

A comparative study on budgetary deficits with reference to FRBM Act, 2003

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Abstract

This paper attempts to study how the **Fiscal Responsibility and Budget Management (FRBM) Act, 2003**, intends to bring transparency and accountability in the conduct of the **fiscal/budgetary and monetary actions of the government**. A government that abides by the FRBM rules enjoys greater credibility among the rating agencies and market participants – both national and international. As the years have rolled by, fiscal deficit has become a key factor to watch out for in every Budget presentation. It is considered the most important marker of a government's financial health. The Fiscal Responsibility and Budget Management Act, which was initiated in 2003 but has been tweaked several times since then, lays down the red lines for all types of government deficits including fiscal deficit. A government that abides by the FRBM rules enjoys greater credibility among the rating agencies and market participants – both national and international. Not letting the fiscal deficit go completely out of control has been one of the standout achievements of the incumbent NDA government. However, as India's economic growth has decelerated, there have been growing pressures on the government to breach the FRBM orthodoxy and spend in excess of fiscal deficit targets in a bid to reboot domestic economic growth.

Others, however, continue to caution that the “real” fiscal deficit is already far more than the official number, and as such, there is no room for further increasing the expenditure by the government. As mentioned above, fiscal deficit is the excess of what the amount the government plans to spend over what the government expects to receive. Obviously, to make up this gap, the government has to borrow money from the market. But all government expenditure is not of the same kind. For instance, if the expenditure is for paying salaries then it is counted as “revenue” expenditure but if it goes into building a road or a factory – that is, something that in turn increases the economy's capacity to produce more – then it is characterised as “capital” expenditure. The fiscal deficit is another key marker and it maps the excess of revenue expenditure over revenue receipts. The difference between fiscal deficit and revenue deficit is the government's capital expenditure. As a broad rule, it is considered fiscally imprudent for a government to borrow money for “revenue” purposes. As a result, the FRBM Act of 2003 had mandated that, apart from limiting the fiscal deficit to 3% of the nominal GDP, the revenue deficit should be brought down to 0%. This would have meant that all the government borrowing (or fiscal deficit) for the year would have funded only capital expenditure by the government.

Key words: budgetary, fiscal deficit, FRBM, nominal GDP, revenue deficit

Introduction

The broad goal of macroeconomic policy is to find the most effective trajectory through which the FRBM goals can be achieved. There are two main questions about the implementation of the fiscal correction which is required by the FRBM: (a) The question of an early or a late adjustment, and (b) The question of how adjustment should be shared between taxation and expenditure. India populist fiscal policy tended to raise inflation and reduce growth, when fiscal policy could have been very productive if it removed structural constraints on growth. Though fiscal dominance reduced after scrapping of automatic monetization and implementation of the Fiscal Responsibility and Budget Management (FRBM) act in 2003, effective monetary-fiscal coordination was still elusive. An example was the delayed exit of fiscal stimulus after the 2008 Global Financial Crisis (GFC), forcing excessive monetary tightening. There was steady reduction in capital expenditure (capex) in response to the pressure to reduce total expenditure while revenue expenditure (revex) grew steadily. Spending policy was sub-optimal. It is not merely the direction of the fiscal policy that matters, but its composition, and its relative impact on output in the long compared to the short run. Frequent supply shocks and the monetary policy response also constrain fiscal policy impact.

In any economy, when the government spends money or cuts taxes it has an impact on the economic activity of the country (measured in terms of a change in the nominal GDP or total incomes). But this impact (also called the “Multiplier” effect) is quite different for revenue expenditure and capital expenditure. Fiscal stimulus were implemented by a number of developed and emerging market economies to revive slowdown in demand caused by the global financial crisis (IMF 2010). Consequently, the analysis of expenditure multipliers gained traction and more precise estimates of multipliers such as for short-run and long-run, for different expenditure components, and under specific economic/policy environment are being attempted by the researchers. These estimates are helpful for policymakers to gauge the likely impact of fiscal adjustment/stimulus. Therefore, in the recent period, the focus of analysis is being extended to examine the impact of country/economy specific factors on the size of multipliers. In the mid 1990s, India experienced a boom in investment until 1995. After this, investment demand has been weak, except for the spurt in investment which was also observed in 1999-2000. This has been a period of consolidation, where firms were improving efficiency, and optimally utilising existing capacity. Largely speaking, after 1995, growth in consumption played a prominent role in obtaining GDP growth. This period of better utilising existing capacity now seems to be behind us, and the next wave of GDP growth in India is likely to be based on investment. Some evidence of an upsurge in investment is visible in the early months of 2004 for which data is available. From the viewpoint of macro policy, our goal should be to best harness this cyclical revival of investment, to prolong the period of positive expectations and high investment rates, and to maximise the impact that these investments have upon GDP growth. The fiscal reforms process needs to foster this process of investment-led growth, by establishing a non-distortionary and effective tax system to raise revenues, and by pursuing expenditure policies which yield an adequate quantity and quality of public goods. Lags in policy Fiscal consolidation is about reforms in revenues and reforms in expenditure. There is an innate time delay between

decisions and their full impact upon the revenue deficit. We may outline the sequence of events that might unfold. First, a new policy would be adopted. After this, there would be a time delay required for implementation in terms of processes and IT systems. There would then be a time delay for these systems to stabilise. Finally, there are time delays before the full impact of new policies is seen in terms of behavioural impact

Objective:

This paper intends to explore and analyze the provisions of **FRBM Act** enacted by the Government of India in 2003 to ensure **fiscal discipline** – by setting targets including reduction of **fiscal budgetary** deficits and elimination of **revenue deficit**.

Challenges of globalization and its effects on Indian society

The concept of fiscal multiplier – the short run effects of a unit change in government spending or tax on economic activity - is core to the debates on fiscal stimulus and consolidation. Despite a slight upward shift in the capital expenditure series since 2011, the gap between real revenue expenditure and real capital expenditure has widened, especially since 2005 . Since the introduction of FRBM in 2003, fiscal authorities are under pressure to keep the fiscal balance in check. Central Government's total expenditure fell from 16% to 14% of GDP in the 2 years following implementation of FRBM. However, the brunt of this expenditure control was borne by capital expenditure which declined to 1.8% of the GDP in 2008-09 from 6.2% in the 1980s while revenue expenditure continued to show a rising trend.

The “size” of the fiscal multiplier has become central to the debates related to magnitude and timing of fiscal stimulus and reversals in the post-Crisis period. India has undertaken fiscal stimulus measures following the global financial crisis. However, these stimulus measures were largely adhoc and arbitrary. Many of these measures related to public spending were introduced even before the crisis set in. There was conspicuous absence of ex-ante fiscal multiplier analysis to understand the impact of such stimulus on reviving demand. To distinguish between the response of Central Government revex and capex in the business cycle, we compute cyclical components of both expenditure heads as well as total central government expenditure. Figure 3 displays the results of the analysis. Before the GFC, total government expenditure was counter-cyclical. This result probably holds because of the reduction in total expenditure that was carried out after the implementation of FRBM in 2003-04, coinciding with a boom. Post the GFC, the total expenditure policy of the Central Government became pro-cyclical, since the rollback of the post GFC fiscal stimulus was delayed. However, separate analysis of capital and revenue expenditure brings out finer details. Figure 3 shows that before the GFC hit the global economy, India had a pro-cyclical revenue expenditure and counter-cyclical capital expenditure policy. This is not so surprising, given post

the implementation of FRBM, capital expenditure as a percentage of GDP declined sharply as compared to the average 1980s level, while revenue expenditure grew to 15% in the same period from 11.2% in the 1980s. The counter-cyclicality of total expenditure manifested in a decrease in capacity-building investments during the period of output growth.

Fiscal challenges are at the core of development challenges across South Asian countries. In India, high off-budget spending in recent years – for example by the Food Corporation of India or the National Highways Authority – calls the planned fiscal consolidation in question. In addition, the newly announced fiscal stimulus will weigh on public finances. And some states remain a source of contingent liabilities, for example, due to borrowing by utilities or due to waivers of bank debts for specific groups. In Bangladesh, the energy mix is becoming increasingly expensive. Passing on the high costs to consumers is politically difficult, which results in an increasing subsidy burden. In Bhutan, exports of electricity from large hydropower projects are an important source of government revenue, but they are lumpy and better mechanisms to smooth out public spending are needed. In Nepal, low government capacity prevents full spending of the budget. In Pakistan, the recent economic history is one of slow growth punctuated by recurrent fiscal adjustments. Finally, in Sri Lanka population aging could make the country's generous social programmes unaffordable in a not-so-distant future.

The fiscal room to manoeuvre is limited, as tax revenues in South Asian countries are lower than could be anticipated given the region's level of economic development. South Asian countries are not different from other developing countries in terms of the tax instruments they use, but their tax bases are small, tax exemptions are common, and tax evasion is widespread. Government spending is not as low as tax revenue and consequently fiscal deficits are large. Prudent fiscal policy ensuring macroeconomic stability is a key prerequisite for sustainable growth, determines the distributional effect of growth, and is crucial for external and currency stability. In addition, fiscal policy should strive to smooth out business cycle fluctuations by strengthening the automatic adjustment of taxes, and by adjusting government expenditures (Clements *et al.* 2004). In other words, government spending should decrease during growth accelerations and increase in economic downturns. Good times ought to provide the fiscal space necessary to manoeuvre during downturns.

This is especially important in South Asia, where the level of fiscal deficits is often affected by developments beyond the control of policymakers. Between 1980 and 2015, South Asian countries experienced over 100 downturns in key global and domestic variables.¹ During the troughs, fiscal deficits were on average 0.75 percentage point of GDP (gross domestic product) larger than two years earlier and 0.85 percentage point higher than two years later. In addition, fiscal deficits in South Asia are also amplified in times of intense political competition. In the year before elections, the fiscal deficit rose on average by 0.5% of GDP and it remained accelerated in the year of the election.

A vast empirical literature suggests that developing countries tend to follow procyclical fiscal policy (Kaminsky *et al.* 2004, Ilzetzki 2011, Frankel *et al.* 2013).² The procyclical bias in fiscal policy is arguably a reflection of two fundamental challenges faced by developing countries. These are the inability to access sufficient external finance, and weak institutions that cannot contain overspending when growth is high. Although the empirical evidence on the size of fiscal multipliers³ in developing countries is relatively scarce, it suggests that multipliers are relevant but smaller than in advanced economies. Using a large sample of developing countries, Kraay (2014) obtains an average government spending multiplier somewhere between 0.4 and 0.5.

Escape Clause in the FRBM Act , Fiscal Responsibility and Budget Management Act

The FRBM rules mandate four fiscal indicators to be projected in the medium-term fiscal policy statement. These are:

1. revenue deficit as a percentage of GDP
2. fiscal deficit as a percentage of GDP.
3. tax revenue as a percentage of GDP.
4. total outstanding liabilities as a percentage of GDP.

The FRBM Act set targets for fiscal deficit and revenue deficit.

The FRBM act also provided for certain documents to be tabled in the Parliament of India, along with Budget, annually with regards to the country's fiscal policy. This included the *Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement, Macro-economic Framework Statement, and Medium-term Expenditure Framework Statement*. For details check the details of the [budget documents](#).

Escape clause refers to the situation under which the central government can flexibly follow fiscal deficit target during special circumstances. This terminology was innovated by the NK Singh Committee on FRBM.

In Budget 2015, Finance Minister Arun Jaitley deferred the fiscal deficit target of 3% of the GDP and chose a target of 3.2%, citing the NK Singh committee report.

However, the Comptroller and Auditor General of India (CAG) pulled up the government for deferring the targets which it said should have been done through amending the Act.

In 2015, the FRBM Act was further amended. Specific details were updated in sub-section (2) of Section 4. The clause allows the govt to relax the fiscal deficit target for up to 50 basis points or **0.5** per cent. Under FRBM, if the escape clause is triggered to allow for a breach of fiscal deficit target, the RBI is then allowed to participate directly in the primary auction of government bonds, thus formalising deficit financing.

The Escape Clauses can be invoked:

- by the Government after formal consultations and advice of the Fiscal Council.
- with a clear commitment to return to the original fiscal target in the coming fiscal year.

In 2015, Finance Minister, Nirmala Sitharaman used the escape clause provided under the FRBM Act to allow the relaxation of the target. Finance Minister revised the fiscal deficit for FY20 to 3.8 per cent and pegged the target for FY21 to 3.5 per cent.

Note: The Act exempts the government from following the FRBM guidelines in case of war or calamity.

	Revised Estimates 2019-2020	Budget Estimates 2020-2021	(Projections)	
			2021-2022	2022-2023
1. Fiscal Deficit	3.8	3.5	3.3	3.1
2. Revenue Deficit	2.4	2.7	2.3	1.9
3. Primary Deficit	0.7	0.4	0.2	0.0
4. Gross Tax Revenue	10.6	10.8	10.7	10.7
5. Non-tax Revenue	1.7	1.7	1.5	1.5
6. Central Government debt	50.3	50.1	48.0	45.5
7. Of which				
Liabilities on account of EBR ¹	0.7	0.8	0.9	0.9

- Fiscal Deficit (FD)- The Fiscal deficit as per the Indian Budget 2015-21 was estimated **3.5 %** of GDP.
- Revenue Deficit (RD)- The Revenue Deficit as per the Indian Budget 2015-21 was estimated **2.7 %** of GDP.
- Effective Revenue Deficit (ERD)- The effective revenue deficit as per the [Indian Budget 2015-21](#) was estimated **1.8 %** of GDP.
- Tax to GDP ratio: 10.8
- Debt to GDP ratio (Central Government): 50.1

Cyclical policy of fiscal policy in India

In recent research ([Beyer and Milivojevic 2015](#)), we analyse whether fiscal policy in South Asia amplifies or smooths business cycle fluctuations. To do so, we first estimate several econometric models to explore the cyclical policy of government spending and tax buoyancy.

The short-term tax buoyancy and spending cyclical policy can be assessed by regressing the growth rate of government expenditure and tax revenues on the growth rate of GDP. Rather than estimating this expression for every country separately, we construct a data panel for 1987-2015 for all South Asian countries.⁴ For every additional percentage point of growth, public spending increases by 1.2 percentage points.⁵ Such a more-than-proportionate increase in expenditures is referred to as ‘voracity effect’. A 1% increase in GDP growth translates into a 0.85% increase in tax revenue, that is, the tax buoyancy is below one. The simple model above considers only short-term movements and is not taking into consideration the possible long-run relationship between the two variables. Taking these into account, the voracity effect is even larger.

Bose and Bhanumurthy (2013) is the first attempt to systematically estimate the size of fiscal multipliers for India. The structural macro-econometric model - on which the study is based- allows for separate treatment of revenue and capital components of combined government (Centre and States) spending. The model has also disaggregated transfer payments from other components of revenue expenditure. This disaggregation of public spending is crucial to capture the various macroeconomic channels through which fiscal stimulus affects aggregate demand. A priori, the fiscal multipliers capture the magnitude of the impact of discretionary fiscal policy on short run macroeconomic stabilization. There are two plausible channels through which public spending can affect aggregate demand. First, the change in the public investment (capital spending) can private investments. Second, the public spending crowds-in or crowds-out private consumption. The model generates strikingly different values for capital and revenue spending multipliers. A value of 2.45 for capital expenditure multiplier translates to a strong impact of public investment on economic activity. The revenue expenditure multipliers are below unity. The transfer payments multiplier – which constitutes the effects of subsidies, pensions and other retirement benefits on output– has an impact multiplier of 0.98, while the multiplier constructed on the “other” revenue expenditure components is 0.99.

A digression is inevitable here to explain the difference between impact multiplier and cumulative multiplier. The impact multiplier is the ratio of change in output to a change in spending, exclusively for the period ‘t’ in which the fiscal stimulus occurs. The cumulative multiplier captures the effects. of fiscal stimulus over longer forecast horizons. It measures the cumulative change in economic activity per unit of incremental governmental spending, for the entire forecast period. The cumulative multiplier for capital spending is even higher at 4.8 per cent (see table 1). This result has significant policy implications.

Table 1: Estimated Expenditure Multipliers

Variable		Impact multipliers	Cumulative multipliers
Capital Multiplier	expenditure	2.45	4.80
Transfer Multiplier	Payments	0.98	0.95
Other Expenditure Multiplier	Revenue	0.99	0.96

Note: Cumulative multipliers for over a period of 7 years

From a policy perspective, high revenue deficits have often compressed capital expenditure, and/or caused a breach in targeted fiscal deficit to GDP ratio, where the latter has been bound by fiscal rules through the *Fiscal Responsibility and Budget Management Act, 2003*. Revenue deficit as a proportion of GDP rose in the post-crisis years, partly because of a dip in revenue receipts, and has yet to return to the levels attained in 2007-08. Capital expenditure of the combined government spending has hovered around 4 percent of GDP, way below the targets recommended by the Thirteenth Finance Commission.

In terms of policy, running higher revenue deficit (above the targeted level) and at the same time sticking to fiscal consolidation targets only result in decline in public capital expenditure (this seems to be the case in 2013-14 where fiscal deficit could be contained at 4.6% while there is a relaxation in revenue deficit target). In such circumstances, the simulation results suggest that the economy could experience negative revenue expenditure multipliers. Hence, sticking to revenue deficit target is the most crucial in the context of fiscal consolidation. At the same time any relaxation of revenue deficit target should also result in relaxation of fiscal deficit target without compromising the public capital expenditure target. In other words, ring-fencing of capital expenditure target is most crucial for reviving growth in India.

Conclusion

The Indian economy is currently experiencing a sharp slowdown, with the most recent official growth estimate for fiscal year (FY) 2015 dropping to 5%. The Government of India reacted with countercyclical measures in the form of corporate tax cuts and a large infrastructure initiative. Both measures show how important it is to preserve some fiscal space to be able to react to economic downturns. For the former, India lowered its corporate tax rate from 30% to 22% for companies that do not seek exemptions, and to 25% for those who do. Based on our results for South Asia, it is questionable whether the impact of this measure will be very strong. In addition, Finance Minister Nirmala Sitharaman unveiled a pipeline of infrastructure projects worth US\$ 1.4 trillion that will be implemented in the next five years.

Going forward, the impact of both measures should be analysed carefully. The FRBM Act set a target for the Centre's annual fiscal deficit ratio (FD) at 3% of gross domestic product (GDP). The states were subsequently persuaded to legislate their own FRBM Acts, limiting a state's FD to 3% of its own GDP. This translated to a combined FD target of 5.8%. Such an arbitrary setting of FD targets, unrelated to the actual requirements of debt sustainability and independent of the prevailing state of the economy, makes fiscal policy pro-cyclical

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