Post COVID Fiscal Framework: Issues and Options

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September 6, 2021

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Introduction

According to the Article 292 of the Constitution 'The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.' After the enactment of the Constitution, various Estimates and Public Accounts Committees urged the government to fix borrowing limits. The RBI too, especially in the 1990s, urged the government to place restrictions on central government deficits and ceiling on public debt[2]. However, the government's position was that law under Article 292 was permissive, not mandatory. It was further argued that explicit limits on government borrowings had to cover both market borrowings and deficit financing and hence had to be fairly high.

Post 1991 economic reform, fiscal consolidation became a major macroeconomic challenge and a rule based fiscal control framework was considered necessary. A Committee was constituted under Dr. E.A.S. Sarma to prepare a draft legislation and 'put our fiscal house in order'[3]. This led to the introduction of the Fiscal Responsibility and Budget Management Bill, 2000 in Parliament and was enacted in 2003.

The FRBM Act, 2003 and its amendments

The Act required achieving a revenue surplus in a timebound manner and reduction of fiscal deficit to 3 per cent of GDP[4]. The Act also provided for escape clauses to enable the government to respond to various crises, but on the recommendation of the Standing Committee on Finance. The government was provided a wide ambit, by allowing ceilings to be breached 'on grounds of national security, national calamity, or such exceptional grounds as the Central Government may specify'. Significantly, the Act did not make public debt as a target for consolidation. It also put a bar on subscription to primary issues of government securities by the RBI, except in specified circumstances.

While the law worked well until 2007-08, it was '*paused*' due to the Global Financial Crisis. It was only in September, 2012 that a path towards fiscal consolidation was recalibrated and the FRBM Act was amended. There have been 2 major amendments to the FRBM Act, one in 2012 and another in 2018.

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[2] Prior to the 1997 agreement between the RBI and the government creating the system of Ways and Means Advances, there was large scale recourse to ad-hoc Treasury bills by the government. For the decade of the 1990s, net RBI credit to the government was 65.9 per cent of the asset base of the RBI (D'Souza 2017), indicating high monetization of deficit.

[3] Budget 2000-01

[4] The target of eliminating revenue deficit was initially to be achieved by 2007-08, which was modified by the Finance Act, 2004 to 31st March, 2009. For fiscal deficit, the Rules required its reduction to 3 per cent by 31st March, 2009.

Amendments to FRBM Act

Some notable changes made in 2012 were the following:

- It introduced the concept of effective revenue deficit(ERD)[5], setting a target for elimination of ERD by 31st March 2015(this date was pushed further to 31st March, 2018 through another amendment).
- Reducing Revenue deficit(RD) to 2 per cent by 31st March, 2015 (the date was pushed further to 31st March, 2018)
- On the recommendation of the 13th Finance Commission, the Act was amended by an insertion of Section 7A, which allowed the Centre to entrust the CAG with the authority to review compliance with the Act[6]. This is meant to improve compliance as CAG audit reports are placed before both Houses of Parliament. The observations of the CAG for the year 2016-17 (latest available report) is given in Box 1.

Box 1: CAG Compliance Audit Observations

Compliance with FRBM for the year 2016-17

The FRBM targets for 2016-17, for RD, ERD and FD were 2.1, 0.9, 3.3 per cent respectively, while the achievement was 2.1, 1.0, 3.5 per cent respectively. Government has repeatedly resorted to off-budget financing for revenue as well as capital spending. In terms of revenue spending, off-budget financing was used for covering/deferring fertilizer arrears through special banking arrangements, food subsidy arrears of FCI through borrowings and for implementation of Accelerated Irrigation Benefits Program(AIBP) through borrowings by NABARD under the Long Term Irrigation Fund. In terms of capital expenditure, off budget financing of railway projects through borrowings of the IRFC and financing of power projects through the PFC are outside the budgetary control. Such off-budget financing are not part of calculation of the fiscal indicators despite fiscal implications. Taking into account the understatement of Public Account liability of 7,63,280 crore, total liability of the Central Government at the end of the financial year 2016-17 would be 76,69,545 crore which is 50.5 *per cent* of GDP rather than 45.5 *per cent* against the projection of 47.10 *per cent* in MTFP statement 2016-17. The Audit also noticed variation in disclosure of actual expenditure on GIA for capital assets between Expenditure Budget and Finance Accounts.

The amendments to the FRBM Act in 2018 were made in light of the recommendations of the FRBM Act Review Committee chaired by Shri N.K. Singh (hereafter the NK Singh Committee). The notable changes made were:

- It removed the target of ERD and RD from the FRBM Act. (The NK Singh Committee recommended discontinuation of ERD, but continued targeting of RD, to bring it down to 0.8 per cent by FY23)
- It specified the limits on fiscal deficit in the Act itself, requiring the government to reduce it to 3 per cent of GDP by 31st March, 2021.

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[5] Effective Revenue Deficit = Revenue deficit- Grants in aid for creation of capital assets. The Union gives GIA to states and other agencies to create capital assets, but as the ownership of these assets don't lie with the Union, they form a part of revenue expenditure, and hence revenue deficit. ERD is hence, meant to depict that part of RD which is spent only on consumptive items.

[6] The CAG had the discretionary authority to review implementation of any Act dealing with financial matters. But the amendment allowed it to be made a mandatory review.

- It made debt, both the Union and General government debt, a target. The government was required to reduce Union debt to 40 per cent and general government to 60 per cent of GDP by 31st March, 2025.
- It specified more grounds for the escape clause, removing the earlier provision which allowed the Centre to specify exceptional grounds.
- It reduced the possible deviation under the escape clause, to 0.5 per cent of GDP.

State Level Fiscal Responsibility Legislation

Among the states, Karnataka became the first state to enact its FRBM Act in September 2002 followed by Kerala (2003), Tamil Nadu (2003) and Punjab (2004). Most states passed the fiscal responsibility act by 2005-06 in order to avail the incentives of debt consolidation and relief facility as recommended by the 12th Finance Commission. Sikkim and West Bengal were the last states to enact their FRBM Acts in 2010. Since then, these fiscal responsibility legislations (FRLs) have been amended several times (details given in Appendix I). The FRLs aimed to impose fiscal discipline. As recommended by the 12th Finance Commission, the overall deficit was to be brought down to 3 percent of GSDP by 31st March, 2009 through a minimum annual reduction of 0.3 per cent of the GDP, while the revenue deficit was to be eliminated by 2008-09 through an annual reduction of 0.5 percent of GDP (later extended to 2009-10). Additionally, the 12th Finance Commission allowed states to borrow directly from the market to introduce market based fiscal discipline at the State level. The FC argued that 'While fiscally prudent states manage to borrow at rates lower than those offered by the federal government, the fiscally imprudent state would find their access to loan finance curtailed. We feel that it would be appropriate for states to take advantage of the market rates and avoid the spread charged by the centre. We, therefore, recommend that, in future, the central government should not act as an intermediary and allow the states to approach the market directly'.

The fiscal deficit target was relaxed temporarily to 3.5 percent of GSDP in 2008-09 and to 4 percent of GSDP in 2009-10 in light of the global financial crisis. The states essentially achieved the fiscal targets years in advance of the target year of FY 2008 (extended to 2009/10 due to the financial crisis). Majority of the states also amended their FRBM Acts between 2010-11 and 2011-12 in order to comply with the fiscal consolidation path suggested by the 13th FC. The 13th Finance Commission recommended both Union and states to eliminate revenue deficit by 2014-15. For its terminal year, 2014-15, it set a target of 68 per cent as general government debt, with Union debt being 44.8 per cent and states' debt being 24.3 per cent.

Next set of amendments to the State FRBM Acts came in 2015-16 and 2016-17 to incorporate the flexibility provision as per the recommendation of the 14th Finance Commission (FFC). The FFC recommended that fiscal deficit limits were to be relaxed by 0.5 percentage points for states which meet three conditions[7]:

- zero revenue deficit in the previous year[8];
- debt to GSDP ratio lower than 25 percent; and
- interest payments to GSDP ratio less than 10 percent of GSDP.

[7] Economic Survey, 2016-17.
[8] This was an entry level condition.

States have further revised their FRLs in 2020-21 following additional 2 per cent borrowing provided by the Union government as part of the Atmanirbhar Bharat package over and above the 3 per cent borrowing limit. This enhanced borrowing limit was a significant component of the fiscal stimulus package announced by the Union Government to deal with the Covid-19 pandemic induced economic contraction.

International Experience of Fiscal legislation.

Back in 2003, fiscal rules were relatively novel for Emerging Market Economies (EMEs). But the number of EMEs that adopted fiscal rules has increased dramatically since then. The experience of the Global Financial Crisis, when countries faced with lack of flexibility in their fiscal rules, led to the **Second Generation Fiscal Framework[9].** It has 4 key traits:

- Countries moved towards adopting more than one fiscal rule to mitigate the shortcomings of a single rule and balance credibility of fiscal policy with required flexibility. The average number of fiscal rules in emerging markets in 2000 was 1. By 2014, it had almost doubled to 1.7[10].
- Flexibility was in-built using 2 approaches- structural or cyclically adjusted deficits and escape clauses
- Inclusion of automatic correction mechanism within the law to handle deviations from legislated fiscal rules.
- Independent fiscal councils have been set up for both ex-ante analysis and ex-post monitoring in more than 30 countries.

As per the IMF Fiscal Rules Dataset, the number of countries with fiscal rule has increased to 96 in 2015, from just 7 nations in 1990. Of the 96 nations, 33 are Advanced Economies(AEs), 36 EMEs[11] and 27 Low Income Countries(LICs).

There were multiple factors triggering the adoption of fiscal rules. Some countries imposed rules to control debt burdens in light of an economic crisis(for example, Finland, Sweden, Brazil, Peru) or controlling a secular rise in debt-deficit levels(Netherlands, Switzerland). Countries also imposed rules to impart fiscal discipline after the expansionary fiscal policies in light of the GFC.

There are 5 broad types of fiscal rules adopted:

- Debt rule- One of the most commonly targeted variable is debt/GDP ratio. However, **exclusive focus on debt to GDP ratio can results in pro-cyclical fiscal bias.**

- Fiscal deficit or Budget Balance rule- This underpins India's original FRBM Act. It provides clear operational guidance to policymakers. It is also closely linked to debt sustainability. However, it also suffers from the problem of pro-cyclicality as adherence to the rule prevents generation of fiscal space during booms and a tight fiscal policy during downturns.

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[9] The First Generation Fiscal Rules were less flexible and had single targets, making them less comprehensive and enforceable.

[10] Ibid. p.30

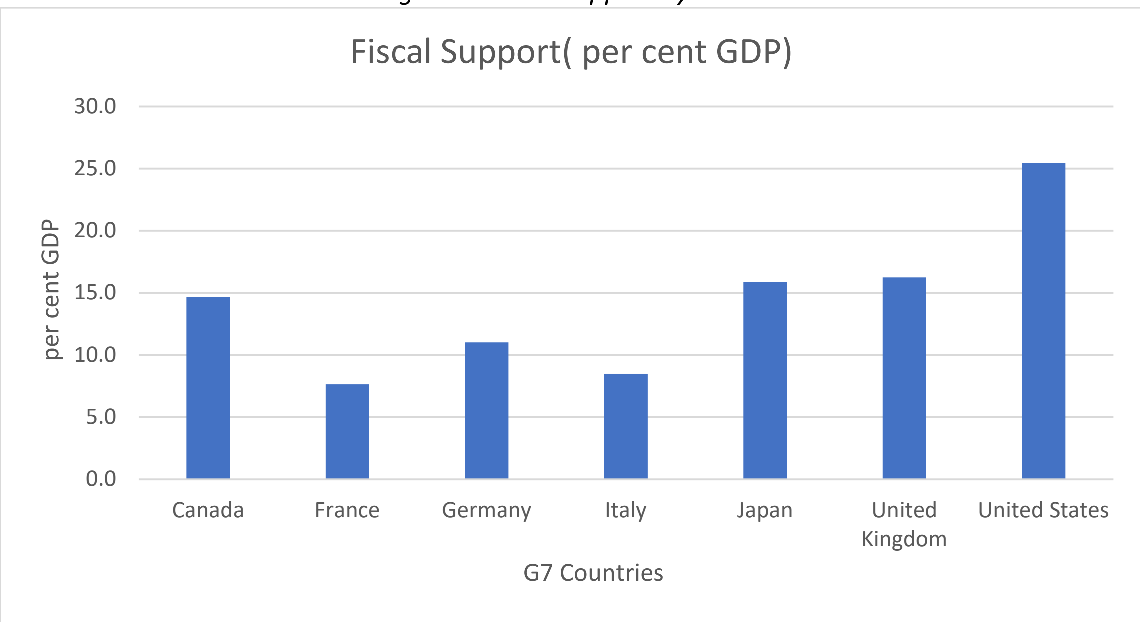
[11] Iran has been considered an EME here. However, the IMF dataset does not classify Iran.

- Structural Budget Balance and 'Over the Cycle' Rule- This is intended to overcome the deficiency of the Budget Balance rule by targeting structural deficits. This has economic stabilisation properties as it accounts for the state of the business cycle. But this poses the difficulty of estimating the output gap and gauging the state of the business cycle, which can be challenging for EMEs and LICs in particular as these countries are undergoing sustained structural transformation and also have data issues.
- Expenditure rule- Sets limit on spending(total/primary/current). These rules have the benefit of directly targeting the size of the government and have counter-cyclical properties. However, the counter-cyclicality is asymmetric, with the limit being more flexible during downturns
- Revenue rules- Aim to put a ceiling or floor on revenues. Ceilings ensure that tax is not burdensome while floors incentivise tax administrations and revenue collections. However, operationalising these can be difficult as revenue is strongly correlated with the business cycle.

<u>International fiscal response to the Covid-19 pandemic</u>

Fiscal support has been the key tool to minimise economic contractions and job losses across countries. But due to drop in revenues, these support measures have resulted in a spike in government debt-deficit levels. Average deficits as a share of GDP in 2020 reached 11.7 per cent for advanced economies, 9.8 per cent for emerging market economies, and 5.5 per cent for low-income developing countries[12]. Public debt worldwide reached an unprecedented 97 percent of GDP in 2020 and is projected to increase to around 99 percent of GDP in 2021[13]. Central banks have used their policy tools to support government spending by purchasing government bonds, which lowered interest rates.

Figure 1: Fiscal Support by G7 nations

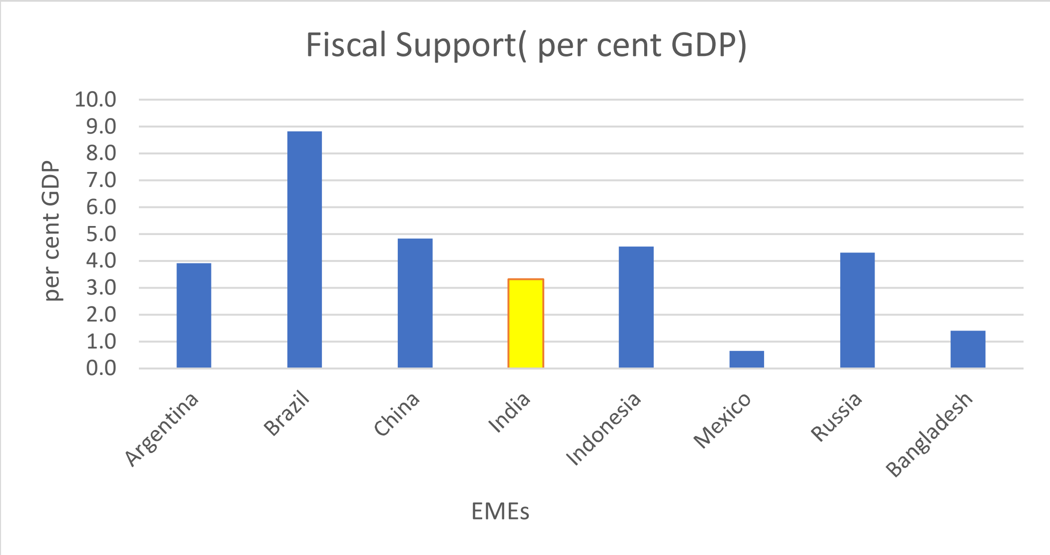


Source: IMF Fiscal Monitor: A Fair Shot, April 2021

[12] IMF Fiscal Monitor, April 2021 p. xi

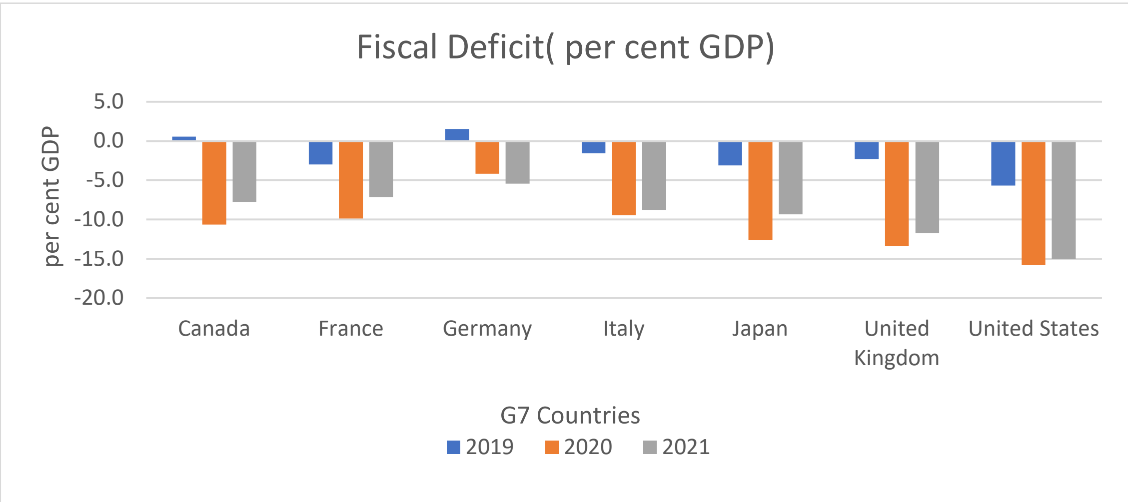
[13] Ibid.

Figure 2: Fiscal Support by EMEs



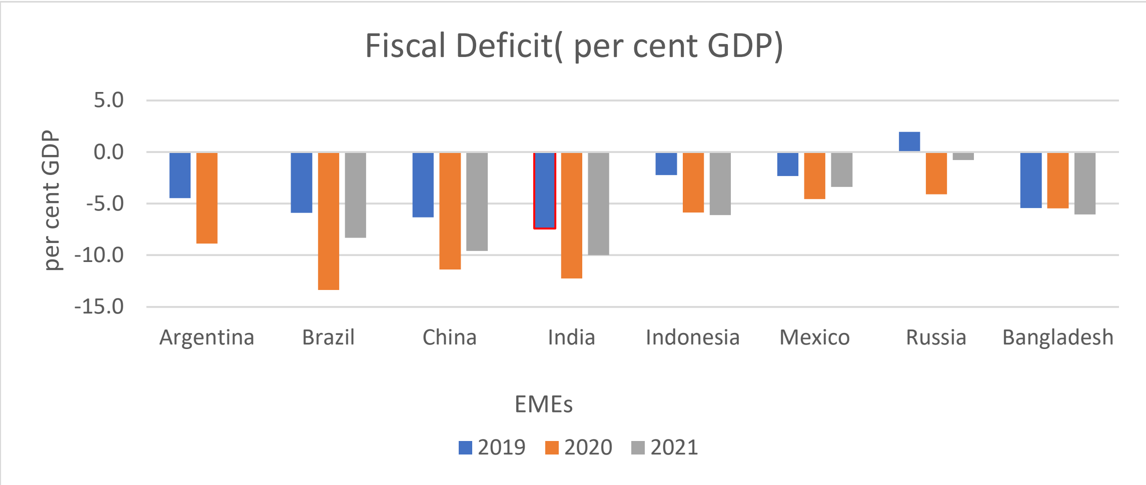
Source: IMF Fiscal Monitor: A Fair Shot, April 2021

Figure 3: Fiscal Deficit of G7 nations



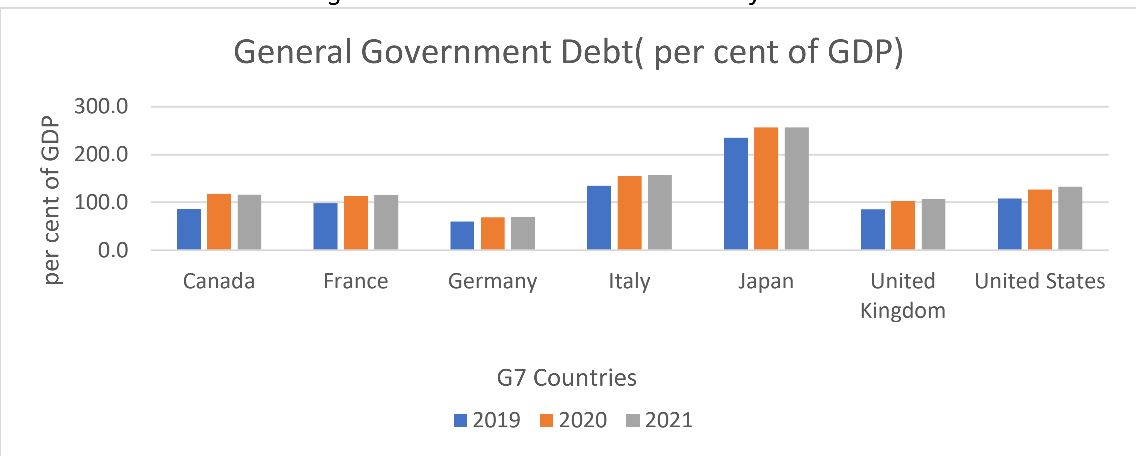
Source: IMF Fiscal Monitor: A Fair Shot, April 2021

Figure 4: Fiscal Deficit of EMEs[14]



Source: IMF Fiscal Monitor: A Fair Shot, April 2021

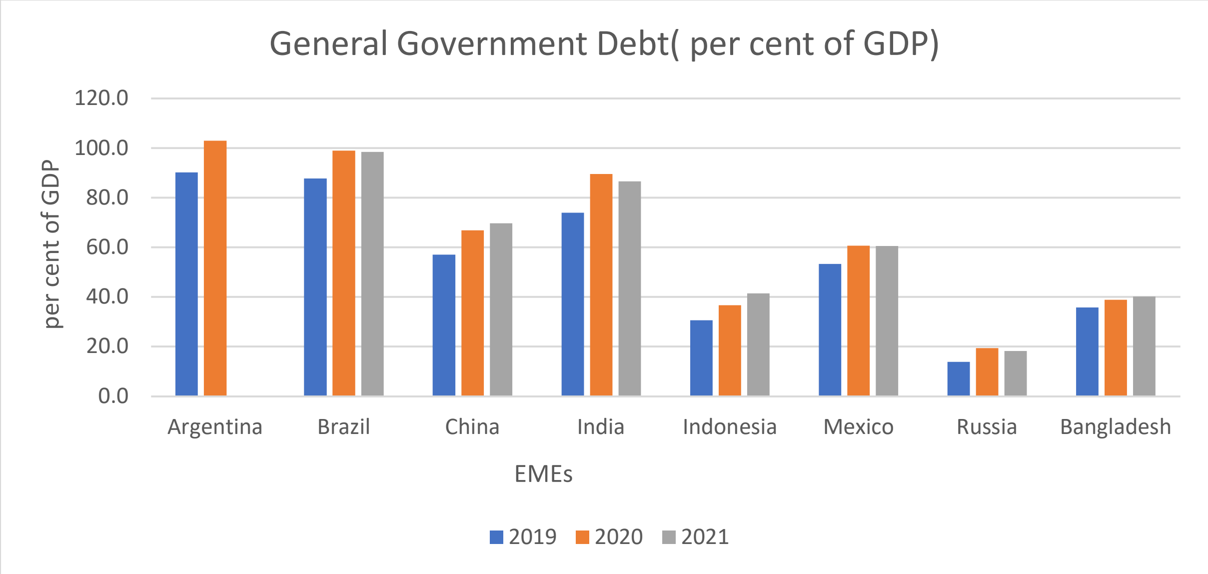
Figure 5: General Government Debt of G7 nations



Source: IMF Fiscal Monitor: A Fair Shot, April 2021

[14] Note that India's general government Fiscal Deficit is 13.83 per cent of GDP as per updated accounts of Union and states.

Figure 6: General Government Debt of EMEs[15]



Source: IMF Fiscal Monitor: A Fair Shot, April 2021

Views on fiscal consolidation in the Covid context.

Since, the Covid-19 pandemic resulted in a sharp increase in debt to GDP ratio across countries, there is reassessment of the conventional wisdom on public debt. Codogno and Corsetti (2020) argue that if the multipliers of the fiscal stimulus due to COVID are high, then the higher debt will be sustainable. Krugman (2020) also argues for a deficit-financed public investment program on a continuing basis. Ardanaz et al (2021) observed that in 75 advanced and emerging economies, 'with either no fiscal rule or with a rigid fiscal rule, a fiscal consolidation of at least 2 per cent of GDP is associated with an average 10 per cent reduction in public investment. Instead, in countries with flexible fiscal rules, the negative effect of fiscal adjustments on public investment vanishes, which implies that flexible rules protect public investment during consolidation episodes. In the context of European Union, Blanchard et al (2021) made the following observations, 'The European Unio n's fiscal rules have been suspended until at least the end of 2021. When they are reinstated, they will need to be modified, if only because of the high levels of debt. Proposals have been made—and more are to come—suggesting various changes and simplifications.' The paper discusses 'how one should think about debt sustainability in the current and likely future EU economic environment.' William G and M Paulo (2021) argue that ' The Covid-19 pandemic and the global economic contraction will put rule-based fiscal frameworks to the test. The severity of the shock will likely result in a temporary large deterioration in the fiscal deficit and public debt. Many countries are already activating escape clauses to deviate or suspend the fiscal rules. It will be important to ensure the use of this flexibility is temporary and done transparently, including explaining the size of the deviation and process to return to the rule, to preserve the credibility of the fiscal framework.' The Economic Survey, Government of

[15] Note that India's general government debt is 88.94 per cent of GDP as per updated accounts of the Union and the states.

India 2020-21 observed that 'Amidst the COVID-19 crisis, fiscal policy has assumed enormous significance across the world. Naturally, the debate around higher Government debt to support a fiscal expansion is accompanied by concerns about its implications for future growth, debt sustainability, sovereign ratings, and possible vulnerabilities on the external sector. For India and other EMEs, which have consistently grown their GDP at high rates over the last few decades, the relationship between debt and growth exhibits a clear direction of causality: Higher growth lowers debt-to-GDP ratios but lower debt does not necessarily lead to higher growth.'

Due to the uncertainty regarding the economic and fiscal effects of the pandemic, the European Commission has refrained from initiating the excessive deficit procedure against member states in 2020 as well as 2021[16]. In the Economic and Financial Affairs Council (ECOFIN) deliberations, EU members have agreed on the need to provide fiscal support in 2021, while safeguarding fiscal sustainability in the medium term.[17] Germany, with its debt significantly increasing in 2021, plans to achieve the medium-term budgetary objective of a general government structural deficit no higher than 0.5 per cent of GDP by 2024 and debt/GDP ratio to 69.25 per cent. The German Bundestag determined the Covid pandemic as an exceptional situation under Article 115(2) of its Basic Law[18], allowing Germany borrowing in excess of the stipulated limits.

Similarly, the UK's borrowing showed a sharp spike, with its general government gross debt/GDP ratio jumping from 85.2 per cent to 103.7 per cent. As per the UK Budget 2021-22, the general government gross debt/GDP ratio is expected to stabilise at 110.4 per cent by 2025-26[19], though it is expected to sharply bring down its fiscal deficit to 3.1 per cent by 2025-26[20]. The UK Government's 'fiscal policy at this Budget prioritises support for the economy in the short term, while reducing borrowing to sustainable levels once the economy recovers,' while being mindful of the interest rate risk, hence also charting a path for sustainability by 2025-26. *Thus, globally, the fiscal response to the pandemic has been an expansion in debt-deficit levels, with the target of medium-term sustainability, to be achieved through investment-led growth.*

<u>Impact of the Covid-19 pandemic on India's Fiscal Balance</u>

During 2011-12 to 2019-20, the fiscal deficit of the Union government remained above the FRBM target, although it improved from 5.9 per cent of GDP in 2011-12 to 3.4 per cent in 2018-19. In 2019-20, it again increased to 4.6 per cent and to 9.22 per cent in 2020-21. As is

[16] https://ec.europa.eu/info/sites/default/files/2021-germany-stability-programme_en.pdf

[17] Ibid.

[18] Article 115(2) states that '…In cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to the state's financial capacity, these credit limits may be exceeded on the basis of a decision by a majority of the Bundestag's Members. The decision has to be combined with an amortisation plan. Repayment of the credits borrowed under the sixth sentence must be accomplished within an appropriate period of time. '

[19] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966868/BUDGET_2021_-_web.pdf

[20] Ibid.

well known, the sharp increase in the fiscal deficit to GDP ratio for the year 2020-21 is attributed to the sharp decline in revenues due to COVID-19 induced contraction in the economy. The revenue receipts declined from ₹ 2020926 crores(BE 2020-21) to ₹ 1632094 crores(PE 2020-21), a shortfall of 1.9 per cent of GDP. Concurrently, expenditures increased from ₹ 3042230 crores(BE 2020-21) to ₹ 3511181 crores (PE 2020-21), an increase of 2.3 per cent of GDP. The combined effect of this on the government finances is termed as the 'scissor-effects'.

The debt/GDP ratio of the Union improved from 53.2 per cent in 2011-12, to 49.4 per cent in 2017-18, before falling to 52 per cent in 2019-20. Due to the elevated borrowing in 2020-21 due to the COVID-19, the debt/GDP ratio of the Union increased to 58.8 per cent[21].

States have fared better than the Union, in terms of meeting fiscal consolidation targets. Except 2015-17, when the impact of UDAY scheme was pronounced[22], states have maintained fiscal deficits (aggregate for all states) below 3 per cent of GDP. State debt/GSDP ratio has risen from 25.9 per cent in 2016-17 to 27.3 per cent in 2019-20.

As per the RE 2020-21 of states, all State fiscal deficit has increased to 4.53 per cent of GDP as against 2.8 per cent (2020-21, BE), while their outstanding liabilities have increased to 30.09 per cent of GDP[23]. India's general government fiscal deficit has increased to 13.83 per cent of GDP in 2020-21. General government debt increased to 88.94 per cent of GDP in 2020-21.

Growth has improved in the Q1:2021-22, with GDP at current prices growing at 31.7 per cent YoY, compared to a contraction of 22.3 per cent in Q1:2020-21. In nominal term, the GDP estimate, has exceeded the pre-COVID level. Also, the improvement has been broad-based, with key sectors like manufacturing, construction, and Trade registering robust growth. This augurs well for government finances as well.

15th Finance Commission's views on Deficit and Debt

The FC-XV highlighted that the revenue deficit of the Union government cannot be eliminated by FY 2025-26 and it would be '*impossible to pursue the FRBM path of fiscal deficit of 3 per cent of GDP even by 2025-26, unless economy gains a greater momentum than expected.*' However, even by FY 2024-25, the general government debt is likely to be 87.8 per cent of GDP, thus missing the FRBM debt target of 60 per cent of GDP in the FRBM Act (as amended in 2018). Table 1 shows the debt-deficit estimates of the FC-XV.

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[21] CGA data

[22] As per the FC-XV, UDAY had an impact of 0.7 per cent of GDP in 2015-16 and 0.8 per cent in 2016-17. Interestingly, capex of states increased from 2.4 per cent in 2014-15 to 3.3 per cent in 2016-17 as states provided support to DISCOMs largely through loans under UDAY.

[23] Calculated from state budgets 2021-22.

Table 1:Debt_Deficit estimates (% of GDP)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Union Revenue Deficit	5.9	4.9	4.5	3.9	3.3	2.8
Union Fiscal Deficit	7.4	6.0	5.5	5.0	4.5	4.0
States' revenue deficit	-0.1	-0.4	-0.8	-1.1	-1.6	-2.4
States' Fiscal deficit	4.2	3.3	3.3	2.8	2.8	2.8
Total Liabilities – Union	62.9	61.0	61.0	60.1	58.6	56.6
Total Liabilities – States	31.1	30.7	31.3	31.1	30.9	30.5
Total Liabilities – Combined	89.8	88.3	89.6	89.1	87.8	85.7

Source: FC-XV report

The FC-XV also considered a range of deficits targets for the Union government by factoring in the uncertainty caused by the pandemic. The FC considered two scenarios for fiscal deficit with upper and lower limits; i.e. 0.5 per cent GDP above and below the assessed fiscal deficit for its terminal year 2025-26. The range of fiscal deficit paths proposed by FC-XV are given in Table 2.

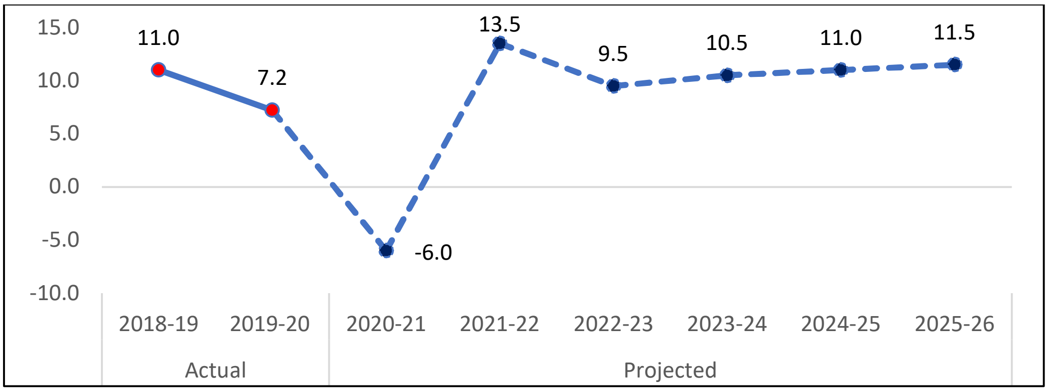
Table 2: Range of Fiscal Deficit Path by FC-XV (% of GDP)

Fiscal Deficit	2021-22	2022-23	2023-24	2024-25	2025-26
Assessed Rate	6.0	5.5	5.0	4.5	4.0
Slower Recovery	6.5	6.0	5.5	5.0	4.5
Faster Recovery	5.0	5.5	5.0	4.0	3.5

Source: FC-XV Report

The FC-XV's growth assumptions are shown below in Figure 7

Figure 7: FC-XV Growth path



Source: FC-XV Report

The growth estimates by other institutions is given in Table 3.

Table 3: Growth estimates.

Growth Projections	2020-21	2021-22
FC-XV	-6.0	13.5
Economic Survey 2021	-4.4	15.4
NSO PE	-3.0	-
Budget 2021-22	-4.2	14.4
RBI MPC – Real GDP	-7.5	9.5

Source: RBI, MoSPI, Economic Survey, 2020-21, FC-XV, Budget

Debt-Deficit Path for the future

According to the Medium-Term Fiscal Policy cum Fiscal Policy Strategy statement 2021-22, 'The Covid-19 related uncertainty makes any forecast of economic growth and fiscal variables including the specification of a return path challenging. The Government endeavours to return to the path of fiscal consolidation as soon as economic growth and receipts return to their long-run averages.' Thus, no path/target for debt/GDP ratio has been indicated in the Budget 2021-22 on account of the uncertainty due to the Covid-19 pandemic.

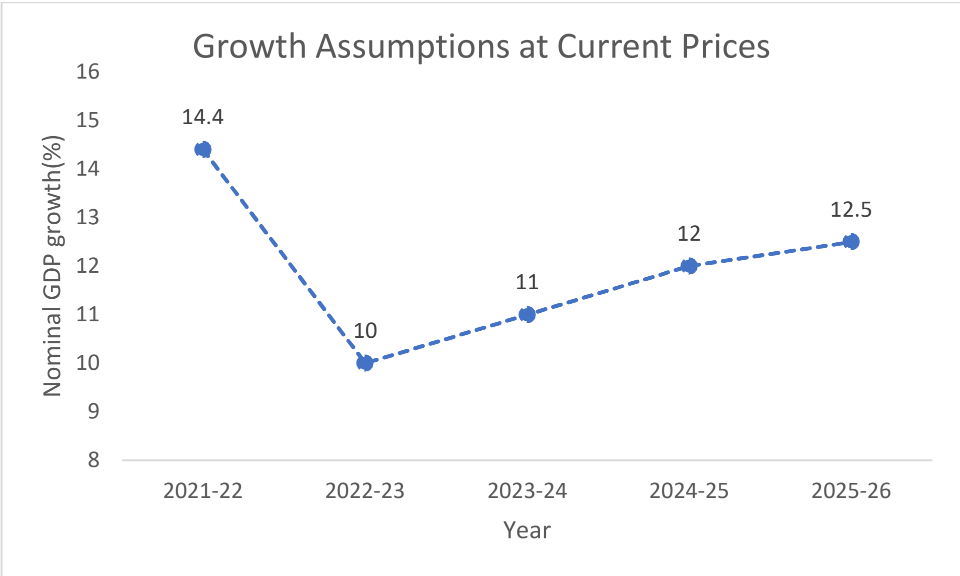
Primarily due to the upturn in growth as visible and validated by the latest GDP estimates for the 2021-21 (Q1) data by MOSPI, we have assumed a higher GDP growth than the rates assumed by FC-XV,[24]. The quarterly GDP data shows much less severe impact of the 2nd wave of Covid compared to the first. With key sectors like manufacturing, construction, and Trade performing better than expected, the improvement has been significantly broad-based. The much larger capex push by the Union in BE 2021-22 also augurs well for the future growth of the country, founded on a revival of investment, both public and private. This augurs well for government finances as well, justifying the case for upward revision of year wise GDP growth rate assumption of the FC-XV. We assume that growth rates of GDP will be 10 per cent for

[24] http://mospi.nic.in/sites/default/files/press_release/PRESS_NOTE-Q1_2021-22.pdf

the year 2022-23 and in the terminal year of Finance Commission cycle it will be 12.5 per cent (Figure 8).

The sharp fall in nominal growth rate in 2022-23 is due to the tapering off of the base effect in 2021-22, which will push the economy towards a more 'normal' growth path. Post this, we expect a steady increase in growth rate (See Figure 8). To arrive at a path for Union debt till 2025-26, we projected the 2021-22 BE data for Union finances. Table 4 shows a major difference in the estimates of the FC and the BE 2021-22, particularly in the push given to capital expenditure.

Figure 8: Scenario 1 Growth assumptions



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Source: Author's estimates

Table 4: FC-XV and BE-2020-21 estimate comparison

	2021-22 BE	FC Estimate 2021-22	% Diff of BE 2021-22 and FC Est. of 2021-22
Gross Revenue Receipts	**24,60,087**	**24,29,405**	**-1.25**
Gross Tax Revenue	22,17,059	21,35,398	-3.68
Non-Tax Revenues	2,43,028	2,94,007	20.98
Tax Share to States	6,65,563	6,58,591	-1.05
Net Revenues to the Centre	**17,88,424**	**17,67,884**	**-1.15**
Revenue Expenditure	**29,29,000**	**28,38,995**	**-3.07**
Grants-in-Aid to State Governments Recommended by FC	2,20,843	2,33,279	5.63
Provision for other transfers (expected) to States**	4,75,435	4,44,485	-6.51
Capital Expenditure	**5,54,236**	**3,69,269**	**-33.37**
Non-Debt Capital Receipts	1,88,000	1,38,345	-26.41
Revenue Deficit/Surplus(-)	**11,40,576**	**10,71,111**	**-6.09**
Fiscal Deficit/Surplus(-)	**15,06,812**	**13,02,035**	**-13.59**
Adjusted Outstanding Debt*	**1,35,86,975**	**1,26,73,209**	**-6.73**
GDP	**2,22,87,379**	**2,17,00,585**	**-2.63**

Source: FC-XV and Union Budget, 2021-22

The effective rate of interest for the year 2021-22 works out to be 6.67 per cent. We apply this interest rate for the period of projection. Additionally, we assume a higher buoyancy of the taxes than those assumed by the FC-XV. The reforms carried out by the government in tax administration, greater digitization, stabilization of the GST regime, greater profitability of the private sector due to growth, are expected to bear their positive effects in the next few years. These are given in Table 5.

Table 5: Tax Buoyancy estimates

Year	Corporation Tax	Income Tax	Customs Duties	Union Excise Duties	Service tax	Goods and Services Tax	Other Taxes
FC-XV Buoyancy	1.24	1.30	1.15	0.7	0	1.2	1
Assumed Buoyancy	1.3	1.35	1.2	0.75	0	1.25	1

Source: FC-XV report and Author's calculations

Based on these, our debt-deficit projections for the Union are given in Table 6. As evident from the Table, upward revision of GDP growth by 1 percentage point in the terminal year will result in the correction of debt to GDP ratio but will remain higher than what is projected by the FC-XV due to the base effect of higher fiscal deficit in 2021-22 (BE).

Table 6 Scenario 1 Union Debt-Deficit Path

Year	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue Deficit	5.12	4.62	3.92	3.25	2.55
Fiscal Deficit	6.76	6.33	5.67	5.00	4.29
Debt	60.96	61.75	61.30	59.73	57.38

Source: Author's calculations

The state budgets of 2021-22 show that as per RE 2020-21, 24 states had a revenue deficit. This trend, though likely to improve in 2022-23 and beyond, in the short-run may result in reduction of capex by states. In view of the facts that the borrowing limits of the States is fixed and the risk of running state level revenue deficit remaining high due to uncertainties surrounding the pandemic, the likely squeeze on State capex[25] has the potential to derail the growth path. ***Therefore, to ensure faster investment-led post-Covid economic recovery, it is critical that the pace of capex, both at the State level and the Union, is not allowed to slacken for want of resources.***

We propose creation of an incentive based special window for investment in capital expenditure in the States through budgetary support from the Union. This special fund will be carved out by the Union for disbursal to states for an amount equal to 0.5 per cent of GDP in 2021-22 and tapering off to 0.1 per cent of GDP in the terminal year of the FC-XV cycle, in 2025-26. The grant will operate on a sharing principle where the Union will contribute 60 per cent for non-NEH states, while 90 per cent for NEH states. The state wise allocation from this capex can be based on the Finance Commission devolution formula. In order to access these funds the States will need to retain their capex at a level which is justifiable by their normal borrowing limits and rationalizing revenue expenditure to ensure improvement in revenue balance. The grant is tapered off as we expect states to raise capex themselves once the economy recovers sufficiently.

The estimated allocation and Centre's share (taking a weighted average of Centre's share for NEH and Non-NEH states, at 69.6 per cent) are shown in Table 7.

Table 7: Capex grant (Amount in ₹ crores.)

Year	2021-22	2022-23	2023-24	2024-25	2025-26
Total Capex	111437	98064	81639	60957	34288
Centre's share	77560	68253	56821	42426	23865

[25] Capital expenditure of the States is almost 60 per cent of the total capital expenditure of the General government.

How will funds required for this Special window become available to the Union, especially with the fiscal deficits remaining high? One of the consequences of the higher capex to states is the potential improvement in growth and the resultant higher buoyancy from taxes compared to the estimates of FC-XV, as shown in Table 5. The reforms carried out by the government in tax administration, greater digitization, stabilization of the GST regime, greater profitability of the private sector due to growth, are also expected to bear their positive effects in the next few years. Given the above, our estimates of the Union debt-deficit are given in Table 8.

Table 8: Debt-Deficit path with Capex grant

Year	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue Deficit	5.12	4.64	3.95	3.29	2.61
Fiscal Deficit	7.11	6.63	5.91	5.19	4.41
Debt	61.31	62.37	62.10	60.63	58.31

Source: Author's calculations

Note that as we have assumed GDP growth to be same in both the cases (without and with capex grant), in reality with higher capex, the growth effect will be even higher and deficit figures will be lower than the one reported in Table 8. Furthermore, recognizing the need to support vital areas like health, education, agriculture, poverty support programs, we have not assumed any reduction in revenue expenditure, although, as the 15th FC has emphasized, there is considerable scope for ~~expenditure~~ rationalization of ~~the~~ revenue expenditure. If such a rationalization is achieved, it will further improve the debt-deficit dynamics of the Union. ***Similarly, at the state level, the contribution of States' share towards the capex grant will have to be made through reduction in revenue deficit, as states' borrowing limit is fixed by the FC. This again will potentially act as an incentive for the States to improve the quality of spending at the state level.***

As per our estimates, the Union government can achieve its fiscal deficit target of 4.5 per cent by 2025-26 even after providing a capex grant to states. As can be seen from the Table 8, there is considerable correction in the debt to GDP ratio from 60.6 per cent to 58 per cent during this period.

We also propose that to provide flexibility to the Union for its counter-cyclical fiscal policy, leveraging automatic stabilisers is key. Hence, if in a year with higher growth, the fiscal deficit is lower than the target, the additional space should be carried forward to be used in a year with low growth, but within the FC cycle. ***This has been accepted by the Union as a recommendation of FC-XV for states, and instituting this for Union will improve the effectiveness of fiscal policy, without worsening the financial position in poor years, while also preventing deficit bias from affecting fiscal policy.***

<u>Targeting revenue deficit and effective revenue deficit</u>

As mentioned earlier, the FRBM Act was amended in 2018 to remove revenue deficit and effective revenue deficit as targets under the FRBM Act. This, in our opinion, can weaken the quality of the fiscal consolidation regime in India by deviating from the 'golden rule' of public finance, which is that governments should not borrow to consume, but to invest. Analysis from Table 9 shows that the correlation between RD/FD ratio and capex/revex ratio is -0.35. Hence a fall in the revenue deficit component of fiscal deficit leads to a major improvement in capital expenditure. But as the revenue deficit forms over 75 per cent of fiscal deficit, reduction in revenue deficit is key, for ensuring that the government does not borrow to consume but to create productive capacity in the economy and increase the potential and actual growth in India. Targeting revenue deficit will also ensure that the FRBM becomes an expenditure switching mechanism, rather than merely an expenditure compression mechanism. Targeting revenue deficit will also bring symmetry in Union-state fiscal stance as currently, Union is not targeting revenue deficit, while states' borrowing targets are set with reference to revenue deficit

Table 9: Quality of expenditure and deficit.

Year	Revenue Expenditure	Capital Expenditure	Capex/ Revex	Revenue Deficit	Fiscal Deficit	RD/FD
2015-16	1537761	253022	0.16	342736	532791	0.64
2016-17	1690584	284610	0.17	316381	535618	0.59
2017-18	1878833	263140	0.14	443600	591062	0.75
2018-19	2007399	307714	0.15	454483	649418	0.70
2019-20	2350604	335726	0.14	666545	933651	0.71
2020-21(PA)*	3086360	424821	0.14	1454266	1821461	0.80
2021-22(BE)	2929000	554236	0.19	1140576	1506812	0.76

Source: Union Budget documents & *CGA

We understand the imperative of increasing expenditure in critical sectors like health and education, upkeep of assets, which will lead to pressure on revenue account. However, expenditure rationalization in areas like subsidies, pensions, general administration should help. On targeting effective revenue deficit, the intention was to eliminate the part of the revenue deficit that was not spent on creation of capital assets. As defined in the FRBM Act, the grants for creation of capital assets meant grants-in-aid given by the Union Government to State Governments, Constitutional authorities or bodies, autonomous bodies, local bodies and other agencies implementing schemes for the creation of capital assets which are owned by the said entities. However, as argued by the 14th Finance Commission, this concept had no foundation in the Constitutional financial scheme, which divides expenditure only in revenue and capital account. It further argued that this 'artificial carving out of the revenue account deficit into effective revenue deficit to bring out that portion of grants which is intended to create capital asset at the recipient level leads to an accounting problem and raises the moral hazard issue of creative budgeting.' Essentially this means that a provision for effective revenue deficit allows masking revenue expenditure as for capital purposes. It can further lead to a proliferation of Centrally Sponsored Schemes to help reduce the overall revenue deficit. Furthermore, the budget documents provide scattered details about the assets to be created through such grants and hence, diminishes transparency and legislative oversight over the finances. The CAG[26] pointed out deviations and inconsistencies in the correct accounting classification of grants under the ERD. Grants given by the Central government under schemes like Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) Member of Parliament Local Area Development Scheme (MPLADS) Indira Awas Yojana (IAY) Rajiv Awas Yojana (RAY) *etc.,* were used for expenditure on general community works with no clear ownership, or for assets like houses whose ownership vested in individual beneficiaries. In view of fungibility of resources at the grantee level, the end-use of grants for asset-creation is desirable only if there is credible assurance that it is not leading to mere refinancing or replacement of existing spending on asset creation and that the assets that would have been created but for these grants continue to be actually so created.

So, we recommend that revenue deficit should be included as a target in the fiscal responsibility legislations to improve the quality of spending. The removal of effective revenue deficit as a target in the FRBM Act should not be reversed.

Escape clause

The FRBM Act, as elaborated above, had an escape clause built into it, with a very wide scope in terms of the circumstances where it could be invoked. Post the recommendations of the NK Singh Committee, the escape clause was narrowed down with circumstances written in much clearer terms. However, the government was allowed to deviate from the fiscal target by merely 0.5 per cent even when the GDP growth fell by 3 per cent. We recommend that while it is required to specify the circumstances when fiscal consolidation could be put on hold to prevent the deficit bias from affecting the normal course of the economy, it is not appropriate to restrict the quantum of deviation. It is highly unlikely that in case of the severe contraction of GDP, the government will restrict the quantum of countercyclical fiscal support to merely 0.5 per cent, thus rendering the clause infructuous. Hence, within the circumstance, **it should be left to the wisdom of the executive to decide the appropriate level of fiscal deviation.**

[26] Report No. 20 of 2018

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Appendix 1

Table A1: Timeline of FRBM Act and their amendments for States

S. No.	States	FRBM enactment	FRBM amendments
1	Andhra Pradesh	Jun, 2005	Jan, 2006; Apr, 2010; Mar, 2011
2	Arunachal Pradesh	Mar, 2006	Dec, 2006; 2011; Mar, 2018
3	Assam	Sep, 2005	Aug, 2007; Aug, 2009; Sep, 2011; Apr, 2017
4	Bihar	Apr, 2006	Mar, 2009; Jan, 2010; 2016; 2020
5	Chhattisgarh	Sep, 2005	Sep, 2011; May, 2016
6	Goa	May, 2006	Apr, 2014
7	Gujarat	Mar, 2005	Aug, 2009; Mar, 2011
8	Haryana	Jul, 2005	Jan, 2006; Sep, 2009; Apr, 2010; Apr, 2011; Aug 2020
9	Himachal Pradesh	Apr, 2005	2011
10	Jammu & Kashmir	Aug, 2006	Oct, 2011; Feb, 2018;
11	Jharkhand	May, 2007	Apr, 2010; Oct, 2011; Mar, 2012
12	Karnataka	Sep, 2002	Mar, 2009; Jul, 2009; Mar, 2011
13	Kerala	Aug, 2003	2011; 2018
.14	Madhya Pradesh	May, 2005	Jan, 2012; Jan, 2016; Mar, 2017
15	Maharashtra	Apr, 2005	Dec, 2006
16	Manipur	Aug, 2005	Jan, 2006; Jul, 2006; Jul, 2010; Oct, 2011
17	Meghalaya	Mar, 2006	Jan, 2007; Sep, 2015
18	Mizoram	Oct, 2006	Oct, 2010; Mar, 2011
19	Nagaland	Sep, 2005	2009; 2011
20	Odisha	Jun, 2005	May, 2006; Feb, 2012; Nov, 2016
21	Punjab	Oct, 2003	2006; 2007; 2011; 2020
22	Rajasthan	May, 2005	Aug, 2009; Mar, 2011; Sep, 2011; Apr, 2016
23	Sikkim	Sep, 2010	Apr, 2011; Mar, 2016; Mar, 2020;
24	Tamil Nadu	May, 2003	Feb, 2004; May, 2005; Feb, 2010; Sep, 2011; Mar, 2015; 2016; 2017
25	Telangana	Undivided Andhra Pradesh	Jan, 2006; Apr, 2010; Mar, 2011; Jun, 2020
26	Tripura	Jun, 2005	Oct, 2007; Aug, 2010; Apr, 2011
27	Uttar Pradesh	Feb, 2004	Mar, 2010; Mar, 2011; Sep, 2011; Mar, 2016; Jun, 2020
28	Uttarakhand	Oct, 2005	Apr, 2011; 2016
29	West Bengal	Jul, 2010	Apr, 2011

Source: State FRBM Acts

Appendix II

Table A2: Scenario 1: The Enhanced Growth and Revenue Effect

Variable	2021-22 (BE)	2022-23	2023-24	2024-25	2025-26
Gross Revenue Receipts	2460087	2788514.48	3165769.26	3597978.08	4093372.09
Gross Tax Revenue	2217059	2520470.61	2867830.01	3264303.41	3716952.38
Corporation Tax	547000	627846.6	720642.327	827153.2635	949406.516
Income Tax	561000	647113.5	746445.422	861024.7946	993192.101
Customs Duties	136000	154550.4	175631.075	199587.1531	226810.841
Union Excise Duties	335000	363575.5	394588.49	428246.8884	464776.348
Service tax	1000	0	0	0	0
Goods and Services Tax	630000	719523	821767.218	938540.34	1071906.92
Other Taxes	7059	7861.6083	8755.47316	9750.970462	10859.6558
Non-Tax Revenues	243028	268043.872	297939.25	333674.6701	376419.703
Interest Receipts	11541	11541	11541	11541	11541
Dividends and Profits	50028	55342.3172	61221.1576	67724.48877	74918.6483
Dividend/Surplus from RBI	53511	59195.2454	65483.3039	72439.31609	80134.2358
Petroleum	10321	11417.4652	12630.4149	13972.22398	15456.5819
Telecommunication	53987	51946.0462	49982.2497	48092.69368	46274.5714
Other Non Tax Revenues	63640	78601.7982	97081.1233	119904.9476	148094.665
Divisible pool	1623324	1833833.3	2071640.52	2340286.023	2643768.85
Tax Share to States	665563	751871.655	849372.614	959517.2694	1083945.23
NCCD Transfer to NCCF/NDRF	6100	6100	6100	6100	6100
Net Revenues to the Centre	1788424	2030542.83	2310296.64	2632360.811	3003326.86
Revenue Expenditure	2929000	3162405.5	3375913.45	3621513.36	3878836.16
General services	1367849	1498323.46	1637931.88	1779123.446	1921486.14
Interest Payments	809701	906251.233	1009807.96	1112683.405	1214319.55
Defence revenue expenditure	212027	227469.459	244036.631	261810.432	280878.743
Pensions	189328	199741.092	210726.906	222316.9432	234544.436
Police	94087	99402.4336	105018.162	110951.1503	117219.322
Fiscal Services	32423	33852.3579	35344.8703	36903.18596	38530.206
External Affairs	9387	10036.5983	10731.15	11473.76607	12267.7726
Other general services	20896	21570.2904	22266.2008	22984.56296	23726.1013
Subsidy	369898	381904.134	394340.187	407222.4473	420567.84
Food	242836	252549.711	262651.982	273158.3543	284084.994
Others	127062	129354.423	131688.205	134064.093	136482.846
Social & Economic Services	446289	481599.827	519704.481	560824.0131	605196.963
Health	68468	79465.0055	92228.2979	107041.5698	124234.079
Grants-in-Aid to State Governments Recommended by FC	220843	227846	198012	190203	183722
Revenue deficit grants	118452	86201	51673	24483	13705

Disaster relief grants to States	22184	23294	24466	25688	26969
Grants to local government to States	67015	84703	87181	92087	92093
Sector-specific grant	13192	23729	24773	33062	36077
State-specific grant	0	9919	9919	14883	14878
Provision for other transfers (expected) to States, of which	475435	517732.66	563793.384	613951.9562	668572.948
CSS	381304	402262.059	424372.06	447697.3189	472304.631
Of which GST compensation to States	94200	112916.354	135351.411	162244.0326	194479.879
Grants-in-Aid to Union Territories	48686	54999.4119	62131.5226	70188.49776	79290.2703
Capital Expenditure	554236	593516.691	635581.345	680627.2717	728865.765
Non-Debt Capital Receipts	188000	172804.742	158837.654	145999.467	134198.937
Revenue Deficit/Surplus(-)	1140576	1131862.67	1065616.81	989152.5492	875509.297
Fiscal Deficit/Surplus(-)	1506812	1552574.62	1542360.5	1523780.354	1470176.12
Adjusted Outstanding Debt	13586975	15139550	16681910	18205690	19675867
GDP	22287379	24516116.9	27212889.8	30478436.53	34288241.1

Table A3: Scenario II: The Enhanced Growth, Revenue and Capex Effect

Variable	2021-22 (BE)[27]	2022-23	2023-24	2024-25	2025-26
Gross Revenue Receipts	2460087	2788514.481	3165769.255	3597978.08	4093372.086
Gross Tax Revenue	2217059	2520470.608	2867830.006	3264303.41	3716952.383
Corporation Tax	547000	627846.6	720642.3275	827153.2635	949406.5158
Income Tax	561000	647113.5	746445.4223	861024.7946	993192.1005
Customs Duties	136000	154550.4	175631.0746	199587.1531	226810.8408
Union Excise Duties	335000	363575.5	394588.4902	428246.8884	464776.3479
Service tax	1000	0	0	0	0
Goods and Services Tax	630000	719523	821767.2183	938540.34	1071906.922
Other Taxes	7059	7861.6083	8755.473164	9750.970462	10859.6558
Non-Tax Revenues	243028	268043.8723	297939.2495	333674.6701	376419.7028
Interest Receipts	11541	11541	11541	11541	11541
Dividends and Profits	50028	55342.3172	61221.15761	67724.48877	74918.64835
Dividend/Surplus from RBI	53511	59195.24538	65483.30391	72439.31609	80134.23578
Petroleum	10321	11417.46525	12630.41494	13972.22398	15456.58189
Telecommunication	53987	51946.0462	49982.24973	48092.69368	46274.57143
Other Non Tax Revenues	63640	78601.79824	97081.12331	119904.9476	148094.6653
Divisible pool	1623324	1833833.304	2071640.521	2340286.023	2643768.845
Tax Share to States	665563	751871.6545	849372.6137	959517.2694	1083945.227
NCCD Transfer to NCCF/NDRF	6100	6100	6100	6100	6100
Net Revenues to the Centre	1788424	2030542.826	2310296.642	2632360.811	3003326.859
Revenue Expenditure	2929000	3167578.753	3385984.243	3636045.831	3897167.758
General services	1367849	1503496.721	1648002.668	1793655.917	1939817.737
Interest Payments	809701	911424.4898	1019878.748	1127215.876	1232651.156
Defence revenue expenditure	212027	227469.459	244036.6311	261810.432	280878.7434
Pensions	189328	199741.0916	210726.906	222316.9432	234544.4356
Police	94087	99402.43361	105018.162	110951.1503	117219.322
Fiscal Services	32423	33852.35791	35344.87033	36903.18596	38530.20596
External Affairs	9387	10036.59829	10731.15003	11473.76607	12267.77255
Other general services	20896	21570.29035	22266.20077	22984.56296	23726.10127
Subsidy	369898	381904.1341	394340.1869	407222.4473	420567.8396
Food	242836	252549.7112	262651.9817	273158.3543	284084.9935
Others	127062	129354.4229	131688.2052	134064.093	136482.8461
Social & Economic Services	446289	481599.8267	519704.481	560824.0131	605196.9632
Health	68468	79465.00551	92228.29789	107041.5698	124234.0792

[27] There are some changes made in this scenario in the BE, on account of the proposed capex grant. See below footnotes.

Grants-in-Aid to State Governments Recommended by FC	220843	227846	198012	190203	183722
Revenue deficit grants	118452	86201	51673	24483	13705
Disaster relief grants to States	22184	23294	24466	25688	26969
Grants to local government to States	67015	84703	87181	92087	92093
Sector-specific grant	13192	23729	24773	33062	36077
State-specific grant	0	9919	9919	14883	14878
Provision for other transfers (expected) to States, of which	475435	517732.6601	563793.3837	613951.9562	668572.9479
CSS	381304	402262	424372	447697	472305
Of which GST compensation to States	94200	112916.3538	135351.4115	162244.0326	194479.8789
Grants-in-Aid to Union Territories	48686	54999.41189	62131.52258	70188.49776	79290.27027
Capital Expenditure	631796[28]	661769.6908	692402.3449	723053.2717	752730.7648
Non-Debt Capital Receipts	188000	172804.7421	158837.6537	145999.467	134198.9374
Revenue Deficit/Surplus(-)	1140576	1137035.927	1075687.601	1003685.02	893840.8981
Fiscal Deficit/Surplus(-)	1584372[29]	1626001	1609252	1580739	1512373
Adjusted Outstanding Debt	13664535[30]	15290536	16899788	18480527	19992900
GDP	22287379	24516116.9	27212889.76	30478436.53	34288241.1

[28] Includes a capex grant of ₹ 77560 crores.
[29] Is different from the BE due to the higher capital expenditure.
[30] IS different from the BE due to the increased expected borrowing on account of the capex grant.