficit. In this chapter, we examine the working of FRLs in the states of India over the past 14 years. We look at the evolution of the macro–fiscal structure of the states taken collectively. We also look at dimensions of state-level budget and financial management that have implications for the overall integrity and structure of general government public finances.

There is limited literature on the link between sub–national and national macro–fiscal management. Claeys et al. (2007), looking at the experience of European federations, find that sub–national governments tend to bear less than their fair share of the fiscal burden (though this effect is more pronounced in Europe than in the United States). Ahrend et al. (2013) also allude to the fact that sub–national governments tend to be more profligate as they expect to be bailed out by the national government, especially when they face special shocks such as natural disasters. We analyse the Indian situation to assess whether such trends are indeed extant in India. We also look at whether state-specific characteristics display heterogeneity that may require our conclusions on general government fiscal responsibility to be calibrated.

2. Fiscal Consolidation in the Post–FRL Period

The post-FRL period saw the sharpest ever sub–national fiscal consolidation in India. The consolidated deficit indicators of the States improved in each of the four years between 2003-04 and the onset of the global financial crisis in 2008-09. There was an equally dramatic fall in consolidated State liabilities and debt (see Table 1 for a summary of the fiscal trends during this period).

However, this improvement in State finances could have been driven by macro-fiscal factors that were concurrent to the implementation of the FRLs (see the reports of the Thirteenth and Fourteenth Finance Commissions for a detailed survey). These included (i) high economic growth and the consequent increase in central and state tax collections, (ii) a rise in the States' revenue collections due to the introduction of the value added tax (VAT) by most states in 2005–06, (iii) an increase in the devolution of central taxes to states by the Twelfth Finance Commission, and (iv) the Debt Consolidation and Relief Facility (DCRF) offered by the Twelfth Finance Commission that included both debt write–offs and restructuring.

Table 1: Sources of Sub-National Fiscal Consolidation: 2000-01 to 2015-16 (Percent of GDP)																
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
A. Total Revenue	10.68	10.59	10.79	10.88	11.21	11.67	12.35	12.51	12.34	11.86	12.02	12.57	12.58	12.15	14.46	14.82
I. Own Revenue	6.64	6.56	6.78	6.73	7.05	7.05	7.35	7.29	7.17	6.98	7.1	7.52	7.76	7.5	7.83	8.24
i) Own Tax Revenue	5.22	5.23	5.39	5.42	5.61	5.75	5.88	5.75	5.72	5.6	5.92	6.38	6.58	6.32	6.54	6.87
ii) Own Non Tax Revenue	1.42	1.33	1.38	1.31	1.44	1.3	1.47	1.55	1.45	1.38	1.18	1.13	1.18	1.18	1.29	1.38
II. Total Transfers	4.04	4.02	4.01	4.15	4.16	4.62	5	5.21	5.17	4.88	4.92	5.06	4.83	4.65	6.63	6.58
i) Share in Central Taxes	2.33	2.22	2.23	2.36	2.42	2.55	2.8	3.04	2.86	2.55	2.82	2.93	2.93	2.82	2.93	3.58
ii) Grants	1.71	1.81	1.78	1.79	1.74	2.08	2.2	2.18	2.31	2.33	2.1	2.13	1.9	1.83	3.7	3
B. Revenue Expenditure	13.22	13.15	13.04	13.11	12.42	11.86	11.77	11.65	12.11	12.34	11.98	12.3	12.38	12.24	14.61	14.42
Of which: Interest Payments	2.34	2.61	2.72	2.83	2.67	2.27	2.17	2	1.83	1.74	1.6	1.57	1.51	1.5	1.54	1.61
C. Capital Expenditure	2.39	2.5	3.13	4.99	4.65	3.35	3.53	3.44	3.56	3.34	2.91	3.17	3.04	2.9	3.56	3.59
D. Total Expenditure	15.61	15.65	16.17	18.1	17.07	15.21	15.3	15.09	15.67	15.67	14.89	15.47	15.42	15.14	18.16	18.01
E. Gross Fiscal Deficit	4.04	4	3.93	4.25	3.32	2.44	1.8	1.51	2.39	2.91	2.07	1.93	1.96	2.2	2.93	2.46
F. Revenue Deficit	2.54	2.56	2.25	2.23	1.21	0.19	-0.58	-0.86	-0.23	0.48	-0.04	-0.27	-0.2	0.09	0.15	-0.4
G. Gross Primary Deficit	1.7	1.39	1.21	1.42	0.66	0.16	-0.36	-0.49	0.56	1.17	0.47	0.36	0.45	0.7	1.38	0.84
H. Primary Revenue Deficit	0.2	-0.05	-0.47	-0.6	-1.46	-2.09	-2.75	-2.86	-2.05	-1.26	-1.64	-1.84	-1.72	-1.4	-1.4	-2.01
I. Total Liabilities	27.29	29.32	31.01	31.79	31.28	31.08	28.91	26.63	26.11	25.45	23.5	22.82	22.17	21.92	22.3	22.87
Of which: Internal Debt	8.22	10.38	12.85	16.78	18.35	18.92	17.79	16.53	16.59	16.57	15.37	15.14	14.63	14.52	15.14	15.96

Notes: Years denote the end of a financial year. For instance, data for 2001 pertains to data for the year 2000-01. Data for 2014-15 relate to Revised Estimates while 2015-16 are Budget Estimates. Data relate to 29 State Governments. Source: Handbook of the Indian Economy, Reserve Bank of India.

Given the positive economic scenario in pre-crisis years following the implementation of state-FRLs, it is difficult to ascertain the extent to which the fiscal correction that followed can be attributed to an FRL-induced discipline in the fiscal conduct of the States. Nevertheless, a number of expenditure rationalisation efforts by the States deserve mention. For instance, to arrest the growing pension bill, many states increased the retirement age, introduced voluntary retirement schemes, imposed restrictions on new recruitments, and tweaked discount rates for commutation of pensions. In addition, some States such as Tamil Nadu have taken steps towards the imposition of ceilings on guarantees while others have created sinking funds and guarantee redemption funds. It is also noteworthy that five States enacted their FRLs even before the Twelfth Finance Commission had submitted its report.

2.1 Key Deficit Indicators of the States

We now analyse the sources of the year-on-year changes in the key deficit indicators of the State governments. Figure 1 decomposes the year-on-year changes in the fiscal deficit to GDP ratio into its revenue and expenditure components as follows.

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

where Δ denotes change from one year to the next.

In terms of the contribution of expenditure and receipts to the fiscal deficit, an increase in the revenue to GDP ratio would mean a lower deficit and its magnitude is recorded below the x-axis in Figure 1. Likewise, a decrease in the expenditure to GDP ratio would be recorded below the x-axis. For example, in the year 2000–01, the fiscal deficit fell by 0.42 percent of GDP. Figure 1 (A) shows that this fall in the fiscal deficit can be decomposed into a rise in the revenue to GDP ratio of 0.65 percent and a rise in the expenditure to GDP ratio of 0.23 percent. Thus, rising expenditures partly countervailed the downward impact of rising revenues on the fiscal deficit in that year.

Panel (B) shows the percentage that each component contributes to changes in the fiscal deficit in each year. In 2000–01 about 74 percent of the total change in the fiscal deficit was due to higher revenues whereas 26 percent was contributed by rising expenditures. Analogously, Figures 1 (C) and 1 (D) calculate the actual and proportional contributions of the sub–components of revenue and expenditure on the fiscal deficit. It is clear from Figure 1 (B) that in the boom–years, the sharp correction in sub–national fiscal deficits was on account of both buoyant revenues and expenditure control. It was not the case that state governments responded in good times by fully utilising their higher revenues to increase spending. In particular, revenue expenditure as a percent of GDP fell in each of these four years, even as capital expenditure was protected. Following the crisis, the fiscal deficit increased sharply after 2008-09. During this time, as part of its countercyclical measures, the Centre had raised the market borrowing limit of states by Rs. 30,000 crore in 2008-09. Additionally, States were also allowed to exceed their fiscal deficit targets by 0.50 percentage points, to 3.5 percent of GSDP in 2008-09. This limit was further revised to 4 percent of GSDP in 2009-10.

Panels C and D further decompose the components of the fiscal deficit. It is clear that transfers played a limited role in the fiscal consolidation of states whereas the improvement in own-revenues was not trivial across this period. In years of fiscal stress, such as 2010-11, the states were also not shy in cutting both revenue and capital expenditure.

In addition to the above exercise, we also analyse the cross-section means and medians of key fiscal aggregates of the states as percent of their respective GSDP over time in Figures 2 and 3 (see Roy and Kotia (2016) for methodological details). Figure 2 shows that the behaviour of the fiscal, revenue, and primary deficits is qualitatively similar, with each of these indicators peaking in the late 1990s and correcting sharply in the pre-crisis 2000s. Though the states largely managed to maintain fiscal prudence, even during and after the crisis, the mean primary and revenue deficit to GSDP ratios have been rising since 2010, though without breaching FRL ceilings.

Figure 2 also shows that there was a sharp fall in the mean of the revenue expenditure to GSDP ratio, led in large part by the precipitous fall in interest payments. However, the same period saw a modest increase in the means and medians of the capital expenditure to GSDP ratio, showing the beneficial impact of the golden rule contained in the FRLs. Figure 3 shows means and medians of various receipts as a ratio of GSDP. There was a marked increase in the tax to GSDP ratios since the early 2000s. Though both the components of tax revenues– own tax, as well as share in central taxes increased, the former registered a sharper rise. In the same period, the mean of non–tax revenue receipts to GSDP ratio saw a modest decline; however, it is interesting that their medians were unmoved.

Thus, in our view, the states as a whole seem to have a prudent, logical approach to their finances and it would be incorrect to dismiss their improved fiscal performance as being primarily due to factors exogenous

to their policy action. Of course, this judgment is based on collective action taken by all states and could not be said to universally apply to individual states, though it must be true for a significant plurality.

3. Consultations with the States

As part of its wide-ranging consultation with experts and stake-holders, the committee held two meetings with State Chief Secretaries and Finance Secretaries respectively. In this section, we discuss some of the issues that came up during our interaction.

3.1 UDAY

The UDAY Scheme may have a significant impact on the liabilities and revenue expenditure of States. However, its impact on state liabilities is likely to vary substantially across different states. Table 2 shows the non-SLR bonds issued and consideration of the borrowings made by the states under earlier schemes (Financial Restructuring Package, 2012) with the consent of the Government of India under Article 293 (3) of the Constitution.

The states mentioned that apart from the higher debt burden, UDAY will raise States' revenue expenditure on account of interest payments on the newly acquired DISCOM debt. In addition to making it harder for the states to adhere to their revenue deficit targets, this is also likely to make it harder for the states to achieve the target of a maximum of 10 percent for the interest payments to revenue receipts ratio.

Table 2: Percentage Share of Non-SLR Bonds on account of UDAY in Total Outstanding Liabilitiesof the State							
State	2016-17						
Rajasthan	26.22	12.5					
Uttar Pradesh	8.17	4.52					
Haryana	18.46	7.75					
Bihar	1.53	0.68					
Punjab	9.18	4.16					
J&K	4.51	2.79					
Chattisgarh	2.72	-					
Jharkhand	14.63	-					
Average	10.68	5.4					
Source: Ministry of Finance, Government of India							

3.2 Cash Balances

Alongside the improvement in fiscal position of States, there has been a build-up of cash balances with them (see Figure 4). Most states held that cash balances are highly cyclical- showing a large surplus in the beginning of the financial year, when funds are received from the central government. These surpluses reflect balances in accounts of various implementing agencies and parastatals, and are drawn down as these agencies utilise this money during the course of the year.

Some states linked the issue of large cash surpluses to the uncertainties and irregularities in the transfer of central funds to the States. For instance, funds for centrally sponsored schemes such as MNREGA, SSA, and NRHM are often released late by the Centre, prompting the states to set aside significant sums of money in order to pay salaries and wages. A number of states suggested that the release of central funds, particularly for CSS, should be timely and in regular tranches.

3.3 Fiscal Discipline

A number of states held that limits on borrowing by them should be better calibrated to their fiscal performance and health. Thus, states that have the requisite fiscal room to borrow more should be allowed to do so. Further, in the present scheme of incentives, there is no distinction between states that operate in the neighbourhood of the 3 percent target and those that have lower fiscal deficits due to prudent fiscal policy. Thus, states emphasized that limits on borrowing should be linked to their fiscal performance in order to provide the right incentives.

It has been observed that while for past few years, Government of India market borrowings have remained constant, the open market borrowings of the States have shown a rising trend. On an average, the State's gross open market borrowings have increased at an annual pace of 25%. The market participants are of the view that State borrowings are set to become increasingly important.

Demand factors: As per the glide path for SLR/HTM cut, both are to be brought down by 0.25% every quarter till March 31, 2017. It is presumed that such cut will lead to reduction in demand for government securities. Further, there have been discussions on reduction in mandatory regulatory investments in G-Sec by Insurance Companies and PFs. In case such cuts come in to effect, it will further hurt the G-Sec demand. Again, Basel III proposal to assign credit risk weights to sub-sovereign borrowings may also impact demand for SDLs as investors will have the option to invest in other instruments with similar capital charge as that of SDLs. Presently, both GoI and SDL borrowings are assigned zero risk weights.

Supply factors: Increase in Gross borrowings for the States for the past few years combined with other issuances like UDAY have led to increase in interest servicing for the States. This in turn is set to further increase the gross borrowings.

A general reduction in demand juxtaposed with elevated supply of SDLs will cause stress on G-Sec yields in general and SDLs in particular. On an average, the weighted average spread of SDLs over GoI has been hovering between 40 to 50 bps during the last few years. However, the spread between rates of borrowing amongst different states have on an average been only 5 bps. Despite SDL borrowing rates being market determined, it is felt that risk asymmetries across states are not adequately reflected in the cost of borrowings. With this background, few well managed states with good fiscal performance have expressed

that they are not adequately compensated for better management of their fiscal and there is some element of cross subsidization by the financially stronger states of the other states. This according to them is akin to financial repression. It is obvious that as and when the risk asymmetries of the different states are efficiently captured by the market, cost of borrowing for the states with fiscal stress will further rise.

3.5 Off-budget Borrowings

Researchers, as well as official appraisers of State compliance with FRLs, have observed that there is some opacity in the manner in which States report certain categories of public finance and budget data. In this light, the Committee sought the views of the states on the growing trend of off-budget public spending. Such spending is financed from off-budget borrowings where parastatals/State PSUs borrow funds from banks and development agencies but the repayment of the principal and interest for these loans are accommodated in the state budgets. However, these loans are excluded from the state's debt as well as fiscal deficit limits.

Some states rationalised such practices by arguing that FRLs have limited the States' fiscal space and that the mobilization of off-budget resources is warranted in order to protect capital expenditure and infrastructure spending. The Finance secretaries candidly admitted that there is significant political pressure on this account. However, in principle, most of the states recognized that such practices lack a sound accounting foundation and should be discouraged.

The disclosure of off-budget borrowings remains unsatisfactory in most states. Off-budget borrowings through public sector undertakings (PSUs) and special purpose vehicles (SPVs) do not form a part of state government liabilities. Moreover, at present, States do not collect or report information on public-private partnerships and other off-budget vehicles in a comprehensive manner.

The Finance Commission as well as the Comptroller and Auditor General of India (CAG), while appraising the States' compliance with FRLs have commented sharply on the above practices. The Fourteenth Finance Commission recommended that "Keeping in mind the importance of risks arising from guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises when assessing the debt position of States, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document".

The CAG, in successive audits of state budgets, has noted that even though off-budget borrowings are explicitly prohibited under Article 293(3), there is a general lack of transparency in reporting such borrowings practices. State governments have often been able to project that borrowed funds for State Plan programs undertaken by public sector corporations would be met out of the resources mobilised by these entities, which are strictly outside the state budget. In reality, however, the borrowings of many of these undertakings turn out to be liabilities that are ultimately borne by the state government.

When government departments directly avail of institutional loans, they are as receipts in their budget accounts. In the case of SPVs and PSUs, such borrowings usually do not enter government accounts, however, the repayment of such borrowings by state governments are booked as debit under MH-6003-Internal Debt sub-head, giving rise to an accounting anomaly of repayments exceeding loans advanced.

In some cases, such repayments should be classified under revenue expenditure which is often not done, resulting in an understatement of revenue and fiscal deficit. Power Corporations, Urban Housing and Development and Agriculture, are some of the PSUs that engage in borrowings on behalf of the state governments.

3.5 Impact of the 7th Pay Commission

The States spoke about their plans to smoothen the impact of the 7th Pay Commission on their budgets in the years to come. The implications of the 7th Pay Commission's recommendations on the states was addressed in chapter 2.2 of their report, and were based on a study conducted by the Indian Institute of Management, Calcutta, for that Commission. It was found that, historically, while special category states did suffer some stress on account of their pay awards, these were historically ameliorated by grants by central government, In the case of the general category states, it was found that "The States have deployed a number of options to deal with impact of their pay awards following the awards made by the Government of India based on the recommendations of the previous Central Pay Commissions. The states used the following options:

- Deciding to awards lower increases than the Centre,
- Deciding on a date of implementation different from that of the Centre,
- Staggering the payments of arrears suitable,
- Generating additional tax and non-tax revenue, and
- Compressing expenditure

On the basis of the above analysis, we conclude that States which have successfully maintained fiscal consolidation will be able to absorb the impact of additional expenditure on Pay, Allowances and Pension (PAP) and the fiscal stress on them in so doing would not exceed that faced by the Government of India. This would require the States to calibrate the speed and the extent of their own award. It is to be expected that the existing fiscal arrangements that govern the relation between the Centre and the Special Category States would continue to hold. In the case of general category States undergoing long term fiscal stress, clearly further structural fiscal reforms are immediately and urgently required. In these circumstances calibration of pay awards in such states would need to be more prudent than other States."

Based on the conclusions of the 7th CPC, it would be reasonable to conclude that as long as states continues to maintain current levels of fiscal prudence and were allowed to maintain their existing fiscal space, implementation of pay increases for their personnel would not cause a structural shock at the general government level.

4. Inter-State Heterogeneity

In the previous sections, we have looked at issues impacting the track record of fiscal responsibility of all states taken as a collective. The intention, in conformity with our terms of reference, was to assess the impact of the fiscal management of states in the past decade on general government debt and deficit. We fully recognize that issues of fiscal responsibility in the case of individual states is something that is best decided by appropriate institutions such as the Finance Commission. However, it is important to see whether inter-state heterogeneity in any way impacts our analytical conclusions that are drawn taking the states collectively as a component of the general government.

Recent Finance Commissions have typically used some measure of the inverse of per-capita income, population, fiscal effort, and geographical area to determine inter-se shares of central transfers. As such, all the above may be seen as factors of heterogeneity among states. We focus on three factors that can cause significant heterogeneity in the fiscal dimension of States and pose the following questions.

- How is the change in the per-capita income of a particular state correlated with the change in its liabilities to GSDP ratio and the level of fiscal deficit?
- How is the change in the size of a state government (measured as the ratio of the sum of its total tax revenues and fiscal deficit to GSDP) correlated with a change in its liabilities to GSDP ratio?
- How is a state's share of own revenue in total revenue correlated with the change in its liabilities to GSDP ratio and the level of fiscal deficit?

Our aim is to estimate the correlation of state-specific characteristics on their fiscal performance. Instead of simple cross–section scatter plots, we estimate a regression specification over a four-year rolling sample. This has the advantage that it allows us to utilise the time variation in our sample, in addition to the cross–section variation which a scatter plot encapsulates. We can thus make inferences about the evolution of the relationship between state-specific characteristics and fiscal performance over time. Our findings are reported in Figures 5 and 6 (see Roy and Kotia (2016) for details of the methodology employed).

Were these correlations to be unexpected then we would have to be more careful with recommendations regarding what states have to do to play their part in fiscal consolidation collectively in forthcoming years.

In the case of the share of own-revenue in total revenues, we expect states with lower ratios to have higher fiscal deficits and liabilities, implying a negative correlation. As we can see from Figures 5 (B) and 6 (B), this is indeed largely true for the years in our sample.

With respect to the correlation between fiscal deficit/change in liabilities and the change in per-capita income, we find that it was the case until the commencement of state FRLs that lower income states tended to have higher fiscal deficits as percent of GSDP. However, this has consistently not been the case since the early 2000s: this result indicates that the two are now barely correlated (see Figure 5 (A) and 6 (A)). This is perhaps an unexpected result of the implementation of state–level FRLs, an extremely laudable one. Poor

¹ Report of the Seventh Central Pay Commission (Chapter 2.2, page17), Ministry of Finance, Government of India.

² Though not the Fourteenth Finance Commission.

and rich states are fiscally prudent with equal probability. In the case of the size of government too, we have the comforting result that the inverse correlation between the change in the size of a state government and the change in its liabilities during the 1990s has decreased in magnitude (see Figure 5 (C).

Hence it is possible for us to argue, at least with respect to these three key macro-fiscal variables, that state-level heterogeneity does not detract from the reasoning we have given with respect to the fiscal consolidation proposed for states as a collective, and its impact on the consolidation of general government finances as a whole.

5. Debt Dynamics

In this section, we present projections for the debt to GDP ratios of the states, union and general governments for a range of primary and fiscal deficit trajectories. How much primary deficit can each tier of the government afford if it was constrained to keep its debt to GDP ratio constant?

Table 3 shows such levels of primary balances for the general, union, and state governments and for different combination of nominal interest rate (r) and nominal growth rate (g). These levels of primary balances, denoted p^* , will ensure that the debt to GDP ratios of the general, union and state governments stay constant at their present, 2016-17 levels⁴ of 49.4, 19, and 68 percent of GDP respectively. For the states, we also consider the scenario of a higher debt stock of 21 percent due to the UDAY scheme. The corresponding primary balance is denoted $p^*_{state(U)}$.

Table 3: Primary balances (as percent of GDP) that will keep debt-ratios constant over time							
r	g	r-g	α	р* ₆₆	p_{union}^{\star}	p_{state}^{\star}	$p^*_{state(U)}$
7.3	10.5	-3.2	-0.029	-1.97	-1.43	-0.55	-0.61
7.3	11.0	-3.7	-0.033	-2.27	-1.65	-0.63	-0.70
7.3	11.5	-4.2	-0.038	-2.56	-1.86	-0.72	-0.79
7.3	12.0	-4.7	-0.042	-2.85	-2.07	-0.80	-0.88
8.0	10.5	-2.5	-0.023	-1.54	-1.12	-0.43	-0.48
8.0	11.0	-3.0	-0.027	-1.84	-1.34	-0.51	-0.57
8.0	11.5	-3.5	-0.031	-2.13	-1.55	-0.60	-0.66
8.0	12.0	-4.0	-0.036	-2.43	-1.76	-0.68	-0.75
8.5	10.5	-2.0	-0.018	-1.23	-0.89	-0.34	-0.38
8.5	11.0	-2.5	-0.023	-1.53	-1.11	-0.43	-0.47
8.5	11.5	-3.0	-0.027	-1.83	-1.33	-0.51	-0.57
8.5	12.0	-3.5	-0.031	-2.13	-1.54	-0.59	-0.66
Note: p* P*	P^* and P^*	denote the re	ouired primary	balances for th	e general govern	ment union go	vernment and

Note: p_{GG}^* , P_{union}^* , P_{state}^* , and $P_{state(U)}^*$ denote the required primary balances for the general government, union government, and the States (with and without incorporating the impact of UDAY) respectively. $\alpha = \frac{r_g}{1+g}$ captures the net impact of the interest rate-growth differential (*r*-*g*). See Roy and Kotia (2016) for details.

³ See Escolano (2010) and Roy and Kotia (2016) for a detailed discussion and extensions.

⁴ The data for liabilities of the Union Government has been taken from Annex 5 (i) of the Receipts Budget 2016-17. Data for liabilities of the state and general governments has been taken from the Indian Public Finance Statistics, Ministry of Finance. The figure for state liabilities includes the debt of state power utilities taken over by the state governments under the UDAY scheme, but excludes the states' share of NSSF liabilities to avoid double counting as they are already included in the Centre's debt figure.

Note that $P_{state(U)}^{*} P_{state}^{*}$, $P_{union}^{*} P_{GG}^{*}$ for all values of r and g. In fact, $P_{state(U)}^{*}$ is less than half in magnitude as compared to P_{union}^{*} . This implies that to maintain their present levels of combined debt to GDP ratio, the States must be appreciably more prudent in their fiscal conduct and run lower primary deficits as compared to the Union government.

This is the case because the Union government, which has a large debt stock of 49.4 percent of GDP, enjoys a greater downward pressure on its debt due to a favourable *r-g*. However, since the debt stock of the States is much smaller, (19-21 percent), the advantage that accrues to them on account of a favourable *r-g* is lower than it is for the Union government. This implies that to bring the level of their debt down by one percent, the states will have to run smaller (larger) primary deficits (surpluses) than the Union Government (see Roy and Kotia 2016 for a detailed explanation of this phenomenon).

The states' combined primary deficit of around 1.3 percent of GDP is much higher than the Centre's primary deficit of 0.3 percent of GDP in 2016-17 (BE). This implies that the combined debt of the States is projected to rise even if they adhere to their FRBM targets. However, the analysis above raises another source of concern for the States. The fact that their debt is already at fairly low levels implies that any further consolidation in their combined debt to GDP ratio would require them to run disproportionately low fiscal deficits. Indeed, a reduction in the fiscal deficit is required even to maintain their existing levels of debt.

Now we look at how much primary deficit can each tier of the government afford if it was constrained to reduce its debt to GDP ratio to a fixed debt to GDP ceiling in a given period of time. Let the target debt ratios be 60, 40, and 21 percent of GDP for the general, union and state governments respectively. Tables 4 presents the required primary balances (p^{T}) that will enable the general, union, and state governments to meet their target debt to GDP ratios by FY2025.

Table 4: Required primary balances (as percent of GDP) to meet the target debt ratio by 2025							
r	g	r-g	α	$p^{T}GG$	p^{T} union	p^{T} state	p^{T} state(U)
7.3	10.5	-3.2	-0.029	-0.86	-0.13	-0.83	-0.61
7.3	11.0	-3.7	-0.033	-1.14	-0.33	-0.91	-0.70
7.3	11.5	-4.2	-0.038	-1.42	-0.52	-1.00	-0.79
7.3	12.0	-4.7	-0.042	-1.70	-0.71	-1.09	-0.88
8.0	10.5	-2.5	-0.023	-0.46	0.15	-0.70	-0.48
8.0	11.0	-3.0	-0.027	-0.74	-0.04	-0.79	-0.57
8.0	11.5	-3.5	-0.031	-1.02	-0.24	-0.88	-0.66
8.0	12.0	-4.0	-0.036	-1.30	-0.43	-0.96	-0.75
8.5	10.5	-2.0	-0.018	-0.17	0.36	-0.61	-0.38
8.5	11.0	-2.5	-0.023	-0.45	0.16	-0.70	-0.47
8.5	11.5	-3.0	-0.027	-0.73	-0.04	-0.79	-0.57
8.5	12.0	-3.5	-0.031	-1.01	-0.23	-0.87	-0.66

Note: $p^T GG$, $p^T union$, $p^T state$, and $p^T (state(U)$ denote the required primary balances for the general government, union government, and the States (with and without incorporating the impact of UDAY) respectively. $\alpha = \frac{r \cdot g}{1+g}$ captures the net impact of the interest rate-growth differential (*r*-*g*). See Roy and Kotia (2016) for details.

In this scenario, the Centre has to consolidate its debt by over 9 percent of GDP (almost one fifth of their existing stock of debt). Despite this significant consolidation, Table 4 shows that the Centre can afford a primary deficit of over 0.5 percent of GDP, which is larger than its present primary deficit. The States, on the other hand, are not required to reduce their debt to GDP ratio at all . However, even to maintain their debt at existing levels, States would be required to reduce their primary deficits below their present levels.

5.3 Trajectories of debt and deficits for the States

Having discussed the properties of debt dynamics for the different levels of the government, we now focus only on the States. The following analysis provides a better understanding of the consolidation required by the States if they were to maintain their debt-GDP ratios at the FY 2017 levels.

Table 5: FD path required to ensure that the debt to GDP ratio of the States in FY25 is the same as its present level of 21 percent of GDP				
Year	Debt	Fiscal deficit	Annual Reduction in FD	
FY17	21.00	2.98	0.16	
FY18	21.65	2.82	0.16	
FY19	22.08	2.66	0.16	
FY20	22.30	2.50	0.16	
FY21	22.34	2.34	0.16	
FY22	22.22	2.18	0.16	
FY23	21.95	2.02	0.16	
FY24	21.54	1.86	0.16	
FY25	21.02	1.70	0.16	

As explained above, some fiscal correction (i.e. a reduction in the fiscal deficit to GDP ratio) will be required at the level of the states even if they were to maintain their debt to GDP ratios at their FY17 levels (21 percent of GDP). Rather than force this correction in one or two years, we allow for the fiscal deficit of the states taken as a collective to fall gradually by 0.16 percent of GDP in each year. As shown in Table 5, this would imply that the debt to GDP ratio of the states rises marginally in the short run but returns to its present level of 21 percent of GDP by FY25 (including the estimated impact of UDAY). Thus, in FY25, the general government debt anchor would be achieved with the Centre's debt down to 40 percent of GDP and the states collectively accounting for debt of around 21 percent of GDP.

As in the case of the Centre, this path is dependent on (a) the assumption that the nominal GDP grows at 11.5 percent (a lower growth rate would require more stringent consolidation or a postponement of the year

⁵ See the column that pertains to our baseline assumptions of a nominal GDP growth of 11.5 percent and an interest rate of 7.3 percent.

⁶ In fact, if we don't incorporate the impact of UDAY, and take the debt to GDP ratio of the States at 19 percent in FY17, then the states can afford to raise their debt to GDP ratio by 2 percent of GDP.

by which the debt target is achieved) and (b) that the liabilities arising from States' participation in UDAY will not be more than 2 percent of GDP, both in the present moment and in the future. If the incremental impact UDAY is less than 2 percent, then the fiscal consolidation will be easier and the required reduction in the fiscal deficit lower. The opposite is also true. Since States can chose the extent to which they wish to avail of the fiscal relaxation under UDAY, they have, therefore, an inter-temporal policy choice to make.

We also explored the possibility of states reducing their debt to GDP ratios from the current estimated level of 21 percent to 20 percent by FY25. This would entail a steeper reduction in fiscal deficits by 0.195 percent of GDP each year (see Roy and Kotia (2016) for details).

6. Conclusion

We have seen that the states of India, taken collectively, have executed a remarkably successful fiscal consolidation since enacting their FRLs ten to fourteen years ago. Our examination of the sources of fiscal consolidation indicates that compliance with the three percent fiscal deficit ceiling and the target of zero revenue deficit were on account of buoyant revenues as well as active expenditure control. While the introduction of VAT and high growth indubitably helped keep revenues buoyant, the fact that revenue buoyancy was seen across rich and poor states indicates that there was collective effort to achieve revenue targets so as to facilitate FRL compliance. State governments did not fully utilise their higher revenues to increase expenditures in good times, a course of action that is politically very attractive. Rather, they exercised political will and executive restraint. Understandably, in crisis years, when revenues fell, expenditure was not curtailed but this was consistent with the 0.5 percent relaxation in state–FRL limits by the Centre. Collectively, the states managed to successfully consolidate their fiscal position after the crisis, unlike the Centre. While transfers helped the states in securing their FRL targets, it is clear from our analysis that they played a limited role; improvement in own revenues was not trivial across the period of analysis.

We have also found that state-specific characteristics such as the level of per-capita income, the size of the state government, and the level of states own revenue, do not have a significant impact on debt and deficit control by individual states. In fact we find that following the execution of state FRLs, the correlation between fiscal performance (fiscal deficit and the change in liabilities) and state-specific characteristics such as per-capita income and size of state governments has reduced sharply; poor and rich states are equally fiscally prudent. Further, states that spend more are able to find the resources to do so within their FRL constraints and without jeopardising macro-fiscal parameters. Thus, state-level heterogeneity does not detract from the recommendations that we make for states as a collective constituent of general government.

Thus, in our view, the states as a whole seem to have a prudent approach to their finances and it would be incorrect to dismiss their improved fiscal performance as being primarily due to factors exogenous to their policy action. Of course, this judgment is based on collective action taken by all states and could not be said to universally apply to individual states, though it must be true for a significant plurality. The total outstanding liabilities of the state government also continued to decline relative to the Centre (see Figure 7 (A)). Thus, there is no case for restricting the share of states in the general government on fiscal grounds. With respect to the international literature we find no evidence in the Indian case that states have any bailout expectations. However, it is clear that the debt relief provided in the 12th Finance Commission did contribute to the states' fiscal correction though it was not the main driver. In the case of state specific shocks, the politico–institutional contract in India is such that such shocks are inevitably socialised across the general government. This arrangement has been systematically institutionalised since the 11th Finance Commission. The Centre as well as the States are required to have disaster management and calamity relief funds. Finance commissions decide the adequate level of fiduciary support that these funds should receive and the terms on which they are replenished.

We have established that states, in aggregate, have secured considerable fiscal consolidation since the implementation of state FRLs. This also assumes structural significance when one looks at the combined size of the state governments relative to that of the general government. Figure 7 (A) shows that since the late 1980s, this share has grown continuously, peaking at 53.6 percent in 2003-04. However, in subsequent years, with the implementation of state FRLs, the share of the state governments in the size of the general government fell sharply to about 43.8 percent in 2008-09. Since then, the share has again begun to increase and stands at 52.3 percent as of 2014-15.

Figure 8 illustrates that the reduction of the states' share in the size of the general government was a direct consequence of better implementation of fiscal responsibility laws by the states relative to the central government. The share of States' combined borrowing in general government borrowing halved from 2004–05 to 2008-09. On the other hand, the share of sub–national tax receipts in general government tax receipts decreased only marginally in this period.

Even with the recent increase in the size of the sub-national government, the share of the total liabilities of the states in total general government liabilities continues to decline (see Figure 7(B)). However, an examination of the primary deficit to GDP ratios of the states and Centre respectively indicate that the states have run relatively higher primary deficits in recent times as compared to the Centre. This is because the states have a far lower initial level of debt than the Centre due to a historically greater fiscal consolidation. As a consequence, the bulk of the fiscal space available to states is used to undertake fresh capital expenditure since the interest payments of the states are very low. The dynamics of this is explained in Roy and Kotia (2016).

Thus, it would be unreasonable to expect the states collectively to reduce their debt GDP ratios purely on the basis of the fact that their primary deficit to GDP ratios are higher than that of the Centre. However, we recognise that the stock of state debt may well be higher if certain operational practices are taken into account (particularly the potential liability burden on account of UDAY), that do not at present impact the debt stock but may well do in future years.

Given the fact that States collectively run a revenue surplus, their low debt relative to their share in total government expenditure, and their track record of collectively securing fiscal prudence, we recommend that states taken collectively be allowed to maintain their debt GDP ratios at FY17 levels through fiscal consolidation in the form of a steady but modest reduction in the primary and fiscal deficits over an 8-year time frame.

The inter-se debt levels are outcomes of ceilings placed by the Centre on individual states. In doing so the Centre is guided, but not bound, by state FRLs and recommendations of the Finance Commission. Fortunately these have been implemented in a largely compatible manner to date.

We have presented a path for the fiscal correction for all states collectively, so as to complement our recommendations with respect to central government debt, thereby securing a general government debt to GDP anchor of about 60 percent of GDP. We recognise that the aggregate debt to GDP ratio of the states will, of course, be determined by actions taken by the individual states. However, it is not within the mandate of this committee to recommend inter-se debt levels, as constitutionally, the fiscal needs and capacities of the States are to be taken into account when assessing state-specific resource needs. This is the constitutional mandate of Finance commissions and recent FCs have also been asked to take account of the FRBM process while making their recommendations. They have indeed done so actively, including making recommendations on the subject of the principles that would govern the borrowing limits of individual states.

We therefore recommend that the Union government entrust this task to the 15th Finance Commission. In doing so, the FC could also make broad recommendations about the debt trajectories of individual states, based on their historic track record of fiscal prudence and health. The FRBM path for the States, taken collectively, so as to secure a general government debt to GDP ratio of around 60 percent by 2025, as set out in this report, can serve as a benchmark for the Fifteenth Finance Commission, should the government accept our recommendation.

Until such time as the Fifteenth Finance Commission makes its recommendations the status quo interse proportions can be maintained. State debt is currently not significantly higher than the end point anchor that we propose. Therefore, maintaining status quo will not significantly impact our longer-term recommendations. This will also allow states to consolidate over an eleven-year time frame with the consolidation path for the first 5 years prescribed by the Fifteenth Finance Commission for individual states.

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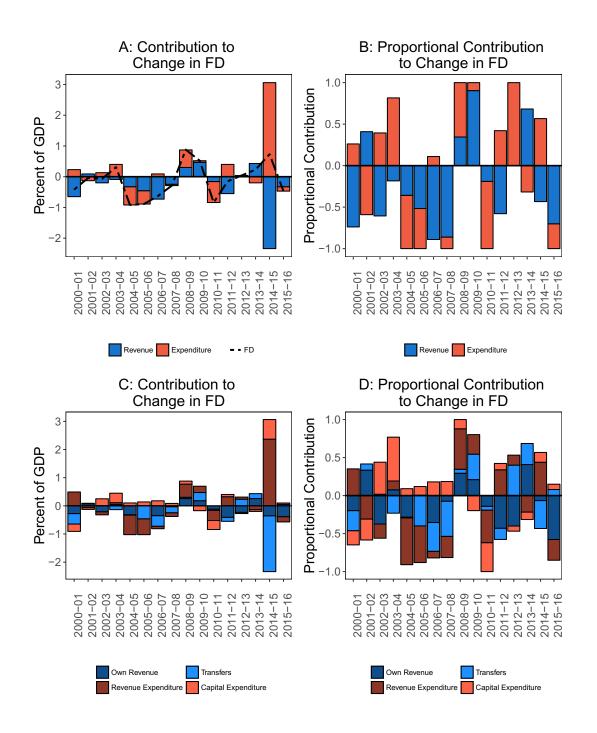


FIGURE 1: Year-on-Year Decomposition of the Fiscal Deficit

FIGURE 2:

Trends in the Deficit Indicators and Expenditure of the State (• and ▲ denote cross section sample mean and median respectively)

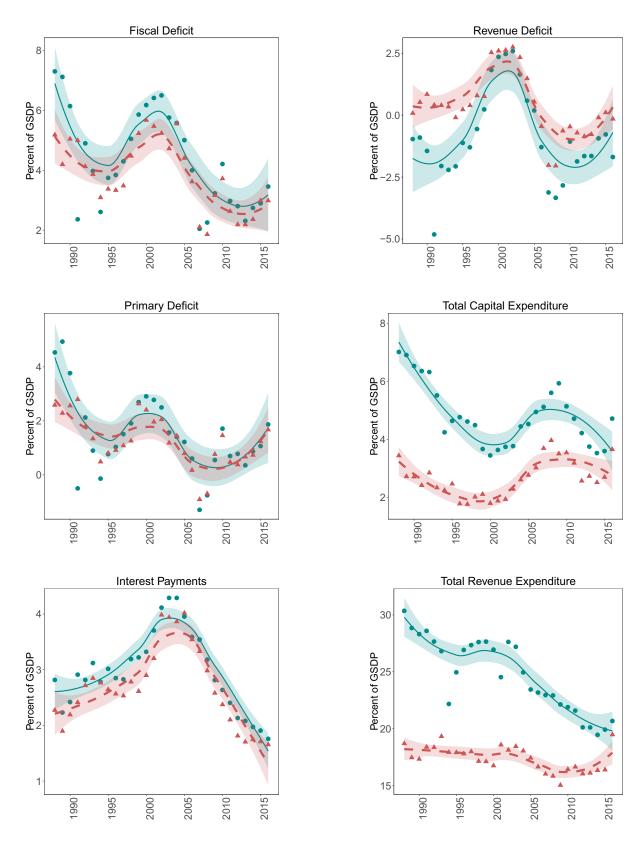


FIGURE 3: Trends in the Receipts of State Governments (● and ▲ denote cross section sample mean and median respectively)

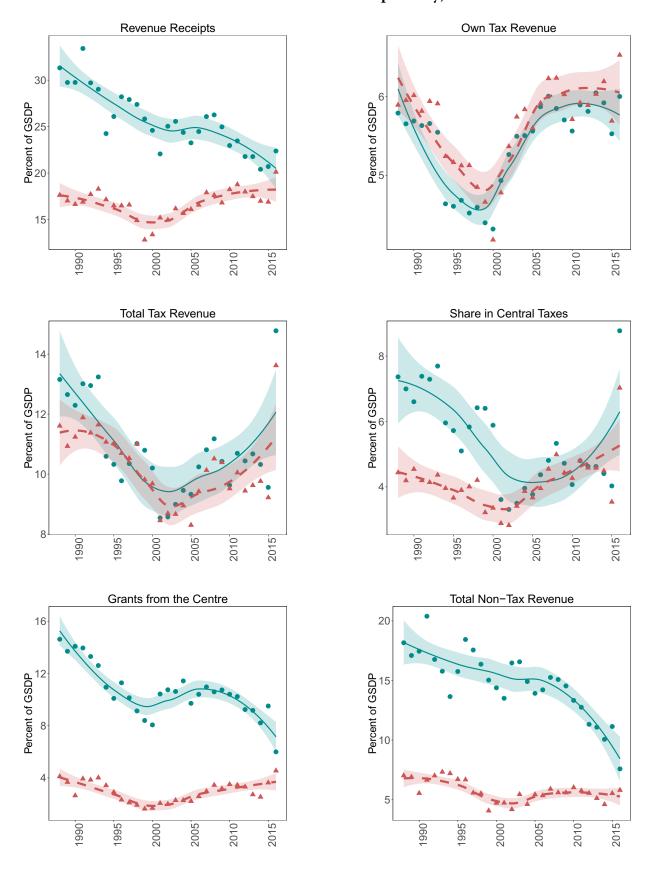


FIGURE 4: Cash Balances in Investment Account (Rs. crore)

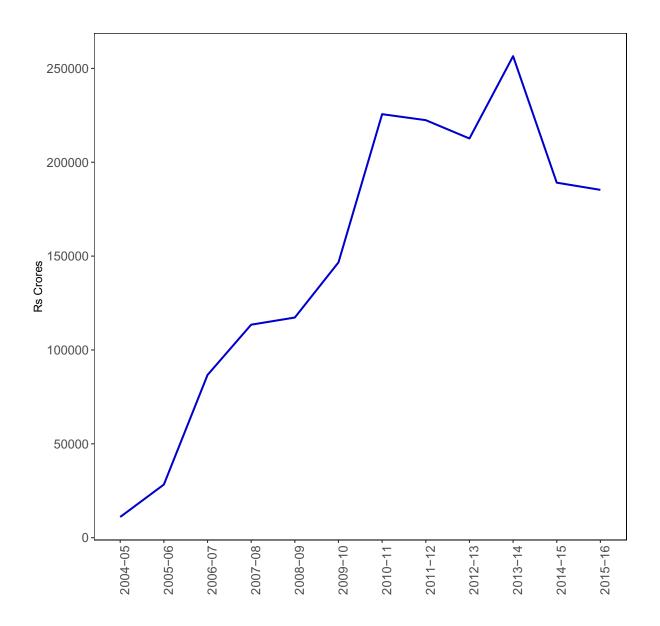


FIGURE 5: Impact of State–Specific Factors on the Change in the Liabilities to GSDP Ratio

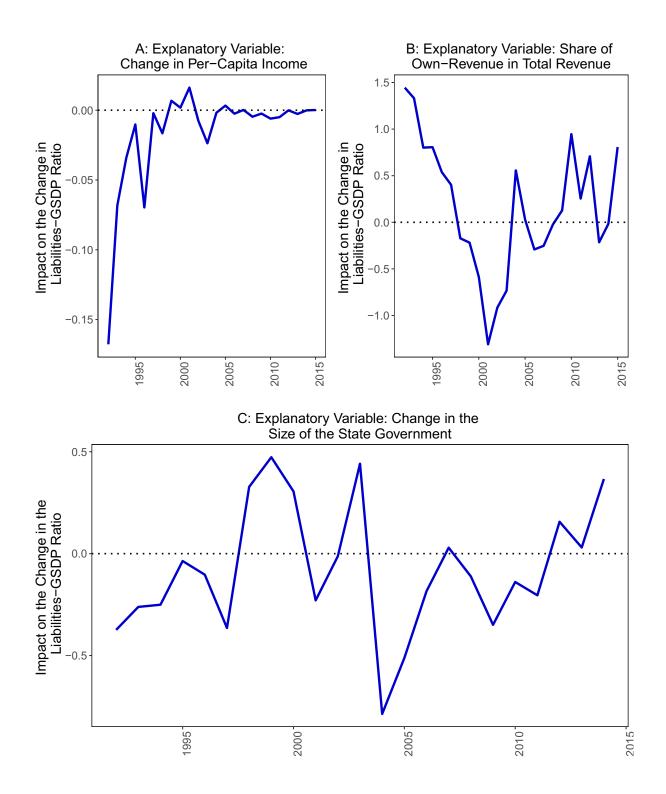


FIGURE 6: Impact of State–Specific Factors on the Fiscal Deficit to GSDP Ratio

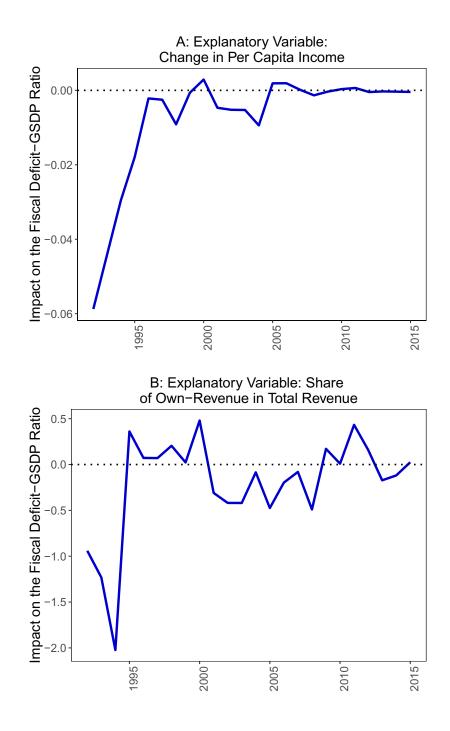


FIGURE 7: The Size and Liabilities of the State Governments as a Share of the Size and Liabilities of the General Government

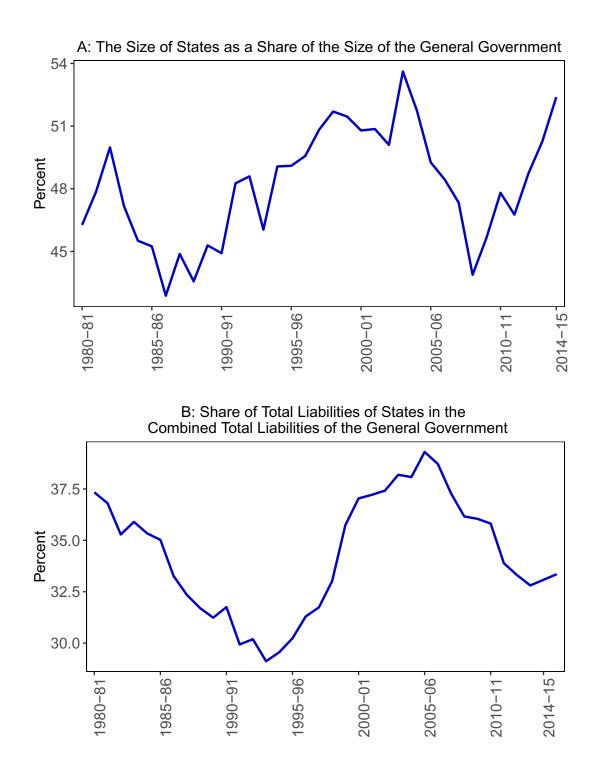
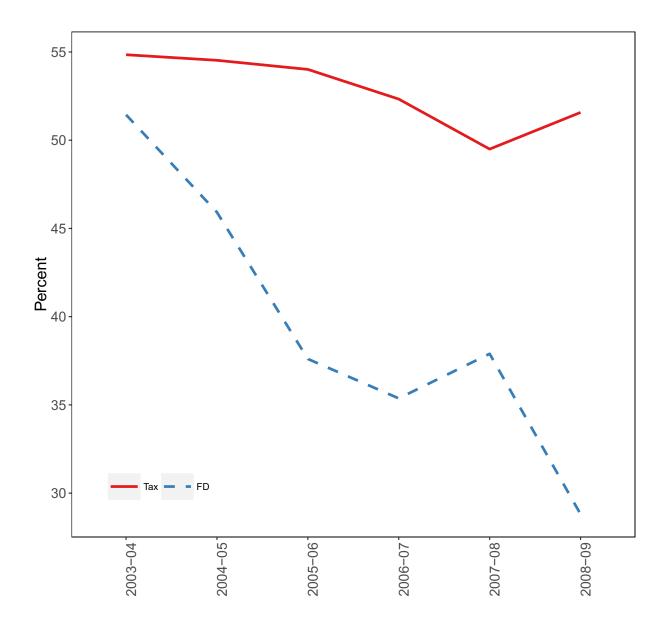


FIGURE 8: Components of the Size of the Government: The share of States' Borrowings and Tax Revenues in the General Government



CHAPTER 6 ANATOMY OF CREDIT

CHAPTER 6

Anatomy of Credit

I. Introduction

This chapter conducts an anatomy of recent movements in output, investment, and credit in India.¹ We document using both macro and micro data that recent movements in real and financial variables in India have been big and sharp. Investment picked up after the Global Financial Crisis (GFC), but declined again around 2011-12. We find a very similar pattern for credit. Importantly, we find that movements in credit and output are positively and strongly correlated.

At the same time, Indian corporates have reported weak performance, and corporate balance sheets have been stressed, which has resulted in difficulties with loan repayments for companies. Iron and steel, energy (electricity, oil, and gas), transport, and textiles are the top ranking sectors with the highest share of low quality loans. Stressed corporate balance sheets in these sectors can be attributed to both domestic and global factors. Domestic factors include, for example, in the case of electricity, the ongoing losses of state power utilities due to their inability to charge higher tariffs from consumers. Global factors, on the other hand, include e.g. a slowdown in commodity prices.

There are several possible factors that can explain recent movements in output and credit. First is the corporate "demand" channel. Firms' weak output and investment performance arising due to domestic and external factors have led to stressed corporate balance sheets, and in turn to subdued demand for credit. Second is the bank-lending channel. This channel is based on the idea that firms' weak outcomes can be related to the fact that they are connected to weak banks. These weak banks are stressed and are not able to supply enough credit.

Third is the channel that works through non-bank sources of credit. Based on this mechanism, although there is reduced supply of credit by banks, corporates are substituting away from bank loans towards non-bank sources of credit.

The rest of the chapter is organized as follows. Section II reports stylized facts about the movements of economic and financial variables in India. Section III documents the importance of various mechanisms that could contribute to the slowdown in credit. Section IV concludes.

II. Documenting Stylized Facts

Documenting facts: Investment

Based on data from the national accounts statistics, the annual growth rate of investment in India declined sharply from a high of 16% in 2009 to below 4% in 2016. The downward trend in investment is also supported by evidence from firm-level data. On average, firm level capital expenditures have decreased. Both macro-level investment and firm-level capital expenditures show some evidence of a "cycle" - a pick up after the GFC, and then a decline again (Figure 1). The rise in stalled projects continues to put a drag on investment.

¹ This chapter draws extensively on Acharya, Viral, Prachi Mishra, and N.R. Prabhala (2016), "The Anatomy of India's Credit Cycle", mimeo.

Documenting facts: Output

Importantly, movements in output follow the same pattern as investment. Real GDP growth also declined sharply after the GFC, but picked up immediately, before beginning to decline again. Firm sales and employment show similar movements (Figure 2).

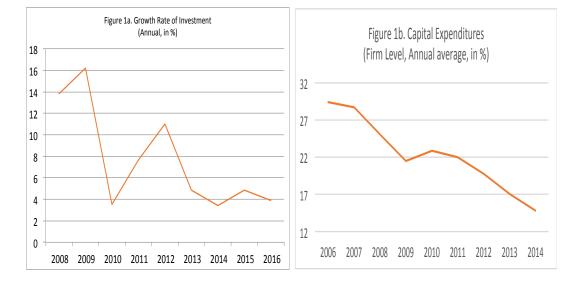
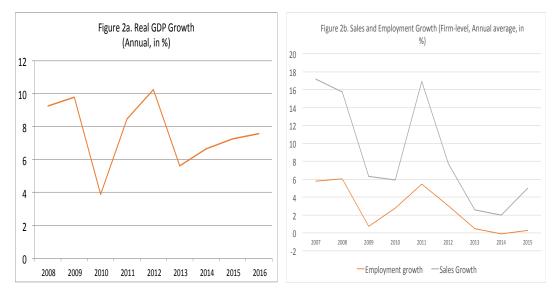


Figure 1. Investment in India

Figure 2. Output Movements in India



Documenting facts: Credit

Credit growth in India shows a pattern similar to investment and real outcomes (Figure 3a). The year-onyear credit growth to the commercial sector by Scheduled Commercial Banks (SCBs) was reported at 9% on average over April-November 2016 (Figure 3b), compared to an average of 12% during the same period in 2014, and as high as 14% in April 2014. Credit growth has slowed even after adjusting for inflation. Real credit growth, deflated by wholesale price inflation, has slowed from 15% year-on-year in August 2015 to 4% most recently (Figure 3c). Credit to deposit ratio has also declined sharply over this year (Figure 3d). More recently, the decline in this ratio may also reflect the fact that bank deposits have increased sharply since the withdrawal of legal tender status of specified bank notes (SBNs), as high-value notes returned to the banking system. As of December 10, 2016, ₹ 12.4 trillion, roughly 80% of the outstanding high-value notes were deposited into the banking system. RBI used reverse repo operations and also temporarily raised reserve requirements to tackle excess liquidity in the banking system. This increase in liquidity is, however, likely to be transient, as the economy is remonetized and deposits of SBNs are offset by withdrawals of new notes, as restrictions on the latter are eased over time.

The aggregate data, however, masks interesting variation across sectors, and across types of banks. While credit to small and medium industry is low, credit to home and personal loans remains relatively robust (Figure 3e). There is also interesting distinction between banks by ownership - public and private banks. Private banks in India faced a resource shortage after the GFC like banks all around the world. Credit growth by private banks declined but then picked up immediately. Public sector banks (PSBs), on the other hand, continued to lend after the GFC, and began to show weak credit growth only more recently (Fig 3e). Importantly, we find that the cyclical component of credit is strongly correlated with that of investment, where the cyclical component is obtained by filtering out the trend component using a simple Hodrick-Prescott (HP) filter (Figure 4).

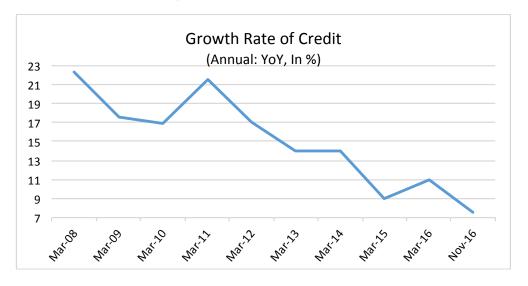
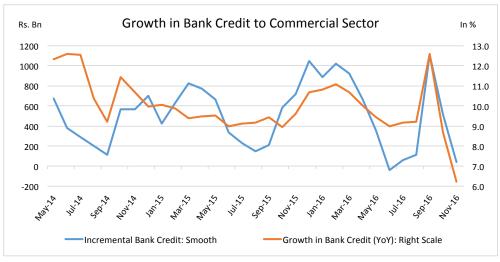


Figure 3a. Bank Credit in India

Figure 3b. Bank Credit: Recent Trends



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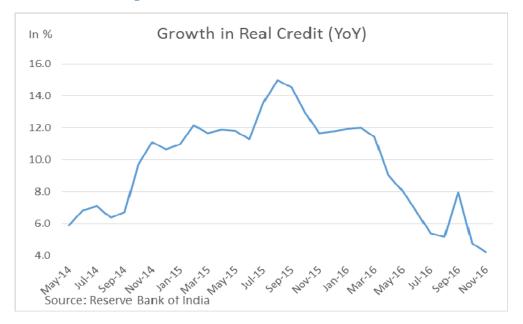
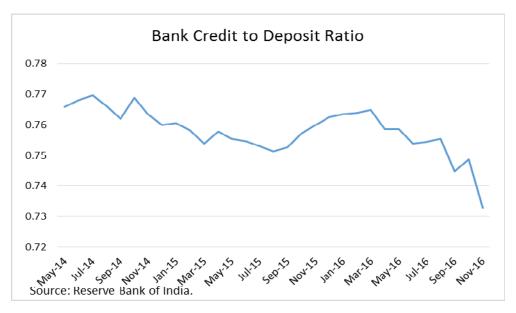


Figure 3c. Real Bank Credit: Recent Trends

Notes: Deflated by WPI. Credit and WPI indices are seasonally adjusted.

Figure 3d. Credit to Deposit: Recent Trends



Notes: Credit and deposits are seasonally adjusted.



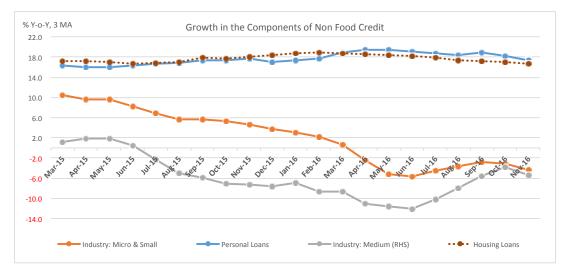
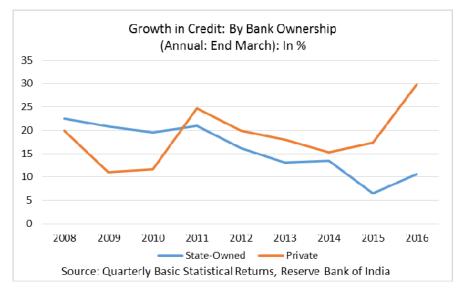


Figure 3f. Bank Credit: By Bank Ownership



Notes: State-owned banks include SBI and its associates, and the nationalized banks. Private banks include only Indian private sector banks (does not include foreign banks).

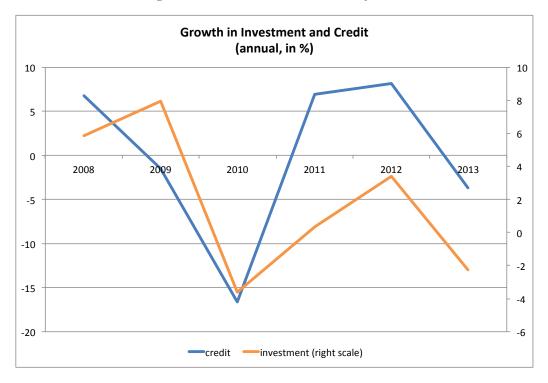
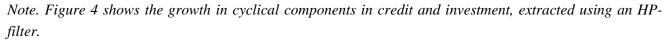


Figure 4. Credit and Investment Cycle



Interestingly, the pattern of credit in India differs from that in the United States or Europe. The US GFC and subsequent EU crisis had three key features: First, there was a resource shortage. Both banks and borrowers faced a resource crunch. Second, those crises were characterized by a problem of aggregate resource crunch – where all banks faced a similar crunch. Third, these were crises where banks were essentially private. The Indian experience differs in all 3 dimensions. (i) Economic cycle post GFC was characterized by a problem of plenty rather than shortage as PSBs were flush with deposits possibly due to a flight to safety; (ii) a redistribution of resources from private to PSBs rather than aggregate shortage, (iii) involving state-owned banks rather than private banks.

III. Contributors to Credit Movements

This section documents stylized facts on various factors that could be contributing to the recent slowdown in credit.

Stressed assets in the banking system

Credit slowdown can be closely related to the stressed assets of banks. Non-performing assets (NPAs) continue to increase in the banking system. Recently, NPAs increased from 5.1% in September 2015 to reach 9.1% of the total advances by September 2016. This partly reflects the clean up and greater recognition of bad assets on the banks' balance sheets. Restructured assets, on the other hand, have declined to 3.2% of total advances, from 6.2% in September 2015, partly reflecting a reclassification of restructured assets as NPA. PSBs comprise the largest proportion of stressed assets. To put the facts in perspective, while

PSBs have 78% of assets, 83% of branches, 74% of employees, 67% of capital, they have 91% of gross NPAs and 93% of net NPAs.

An important factor contributing to the rising stress in bank balance sheets is the persistent losses being incurred by the state power distribution companies. The financial health of the state power utilities remains a key risk for banks, for the states' fiscal position, and therefore for the general government position (Box 1). The stress in bank balance sheets can also be linked to many of the implicit and rising contingent liabilities of the government, which pose a threat to both the banking system and government finances. Box 2 discusses some of these rising liabilities.

Box 1. Issues in the Power Sector

Electricity production: Generation capacity has increased significantly over the last few years – by 50% between FY08 and FY15.

Consumers' demand: Despite a record generation capacity, the final demand of consumers continues to remain unsatisfied. Based on the limited data we could gather from several sources, outages in metropolitan cities such as Delhi increased by more than 40% between FY15 and FY16. This is because intermediaries like the state power distribution companies (Discoms) create a "wedge" between the supply by generation companies and final consumers' demand. This mismatch between the supply and demand occurs partly due to the weak financial health of state power utilities. For example, the outstanding debt (excluding Discom bonds) of the Discoms of Rajasthan, Haryana, Uttar Pradesh and Tamil Nadu was around ₹ 2,13,446 crores as on September 30, 2015.

Financial health of state power utilities: The newly designed UDAY scheme aims to improve the financial health of power utilities, but it solves only the debt "stock" problem whereas the "flow" problem continues to exist as described below.

- Stock problem addressed by UDAY: Under the UDAY scheme, 75% of the "stock" of debt outstanding as on September 30, 2015 is envisaged to be taken over by the state governments over a two- year period.
- Flow problem remains: 25% of the debt outstanding as on September 30, 2015 will, however, remain in the books of the Discoms. The debt that will continue to be in the banks' books will be charged an interest of 0.1 per cent over the base rate. Despite the renegotiation of the interest rate, the Discoms will have a "flow" of operating losses because their average cost of supply (ACS) will continue to be higher than the average revenue realized (ARR). This implies that Discoms will be unable to supply the required market demand despite record generation. There are two primary reasons for the continued losses of the Discoms: first, the infrequent revisions in tariffs and their implementation by the State Electricity Regulatory Commissions (SERCs), and second, the high aggregate technical and commercial (AT&C) losses. The AT&C losses are caused by thefts, delayed payments by state government departments to the Discoms, non-payment of agriculture subsidies to the Discoms by the state government, etc.

Box 1. Issues in the Power Sector (contd.)

Way forward

- Fix the stock problem completely: To further fix the stock problem, 100% of the debt of the Discoms would need to be taken over by the respective state governments. This will further reduce the interest costs for the Discoms and raise their ARR.
- Deal with the flow problem: There should not be further bank financing of operating losses of Discoms and instead, state governments should make a firm commitment to underwrite the shortfall in the revenue of Discoms as equity or interest free loan on an annual basis. While the UDAY scheme states that the banks shall not extend short-term loans, there is little clarity on how the remaining cash loss will be funded. The scheme provides for banks to give loans for working capital to the Discoms; but without any arrangement for funding the remaining operating losses, the burden might fall on the banks once again. Moreover, with the residual 25 per cent exposure in the banks' books having to be classified as NPA, any further exposure without establishing viability will also be classified as NPA, requiring additional provisions. It would thus be highly unviable for banks to extend any further financial assistance to loss making Discoms.
- Increasing ARR: Discoms and state governments must achieve time-bound targets to earn positive revenue. Compulsory metering, technological upgradation, and periodic tariff revision and implementation should be adhered to. Notably, raising tariffs is bound to increase the incentives for thefts, and lead to increased AT&C losses. Therefore, separate measures to address AT&C losses should be taken by all states drawing from the Gujarat case e.g. crack down on thefts and unmetered power supply, introduction of separate feeder lines for different segments, etc.
- Cutting down the role of the intermediaries: A framework may be developed to facilitate electricity generation companies to directly sell their surplus power to consumers at a negotiated price. Further, open access policies, charges, and other non-price barriers at the state-level, may be revisited so that final consumers can benefit from a wider set of choices, and the lowest prices; and producers can also sell, perhaps also across state borders, to the destination with the best price.

Box 2. Contingent Liabilities of the Central Government

This box discusses two of the implicit and rising contingent liabilities of the government, which pose a threat to both the banking system and government finances.

A. Food Credit

Facts

State governments maintain food credit accounts with commercial banks. The credit is used by certain entities for centralized procurement of cereals on behalf of the Food Corporation of India (FCI).

There are long delays in servicing these accounts, particularly in the case of some states. These arise mainly due to several disputes between the state governments and the FCI, and resulting delays in the FCI finalizing and effecting reimbursement of procurement expenses to the state concerned. In principle, these accounts should have long back been classified as Non-Performing Assets (NPAs).

Box 2. Contingent Liabilities of the Central Government (contd.)

As a result of the above delays, there are significant and rising "irregularities" in the food credit accounts. These irregularities arise because the outstanding food credit often exceeds the amounts that can be drawn based on the procurement value of the grain stocks. The irregularity in the food credit account (defined as the difference between the outstanding credit and the drawing power available in the account) was high for certain states and comprised a large fraction of the total outstanding credit. This is a chronic and continuing irregularity. Such irregularities will remain a constant feature unless the food credit

mechanism used by the FCI for centralized procurement through states is centralized with the FCI.

Way forward

Food credit to centralized procurement states could be routed only through the FCI, duly guaranteed by the Government of India. This would streamline the process, improve the efficiency, and minimize disputes between the procuring states and the FCI that lead to persisting irregularity in the food credit account of the concerned states. In addition, the present irregularity should be accurately determined after a comprehensive special audit of grain stocks, and adjusted by the GoI/FCI at the earliest.

B. Government Sponsored Credit Guarantee Schemes

The Government of India has launched many credit guarantee schemes, viz., Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), Credit Risk Guarantee Fund Scheme for Low Income Housing, etc., to aid higher credit flow from formal credit channels to certain targeted beneficiaries. While these credit guarantee schemes have helped the intended beneficiaries in getting credit at more favorable terms, it is important that these schemes are run in a prudent and transparent manner.

These credit guarantee schemes are heavily under-capitalized in relation to the aggregate amount of guarantees outstanding under the respective schemes. Loan losses are mounting in CGTMSE suggesting that the guarantees have reduced the quality of loans banks have made, and reduced the willingness of the bank to monitor and collect, or borrowers to repay. Further, very little information is available on the operations of these schemes for an independent evaluation of their operations. In the absence of regular and adequate disclosures on their operations and solvency, these schemes may pose unexpected and huge challenges to the government finances, especially if the government has to meet any sudden and large deficit on account of their operations.

While GoI has explicitly assured to fund these schemes in case of deficit in their corpus fund, it would be important to make sure that the schemes are run well so that loan losses are minimized, and are kept adequately funded on an ongoing basis, based on certain prudential norms.

Low bank capital

The rise in NPAs can affect banks' profitability and also their ability to augment their capital base through internal accruals. The lack of adequate bank capital could also be a contributor to lower credit supply from PSBs; and a further program of targeted and staged capital allocation on the lines of "Indradhanush" could be beneficial in this context (see Box 3).

Box 3. Capital Infusion into Public Sector Banks

Banks need to augment their capital base on an ongoing basis in order to be able to meet the demand for credit in a growing economy like India, and at the same time maintain minimum capital in line with international requirements. The adoption of the Basel III norms will also push up the capital requirement of banks, especially public sector banks (PSBs), moderately. According to the Financial Stability Report of the RBI, PSBs continue to record the lowest capital to risk-weighted assets ratio (CRAR) among the bank groups with negative returns on their assets. Stress tests, moreover, show that the capital ratios for PSBs may decline further if macroeconomic conditions deteriorate sharply.

While the exact quantum of capital requirement would depend on many factors and may vary over time, the extra capital requirement for public sector banks, excluding internal accruals, is estimated by the Ministry of Finance to be around ₹ 180,000 crore up to March 2019. Out of this total requirement, the Government has proposed to contribute around ₹70,000 crores in four years from FY16 to FY19. This assumes, optimistically, that the remaining capital can be sourced from the market. The Government has demonstrated its intent and commitment to provide additional budgetary support to public sector banks to ensure that they remain adequately capitalized to support economic growth. Reserve Bank, on its part, has also made significant changes to the capital regulations by reviewing some of its norms, which were more conservative than Basel III requirements, and by aligning these closer to the Basel standard. The improvement in the equity capital and all other measures taken together would support raising non-equity capital instruments on more competitive terms. In fact, 20 banks have already raised ₹ 3,950 crores in Additional Tier I capital and Rs 25,515 crores in Tier 2 capital from the market during FY16. However, as discussed above, the NPAs of banks have increased, partly due to recognition of bad assets, affecting banks' profitability and their ability to augment their capital base through internal accruals. The Reserve Bank recently conducted a banking system-wide Asset Quality Review (AQR) to bring in greater transparency in the balance sheets of the PSBs. Based on the AQR, banks have made significant additional provisions during FY16. While higher provisions could lead to a short-term compression in the capital of banks, it is expected that this will reduce the uncertainty for potential investors about the extent of the asset quality stress faced by the banks and will encourage investors to invest in the capital instruments of the banks with greater confidence.

Hence, the quantum of capital infusion by the Government perhaps may need to be much higher and at a pace quicker than the earlier estimations and commitments. While the Government is infusing some amount of equity in PSBs, it may need to do so quickly and even increase the capital committed to make sure that PSBs are in a position to support the required economic growth by being able to lend to productive assets without being constrained by capital. At the same time, accessing equity from the market is long overdue by the banks and delaying such issuance on the grounds of current low market valuations, is likely to only exacerbate the problem, given the medium-term trends.

Weak corporate performance and stressed corporate balance sheets

Stressed assets of banks, and their reduced willingness to lend also coincide with weak corporate performance and rising corporate stress. Interest coverage ratio of Indian firms has declined (Figure 5a). High quality debt of firms has also decreased alarmingly from 80% of total debt to 40%, while low quality

debt has increased. (Figure 5b). In an international perspective, India's corporate debt at risk (share of corporate debt, or debt held by weak firms, or those with ICR (EBIDTA/interest expenses)<2) remains higher than compared to other emerging economies (Table 1). Weak corporate performance leading to stressed corporate balance sheets could be another factor leading to low demand for credit, and subdued credit growth.

Stressed corporate balance sheets in these sectors can be attributed to both domestic and global factors. Domestic factors include, for example, a rise in stalled projects due lack of clearances (e.g. environmental and non-environmental clearances) and land acquisition issues. Global factors, on the other hand, include e.g. a slowdown in commodity prices. While corporate earnings have been weak in recent times, profits have fared better, as input costs have also declined due to low commodity prices and subdued inflation.

Figure 5a. Corporate Balance Sheets: Interest Coverage Ratio

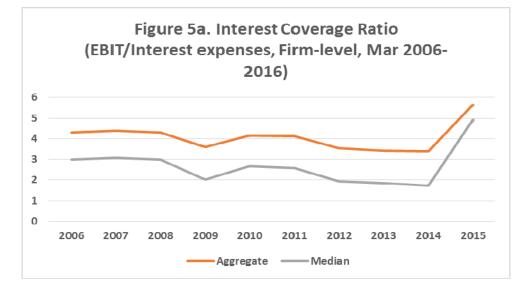
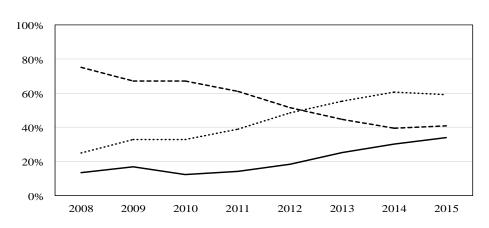


Figure 5b. Corporate Balance Sheets: Corporate Debt



% Debt by Interest Coverage

--- High Quality Debt (ICR>=2) ····· Moderate Quality Debt (ICR<2) --- Low Quality Debt (ICR<1)

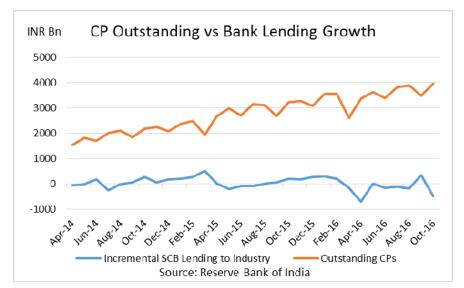
Table 1. Corporate Debt Corporate Debt-at-risk* (in %)				
Brazil	25.3			
Russia	13.6			
India	36.9			
China	24.5			
South Africa	16.1			
Mexico	17.9			

* Debt-at-risk is the share of corporate debt held by the "weak firms" or those with interest coverage ratios (EBITDA/ interest expense) < 2

Substitution away from bank credit

Finally, another important contributor to low credit growth could be that corporates are substituting away from bank credit. In fact, firms are bypassing banks to borrow directly from the commercial paper markets. Banks, in comparison, have transmitted RBI's prior past policy actions only to a limited extent. Short-term market rates, however, have seen full pass-through. Not surprisingly, highly rated firms are bypassing banks to borrow from the commercial paper markets, with outstanding commercial paper having more than doubled in the last two years to over 3 lakh crores (Figure 6). 60 banks, out of which 28 are foreign banks, have reduced the recently introduced marginal cost of funds based lending rate (MCLR) rates since April 1st, but the median cut in the MCLR rate of both public and private banks was only 18 basis points (compared to a reduction in the policy repo rate by 150 basis points since January 15th 2015). Foreign banks, in comparison, have transmitted more - the median cut in the MCLR rate for foreign banks was 31 basis points.





Notes: Bank lending includes only the lendings by the Scheduled Commercial Banks (does not include co-operative banks)

Corporates are also trying to access offshore rupee bond markets. Three companies – HDFC, NTPC, and Adani Transmission – have successfully issued rupee-denominated (Masala) bonds in offshore markets. HDFC raised ₹ 3000 Cr at 8.33% annual yield and 37 months maturity on the London Stock Exchange (LSE); NTPC raised ₹ 2000 Cr at 7.48% annual yield and 5 year maturity on the LSE as well; and Adani Transmission raised ₹ 500 Cr at 9.10% annual yield and 5 year maturity on the Singapore Exchange. Importantly, these issuances were met with enthusiastic investor response.

In order to enable corporates to access non-bank financing, the RBI recently announced a package of measures for the development of fixed income and currency markets. These measures are intended to further market development, enhance participation, facilitate greater market liquidity and improve communication. These measures would also play a crucial role in increasing the effectiveness of monetary policy. The measures described in Box 4 underline the broad philosophy of measured and well-signaled liberalization of markets while minimizing the associated risks.

Box 4: Measures for Development of Fixed Income and Currency Markets

In order to develop the corporate bond market, it has been decided to enhance the aggregate limit of partial credit enhancement (PCE) provided by banks, permit brokers in corporate bond repos, authorize the platform for repo in corporate bonds and encourage credit supply for large borrowers through market mechanism. It has also been decided to seek suitable legal amendments to enable the RBI to accept corporate bonds under Liquidity adjustment Facility (LAF). To further encourage the overseas Rupee bond market, banks are being permitted to issue Rupee bonds overseas (Masala Bonds) for their capital requirements and for financing infrastructure and affordable housing.

A market-making scheme in government securities by primary dealers has been worked out in consultation with the Government, which may help in increasing the liquidity of semi-liquid securities. Relaxation of tenor and counterparty restrictions in repo market in G-sec will also help in increasing market liquidity. Foreign Portfolio Investors (FPIs) will be given direct access to Negotiated Dealing System-Order Matching (NDS-OM) to ease the process of investment in debt securities. It has also been agreed with SEBI to provide FPIs the facility to trade directly in corporate bonds. In a fundamental shift in foreign exchange market regulations, greater leeway is being proposed for residents to maintain open positions. The permissible limits for hedging in the OTC as well as exchange traded markets are also being rationalized. It is also proposed to comprehensively review the framework for hedging of commodity price risk in the overseas markets by Indian companies.

Evidence from firm-level data

What can explain the recent credit and economic movements in India? We shed light on this question from another angle - using very detailed firm-level data from the Centre for Monitoring Indian Economy (CMIE-Prowess). We distinguish between weak and strong firms based on their interest coverage ratios (measured as the ratio of interest payments to profits); and firms connected to weak or strong banks (firms connected to weak banks defined, for example, by banks which have high exposure to weak sectors). Analysis using firm-level data suggests that both corporate demand and bank lending channels contribute to explaining the movements in credit and investment. Firms with stressed corporate balance sheets, or weak firms, were associated with weak real outcomes. In addition, real outcomes – employment, sales, and capital expenditures were stronger for firms connected to weak banks during pre-2012; but turned down thereafter.

Firms connected to weak banks also had weak financials throughout the sample period. They had lower ICR, higher leverage, and were larger in size.

IV. Conclusions

To summarize, this chapter first documents stylized facts on credit, investment, and output. Our findings suggest that there has been a sharp slowdown in credit growth in India since the global financial crisis. The movements in credit have mirrored the investment and output movements. Credit slowdown can be explained by a combination of several factors e.g. weak firm performance and stressed corporate balance sheets leading to subdued demand; stressed balance sheets of banks resulting in weak supply; and substitution by corporates away from bank towards non-bank sources of credit.

What does this chapter imply for policy, and specifically for fiscal policy? Overall, the findings in this chapter may not suggest the feasibility for explicitly aligning fiscal policies with credit behavior in the economy. Enhanced investment, both public and private, along with mitigated stress in bank balance sheets, can resurrect credit growth.

CHAPTER 7 FISCAL COUNCIL

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Robust institutions underpin the credibility and efficacy of the macroeconomic fiscal regime. In our context of the fiscal responsibility parameters, experience suggests that the absence of an institutional underpinning remained a serious lacuna in securing compliance to the letter and spirit of Fiscal Rules. While Fiscal Rules have been in vogue for a long time, Second Generation Fiscal Reforms have been invariably underpinned by fiscal institutions.

A cross-country study of the Second Generation Fiscal Rules suggests that by 2014, more than 80 countries (including several emerging economies) had adopted fiscal rules in some form or the other. Of these, more than 35 countries had constituted autonomous fiscal councils.¹

While there is little homogeneity in the mandate and constitution of fiscal councils, they are typically independent bodies which evaluate the sustainability and stability of the government's fiscal policies and performance. According to an IMF study, fiscal councils may:

"(i) contribute to the use of unbiased macroeconomic and budgetary forecasts in budget preparation (through preparing forecasts, or proposing prudent levels for key parameters),

(ii) identify sensible fiscal policy options, and possibly, formulate recommendations,

(iii) facilitate the implementation of fiscal policy rules, and

(iv) cost new policy initiatives".²

It has been highlighted in several studies that apart from its direct contribution to fiscal policy, fiscal councils strengthen public information, and discourse about fiscal policy.³ For example, the United Kingdom created an Office of Budget Responsibility (OBR) in 2010, and granted it statutory status in 2011 to provide independent analysis of the country's public finances. Its functions include:

- providing economic and fiscal forecasts,
- evaluating the government's performance against targets,
- analysing the long-term sustainability of public finances, as well as analysing the balance sheet of the public sector,
- evaluating and identifying fiscal risks of relevance, and
- scrutinising the Government's costing of individual tax and welfare spending measures.⁴

The OBR is an independent body which is primarily responsible to the Chancellor of the Exchequer for its activities. The Chancellor accounts for the OBR's activities in Parliament.

On the other hand, directly responsible to the legislature (Congress) is the Congressional Budget Office

¹ International Monetary Fund, *Fiscal Councils: Rationale and Effectiveness*, WP/16/86 available at <u>https://www.imf.org/external/pubs/ft/wp/2016/wp1686.pdf</u>

² International Monetary Fund, *The function and Impact of Fiscal Councils*, available at <u>http://www.imf.org/external/np/pp/eng/2013/071613.pdf</u>.

³ International Monetary Fund, *Fiscal Councils: Rationale and Effectiveness*, WP/16/86 available at <u>https://www.imf.org/external/pubs/ft/wp/2016/wp1686.pdf</u>

⁴ Budget Responsibility and National Audit Act, 2011 available at http://budgetresponsibility.org.uk/docs/dlm_uploads/Budget-Responsibility-and-National-Audit-Act-2011.pdf; Office for Budget Responsibility, *About us* available at http://budgetresponsibility.org.uk/about-the-obr/what-we-do/.

(CBO) in the United States of America. Since 1975, the CBO supports the Congressional budget process by providing independent analyses of budgetary and economic issues. To achieve this, they provide *inter alia*:

- budgetary and economic forecasts or projections,
- cost estimates of all legislation,
- analysis of the President's budget, and
- evaluation of legislative action with consistency on consistent spending and revenue levels set by budget resolutions.⁵

The CBO is independent from the Executive and does not report directly to any Congressional Committee.

A relatively smaller economy, which provides an illustrative example of a typically functioning Fiscal Council is the Republic of Ireland. Ireland established a Fiscal Advisory Council in 2011 to provide an independent assessment of official budgetary forecasts and proposed fiscal policy objectives. In particular, it performs the following functions:

- assessing the macroeconomic and budgetary forecasts prepared by the Department of Finance,
- assessing if the fiscal stance of the Government is conducive to prudent economic and budgetary management,
- monitoring compliance of the Government's budget with the budgetary rule, requiring the budget to be in balance or surplus, and
- assessing if any non-compliance with the budgetary rule is a result of 'exceptional circumstances'. ⁶

The Irish Fiscal Advisory Council is stand-alone statutory body that functions independently.

In India, while there is no Fiscal Council, there are several existing financial institutions which have important functions in fiscal policy. They include:

- The Finance Commission which makes recommendations to the President regarding the devolution of funds between Union and States, principles governing grants-in-aid to States, and measures to augment the Consolidated Fund of a State.⁷
- National Statistical Commission which serves as an empowered body for all essential statistical activities (mainly by the Central Statistical Organisation and the National Sample Survey Office) in India. It ensures the credibility of data which provides the basis for fiscal projections by the Centre and the States.⁸
- Comptroller and Auditor General ('CAG'): The CAG, an independent constitutional functionary which performs an ex-post audit function ensuring the accountability of the Government and other public authorities to Parliament and State Legislatures is ensured.⁹

Conspicuous by its absence is a Fiscal Council. The need for a Fiscal Council, in one form or the other, has been a recurring theme from the inception of the first Fiscal Responsibility and Budget Management Act, 2003 ('FRBM Act'). The Report of the Committee on Fiscal Responsibility Legislation, on the basis of

⁵ Congressional Budget Office, An Introduction to the Congressional Budget Office available at

<https://www.cbo.gov/sites/default/files/cbofiles/attachments/2016-IntroToCBO.pdf>.

⁶ Fiscal Responsibility Act, 2012 available at http://www.fiscalcouncil.ie/wp-content/uploads/2013/02/FRA.pdf.

⁷ Article 280, the Constitution of India, 1950.

⁸ <u>Government of India Notification No. 85 dated 1st June 2005 available at</u> <<u>http://mospiold.nic.in/Mospi New/upload/nsc/nsc notifc85.pdf</u>>.

⁹ Article 148 of the Constitution of India, 1950.

which the first FRBM Act was drafted, had proposed the constitution of a Fiscal Management Review Committee. However, the CAG had objected to the creation of such a committee, claiming it would be superfluous.¹⁰

Thereafter, the Thirteenth Finance Commission had also recommended the constitution of an independent review mechanism by the Centre to evaluate its fiscal reform process. It recommended the establishment of a mechanism:

"to conduct an annual independent and public review of FRBM compliance, including a review of the fiscal impact of policy decisions on the FRBM roadmap. This review should present its findings concurrently with the annual budget and the medium term strategy ...*it is imperative that such an institution be developed to assist the government in addressing its fiscal tasks in a professional, transparent and effective manner.*"¹¹

The Thirteenth Finance Commission suggested that the proposed Fiscal Council should be an autonomous body, reporting to the Ministry of Finance, which should further report to Parliament on the matters dealt with by the Council.¹²

The Fourteenth Finance Commission too noted that globally, several countries had constituted fiscal councils which help in monitoring and evaluating fiscal policies and management. These also create transparency by providing costing estimates of various programmes, and increase accountability of the Government.¹³ Accordingly, they express the view that:

"it is important to have an ex-ante evaluation of the fiscal implications of the budget proposals and, therefore, believe that it is essential to establish an independent fiscal institution for this purpose. This could be done through the establishment of a fiscal council by an amendment to the FRBM Act, similar to the one that enables the ex-post assessment by the C&AG......In the light of the above, we recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council on the lines indicated above to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules..." ¹⁴

On this basis, it is clear that the need for a Fiscal Council in India is widely recognised.

Proposal:

1. Keeping in view best international practices and the Indian context, it is proposed that an independent Fiscal Council may be constituted as part of the new institutional framework to be made part of the new proposed Debt Management and Fiscal Responsibility Act ('Debt Act') to replace the FRBM Act.

¹⁰ Report of the Committee on Fiscal Responsibility Legislation, 2000.

¹¹ Paras 9.65- 9.66, Report of the Thirteenth Finance Commission (2009) available at ">http://fincomindia.nic.in/ShowContentSho

¹² Paras 9.65- 9.66, Report of the Thirteenth Finance Commission (2009) available at <u>http://fincomindia.nic.in/ShowContentOne.aspx?id=28&Section=1</u>.

¹³ Paras 14.96-14.99, Report of the Fourteenth Finance Commission (2015) available at http://finmin.nic.in/14fincomm/14fcreng.pdf>.

¹⁴ Para 14.100, Report of the Fourteenth Finance Commission (2015) available at http://finmin.nic.in/14fincomm/14fcreng.pdf>.

- 2. The functions of the Fiscal Council could inter-alia include the following:
 - (i) preparing multi-year fiscal forecasts;
 - (ii) preparing a fiscal sustainability analysis that makes projections on key fiscal indicators;
 - (iii) providing an independent assessment of the Central Government's fiscal performance and compliance with targets set under the Debt Act;
 - (iv) recommending suitable changes to fiscal strategy to ensure consistency of the annual financial statement with targets set under the Debt Act;
 - (v) taking steps to improve quality of fiscal data;
 - (vi) producing an annual fiscal strategy report which will be released publicly;
 - (vii) providing policy guidance to Central Government on any matter relating to fiscal policy where advice is sought;
 - (viii) advising the Central Government on whether conditions exist to permit a deviation from the targets established and make recommendations on the plan to return to the established targets;
 - (ix) advising the Central Government on corrective steps to be taken if periodic review demonstrates non-compliance with any targets set under the Debt Act.
- 3. In addition to the functions above, the Fiscal Council will prepare the Macroeconomic Framework Statement containing an assessment of the economy with respect to trends in the growth of Gross Domestic Product, public debt, fiscal balance and the external balance of the Union of India. This will be presented along with the Annual Budget by the Finance Minister. It should also produce an Annual Fiscal Strategy Report on all issues relating to fiscal policy and its own activities and release the same publicly.
- 4. The Fiscal Council would be an autonomous body, under the aegis of the Ministry of Finance (Department of Economic Affairs). It is proposed that it should comprise a Chairperson and two Members to be appointed by the Central Government. The persons to be appointed ought to have significant experience in public finance, economics or public affairs. To ensure they function independently, such persons should not be in the current service of the Government, should have a non-renewable term of four years and non-diminishing salaries while in office, and their appointment should be capable of termination only on limited grounds.

Establishing a Fiscal Council on the aforementioned lines will ensure that a robust and independent institution underpins the credibility of the macroeconomic fiscal regime in India.

CHAPTER 8 ESCAPE CLAUSES

CHAPTER 8

Escape Clauses

Second Generation Fiscal Rules in a number of countries now increasingly provide for 'escape clauses', namely contingent circumstances which necessitate a deviation from the path of fiscal consolidation and the adherence to the targets prescribed under the Fiscal Rules. These clauses allow for temporary deviations from the Fiscal Rules without compromising on long term fiscal targets.

This is highly desirable as Fiscal Rules need to be designed with sufficient built-in flexibility, to enable them to respond adequately to economic shocks without undermining the discipline promoted by the rules. The absence of escape clauses has been found to be associated with frequent procyclicality.¹ In the absence of such clauses, the Government would not be able to respond to events such as recessions or natural calamities by adopting necessary countercyclical measures. Well-designed escape clauses also enhance the credibility of fiscal rules by preventing flagrant violation of these rules by giving sufficient flexibility for necessary deviations. In a survey conducted by the IMF in 2009, it was found that in more than half the countries surveyed, fiscal rules offered insufficient room for adequate countercyclical measures.² However, in a bid to account for countercyclical action, escape clauses must not be left vague or unclear. The Indian experience with the FRBM Act 2003 may be argued to fall in this category. Section 4 (2) (b) of the current FRBM Act provides that "the revenue deficit and fiscal deficit may exceed such targets due to ground or grounds of national security or national calamity or such other exceptional grounds as the Central Government may specify." The aforesaid definition of exceptional circumstances leaves the invocation of the Escape Clauses, liable to expedient interpretation, to suit the needs of the Government in office which seeks to increase expenditure for the exigencies of the time. Schaechter et al. cite the FRBM Act along with the example of Germany³ as an instance of an escape clause not being well specified.⁴

Thus, it is crucial that escape clauses strike a fine balance between flexibility and adherence. In this regard, *Schaechter et al.* (2012) suggest that fiscal rules should be designed with appropriate escape clauses that include:

- "(i) A very limited range of factors that allow such escape clauses to be triggered in legislation;
- (ii) Clear guidelines on the interpretation and determination of events (including voting rules);
- (iii) Specification on the path back to the rule and treatment of accumulated deviations".

¹ Elva Bova, Nathalie Carcenac, and Martine Guerguil, Fiscal Rules and the Procyclicality of Fiscal Policy in the Developing World, IMF Working Paper, WP/14/122. (2014).

² Teresa Ter-Minassian, Preconditions for a successful introduction of structural fiscal balance based rules in Latin America and the Caribbean: A Framework paper, Inter-American Development Bank, DISCUSSION PAPER No. IDB-DP-157.

³ Until 2009, in Germany deviations were permissible on "a disturbance of the macroeconomic equilibrium". This was altered in 2009. Articles 109 and 115 of Basic Law for the Federal Republic of Germany which deal with Budget Management now provide for exceptions for national disasters or unusual emergency situations beyond governmental control and substantially harmful to the state's financial capacity. See also I. Lienert, "Should Advanced Countries Adopt a Fiscal Responsibility Law?," IMF *Working Paper 10/254, (2010),17.*

⁴ Andrea Schaechter, Tidiane Kinda, Nina Budina, and Anke Weber, Fiscal Rules in Response to the Crisis—Toward the "Next-Generation" Rules. A New Dataset, IMF Working Paper, WP/12/187 (2012), 20. See also Elva Bova, Tidiane Kinda, Priscilla Muthoora, and Frederik Toscani, Fiscal Rules at a Glance, IMF, (April 2015), 35.

A number of countries incorporate these features in their fiscal rules. Cross-country international examples of Escape Clauses bring out the wide variations in the practice followed by many countries. The following chart from an OECD presentation illustrates the variations⁵:



Country and Date	Natural disaster	Economic recession	Banking system bailout, guarantee schemes	Change in Government	Change in budget coverage	Other events outside govt. control	Voting mechanism defined	Transition path defined
Brazil (since 2000)	X	X	•		•	•	X	•
Colombia (since 2011)		X				X		-
Germany (since 2010)	X	X				X	X	X
Jamaica (since 2010)	X	X				X		
Mauritius (since 2008)	X	x				x		-
Mexico (since 2006)		X						
Panama (since 2008)	x	X			-	x		x
Peru (since 2000)	X	X			-	X		X
Romania (since 2010)		X	-	X	X	X	-	X
Slovakia (since 2012)	X	X	X		-	X		-
Spain (since 2002)	X	X		-	-	X	X	х
Switzerland (since 2003)	X	X				x	X	X
EU member states/ euro area (since 2005)		x					•	x
WAEMU (since 2000)		X						

Even amidst the variations, it can be seen that a majority of countries have identified natural disasters, economic recession and other events outside governmental control as trigger factors for deviations. Similarly, though not a majority, fiscal responsibility legislation in a number of countries specify control mechanisms for the invocation of escape clauses and also insist on the preparation of return paths to long term fiscal targets.

In the next section, an appropriate framework for India addressing the three features identified above is set out.

⁵ This chart may be found in Andrea Schaechter, Tidiane Kinda, Nina Budina, and Anke Weber, Fiscal Rules in Response to the Crisis—Toward the "Next-Generation" Rules. A New Dataset, IMF Working Paper, WP/12/187 (2012)

Proposal

1. A limited range of Trigger factors

It is necessary to firewall Escape Clauses from potential misuse by closely defining the circumstances under which these can be invoked. The main point to note while identifying trigger factors is that they should be "exceptional" situations, entirely outside Government's control, which can significantly jeopardise the macro-economic stability of the country. The idea is to allow for the adoption of discretionary counter-cyclical policies when most needed, while specifying a necessary path of return. Further, policy responses both during growth spurts and decline should be symmetric.

The circumstances which can provide a trigger for using them could include :

- *i)* Over-riding considerations of national security, acts of war, calamities of national proportion, and collapse of agriculture severely affecting farm output and incomes.
- *ii) Far-reaching structural reforms in the economy with unanticipated fiscal implications.*
- *iii)* Sharp decline in real output growth of at least 3 percentage points below the average of the previous four quarters.

It is important that trigger factors are defined in the kind of detail as exemplified above so that it is clear that these do not apply in normal times.⁶

2. Interpretation and determination of events

Apart from identifying trigger factors, the manner of invocation of escape clauses must also be prescribed carefully. There is a growing preference across the world to combine numerical fiscal rules with the establishment of a fiscal council. An important function entrusted to fiscal councils in similar legislations across the world is to ensure that escape clauses are not unduly exploited.⁷ The presence of a Fiscal Council to oversee the invocation of an escape clause is a factor that lends credibility to the fiscal rules.

It is highly desirable that the invocation of escape clauses in India is taken by Government based on the advice of an independent Fiscal Council. The advice of the fiscal council is likely to provide an objective account of whether the circumstances in question warrant a deviation.

3. Treatment of deviations and return to the fiscal path

Any deviation in response to an event should only be temporary. Escape clauses must be designed in a way to ensure that permissible deviations do not alter the long term fiscal path. To this end, escape clauses must set out with clarity the extent of the deviation and the period of the deviation. Further, it is desirable that the escape clause specifies a path of return to the full observance of the original fiscal rule.⁸

In the Indian context, an escape clause deviation must be concomitant with setting out the return path. It must be made clear that deviation can be on an annual basis subject to the condition that the total deviation from the fiscal deficit target does not aggregate to more than 0.5% of GDP. (One of the members, Dr. Urjit Patel, however, is in favour of 0.3 percentage points).

⁶ Prudent Debt Targets and Fiscal Frameworks, OECD Economic Policy Paper, July 2015, No. 15.

⁷ International Monetary Fund, The Functions and Impact of Fiscal Councils, July 16, 2013.

⁸ Teresa Ter-Minassian, supra n.2.

Further the escape clause should mandate that the Government prepare a plan which evinces a clear commitment to return to the original fiscal target in the ensuing fiscal year. Just as in the case of invocation of the deviation, the unbiased inputs of the Fiscal Council should be sought in the preparation of the plan to return to the prescribed fiscal path.

4. Buoyancy clause

The Committee also felt that the policy responses to sharp changes in ouptut growth should be symmetric. If there is a sharp increase in real output growth of at least 3 percentage points above the average for the previous four quarters, fiscal deficit must fall by at least 0.5 percentage points below target. Similar to the escape clause, the buoyancy clause can be invoked by the Government, after formal consultations and advice of the Fiscal Council.

* * * * *

CHAPTER 9 OTHER ISSUES

CHAPTER 9

Other Issues

Additional Terms of Reference (ToR)

The ToR was expanded to include recommendations contained in the Fourteenth Finance Commission (FFC) Report as well as of the Expenditure Management Commission (EMC). These are the following :

- i) Amending FRBM Act to provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual Budget provision (Para 14.102 of FFC).
- The government should allow the inflation targeting agreement with RBI to settle and succeed for a period of time before considering a debt rule as a target of fiscal responsibility. Later, Government may consider introducing a Debt Rule in addition to Budget Balance Rules. However, pursuing only a Debt Rule would not be a suitable strategy (Para 22 of EMC-March 2016).
- iii) FRBM act indicates the exceptional circumstances when non-compliance of the targets will be allowed, viz. ground of national security, national calamity or any other grounds that the Central Government may specify. EMC is of the view that these parameters need to be defined more clearly for better interpretation and determination of events that necessitate deviation from the fiscal roadmap, along with guidance as to the path back to the roadmap. The parameters could include events with significant impact on fiscal management that are outside the control of the Government, such as recession in the economy, in addition to national calamity and major national security event, which are already given in the FRBM Act. (Para 41 of EMC-March 2016)
- iv) Government may consider placing all the FRBM mandated disclosures in the parliament in the session after the budget session. (Para 43 of EMC-March 2016)
- v) There is a strong case for a separate Fiscal Responsibility Unit under the Department of Economic Affairs to monitor compliance and report to the Secretary and to the Minister. (Para 49 of EMC-March 2016)
- vi) A Fiscal Council should be considered only after the Fiscal Responsibility Unit is established, so that capacity for data collection and analysis is first built within the Government. (Para 50 of EMC-March 2016)

In response to the supplementary ToR, the views of the Committee are herein under:

On the recommendation of the FFC at (i) above, the Committee believes that this suggestion is in congruity with the architecture of the proposed FRBM and also concerns to prudent budget management and public disclosure of liabilities and commitments. It, therefore, suggests that a disclosure statement may be introduced in the Budget about profile of the total sanctioned works/procurements/projects at least in terms of number and their aggregate value. Furthermore, while a ceiling on new sanctions may not be appropriate, the Ministry of Finance, while making budgetary provisions (particularly large expenditure outlays of the Ministry of Railways and Defence) must ensure that acceptable headroom is available for other Ministries

as well. It could also periodically monitor and issue appropriate advisories to those Departments which have been indiscriminate in issuing new sanctions.

In respect of the recommendations of the EMC, its views are that with the new regime on inflation targeting already in place, both inflation targeting and prudent fiscal management are contributory to ensuring continued macro-economic stability. The Chapter in the Report relating to the congruence of monetary and fiscal policy addresses this concern holistically.

On improving the definition of escape clauses, the Committee has accepted this suggestion and this is addressed in the Chapter "X" of the report. On the suggestion of placing FRBM mandated disclosure in the Parliament in the session after the budget session, the Committee does not see merit in tampering with the existing practice of presenting the FRBM statement along with the budget. On the recommendation of constituting a Fiscal Responsibility Unit in the Department of Economic Affairs, the Committee was informed that in 2004, a separate FRBM Cell was already created and the Department of Economic Affairs (DEA) may consider strengthening this Cell further to effectively discharge its obligations. On the suggestion of setting up a Fiscal Council, the Committee while accepting the suggestion has made recommendations on the issue in Chapter "7" of the Report.

Summary of Recommendations: Additional Details

Ceiling on sanction of new capital works to an appropriate multiple of the annual budget provisions:

The sanction of new capital works/projects without adequate budgetary provisions or allocation of funds has been an issue resulting in thin spread of resources and undue delays in completion of projects along with cost overruns. The additional Terms of Reference to this Committee requires us to keep in view the following recommendation of the Fourteenth Finance Commission while finalizing our recommendations.

"Amending FRBM Act to provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual Budget provision".

This Committee is of the view that sanctioning of new projects/works without adequacy of budgetary allocations or extra budgetary support has large fiscal implications. This practice has led to a huge increase in the size of the Government's unfunded committed liabilities on account of incomplete capital works/projects. A case in point being the Ministry of Railways. The present practice of sanctioning new projects/works without paying attention to adequate funding of the ongoing works is an erroneous practice and must be discouraged. This Committee, however, is not in favour of putting a statutory limit on the sanctioning of new capital works/projects as a multiple of the annual budget provision, keeping in view the fact that this may interfere with the new priorities of the Government. However, we recommend that each Ministry must place a separate Statement in their Annual Report, indicating viz.

- The total number of capital works/projects sanctioned along with the total value of the works sanctioned till the previous year;
- Number of capital works/projects pending completion along with the estimated amount required for completing these works sanctioned in the past year;
- The total number of new capital works/projects sanctioned during the year and the estimated budgetary implications.

The Committee further recommends that the Ministries/Departments should place the information relating to commitments on account of past sanction of capital projects to take prudent financial decision while appraising and approving fresh proposals for new capital works/projects.

Expeditiously review and finalise policy on management of the National Small Savings Fund:

The Fourteenth Finance Commission has recommended that the State Governments be excluded from the operations of the NSSF and that the involvement of the States in the NSSF scheme with effect from 1 April 2015, be limited solely to discharging the debt obligations already incurred by them until that date. The Committee has been apprised during the course of discussions with Finance Ministry that the Government is considering implementation of the above recommendation to discontinue investments out of net NSSF receipts into State Government securities in future.

In case the Government decides to go ahead with the above recommendation of the FFC, we recommend that the Government may consider looking at alternate avenues for investing net collection of NSSF receipts including by providing loans to the Central Public Sector Enterprises (CPSEs). This will benefit both the Central finances as well as the CPSEs as the market rate of borrowings by the CPSEs in general, are substantially higher than the NSSF rates, despite mark up on account of the management costs and the higher rates of interest provided under the NSSF schemes. The Government expenditure on interest payments in the process will also have a benevolent impact to the extent of investments made out of NSSF collections in the CPSEs. The residual net collections will by default require to be invested in the Central Government securities.

Back to back Loans for Externally Aided Projects (EAPs):

According to Article 292 of the Constitution of India, the executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law. Furthermore, under the Constitution, Article 293 (1), State governments, unlike the Centre, cannot borrow externally. The Centre plays the role of an intermediary in the transfer/pass through of external borrowings to States. From April 1, 2005, all general category states borrow from multi-lateral and bilateral agencies (World Bank, ADB etc.) on a back-to-back basis viz. the interest cost and the risk emanating from currency and exchange rate fluctuations are passed on to the States. As a result of the above arrangements the fiscal deficit impact is there both on the Centre and the concerned State Government's budget/ and accounts.

Keeping the above in view whereby the fiscal space of the Centre is reduced/constrained to the extent of external borrowings made simply on account of passing EAP loans meant for State Governments, this Committee is of the view that Centre should be allowed additional fiscal space over the Fiscal Deficit limit laid down for it. The Committee, therefore, recommends that the Fiscal deficit limit laid down for the Centre will not include the amount of external borrowings made on account of EAP loans taken for passing on to the State Governments on back to back basis.

CHAPTER 10 SUMMARY OF RECOMMENDATIONS

CHAPTER 10

Summary of Recommendations

New statutory framework for debt and fiscal targets

- 1. Repeal the existing FRBM Act, 2003 and the FRBM Rules, 2004.
- 2. Enact a new Debt and Fiscal Responsibility Act and in pursuance of the new Act, enact and adopt the Debt and Fiscal Responsibility Rules, as per drafts suggested by the Committee.
- 3. Adopt a prudent medium-term ceiling for general government debt of 60% of GDP, to be achieved by no later than FY23.
- 4. Within the overall ceiling specified above, adopt a ceiling of 40% for the Centre, and the balance 20% for the States.
- 5. Adopt fiscal deficit as the key operational target consistent with achieving the medium-term debt ceiling.
- 6. The path of fiscal deficit to GDP ratio of 3.0% in FY18-FY20, 2.8% in FY21, 2.6% in FY22, and 2.5% in FY23 be adopted.
- 7. Revenue deficit to GDP ratio to decline steadily by 0.25 percentage points each year with the path specified as follows: 2.3% in FY17, 2.05% in FY18, 1.8% in FY19, 1.55% in FY20, 1.30% in FY21, 1.05% in FY22, and 0.8% in FY23.

Recommended Path of Debt and Deficits							
	Debt to GDP (%)	Fiscal deficit (% of GDP)	Revenue deficit (% of GDP)				
FY17	49.4	3.5	2.30				
FY18	47.3	3.0	2.05				
FY19	45.5	3.0	1.80				
FY20	43.7	3.0	1.55				
FY21	42.0	2.8	1.30				
FY22	40.3	2.6	1.05				
FY23	38.7	2.5	0.80				

- 8. Adhere to the operational fiscal deficit target specified above except as provided for in the manner of invocation and the ingredients prescribed in the Escape Clauses specified below.
- 9. Escape clause triggers are specified below:
 - a) Over-riding consideration of national security, acts of war; calamities of national proportion and collapse of agriculture severely affecting farm output and incomes.

- b) Far-reaching structural reforms in the economy with unanticipated fiscal implications.
- c) Sharp decline in real output growth of at least 3 percentage points below the average for the previous four quarters.
- 10. The deviations from the stipulated fiscal deficit target shall not exceed 0.5 percentage points in a year. (One of the members, Dr. Urjit Patel, however, is in favour of 0.3 percentage points).
- 11. If there is a sharp increase in real output growth of at least 3 percentage points above the average for the previous four quarters, fiscal deficit must fall by at least 0.5 percentage points below the target. Similar to the escape clause, this buoyancy clause can be invoked by the Government, after formal consultations and advice of the Fiscal Council.
- 12. The Escape Clauses can be invoked:
 - a) by the Government after formal consultations and advice of the Fiscal Council.
 - b) provided it is accompanied by a clear commitment to return to the original fiscal target in the ensuing fiscal year.
- 13. Constitute a Fiscal Council with the Terms and Conditions as stated herein under and do so by suitable provision in the new Debt Law and Rules suggested above.
- 14. Key Terms and Conditions of the Fiscal Council:

1. Composition. -

- (1) There shall be a Fiscal Council consisting of a Chairperson and two Members.
- (2) The Chairperson, Members and Member-Secretary shall be appointed by the Central Government.

2. Eligibility. –

- (1) Only persons with domain expertise in public finance, economics, or public affairs shall be eligible to become Chairperson or Member.
- (2) No person in current employment of the Central Government or State Government in any capacity shall be eligible to be the Chairperson or a Member of the Fiscal Council.

3. Terms. –

- (1) The Chairperson and Members shall hold their offices as determined by the terms of their appointment.
- (2) They shall be appointed for a term of four years which shall not be renewed.
- (3) They shall draw a salary as may be fixed by the Central Government. Such salary shall not be reduced during their continuance in office.

- 4. Functions. The Fiscal Council shall perform the following functions, namely:-
 - (a) prepare multi-year fiscal forecasts for Central and General Government;
 - (b) prepare a debt and fiscal sustainability analysis that makes projections on key fiscal indicators;
 - (c) provide an independent assessment of the Central Government's fiscal performance and compliance with targets set under this Act;
 - (d) prepare the Macroeconomic Framework Statement;
 - (e) recommend suitable changes to fiscal strategy to ensure consistency of the annual financial statement with targets set under this Act;
 - (f) take steps to improve quality of fiscal data;
 - (g) prepare a comprehensive statement of liabilities;
 - (h) produce an annual fiscal strategy report relating to clauses (a) to (g) in such manner as may be prescribed;
 - (i) provide policy guidance to Central Government on any matter relating to fiscal policy where advice is sought;
 - (j) advise the Central Government on whether conditions exist to permit a deviation for invocation in the escape or buoyancy clause;
 - (k) make recommendations to the Central Government on the action plan for returning to the stipulated fiscal targets from which the deviations have taken place;

5. Procedure and powers. -

- (1) The Fiscal Council shall determine its own procedure for carrying out its functions under this Act.
- (2) The Fiscal Council may require any entity or person to furnish information on any matter under the consideration of the Council.
- (3) Such person shall be deemed to be legally bound to furnish such information within the meaning of section 176 of the Indian Penal Code.

Institutional reforms in general government's fiscal management

- 15. Issue detailed policy guidelines on the procedure for Central Government consent to State borrowings under Article 293 of the Constitution of India, as a proactive guidance to the State Governments.
- 16. The Inter-State allocation for State Governments for the achievement of the overall debt and fiscal targets be assigned to the Fifteenth Finance Commission through a specific ToR.

- 17. Request the Reserve Bank of India to arrange for annual issuance of a consolidated annual prospectus for planned annual bond and loan issues by each government to provide guidance to the market on its intentions to borrow during the year
- 18. Introduce Credit Rating of each such Prospectus by approved Credit Rating Agencies.
- 19. Each Ministry must place a separate statement in their Annual Report, indicating the following (i) the total number of capital works/projects sanctioned along with the total value of the works sanctioned till the previous year; (ii) number of capital works and projects pending completion along with the estimated amount required for completing these works sanctioned in the past year; (iii) the total number of new capital works and projects sanctioned during the year and the estimated budgetary implications.
- 20. The Ministries and Departments may use and take into consideration the above information relating to commitments on account of past sanction of capital projects to take prudent financial decision while appraising and approving fresh proposals for new capital works/projects.
- 21. Issue guidelines to minimize interest payment on refund of taxes or advance deposits of taxes.
- 22. Evolve procedures to minimize delays and mismatches in actual collection of taxes and sharing of prescribed percent of net proceeds with the State Governments.
- 23. In order to avoid double counting issues, external borrowing by the Centre may not include the amount of external borrowing made on account of EAP (Externally Aided Projects) loans taken for passing on to state governments on a "back-to-back basis". These are already included in the states' borrowings, with the interest costs and risks emanating from currency and exchange rate fluctuations being passed on to the states.

Fiscal transparency

- 24. Move towards international best practices for compilation and presentation of fiscal accounts, as laid out in the International Monetary Fund Government Finance Statistics Manual 2014 (GFSM 2014).
- 25. Effectively utilize provisions of Article 150 of the Constitution of India to improve accounting and fiscal reporting on Central and General Government finances. In particular, the Central government may
 - a) Initiate a review of the principles and practices governing classification of expenditure as Revenue and Capital, based on best international practices, for uniform application by the central and all State governments.
 - b) Initiate standardization of Object Heads across Centre and States and publish Object-head wise summary of public expenditure on a fixed periodicity, say at least once in a year.

- 26. Expeditiously review and finalise the policy on management of the National Small Savings Fund.
- 27. Explore the feasibility of selling the portfolios of government loans or NSSF investments to raise resources for large financing requirements.
- 28. Transfer the unutilised proceeds of any Cess to designated Reserve Funds created in the Public Accounts at the end of the year, as has also been recommended by the Expenditure Management Commission.
- 29. Strengthen the Budget Division to effectively interface with the Fiscal Council.

n.K. Sink

N.K. SINGH Chairman

SUMIT BOSE Member

ARVIND SUBRAMANIAN **

Member

Dated : 19th January, 2017

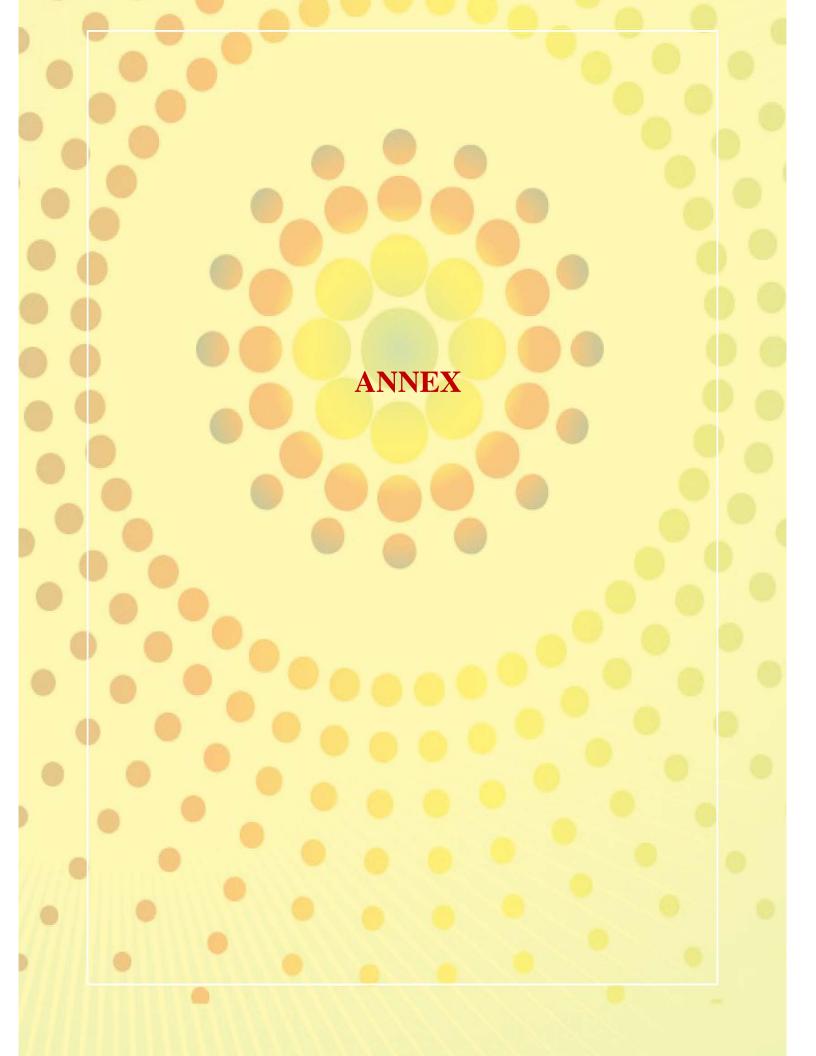
Place : New Delhi

**Subject to the appended Note of Dissent - Annexure V

**Rejoinder of the Committee to the Note of Dissent - Annexure VI

URJIT R. PATEL Member

RATHIN ROY Member



Debate in the Constituent Assembly

- 1. It would be useful to refer to the debate in the Constituent Assembly while passing Articles 292 and 293 of the Constitution (adopted as article 268 and 269 at the time of initial adoption). The corresponding provision was in S.162 of the Government of India Act, 1935 with the only substantial difference being that it referred to the security of the "revenues of the Dominion" which was amended to the security of the "Consolidated Fund of India" by the Constituent Assembly. *Mutatis mutandis* changes were made in respect of borrowings by the States under S.163 (*ibid*). Another significant difference was that under S.163 (*ibid*), provinces could borrow outside India with the consent of the Dominion. In the Constitution, the States' power to borrow was limited to within the territories of India.
- 2. [Article 292 and 293 of the Constitution were adopted as article 268 and 269 at the time of initial adoption. The corresponding provision was in S.162 of the Government of India Act, 1935 with the only substantial difference being that it referred to the security of the "revenues of the Dominion" which was amended to the security of the "Consolidated Fund of India" by the Constituent Assembly. Mutatatis mutandis changes were made in respect of borrowings by the States under S.163 ibid. Another significant difference was that under S.163 ibid, provinces could borrow outside India with the consent of the Dominion. In the Constitution, the States' power to borrow was limited to within the territories of India]. (Comment: Repetitive; definitely delete)
- 3. [(Comment: The rest of the Annex is not edited because it is presumed that excerpts from speeches have been reproduced verbatim)]Shri M. AnanthasayanamAyyangar, Prof. Shibban Lal Saksena, Shri H. V. Kamath, Prof. K. T. Shah, and the Honourable Dr. B. R. Ambedkar participated in the discussion on Article 292 (then article 268). Shri B. Das, the Honourable Shri K. Santhanam, and the Honourable Dr. B. R. Ambedkar participated in the discussion on Article 293 (then article 269). An important amendment was to substitute the security of the "revenues of India' with that of the 'Consolidated Fund of India'. Another important change was that originally the Government of India was given a free hand in the matter of lending to the States whereas in the adopted version the action of the Government of India was made subject to such conditions as may be laid down by or under any law made by Parliament. Excerpts from the speeches in the Constituent Assembly on these two articles are given below:
- 4. Shri M. AnanthasayanamAyyangar: The borrowing both of the Centre as well as of the provinces and loans that may be granted by the Union Government to States are "more important and require greater scrutiny than the powers to impose taxation" as the borrowings impose "heavy obligations upon not only the present generation but future generation also". He observed that development schemes generally are to be undertaken by borrowings and ought not to be legitimately borne on the current revenues because the benefits of these schemes will be shared not only by the existing people, by the mass of the people now present, but also by all the succeeding generations. There is a similar provision in the existing Government of India Act. It is open to the Dominion Parliament to give directions as to the methods of borrowing, the amount of borrowing and so on. But all the same, all these matters have not been placed before us except as an appendix, as the tail-end of the budget, indicating

what the capital outlay will be, and how in very brief outline, that money is to be made up. Parliament, when it makes provisions, should be very chary in granting permission to all and sundry loans being floated, irrespective of the capacity of the people to subscribe etc. These and the purposes for which the borrowings take place will all be regulated by Parliament under article 268.

- 5. **Prof. Shibban Lal Saksena:** I again want to voice my feeling against arming the executive with powers to borrow upon the security of the revenues of India etc...In such important matters where the entire security of the State may be pawned, there must be some voice for Parliament. It must not merely be that Parliament shall fix the limit, but that in other matters the Executive shall have all the power. At least, after taking a decision, the executive must take the Parliament into confidence. After all the Ministry will have always the majority in the Legislature and whatever they may do, they will be able to carry through the House. That being so, I do not know why they should feel shy to bring these things to Parliament. I therefore, think that such sweeping powers as are proposed in this article, should not be given to the Executive.
- 6. Shri H. V. Kamath:in modern times, and in the modern world, when economics has assumed such tremendous importance, and when loans are floated and subscribed very frequently by every State, by every country in the world, I feel that the executive of the Indian Union-to-be, should not be vested with the power to decide upon borrowing, within the limit, of course, fixed by Parliament, no matter what the purpose of the borrowing may be. I feel that the purpose for which the loan is raised, under this article must be laid before Parliament and the approval of Parliament must be sought and obtained for the purpose of that loan. But under this article 268, Parliament is empowered merely to fix the limits- I suppose it means the pecuniary limits, the monetary limits, within the limits of so many crores, and that sort of thing. Also the second part of the article relates to similar safeguards not very important, in my estimation regarding monetary limits of the guarantees to be given by the Union for loans. Nowhere does the article envisage the purpose for which the loan is raised or borrowed or guarantee is given. In recent months, as the House is very well aware, various proposals have been made for loans from the World Bank or loans from America or from some other country as is willing to finance and promote our economic and industrial development. The House will also recollect that this House sitting as Parliament, during the last budget session and even in earlier sessions, pointedly asked the Prime Minister and perhaps the Finance Minister too, whether loans borrowed from foreign countries, from America, or may be from U.S.S.R. if Government will consider such a proposal, will be subject to any political, economic or military strings. After all, I am sure that Parliament will ultimately decide our international relations. It is neither the executive nor the President but Parliament which will have the final word on what our foreign relations are going to be. But the executive may be at variance with Parliament in certain matters and if the executive takes it into its head to pursue a foreign policy which Parliament, later may not approve or which may not be quite in consonance with the decisions of Parliament in this regard, then a very unfortunate situation pregnant with dire consequences may arise when a commitment will have been made by the government of the day-by the President and the executive- with regard to borrowing, or the raising of loans from foreign countries. Of course they will not transgress the limits prescribed by Parliament. They will not borrow more than one, ten or twenty

crores-whatever the limit may be. But the real purpose of that loan may be kept a guarded secret, and the purpose of the loan is an essential matter which will ultimately help or hinder us, and save or destroy us. I hope the House will consider this aspect of the matter which is far more important in my judgement than the financial limits to be fixed by Parliament. The purpose of the loan goes to the root of the matter. If the President, or the executive borrows a loan from America and either in a secret pact or in some secret terms of the agreement there is some military commitment or political commitment, to be effective in future if there be war- that we will assist it against certain other countries-do we wish to face such a dangerous situation as that? I therefore want that this article should be so amended as to enable Parliament not merely to fix the limits, of borrowings and the giving of guarantees but also to see on every occasion that the purpose of the loan or the purpose of giving guarantee is justified by circumstances and that it is in absolute and complete consonance with the policy adopted by Parliament in our internal as well international relations-the more so in our foreign and international relations. If the executive raises a loan on terms contrary to the policy, which has been approved of by Parliament or which be subsequently enunciated by Parliament a conflict may arise between Parliament and the executive and it will be too late in the day to undo the disastrous effect of loan that might been borrowed by the executive with certain commitments made without reference to Parliament We must be on our guard against this situation arising in future. I plead with the House that this is no small matter, to be dismissed with just a flippant consideration or just because Dr. Ambedkar or the Drafting Committee is not going to consider the matter. I plead in the name of the future of India, of the peace, liberty, and progress that we all have at heart-of the peace of India as well as of the world-that this article, and this Chapter as a whole, should receive more consideration than most articles usually do in the hands of this House. I hope that not merely the financial limits but also the purpose of every loan will come before Parliament for its approval, and action is taken by the President in accordance with the policy laid down by Parliament with particular regard to our international relations or our internal policies.

7. Prof. K. T. Shah: I agree that every act of borrowing is an executive act. But the power to borrow need not necessarily be regarded as an executive power exclusively..the borrowing power, or the use of the national credit, is a very delicate matter. Under the conditions under which we are now living, it cannot be treated too scrupulously or too carefully if we would bear in mind the interests not only of the present generation, but of generations to come. As we know, the security of the revenues of India -as the clause speaks here-is, at the present time any rate, and judged strictly from purely economic considerations, a very thin security. That is to say, we have been, in the last ten years or so, habitually living in a deficit economy, and that deficit, considered in its budget aspect as well as in the aspect of the aggregate national economy, shows so far no sign of abatement. The various projects we have undertaken promise to remedy these deficits within ten or fifteen years. At the present moment, at any rate, and for some years to come it seems to me that our economy being s deficit economy, borrowing would be a necessity for years to come, and, as such, we cannot too carefully regulate, limit or restrict this power. Taking this view I think that if the Constitution categorically assigns this power to the executive, the Constitution would be doing injustice, not only to the legislation, but also to the interests of generations to come, and for this reason, Parliament should not only regulate the borrowing by the Executive in the sense of fixing limits up to which borrowing can take place or lay down conditions for offering securities or guarantee but Parliament should in my opinion say every year, in what may be called the Ways and Means Act, or the Finance Act, how much shall be borrowed, so that from time to time-from year to year-the Parliament is aware of the state of the national credit and husbands it accordingly. The question is still more fearful as I conceive it, because it is very likely that borrowing within the home market may not suffice, and that you may have to resort to borrowing outside the limits of the country. At that point, the danger would be much more acute than perhaps we are inclined to envisage it today. It has been the unfortunate experience of many countries which have been chronically indebted that the lender has time and again exercised influence, demanded security or guarantee, which is beyond the capacity of the country to afford. I will not quote any remote examples, but even that country which was once regarded as the banker of the world-I mean Britain-whose credit is now being questioned is in a similar position, and the principal lender today is suggesting or inclined to interfere even in its domestic affairs. ..I mention this illustration just to point out the danger inherent in a provision like this, wherein the power to borrow is left almost unconditionally to the executive, the only condition being that Parliament may impose limits as to the amount and nature of guarantees from time to time that may be given. The wording of the article suggests that even the imposition of such limits is a very doubtful proposition. The limits, "if any"-that means limits may not be there at all, and the Executive may be entitled to borrow without limit, either of the charge it may create upon the consolidated fund which will be then outside the annual votes of Parliament, or which may be so excessive that the country's entire future may be mortgaged to the lender, a consideration which fills me with great apprehension for the future. I am not prepared to say that there should be an utterly unconditional or unlimited power even under the Constitution to the executive to borrow up to what limits and in what manner it likes whether at home or abroad. As you know, in the past I have pleaded for more power to the Parliament as against the executive. In this instance, I am even prepared to go so far as to say that, by express provision of the Constitution, even the power of the Parliament should be restricted in the matter of the use of the national credit. Not only should the power of the executive be restricted; the executive should only confine itself to administering the law, the Act, under which borrowing should be authorised every year, so that every year Parliament is in a position to take stock. I go further and say that even the power of Parliament should be restricted in the nature of assurances and guarantees that it is in a position to give. Parliament should not, for instance, I suggest, be able to guarantee or mortgage the primary productive resources, nor mineral wealth nor rivers nor any of the primary sources of production on which the future happiness of the country may depend. And if such a thing as this can be done the people as a whole, I would suggest, should be, in a position to know it, and a revision of the Constitution may be necessary before even Parliament could mortgage the resources of the country. As I have said before, while I have always suggested that the supreme power should be vested in Parliament here is an instance in which, by the Constitution, I would limit the power even of Parliament to allow any borrowing within and much more so outside the country. This article, therefore, cannot be viewed too seriously, and- I would appeal to the Draftsman to reconsider this matter if he takes into account, as I hope he will take, the seriousness of the stakes involved in this article.

8. **The Honourable Dr. B. R. Ambedkar:** Sir, except for the last oration of my Friend Prof. K. T. Shah in which he suggested that we should introduce a clause putting limitation upon the authority of Parliament

to sanction loans, I was really quite unable to understand the dissent which has been expressed by other speakers with regard to the provision contained in article 268. It is admitted that it is the executive alone which can pledge the credit of the country for borrowing purposes, for borrowing is an executive act, in one aspect of the case, but in this article it is not proposed that the power of the executive to borrow is to be unfettered by any law that is to be made by Parliament. This article specifically says 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, I 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. I therefore do not see what more is wanted by those who expressed their dissent from the provisions of article 268. It is of course a different matter for consideration whether we should have a further provision limiting the power of the Parliament to pledge the credit of the country. It seems to me that even that matter may be left to Parliament because it will be free for Parliament to say that borrowing shall not be done on the pledging of certain resources of the country. I do not see how this article prevents Parliament from putting upon itself the limitations with regard to the guarantees that may be given by Parliament for the ensurement of these loans, or borrowings. I therefore think that from all points of view this article 268 as it stands is sufficient to cover all contingencies and I have no doubt about it that, as my friend Mr. AnanthasayanamAyyangar said, we hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the Union, I go further and say that I not only hope but I expect that Parliament will discharge its duties under this article.

9. Shri B. Das (Orissa: General): Today the Union Government is charged with the additional responsibility of the borrowings of the States. Of course, it is qualified that such loans, such borrowings will be within the territory of India and also will be upon the security of the revenues of the State. Certain provinces thought that they can float any loans and issue any bonds or securities whether negotiable or non-negotiable. Those of us who think that all borrowings should be done through the Union Government felt at that time that the national credit of tile Union Government would suffer if Provinces were given the freedom in the matter of borrowing. I do not what is the security of the revenues of the Provincial Governments. Who is to fix them? Will the Auditor-General fix at the time of the promulgation of this Constitution that such and such States and such and such provinces will have so much power of borrowing? Unfortunately, I do not like the wording of article 268. How will Parliament fix by law the amount of borrowing every year for the Union and for the different provinces? As my memory goes over the past twenty-five years, I do not remember a single occasion when the alien Government which ruled over us consulted Parliament over their borrowing policy. It always came through the backdoor of explanatory memorandum. Never has Government of India introduced the practice of raising a debate on their borrowing policy. The borrowing is sanctioned when the Budget is passed. Then we have article 269 under which the finance ministers of the States can claim sums of money for the development, of their States. Whatever money they claim, article 269 is going to provide. It will be a charge on the revenues of the State. But who will be the judge as to whether a certain

province has got the paying capacity? Already the Government of India is committed to large development schemes on behalf of the provinces. We have the Bhakra Dam in East Punjab, the Hirakund Dam in Orissa, theDamodar Valley Corporation in Bengal and the Kosi Dam in Bihar about which our friends from Bihar are so very anxious. Who is to judge that these development projects will stand the national credit of the particular province, for which the money is borrowed? I wish there is someone to do this. I think, whatever be enacted in articles 268 and 269, we must not throw this responsibility on Parliament alone. Parliament, as I know it for the last twenty-five years, pays very little attention to the question of borrowing. If I remember all right, there have been only half a dozen debates in all during the last twenty-five years on the policy of borrowing. Will we improve our financial knowledge in the next few years when we will be discussing the national credit of the Union and of the provinces and who will say boldly that such and such province will only have so many crores of loan and nothing more? Unfortunately, when provincial feelings come into play in the discussion over such matters, members simply fight for the benefit of their own provinces. I think articles 268 and 269 envisage giving more powers to the Auditor-General. The Auditor-General must review and submit the papers to the Members of Parliament every year about the credit of each province apart from the Union Government. The Auditor- General is not now doing that. I am discussing the handicaps that surrounds us in considering questions of this kind. Unfortunately the Finance Department, of the Government of India is still following the old tradition and treating the Auditor General as a mere auditor of a company, where the directors tell him to overlook certain errors and malpractices. But if the House accepts article 269 as it is, the House should somehow incorporate some provision whereby the Auditor General must report to Parliament the credit, conditions of the provinces. Most of us are laymen and politicians. Very few members of Parliament will be financiers. Financiers do not belong to the class of democracy from which we come. The future legislatures will not contain businessmen or men who understand stock exchanges or the financial credit of our country. Therefore, there is a double duty imposed by article 269 and I would ask my honourable Friend Dr. Ambedkar to explain how he thinks that Parliament will understand and appreciate the national credit of each of the States and of the Union and how it will limit the amount of borrowing of the Union Government and the States. The Parliament is empowered under article 268 and is going to be further empowered by article 260 to maintain the national credit of India. But then how will the national credit of India be maintained? I view with grave concern article 269. If any province rebels against the Centre and against the unification of the national economy of India, the national credit will not be a settled fact. Some other method must be thought of.

10. The Honourable Shri K. Santhanam (Madras: General): Prof. Shah had suggested that the Government of India and even Parliament should not be entitled to pledge the primary resources of the country in order to borrow. I entirely agree. But, according to my reading of articles 268 and 269, there is no question of either the Government of India or any State pledging any particular resources for any particular borrowing. They give power to borrow only on the security of the Consolidated Fund of India or of the States. It will not be open to the Government of India to say that they pledge the railways for a particular loan, say from America. Only the entire Consolidated Fund of India will be the security. It means that it will only be a general security of the credit of the people of India. There can be no question of particular general resources or the railways being pledged for any

loan from abroad or internally. The same will be the case with every State. Therefore there should be no apprehensions on the point. I think the plain meaning of articles 268 and 269 makes it certain in this respect. I would, however, like to suggest to Dr Ambedkar that, if there is the slightest doubt in the wording, the Drafting Committee should look into it and remove the doubt. It should be made clear that the only security should be the general credit, of the whole of India or of a State and not particular resources.

11. The intervention of the Honourable Dr. B. R. Ambedkar, Chairman, Drafting Committee, makes it abundantly clear that the Parliament's powers under article 292 and 293 are intended to be very wide and there is no scope of putting any narrow, restrictive interpretation. The word "limits" does not connote merely a fixed numerical ceiling but is intended to be used in a wider sense of "limitations" that can cover any aspect of borrowing on the security of the Consolidated Fund of India. This view is also consistent with article 266 under which disbursements from the Consolidated India Fund of mandatorily require Parliamentary approval and, therefore, Parliament must be understood to be bestowed with the power to regulate future outflows from the Fund, both direct as well as contingent.

Annex-II

A STATEMENT OF OBJECTS AND REASONS

The Debt Management and Fiscal Responsibility Bill, 2017 seeks to establish and ensure compliance with fiscal targets with a view to sustaining macroeconomic stability and promoting prudent fiscal policy. The operation of the Fiscal Responsibility and Budget Management Act, 2003 as amended from time to time has demonstrated the need for three interventions: first, a greater focus on public debt management by setting a debt ceiling as a percentage of the Gross Domestic Product; second, a realignment of balance between the need for fiscal discipline, and the need for flexibility of the Central Government to respond to unforeseen circumstances, third, an independent fiscal council to ensure high-quality advisory to the Central Government regarding fiscal targets and circumstances under which government may deviate from them.

This Bill addresses these three issues by:

A. Setting fiscal targets:

- 1. Providing a long-term fiscal anchor through a debt ceiling as a proportion of GDP, which the Central Government shall endeavour to maintain.
- 2. Establishing fiscal deficit and revenue deficit targets to be achieved by FY 2024-25.
- 3. Setting year-on-year fiscal deficit and revenue deficit targets.
- 4. Providing circumscribed grounds that permit the Central Government to deviate from such targets, with necessary checks and balances.
- B. Ensuring compliance
 - 1. Requiring the preparation of the Medium Term Fiscal Policy Statement, the Fiscal Policy Strategy Statement, the Medium Term Expenditure Framework Statement and the Macroeconomic Framework Statement to transparently and comprehensively demonstrate the ability of the Central Government to meet the targets set under the Act.
 - 2. Vesting power with the Central Government to entrust review of its fiscal position to the Comptroller and Auditor General of India.
 - 3. Providing appropriate oversight of the fiscal position of the Central Government by Parliament.

C. Establishing a Fiscal Council

- 1. Establishing a Fiscal Council for providing advice to the Central Government on matters relating to the maintenance of fiscal targets and circumstances in which government may deviate from them.
- 2. Ensuring the independence of the Fiscal Council through necessary means.

The Bill seeks to achieve the above objectives.

Annex – III

The Debt Management and Fiscal Responsibility Bill, 2017

A Bill to set and implement national debt management, fiscal deficit and revenue deficit targets with a view to ensuring macroeconomic stability and promoting prudent fiscal policy.

CHAPTER I

PRELIMINARY

- (1) Short title. This Act may be called the Debt Management and Fiscal Responsibility Act, 2017.
- (2) Commencement.
 - (1) This Act shall come into force on a date that the Central Government may appoint by notification in the Official Gazette.
 - (2) Different dates may be appointed for different provisions of the Act.
- (3) Extent. This Act shall extend to the whole of India.
- (4) Definitions. In this Act, unless the context otherwise requires,—
 - (a) "annual limits" means such limits as are specified in Section 6;
 - (b) "Central Government debt" at any date means
 - (i) total outstanding liabilities of the Central Government on the security of the Consolidated Fund of India, including external debt valued at current exchange rates;
 - (ii) total outstanding liabilities in the Public Account of India;
 - (iii) such financial liabilities of other legal entities as the government is to repay or service from the Annual Financial Statement, reduced by the cash balance available at the end of that date.
 - (c) "Fiscal Council" means the council established under section 16;
 - (d) "fiscal deficit" means the excess of total expenditure, from the Consolidated Fund of India, excluding the repayment of debt and loans to state governments against external assistance, over total receipts into the Consolidated Fund of India, excluding the debt receipts, during a financial year;
 - (e) "fiscal indicators" includes the ratios of fiscal deficit, revenue deficit, tax revenues and Central Government debt, to Gross Domestic Product, and other such measures which are used to evaluate the fiscal position of the Central Government;
 - (f) "form" means a form appended to the rules made under this Act;
 - (g) "general government debt" means total liabilities of the Central Government and the State Governments excluding inter-governmental liabilities;

- (h) "Gross Domestic Product" or GDP means the sum of the gross value added by all resident production units plus that part of taxes, less subsidies, on products, which is not included in the valuation of output, during a financial year, reckoned at current market prices, as published by the Central Statistical Organisation from time to time;
- (i) "prescribed" means prescribed by rules made under this Act;
- (j) "revenue deficit" means the excess of revenue expenditure, from the Revenue Account of the Consolidated Fund of India, over revenue receipts into the Revenue Account of the Consolidated Fund of India, during a financial year;
- (k) "statements" mean the statements referred to in sub-section (1) of section 8.

CHAPTER II

TARGETS

(5) Debt target. -

- (1) The Central Government shall endeavour to ensure that general government debt does not exceed 60% of Gross Domestic Product by the end of financial year 2022-23.
- (2) The Central Government shall endeavour to ensure that Central Government debt does not exceed 40% of Gross Domestic Product by the end of financial year 2022-23.
- (3) The Central Government shall not give additional guarantees with respect to any loan on security of the Consolidated Fund of India in excess of half percent of Gross Domestic Product, in any financial year.
- (4) On achieving the targets specified in sub-sections (1) and (2), the Central Government shall endeavour to maintain the targets thereafter.

(6) Fiscal deficit and Revenue deficit target. -

(1) The Central Government shall ensure that its fiscal deficit and revenue deficit do not exceed the following annual limits in terms of percentage of Gross Domestic Product:

	Fiscal Deficit target	Revenue Deficit target
FY2017-18	3.0	2.05
FY2018-19	3.0	1.80
FY2019-20	3.0	1.55
FY2020-21	2.8	1.30
FY2021-22	2.6	1.05
FY2022-23	2.5	0.80

(2) No deviations are permissible from the targets specified in this section except in accordance with section 7.

(7) Deviations. –

- (1) Any deviation from the targets specified in Section 6 may be initiated by the Central Government only in accordance with this section and in such manner as may be prescribed.
- (2) The Central Government shall not deviate from the targets specified in Section 6, except on the advice of the Fiscal Council.
- (3) Deviations shall be permissible in case of:

(a) Over-riding considerations of national security, acts of war; calamities of national proportion and collapse of agriculture severely affecting farm output and incomes.

(b) Far-reaching structural reforms in the economy with unanticipated fiscal implications.

(c) Decline in real output growth of at least 3 percentage points below its average of the previous four quarters.

- (4) Any deviation from the fiscal deficit target under sub-section (3) shall not exceed 0.5 percent of Gross Domestic Product in a year.
- (5) When seeking the advice of the Fiscal Council under sub-section (2) in respect of a deviation under sub-section (3), the Central Government shall propose a plan for return to the applicable annual limit within one year from the final date for achievement of the target sought to be deviated from.
- (6) The Central Government shall, in case of increase in real output growth of at least 3 percentage points above its average of the previous four quarters, initiate, on the advice of the Fiscal Council, a deviation from the fiscal deficit target, to reduce the fiscal deficit by at least 0.5 percent of Gross Domestic Product in a year.
- (7) The grounds and extent of deviation, advice tendered by the Fiscal Council on the deviation, and in case of a deviation under sub-section (3), the plan of the Central Government for return to the annual limit as per sub-section (5), shall be placed before both Houses of Parliament.

CHAPTER III

COMPLIANCE

(8) Statements. -

- (1) The statements referred to in this section, shall transparently and comprehensively demonstrate the ability of the Central Government to meet the targets set under this Act.
- (2) The Central Government shall lay the following statements before both Houses of Parliament in each financial year in such forms as may be prescribed:-
 - (a) Medium Term Fiscal Policy Statement;
 - (b) Fiscal Policy Strategy Statement;
 - (c) Medium Term Expenditure Framework Statement; and
 - (d) Macroeconomic Framework Statement.

- (3) The Medium Term Fiscal Policy Statement, the Fiscal Policy Strategy Statement, and the Medium Term Expenditure Framework Statement shall be prepared by the Central Government.
- (4) The Macroeconomic Framework Statement shall be prepared by the Fiscal Council.
- (5) The Macroeconomic Framework Statement, the Fiscal Policy Strategy Statement and the Medium Term Fiscal Policy Statement shall be laid together with the annual financial statement every year.
- (6) The Medium Term Expenditure Framework Statement shall be laid in the session immediately following the session in which the annual financial statement is laid.

(9) Medium Term Fiscal Policy Statement. -

The Medium Term Fiscal Policy Statement shall set out a three-year rolling target for fiscal indicators, as well as an explanation of the assumptions underlying these estimates.

- (10) Fiscal Policy Strategy Statement. The Fiscal Policy Strategy Statement shall contain:-
 - (a) a statement of the policies of the Central Government for the ensuing financial year with respect to taxation, expenditure, public debt, contingent liabilities including guarantees, loans and investments, as well as any other activity with potential budgetary implications;
 - (b) the fiscal priorities of the Central Government for the ensuing financial year; and
 - (c) an assessment of whether the Central Government's policies will ensure compliance with the targets set under this Act and in the Medium Term Fiscal Policy Statement.

(11) Medium Term Expenditure Framework Statement. –

(1) The Medium Term Expenditure Framework Statement shall:

- (a) set out a three-year rolling target for projected expenditure, as well as an explanation of the assumptions underlying these estimates.
- (b) provide a detailed breakdown of projected revenue and capital expenditure in the format of demand for grants.

(12) Macroeconomic Framework Statement. -

The Macroeconomic Framework Statement shall provide an assessment of the economy with respect to trends in the growth of Gross Domestic Product, public debt, fiscal balance and the external balance of the Union of India.

(13) Periodic Review. –

- (1) The Central Government shall prepare a monthly statement of its accounts.
- (2) The Minister-in-charge of the Ministry of Finance shall review the trends in receipts and expenditure in relation to the Annual Financial Statement on a half-yearly basis.
- (3) If the outcome of such review indicates non-compliance with any minimum thresholds as may be prescribed, then corrective steps shall be taken by the Central Government and placed before both Houses of Parliament.

(14) Disclosure requirements. –

The Central Government shall take suitable measures to ensure greater transparency in fiscal operations by making such disclosures as may be prescribed.

(15) Review by the Comptroller-and-Auditor General of India. -

- (1) The Comptroller-and-Auditor General of India shall review the compliance of the provisions of this Act with such periodicity as may be prescribed.
- (2) The reports of the Comptroller-and-Auditor General of India based on such reviews shall be laid on the table of both Houses of Parliament.

CHAPTER IV

FISCAL COUNCIL

(16) Composition. –

- (1) There shall be a Fiscal Council consisting of a Chairperson and two Members.
- (2) The Chairperson and Members shall be appointed by the Central Government.

(17) Eligibility. –

- (1) Only persons with more than fifteen years of experience in public finance, economics or public affairs shall be eligible to become Chairperson or Member.
- (2) No person in current employment of the Central Government or State Government in any capacity shall be eligible to be the Chairperson or a Member of the Fiscal Council.

(18) Terms. –

- (1) The Chairperson and Members shall be appointed for a term of four years which shall not be renewed.
- (2) They shall draw a salary as may be fixed by the Central Government. Such salary shall not be reduced during their continuance in office.
- (3) The Chairperson or a Member may only be removed by the Central Government on the following grounds, namely:-
 - (a) he has been convicted for an offence which, in the opinion of the Central Government, involves moral turpitude; or
 - (b) he is an undischarged insolvent; or
 - (c) he has been declared by a competent court to be of unsound mind; or
 - (d) he has, in the opinion of the Central Government, such financial or other interest, as is likely to affect prejudicially his functioning as Chairperson or Member.
- (19) Functions. The Fiscal Council shall perform the following functions, namely:-
 - (a) Prepare multi-year fiscal forecasts;
 - (b) prepare a fiscal sustainability analysis that makes projections on key fiscal indicators;

- (c) provide an independent assessment of the Central Government's fiscal performance and compliance with targets set under this Act;
- (d) recommend suitable changes to fiscal strategy to ensure consistency of the annual financial statement with targets set under this Act;
- (e) take steps to improve quality of fiscal data;
- (f) produce an annual fiscal strategy report relating to clauses (a) to (d) in such manner as may be prescribed;
- (g) provide policy guidance to Central Government on any matter relating to fiscal policy where advice is sought;
- (h) advise the Central Government on whether conditions exist to permit a deviation under section 7;
- (i) make recommendations to the Central Government on the plan for return to the targets sought to be deviated from, under sub-section (5) of section 7;
- (j) prepare the Macroeconomic Framework Statement referred to in section 12;
- (k) advise the Central Government on corrective steps to be taken under section 13; and
- (l) such other functions as may be prescribed.

(20) Procedure and powers. –

- (1) The Fiscal Council shall determine its own procedure for carrying out its functions under this Act.
- (2) The Fiscal Council may require any person to furnish information on any matter under the consideration of the Council.
- (3) Such person shall be deemed to be legally bound to furnish such information within the meaning of section 176 of the Indian Penal Code.

(21) Secretariat. –

- (1) The Fiscal Council shall have a secretariat.
- (2) The Fiscal Council shall appoint such other officers of the secretariat as it may require to perform its functions.

CHAPTER V

MISCELLANEOUS

(22) Borrowing from Reserve Bank. —

- (1) The Central Government shall not borrow from the Reserve Bank.
- (2) The bar in sub-section (1) shall not apply:-
 - (a) when the Central Government borrows from the Reserve Bank an advance to meet temporary excess of cash disbursement over cash receipts in any financial year pursuant to an agreement with the Reserve Bank;

- (b) when the Reserve Bank subscribes to primary issues of Central Government securities in case of deviation from the targets specified in Section 6 as per the procedure specified in section 7;
- (c) to the purchase and sale of Central Government securities in the secondary market by the Reserve Bank.

(23) Power to make rules. -

- (1) The Central Government, may by notification in the Official Gazette, make rules for carrying out the provisions of this Act.
- (2) The rules may provide for the following:
 - (a) manner of deviating from the targets specified in Section 6, under section 7;
 - (b) forms of the Medium Term Fiscal Policy Statement, Fiscal Policy Strategy Statement, Medium term Expenditure Framework Statement and Macroeconomic Framework Statement under subsection (2) of section 8;
 - (c) disclosures to be made under section 14;
 - (d) contents and form of the review by the Comptroller-and-Auditor General of India under section 15;
 - (e) manner of producing the annual fiscal strategy report under sub-section (e) of section 19;
 - (f) any other matter which may be prescribed.

(24) Rules to be laid before the Parliament. -

- (1) Every rule made under this Act shall be laid before each House of Parliament, while it is in session, for a total period of thirty days in one session or in two or more successive sessions.
- (2) Before the expiry of the session immediately following the session or the successive sessions,
 - (a) if both Houses agree in making any modification, the rule shall thereafter have effect only in such modified form;
 - (b) if both Houses agree that the rule should not be made, the rule shall thereafter have no effect.
- (3) Any change in the rule under subsection (2) shall not affect the validity of anything previously done under the rule.

(25) Good faith. –

No suit, prosecution or other legal proceedings shall lie against the Central Government, any officer of the Central Government or the Chairperson or Members of the Fiscal Council for anything which is done in good faith under this Act or rules.

(26) Jurisdiction of civil courts barred. —

No civil court shall have jurisdiction to question the legality of any action taken by, or any decision of, the Central Government, under this Act.

(27) Power to remove difficulties. —

(1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may make such provisions as may appear to be necessary for removing the difficulty.

(2) Such provisions—

- (a) shall not be inconsistent with this Act;
- (b) shall be made by order published in the Official Gazette and laid before each House of Parliament on publication.

(28) **Review.**—

The Central Government shall establish a Review Committee to review the functioning of the Act in the FY 2023-24.

(29) Repeal.—

The Fiscal Responsibility and Budget Management Act, 2003 is hereby repealed.

Annex – IV

The Debt Management and Fiscal Responsibility Rules, 2017

In exercise of the powers conferred by section 23 of the Debt Management and Fiscal Responsibility Act, 2017, the Central Government hereby makes the following rules, namely:

- **1.** Short title. These rules may be called the Debt Management and Fiscal Responsibility Rules, 2017.
- 2. Commencement. They shall come into force on the date of the Act coming into force.

3. Definitions. -

- (1) In these rules, unless the context otherwise requires,
 - (a) "Act" means the Debt Management and Fiscal Responsibility Act, 2017;
 - (b) "Form" means a form appended to these rules;
 - (c) "section" means a section of the Act.
- (2) Words and expressions used in the rules and not defined but defined in the Act shall have the same meaning as in the Act.

4. Deviations. –

- (1) In respect of sub-section (3) of Section 7 of the Act,
 - (a) If it appears to the Central Government that circumstances exist that require a deviation from any of the targets specified under section 6 of the Act, it shall prepare an explanatory memorandum containing such circumstances, the extent of deviation required, a plan for return within one year from the final date for achievement of the target sought to be deviated from and any other matter the Central Government deems relevant.
 - (b) The explanatory memorandum shall be sent to the Fiscal Council with a request for advice on whether the deviation is permissible under the Act and if so, under what conditions.
 - (c) The Fiscal Council shall assess the explanatory memorandum and provide its advice to the Central Government along with any recommendations incidental to such advice.
- (2) In respect of sub-section (6) of Section 7 of the Act,
 - (a) The Central Government shall prepare an explanatory memorandum containing the circumstances causing increase in real output growth and the extent of deviation proposed.
 - (b) The explanatory memorandum shall be sent to the Fiscal Council with a request for advice on the extent of deviation sought and its conditions.
 - (c) The Fiscal Council shall assess the explanatory memorandum and provide its advice to the Central Government along with any recommendations incidental to such advice.

5. Forms of Statements. -

The Central Government shall lay before both the Houses of Parliament the statements referred to in section 8 of the Act in the following forms:

- (a) the Medium-term Fiscal Policy Statement in Form F-1;
- (b) the Fiscal Policy Strategy Statement in Form F-2;
- (c) the Macro-Economic Framework Statement in Form F-3; and
- (d) the Medium-term Expenditure Framework Statement in Form F-4.

6. Minimum Thresholds.-

The minimum thresholds for the purpose of Section 13 (2) shall be as follows:

- (a) the total non-debt receipts are less than 40% of the Budget Estimates for that year
- (b) the fiscal deficit is higher than 70% of the Budget Estimates for that year;
- (c) the revenue deficit is higher than 70% of the Budget Estimates for that year.

7. Disclosure Requirements. -

The Central Government shall, at the time of presenting the annual financial statement and demands for grants, place before Parliament the following:-

- (a) any significant change in accounting standards, policies and practices affecting or likely to affect the computation of prescribed fiscal indicators;
- (b) statements of receivables and guarantees in Forms D-1 to D-3;
- (c) a statement of assets in Form D-4;
- (d) a statement of explicit contingent liabilities, which are in the form of stipulated annuity payments over a multi-year time-frame in Form D-5; and
- (e) a statement providing the detailed breakup of grants for creation of capital assets in Form D-6.

8. Review of compliance by the Comptroller and Auditor General of India. –

- (1) The Comptroller and Auditor General of India shall carry out an annual review of the compliance of the provisions of the Act and the rules made by the Central Government.
- (2) The review shall include the following:
 - (a) analysis of achievement and compliance of targets and priorities set out in the Act and the rules;
 - (b) analysis of achievement and compliance of targets set out in the statements under section 8 of the Act;
 - (C) analysis of trends in receipts, expenditure and macro-economic parameters under the Act and the rules;
 - (d) comments related to classification of revenue, expenditure, assets or liabilities having a bearing on the achievement of targets set out in the Act and the rules;

- (e) analysis of disclosures made by the Central Government to ensure greater transparency in its fiscal operations.
- (3) For the purpose of conduct of the review under sub-rule (1), the Comptroller and Auditor General of India shall have the authority to-
 - (a) call for such records or information as he may require, for the preparation of the report; and
 - (b) require that any accounts, books, papers and other documents which deal with or form the basis of, or are otherwise relevant to the review, shall be sent at such place as he may appoint for the inspection.
- (4) The officer in charge of any office or department, the accounts of which are to be inspected and reviewed by the Comptroller and Auditor General, shall afford all facilities for such inspection and comply with the requests for such records or information as expeditiously as possible and in a complete form.
- (5) The report of review by the Comptroller and Auditor General of India shall be submitted to the President, who shall cause them to be laid on the table of both Houses of Parliament.

9. Annual Fiscal Strategy Report. -

- (1) The Fiscal Council shall produce an Annual Fiscal Strategy Report every year pursuant to subsection (e) of section 19 of the Act.
- (2) The Report shall be made available publicly at such cost, if any, that the Fiscal Council may determine.

Annex - V

FRBM: A DISSENT NOTE OUTLINING AN ALTERNATIVE ARCHITECTURE OF FISCAL RULES

ARVIND SUBRAMANIAN MEMBER

I. INTRODUCTION

It has now been thirteen long years since the FRBM was enshrined in law and the basic principles of prudent fiscal management elaborated. Over this period, the situation in India has changed utterly. Back in 2003, the economy was fairly small and still relatively closed to the outside world, generating per capita incomes that lagged far behind that of other emerging markets. Today, India has become a middle income country. Its economy is large, open, and growing faster than any other major economy in the world.

Amidst these dramatic changes the fundamental insight of the FRBM has endured. The country should always endeavour to strengthen its fiscal position, so as to ensure medium-term debt sustainability and contain macro-economic imbalances. If this is done, credibility will be preserved, borrowing costs will be kept low, and – most importantly – crises can be averted.

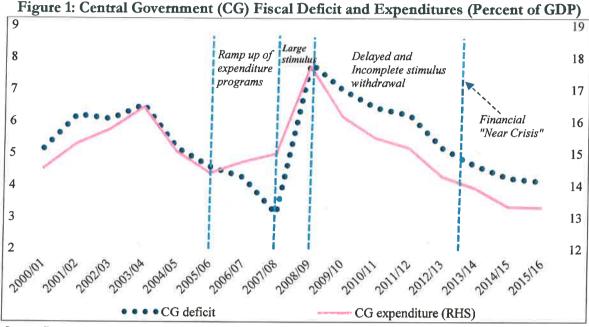
A strong fiscal position also supports growth. It generates the savings needed to allow high levels of private investment to be sustained over the medium term. And it provides room for counter-cyclical policies, allowing public investment to be stepped up when growth is temporarily weak.

These basic principles of fiscal rectitude are ever-enduring. At the same time, the transformation of India's economy means they will need to be translated into a very different fiscal framework from the one envisaged 13 years ago. The broad objectives, longer-term targets, and glide paths must all be rethought, as those that were appropriate for the small and vulnerable economy of long ago are surely no longer valid for the large and strong economy of today.

The new framework will also need to take account of the experience gained during the first decade of the FRBM's operation. The FRBM has served a vital role in promoting the concept of fiscal discipline. It was also successful for a time in ensuring that fiscal discipline was actually maintained. But it failed in two important ways.

First, it failed in flow terms, in the sense that it failed to prevent a build-up of dangerous fiscal imbalances. During the growth and revenue booms of the mid-2000s, it allowed new spending programs to be introduced, which could not be sustained when receipts fell back to more normal levels (Figure 1). Then after the Global Financial Crisis the FRBM failed to prevent an

excessively large stimulus, which was withdrawn neither adequately nor on time. The end result was the financial-currency "near-crisis" in the autumn of 2013.¹



Source: International Monetary Fund.

Second, the FRBM failed in stock terms, in that it failed to place the country's debt securely on a downward path. To be sure, the stock of central and general government debt initially followed a declining trajectory (Figure 2). But after 2010-11 the trend was first interrupted, then actually reversed. This failure ultimately stemmed from the reliance on rapid growth rather than fiscal adjustment to do the "heavy lifting" on debt reduction. Such a strategy worked well when nominal GDP was increasing rapidly. But it proved unsuccessful when nominal growth slowed.

¹ A similar flow failure, stemming from a large increase in the fiscal deficit, led to the 1991 balance-ofpayments crisis. The pattern in Figure 1 holds broadly at the general government level as well.

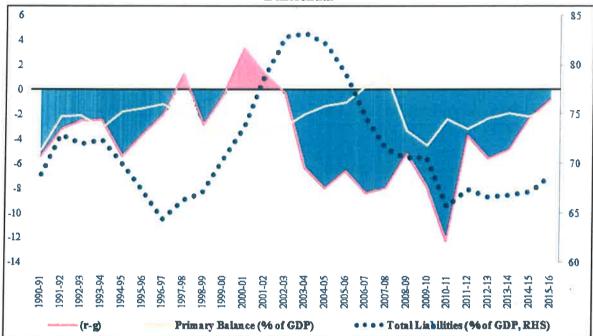


Figure 2: General Government Debt, Primary Balance and Interest Rate-Nominal Growth Differential

From this experience, two important lessons can be drawn. The fiscal rules need some flexibility, so that large cyclical swings can be handled within the framework—rather than by abandoning it—thereby disciplining departures from fiscal rules during these swings. And the rules need to be reformulated, to ensure that this time debt is placed firmly on a downward trajectory.

The Committee's report accordingly focuses on these issues. On the first, it proposes an "escape clause" to deal with the cyclicality problem. Ideally, this problem should be handled by cyclically adjusting the deficit targets. But as the report points out, calculating such adjustments is not possible at the present time. So instead the Committee has formulated an escape clause, with a number of carefully defined triggers, a bounded adjustment to the target, and a sensible timeframe for returning to the adjustment path. Notably, and to address the flow problem described above, the clause is symmetric, curtailing spending in booms as well as curbing prolonged and unduly large fiscal expansions in response to downturns.²

The Committee's recognition that the FRBM needs an escape clause is welcome. However, the formulation of this clause is problematic. The key trigger relating to growth would only be

Note: r is the average nominal cost of government borrowing, g the nominal GDP growth rate; and primary balance is total government revenue minus non-interest costs. Green (red) areas denote periods of favorable (unfavorable) debt dynamics.

² It is worth noting that while the international consensus is moving toward providing greater scope for countercyclical policy (Furman, J., 2016, "The new view of fiscal policy and its application," VOXEU.ORG, Nov. 2, 2016), the Indian experience highlights the need to judiciously circumscribe counter-cyclical policy.

activated in exceptional circumstances, when growth departs by 3 percentage points or more from its latest 4-quarter average. As a result, two distinct problems are likely to arise. The government would have no flexibility to relax the fiscal stance to combat ordinary recessions, yet it would simultaneously have too much room to expand spending during growth booms.

Some simple examples make the problem clear. If real GDP growth declined from 5 percent to just above 2 percent, causing revenue growth to falter, the government would be required to cut spending to achieve the fiscal deficit target. Similarly, if growth increased from say 6 percent to just below 9 percent, all of the increased revenue could be spent. Such behavior would produce a dramatically pro-cyclical fiscal policy, aggravating the slumps and booms, thereby running the risk of generating macroeconomic instability. To avoid such an outcome (especially to escape from the straitjacket of no flexibility even in the face of a serious downturn), the government would likely abandon the FRBM framework, as it did after the Global Financial Crisis.

In other words, the design of the escape clause risks ignoring the lessons from the Indian experience during the period 2007-08 to 2014-15 discussed earlier.

On the basic architecture of the Committee's recommendations – the proposed objectives and operational targets – I have serious reservations.

In effect, the Committee is proposing three targets: stock (debt-GDP ratio), flow (fiscal deficit-GDP ratio), and composition (revenue deficit-GDP ratio, with the revenue deficit defined as current expenditures less current revenues). This is a problem, because multiple targets force policymakers to aim at too many, potentially inconsistent objectives and analytical frameworks, running the risk of overall fiscal policy being difficult to communicate for the government and comprehend for market participants, and the risk of the government not achieving any of its goals.

Moreover, each of the targets is questionable. The debt target is set at an arbitrary 60 percent of GDP for general government. The medium-term fiscal deficit target is set an equally arbitrary 2.5 percent of GDP for the central government. The revenue deficit target, whose very rationale is debatable, is nonetheless set at an extremely precise 0.8 percent of GDP for the central government. Perhaps, oddest of all is the fiscal deficit path, which calls for a deep cut in the first year (2017-18) to 3 percent of GDP for the central government, then a pause for two years, then a resumption of deficit cutting, this time by moderate amounts. No real rationale is provided for such a serpentine path, and it is difficult to find one.

In contrast, I would propose a simpler architecture, comprising just one objective: placing debt firmly on a declining trajectory. To achieve this, the operational rule would aim at a steady but gradual improvement in the general government primary balance (Non-debt receipts minus noninterest expenditures), until the deficit is entirely eliminated. This strategy would ensure that debt will remain on a downward path even over the longer term, when India's debt dynamics turn less favorable.

These points are elaborated below.

2. OBJECTIVE: DEBT LEVEL OR TRAJECTORY?

The lodestar of this report is the level of government debt. In this respect, it echoes the reviews by rating agencies, which have repeatedly claimed that debt is India's main fiscal problem. Indeed, the level of concern expressed in this report is such that, while debt is invoked to be an "anchor" for fiscal policy, this anchor hovers uneasily between being a "ceiling" and a "target." Clearly, it cannot be a ceiling because in that case the government would be in violation of the FRBM from the moment the revised framework is introduced. So, it must be something more akin to a target.

But it has never been obvious that the current level of debt is such a problem, much less such a pressing one that it needs to be brought down to 60 percent of GDP within the next five years. To begin with, India has carried much higher debt ratios in the past, as much as 83 percent of GDP, without encountering debt servicing difficulties or finding that the debt posed obstacles to growth. In fact, the country experienced its greatest-ever period of growth in the mid-2000s when the debt was as much as 10 percentage points higher than it is today. So, the public might well ask why the debt ratio is suddenly considered such an impediment to India's aspirations that it merits a legal response taking the form of a "debt ceiling" well below levels of the recent past.

The answer given in the report is that India needs to reduce its debt to a safe level, which is confidently asserted to be 60 percent of GDP. But increasingly, economists are doubting whether it is really possible to identify "optimal" or even "safe" levels of debt. Different studies have identified very different thresholds of debt danger, ranging from 20 percent of GDP to 90 percent of GDP. Moreover, all of these studies, most prominently Reinhart and Rogoff (2010)³, have been criticized as methodologically questionable. The negative relationship they find between the level of public debt and growth turns out to be sensitive to many factors, most importantly the direction that debt is heading.

Recent developments have only underscored the doubts. Earlier, it was assumed that debt levels exceeding 100 percent of GDP would surely be dangerous. Yet after the Global Financial Crisis, debt ratios in many advanced countries crossed this threshold – and interest rates simultaneously fell to historically low levels. As a result, it is now unclear to policymakers whether debt in

³ Reinhart, C.M., and Kenneth S. Rogoff, 2010, "Growth in a Time of Debt," NBER Working Paper No. 15639.

Europe really needs to be reduced to the 60 percent of GDP level specified in the Maastricht treaty. Certainly, EU authorities are no longer making any serious efforts to enforce this rule.

In the end, the safe level of debt is more a matter of the willingness of the political system to service its debt than any innate ability to do so. And India has always demonstrated any exceptionally high determination to repay, most famously in 1991 when it shipped gold out of the country as collateral for foreign loans, to prove that it was committed to repaying them.

For India, indeed for any country, what matters far more than the precise level of debt is the *direction* the debt is heading. If investors see that debt is on a declining path, they are reassured. If it is instead rising explosively, they might worry that the commitment to fiscal discipline has been eroded. In that case, they would demand higher interest rates on government securities, which would quickly feed through into higher borrowing costs for the private sector, damaging investment and growth. In a worst case scenario, markets might completely refuse to purchase government debt, forcing the government to default, and triggering a financial crisis.

A loss of debt sustainability is extremely unlikely in India. But the country does have an underlying vulnerability, which needs to be addressed, lest such a scenario one day come to pass. This vulnerability is the country's primary deficit. Put simply, India's government (Centre and states combined) is not collecting enough revenue to cover its running costs, let alone the interest on its debt obligations.

There is nothing extraordinary about running a primary deficit, *per se*. Most of the other large emerging markets do so, having fallen into this situation after the Global Financial Crisis when GDP growth and revenues slowed, while stimulus spending was increased (Table 1). Even so, India stands out both for the size of the deficits that it has run over the past decade, especially when compared with its rate of growth. At such rapid rates of growth, substantially greater than those of its peers, its primary deficit should have been much lower than others; instead it has been significantly greater (Figure 3).

As a result of running a primary deficit, the government is dependent on growth and favourable interest rates to contain the debt ratio.⁴ In recent years, the growth-interest rate [g-r] differential has been just sufficient to keep the debt ratio stable. It follows that if one day growth were to falter and interest rates to rise, the debt ratio could start to spiral upwards. A debt explosion would admittedly require a large, unlikely shock. But it is not just a completely theoretical possibility, either: it is exactly what happened to Greece.

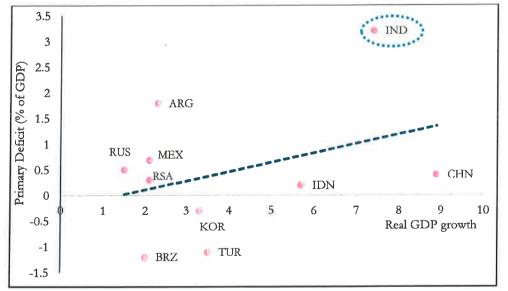
⁴ Recall that the condition for a declining debt path is for the primary balance (pb) to be greater than [(r-g)*d]/[1+g], where r is the nominal cost of borrowing, g the nominal growth rate, and d the debt-GDP ratio.

												· · ·
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Average	Real GDP growth (%)
Argentina	1.7	1.8	-1.1	-0.4	-1.4	-1.5	-2.4	-3.2	-5.4	-5.6	-1.8	2.3
Brazil	3.2	3.8	1.9	2.3	2.9	1.9	1.7	-0.6	-1.9	-2.8	1.2	2.0
China	0.4	0.4	-1.3	1.1	0.4	-0.2	-0.3	-0.4	-2.1	-2.2	-0.4	8.9
India	0.4	-5.3	-5.2	-4.2	-3.9	-3.1	-3.1	-2.8	-2.3	-2.1	-3.2	7.4
Indonesia	0.9	1.7	-0.1	0.0	0.5	-0.4	-1.0	-0.9	-1.2	-1.0	-0.2	5.7
Mexico	1.5	1.7	-2.3	-1.4	-1.0	-1.2	-1.2	-1.9	-1.2	0.1	-0.7	2.1
Russia	5.6	4.7	-6.2	-3.1	1.7	0.7	-0.8	-0.7	-3.2	-3.4	-0.5	1.5
South Africa	3.9	2.1	-2.5	-2.1	-1.1	-1.3	-0.9	-0.6	-0.6	-0.4	-0.4	2.1
South Korea	1.4	1.2	-0.7	0.8	0.9	0.8	-0.2	-0.3	-0.4	-0.3	0.3	3.3
Turkey	2.9	1.7	-1.4	0.3	2.1	1.1	1.4	1.4	1.2	0.3	1.1	3.5

Table 1: General Government Primary Balance (% of GDP) & Real GDP Growth (%)

Source: IMF Fiscal Monitor, October 2016.





Source: IMF, World Economic Outlook, October 2016

There is another consideration that needs to be kept firmly in mind. Both theory and evidence show that highly positive [g-r]—economic growth exceeding interest rates--is a feature of emerging markets. For advanced countries, the differential is typically close to zero; and indeed, growth theory suggests that in the long run, there should not be a substantial wedge between the two. If [g-r] is zero, then the primary balance must also be zero (or in surplus); otherwise, the debt will not be sustainable. Since India is converging rapidly toward the West, it should prepare for the day when the growth-interest differential turns unfavorable sustainedly. It is certainly better to take preemptive action, rather than wait until a problem arises. The central objective of the fiscal framework, consequently, should not be to achieve an arbitrary debt objective. Rather, the framework should aim at eliminating the primary deficit so that debt will continue to decline steadily, even in the longer run when favorable [g- r] dynamics fade away.

Admittedly, a primary deficit objective may sound unusual, for so far there has been little focus on this problem in India. But in other countries, particularly those in Latin America such as Brazil, it has long been the linchpin of the fiscal framework. Moreover, in recent years the primary balance has become quite a standard concept internationally Over the past decade, there have been 16 IMF lending programs in which the primary balance—and not the overall balance—was the operational target, including important cases such as Greece and Ireland.

It will doubtless take some effort to accustom India to this framework. For example, the government would need to explain that adopting a primary deficit objective does not mean that the bulk of the deficit is being ignored. Rather, it means the government is focusing squarely on the part of the budget that the government can control, as opposed to interest payments, which are largely predetermined. The government would also need to explain why eliminating the primary deficit is so important. This can be done simply, by pointing out that a zero deficit is needed to end the current Ponzi scheme-like situation in which the government is borrowing merely to pay its running costs, leave alone the interest on its debt.

In the meantime, until these principles sink into the public consciousness, a primary deficit path can always be translated into the more familiar yearly objectives for the fiscal balance.

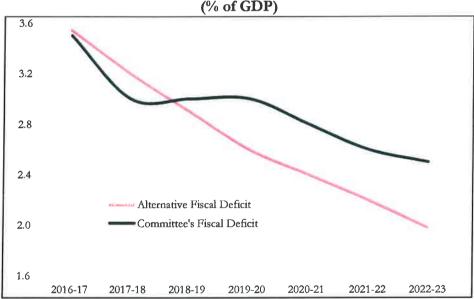
3. PATH: UNEVEN OR SMOOTH?

Any glide path needs to be grounded in India's past experience and its prospects for the future. Here, three distinct features must be kept in mind. First, over the medium term (the likely horizon for the revised FRBM), forces of convergence combined with steady reforms should deliver robust growth averaging around 8 percent. By the same token, these forces may well lead to a slowdown thereafter. Consequently, the next decade should be viewed as a golden opportunity to "fix the roof while the sun is shining".

A second related point is that India like most emerging markets normally undertakes policyrelated fiscal adjustment only gradually. Aside from crisis periods, the fiscal position has only improved sustainedly when it has benefitted from windfalls, arising from exceptional growth (as in the mid-2000s) or major declines in oil prices that allow for lower petroleum-related subsidies and higher excise taxes. For example, between 2014-15 and 2016-17, lower oil prices will have contributed about a percentage point to fiscal adjustment. Figure 2 illustrates the point, showing that the primary balance has remained relatively stable, apart from the growth boom around 2007-08 and the oil-related improvement more recently. Third, there is no clear and present danger that demands a sharp response. To the contrary, the standard macroeconomic indicators – growth, inflation, current account balance, reserves – are all at the best level they've been in years.

These three considerations suggest that that the fiscal strategy should aim at modest but steady improvements that over the course of this decade will gradually transform the fiscal position. But this is not what the Committee proposes. Instead, it recommends a serpentine path for the Centre's fiscal deficit, starting with an exceptionally large 0.5 percentage point reduction to 3 percent of GDP in 2017-18, followed by no further change for two years, then a further gradual reduction to 2.5 percent of GDP by 2022-23 (Figure 4). In other words: cut sharply, pause, cut moderately. It is difficult to imagine a path that is more uneven, and more difficult to justify or explain to the public.

Figure 4. Fiscal Deficit: Committee's Recommendation and Alternative Proposal



Instead, I would propose a trajectory much more consistent with India's experience and prospects. The Centre's primary deficit should be put on a gentle glide path, whereby it is reduced by 0.2 percentage points a year until a modest surplus of around half a percent of GDP is attained. If this path were followed, by 2022-23 the Centre's fiscal deficit would have narrowed to 2 percent of GDP.

4. STRATEGY: APPROPRIATELY AMBITIOUS?

The problems with the Committee's proposal go far beyond than the shape of the glide path. The deeper problem is that the envisaged strategy is at once excessively ambitious, and insufficiently so. Excessive, in the sense that there is no reason why such a large and disruptive adjustment would be needed next year. Insufficient, in the sense that over the longer term it fails to deal decisively with the true fiscal vulnerability, namely the primary deficit.

Short Term Problems

Consider first the short run problem. Not only is there no threat of imminent crisis, but such a large adjustment would be inappropriate from a cyclical point of view, as it would impart a contractionary impulse to an economy that remains in the early stages of a recovery, with export demand weak, and investment and real credit actually falling.

Invocations of 7 percent real GDP growth to justify a sharp fiscal contraction should be seen in the light of the fact that growth remains below potential. Moreover, growth projections are subject to higher-than-normal confidence margins because the demonetization exercise in November 2016 was an unprecedented event. There are no guideposts from the past that allow one to confidently forecast the extent or duration of its impact on GDP.

Nor is it convincing to argue that credibility demands that the fiscal deficit be reduced sharply to 3 percent next year. The government has already demonstrated its commitment to fiscal probity by continuing to cut the fiscal deficit even in the face of tepid economic activity.⁵

Medium-term Problems

Clearly, then, the Committee's framework is not adequate to assess the desirability of the medium-term strategy. So let's employ the one set out in Section 2. From this perspective, one can see that the proposed path is insufficiently ambitious, as it manifestly fails to "fix the fiscal roof".

Over, the next five years, the ratio of the Centre's interest obligations to GDP is likely to fall by around 0.5 percentage points of GDP, as high-cost debts from the previous decade are repaid. This will create considerable room for additional spending during the period when the Committee calls for the fiscal deficit to be kept at 3 percent of GDP, meaning that for two years the primary balance would actually be deteriorating, rather than improving (Table 2). This deterioration would ultimately be reversed, assuming that the adjustment resumes as scheduled.

What about the overall (general government) balance? Even assuming that the states succeed in curbing their deficit to around 2 percent of GDP⁶, it would not achieve the needful: the general government primary balance would remain in deficit throughout the medium term. In contrast, the alternative proposal would indeed eliminate, or come close to eliminating, the general government primary deficit by 2021-22.

⁵ Any fiscal windfall from demonetization—either in the form of unreturned high denomination notes or tax revenues under the Pradhan Mantri Garib Kalyan Yojana--should not affect the path of consolidation going forward as it is one-off in nature.

⁶ See the chapter in the Committee's Report on "State-level Fiscal Responsibility Legislation," Table 5.

	Primary deficit; Alternative	Primary deficit; Committee	Fiscal deficit; Alternative	Fiscal deficit; Committee	Debt; Alternative	Debt; Committee
2016-17	0.3	0.3	3.5	3.5	49.4	49.4
2017-18	0.1	-0.3	3.2	3.0	47.6	47.3
2018-19	-0.1	-0.1	2.9	3.0	45.6	45.5
2019-20	-0.3	0.0	2.6	3.0	43.3	43.7
2020-21	-0.5	-0.1	2.4	2.8	40.7	42.0
2021-22	-0.6	-0.1	2.2	2.6	38.2	40.3
2022-23	-0.7	-0.1	2.0	2.5	35.7	38.7

Table 2. Medium-Term Fiscal Deficit, Primary Deficit, and Debt Paths for Central Government: Committee's Recommendation vs. Alternative Proposal

The Committee's strategy may also fall short of its own debt objective. It may seem that adhering to fiscal deficit targets could ensure achieving a debt target. After all, stocks (such as debt) are merely the sum of flows (such as deficits). But this is not true when the targets are expressed as ratios to GDP, as they must be since the economy is growing. In this case, the precise relationship between deficits and debt depends on how fast the economy is growing.

Under the Committee's scenario, growth is sufficient to ensure the debt target will be achieved, as long as the deficit targets are respected. But in a slightly more adverse scenario, where real growth falls to 5 percent for a few years before recovering—as indeed occurred a few years ago—the debt/GDP target at the end of the decade would be missed by no less than 3-4 percentage points. This alternative scenario underscores India's basic vulnerability: as long as the primary balance remains in deficit, progress in reducing the debt ratio will remain hostage to the vagaries of the growth-interest differential, factors outside the government's control.

The need for ambition in the medium term is reinforced by the situation of state government finances, which has been adversely affected by slower growth, the need to assume debt of the discoms (under the Ujwal DISCOM Assurance Yojana [UDAY] scheme), and the need to implement the Seventh Pay Commission recommendations.

5. CONSISTENCY BETWEEN DEBT OBJECTIVE AND OPERATIONAL FISCAL DEFICIT RULE

Further, there is a consistency problem between the debt objective recommended by the Committee and the operational flow targets proposed. The debt objective hovers uneasily between a "ceiling," a "target," and an "anchor." In places, the Committee refers to this objective as a "ceiling". But clearly this wording cannot be taken literally, for in that case the government would be in violation of the FRBM from the moment the revised framework is introduced because the current level of debt is above this ceiling.

Alternatively, the debt target could be interpreted as notional (an "anchor"), something to be achieved "one day," similar to the 60 percent objective in Europe. In this case, it would not be adding much to the framework: the binding constraint would remain the fiscal deficit path.

These considerations suggest a third interpretation, namely that the debt objective should be seen as a target, meant to be achieved over the next decade. In this case, a number of serious questions arise.

If debt is indeed a target, the operational rules for the fiscal deficit should have flowed from the debt objective. But they do not as the Committee makes clear that the operational target instead flows from an alternative (and orthogonal) framework based on macro-economic balances.

The well-known standard equation that relates the steady state debt ratio (D) with the constant fiscal deficit (FD) and constant nominal growth rate (g) is given by:

FD = D times [g/(1+g)]

This was the equation that led to the famous Maastricht Stability and Growth Pact (SGP). In Europe, the objective of a debt target of 60 percent of GDP (arrived at because that was close to the average prevailing then in Europe) combined with a medium-term nominal growth assumption of 5 percent, led to the choice of the fiscal deficit target of 3 percent of GDP (60 times 5).

Taking the Committee's debt target of 40 percent (for the central government) and the assumed nominal growth rate of 11.5 percent, yields a central government fiscal deficit target of about 4.1 percent of GDP (11.5/1.115 times 40). But the Committee has proposed a resting place for the fiscal deficit of 2.5 percent of GDP by 2022-23, substantially lower than dictated by the debt objective. So, the operational target does not stem from the debt objective.

Where does the medium term fiscal deficit target of 2.5 percent of GDP come from? The Committee has used a simple macro balance equation to arrive at this number. The report assumes a current account deficit target, adds on the latest data for household financial saving to get a figure of 10 percent of GDP in available resources, then divides this amount equally between the government and the private sector, and divides the government share equally between the Centre and the states. Hence, the 2.5 percent of GDP.

There is some rationale for the last step, in that an equal division between the Centre and states follows a long-established precedent. But the other steps are arbitrary and the assumptions fragile.

It is not obvious that domestic saving should be predicted on the basis of the latest data. Saving fluctuates widely and is endogenous to growth: household financial saving was around 10 percent of GDP in the early 2000s, then surged to around 11.5 percent of GDP during the

boom, and fell sharply during the recent years to around 7 percent of GDP. So the latest reading forms a slender reed on which to base legally binding medium-term fiscal targets.

Finally, the division of resources equally between the public and private sector is not only arbitrary but seems normatively wrong. Should the state really aim to take half the available household financial saving? On what basis?

Next, consider the implications of adding a hard debt (stock) objective to the fiscal deficit (flow) targets.

Consider how the government would need to respond if inconsistencies develop between the deficit and debt targets. Recall that the change in the debt-GDP ratio depends essentially on two factors: the fiscal deficit-GDP ratio, which essentially measures the flow of new debt⁷, and the rate of growth of nominal GDP, which effectively inflates away the old debt. To see this, imagine the case where the fiscal deficit is zero, real growth is zero, but inflation is 10 percent. The debt-GDP ratio will shrink because the debt will stay the same but the denominator will increase by 10 percent.

This situation creates a potential inconsistency between the deficit and debt targets. If inflation turns out to be lower than anticipated, the deficit targets would need to be tightened to ensure the debt-GDP target is respected. If these adjustments were to occur frequently (say every year) all predictability of the framework would be lost. But if adjustments were made infrequently, then large and disruptive adjustments would be needed.

In fact, even if targets were adjusted frequently, the adjustments might need to be large, if the deadline for achieving the debt target were approaching. For example, if the target were one year away, and debt still needed to be reduced by 1 percentage point, then spending might need to be cut by 0.3-0.4 percentage point of GDP in the middle of the fiscal year (about Rs 45,000-60,000 crores in today's terms), if inflation fell just a percentage point short of what was projected.

Such cuts would not only be disruptive and difficult to achieve: they would also be unwise. For if inflation was falling short of target, this could well be occurring because the economy was in a cyclical slump—which would be exactly the wrong time to be tightening the fiscal stance.

Summing up, a meaningful debt target requires the operational rules to flow from the target. But they don't. Instead, they flow from an alternative and orthogonal framework based on macroeconomic balances. And the numbers that stem from this framework are based on fragile assumptions about saving in the future and ad-hoc choices on how that saving should be allocated between the public and private sectors.

⁷ Ignoring valuation changes and the assumption of debts from other branches of government.

Moreover, a hard target would quickly run into operational problems, forcing frequent reassessments of the fiscal deficit path and occasional large, pro-cyclical spending cuts. At some point, many will begin to wonder why these adjustments are necessary, why it is so important to reduce debt to 60 percent of GDP. And when that happens, it will be impossible to give a credible answer, in which case the framework will be abandoned.

6. A REVENUE DEFICIT TARGET?

There is a valid reason to focus on the revenue deficit, namely that capital expenditure should not be viewed in the same way as current spending. Capital spending is an addition to the nation's capital stock, which should bear future dividends that will counterbalance the interest costs of the debts incurred to finance it. Current spending yields no such future dividends. For this reason, the UK government attempted until the Global Financial Crisis to follow a "golden rule" of borrowing only for investment, and such a concept was built into the original FRBM as well.

That said, there are stronger reasons why the revised FRBM should eschew a revenue deficit rule. The most obvious one is that it is simply not true that capital spending is always better than current spending. Both types of expenditure can be wasteful. At the same time, both types can be useful. There is a lot of context-specificity to actual choices between the two which would be constrained by a blanket rule. There is a strong critique that India underspends dramatically on health and education, arguably to an even greater extent than on capital expenditure.

Moreover, one could argue that since future generations of Indians will be vastly richer than current ones, it would be optimal to borrow some consumption from the future for the benefit of those Indians alive today. And the way to do this would be by running a revenue deficit. Accordingly, it makes little sense to place arbitrary limits on the share of the revenue deficit in the overall deficit.

One could even go further. It might actually be counterproductive to establish a revenue deficit target. The reason is that the greater the proliferation of targets, the greater the chance that the government will ignore some of them, damaging the credibility of the entire framework. This is not just a theoretical point: it is exactly what has happened over the past decade. The existing FRBM already contains revenue deficit objectives, but these have been routinely ignored, so much so that this objective has essentially been forgotten. The problem is not one of negligence; it is inherent to any framework where the objectives are many and potentially conflicting.

So, adding a revenue deficit rule would further add to complications that already stem from having both a debt and fiscal deficit rule, as described above.

7. CONCLUSION

The existing FRBM has served several important purposes. It has brought to the fore the vital importance of fiscal discipline, underscoring its central role in keeping the country on its rapid growth path, which is raising living standards toward those in the West. It has also provided a valuable framework for budgetary discussions.

That said, India has changed substantially since 2003. The FRBM consequently needs to be updated in the light of the country's distinctive experience and its unique prospects going forward. After all, fiscal rules gain their force not so much from their legal strategy as from the consensus that lies behind them, in the economic, political, and wider social communities. For such a deep consensus to be forged, the rules themselves need to be simple, consistent, and broadly feasible.

Unfortunately, the Committee's proposed architecture falls short on all these counts. There are multiple targets on stock, flow, and composition, diffusing the focus, complicating communication and comprehension, and risking non-compliance. Further, the targets themselves are arbitrary. A 60 percent debt-GDP rule cannot command broad consensus. Nor can a revenue deficit target of 0.8 percent of GDP. And the medium-term fiscal deficit target of 2.5 percent of GDP is based on a conceptual framework that is unrelated to the debt objective and based on calculations that are hard to justify.

Most critically, the fiscal deficit path follows an odd sequence of cut-sharply, pause, and cut again that is: difficult to explain or justify; inappropriate in the short run because of cyclical considerations; and insufficiently ambitious in the medium term in placing India's debt on a sustainable long term trajectory.

Finally, the key trigger for invoking the escape clause (growth to exceed the recent trend by 3 percentage points) is so demanding that it would fail to provide enough flexibility during severe downturns and enough discipline during growth booms. In other words, the new architecture would be a corset on fiscal policy, resulting in extreme procyclicality—aggravating booms and busts--with adverse effects on the economy.

Instead, I propose a simple and consistent architecture that reflects India's fiscal realities of the past, and its prospects for the future. There should be one target: a steady glide path that eliminates the general government primary deficit within five years. This would ensure a declining debt trajectory, which would reassure investors and ensure that India's debt remains sustainable even when India's debt dynamics turn less favorable in the medium term. And the escape clause should have a more reasonable growth trigger that allows for some relaxation of the deficit targets during recessions, and some tightening of these targets during booms.

Such a simple, clear, and consistent architecture would truly be an FRBM for the 21st century.

I am extremely thankful to the Chairman and members of the FRBM Review Committee for providing me the opportunity to express my views.

(Arvind Subramanian) Member and Chief Economic Adviser

New Delhi January 18, 2017.

Annex - VI

Rejoinder of the Committee to the Note of Dissent

This note briefly summarizes the main points made in the dissent note, and the detailed responses of other members of the Committee (henceforth referred to as the "Committee") to each of these points. The Committee believes that these responses can serve two useful purposes (i) establish conclusively that the case for the alternative proposal in the dissent note is weak in its economic logic as well as on practical grounds (ii) further address any valid questions and concerns about the framework that is being proposed by the Committee.

I. Alternative proposal in the dissent note

We first summarize the essence of the alternative proposal, and then discuss its economic logic as well as its practical implications.

Summary of the alternative proposal

There are essentially two elements in the alternative strategy proposed in the dissent note:

- (a) The primary balance is the principal quantifiable objective or goal of fiscal policy with zero general government primary balance as the medium-term target. Although the dissent note does not derive the optimal medium-term primary balance for India using any economic theory or empirical analysis, it refers to zero primary balance as the goal in several places in the note e.g. "zero deficit (page 7)", "eliminating the general government primary deficit" (page 10), "as long as primary balance remains in deficit ..." (page 11).
- (b) The primary balance is also the operational target secured through a 0.2 percentage point annual reduction in primary deficit for both the center and the states.

In what follows, we analyze the economic underpinnings, and the practicality, of introducing primary balance as the principal quantifiable objective and the operational target.

Economic theory

Primary balance as the principal quantifiable objective

We present below four economic arguments for why primary balance may not be desirable as the key quantifiable objective for the medium-term.

(i) The economic reason the note gives for introducing primary balance, as the principal objective for fiscal policy, is that declining or eliminating primary deficits, can ensure a declining debt to GDP ratio. For example "a steady but gradual improvement in the general government primary balance, *until* the deficit is entirely eliminated … would ensure that debt will remain on a downward path ….." (page 4). This implies that a declining primary deficit is necessary for debt sustainability.

We establish below that a declining primary deficit, the centerpiece of the alternative proposal, is neither necessary nor sufficient for debt ratios to decline.

Consider the debt dynamics in Equation (2) of Chapter 4 of the report specified as follows:

$$d_{t+1} - d_t = \frac{r}{(1+g)}d_t - \frac{g}{(1+g)}d_t - pb_{t+1}$$

Consider two cases:

1. Interest rate-growth differential (r-g) > 0

a. In this case declining primary deficit cannot ensure that debt ratios will decline.

b. Running primary surpluses is a necessary, but still not sufficient, condition for debt to GDP ratio to decline. Even if a country generates very high primary surpluses, if its stock of debt is large, it will not be enough to offset the interest payments, and the debt path can be explosive.

2. If (r-g)<0 as it is now in India, then running primary surpluses is not necessary for debt to GDP to decline.

In either of the cases, a **zero general government primary balance is neither necessary nor sufficient for debt to GDP to decline.** Incidentally, while the dissent note proposes declining "debt" to be the objective of fiscal policy, and in fact, envisages central government debt to decline to under 40% (see Table 2), it does not specify debt as the ultimate goal of fiscal consolidation.

(ii) Even if the primary balance is the main quantifiable objective, the next obvious question is at what level it should be anchored. This is not an easy problem to solve. Theoretically, it can be shown that if the primary balance target is not consistent with the initial debt level, debt will be unsustainable (meaning it will diverge either to zero or infinity depending on whether the primary balance is above or below the level that stabilizes the initial debt level). This is not true of the overall balance: regardless of the initial level of debt, targeting an overall balance puts the debt ratio on a sustainable path, meaning that the debt to GDP ratio will converge towards a specific level (Escolano, 2010).

(iii) Even if we consider zero general government primary balance as the medium-term goal, a relevant question in the context of the Indian federation is: what would that imply for the primary balance for the center and the states? The note considers a primary "surplus" to be optimal for the center in the medium-term, which implies that states are envisaged to run a primary "deficit". Why is that the case? Why does the optimum differ? Why is it optimal for the center to collect more revenues than its non-interest expenditures, while the states' revenue collection efforts should not match its non-interest expenditure needs? The latter is likely to create moral hazard issues for the states, and dis-incentivize them to intensify their own tax collection efforts.

(iv) Zero general government primary balance poses another serious issue. It basically implies that it is not optimal for the government to borrow for any additional non-interest expenditure. This defies economic logic because there is an incentive for capital scarce countries, especially those with infrastructure gaps like India, to borrow and invest, since the marginal product of capital is higher than the cost of borrowing. Another point to note may be that while the dissent emphasizes counter-cyclicality - that revenues garnered in good times should not be spent but saved; at the same time, it considers zero primary balances as optimal,

which implies exactly the opposite, that any additional revenues should be completely spent.

Primary balance as the operational target

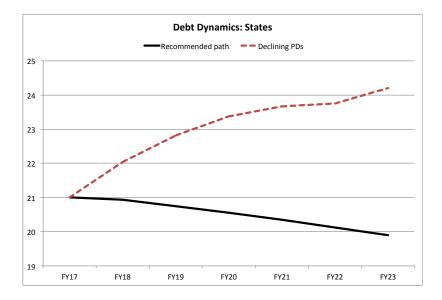
(i) Conceptually, the simplest equation that drives the evolution of debt can be expressed as follows:

$$d_{t+1} - d_t * [\frac{1}{(1+g)}] + f d_{t+1}$$

If the ultimate objective is to have debt on a declining path, the simplest and straightforward operational target that clearly emerges from the above equation that can be easily and effectively monitored, is the fiscal deficit. The note does not make it clear why there is a need to get into the intricacies of different components of fiscal deficit to derive the key operational target – e.g., that which distinguishes between interest payments and other components of fiscal deficit in this case.

(ii) The note envisages a 0.2 percent point reduction in primary deficit to GDP each year. Where does the 0.2 pp come from? Why not 0.3 pp? What are the underlying economic assumptions? Won't the implied path of primary balance have to be re-calibrated if the assumptions change dramatically? The note does not elaborate on any of these issues.

(iii) In fact, for the states, a gentle so-called "glide path" for primary deficits as proposed by the note, can put debt to GDP on an explosive path, and clearly violate debt sustainability.



Notes. Nominal GDP is assumed to grow at 11.5%. Based on data from the RBI on weighted average coupon yields on the outstanding stock of market borrowings, we assume an interest rate of 8.5%, and we project it to decline by roughly ten basis points every year. Finally, initial debt to GDP in FY17 is assumed at 21% of GDP.

(iv) Finally, the note argues that the government should be "focusing *squarely* on the part of the budget that government can control, as opposed to interest payments, which are largely predetermined".

The Committee disagrees with the essential message in the note that the fiscal stance of the government

should ignore interest payments. In theory, interest payments depend on the stock of government borrowing and average borrowing costs. Average borrowing costs depend on annual borrowing costs, which in turn depend on the nominal policy rate, and the term premia, the latter being determined by the slope of the yield curve. The slope of the yield curve is clearly influenced, in part, by government actions. Therefore, if government actions, for example, lead to a loss in credibility, and to large shocks to annual borrowing costs, they can potentially affect interest payments significantly, despite the fact that a relatively small fraction of the stock of existing debt may be newly incurred or re-priced.

Practicality

In addition to weak economic rationale, the Committee also has serious reservations about the practicality of introducing primary balance as the principal quantifiable objective and the operational target.

(i) The fiscal and primary deficit for the central government for FY17 - FD=3.5% of GDP. PD=0.3% of GDP. Interest payments are 92% of FD. The share of interest payments as a share of FD, moreover, has increased, from an average of 2.9% in 1980s to 3.6% of GDP on average during this decade. The Committee's view is that how can India have a fiscal framework with an operational target that ignores a component that constitutes more than 90% of the government's fiscal deficit?

(ii) Would it be practical for the center to run a primary surplus of 0.7% of GDP in the medium-term, as envisaged in Table 2 of the dissent note? Indeed, barring one year, this has never happened in the last four decades.

(iii) As pointed out in the dissent note and discussed within the Committee, communication issues cannot be ignored. Primary balance is not a concept easily understood even by economists, and will be impossible to explain to an ordinary citizen.

(iv) How common are primary balance rules across countries? In fact, there is no other G20 country, in fact no other large country, with a *permanent* fiscal rule on primary balance embedded in their legislation. As mentioned in the dissent note, countries do have primary balance as short-term fiscal targets or goalposts in the context of IMF programs, but these are not fiscal rules that by definition would impose a more durable constraint on fiscal policy. IMF fiscal programs seek to bring immediate fiscal correction to an unsustainable situation. They are not, and are not intended to be, fiscal rules.

(v) Incidentally, while the dissent note appears to accept the committee's recommendation for escape clauses specified in terms of fiscal deficit, it does not agree to the Committee's recommendation of fiscal deficit as the key operational target for fiscal policy.

(vi) The dissent note disagrees with the trigger for the escape and buoyancy clause as 3 percentage points below or above the average for the previous four quarters. It notes "the new architecture would be a corset on fiscal policy, resulting in extreme procyclicality, aggravating booms and busts – with adverse effects on the economy". This issue was discussed and debated extensively within the Committee. The right solution, however, to address this problem is to adopt "cyclically-adjusted deficits", or to introduce "expenditure rules". The Committee discussed these issues at length, but there was unanimous agreement (including by the author of the dissent note) that operationalizing cyclically adjusted deficits or ceilings on expenditures is not practical in the Indian context at this point of time. This is because there is considerable uncertainty around estimating "output gaps" – an economic measure of the cycle (this is true

even in advanced economies, see e.g. Kuttner (1994), Staiger, Stock and Watson (1996) and the literature thereafter); and expenditure rules may not be practical to implement and enforce. Therefore, as fiscal institutions develop, with improved fiscal management and increased transparency (see Summary of Recommendations attached to this report), future reviews of the fiscal framework should consider more sophisticated rules to adjust for cyclicality.

Nonetheless, in order to provide flexibility in the case of exogenous shocks, and to introduce additional discipline during unusually good times, the Committee agreed to recommend an escape and a buoyancy clause. However, in order to preserve the sanctity and credibility of the framework recommended by the Committee, it is crucial that the conditions that trigger deviations from the recommended framework, if any, should be "large" and "rare". Based on analysis undertaken with historical data, it was established that there is a 25% probability that real GDP growth exceeds or fall below its average value over the previous four quarters by more than 2 percentage points, while there is a 8% probability that the real GDP growth exceeds or fall below its average value by more than 3 percentage points. The Committee took the judgment call that the latter is more consistent with a representation of a rare event and a large shock than the former, and therefore decided to recommend 3 percentage points deviation to trigger the escape clause. Importantly, the escape or the buoyancy clause recommended by the Committed is not designed to be a substitute for cyclically adjusted deficits or expenditure rules which should be looked into seriously by future reviews of the fiscal framework.

II. Concerns relating to the Committee's recommended framework

In this section, we summarize the concerns related to the Committee's framework, and provided a detailed point-by-point response.

(i) Debt as an anchor, ceiling, or a target?

An anchor for fiscal policy: "Conceptually", the Committee recommends introducing a medium-term anchor for fiscal policy. The Committee believes that a transparent and predictable policy framework is one that is rule-based. Central to a credible framework is the concept of an anchor. An anchor ties down the final goal of policy, and the expectations of economic agents adjust accordingly. By acting as a constraint on policy discretion, an anchor dis-incentivizes time inconsistency, including due to pressures from interest groups.

Debt as an anchor: As laid out clearly in the introduction and in Chapter 4, the choice of debt as an anchor by the Committee is guided by economic theory, practical evidence, and equally importantly a noneconomic but powerful argument, particularly relevant in the Indian context: (i) economic theory: standard government solvency constraint suggests debt to be the ultimate objective of fiscal policy, (ii) practical evidence: debt is an important variable in the assessment of credit rating agencies; and 70% of emerging markets use debt in their fiscal framework, and (iii) non-economic argument: debt is a concept embedded in the psyche of the ordinary citizen, and that can be communicated easily to the public.

Ceiling: "Operationally", the concept of a debt anchor translates to a ceiling, to be achieved in the mediumterm. It is a "ceiling" because the Committee believes that the detrimental effects of debt are likely to materialize at relatively high rather than at low levels of debt.

Target: Given that currently India is at levels higher than what the Committee believes is a prudent level,

operationally, the ceiling also translates to a medium-term target to guide fiscal policy. Of course, the operational target in the Committee's framework is fiscal deficit.

Therefore, all the three terms – anchor, ceiling, and target - used in the report have been guided by their conceptual and operational relevance.

(ii) Debt is not currently India's "main" fiscal problem

The choice of debt as an anchor by the Committee was *not* guided by it currently being India's main fiscal problem or not, but by the arguments presented above. That said India does stand out as among the most indebted countries among the relevant peer group of emerging markets, and India's incremental debt to GDP, which equals its overall fiscal deficit, remains one of the highest among emerging markets.

(iii) 60% is not a prudent level for India

The Committee acknowledges the challenges in determining an appropriate level of debt. That is precisely why the Committee did not rely on any single approach. The Committee employed *seven* different approaches to determine an appropriate or prudent debt ceiling for India. Although any single approach may have some limitations, the Committee believes that these approaches **taken together** with cross country evidence and assessment methodology of rating agencies, suggest a prudent ceiling of around 60% of GDP for general government debt in India.

The dissent note does not elucidate any technical limitations of the seven approaches employed in the report. That India grew significantly, even when debt levels were higher than 60% of GDP, or that Europe is reconsidering its debt rules, hardly provides a convincing case against the seven methodologies presented in the report. On the former, the empirical analysis and simulations presented in the report simply suggest that India may have grown even more, had the debt levels been lower. On the latter, the Committee recognizes the thinking in Europe on the subject. Yet, the initial conditions facing India at the current juncture are different, with the framework recommended by the Committee being rooted in India's own experience, against the backdrop of what has worked and not worked in other emerging markets.

(iv) Fiscal deficit as the key operational target

- Inconsistency between debt objective and the key operational target

The annual path of the operational target is determined by a simple identity describing the evolution of debt over time as specified by Equation (2) in Chapter 4, and consistent with reducing debt to below prudent levels. It does not rely on what the debt ratio or fiscal deficit would look like in any "steady state".

- If inflation turns out to be lower than anticipated, the framework would be inconsistent.

This is a valid concern discussed several times within the committee. What happens if the assumptions underlying the framework change (e.g. nominal growth turns out to be higher (lower), e.g. if inflation or real growth is higher (lower) than anticipated), *ceteris paribus*? This scenario is discussed in the introduction, as well as in detail in a separate section with specific examples in Chapter 4 (Section II).

First, it was recognized that the *ceteris paribus* assumption may not be realistic. For example, typically interest rates would also be higher in a growing economy, perhaps due to policy responses, but also due to increased demand for credit. Hence the interest-growth differential [r-g], which matters for debt dynamics, may not be very different as higher values of r and g would go together.

Second, the Monetary Policy Committee and the recent amendments to the RBI Act enjoin the RBI to secure a central target of 4% inflation. Therefore, a priori, the Committee does not wish to assume large deviations from the central target.

Finally, the Committee believes that the key elements of the proposed framework - a medium-term debt ceiling, and a fiscal deficit path consistent with achieving that ceiling - remains essentially unchanged. The recommended framework, however, does allow flexibility to the government to re-calibrate its path of primary deficit depending on shocks or changing assumptions relating to key parameters like nominal GDP growth, or interest rates.

- Basis for choice of the recommended path for the operational target (the so-called "serpentine" path in the dissent note)

Since, there can potentially be several paths for the operational target that would be consistent with reducing debt to prudent levels, the Committee relied on three key pieces of thinking backed by evidence to arrive at its recommended path.

(1) **Thinking in the present FRBM** that explicitly links household financial savings and external borrowings to fiscal deficit. This thinking was applied using recent data on savings, and estimates of a sustainable current account deficit for India, to arrive at an operational target of 2.5% of GDP in the medium-term. This thinking relies on rigorous foundations applied to the Indian context laid out in e.g. Rangarajan and Srivastava (2005). The Committee felt that it may be imprudent to suggest that government can borrow without taking any account whatsoever of the impact of such borrowing on the investment and consumption behavior of firms and households, particularly in a situation where financial savings have been declining in recent years.

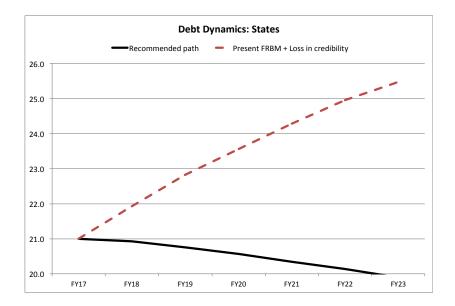
(2) The cost to credibility of deviating from a path of fiscal deficit agreed on by two successive governments – a crucial aspect completely ignored in the dissent note – guided the Committee's recommendation. As discussed in the introduction, and in Chapter 4, a deviation from the fiscal deficit target in the short-term could also lead to a loss in India's credibility among foreign institutional investors (FIIs), which would reduce the demand for Indian government securities, reduce their price, and increase government bond yields. The rise in government bond yields would lead to an increase in interest burden on new debt, and also for the old debt that is re-priced. Given that India is increasingly getting financially integrated with the world economy - with foreign holdings in government and corporate bonds, having increased sharply over the last few years, and the recent decision to allow foreign participation in state government securities – such costs to credibility can be substantial.

In order to make a case for relaxation relative to the agreed path of fiscal deficit, the note argues that "growth remains below potential" (page 9), and "tepid economic activity" (page 10); however, the

Committee did not find the argument in the dissent note convincing enough to justify a deviation from the path committed by two successive governments. The Committee, moreover, felt that dissent note itself is internally inconsistent because, for example, it notes that "standard macroeconomic indicators – growth, are all at the best level they've been in years" (page 8).

(3) India's own experience when it has deviated from a path of fiscal prudence guided the Committee's recommendation. Two key examples are as follows: (a) Unsustainable fiscal deficit in the years preceding the 1991 crisis (b) Post the global financial crisis, when India did not adhere to the envisaged path of fiscal consolidation, were also the years characterized by macroeconomic instability, leading to the "taper tantrum" crisis of 2013.

We would like to highlight three points on the importance of cost to credibility: (1) Small shocks to costs of borrowing can have dramatic effects on debt dynamics. This is particularly true for the states, which face higher borrowing costs than the center, and whose debt dynamics can be explosive if there is a loss in credibility (see below)

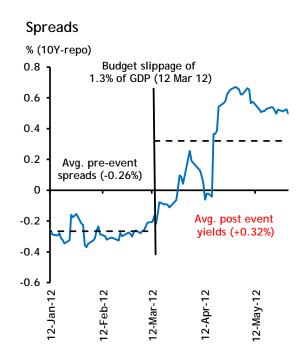


Notes. Nominal GDP is assumed to grow at 11.5%. Based on data from the RBI on weighted average coupon yields on the outstanding stock of market borrowings, we assume an interest rate of 8.5%, and we project it to decline by roughly ten basis points every year in the recommended path. Finally, initial debt to GDP in FY17 is assumed at 21% of GDP. "Present FRBM + Loss in Credibility" assumes 50 basis points higher cost of borrowing.

(2) An increase in G-sec yields would also increase corporate bond yields, which are a "spread" over the 10year Gsec yields; and banks would be dis-incentivized to cut lending rates if the "opportunity cost" for corporates are higher – therefore an increase in government bond yields would also increase private sector borrowing costs, and crowd out investment by the private sector.

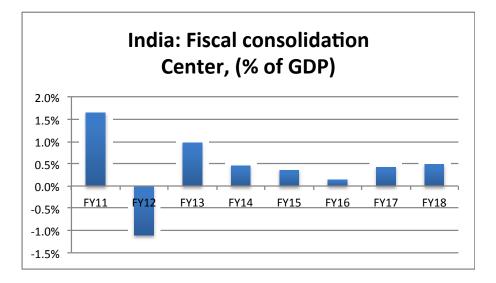
(3) Regression analysis presented in Chapter 4 establishes a significant relationship between government's fiscal deficit and government bond yields. Importantly, there have been instances in the past, when fiscal

slippage has been associated with sharp increase in yields; for example, a 1.3% of GDP slippage in fiscal deficit in March 2012, steepened the yield curve by 60 bps.



(vi) 0.5% of GDP consolidation in fiscal deficit in FY18 is "large", and "disruptive".

The figure below clearly shows that the envisaged consolidation would neither be extraordinarily large, nor disruptive, based on India's past record since the start of this decade, rather it would establish government's continued commitment to a path of fiscal prudence and macroeconomic stabilization.



(v) Path for revenue deficit

As specified clearly in the report, the framework proposed by the Committee entails only two key elements:

(i) a medium-term debt ceiling; and (ii) fiscal deficit as the key operational target with a path consistent with achieving that ceiling.

Given that the Constitution recognizes revenue and fiscal deficits as measures of fiscal prudence (with an overarching focus on debt control), this Committee has given serious consideration to each of these categories in its deliberations. A path for revenue deficit has also been included based on several discussions within the Committee, with policy makers, and with outside experts, who find revenue deficit as a useful goalpost in their day-to-day policy making process. In principle, the Committee believes that borrowings for expenditures that are of a recurrent nature, and that need to be incurred every year, may not be desirable, and should be tax-financed, and therefore agreed to specify a plausible guiding path for revenue deficit. The Committee, however, is also cognizant of the practical difficulties in seperating current and capital expenditures.

The dissent note accepts that there is a "valid reason to focus on the revenue deficit" but then pleads that this is not so in the Indian case.

The first reason given in the note is that there is no reason to favour capital spending over current expenditure, citing India's need to increase spending on health and education as an example.

The Committee, however, believes that it is not prudent to borrow for current expenditure on a permanent basis. The reason for this is that current expenditure on important public services have to be provided for year after year since the services provided by such expenditures in a given year (for example, on a teacher or health worker) are 'exhausted' within the year when this job is done. This does not negate the need to continue employing them in subsequent years. Therefore, such public expenditures are recurrent expenditures and must be financed out of current, i.e. revenue receipts (Roy et.al, pp.57)¹.

In any case, as we have shown at some length in the report, the main heads of central government revenue expenditure are not health and education, and it is not these components that drive the center's revenue deficit; such expenditures are, and will continue to be, the principal responsibility of the states. But the dissent note does not argue in favour of increasing the revenue deficit allowed to states, or even doing away with a revenue deficit path for the states. This obvious misconception, leading to asymmetric treatment in the dissent note, is rather disconcerting.

The second argument is that since future Indian generations will be richer than current ones, it would be optimal to allow some consumption in the present to be financed by running a revenue deficit. But this is exactly what the Indian state has been doing since the 1980s in an abundant manner with the result that, as shown in the report, the revenue deficit has ballooned to $2/3^{rd}$ of the fiscal deficit over the past 36 years. Based on our consultations with stakeholders, the Committee makes the point in the report that this cannot be allowed to continue unabated. Our examination of the history of the FRBM process indicates that there is also a broad consensus on this issue. Hence, it is imperative to specify a revenue deficit path. However, while acknowledging the desirability of the 'golden rule', the Committee has examined the constraints on the central government in its ability to reduce the revenue deficit to zero. For this reason, we have not recommended a zero revenue deficit in the medium-term but rather a continue effort to reduce the revenue deficit so that the revenue deficit/fiscal deficit ratio falls to more reasonable levels.

¹ This issue has been formally discussed in Roy et.al 2009, pp.56-58 in details.

Finally, the argument that the government could simply ignore the revenue deficit path implies a judgment on the credibility of the government which this committee does not share with the author of the dissent note. Over the past 3 years, the present government has indeed managed to reduce the revenue deficit/fiscal deficit ratio and has begun the virtuous task of controlling central government borrowing for consumption. It has sought to limit increases in public sector pay, despite the legacy of a pay commission; it has cut fossilfuel subsidies and also attempted to rationalise and better target central transfers to states. It has made huge efforts to increase the tax/GDP ratio through improvements in tax compliance, so as to reduce the revenue deficit. This committee, therefore, cannot dismiss the credibility of this government as lightheartedly as the author of the dissent note seems to.

Urit Bates

Sumit Bose Member

Urjit R Patel Member

Rathin Roy Member

n.K. Sink N. K. Singh

Chairman

Dated : 19th January, 2017

Place : New Delhi

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