

CHAPTER-5

FRBM Act - The Rationale

5.1 The debate about fiscal responsibility and the need to enact a law to limit the borrowing power of the executive in India is older than independent India. Even the Constituent Assembly discussed the need to fix limits to borrowing by Parliament. Dr. B. R. Ambedkar said during the debate on this subject in the Constituent Assembly, *"This Article specifically says that the borrowing power of the executive shall be subject to such limitations as the Parliament may by law prescribe. If Parliament does not make such 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..... I go further to say that I not only hope but I expect that Parliament will discharge its duties under this article."*

5.2 The essence of the Constituent Assembly debate on the subject can be summarized as follows:

- There should not be any borrowings without the approval of Parliament
- In each case, the purpose of borrowing should be clearly specified
- There should be build-in underlying safeguard for borrowing
- The Government should introduce prudent practices of borrowing policy

5.3 The debate of the Constituent Assembly finally got translated into Article 292 of the Constitution, which states that the executive power of the Union should extend to borrowing upon the security of the CFI 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. The Constitution, thus, envisaged that at an appropriate time the parliament of the day would fix up limits by law on borrowing by the Government, thereby limiting the size of Government debt and consequently limiting the size of budgetary deficit. Article 292 notwithstanding, Indian Union did not initiate any action towards passage of such an Act limiting the size of Government borrowing till as late as the year 2003 i.e a good 53 years after the adoption of the Constitution.

5.4 The need to adopt fiscal discipline and to limit the size of Government borrowing was felt time and again, but the debate became particularly sharp following the 1990-91 crisis, which prompted Government of India to adopt, what are commonly known as the first generation economic reforms. However, FRBM Act had to wait till the second generation economic reforms became a reality in India. While the Indian Government was still debating on the prudence of adopting fiscal responsibility legislation, the world had witnessed substantial action on this front. Countries across continents were adopting explicit fiscal restraint policies often

embedded in legislation. The following paragraphs give a brief record of the journey of fiscal responsibility laws and rules across the continents.

The International Experience

5.5 A number of countries have experimented with medium -term fiscal adjustments for making a credible reduction in fiscal deficit and debt-GDP ratio, often backed by rule based fiscal policy framework. The rules have varied from constitutional and legal arrangements within the countries to agreements between countries (in case of European Union). The countries which have adopted rule based fiscal policies, can be grouped into three major categories depending on the specific rules(s) followed by them. These are; (a) countries following formal deficit rules, (b) countries which are following expenditure limits and fiscal rules and (c) countries following transparency based rules.

5.6 The main examples of countries following the formal deficit and debt rules are the countries of the euro area which are bound by the Maastricht Treaty and subsequent Stability and Growth Pact of 3% of GDP as deficit; and the United Kingdom, which adopted since 1997 the golden rule which requires that the government borrows only to finance investment.

5.7 Other countries like Sweden and United States, as well as Finland and Netherlands in the euro area, have put more emphasis on expenditure limits, supported by procedural requirements, whereby proposals resulting in overruns in certain areas must be accompanied by cuts elsewhere or by revenue increases. Canada has focused on instituting a rigorous expenditure review process. New Zealand pioneered an approach to fiscal management that places primary and explicit emphasis on transparency and Australia and United Kingdom have since adopted similar approaches.

5.8 In case of the **European Union, the Maastricht Treaty (1992)** is a well known institutional arrangement which set out convergence criteria for those seeking to participate in Economic and Monetary Union (EMU). The Treaty lays down two separate rule-based criteria to judge fiscal discipline of a member country: one based on the flow of debt during a year, i.e, the public deficit representing net borrowing of the general government, and the other based on the debt stock representing the gross debt at nominal value outstanding at the end of every financial year. Under the treaty, a member country is required to achieve general government deficit not in excess of 3% of GDP and gross debt not in excess of 60 percent of GDP. The **Stability and Growth Pact (SGP)** further strengthened binding of Maastricht Treaty provisions.

5.9 In the USA, deficit controls were introduced through the **Balanced Budget and Emergency Deficit Control Act (Gramm-Rudman-Holling Legislation)** of

1985. This Act imposed an annual deficit reduction for a five year period with a balance budget (zero deficits) target set for 1991 for the federal Government, which was later revised to be achieved by 1993. The deficit targets of the 1985 Gramm-Rudman-Holling Act was replaced by the **Budget Enforcement Act (BEA)** of 1990 which shifted focus from deficit target to revenue and expenditure controls. Under the BEA the discretionary spending categories were defined and capped in nominal terms. The BEA applied to fiscal years 1990 to 1995 was extended to 1998 by the Omnibus Budget Reconciliation Act of 1993 and further extended through 2002 by the Balanced Budget Act of 1997.

5.10 The New Zealand Parliament enacted the **Fiscal responsibility Act** in June 1994 (FRA) to promote consistent and good quality fiscal management. The Act provides the legislative framework for the conduct of fiscal policy in the country and requires the Government to follow a legislated set of principles of responsible fiscal management. It also requires the Government to publish a 'Budget Policy Statement', fully disclose the impact of their fiscal decisions over a three year forecasting period and present all financial information under generally acceptable accounting practices (GAAP).

5.11 In Australia, the **Charter for Budget Honesty** enacted in 1998 provides the institutional framework for the conduct of government fiscal policy. The charter provides for fiscal strategy to be based on principles of sound fiscal management. The government's original debt target was to reduce the commonwealth general

government net debt to GDP ratio to half of its 1995-96 level by the turn of the century. Under the current fiscal strategy, the primary objective is to achieve fiscal balance on an average over the economic cycle.

5.12 The **United Kingdom** introduced in 1997 two fiscal rules that apply over a cycle; the **golden rule** which stipulates that borrowings should be used only to finance investment and second, the **sustainability rule** under which public sector net debt is to be held at a stable and prudent level. A complimentary code of fiscal transparency was added in 1998.

5.13 In **Canada**, since 1993, the federal budget has been based on three key elements; a two year planning horizon based on systematically prudent macroeconomic assumptions and *ex ante* balanced budget targets; the inclusion of an annual contingency reserve; and a commitment to use of latter, when it is not needed, to pay down public debt. The government's Budget Plan 2000 included commitments to maintaining balanced budgets in 2000-01 and 2001-02 and to keeping the debt-GDP ratio on a permanent downwards path.

5.14 In **Sweden**, the **State Budget Act 1996** sets a ceiling for total Central expenditure consistent with a surplus of 2% of GDP on average over the cycle for the coming budget year and the following two years. Indicative nominal funding levels were set for each expenditure area, together with a "budget margin" to provide a buffer against forecasting errors.

5.15 The Fiscal Responsibility law 1999 of Argentina, which was modified in December 2000, set a ceiling for the deficit and required that it should decline so that a balance is achieved in 2005.

5.16 The Fiscal Responsibility Law 2000 of Brazil prohibited financial support operations among different levels of Governments, set out limits on personnel expenditure, and required that limits be set on the indebtedness of each level of Government.

5.17 In Peru, the Fiscal Transparency Law 1999 set limits on deficit and growth of government expenditure. It also established a fiscal stabilization fund to ensure that fiscal savings in a good year are used during recessions and contained measures to encourage transparency.

5.18 Japan initiated fiscal rules way back in 1947 mainly to prescribe limit on issuance of bonds to raise funds for financing of public works. Later, the Fiscal Structural law of 1997 was legislated in Japan with the objective of effecting fiscal tightening. This legislation prescribed that the sum of Central and Local Governments as a percentage of GDP be reduced to 3% of GDP or less by the fiscal year 2003 from around 6% in the year 1997.

Adoption of fiscal responsibility legislation in India

5.19 Meanwhile, in India, the growing fiscal crisis post 1990-91 which was enveloping both the centre and the states was calling for a decisive action. It became increasingly clear that the growing fiscal stress and the resultant debt service was crowding out government's other expenditure and restricting capital investment by Government. The possibility that this may eventually lead to yet another Balance of Payment crisis was fast becoming a reality. The Government feared that its growing debt liabilities may set into motion inflationary forces impairing investor's confidence. The question of intergenerational equity could also no longer be ignored as by the year 2000, out of every 3 rupees spent by the centre, about 2 rupees come from Government's own resources and about 1 rupee came from borrowed funds thereby implying that incidence of two-third of Govt. expenditure fell on the present generation and one-third on the next generation. There was, thus, a felt need for Government to commit itself to a policy of fiscal responsibility through enactment of a law as envisaged under Article 292 of the Constitution.

5.20 Following were some of the persistent indicators of systemic lacunae which finally compelled the union Government to enact the legislation embedded in Article 292 of our Constitution:

- Persistent fiscal deficit
- Unabated revenue deficit

- Revenue deficit was more than half of fiscal deficit
- Growing public debt
- Increasing debt servicing burden
- Borrowing for unproductive purposes
- Unsustainable levels of subsidies
- Nearly 90 % of Govt. Budget was being consumed by committed liabilities
- Salaries and pensions claimed nearly one-fourth of centre's revenue receipts
- Interest payments took away nearly 50% of revenue receipts

5.21 Broadly speaking fiscal responsibility means management of Government finances in such a manner that the fiscal situation becomes sustainable and conducive to macro-economic stability and economic growth. The FRBM Bill defined Fiscal responsibility as "responsibility of the Government to ensure inter-generational equity in fiscal management and long-term macro-economic stability by achieving sufficient revenue surplus and removing fiscal impediments'.

5.22 FRBM Bill was introduced in the Parliament, in December 2000, towards fulfillment of a promise made by the then Finance Minister in his Budget Speech to put in place a mechanism to promote overall fiscal prudence and remove impediments to the effective conduct of monetary policy and debt management.

5.23 To build consensus on the issues contained in the Bill and honouring the accepted best parliamentary practice in this regard the Bill was referred to the

Standing Committee on Finance for detailed examination and report thereon. The committee deliberated upon the various provisions of the Bill and after recording evidence of the officers of Ministry of Finance, Reserve Bank of India, Non- Official Experts etc., placed its recommendations on the Table of the Lok Sabha in November 2001. The main recommendations of the Standing Committee were as follows:

- Ceilings relating to fiscal deficit, guarantees, liabilities etc. included in the FRBM Bill should not be specified in the Act
- The Bill should be modified to allow greater flexibility to Govt. regarding adherence to the various provisions.
- The Bill should be suitably modified to ensure that economic decision making does not become subject matter of judicial scrutiny.

5.24 Most of the recommendations of the Standing Committee were accepted by the Government and all fiscal targets except the one relating to elimination of revenue deficit in a time bound manner were shifted from the Act itself to the Rules framed thereunder. The provisions relating to circumstances allowing Government to deviate from the FRBM targets were relaxed and a special clause was added to limit judicial intervention in economic decision making of the Government.

5.25 The amended Bill was deliberated upon and approved by Parliament in May 2003. The Bill, which had the support of the majority of the members cutting across party lines, got the Presidential assent on August 26, 2003 and became an Act.

Various Provisions of the FRBM Act

5.26 The world noted with mild surprise the initiation of such a step by the Government of India since the Act was prompted, neither by the possibility of an anticipated fiscal disaster nor in response to pressure from international creditors, as is the case in many developing economies which have enacted fiscal responsibility legislations. In India, it was seen by majority as a part of the on- going fiscal reform programme and had been enacted at a point in time when the major economic parameters were sound and the economy was experiencing high growth rate, next only to China.

5.27 The rationale behind the FRBM Act was best described by the Finance Minister at a seminar on follow up on the FRBM Act in 2004 when he stated that,

“Every generation owes a responsibility to succeeding generations that we do not leave behind a burden of debt. Secondly, it is a responsibility of every government to conduct its affairs in such a manner that it does not damage the prospects of sustainable economic growth. These are, in my view, unalterable objectives. In the past, we have ignored these objectives and, we have done so at our own peril. Because the Government of India had the power to borrow, and in the past it believed

that it had an infinite capacity to borrow, it borrowed heavily. We paid a heavy price for that. We crowded out investment, interest rates soured and the bulk of government's expenditure became inelastic and, there was little room for development expenditure. Our borrowing spree reached a point where there was no one to lend money to us and we had to pledge our gold in order to meet immediate external and internal obligations. The first lesson that we must all observe is that even the Government of India must observe severe limits towards borrowing. Just because it has the power to borrow it cannot borrow in order to spend its way to what it believes is prosperity".

5.28 The FRBM Act, 2003 and the Rules (effective July 5, 2004) notified thereunder by the Government together mandated certain obligations for the Government of India, which were expected to take the existing fiscal consolidation and reforms program to its logical culmination with inter-generational equity, long-term macro-economic stability and transparency in institutional arrangements and fiscal reporting as its hallmark.

5.29 Under the FRBM Act, the Central Government was obliged to take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by 31st March 2008 and thereafter build up adequate revenue surplus. This deadline was shifted to 31st March 2009 through an amendment to the Act. This single most important target, determined the course of budgets for the next few years.

5.30 The inter-year targets relating to annual reduction in revenue deficit as well as fiscal deficit, which were a part of the FRBM Bill, do not find place in the FRBM Act in view of recommendations of the Standing Committee on Finance. These inter-year targets along with caps on contingent liabilities and the total liabilities of the Government etc. are enlisted in the FRBM Rules.

5.31 The FRBM Act also mandated that the Central Government shall not borrow from the Reserve Bank after 31st March 2006, which implies that the Reserve Bank was not be permitted to subscribe to the primary issues of the Central Government securities from the financial year beginning April 1st 2006. The RBI could, however, operate at the secondary market, if it so desired. This condition does not apply to any advances made by RBI to Government of India to meet temporary excess cash disbursements over cash receipts in any financial year, which are repayable within the same financial year.

5.32 The FRBM Act provides that there are certain conditions under which the aforementioned targets may not be met. This implies that the revenue deficit and fiscal deficit may exceed the targets and the Government may be allowed to borrow directly from the Reserve Bank of India even beyond the year 2006 on grounds of National Security, National Calamity or such other exceptional grounds as the Central Government may specify. But these grounds were required to be placed by the Government before the Parliament. It may not be out of place to mention that the

words "Such Other Exceptional Circumstances as the Central Government may specify" were not a part of the FRBM Bill but were added in the FRBM Act based on a recommendation of the Standing Committee.

5.33 The FRBM Act also stated that the Central Government shall by rules, made by it, specify the annual targets for reduction of fiscal deficit and revenue deficit during the period beginning with the commencement of the Act and ending on 31st March 2008. It also mandated specification of the annual targets of assuming contingent liabilities in the form of guarantees and the total liabilities as a percentage of the Gross Domestic Product under the FRBM Rules.

5.34 The preamble of the FRBM Act, *inter alia*, states that the Government shall conduct its fiscal policy in a medium term framework and move towards greater transparency in its fiscal operations. With a view to move the mindset of the Government from annual targeting to medium term framework of budgeting, the FRBM Act provides that the Government shall lay before both Houses of Parliament, along with the Annual Financial Statement and Demands for Grants, the medium term fiscal policy statement, the fiscal policy strategy statement and the macro-economic framework statement. The FRBM Act also provides that the Government shall ensure greater transparency in fiscal operations and make such disclosures and in such form as may be prescribed and shall place before Parliament every quarter the trend of receipts and expenditure.

FRBM Rules

5.35 Many of the provisions of the FRBM Act have been quantified and made more explicit in the FRBM Rules, which came into effect from July 2004. These are some of the **annual targets** that the FRBM Rules lay down with regard to important fiscal parameters.

- Reduction of revenue deficit by at least 0.5 percent of GDP from 2004-05
- Reduction of fiscal deficit by at least 0.3 percent of GDP from 2004-05 so as not to exceed 3 percent of GDP by 2008
- Guarantees given in a year not to exceed 0.5 percent of GDP
- Additional liabilities assumed not to exceed 9 percent of GDP in 2004-05 and to reduce progressively by atleast one percent of GDP each year thereafter

5.36 The FRBM Rules make it obligatory for the Government to make disclosure about the following at the time of presenting annual financial statement and the Demands for Grants.

- Significant changes in accounting standards, policies, and practices
- Statement of receivables and guarantees
- Statement of assets and liabilities

5.37 The forms of disclosure which include disclosure about tax revenues raised but not realized arrears of non-tax revenue, guarantees given by the Government and the Assets Register to be maintained by the Government have been specified in the FRBM Rules.

5.38 The FRBM Rules also specify the form in which the three strategy statements and the quarterly statement of receipts and expenditure are to be presented to the Parliament by the Government. Of these, the most significant is the format of the medium term fiscal policy statement which according to the FRBM Rules must indicate the three year rolling target in respect of:

- Revenue Deficit as a percentage of GDP
- Fiscal Deficit as a percentage of GDP
- Tax Revenue as a percentage of GDP and
- Total Outstanding Liabilities as a percentage of GDP

5.39 In order to strengthen the compliance mechanism, the FRBM Rules require that the Finance Minister shall make a Statement in both Houses of Parliament during the session immediately following the end of the second quarter, detailing the corrective measures taken, the manner in which any supplementary demands for grants are proposed to be financed and the prospects for the fiscal deficit for that financial year in case the quarterly statement of receipts pertaining to the second quarter show that the:

- Total non-debt receipts are less than 40 percent of budget estimates

- The fiscal deficit is higher than 45 percent of budget estimates
- The revenue deficit is higher than 45 percent of budget estimates

Reactions to FRBM Act

5.40 Enactment of the FRBM Act was seen by a majority of people as a historical step in the process of fiscal consolidation and reform programme meant to ensure intergenerational equity, long-term macro economic stability and growth for India. This Act was also welcomed by many as it was expected to bring about transparency in institutional arrangements and fiscal reporting. Nevertheless, there were serious detractors. Politicians and thinkers of the left ideology, particularly, doubted the efficacy of the Act as well as intention of the Government. The opposition to the Act is best captured in Ms. Jayati Ghosh's words, who wrote,

"Clearly, therefore, this (FRBM ACT) is not just a foolish piece of legislation but also fundamentally undemocratic and possibly even unconstitutional. The new government should without delay reconsider this Act, with a view to repealing it, if it is to remain responsive and accountable to its citizenry, rather than following the dictates of the highly dubious economic logic favoured by international investors."

5.41 Then, there were others who felt that the FRBM Act was just a paper tiger. They felt that the provisions of the FRBM were seriously diluted to get it passed

through the Parliament. Shifting of targets from the Act to the Rules was seen by many as an act of compromise resulting in the Legislation becoming ineffective. Critiques like Ajit Karnik wrote (Economic and Political Weekly 19th January 2002) that the Government is seen to be completely diluting the provisions of the bill so as to render it completely ineffective. The Government, in defence, stated that there was no serious dilution of the provisions as the target of elimination of revenue deficit in a time bound fashion remained very much a part of the Act and that most other targets relating to fiscal deficit, total liabilities, government borrowing etc followed therefrom. In an unstructured interview, a senior official of the Ministry of Finance, who was Additional Secretary (Budget) at the time of passage of the FRBM Bill, clarified that when confronted with the choice of abandoning the FRBM Bill altogether or getting the modified Bill approved by the Parliament the executive chose the latter. It was a wise choice as law making is the prerogative of the Parliament and their will and desires must be kept in mind in framing of any legislation as at the end of the day they are the representatives of the people. He further added that despite the amendments the FRBM Act remained intrinsically unchanged and was strong enough to bring about tremendous discipline in fiscal decision making in Government of India.

Other Related Developments

5.42 Two important developments which took place following the enactment of the FRBM Act and merit mention are the setting up of a Task Force by the Government to draw up a road map for implementation of the Act and the recommendations of the XII Finance Commission regarding enactment of fiscal responsibility legislation at state level.

5.43 A task Force was set up under the chairmanship of the then adviser to the Finance Minister, Dr. Kelkar to set the road map for implementation of the FRBM Act. In its Report, the Task Force, recommended *inter-alia* that the fiscal correction under the FRBM Act should be front loaded and revenue-led. On the expenditure side, the task force admitted that in a growing nation like India, reduction in Government expenditure is not an option. They, therefore, advocated that efforts be made by the Government to improve the quality of its expenditure so as to get maximum value for money. They also advocated increase in capital expenditure so as aid asset building and infrastructure development. The recommendations on the expenditure side included debate on the following aspects of public expenditure:

I. Public goods versus subsidies

A greater portion of expenditure needs to be devoted to legitimate public goods, as opposed to transfers and subsidies. The plan versus non-plan or the capital versus revenue classifications need to be re-examined in this light.

II. Central versus local public goods

In the spirit of the 74th amendment, resources that are used for the production of local public goods, such as water, sanitation, and primary education, should be transferred to Panchayati Raj institutions, who have better *incentives* to spend effectively, and have better *knowledge* about local preferences, local problems, and alternative production technologies.

III. Focus on public goods outcomes

The public finance system in India has traditionally focused on *expenditure*. There is a need for a greater focus on public goods *outcomes*.

IV. Improvements in institutional mechanisms

The *provision* of public goods can often be achieved more effectively through the use of the private sector in production. The role of public-private partnerships needs to be extended into a broader range of public goods.

5.44 As decreasing public expenditure was seen by the Kelkar Committee as an unviable option, their emphasis was on revenue led fiscal correction. The Task Force Report, thus, listed out several tax reforms, which they felt were the pre-condition for successful implementation of the Act. They recommended the following:

- Widening the tax base
- Few rates – low rates
- Enhancing equity of tax system
- Shift to non-distortionary consumption taxes
- Enhance the neutrality between present consumption and future consumption
- Enhancing neutrality of tax system to the form of the organization
- Enhancing the neutrality of the tax system to source of finance
- Establish an effective and efficient compliance system
- Focus on buoyancy rather than immediate sources of revenue

5.45 Reflection of recommendations of the Task Force could clearly be seen in the tax reform measures introduced by the Finance Minister in Budget 2005-06.

5.46 Given the federal set up, it is neither possible nor desirable for the Union Government to force any state Government to adopt a particular fiscal reform. Thus, despite the fact that most of the state government were facing the same fiscal problems as the Centre, in many cases much more acutely, it was not possible for the centre to force them to adopt the FRBM Act. A major initiative in this direction was

taken by the Reserve Bank of India (RBI). A special group was set up at the initiative of the RBI to formulate model Fiscal responsibility legislation for the state Governments. This special group had representatives from the State Government, the RBI and the Union Government. Another major impetus towards accelerating the pace of the fiscal reform programme at the state level came in the form of recommendations of the Twelfth Finance Commission.

5.47 The Commission recommended that each State should enact fiscal responsibility legislation. This legislation should, at a minimum, provide for

- (a) eliminating revenue deficit by 2008-09;
- (b) reducing fiscal deficit to 3 per cent of GSDP or its equivalent defined as ratio of interest payment to revenue receipts;
- (c) bringing out annual reduction targets of revenue and fiscal deficits;
- (d) bringing out annual statement giving prospects for the state economy and related fiscal strategy;
- (e) bringing out special statements along with the budget giving in detail number of employees in government, public sector, and aided institutions and related salaries.

5.48 The Commission also recommended that any state complying with its directions in this regard would become eligible for debt relief comprising consolidation, rescheduling and lowering of interest rates etc. Further, a fund called the 'Medium Term Fiscal Reform Facility Fund' was carved out of the grants-in-aid to incentivise the states to follow the path of fiscal rectitude recommended by the

Twelfth Finance Commission. Result of the combined efforts of the RBI, Union Government and the twelfth Finance Commission was that by 2008, 26 states had enacted their Fiscal Responsibility legislation.

5.49 This study has limited itself to examination of the process of budgetary reforms and fiscal responsibility at the Union level, the study of rationale and impact of state Fiscal responsibility legislations is, therefore outside its purview. We shall, therefore, restrict our analysis to the developments that have taken place at the level of the Union Government in this area i.e we shall be concerned only with the FRBM Act 2003.