ENFORCING FISCAL RULES

HOUSING THE COMMISSION UNDER THE FINANCE MINISTRY WILL UNDERMINE ITS INDEPENDENCE; MAKE IT ANSWERABLE TO PARLIAMENT ONLY

Need for an independent fiscal commission

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WHEN THE MARKETS fail for reasons of providing public or merit goods, or imperfections in the market or information asymmetry or ensure proper distribution of income and wealth, governments are required to intervene. However, what happens when the governments fail in their task in correcting the market failure? If the governments are benevolent, we can simply assume that they do not fail. Unfortunately, experience has shown that government failure is as serious as market failure and, therefore, we need systems and institutions to guard against them.

A major area of government failure is in the conduct of fiscal policy itself. Worldwide experience has shown pro-cyclicality in the conduct of fiscal policy. Myopic view of the policy makers and in particular, electoral budget cycles imparts a deficit bias in calibrating fiscal policy. This is aided further by the lack of transparency and fiscal illusion. Not surprisingly, the world over, there have been institutional innovations to provide a check against this behaviour; these include legislating fiscal responsibility and requirement to prepare and place a medium-term fiscal framework in Parliament, stipulating numerical fiscal targets to conduct a rule-based rather than a discretionary fiscal policy and creation of independent fiscal institutions to review and monitor the conduct of fiscal policy.

In India, too, the Fiscal Responsibility and Budget Management Act was legislated in August, 2003. While the initial years after the enactment, particularly during 2003-07 saw significant fiscal correction, thanks mainly to robust growth of revenues from direct taxes due to the creation of the tax information network (TIN) and the expansion of the base of service tax, the subsequent period has seen serious slippages, governments taking pauses in adhering to the path of adjustment and indulging in creative accounting and unhealthy budgetary practices in the cash accounting budget system. With this uneven experience in the background, the time is opportune for a comprehensive review of the rule-based fiscal policy in the country and, therefore, the Union Finance Minister announced the setting up of the FRBM Review Committee in his 2016-17 budget speech. The mandate of the Committee included (i) the review of FRBM targets; (ii) examination of the range rather than a point estimate of fiscal targets; and (iii) exploring the possibility of linking fiscal expansion or contraction to credit contraction or expansion.

The committee has, after detailed analysis and wide-ranging consultations, submitted the report to the government. The main report of the committee as well as the note of dissent by the Chief Economic Adviser was placed in the public domain last month. The committee must be complimented for its continued stance on fiscal prudence. The important recommendations of the committee include (i) taking debt as the anchor and fiscal deficit as the instrument to achieve this. The debt to be reduced to 60% of the GDP in 2023 from the present level of about 70% and the Central and state targets, respectively, fixed at 40% and 20%. This is supposed to be achieved by containing the fiscal deficit at 3% of GDP in the first three years and 2.5% in the next two years and containing the fiscal deficit at the state level at 2.5%. The target is based on the available information on the household sector's financial saving and available foreign funds and equal sharing of the available funds between the government and enterprise sectors. The revenue deficit should be progressively reduced each year by 0.25 percentage point to reach 0.8% in 2023 which will improve the quality of adjustment in terms of the ratio of revenue deficit to fiscal deficit from 66% prevailing at present to 32%. (ii) The committee did not recommend fixing the targets in terms of a range nor did it favour linking deficit changes to coincide inversely to credit expansion and contraction. (iii) The committee specified the circumstances for deviating from the target as overriding considerations such as natural calamity or war, far-reaching structural reforms with fiscal implications and a sharp decline/increase in the output by 3 percentage points in four successive quarters for a 25 basis point deviation; and (iv) setting up of an institution "Fiscal Council" to forecast, review and monitor the conduct of rule based fiscal policy.

The major recommendations relating to the fixing of the targets and invoking exceptional clauses have been discussed by Rangarajan and Srivastava (*Business Line*, May 16). In particular, they contend that there is no clear evidence of permanent decline in household sector's savings and there is no need to reduce the fiscal deficit to 2.5%. Given the large interest outgo, there is no case for taking primary deficit as the target variable as argued in the dissent note. The specification of circumstances for deviation may not be effective and sometimes, could pose constraints in calibrating counter-cyclical policy.

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On the issue of setting up of an independent institution Fiscal Council, there has not been much discussion. The committee has broadly followed the recommendation by the 13th Finance Commission which suggested the setting up of a committee by the finance ministry which was supposed to eventually evolve into a Fiscal Council reporting to the ministry. The idea of a council is sound, but if it has to be appointed by the finance ministry and will be reporting to the finance ministry, it will cease to be independent. Therefore, the 14th Finance Commission recommended that an independent Fiscal Council should be established through an amendment to the FRBM Act, by inserting a new Section mandating the establishment of an independent Fiscal Council to undertake *ex ante* assessment of budget proposals and to ensure their consistency with fiscal policy and Rules. The council is supposed to be appointed by, and report to, Parliament and should have its own budget. The functions of the council include *ex ante* evaluation of the fiscal implications of the budget proposals which includes evaluation of how real the forecasts are and their consistency with the fiscal rules and estimating the cost of various proposals made in the budget. The *ex post* evaluation and monitoring of the budget was left to the CAG. In the light of the above, there are questions about the independence of the Fiscal Council if it is appointed by the finance ministry and reports to it.

Finally, experience has shown that establishment of the institutions by themselves is not going to curb the tendency of the governments to live beyond their means. Fiscal rules and independent fiscal councils are neither necessary nor are they sufficient if we really have governments that are benevolent. If there is political will, we do not need the fiscal rules, and in its absence, governments will find ways to deviate. Nevertheless, in a democratic polity, these institutions help in raising the awareness of people about the lurking dangers of fiscal profligacy.

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