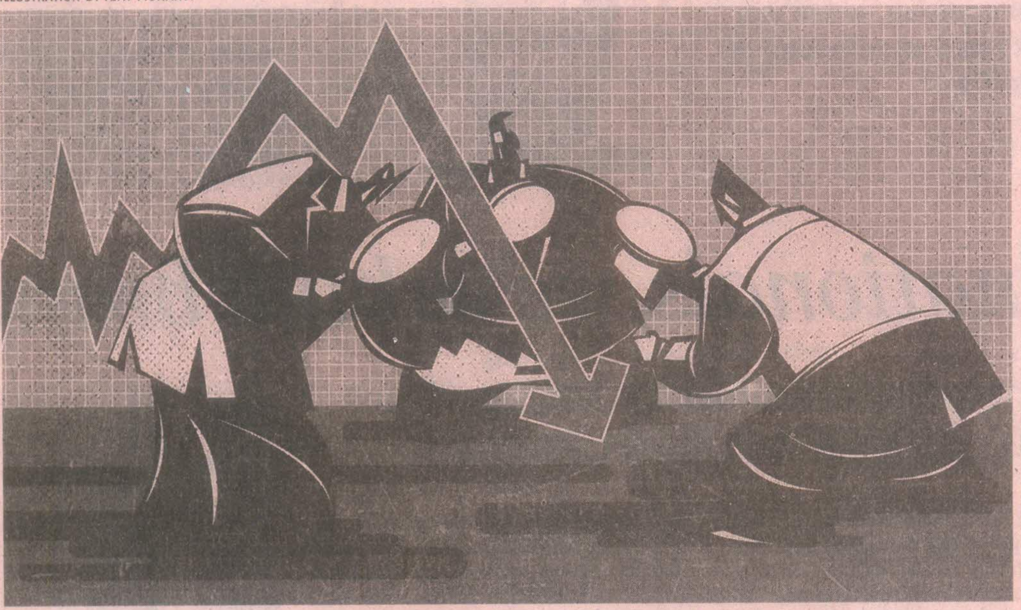
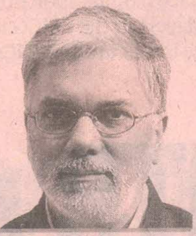
ILLUSTRATION BY AJAY MOHANTY



Why FRBM failed

As long as the notion of money Bill stays in the Constitution, the only effective fiscal responsibility rule is one that is in the Constitution



SNAKES & LADDERS

AJAY SHAH

India has a chronic fiscal problem. Economists have worked for 20 years on designing and enacting parliamentary law that would constrain Budgets. This enterprise suffers from a fatal problem: The notion of 'money Bills' in the Constitution of India. The money Bill route makes evading fiscal responsibility as easy as enacting the Budget. In order to constrain Budgets, we have only two viable pathways: (a) Putting fiscal responsibility clauses into the Constitution and (b) Unmuzzling the bond market.

India has a long-term problem with deficits. Sound public finance involves running a small primary surplus in most years, and occasionally running large deficits when faced with a crisis. We run a primary deficit in most years. In the last 15 years, our deficit is too large by 2.5 per cent of GDP on average.

We need to find the institutional reforms that will push the deficit down by roughly 2.5 per cent of GDP, on average, on a sustained and long-term basis.

For 20 years, economists have worked on Parliamentary legislation that will deliver this sustained change in the Indian fiscal position. As with all sound work in Indian public policy, this has been a bipartisan project. The work was begun when AB Vajpayee was Prime Minister, and implemented when Manmohan Singh was Prime Minister. All economists in India were proud and excited when the FRBM Act came about.

The FRBM Act did not deliver the desired results. Fifteen years into the process, we know the outcome: Our fiscal deficit is too large by a factor of 2.5 percentage points. It is important to ask: Why did the FRBM Act, 2003, fail to deliver the desired results? Pratik Datta, Radhika Pandey, Ila Patnaik, and I have a forthcoming paper on this, which is summarised here.

The Constitution of India has the concept of a 'money Bill'. One important money Bill every year is the Finance Bill, which contains the plan for taxation and spending for the year. The ruling party is required to cobble together a majority in the Lok Sabha when this is presented. Otherwise the government falls.

Article 110 of the Constitution defines what is permissible in a money Bill. Unfortunately, amendments to the fiscal responsibility law are permissible in money bills, which include Finance Bills. As a consequence, any parliamentary law which requires fiscal responsibility is no impediment to the ruling party. When introducing the Finance Bill, it is easy to introduce amendments to the fiscal responsibility law, and thereby defanging it.

As an example, the FRBM Act, 2003, originally required eliminating the revenue deficit by March 31, 2008. The Finance Act of 2004 amended the FRBM Act to shift the deadline to 2009. This was further changed in 2012, and then to 2015, and in 2015 to 2018. This is the root cause of how the FRBM Act, 2003, failed. It is too easy to tuck in a sentence into the Finance Bill, amending the FRBM Act.

The essence of fiscal responsibility legislation is that it must constrain the Budget process. Successful fiscal responsibility frameworks, elsewhere in the world, have teeth. In the US, we have seen government shutdowns when the Budget negotiation was not able to fit within the debt ceiling. In Germany, the 'Federal Debt Brake' is in the Constitution, and there would be a shutdown of government payments if it were violated. In India, all the FRBM Act does is to induce a few lines in the Finance Bill.

Fiscal responsibility legislation that does not constrain the Budget process is irrelevant. We, the economists, have spent 20 years in pursuit of the wrong objective.

The failure of the FRBM Act, 2003, lay in legal engineering. There is no point tinkering with the macroeconomics in the Act. A completely rewritten Act will equally be brushed aside by the Budget process. Refining the economics in the FRBM Act is an exercise of counting angels on pinheads.

As long as the present notion of money bill remains in the Constitution, the only effective fiscal responsibility rule is one which is in the Constitution. The Finance Bill will then be forced to respect these constraints. For this constitutional amendment to become politically feasible, the larger public needs to see that India's chronic fiscal problem is causing harm, much like the fat on a chronically overweight man. This calls for a two-pronged effort of technical work (designing the Indian Debt Brake, which would amend the fiscal machinery embedded in the Constitution) and advocacy (explaining this to the larger public).

Indira Rajaraman has long argued that we in India have placed an excessive emphasis on fiscal responsibility legislation. Constraining the leviathan, the State, is a difficult problem and the entire burden cannot be placed upon fiscal responsibility legislation. We should use another lever — the cost of borrowing — to shape the Budget process.

In a well-functioning system, the bond market should be judging the sustainability of the borrowing of a central/state/local government, and demanding higher interest rates when public finance is on an unsustainable path. This generates a healthy system where fiscal responsibility is rewarded by cheaper debt financing and vice versa.

We lack this check-and-balance in India as the bond market has been muzzled. When the government needs to buy steel, it puts out a tender and steel producers place voluntary bids. But when the government needs to borrow, it forces financial firms to lend to it. For example, banks are forced to lend 21 per cent of their deposits to the government, regardless of the interest rate offered.

This is a tax on the households that consume financial services. This tax is not authorised by Parliament in the Finance Bill. This coercive resource mobilisation gives an easy ride in normal times but has blocked the emergence of a bond market that can be turned to when larger quantities are occasionally required. To solve this problem, we require the Public Debt Management Agency and bond market reforms.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi