CHAPTER-6

Experience with Rule Based Fiscal Policy- FRBM Act, 2003

Fiscal Responsibility Legislation, if well designed and rightly implemented is considered as a commitment device. It commits the Government through cooperative framework to follow a certain fiscal discipline and ensure that deficits are within tolerant levels so that the tendencies of an individual Government to run excessive deficit is minimized.[1] Fiscal rules could be defined as legislated or constitutional constraints on government deficits, taxes, expenditures or debt. The adoption of fiscal policy rules commits the government to a deficit or debt reduction path into the future thereby enhancing the credibility of the fiscal stance.[2] The introduction of Fiscal Responsibility and Budget Management **(FRBM)** bill in Dec. 2000 with a view to improve the fiscal scenario by reducing the deficit in quantified terms and bring in fiscal discipline marked the beginning of rule based fiscal policy in India .

6.1 Background

In the first half of the 1990s, during the period 1991 to 1997 there was significant reduction in the magnitude of fiscal deficit and the proportion of debt relative to GDP, as a result of the concerted efforts to restore fiscal balance through tax reforms, expenditure management, institutional reforms and financial sector reforms. However, during the subsequent period from 1997 to 2003, there was a reversal in the trend of fiscal consolidation, and the cumulative impact of industrial slowdown, fifth pay commission award, and a lower than

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1 Alok Vishwa Nath. *Does Fiscal responsibility legislation undermine Federalism?* Emerging Issues in Fiscal Federalism, Viva Books, Private Ltd, New Delhi.

2 Kopits, George, Fiscal Rules: Useful Policy Framework or Unnecessary Ornament? *Fiscal Rules, Public Finance Workshop,* Banca D'Italia, 2001.

expected revenue buoyancy culminated in fiscal deterioration. This deterioration in the Indian fiscal position happened at an inopportune time when there was fiscal improvement the world over and India was trying to globalize.

In view of the deteriorating fiscal situation **of the** country in the late nineties, extensive debates went on over the need for fiscal transparency and fiscal responsibility and concerned over the weakening fiscal situation, the Government of India set up a committee in January, 2000, headed by Dr. E.A.S. Sarma to recommend a draft legislation on fiscal responsibility. The committee submitted its report in July 2000.

The need for improvement in budgetary practices was also underscored by the Ahluwalia Committee Report (2001) that recommended that the budget should provide forecasts of key fiscal magnitudes not only for the budget year but also for the two subsequent years and must indicate how the annual budget fits in with the government's long term deficit and debt targets.[3]

It was in this background that **Fiscal Responsibility And Budget Management (FRBM) bill was introduced in parliament in Dec. 2000.** The FRBM bill was referred to parliamentary standing committee for recommendations and after a series of extensive discussions, analysis and deliberations, their recommendations were incorporated and the bill was passed. It received the President's assent in August the same year and was enacted on August 23, 2003. Subsequently, the government notified the FRBM Rules in July 2004 which came into force from July 5, 2004.

The enactment of the FRBM Act, 2003 constitutes a landmark in the history of budgetary operations in India, whereby for the first time the government ushered in an era of fiscal consolidation based on fiscal policy rules, thus aiming to bring fiscal discipline in the management of finances of the country.

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3 Venktiramanan, S., Whither Fiscal Transparency, *Business Line*, Aug. 27, 2001

6.2 Provisions of the Act and Targets

The Act embodies the spirit of inter-generational equity and provides for long term macroeconomic stability by achieving sufficient revenue surplus and removing the fiscal constraints on the conduct of monetary policy and debt management. This is sought to be achieved through limits on deficits, borrowings and debt of the Central Government over the medium term while increasing transparency of fiscal operations.

It also stipulates appropriate measures by the Central Government to reduce the fiscal deficit and eliminate revenue deficit by March 31, 2008 and thereafter build up adequate revenue surplus (The Union Budget for 2004-05 proposed to eliminate the revenue deficit by 2008-09). These deficits could, however, exceed the targets on grounds of national security, natural calamity or other exceptional circumstances. In addition to stipulating ceilings on fiscal indicators, the legislation laid down fiscal management principles combining fiscal transparency, budget integrity and accountability. The main obligations of the Centre under the FRBMA 2003 and FRBM Rules 2004, as amended through the Finance Act, 2004 are as follows:-

i) Eliminating **revenue deficit** by 2008-09 by ensuring a minimum annual reduction of 0.5 per cent of GDP every year from 2004-05. It is pertinent to point out here that the original FRBM Bill had proposed that the revenue deficit would be eliminated by 2005-06. However, the Act, as passed by Parliament, modified this to 2007-08. On 8 July 2004, the Finance Minister announced that an amendment to the FRBM Act would be proposed to Parliament, which would further amend this date to 2008-09. In 2004, the target was shifted to March 2009 by an amendment of the Act.

ii) Reducing **fiscal deficit** by at least 0.3 percent of GDP annually from 2004-05, so that fiscal deficit is reduced to no more than 3 per cent of GDP at the end of 2008-09.

iii) Limiting government guarantees to 0.5 per cent of GDP in any financial year and limiting additional liabilities to 9 per cent of GDP in 2004-05 and thereafter reducing the limit of 9 per cent by one percentage point of GDP in each subsequent year.

iv) Central Government not to borrow from the Reserve Bank of India from 2006-07.

v) Disclosing specified information, such as arrears of revenue, government assets and guarantees, latest from 2006-07.

vi) Undertaking quarterly review of receipts and expenditure.

Under the Act , the Central Government is required to fix annual targets indicating the path of adjustment, and required policy measures, so as to eliminate the revenue deficit. Further, the act envisages that three reports mentioned below, as per the details given against each be placed before houses of Parliament every financial year:

i) Macroeconomic Framework Statement - the underlying assessment of growth prospects, and the underlying assumptions. It defines the macroeconomic backdrop under which the fiscal policies and projections are being made.

ii) Fiscal Policy Strategy Statement - specifying the policy measures pertaining to taxation, expenditure, subsidies, administered prices and borrowing.

iii) Medium-term Fiscal Policy Statement - specifying three-year rolling targets for prescribed fiscal indicators, and the underlying assumptions.

The FRBM Act envisaged that the Finance Minister should conduct quarterly reviews of receipts and expenditure, and place the outcome of these reviews before Parliament. In case of deviations from the FRBM Act obligations, he is supposed to make a statement in Parliament, explaining the reasons for the deviations and remedial measures that are proposed to be taken in order to overcome these.

6.3 Impact of FRBM Act 2003 on Fiscal Indicators

A review of the fiscal situation reached between the period 2003-04 and 2007-08 reveals that all fiscal indicators, after registering an improvement in the years following the enactment of the FRBMA, have witnessed sharp deterioration in 2008-09 and 2009-10. The table 6.1 and Figure 6.1 present a profile of the fiscal indicators of the Central Government from 2003-04 onwards.

The **revenue deficit** of the Centre declined by 2.5 percent of GDP from 3.6 percent in 2003-04 to 1.1 per cent of GDP in 2007-08, touching its lowest level since 1990-91. Most of this decline came from an improvement in tax revenues and a marginal decline in revenue expenditure of the Centre on account of the decline in interest payments following softer interest rates. In 2008-09, there was a total reversal of fiscal correction with the revenue deficit reaching a level of 4.4 per cent of GDP. The Union Budget for 2009-10, which was formulated against the backdrop of the global downturn and low domestic demand, envisaged a revenue deficit of 4.6 per cent of GDP.

The **fiscal deficit** of the Centre declined significantly from 4.5 per cent of GDP in 2003-04 to 2.6 per cent in 2007-08, the lowest since 1990-91. The fiscal correction at the Centre was largely on account of revenue augmentation and partly on account of capital expenditure compression.

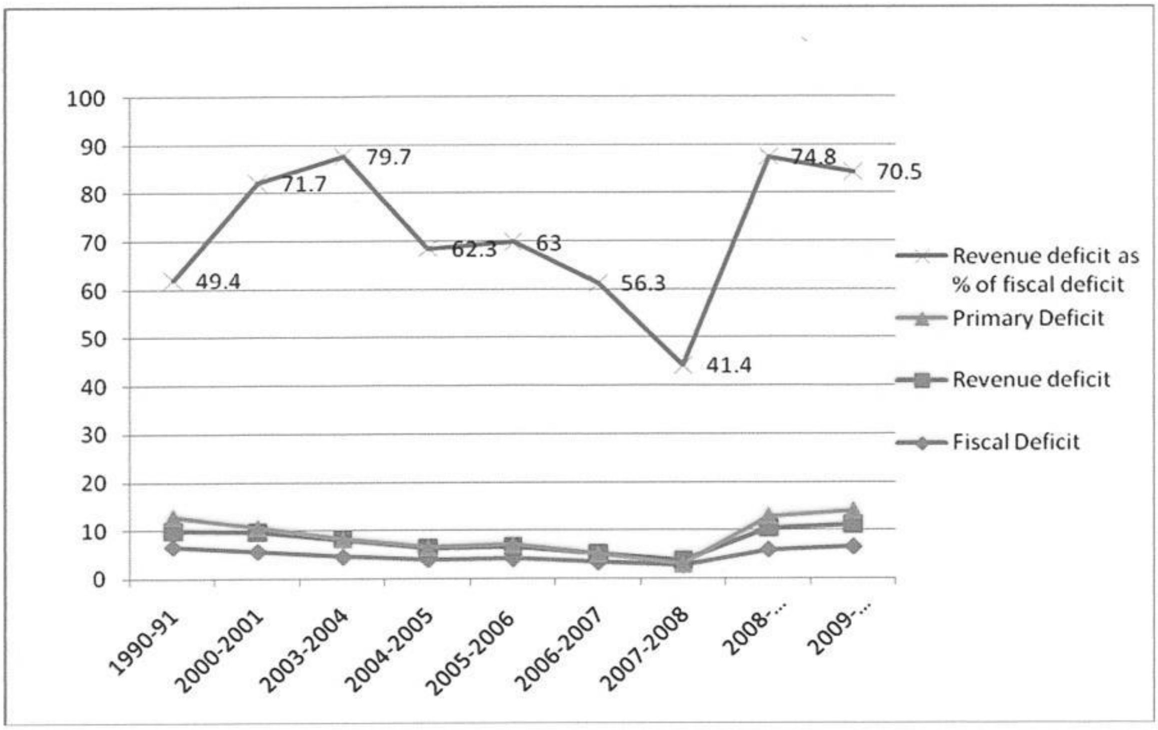

Figure 6.1

However, there was a reversal of the declining trend in 2008-09, with the fiscal deficit rising to 5.9 per cent of GDP during 2008-09(RE) and 6.5 per cent of GDP for 2009-10(BE). [4]

The **primary deficit** which turned into a marginal surplus in 2003-04 continued to remain in surplus till 2007-08 with the exception of 2005-06. The year 2008-09 witnessed a sharp increase in primary deficit to 2.5 per cent of GDP, the highest in the post -reforms period.

The **ratio of revenue deficit to fiscal deficit**, which indicates the quality of expenditure, also declined from nearly 80 per cent in 2003-04 to 41.42 per cent

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4 The fiscal deficit figures presented in the Table 6.1 do not take into account the off-budget bonds issued to the oil marketing and fertiliser companies amounting to Rs. 95,942 crore or 1.8 per cent of GDP in 2008-09.

The **ratio of revenue deficit to fiscal deficit**, which indicates the quality of expenditure, also declined from nearly 80 per cent in 2003-04 to 41.42 per cent by 2007-08, but went back to nearly 74 per cent in 2008-09 (RE). The trends in fiscal deficit were mirrored in the rising public debt levels.

In accordance with the Rules framed under the FRBM Act, the Government presented the Medium term Fiscal Policy Statement, the Fiscal Policy Strategy Statement and the Macroeconomic Framework Statement along with the Annual Financial Statement for 2004-05.

The reversal of fiscal correction in 2008-09 was largely on account of expenditure on a sequence of financial stimulus measures taken by the government to counteract the impact of the global slowdown on the Indian economy, but the outgo on account of implementation of the recommendations of the Sixth Central Pay Commission (CPC) by the Centre, farm debt waiver and additional provision of funds for food and fertiliser subsidies also added substantially to the fiscal burden and subsequent deterioration in fiscal indicators observed in 2008-09. These additional commitments, though not a part of the stimulus, have, served as fiscal stimulus to the economy, but at the same time collectively, meant a 'break' in the implementation of the FRBMA by the Centre. The Economic Advisory Council (EAC) to the Prime Minister, in its Economic Outlook for 2009/10, has placed the deficit on account of reduction in tax revenue due to economic slowdown as well as the tax cuts in excise and service taxes effected as part of the fiscal stimulus at about 1 per cent of GDP[5].

To sum up , the fiscal deterioration in India manifested in the eight year period from 1996-97 to 2004-05, when the liabilities /GDP ratio deteriorated badly. The fiscal correction path, following the enactment of FRBMA, was more or less on track till 2007-08, after a pause in 2005-06.

[5] Report of the Thirteenth Finance Commission(2009)

The targets laid out by the government's FRBM Act were to be achieved by 2008–2009 against which the same were largely achieved in 2007–2008, (except for the central government's revenue deficit target). However, the slowdown of the economy and its adverse impact on revenue growth, anti-recessionary measures, and additional expenditure commitments on farm loan waiver and implementation of the recommendations of the Sixth CPC, resulted in worsening, going beyond the reversal of the fiscal correction achieved till 2007-08.

The rapid fiscal consolidation achieved in the post-FRBMA period upto 2007-08 was indeed an important achievement that allowed greater fiscal room for a macro-economic policy stand to offset the impact of global economic crisis. The higher tax revenues and expenditure compression achieved by the use of both tax and expenditure measures in the expansionary fiscal policies contributed to the reductions in fiscal deficit as a proportion of the GDP in the period 2003-04 to 2007-08.

The Thirteenth Finance Commission was assigned the mandate to suggest a suitable roadmap factoring in the need to bring the liabilities of the Central Government on account of oil, food and fertiliser bonds into fiscal accounting as well as the impact of various other obligations on deficit targets with a view to maintaining the gains of fiscal consolidation through 2010-15.

The Finance Minister in the Medium Term Fiscal Policy Statement presented on 28th Feb 2011 to the House, announced "additional resources of about`50,000 crore have been provided to critical infrastructure and social sectors and also to meet the expenditure on subsidies. The Fiscal deficit has been reduced to 5.1 per cent of the GDP for 2010-11 and kept at 4.6 per cent of GDP for 2011-12, which improves upon target set earlier for 2011-12 indicated in the fiscal road map presented in the last Budget. The rolling targets for fiscal deficit are placed at 4.1 per cent for 2012-13, and 3.5 per cent for 2013-14.

For 2010-11 as against a target of 4 per cent, the revenue deficit is estimated at 3.4 per cent of GDP. The fiscal deficit of 4.6 per cent of GDP in 2011-12 works out to`4,12,817 crore. Taking into account the various other financing items for fiscal deficit, the net market borrowing of the Government in 2011-12 would be`3.43 lakh crore. In addition, `15,000 crore is proposed to be financed through Treasury Bills. Accordingly, the Central Government debt as a proportion of GDP is estimated at 44.2 per cent for 2011-12 as against 52.5 percent recommended by the Thirteenth Finance Commission."

It is thus expected that the country will revert to the FRBM path of fiscal correction, soon .