



## FRBM ACT, 2003 AND FISCAL CONSOLIDATION IN INDIA A STATE LEVEL STUDY

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### ABSTRACTS

The present paper discusses the fiscal consolidation process under the FRBM/FRLs Acts at the State level. It finds that up to 2007-08, under the rule based framework, State Government was capable to recover from the severe fiscal stress experienced during mid/late nineties and early phase of present decade. The high growth rate leading to improved revenue buoyancy and growth dividend played a significant role in the improvement of deficit indicators. At the same time, the paper also describe that despite the significant fiscal corrections at States level, the fiscal consolidation process remained insufficient on several fronts. The need for designing appropriate post FRBM/FRL fiscal architecture to carry forward the process of fiscal correction and consolidate the gains, the paper further suggests some elements of future design of the fiscal architecture for deliberation and consideration.

**KEYWORDS:** Fiscal Deficit, Fiscal Consolidation, Borrowings, Revenue Deficit.

### INTRODUCTION

The Fiscal Responsibility and Budget Management Act, 2003 was enacted by the Parliament of India to institutionalize financial discipline, reduce India's fiscal deficit, improve macroeconomic management and the overall management of the public funds by moving towards a balanced budget. The main purpose

was to eliminate revenue deficit of the country and bring down the fiscal deficit to a manageable 3% of the GDP by March 2008. However, due to the 2007 international financial crisis, the deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009. FRBM Act

provides a legal institutional framework for fiscal consolidation. It is now mandatory for the Central government to take measures to reduce fiscal deficit, to eliminate revenue deficit and to generate revenue surplus in the subsequent years. The Act binds not only the present government but also the future Government to hold to the path of fiscal consolidation. The Government can move away from the path of fiscal consolidation only in case of natural calamity, national security and other exceptional grounds which Central Government may specify.

### **OBJECTIVES**

- ▲ To introduce transparent fiscal management systems in the country.
- ▲ To aim for fiscal stability for India in the long run.
- ▲ To ensure inter-generational equity in fiscal management.
- ▲ To make better coordination between fiscal and monetary policy.
- ▲ To introduce a more equitable and manageable distribution of the country's debts over the years.

### **BACKGROUND**

Indian economy faced with the problem of large fiscal deficit and its monetization spilled over to external sector in the late 1980s and early 1990s. The large borrowings of the government led to such a precarious situation that government was unable to pay even for two weeks of imports resulting in economic crisis of 1991. Consequently, Economic reforms were introduced in 1991 and fiscal consolidation emerged as one of the key areas of reforms. Fiscal consolidation constituted a major plank of the policy response. The fiscal performance during the reform period, however, was characterized by a clear divide in the mid-1990s in the attainment of fiscal targets.

There was evidence of the successful fiscal correction during 1991-92 to 1996-97 (except for 1993-94) in terms of a significant reduction in the fiscal deficit indicators. Since then, there has been a significant reversal of trend mostly up to 2002-03. In an effort to renew the process of fiscal consolidation and provide for long-term macroeconomic stability, the Central Government enacted the Fiscal Responsibility and Budget Management Legislation in August 2003. At the State level, several State Governments have enacted a similar legislation on fiscal responsibility. Subsequent economic and fiscal downturn and the recent scaling down of India's sovereign credit rating by international credit rating agencies are causes for serious concern. These call for urgent and comprehensive reform measures, including amendments to the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, so as to signal India's unambiguous commitment to fiscal correction and consolidation. The FRBM Act widely regarded as a landmark in India's economic history - clearly recognizes that without an enduring commitment to fiscal discipline, no government can redeem the development mandate vested upon it by the people.

### **EMPIRICAL EVIDENCE**

In terms of empirical literature, large fiscal consolidations have been associated with a positive macroeconomic development **Daniels et al, (2006)**. High quality fiscal adjustment can help mobilize domestic savings, increase the efficiency of resource allocation and boost confidence and expectations. The possibility of expansionary fiscal contraction is confirmed by **Gupta et al (2002)** for a panel of low-income countries. In a study of transitional countries, **Segure-Ubioergo et al (2006)** find that fiscal adjustment has been associated with higher growth primarily

through two channels: (i) reduced Government borrowing requirements, which curtailed the need to monetize budget deficits; and (ii) a credibility effect that signaled a political commitment to long-term fiscal sustainability and macro-economic stability. Further, **Baldacci *et al* (2003)** state that the most important transmission mechanism through which fiscal adjustment stimulates growth in low-income countries is factor productivity. The Task-Force on FRBM (Government of India, 2004) underlined the importance of several channels of 'expansionary fiscal consolidation' in the Indian context.

## **FISCAL CONSOLIDATION AT STATE LEVEL**

### **Historical Backdrop:-**

The State Governments have adopted a rule-based framework for fiscal correction and consolidation through progressive enactment of Fiscal Responsibility Legislation (FRL). The fiscal position of the State Governments broadly followed the pattern witnessed for the Central Government. There has been a severe fiscal stress in respect of finances of State Governments since the mid-Eighties. The fiscal stress emanated from inadequacy of receipts in meeting the expenditure requirements. The low and declining buoyancies in tax and non-tax receipts, constraints on internal resource mobilization due to losses incurred by State Public Sector Undertakings and decelerating resources transfer from Centre contributed to worsening of State finances. Since 2002-03, States started enacting fiscal responsibility legislations (FRLs).

Karnataka was the first to enact the FRL in September 2002 followed by Kerala and Tamil Nadu in 2003, and Punjab in 2004. Subsequently, twenty-two more States enacted the FRLs. All State Governments barring Sikkim and West Bengal have enacted FRLs so far. The enactment of FRLs has provided impetus to the process of attaining fiscal sustainability as reduction in key deficit indicators, viz., revenue deficit (RD) and gross fiscal deficit (GFD), is critical for reducing the mounting level of debts of the States. Apart from fiscal sustainability, meeting the targets set in FRLs is crucial not only for maintaining credibility in budgetary operations but also for ensuring prudent debt management and greater transparency.

The process of fiscal correction indicates that there has been a rise in total expenditure involving both revenue and capital components accompanied by some rise in revenue receipts. While tax-revenue as a ratio to GDP rose to 8.6 per cent during 2004-08 from 7.8 per cent during 1997-2002 owing to rise in own-tax revenue, non-tax revenue as a ratio to GDP declined from 3.9 per cent to 3.5 per cent due to fall in own non-tax revenue. Non-discretionary components of expenditure showed a rise over the period while administrative services stabilized around 1 per cent of GDP. There has been some marginal decline in the non-interest revenue expenditure. Very significantly, capital expenditure as a ratio to GDP during the current phase of about 4 per cent has been much higher than that in the earlier phases (around 2.8 per cent of GDP). Capital outlay, which reflects the investment spending, has also moved up.

**Table-1: Major Fiscal Indicators of State Government (Percent of GDP)**

Item	1991-92 to 1996-97	1997-98 to 2002-03	2003-04 to 2008-09	
<b>Average</b>				
1	2	3	4	
<b>A Revenue Indicators</b>				
1	Tax Revenue	7.9	7.6	8.6
2	Non Tax Revenue	4.0	3.2	3.7
3	Total Own Revenue	7.1	6.7	7.3
4	Total Current Transfers	4.6	4.0	4.8
	Total Revenue Receipts (1+2)	11.8	10.7	12.1
<b>B Expenditure Indicators</b>				
1	Revenue Expenditure	14.4	15.6	12.8
2	Capital Expenditure	2.9	2.7	4.1
3	Development Expenditure	10.2	9.3	9.7
4	Social Sector Expenditure	5.5	5.6	5.4
	Total Expenditure	33.5	33.1	34.4
<b>C Deficit Indicators</b>				
1	Revenue Deficit	0.8	2.3	0.7
2	Gross Fiscal Deficit	2.7	4.0	3.1
3	Primary Deficit	0.9	1.6	0.6
<b>D Debt Indicators</b>				
1	Debt	21.6	26.9	31.7
2	IP/RR	15.4	22.0	20.8
Sources : <b>State Finance - A study of Budget various years</b>				

In recent years, finances of State Governments have witnessed noticeable improvement with the major deficit indicators showing substantial decline. However, average level of gross fiscal deficit during the current phase of fiscal reforms (2004-08) has been higher than those during the earlier phase of fiscal reform (1992-97). The consolidated fiscal position indicates that fiscal correction has been faster for the States than the Centre in the recent period.

### SUGGESTIONS

The legislative route to fiscal consolidation is based on the premise that generally politicians are spendthrifts and reluctant revenue raisers as dictated by their self-interests. The Public Choice Theorists, the proponents of this sort of legislative control, also consider that the Keynesian economics, like pump-priming strategy, provides the rationale for such political behavior. Therefore, a legislative compulsion to balance the budget should force politicians to reduce public expenditure to the current level of public revenue, and hence maintain a minimum state. Therefore:

- Fiscal consolidation should be revenue-led,
- Fiscal consolidation should be front-loaded and
- Capital expenditure should be enhanced, to counter-balance the contra dictionary effects of the fiscal consolidation.
- India should consider adopting a more comprehensive “cyclically adjusted budget balance” as the rule to measure and monitor fiscal performance.
- Fiscal responsibility has to be enforced to ensure that no political party free-rides on the fiscal discipline of others. To achieve this, a Fiscal Responsibility Council (FRC) headed by the prime minister, and comprising the finance minister and leaders of major political formations in Lok Sabha, has to be constituted.
- The budgeting practices in the Union government need to be improved in line with international best practices. The budget manual can be amended through an executive order to adopt a “top-down” approach to budgeting.
- The Finance Minister of India should conduct quarterly reviews of the receipts and expenditures of the Government and place these reports before the Parliament. Deviations to targets set by the Central government for fiscal policy had to be approved by the Parliament.

## CONCLUSION

The fiscal performance of the States under the rule based framework has been encouraging. The State Governments were able to recover from the severe fiscal stress

experienced starting with mid/late nineties till early part of this decade. The major highlight of the improvement has been in the direction of reducing the key deficit indicators in terms of targets set under the fiscal regulations (FRBM/FRLs). The soundness of the macro economy aided the process of fiscal correction.

While the fiscal correction at the State level has been significant during the current phase of fiscal reforms, the fiscal consolidation has been incomplete in several respects. Debt level of States continues to be high and unsustainable. The fiscal reform process has been basically revenue-led but lacked focus with regard to expenditure management, particularly in respect of reprioritizing expenditure for developmental purposes. Thus, the fiscal architecture for the future has to be designed taking into account the experience gained so far so that the fiscal correction of both national and sub-national levels can be consolidated and carried forward. So we attempt to provide some elements for designing of future fiscal architecture of the States. Designing appropriate post FRBM/FRL fiscal architecture would carry forward the process of fiscal correction further to consolidate the gains on a durable basis. Some elements of future design of fiscal structure have been suggested in this paper for deliberation and consideration.

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