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Fiscal Discipline in India

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ABSTRACT

The present study broadly attempts to analyze the role of Fiscal Responsibility and Budget Management Act in restoring fiscal balance in India. It analyses the need for fiscal rules and constraints in India. The study aims at finding out the major factor behind rising fiscal imbalance in India and to examine whether there is an electoral motive towards high fiscal deficit to GDP ratio or not. It also analyzes the effectiveness of various measures undertaken at the central and state level to inculcate fiscal discipline in the fiscal management. The study also makes an attempt to do a critical in depth reviews of the Fiscal Responsibility and Budget Management Act and make an attempt at examining effectiveness and suitability of FRBM Act through a quantitative analysis. It also makes an attempt to suggest improvements in the fiscal monitoring mechanism in India. We employ Ordinary Least Square (OLS) method to examine the impact of Fiscal Responsibility and Budget Management Act on fiscal deficit in India using the data for the period 1980-81 to 2008-09. The regression results indicates that FRBM Act does not have a significant effect on the Gross Fiscal Deficit (GFD) to GDP ratio where as GDP (at factor cost) growth rate has a significant negative effect on the GFD to GDP ratio.

Keywords: Fiscal policy rules, fiscal responsibility, tax effort, fiscal discipline, fiscal deficit

JEL codes: E62, H87

1. Introduction

Fiscal policy rule is defined as a permanent constraint on fiscal policy expressed in terms of a summary of fiscal performance, such as the budget deficit, borrowing, debt or a major component thereof (Kopits and Symansky, 1998). The need for fiscal policy rule arises due to the impact of the fiscal policy on stabilization and growth objectives, the sustainability of the fiscal policy stance, and the linkages between fiscal and other policy instruments. Loose fiscal policy, especially when financed by printing money, can lead to high and volatile inflation. When the government borrows to finance a looser fiscal position, the greater demand for loanable funds can reduce private investment by raising interest rates. Under a floating exchange rate, higher interest rates will also tend to attract foreign capital, leading to an appreciation of the exchange rate, which will also crowd out exports. Loose fiscal policy may not be sustainable. Continuously rising debt levels creates uncertainty (regarding inflation, a disorderly depreciation, price and foreign trade restrictions, or large tax increases). These states of affairs reduce private investment as they cause investors to wait and see. Loose fiscal policy may also make the economic environment more volatile (e.g., by recurrent, and ill-timed, bursts of fiscal contraction and expansion), which can weaken investment by increasing risk and focusing investment on the short run. Fiscal policy rule through its fiscal adjustment policy can help mitigate cyclicality (recurrent recessions and booms), reduce large external current account imbalances, and contain inflation. During capital account crisis, fiscal adjustment can restore confidence, ease financing constraints, and support the growth. Fiscal adjustment may be needed to facilitate external adjustment, especially to reduce excessive current account deficits or surpluses. A successful fiscal adjustment durably and efficiently improves the fiscal position. Success depends on a range of factors especially, the timing, speed, size, and quality of adjustment (IMF, 1995). Accordingly, fiscal policy rules – if well designed and properly implemented are viewed as potentially useful techniques for emerging market economies.

The present study is a modest attempt to examine the role of Fiscal Responsibility and Budget Management Act in restoring fiscal balance in India from 1980-81 to 2008-09. The econometric methodology used in this study is time series analyses with OLS test. These techniques allow us to find impact of FRBM Act on fiscal deficit in India. Data on the relevant variables between 1980-81 to 2008-09 is used. The remaining of the paper is organized into six sections including introduction. Section-II describes the rationale for fiscal responsibility in India. Section-III makes an evolution of India's central and state government measure to inculcate fiscal discipline and analyses their effectiveness. Section-IV discusses briefly the Fiscal Responsibility and Budget Management Act India. This section includes FRBM Act in terms of fiscal deficit and rationale of fiscal deficit. Section-V makes an attempt to do a critical in depth reviews of the Fiscal Responsibility and Budget Management Act and make an attempt at examining the effectiveness and suitability of FRBM act through a quantitative analysis. Section-VI concludes and suggests the measure to improve in the fiscal monitoring mechanism in India.

2. Rationale for Fiscal Responsibility in India

In India rationale for fiscal policy rule is in part attributable to the deterioration in fiscal performance. India has done a tremendous economic growth within these two decades. Its GDP growth rate has become 9 percent but its sustainability has been in question, first with the 1991 fiscal-balance of payments crisis, and then again after 1997-98, when fiscal deficits became 10 percent of GDP range and government debt grew. High deficit, unproductive expenditure and tax distortion have constrained the economy from realizing its full growth potential. To make this economic growth sustainable with macroeconomic stability, fiscal policy rule is a critical component (Economic survey, 2007).

In India persisting fiscal imbalance has been a major macro-economic concern to policy makers. The combined fiscal deficit of the centre and the states which was 9.3 percent of GDP in the crisis year of 1990-91 dropped to 6.3 percent in 1996-97 before creeping back up to 9.0 per cent in 1998-99. The fiscal deficit had remained at over 9.0 percent until 2002-03 and has since been on a downward shift declining to 4.2 percent in 2007-08. Due to the global economic crisis it is again estimated to up to 10.2 percent for 2009-10 (Budget Estimate). Similarly, the combined revenue deficit of the centre and the states which was 4.2 percent in the crisis year of 1990-91 and had declined to 3.2 percent by 1992-93 grew to an alarming level of 6.9 percent by 2001-02. Like fiscal deficit, revenue deficit too showed a welcome downward shift since 2002-03 declining to 0.2 percent for 2007-08. Due to the global economic crisis it is again estimated to up to 5.5 percent for 2009-10 (Budget Estimate).

In India growing deficit, not only deserves concern, but the composition of this deficit and the way it is being financed deserve concern because, the impact of fiscal deficit depends on it. Growing revenue deficit in India is a major concern because more and more revenue deficit implies preemption of private saving for government current consumption which tends to crowd out private investment without corresponding increase in capital spending by the government. It is also recognized that since the 1990s primary deficit has turned negative, implying that states are borrowing to meet their current expenditure or significant part of the fiscal deficit is due to the burden of the serving the past debt.

Widespread deterioration in fiscal position with associated impact on fiscal sustainability, macroeconomic vulnerability and economic growth led an emerging, consensus to adopt fiscal reform to improve fiscal responsibility. In 2003 the Central Government of India enacted Fiscal Responsibility and Budget Management (FRBM) Act on the presumption that fiscal deficit is the key parameter adversely affecting all other macroeconomic variable. It put statutory ceilings on Central Government's borrowings, debt and deficits. Now all the major States have enacted Fiscal Responsibility Law except West Bengal and Sikkim.

3. Evolution of Central and State Government Measure to Inculcate Fiscal Discipline and their Effectiveness

In India fiscal policy rule is not a new concept. For more than fifty years since the inception of the constitution, government debt and borrowing programmes for the central as well as the state governments in India were managed without any explicit targets or rules except for the constitutional provisions under articles 292 and 293. Apart from this the governments of India time to time have taken different fiscal incentives to inculcate fiscal discipline.

Constitutional Provisions on Public Debt

Dr. Ambedkar[1] highlighted the importance of Parliamentary Legislation to control borrowing in Constituent Assembly debates on articles 292 and 293. He referred to the need for an "Annual

[1] Dr. B.R. Ambedkar, the man behind the drafting and formation of the Indian Constitution.

Debt Act"[2]. Article 292 of the constitution of India contemplates limiting government borrowing through a parliament law. It mandates "borrowing by government of India the executive power of the union extends to borrowing upon the security of the consolidated fund of India within such limits. Under Article 266 any disbursement from the consolidated fund of India mandatorily requires parliamentary approval. Similarly article 293 provides that the legislation of a state can fix limits on borrowing by a state as well as limits on guarantee given by it.

Article 292 and 293 of the constitution covers only the Public Debt. This is forming part of consolidated fund of India, as this alone can be deemed to be "borrowing upon the consolidated fund of India". Other liabilities forming part of the Public Account such as post office saving deposits, deposits under small saving certificates and provident funds are not recorded as "borrowing upon the security of consolidated fund of India" (IMF, 2001). Constitutional provision on public debt is sufficient enough to control total liabilities of the government.

RBI Attempts towards Controlling Borrowing

In September 1994 an agreement (without legislated sanction) was signed between the central government and the Reserve Bank of India (RBI) to phase out the system of ad-hoc treasury bills by 1997- 98. Adhoc treasury bills facilitated automatic monetization of the budget deficit. This adhoc Treasury bill was replaced with Ways and Means Advances.

Eleventh Finance commission Provision of Extended Ways and Means Act to Control Borrowing

Eleventh Finance Commission (EFC) recommends for extended ways and means advance and additional open market borrowings in order to give the incentive for better performance. The scope and dimension of these facilities were decided by the central government, bearing in mind their macro-economic implications and the centre's fiscal position. The facilities were linked to the monitor able fiscal reform programme drawn up by the state. Eleven States signed confidential Memoranda of Understanding (MoU) with the central government in 1999-00, which promised fiscal reforms in return for advances of tax shares (Government of India, 2000). The incentive given under this Extended Ways and Means Act (EWMA) was not enough encouraging for better fiscal performance.

Government of India's Debt-Swap Scheme to Control the Burden of Debt

Government of India (GoI) formulated a Debt Swap Scheme (DWS) realizing the mounting burden of interest payments on the states, and to supplement their efforts towards fiscal

[2] In the constituent assembly debates article 292 of the constitution was referred to as article 268. Dr. Ambedkar had observed "that the borrowing power of the executive shall be subject to such limitations as Parliament may by law prescribe. If parliament does not make a law it is certainly the fault of Parliament and I should have thought it is very difficult to imagine any future Parliament which will not pay sufficient or serious attention to this matter and enact a law. Under the article 268 even concede that there might be an Annual Debt Act made by Parliament prescribing or limiting the power of the executive as to how much they can borrow within that year."

management. The scheme was in operation from 2002-03 to 2004-05. These additional recoveries enabled the centre to repay some of its high cost debt to NSSF. The central government used the proceeds of debt swap to effect prepayment of its debt to the National Small Saving Fund (NSSF) at lower interest rate. This had the effect of bringing down centre's overall debt as well as its effective interest rate.

The debt-swap scheme was only a small step in the direction of dealing with the unsustainable deficit faced by the states. It covered only 15 percent of their total debt. Here, again, the scheme merely aimed at reducing the cost of servicing the debt, and not extinguishing it. Though there was a benefits of Debt-Swap Scheme in terms of reducing pressure on the state by way of lower interest rate but it lead to loss of revenue for centre as the high cost loan were brought to lower level (Government of India, 2005).

Finance Commission's various Debt-Relief Schemes to Control Debt Burden of States and to Bring Fiscal Balance

Tenth Finance Commission recommended debt relief scheme in two parts, namely, (i) specific relief for state with high fiscal stress (ii) a scheme for general debt relief for all states. The second one was linked to fiscal performance. Improvement of fiscal management was measured by comparing the ratio revenue receipt (including devolution and grants from centre) with the total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. The performance of each state was measured against its own performance. Twice the excess of the ratio over the average ratio of fiscal improvement during the preceding three year was recommended for relief on loans contracted during the period 1989-95 and failing due for repayment after 31st March 1995.

The improvement of fiscal management was measured by comparing the ratio revenue receipt (including devolution and grants from centre) with the total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. When the devolution and grants from centre was increasing the revenue receipt to total revenue expenditure ratio was showing an improvement but it was not an actual improvement of fiscal management of state.

Eleventh Finance Commission (EFC) did not consider any special debt relief for the fiscally stressed states, but continued general debt relief of Tenth Finance Commission. EFC enhanced general incentive from 10 percent to 25 percent. In addition to it instead factors of two, a factors of five was applied on the ratio of fiscal improvement in terms of revenue receipts to total revenue expenditure. In the calculation of revenue receipts, the revenue deficit grants recommended by EFC under article 275 were excluded.

Though under EFC in the calculation of revenue receipts, the revenue deficit grants were excluded still devolution from centre remained as a part of revenue receipts. So when the devolution from centre was increasing the revenue receipt to total revenue expenditure ratio was showing an improvement but it was not an actual improvement of fiscal management of state.

Twelfth Finance Commission also recommended for debt relief scheme but, it also recommended that each state has to enact Fiscal Responsibility Law (FRL) with a target to eliminate revenue deficit and reducing fiscal deficit by 2008-09. Enacting FRL became a precondition for availing debt relief. A debt write off scheme became linked with the reduction of revenue deficit of the state. The quantum of repayment was linked to the absolute amount by which the revenue deficit is reduced in each successive year during award period. Fiscal performance measured with reference to the revenue deficit/ revenue surplus as worked out in absolute numbers by taking an average of three years, viz, 2001-02 (Actual), 2002-03 (Actual) and 200-04 (Revised Estimate). This average was taken as the base year for 2003-04.

The scheme of debt-write off linked to revenue deficit reduction recommended by the TWFC favored state with low base year revenue deficit. The relatively better of state received large benefits from debt write-off scheme, though they had relatively lower revenue deficit. Thus, the state with larger deficit gained less in terms of debt write-off in terms of the overall transfers they received. This did not induce them to undertake the fiscal adjustment. It encouraged creative accounting while preparing budget. The scheme of debt write off which was recommended by the TWFC commission guided more by the need for fiscal consolidation rather than providing relief to debt stressed poor state (Rao and Jena, 2005). Interest payments on special securities issued to NSSF, which constitute more than half of the total interest payments obligations in a number of state kept out of the purview of Debt Swap Scheme and the Debt Consolidation and Relief Facility (DCRF) recommended by the Eleventh and Twelfth Finance Commission respectively.

Debt Consolidation and Relief Facility (DCRF) under Thirteenth Finance Commission

The Thirteenth Commission has recommended two debt relief measures to be extended to all state. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to state contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9 percent. Thirteenth Finance Commission recommended for the structural reform in NSSF to make it more market linked. The second debt relief recommended by the Commission is write-off of central loans to state that are administered by central ministries other than Ministry of Finance outstanding as at the end of 2009-10. The Commission has also recommended that any further loans under Centrally Sponsored Schemes should be completely avoided. The Commission has also recommended extension of the debt consolidation facility recommended by the Twelfth Finance Commission to state that have not yet availed this benefit.

Eleventh Finance Commission Provision of Fiscal Reform Facility (FRF) to State

On April 2000, Eleventh Finance Commission drew a monitor able fiscal reform programme, aimed at reduction of revenue deficit of the state. It recommended the manner in which the grants to the state to cover the assessed deficit in their non plan revenue account may be linked to progresses in implementing programme. EFC identified growth of tax revenue, growth of non tax revenue, growth of non-plan revenue expenditure on salaries and allowances, interest payments and reduction of subsidies as the five indicators as a measure of the fiscal performance of the state and recommended weights for each. As recommended by EFC, an incentive fund in the form of Fiscal Reform Facility (FRF) was set up by Ministry of Finance leaving 85 percent of the revenue deficit grant recommended by EFC to be released to the state without linking it with performance. The remaining 15 percent was linked with improvement in fiscal performance. While introducing the scheme of FRF, Government of India prescribed a single monitorable indicator for the purpose of making releases from the incentive funds. The indicator expected each state to achieve a minimum improvement of 5 percent in revenue deficit/surplus as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-2000. The revenue deficit was to be inclusive of contingent liabilities and subsidies due to public sector enterprises (Government of India, 2000).

Only a minor portion of the grants of non plan revenue account was linked to fiscal performance so it did not give much incentive to state towards fiscal responsibility.

Medium Term Fiscal Reform Programs (MTFRPs)

In 2000-01 the finance ministry issued guide lines to state for Medium Term Fiscal Reform Programs (MTFRPs). The MTFRP had dual aim of reducing wasteful expenditure (cutting low priority spending) and improving tax collection or improving the efficiency of the tax administration. The MTFRPs required the state to make time bound reform in four areas like, fiscal, power and public sector and budgetary. The main objective of MTFRPs were to bring the consolidated fiscal deficit to sustainable levels by 2005 and to bring down debt-GDP ratio as well as interest payment to revenue expenditure rate over the medium term. The MTFRPs finalized for nine states, namely Nagaland, Andhra Pradesh, Karnataka, Orissa, Kerala, Arunachal Pradesh, West Bengal, Himanchal Pradesh and Manipur. Despite the operation of Fiscal Reform Facilities (FRFs) state achieved 6.23 percent reductions in Revenue Deficit/Revenue Receipt ratio by 2002-03 as against the targeted 15 percent reduction over the base year 1999-00. In 2003-04, the position deteriorated by 1.89 percent. The aggregate fiscal deficit of state actually increased from 2.35 percent of GDP in 1993-94 to 3.5 percent in 2004-05. Similarly state revenue deficit increased marginally from 0.45 percent of GDP in 1993-94 to 1 percent of GDP in 2004-05. The outstanding debt to GDP ratio of state increased substantially from 21.79 percent of GDP in 1993-94 to 31.15 percent in 2002-03. FRF did not play a significant role in bringing about an improvement in state fiscal position in past five years. On the basis of performance five states classified as consistently improving (Kerala, U.P, Goa, Sikkim and Chhatisgarh). Some state classified as consistently deteriorating (Gujrat, H.P, Uttarachhal and Jharkhand). Twelve states showed initial improvements and then deteriorated (W.B, Rajastan, Punjab, Bihar, T.N, Manipur, M.P, Assam, Haryana, Karnataka, Tripura and Meghalaya). The remaining state were initially deteriorating and then improved such as, Maharastra, J&K, A.P, Mizoram, Nagaland, Arunachal Pradesh and Orissa (Government of India, 2005).

There were certain reasons, why MTFRPs could not achieve its target. There was a design failure in prescribing a uniform 5 percent improvement in the ratio for all state. If state start off with larger base year deficits, it was relatively easier for them to make huge improvements. In the initial years MTFRPs target were set in terms of revenue deficit as a per cent of total revenues of state and when transfer to state declined, the ratio went up. The single monitor able factor was needed to be removed. The definition of revenue deficit was not uniform for all state. The size of fund, which was promised to be given to a state, as an incentive for achieving targeted reduction in fiscal deficit was insignificant, so could not give sufficient incentive to state to restore fiscal balance (Rao and Jena, 2005). The Twelfth Finance Commission (TWFC) and Thirteenth Finance Commission recognized this problem and it recommended for linking the debt write off to improvement in revenue deficit. It has a lot merit as there is a direct link to absolute in the revenue deficit. The debt relief will be available, only if state enacts appropriate legislations to bring down the revenue deficit to zero and commit to reducing the fiscal deficit in a phased manner. MTFRPs was an important development in managing state finances, as the state started thinking about fiscal matters on a medium term framework.

Restructuring the System of Fiscal Transfer towards Fiscal Responsibility under various Finance Commissions in the process of Tax Devolution

Even though the system of transfer is always guided by equalization and efficiency criteria, but still an objective for providing incentive to state towards achieving fiscal discipline has been always taken care of by different Finance Commissions (FCs). In the tax devolution process time to time different Finance Commissions have taken certain criteria and have assigned them certain weights, considering the urgency of fiscal consolidation.

(a) Tax Effort: Tenth Finance Commission (TFC) for the first time took tax effort as criteria for tax devolution to state. It worked as an incentive among the state to raise tax potential capacity. Tax effort was measured by the ratio of per capita own tax revenue of a state to its per capita income. It was weighted by the inverse of per capita income. It ensured that if a poorer state exploited its tax base as much as a richer state, it got an additional consideration in the formula. TFC gave 10 percent weight to tax effort criteria. Eleventh Finance Commission (EFC) also recommended this criterion but it reduced the weight of inverse of per capita income from 1 per cent to 0.5 percent. EFC gave 5 percent weight to tax effort criteria. Twelfth Finance Commission (TWFC) also took tax effort criteria for tax devolution and it also raised the weight to 7.5 percent considering the urgency of fiscal consolidation (Government of India, 2005). Thirteenth Finance Commission dropped this criterion for tax devolution (Government of India, 2010).

(b) Fiscal Discipline: Eleventh Finance Commission for the first time introduced the fiscal discipline criteria for tax devolution. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the state. The ratio so computed was used to measure the improvement in the index of fiscal discipline in reference period in comparison to a base period. TWFC also recommended fiscal discipline criteria for tax devolution to state. Fiscal discipline criteria got the relative weight age of 7.5 percent in both the Eleventh and Twelfth Finance Commission. Twelfth Finance Commission had worked out the index with the reference period of 2000-01 to 2002-03 and the base period of 1993-94 to 1995-96. These criteria provided an incentive for better fiscal management. Thirteenth Finance Commission have retained this criterion and have worked out the index of fiscal discipline with 2005-06 to 2007-08 as reference years and 2001-02 to 2003-04 as the base years. The own revenue receipts of a state include own tax revenues and thus, the criterion of fiscal discipline also captures the tax effort of state. Thirteenth Finance Commission has, therefore, dropped the use of tax effort as a separate criterion. Twelfth Finance Commission assigned a weight of 7.5 percent each to fiscal discipline and tax effort. Thus, the combined weight assigned by Twelfth Finance Commission to these two criteria was 15 per cent. There is a strong case to incentives state following fiscal prudence, particularly in the context of the need to return to the path of fiscal correction. Thirteenth Finance Commission, therefore, assigned a weight of 17.5 percent to fiscal discipline. Under this criterion, if all state improved their respective ratios of own revenue to total revenue expenditure, then the state with relatively higher improvement than the average receives higher transfers. Similarly, if the ratio has deteriorated in all state, then state with lower deterioration than the average receives higher transfers (Government of India, 2010).

Although the Finance Commission has earned appreciation as a useful fiscal institution for a federation, the transfer system that has been operating on the ground is marked by features that are widely perceived to be not very conducive to fiscal discipline among state. Multiplicity of transfer channels with little effective coordination among them and mediation of capital transfers (loans from the centre) without adequate regard for the repaying capacity of the recipient governments are the major road block on the way of achieving fiscal discipline. The allocation of the other component of the Finance Commission's transfers (share of central taxes, which accounts for the bulk of the "statutory transfers") is decided on the basis of formulae which are also believed to have generated wrong signals for fiscal discipline. However, the emphasis is on equity rather than efficiency. While the transfer formulae also contain weights for efficiency ("tax effort", fiscal self-reliance etc.) their effects are often perceived to be weak and subdued by equity factors. Even though criteria like tax effort, fiscal discipline has been taken in the tax devolution process under different Finance Commission's to achieve fiscal consolidation; it could not act as an incentive to the state for going towards fiscal stability. Though these criteria constitute only a minor portion of the total devolution process, it could not have any significant effect on the efficiency or on the equity among the state (Rao and Jena, 2005). Thirteenth Finance Commission have taken Fiscal Discipline criteria and has given the weight of 17.5 percent, in the tax devolution process to achieve fiscal consolidation, under the presumption that it will act as an incentive to the state for going towards fiscal stability. Though this criterion constitutes only a minor portion of the total devolution process, it will not have any significant effect on the efficiency or on the equity among the state

The conflict between equity and efficiency in the transfer formulae is often overplayed as both can be taken care of simultaneously if the revenue gaps of the state are assessed normatively. However, for practical reasons, application of norms has not proceeded far and it may not be unfair to say that the persistence of gap filling approach in the Finance Commission's transfers noted above continues to generate perverse incentives for fiscal indiscipline among state. With such a transfer system, the states have found it profitable to undertake expenditure commitments exceeding their available revenues on the expectation that the gap would ultimately be made up by the Finance Commission. The design of statutory transfers thus has tended to create a bias towards improvident budgeting by "legitimizing incipient deficits" caused by inadequate revenue effort and imprudent expenditure decisions of the past.

Contrary to the scheme of inter Governmental transfer that was apparently contemplated in the Indian Constitution with Finance Commission as the chief mediator, central funds are transferred to state in India through other channels as well, of which Plan transfers constitute the main component. Some transfers are made directly by central ministries for implementing Centrally Sponsored Schemes (CSS). Initially, central assistance for the state plans used to be project-specific. In 1969, this system was replaced by the Gadgil formula whereby support for state plans was extended out of central budget in the form of grant and loan with the share of individual state determined largely on the basis of population, and, in part, with reference to relative income levels. Some weight was given to tax effort but its effect was submerged by the other factors. An element of discretion was provided in the form of weight age for special factors. In the pursuit of national objectives like literacy program, the Centrally Sponsored Schemes (CSS) under the 'Plan' which are implemented through the state but are not all funded fully by the centre adding to their expenditure commitment. Often they carry a matching component, casting an additional burden on the state budgets and distorting their priorities. Finally, resources transferred to state in the form of loans are made up largely of 'plan loans'. These are the on-lending by the centre from its own borrowing constituting the largest component of funds flowing from the centre to the state as loans. These, together with the system of state borrowing from the market mediated by the Centre at uniform rates of interest and maturity, taking no account of the debt sustainability of individual state or their varying creditworthiness, constituted a potent source of budgetary instability of state. Unless the distortions in the fiscal federal system are removed, any attempts at fiscal correction at the state level are doomed to failure (Anand, Sen and Bagchi, 2001). There is lack of effective coordination between Finance Commission and Planning Commission. As a result, it was possible for a state to underplay its resource availability before the Finance Commission but present a different picture before the Planning Commission to obtain approval for its plan of a size unwarranted by available funds.

Restructuring the System of Fiscal Transfer towards Fiscal Responsibility under Planning Commissions Transfer to State

In the fourth and fifth five year plan planning commission transferred financial assistance to the state on basis of Gadgil[3] formula. Under Gadgil formula basically population, per capita income, tax efforts, ongoing irrigation and power projects and special problems were taken as the bases for financial transfers. Under these formula tax efforts was taken as indicator to achieve fiscal responsibility but though it constitute only 10 percent of total financial assistance it could not achieve its objective. For 1991-92 annual plans some modification took place in formula and in the modified formula population, per capita income, financial arrangement and special development problems were taken as the bases for financial transfers. Under these formula financial arrangement was taken as the base to achieve fiscal responsibility but though it constitute only 5 per cent of total financial assistance it could not achieve its objective. Again in eight five year plan some modification took place and financial assistance to the state was made on the basis of Gadgil Mukherjee formula. Under this formula basically population, per capita income, performance and special development programmes were taken as the bases for financial transfers. Performance base was given 7.5 percent weight of total assistance. It took tax effort, financial management; progress in the form of national objectives as the indicator of performance base. Though this performance base constitutes only a minor portion of the total transfer, it did not have any significant effect on the efficiency or on equity among the state. Under Eleventh Plan Central assistance to general category state is provided by Gadgil formula.

In the case of plan assistance for general (non-special) category state, 30 per cent of plan assistance was given as grant and 70 percent as loan. In the case of special category state 10 percent of plan assistance was given as loan and 90 percent as grant. Interest rate charged by the central government on the plan loan to state, which has been, in the past sometimes 300 to 400 basis points higher than the cost of funds to centre. Plan grant are not interest free grants. While at least two-thirds of the plan expenditure have always been debt-financed (since 1974-75), in 1998-99, borrowings of the state meant for plan financing reached an unprecedented high of 139 percent of plan expenditure.

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[3] The Gadgil formula is due to D.R. Gadgil, the social scientist and the first critic of Indian Planning. It was evolved in 1969 for determining the allocation of central assistance for state plans in India. Gadgil formula was adopted for distribution of plan assistance during Fourth and Fifth Five Year Plans According to this formula, allocation for states was based on 60 per cent of population, 10 per cent of per capita income, 10 per cent of tax effort, 10 per cent of on-going irrigation and power projects and the remaining 10 per cent of special problems. This formula was modified in 1980 and the modified formula was the basis for allocation during the Sixth and Seventh Five Year Plans. As per the modified formula, the total weightage for on-going schemes and per capita income was 20 percent.

Several features of plan financing and plan transfers tended to generate imbalance in the revenue budget of the state, of which the following deserve mention: 1) Approval of state plans by the Planning Commission in terms of the 'outlay' without specification of its revenue and capital components. 2) The practice of the Planning Commission to approve large state plans even when a state failed to achieve the targets set in the preceding year by a large margin. 3) Plan, non-plan dichotomy in budget accounting with the revenue component of a Plan project shown under 'Plan' for the given plan period but under 'non-plan account' thereafter. This added to the state's 'committed' expenditure. It also provided a built-in incentive to launch new programs involving substantial expenditure on current account without regard for the consequence for future budgets.

Non Plan Revenue Grant by Thirteenth Finance Commission

It has been argued that Non-Plan Revenue Deficit (NPRD) grants risk moral hazard by providing an incentive to state to run non-plan revenue deficits. In Thirteenth Finance Commission's award there has been a significant reduction in the volume and state-wise incidence of NPRD grants, which is to be expected, given the structural improvements in the fiscal position of much state, including special category state. In the latter case, in recognition of the effort made to exit NPRD, Thirteenth Finance Commission, deemed it appropriate to acknowledge such achievement with a performance incentive. Therefore, the need for NPRD grants diminishes as structural fiscal reforms are implemented and economic performance improves (Government of India, 2010).

4. Fiscal Responsibility and Budget Management Act

India enacted the FRBM Act in August 2003. At central level under the FRBMA the stated objective are to ensure inter-generational equity in fiscal management, achieve fiscal sustainability necessary for long-term macroeconomic stability, and improve the transparency in the fiscal operations. Similar to most Fiscal Responsibility Laws (FRLs) around the world, the FRBMA establishes the broad framework for conducting fiscal policy by setting out both procedural as well as numerical rules[4].

FRBM in Terms of Fiscal Indicators

Under FRBMA the principles of fiscal responsibility have been defined in relation to deficit, borrowing and debt and deliberated on the choice, coverage and targets of fiscal indicators. Under deficit principles a group of deficit indicators, viz, Revenue Deficit and Gross Fiscal Deficit have been identified and targeted. FRBM Act under its rates set the target for eliminating revenue deficit by 2008-09 and reducing fiscal deficit to 3 percent of GDP by 2008-09. To

[4] Procedural rules refer to those that define attributes and interaction of participants in the budget process aiming to enhance transparency, accountability and fiscal management. Numerical rules instead are defined on the basis of overall indicators of fiscal policy such as fiscal balances, debt, revenue, and expenditure.

achieve the target of revenue deficit and fiscal deficit the central government has to reduce revenue deficit by an amount equivalent to 0.5 percent and fiscal deficit by 0.3 percent or more of GDP at the end of each financial year, beginning with financial year 2004-05.

Under borrowing related principles, government borrowing from Reserve Bank has been prohibited. It may borrow from it by Way and Means of Advances (WMA) to meet temporary excess cash disbursement over cash receipts. Under the debt related principles, a limit on debt stock has been prescribed. In India, the FRBM Act sets a limit of 50 percent of GDP on total liabilities of the central government. The central government shall not give guarantees to an amount exceeding 0.5 percent of GDP in any financial year, beginning with financial year 2004-05. The central government should not assume additional liabilities (excluding external debt at current exchange rate) in excess of 9 percent of GDP for the financial year 2004-05 and in each subsequent year, the limit of 9 percent of GDP has to be progressively reduced by at least one percent of GDP. The FRBM Act is operationally effective because it seeks year to year ceiling rather than a medium term ceiling.

Rationale of Targeting Fiscal Deficit: Fiscal deficit as a proportion of GDP has emerged as a key indicator to measure the fiscal health of a country. Fiscal Deficit is measured as the difference between aggregate disbursements and revenue and non debt capital receipts. Fiscal deficit summarizes in a way the total range of public finances covering expenditure and revenue. Therefore a limit on fiscal deficit has been put. Continued high fiscal deficit are concern for several reasons. First this disempowers the government fiscal stance by preempting larger share of public resources for debt servicing there by leaving that much less for desirable expenditure such as physical infrastructure (e.g. roads, power) and social infrastructure (e.g. education and health). This leads to declining ratio of capital expenditure to total expenditure as seen over the period 1990-91 to 2002-03 in the case of India. Continued fiscal deficit impact on interest and inflation rates depending on how the deficits are financed. If the government borrows in the domestic market, it puts pressure on the interest rate. If the government finances the deficit by creating high power money, it fuels inflation. In India’s case since deficits are financed by open market borrowing, albeit through a preferential Statutory Liquidity Ratio (SLR) window, the risk is largely of government borrowing leading to higher interest rate. Mere limiting of its size alone may not yield the required result. The impact of fiscal deficit depends upon the composition of the fiscal deficit and the way it is being financed.

Rationale of Targeting Revenue Deficit: Revenue deficit is one of the important components of fiscal deficit it is the difference between revenue expenditure and revenue receipts which indicates increase in liabilities of the government without corresponding increase in assets of that Government. Such expenditure of borrowed resources makes additional borrowing inevitable in subsequent periods for the servicing of the original borrowing and sets off a vicious circle of borrowing. It means that centre and states are using up a significant proportion of borrowed funds not for capital investment that will yield future income but for current consumption like payment of salaries, pensions and subsidies. Revenue deficit exacerbate inter temporal equity concerns as they give the pleasure of spending to current generation while pressuring on the pain of debt serving to latter generation. Hence, elimination of revenue deficit is justified under FRBM Act.

Eliminating revenue deficit requires reducing revenue expenditure drastically which is not always feasible. Interest obligations take away around 30 percent of total expenditure. Similarly, expenditure on defense is not to be compromised. So, if government tries to reduce expenditure it may do so in crucial sector like social services. It is also argued that several items expenditure that has been traditionally classified as revenue (current) expenditure are in the nature of capital expenditure, designed to generate future income streams. Thus although there can be little doubt regarding the desirability of zero revenue deficits, care must be taken that expenditures that bestow widespread benefits (such as social sector) but which are not backed by powerful interest groups are not axed. Targeting revenue deficit in the one hand protects capital spending on the other hand can lead to budgetary distortions. These can already be observed as states, for example, classify their budgetary support to the power sector as equity investments to avoid counting them as revenue expenditures. Reason for targeting the fiscal rather than the revenue deficit is the need to cap off-budget borrowing, much of which finances capital expenditure. With capital expenditures uncapped, states could continue to bankrupt themselves by shifting capital expenditure, and borrowing for the same, off budget.

Rationale of Targeting Debt-GDP Ratio: A major objective of fiscal policy rule is to reduce public debt and stabilize it at a prudent level. Borrowing may need to be constrained because of longer-term debt sustainability concerns. A fiscal rule that establishes a medium term limit on the gross Debt-GDP ratio can provide a broad gauge of fiscal decency, whereas a rule that seeks to set year to year debt ceilings is unlikely to be credible or operationally effective. Since measures of public indebtedness (especially as a proportion of GDP) are usually exposed to valuation changes and other factors beyond the control of the authorities, they are difficult to treat as an annual operational target. It is difficult to calculate true extent of the states' debt burden as states engaged in off-budget activity. The level of outstanding guarantees grew by over 40 percent between 1993 and 2000, outstripping the growth in official state level debt. Fiscal activities are also conducted off-budget through various State-owned Financial Corporation's (SFCs) and utilities with adverse consequences for their financial health. These off-budget sources of fiscal activity are contingent liabilities that could result in future claims on states' budgets. There is a need to go beyond the budget in setting Fiscal Policy Rules (FPR) target. There is a need to incorporate off-budget borrowing and the power sector deficit. Some states now incur more capital expenditure financed by off-budget borrowing than they do on the budget. Since there is an extensive use of off-budget borrowing at the state level, any FPR which did not tackle this issue would be creating a huge loophole for the states to walk through. The definition of liabilities needed to include not only the total liabilities under the Consolidated Fund of the state but also all the items under the Public Account of the state.

Institutional Framework under FRBM Act: In India statutory instrument is legislation, mainly under the authority of Articles 292 and 293 of the constitution to set limits on borrowing or extending guarantees. An additional institutional issue touches the authority responsible for the surveillance and enforcement of rules, as well as the associated transparency requirements. In India by principle the government is accountable to parliament; the actual surveillance authority could exercise (on behalf of parliament) by the comptroller and Auditor General, whose functions are specified under Act 148 of the constitution. Ministry of finance reports to parliament any deviations from obligations under the rules and to propose remedial action.

Transparency under FRBM Act: The FRA adopts certain improvements in fiscal reporting in order to take care of quasi–fiscal operations and ensuring better fiscal transparency. The central government takes suitable measures to ensure greater transparency in its fiscal operations in the public interest and minimize as far as practicable, secrecy in the preparation of the annual financial statement and demand for grants. In order to ensure greater transparency in fiscal operation in the public interest, the central government at the time of presenting the annual financial statements and demands for grant has to make disclosure of any significant change in accounting standards, policies and practices affecting or likely to affect the computation of prescribed fiscal indicators, statement of receivables and guarantees and a statement of assets.

Fiscal Policy Statement to be laid before Parliament under FRBM Act: The central government has to lay the statement on medium-term fiscal policy Statement, the macroeconomic frame work statement and the fiscal policy statement in each financial year. The medium-term fiscal policy statement has to set forth a three year rolling target for four fiscal indicators via, revenue deficit as per cent of GDP, fiscal deficit as per cent of GDP, tax revenue as percentage of GDP, total outstanding liabilities of the central government as percentage of GDP. The medium-term fiscal policy statement has to include an assessment of sustainability relating to the balance between revenue receipt and expenditure. Ministry of Finance shall review, every quarter; the trends in receipts and expenditure in relation to the budget and place before both houses. It has to also include an assessment of sustainability relating to the use of capital receipts including market borrowing for generating productive assets. The fiscal policy strategy Statement shall contain the policies of central government for the ensuring financial year relating to taxation, expenditure, market borrowings and other liabilities, lending and investment, pricing of administered goods and services, securities and description of other activities such as underwriting and guarantees which have potential budgetary implications. It has to also contain the key fiscal measures and rationale for any major deviation in fiscal measures pertaining to taxation, subsidy, expenditure, administered pricing and borrowings. An evaluation as to how the current policies of the central government are in conformity with the fiscal management principles has to be in it. Fiscal policy strategy Statement will contain the intra year bench marks for assessing the trends in receipts and expenditure relating annual targets and budget estimates. It has to contain the strategic priorities of the central government for ensuring financial year in the fiscal area. The macroeconomic framework statement has to contain an assessment relating to the Gross Domestic Product (GDP), the fiscal balance of the union government (revenue balance and gross fiscal balance) and the external sector balance of the economy reflected in the current account balance of the balance of payments.

Enforceability under FRBM Act: Fiscal Responsibility Act (FRA) is in terms of compliance at stages of both budget approval (ex- ante) and budget execution (ex-post). Further ex-ante compliance in terms of actual performance is contemplated not only ex-post (end of year performance), but also contemporaries (intra year).

Exclusion Clause under FRBM Act: An escape or exclusion clause, in non performance of the contract if a certain specified condition occurs. In the context of Fiscal Responsibility Law (FRL) for government, government can deviate from the pre specified fiscal targets such as revenue deficit and fiscal deficit if there are unforeseen demands on the finances of the Government arising out of internal disturbances or natural calamity or such exceptional grounds as the government specify.

Following the footsteps of the central government and the recommendations of the Twelfth Finance Commission[5], all state governments, except Sikkim and West Bengal, have enacted Fiscal Responsibility Laws (FRLs).

5. Impact of FRBM on Fiscal Balance

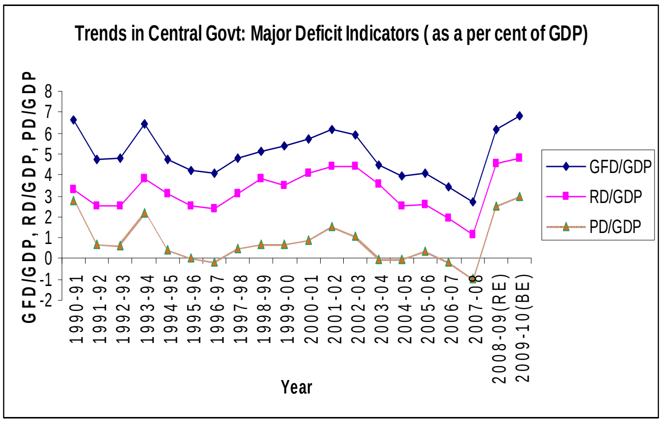
No doubt FRBM Act is an important development in managing Centre and States finances. Recently after the implementation of FRBM Act Central Government major fiscal deficit indicators showing a declining trend.

The fiscal deficit of the central government, as a proportion of GDP, declined from 6.6 per cent in 1990-91 to 4.1 percent in 1996-97, but this progress could not sustained and in 2001-02 it increased to 6.18 percent. After that, there is a fall in fiscal deficit relative to GDP. A similar profile is observed in the case of revenue deficit, which after declining from 3.3 per cent of GDP in 1990-91 to 2.4 percent in 1996-97, rose steadily to 4.4 percent in 2001-02. Further, increase in the ratio of fiscal deficit to GDP during this period was also associated with an increase in the proportion of revenue deficit, which increased from 49.4 percent of fiscal deficit in 1990-91 to 79.7 percent in 2003-04.

[5] The Twelfth Finance Commission (2004) recommendations aimed to alleviate states' fiscal distress by (i) raising the share of central government revenue (from 29.5 to 30.5 percent) and the amount of grants received by states, (ii) conditional debt restructuring and interest rate relief, provided that the states pass and implement FRLs targeting revenue balance by 2008/09 and a 3 percent of GDP overall deficit by 2009/10, (iii) a stricter borrowing ceiling with the center setting global ceilings on borrowing and only lending to fiscally weak states.

After the implementation of FRBM Act the fiscal situation seems to have improved both in terms of fiscal deficit as well as in revenue deficit. In the era of fiscal consolidation the revenue deficit of the centre declined to 1.11 percent of GDP in 2007-08, its lowest level since 1990-91. In 2008-09, there was a total reversal of fiscal correction with the revenue deficit reaching a level of 4.53 percent of GDP.

Figure 1 Central Government: Trends in Major Deficit Indicator (as a percent of GDP)



Source: Hand book of Statistics on Indian Economy, RBI Annual policy Statement and RBI bulletin, (various issues)

The Union Budget for 2009-10, which was formulated against the backdrop of the global downturn and subdued domestic demand, envisaged a revenue deficit of 4.83 percent of GDP. The fiscal deficit of the centre declined from 4.48 percent of GDP in 2003-04 to 2.69 percent in 2007-08, the lowest since 1990-91. There was a reversal of the declining trend in 2008-09, with the fiscal deficit ballooning to 6.14 percent of GDP. For 2009-10, it has been budgeted at 6.85 percent of GDP.

Table 1 Adjustment in Central Government Finances, 2003-2009-10 (as per cent of GDP)

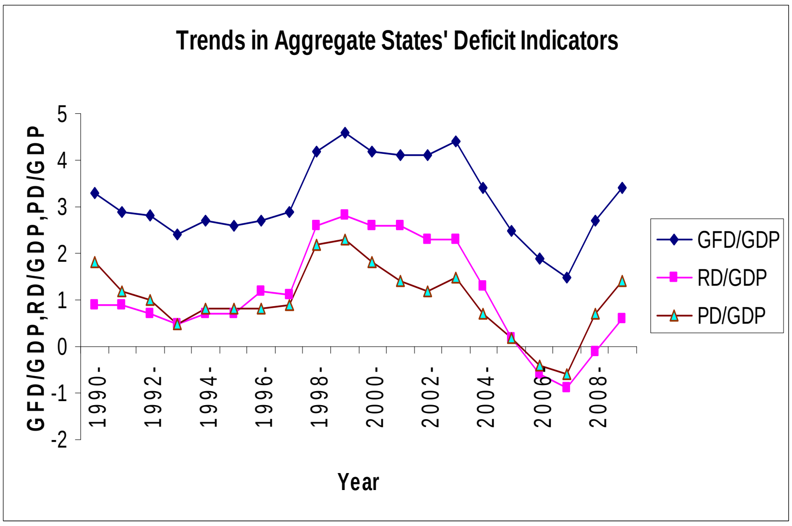
Indicators	**2003/4**	**2004/5**	**2005/6**	**2006/7**	**2007/8**	**2008/9(RE)**	**2009/10(BE)**
1. Revenue Receipts (a+b)	9.6	9.7	9.7	10.5	11.47	10.56	10.49
(a) Tax Revenue (net of States Share)	6.8	7.1	7.5	8.5	9.3	8.76	8.10
(b) Non Tax revenue	2.8	2.6	2.2	2.0	2.2	1.8	2.4
2. Revenue Expenditure	13.1	12.2	12.3	12.4	12.6	15.1	15.3
(a) Interest Payments	4.5	4	3.7	3.6	3.6	3.6	3.8
(b) Major Subsidies	1.61	1.46	1.32	1.38	1.50	2.43	1.90
3.Revenue Deficit (2-1)	3.6	2.5	2.6	1.9	1.1	4.53	4.83
4. Capital Expenditure	3.96	3.62	1.85	1.67	2.50	1.83	2.11
5. Total Expenditure (2+4)	17.1	15.8	14.11	14.13	15.1	16.93	17.43
6. Fiscal Deficit	4.5	4	4.1	3.5	2.7	6.14	6.85
8. Primary Deficit	-0.03	-0.05	-0.38	-0.19	-0.93	2.5	3.00
9. Outstanding Liabilities	63.05	63.33	63.13	61.23	60.07	58.93	59.68

Source: Economic Survey, (2008-09) & Government of India (2010) "Report of the Thirteenth Finance commission", 2010-2015, Ministry of Finance, June, New Delhi
BE: Budget Estimate, RE: Revised Estimate

By looking into the data we can say that the improvement in fiscal deficit indicators at central level is due to improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that at central level among expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there are not much changes. Fiscal Policy Rules should also take capital expenditure as a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment.

In the recent period after the Implementation of FRL, a significant development in respect of state finances is observed. Continuing the fiscal correction and consolidation process, in 2007-08 there was a surplus in the revenue account after a gap of two decades.

Figure 2 Aggregate States': Trends in Major Deficit Indicators (as a per cent of GDP)



Source: Hand book of Statistics on Indian Economy, RBI Annual policy Statement and RBI bulletin, (various issues)

The improvement in States finances during the recent years owes a great extent to the various fiscal reforms, *viz*., implementation of FRLs, introduction of VAT, imposition of new taxes and measures to improve tax administration, measures aimed at limiting non-development expenditure, etc. The larger devolution and transfer of resources from the Central Government backed by strong macroeconomic growth also aided the fiscal correction and consolidation process at the States Government level.

Table 2 States' Government Aggregate: Fiscal Adjustment 2003/04-2008/09

Indicators	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9 (BE)	2009/10 (RE)
I. Total Revenue	11.2	11.5	11.99	12.9	13.2	13.87	13.6
A. State own Revenue	7	7.25	7.24	7.73	7.70	7.70	7.60
i). State Own Tax	5.6	5.8	5.9	6.1	6.07	6.21	6.27
ii). State Own Non Tax	1.4	1.47	1.3	1.62	1.63	1.50	1.33
B. Transfers from Centre	4.1	4.2	4.7	5.2	5.5	6.16	6
i). Tax Share	2.4	2.5	2.65	2.9	3.2	3.26	3.17
2. Grant in Aid	1.7	1.7	2.1	2.27	2.29	2.9	2.83
II. Revenue Expenditure	13.5	12.7	12.2	12.2	12.3	13.6	14.09
III. Capital Expenditure		1.88	2.14	2.32	2.47	2.8	2.6
IV. Revenue Deficit	2.3	1.2	0.19	-0.77	-0.94	-0.27	0.5
V. Gross Fiscal Deficit	4.4	3.4	2.56	1.69	1.51	2.64	3.23
VI. Primary Deficit	1.5	0.65	0.2	-0.6	-0.61	0.68	1.28
VII. State Government Outstanding Liabilities	33.2	32.7	32.6	30.2	27.8	27.27	na
VIII. State Government Outstanding Guaranties	7.5	8	6.5	5.5	3.7		na

Source: Economic survey 2008-09, Government of India (2010), "Report of the Thirteenth Finance Commission", Ministry of Finance, 20010-15 New Delhi

BE: Budget Estimate, RE: Revised Estimate, na: not available

The state Governments may pursue their efforts for improving revenue collection from non-tax resources, ensuring the quantity and quality of major expenditure heads, reducing recourse to borrowed funds for financing expenditure and enhancing devolution of resources to the local Government level. The states Governments may have to design post-FRL architecture after assessing their performance under the rule-based framework. There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing, by States level public sector undertakings and power sector deficit. Contingent liabilities should be capped, but in addition off budget borrowing, where debt serving will fall to government, should be consolidated with on budget borrowing.

The impact of FRBM Act on fiscal indicators can be examined through empirical method.

Empirical Measurement of the Impact Of FRBM Act On Fiscal Deficit

FRBM was implemented to bring fiscal balance. An attempt has been done to examine whether the enactment of FRBM has brought the fiscal balance in terms of reduction in Fiscal Deficit to GDP ratio.

The data have been collected from secondary sources from Hand Book of Statistics on Indian Economy 2009 published by Reserve Bank of India (RBI), Government of India. The yearly time series data have been taken for the period from 1980-81 to 2008-09.

Model Design

Simple Ordinary Least Square (OLS) method has been applied to examine the impact of FRBM Act on fiscal balance. Fiscal deficit to GDP ratio has been taken as the indicator of for fiscal balance. The study regress Fiscal Deficit to GDP (at market price) ratio against GDP (at factor cost) growth rate, Population growth and FRBM to find out the impact of FRBM Act on fiscal balance.

Fiscal Deficit = (Revenue Receipt + Capital Receipt) - Total Expenditure
Revenue Receipt and Capital Receipt = f (Gross Domestic Product)
Expenditure = f (Population)

So here Fiscal Deficit to Gross Domestic Product is a function of Gross Domestic Product Growth Rate, Population Growth Rate and FRBM:

FD/GDP =f {GDFC, PG, FRBM}

Symbolically, the model can be written as:

$$FD\_GDP = \alpha_0 + \alpha_1 GDPFCG_t + \alpha_2 PG_t + \alpha_3 FRBM + u_t \quad (1)$$

Here:
FD_GDP = Gross Fiscal Deficit / GDP (at market price);
GDP= Gross Domestic Product at Market Price;
GDFCG = Gross Domestic Product Growth Rate at Factor Cost;
PG = Population Growth Rate.

FRBM (here FRBM is dummy is taken as 1 for year which have FRBM and 0 is for other years).

Table 3 Empirical result of the measurement of FRBM Act on Fiscal Deficit to GDP ratio

Dependent Variable: FD_GDP				
Method: Least Squares				
Sample (adjusted): 1981 2008				
Included observations: 28 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.022764	0.030075	0.756905	0.4568
GDPFCG	-0.001477	0.000651	-2.269374*	0.0329
PG	0.013107	0.013434	0.975692	0.3394
FRBM	-0.004358	0.008335	-0.522797	0.6061
FD_GDP(-1)	0.650711	0.136409	4.770293	0.0001
R-squared	0.701105	Mean dependent var		0.077248
Adjusted R-squared	0.649123	S.D. dependent var		0.015142
S.E. of regression	0.008969	Akaike info criterion		-6.429602
Sum squared resid	0.001850	Schwarz criterion		-6.191708
Log likelihood	95.01442	F-statistic		13.48752
Durbin-Watson stat	2.266538	Prob(F-statistic)		0.000008

Note: FRBM dummy (FRBM) taken as 1 for years which has FRBM other years 0
** Indicates the t values are significant at 1 percent level*

The study regress FD_GDP on GDPFCG, PG and FRBM to find out impact of FRBM act on fiscal balance in India. The model uses OLS technique, but the result can be considered by taking the goodness of fit of R^2, adjusted R^2 and Durbin-Watson (DW) statistic. The DW statistics is 2.26, which means there is absence of auto correlation in the error term. The R^2 and adjusted R^2 of this model is 0.70 and 0.64 respectively. Therefore we consider the model reported in table 3 for our analysis.

The empirical analysis find out that FRBM Act does not have a significant effect on the Gross Fiscal deficit (GFD) to GDP ratio though the calculated (t) value is not significant for FRBM and it is only -0.523 which is less than the 2. Here GDP (at factor cost) growth rate has a significant negative effect on the GFD to GDP ratio though the calculated (t) value is (-2.27) which is greater than 2. It means when GDP (at factor cost) growth rate is increasing fiscal deficit to GDP ratio is declining. Population growth does not have a significant effect on Gross Fiscal deficit to GDP ratio though the calculated (t) value is 0.97 which is less than 2.

6. Conclusion

After the implementation of FRBM Act central and government major fiscal deficit indicators showing a declining trend. The improvement at central level is due to slight improvement in revenue receipts (tax receipts) and mainly due to expenditure cut. It can be observed that among expenditure there is a heavy deterioration in the capital expenditure, where as among revenue expenditure (like interest payments, pension) there is not much changes. Fiscal Policy Rules should also take care of capital expenditure as it is a major indicator of growth and priority should be given for increasing this expenditure rather than cutting it off in the fiscal consolidation process. Target variables should be chosen in such a way that social sector and capital spending do not suffer in the course of adjustment.

No doubt FRBM Act has been proved as an important development in managing Centre and States finances but this improvement may not be sustainable because mere implementation of FRBM Act cannot solve the problem further improvement is require in terms of target variable, in terms of coverage in terms of procedure and transparency.

FRBM Act is lacking clear accounting definitions for target fiscal indicator. It has allowed creative accounting as reflected by the issuance of off-budget bonds to finance subsidies, which have thus been excluded from the definition of the FRBMA relevant deficit variable. So care must be taken to bring to capture off budget borrowing. Numerical targets under FRBM have not been supported by comprehensive expenditure reform plans. FRBM has emphasized on current balance target. This allows weaknesses in budget classification to be exploited, by misclassifying current expenditures as capital expenditures. Targeting the current balance may also bias spending against education and health, which have a large current expenditure component. Focus on current deficit type targets such as the current balance are more likely to reduce incentives for fiscal savings in good times, and to force adjustment in bad times (i.e.

procyclicality). Numerical targets under FRBM have not been supported by comprehensive expenditure reform plans. Despite rapid economic growth and buoyant revenues, India's inability to contain expenditure growth led to modest declines in the general government debt. Since the enactment of the FRBMA, general government debt fell by only 7-8 per cent of GDP and, at 80 percent of GDP, is high by emerging markets standards.

Our empirical result find out that FRBM act does not have a significant effect on the Gross Fiscal deficit (GFD) to GDP ratio where as GDP (at factor cost) growth rate has a significant negative effect on the GFD to GDP ratio. Population growth does not have a significant effect on Gross Fiscal deficit to GDP ratio.

FRBM Act in India need to be accompanied by an overarching structural reform effort covering intergovernmental fiscal relations, public sector employment, subsidies, and the financial system. For achieving transparency clarity in institutional arrangements (intergovernmental fiscal relations, relations between the government and the so-called public accounts, relations between the government and public utilities), in fiscal reporting (including timely, accurate and comprehensive financial statements) and in accounting (in particular through accruals-based treatment). In India sharing of tax powers between Central and state Government is also a source of complexity and the expenditure framework needs to be strengthened by clearly distinguishing between current and capital spending and by placing more emphasis on performance audit.

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