Review of the FRBM Act

# Should targets be range-bound?

## The range could be tried so long as you fix the threshold properly

The committee tasked with a comprehensive review of the FRBM Act and making recommendations on the roadmap of fiscal rules for the future is expected to submit its report soon. The constitution of the committee is opportune. There is considerable debate in the target variable to be chosen and, more important, the need to provide flexibility to the government to calibrate counter-cyclical fiscal policy. Moreover, it is important to incorporate the lessons learnt from implementing the FRBM Act during the last 12 years in charting out a roadmap for fiscal discipline for the future. The committee has been engaged in wide-ranging consultations and has sought suggestions from the stakeholders on the terms of reference. It is expected to submit the report in October.

The terms of reference (TOR) of the committee includes, (i) the review of the working of the FRBM Act during the last 12 years, (ii) analysing the factors determining the FRBM targets, (iii) examining the feasibility of fixing the range of fiscal targets in the place of fixed numbers and how the range should be determined and (iv) designing the fiscal targets in a counter-cyclical manner varying with credit contraction and expansion. The recommendations of the committee will have far-reaching consequences for calibrating both fiscal and monetary policy and, hence, growth and macroeconomic stability.

Unfortunately, the experience of implementing the fiscal rules during the last 12 years does not infuse much confidence and raises serious questions on the credibility of the government in not sticking to the fiscal rules it formulates for itself. The state governments, riding on the generous incentive recommended by the Twelfth Finance Commission, barring the power sector losses, have by and large conformed to the prescribed targets. The exceptions to this have been the states of Kerala, Punjab and Bengal. In contrast, the Union government has observed the rules more in their breach than in conformity. Although the fast growth in tax revenues helped the Union government to achieve substantial fiscal consolidation until FY08, the huge fiscal expansion in the FY09 budget resulted in the severe escalation in both revenue and fiscal deficits. The blame for this was placed on the global financial crisis though the difficulties started with the farm loan waiver, expansion of the rural employment guarantee and the implementation of the pay commission award. This was compounded by the unwillingness of the government to realistically price petroleum products in the wake of sharply increasing international crude oil prices. The subsequent years have seen continued slippages in conforming to both revenue and fiscal deficit targets. Thus, the 3% fiscal deficit target, that had to be reached in FY09, continues to elude and, now, has been postponed to FY19. The government found it impossible to achieve the target of phasing out revenue deficit and instead, created a new target concept of "effective revenue deficit"! The latest attempt is to transfer the capital expenditure liability to special purpose vehicles.

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What are the factors that should go into the determination of fiscal targets? There has been a lot of misinformation that the targets for India were simply copied from the Maastricht treaty. In fact, the Twelfth Finance Commission set the target at 6% of GDP, 3% each for the Union and the states. The 13th Finance Commission revised it at 5.4% as 3% of GSDP for individual states works out to 2.4% of GDP. The reasoning given by the Twelfth Finance Commission for choosing the target of 6% of GDP was that the only sector with a surplus savings over investment is the household sector and only household sector's financial saving is available for lending to the government, public enterprises and the corporates. Considering that the average household sector's financial saving was about 10% of GDP during the period from 1993 to 2002, and assuming an acceptable current account deficit at 1.5%, total available funds for lending works out to 11.5%. Containing fiscal deficit at 6% and limiting the lending to public enterprises at 1.5% would leave about 4% borrowing space for the corporate sector. Currently, the financial savings of the household sector has fallen to 7.7% of GDP and with the fiscal deficit of the Union and states for FY17 estimated at 6.5%, additional borrowing from special purpose vehicles (NHAI, NABARD, Railways) estimated at 1% and the public sector claiming another 2%, there is hardly any borrowing space available to the corporate sector. In this situation, RBI will find it difficult to reduce the interest rate and even if it did, liquidity will be a problem unless the agreement to do away with monetising the deficit between the ministry of finance and RBI is abandoned.

The FRBM implementation experience of the past 12 years has a number of lessons to offer. First, the target chosen should provide a comprehensive measure of borrowing by the government. As the Union government has substantially increased the borrowing through special purpose vehicles to undertake public investments, it is appropriate to consider the public sector borrowing requirements (PSBR), in addition to fiscal and revenue deficit targets. At the state level, as the Fourteenth Finance Commission recommended, it is necessary to include the losses and outstanding loans of power distribution utilities in the target variables of deficit and debt. Second, it is necessary to clearly specify the conditions in which the slippages in the targets could occur. Third, the target variables chosen should not only ensure the magnitude of fiscal adjustment but also its quality. Fourth, it is necessary to fix aggregate targets and break them into the targets for Union and states. Finally, an institution to ensure checks and balances such as the Fiscal Council, to monitor the implementation of FRBM—accountable to Parliament—could help to ensure greater legislative accountability. In fact, over 35 countries have set up such an institution and studies by IMF show that this has significantly improved the quality of fiscal policy calibration in these countries.

Admittedly, implementing pro-cyclical fiscal policy has been a problem and the government has suggested the feasibility of having a range of target variables rather than fixing them and varying the targets according to credit contraction and expansion. While this may indeed be desirable, it is important to fix the mean in relation to the household sector's financial savings to ensure adequate borrowing space to the private sector. In other words, the range could be tried so long as you fix the threshold properly. Unfortunately, the global experience shows that all governments want to spend the maximum they can and there is a danger that the governments will always work on the ceiling of the range. It is important to ensure sufficient safeguards against such a practice.

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