Fiscal Complexities

Lecture for EGROW Foundation

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Let me at the outset thank my old colleague Dr. Arvind Virmani, Chairman of the EGROW Foundation for Economic Growth and Welfare, for this opportunity to deliver this online talk on "Fiscal Complexities". When Arvind worked with me in the erstwhile Planning Commission, he was largely instrumental in the report we submitted on Direct Foreign Investment, whose implementation much earlier than today altered the psychology and the opportunities for Direct Foreign Investment.

I am grateful also to Dr. Charan Singh, Chief Executive, for this opportunity. He has been keenly following and contributing to the debate on key aspects of macroeconomic policy whose key component remains fiscal challenges.

In my recent book *Recalibrate: Changing Paradigms*, I have devoted an important chapter to fiscal and fiscal related issues. Even at the cost of repetition, let me reiterate the historical evolution in this country of the debate on fiscal issues and the challenges which meaningful macroeconomic management would imply.

Brief history of fiscal policy in India

While passing Articles 292 and 293 (adopted as Articles 268 and 269 during the discussion on the Draft Constitution), the Constituent Assembly discussed the borrowing powers of the

Centre and states at length. It is important to note that many of the members were in favour of placing a limit on the borrowing powers of the executive government by Parliament.

In the nascent years of India's economic planning, there was popular belief that an emerging market like India could not rely on the private sector. Large public outlays had to be financed from government borrowings or fiscal deficit, particularly on infrastructure. It was a predominant thought that such investment would create a virtuous cycle of having multiplier effects on growth and development in the long run, which would also bring down fiscal deficit. Private capital, especially foreign capital, was highly regulated and, hence, limited. India's foreign exchange requirements were largely met from the capital flows of donor communities or multilateral institutions. This led to some Balance of Payments (BoP) difficulties during the 80s, leading to a paradigm shift in economic policy in 1991.

In 1985, the Sukhamoy Chakravarty Committee presented a report on the 'Review of the Working of the Monetary System in India'. The report recommended that fiscal deficit is a better and more accurate representation of the government's draft on credit available in the economy rather than uncovered deficit. Only six years later, fiscal deficit made its first appearance in the Economic Survey of 1990–91 under the shadow of the IMF's structural adjustment programme. Later, fiscal deficit made its way into the Union Budget of 1991–92.

In an increasingly interdependent world, India wanted to attract foreign and private capital for investment. Large foreign investors were looking at rating agencies to get a sense of India's macroeconomic stability, which prompted the observance of fiscal prudence and adherence to fiscal norms. It was realized that fiscal prudence could create space for private investment and deliver better quality of infrastructure for the country; but this did not last long. Fiscal consolidation started faltering again by 1997–98. At this point, the government acted with some alacrity and introduced the Fiscal Responsibility and Budget Management (FRBM) Bill in Parliament in the year 2000. For inexplicable reasons, the first FRBM Act was not enacted until PM Atal Bihari Vajpayee did so in 2003. The Act legally obligated the central government to reduce its fiscal deficit to 3 per cent and maintain it below that level over a period. After the central government enacted the FRBM Act, with incentives and nudges from the Finance Commission (FC), such legislation was enacted in most states by 2007. This placed a limit on the borrowings of the states.

The Act had a salutary effect on overall fiscal management. This effect was further reinforced by the acceptance of the 11th FC's recommendations enjoining the state governments to enact similar state-level legislations. Thereafter, as mentioned above, exogenous and other expenditure compulsions led to long periods of pause or inactivity of the FRBM legislations. It was not until the return of the National Democratic Alliance (NDA) government in 2014 that we, once again, refocused on the broader issues of macro stability and reactivated as well as made changes to the Union Budget. My own experience with PM Modi suggests that under his leadership, conformity to the amended FRBM and its centrality in macroeconomic management received the priority it deserves.

Recalibration of fiscal regulation can always be sought to examine if there can be greater flexibility through automatic stabilizers and contracyclical action, notwithstanding the methodological and other complexities in making such projections. These projections, of course, will need to be made not only for the central government but also for state governments. Investors, both domestic and foreign, invariably look to the overall debt and the fiscal picture of the government, which includes both the central and state governments.

The FRBM Act, 2003 provided a legal framework for fiscal consolidation of the central government finances for the first time. It mandated the following targets.

- Reduction of the fiscal deficit to 3 per cent of the GDP by 2008–09, with an annual reduction target of 0.3 per cent of the GDP per year by the central government.

- Revenue deficit reduction by 0.5 per cent of the GDP per year with a complete elimination of revenue deficit by 2008–09.

- Prohibition of borrowing by the government from the RBI, thereby making monetary policy independent of fiscal policy.

- Banning the RBI from purchasing the primary issues of the central government securities after 2006, preventing the monetization of the government deficit.

After the enactment of the FRBM Act, there was a clear improvement in the fiscal position of the government. The general government deficit declined from a peak of 9.6 per cent in the FY 2002 to 4 per cent in FY 2008. In fact, a year before the 3 per cent deficit target was to be achieved, the central government deficit declined to 2.5 per cent of the GDP in FY 2008. The debt to GDP ratio also declined during this period from 83 per cent in FY 2003 to 71 per cent in FY 2008.

Post the global financial crisis in 2008, fiscal deficit started to soar as many of the earlier gains in fiscal consolidation were eroded. This impeded the credibility of the FRBM Act. FM Pranab Mukherjee, in his 2009–10 Budget speech, announced a return to the FRBM target for fiscal deficit at the earliest, as soon as the negative effects of the global crisis on the Indian economy were overcome. The deficit rules remained in abeyance for a period of five years. In the Budget speech of 2012–13, Dr Mukherjee announced his intention to reoperationalize the FRBM Act and proposed several amendments to the Act in the Finance Bill, 2012. These included pushing the deadlines for numerical targets from 2009 to 2015 and introducing a new fiscal indicator, namely the ‘effective revenue deficit’ (revenue deficit excluding grants for creating capital assets). However, he later postponed the deadlines for meeting the numerical targets from 2015 to 2018 to create fiscal space for public expenditure. During this period, despite performing well in terms of growth, inflation and current account management, India's fiscal performance remained an outlier among its peers.

Under such circumstances, and because of changes in the external environment, a review of the FRBM Act became necessary.

In the Union Budget 2016–17, FM Arun Jaitley proposed to constitute a high-level committee to review the implementation of the FRBM Act and to give recommendations on the way forward. Elaborating on this point, the FM said,

> "The FRBM Act has been under implementation for more than a decade. Both Central and State Governments have made significant gains from the implementation of this Act […] While remaining committed to fiscal prudence and consolidation, a time has come to review the working of the FRBM Act, especially in the context of the uncertainty and volatility which have become the new norms of global economy. I, therefore, propose to constitute a committee to review the implementation of the FRBM Act and give its recommendations on the way forward."

The FRBM Act Review Committee was constituted under my chairmanship in May 2016, with the following terms of reference:

- to review the working of the FRBM Act over the last 12 years (2004–16) and to suggest a way forward, keeping in view the broad objective of fiscal consolidation and prudence, and the changes required in the context of the uncertainty and volatility of the global economy;

- to look into various aspects, factors and considerations that go into determining the FRBM targets;
- to examine the need and feasibility of having a ‘fiscal deficit range’ as the fiscal deficit target in place of the existing fixed numbers (percentage of the GDP) for this target; and if we are to do so, providing the specific recommendations of the committee thereon; and
- to examine the need and feasibility of aligning the fiscal expansion or contraction with credit contraction or expansion, respectively, in the economy.

The committee, after extensive consultations and deliberations with all stakeholders, submitted its report to the government in January 2017. The following are its key recommendations for a legal framework on fiscal consolidation:

- Enact a new Debt and Fiscal Responsibility Act
- Adopt a prudent medium-term ceiling of 60 per cent of the GDP for general government debt, to be achieved by no later than FY 2023.
- Within the overall ceiling specified above, adopt a ceiling of 40 per cent for the Centre, and the balance 20 per cent for the states.
- Adopt fiscal deficit as the key operational target consistent with achieving the medium-term debt ceiling.
- Adopt the path for debt-to-GDP ratio and fiscal deficit as well to be achieved by FY 2023.

India’s fiscal architecture in contemporary times

The fiscal architecture of any economy in the 21st century inevitably rests on three pillars: fiscal rules, financial management process and fiscal institutions. The first phase covered these rules by stipulating norms relating to fiscal deficit targets, consistent with macroeconomic stability.

In the second phase, we recognized that fiscal management must be guided by principles of equity, efficiency and transparency. These rules must be applied to all levels of government, including the subnational levels, budgetary institutions and management practices. The question of raising the quality and efficiency of public spending remains a continuing challenge. The availability of credible data across levels of government remains elusive. The strain on public finances during the Covid-19 crisis especially highlights the importance of reprioritizing expenditure, how quickly expenditures are reprioritized for financing health, skill inculcation and infrastructure accentuates the importance of ensuring public financial management policies.

The second-generation fiscal rules have increasingly recognized the need to adopt more than one fiscal rule to balance competing options and enhance credibility. These include the need to create a fiscal anchor, the challenge of having multiple rules and the inconsistencies in seeking to monitor, verify and communicate, fiscal data on all the contingent liabilities incurred by the sovereign, subnational and parastatals, and recourse to off-budget borrowing. These issues distract from the credibility of debt numbers. The second-generation fiscal rules typically rely on escape clauses or equivalent mechanisms to create flexibility. Countries very often adopt automatic correction mechanisms, which also need to specify in advance how deviations from the general rule must be handled. This inevitably implies the need for medium-term fiscal policies to be adopted with multiple fiscal indicators. Moreover, having public debt as a principal macroeconomic anchor is widely accepted.

However, several questions remain unanswered. What levels of public debt would be acceptable based on conditions that are country-specific and have been worked out in accordance with international benchmarking? The Reinhart–Rogoff suggestion of external debt becoming a problem at around 60 per cent of the GDP and growth turning negative at 90 per cent of the GDP110 must be interpreted in a broader and country-specific context. Countries with significantly higher per capita incomes have significantly higher debt levels without compromising their long-term macroeconomic stability.

Challenges and Issues in Fiscal Policy

With your permission, I would base this lecture of mine today on the analysis contained in my book, which I have earlier referred to. Some settles issues need our reiteration. Coupled with this, of course, there are many unsettled issues on which public dialogue would be meaningful.

In the context of the pandemic, we need to focus not on fiscal rectitude but on fiscal forbearance. Fiscal norms designed for normal times are not appropriate in distressed times. The last major global pandemic happened 102 years ago, long before the UN and the Bretton Woods institutions, namely the World Bank and IMF, were established. The multilateral institutions are, thus, confronting the challenges of a pandemic of this nature for the first time with no past precedents. The first challenge for these institutions is how to determine fair, appropriate and consistent norms of fiscal forbearance that address the health emergency, build economic recovery, accept the fiscal shock and address its nature, and reform the international debt architecture.

The next issue is connected with the central bankers. Seeking synchronization between the policies of the sovereign and the central bankers is critical to address events like the pandemic. This is true, not only for the non-banking financial sectors, like the cooperative sector but also for private corporate entities. Such entities that are seeking a restructuring of the debt process would need the advice and guidance of central bankers. There are no hard and fast rules to address these. Evolving norms on some of these issues will remain a continuing challenge.

While it is necessary, and perhaps easier, to argue in favour of fiscal forbearance it is equally important to get back on track as soon as the pandemic is under control. Fiscal forbearance must be followed by fiscal rectitude. The path to this shift must be central to these norms. It is easier to exit than to re-enter. This begs the question of at what point will nations determine that the pandemic has started waning and we need to reconfigure the contours of macroeconomic stability?

In the Indian context, the focus is on the optimum mix between monetary and fiscal policies. As inflation rises globally, monetary authorities will inevitably need to review their strategies. A northward direction in the more accommodative interest regime appears inescapable. The absence of credible data in relation to the informal sector is a continuing challenge. While this is scarcely a time for deep fiscal consolidation, fiscal policies must inevitably assist the recovery process. A differentiation in the expenditure pattern, namely to incentivize capital expenditure rather than revenue expenditure, has multipliers in terms of employment, output, demand creation and capacity utilization.

Clearly, investment in infrastructure through multiple initiatives, like the National Infrastructure Pipeline project and enhanced outlays for roads, highways, airports and ports, are an important step forward. However, given the needs and lags, the needs of the micro, small and the informal sector must be addressed. The distress of the informal sector cannot be overstressed. The service sector, or in a more limited sense, the contact-based patterns of activity, including retail outlets, micro, self-employed activity, travel and hospitality, suffered enormous economic hardship. Putting resources directly in their hands along with continuing support to the PDS or rural employment have to proceed alongside the support of capital expenditure with high growth multipliers. Those who advocate the need for contracyclical fiscal action have to reckon with the difficulties of determining parts of the cycle, measuring output gaps, their geographical and spatial distribution and designing a framework which does not contribute to inflationary trends. The contracyclical action and automatic stabilizers embedded in the escape clause of the fiscal policy have been understandably already resorted to. The issue is whether the magnitude of these interventions is adequate to sustain the recovery process.

In this endeavour, one cannot be unmindful of the rising debt stock. The FRBM Act stipulated that fiscal deficits should not exceed 3 per cent of the GDP; adding them together resulted in a desirable split of 6 per cent. In a certain sense, if this split of 6 per cent equally between the Centre and the states had been based on the savings of the informal sector and the tolerable current account deficits of 1.5 per cent of the GDP, the debt profile would have looked vastly different than what it is today. This assumes that, at that time, the desirable sustainable debt level of 60 per cent over a medium-term, disaggregated as 40 per cent for the central government and 20 per cent for the state government, seemed like an optimum arrangement. All norms of managing fiscal deficit were calibrated on this assumption. Since then, as the report of the 15th FC recognized, we have developed a more realistic debt and fiscal trajectory.

Even this somewhat more realistic recalibration from the 15th FC report looks misaligned with the current realities. If by a conservative estimate, current debt to GDP ratio is around 85 per cent, getting it back to 60 per cent, from where it all began, will be a daunting challenge, as will recalibrating the break-up of the debt plan between the Centre and the states. No doubt, one must recognize the enormous gains that greater transparency and data credibility have brought in favour of our reputation for responsible growth. Taking and assimilating all contingent liabilities fully into our accounting process has demonstrated that the earlier figures were a total suppression of the actual debt, and credit rating agencies have realized this throughout.

We need a new National Debt Plan that is applicable both to the Centre and the states. Differentiating between national and subnational entities would be generic in this process. Recalibrating fiscal deficit to this revised debt plan needs both partnership and, more importantly, concerted action. Initiating credible action will enhance the confidence of investors. From this point of view, some of the suggestions made in the 15th FC report for an intergovernmental group embracing both the Centre and the states, deserve further consideration. Any concerted plan must also be cognizant of the new challenges in terms of uncertainties of the emerging geopolitical scenario, behaviour of oil prices, policies of monetary authorities globally and trade frictions between large economies. A new legal framework on debt and fiscal consolidation must be designed to address these challenges.

Connected with these challenges are some other issues, which have been detailed below.

First, the need for credible fiscal institutions. The case for an independent fiscal council acting in an advisory capacity has been in the public domain for a long time. Successive FCs have reiterated their recommendations that now over 80 countries, including emerging markets, have adopted fiscal councils in one form or the other. The IMF, in a study on fiscal councils, suggested that these councils may:

- contribute to the use of unbiased macroeconomic and budgetary forecasts in budget preparation (through preparing forecasts or proposing prudent levels for key parameters);

- identify sensible fiscal policy options, and possibly, formulate recommendations;
- facilitate the implementation of fiscal policy rules; and
- cost new policy initiatives.

Second, and connected with the fiscal council, is the issue of compliance and endorsements. Clearly, unlike many countries, the sovereign cannot be bound down by any legislative requirement, particularly if Parliament endorses these actions. This would be equally true of state governments seeking the approval of the state legislatures. Nonetheless, the issue has arisen whether this latitude and flexibility offers adequate protection against irresponsible populism. The continuing cycle of elections offers enormous opportunities for varied political parties to make promises, which, by any stretch, are financially irresponsible. If elected to power, they are obligated to implement these commitments with far-reaching irreparable damages to the finances of the state. Mitigating the impact of irresponsible populist action would be integral to any compliance process. In the 15th FC report, three compelling arguments have been outlined in this regard:

- to bridge the gap between the high-level public financial management framework in the Constitution and the detailed guidelines, rules, regulations and manuals and, thereby, codify the principles and processes, while providing them statutory strength;
- to enable a review and rationalization of the existing rules and regulations, some of which date back to the pre-Independence era and make them internally consistent between the Union and the states;
- to build a more resilient public finance framework with the capacity to better manage and mitigate future shocks.

<u>There are a few other issues in India’s fiscal policies that have assumed contemporary relevance.</u>

The first issue is the relentless electoral cycle. While the central government is elected for a term of five years, its focus on governance is constantly interrupted by unabated state elections. Each state election entices governments towards populist measures, known as freebies. This has become particularly endemic in recent times, where more and more freebies are being offered to influence the electoral psyche. There are serious financial consequences of fulfilling these promises. The tendency to demand large sums of money from the central government are embedded in those promises, which compound the challenges.

There is no mechanism for the central government, except in times of emergency like pandemics, natural disasters and urgent relief, to transfer large resources to the consolidated funds of state governments. The transfer mechanism to states is primarily governed by successive FCs. This system inadequately considers constitutional and legal provisions. Furthermore, FCs invariably make their recommendations on the percentage of devolution to states based on intensive analysis, interactions and what is formulaic and normative. In addition to the direct transfers from the divisible pool, recommendations made under Article 275, by way of revenue deficit grants, are also based on a normative approach but these outgoes are charged to the Consolidated Fund of India. Being grants, they can be performance-based or conditional. At any rate, the revenue deficit grants are based on norms of acceptable behaviour, which will enable, based on expenditure and revenue buoyancy, the states to not be in deficit at the end of the award period. The politics of freebies trumps the norms of such responsible behaviour.

Second, is the issue of financial mismanagement by the states. This also raises issues of overall stability and solvency. Should there be constitutional provisions to define the parameters of what is described as subnational bankruptcy among federal entities? The recourse to Article 293(3) by the central government is designed to regulate the borrowings of state governments and is necessary to secure the prior approval of the central government. Notwithstanding this, state governments have often resorted to what was characteristically known as accommodation by way of overdrafts for very limited periods. The issue of subnational bankruptcies and its implications for the rating of the central government or the sovereign rating needs wider debate.

The third issue is with the mechanisms that would allow the voice of the market to be permeated and appreciated by subnational and parastatal entities. How can markets recognize and differentiate the cost of borrowings by states between those whose finances are better managed than others with fiscal profligacy? As long as there is an implicit sovereign guarantee, any such mechanism is unlikely to be meaningful. The 15^{th} recommended that all state governments should have a fiscal or debt management cell. This cell, coupled with the obligation for getting a credit rating to enable market differentiation, would encourage prudent behaviour among state governments.

Fourth, parliamentary awareness and understanding on fiscal issues remains somewhat rudimentary. Fiscal issues are an integral part of overall macroeconomic management. Parliament, in taking up the Finance Bill, has rarely debated the issue of compliance with the FRBM targets and their rationale for significant deviations. Creating mechanisms for greater parliamentary engagement in economic issues would improve the quality of parliamentary debates on them. Holding the executive more meaningfully responsible for deviations from the macroeconomic trajectory contained in the legislations would fortify investor confidence.

Finally, I have outlined some of the key remaining challenges for coherent macroeconomic policy. The centrepiece of this must rest on pursuing responsible growth, acceptable levels of fiscal deficit and debt are its two critical ingredients. So what are the key lessons that we have learned?

First and foremost that India has not been served well in pursuing bouts of unabated fiscal profligacy. We learn that our balance of payments difficulties and recourse to special borrowing arrangements have invariably been preceded by proximate years of fiscal profligacy. No doubt, this has been compounded by other exogenous events of war, energy crisis, geopolitical tensions or unexpected fuel and food inflation. We are better off in promoting responsible fiscal behaviour and to build reserves or cushions for so to say a rainy day.

Second, any false dichotomy between high rates of inflation inevitably spills over into the external sector.

Third, a monetary policy embedded in predictable inflationary band is a major anchor. It enjoins on the central bank to pursue monetary policies consistent with this inflationary band. We also know that managing inflation needs the active participation of other stakeholders and demand compression must be symmetric to improving supply side responses.

Fourth, managing realistic exchange rates in periods of volatility on capital flows needs innovation and constant recalibration. Export elasticity goes far beyond competitive exchange rates as contingent on the overall competitiveness of the export sector, which has several other key variables. It is not mere fiscal deficit but the priorities of public outlays with continued emphasis on capex expenditure with larger multiplier effects. The past experience of neglecting the social sector, particularly health and education, has long run negative implications both for growth and the human development parameters. We know that the central government alone cannot manage the fiscal complexities but needs the active involvement and partnership of multiple layers of governance, part the States and I would include the third tier as well.

Last but not the least, both monetary and fiscal policy must encourage innovation, sustainable lifestyles and an orderly transition to an era of non-fossil fuel energy even as we seek to reduce the energy intensity of our economic activity.

Mahatma Gandhi said, “Economics that hurts the moral well-being of an individual or a nation are immoral and therefore sinful.” Rising expenditure financed through unsustainable borrowings and high public indebtedness hurts the moral well-being of a nation. This is why responsible growth must be an obligation and necessity for us.