**Chapter 14**

**Introduction**

The Commission has been tasked with evolving an approach, based on its review of Union and State finances, to create a fiscal environment that is sustainable and promotes equitable growth. This would involve reviewing the functioning of the Fiscal Responsibility Budget Management Act, 2003 (FRBM Act i.e. The **Fiscal Responsibility and Budget Management Act, 2003** (FRBMA) is an act of the Parliament to institutionalize financial discipline, reduce India's fiscal deficit, improve macroeconomic management and the overall management of the public funds), and suggesting amendments, if necessary, keeping in mind the effective revenue deficit (which takes into account the difference between revenue deficit and grants for creation of capital assets). The Commission is also expected to recommend incentives and disincentives for States to comply with the provisions of the FRBM Act. In making its recommendations, the Commission must consider resources of State Governments and the demands made on these resources, particularly how debt impacts the resources of the states which are already debt stressed.

**Review of Debt and Deficit**

* The consolidated fiscal deficit of Union and State Governments declined from 7.2 % of GDP in 2004-05 to 4 % in 2007-08, its lowest level in our period of analysis which is 2004-05 to 2013-14(BE). This was a period of high economic growth, revenue buoyancy and fiscal consolidation. However, the combined fiscal deficit-GDP ratio increased sharply to 8.2 per cent in 2008-09 and reached a peak of 9.4 per cent in 2009-10 on account of the economic slowdown and the fiscal stimulus given to mitigate its effects, pay revision, debt relief measures, a high subsidy bill and increased welfare spending initiated largely by the Union Government. Subsequently, the fiscal deficit-GDP ratio declined to 7.6 per cent in 2011-12 and 6.9 per cent in 2013-14 (BE). Similarly, the combined revenue deficit-GDP ratio showed significant improvement from 3.5 per cent in 2004-05 to 0.1 per cent in 2007-08, before a sharp increase to 5.7 per cent in 2009-10. It later declined to 2.8 per cent in 2013-14 (BE). The debt-GDP ratio deteriorated after 2007-08 primarily due to a higher fiscal deficit. However, they were within the targets.

**Review of Fiscal Indicators of the Union**

* High growth in revenues from income tax and service tax from 2004-05 to 2007-08 enabled the Union Government to reduce its fiscal deficit to 2.5 per cent in 2007-08. However, the fiscal deficit increased sharply thereafter to 6.5 per cent in 2009-10 and although it later declined from 5.7 per cent in 2011-12 to 4.6 per cent in 2013-14.
* Union Government finances remained under pressure. The revenue deficit declined to 1.1 per cent of GDP in 2007-08, but later increased. Except for two years - 2006-07 and 2007-08 - the Union Government had a primary deficit through the period from 2004-05 to 2013-14.
* The total outstanding debt of the Union Government includes liabilities contracted in the Consolidated Fund and obligations secured under the Public Account. While the former consists of internal debt (dated securities and treasury bills) and external debt, the latter include liabilities on account of the NSSF (National small savings fund) and provident fund, among others. However, the outstanding debt as reported in the Union budget needs to be adjusted for certain liabilities that are not used to finance the Union Government's fiscal deficit such as Market Stabilization Scheme (MSS) securities and borrowings by States under NSSF.
* Market Stabilization scheme (MSS) is a monetary policy intervention by the RBI to withdraw excess liquidity (or money supply) by selling government securities in the economy. The MSS was introduced in April 2004. Main thing about MSS is that it is used to withdraw excess liquidity or money from the system by selling government bonds.
* The adjusted Union debt-GDP ratio4 declined from 54.3 per cent in 2004-05 to 46.3 percent in 2013-14 (RE) and further to 45.4 per cent in 2014-15 (BE). However, the public debt component of this increased from 79.8 per cent in 2007-08 to 87.9 per cent in 2013-14 (RE), before marginally falling to 87.2 per cent in 2014-15 (BE). This decline was largely due to an increase in the share of internal debt in total liabilities.

**Review of Fiscal Indicators of the State**

* Fiscal indicators of States improved in the period from 2004-05 to 2013-14(RE). The fiscal deficit-GDP ratio for all States declined from 3.3 per cent in 2004-05 to 1.4 per cent in 2007-08. Although the aggregate fiscal deficit later increased to 3 per cent in 2009-10, it declined to 1.9 per cent in 2012-13, before increasing again to 2.5 per cent in 2013- 14 (RE). States, taken together, moved into a revenue surplus position in 2006-07 and have maintained this since then, except for 2009-10 when the implementation of Pay Commission and reduced revenue buoyancy on account of the economic slowdown resulted in a revenue deficit.
* However, Kerala and West Bengal incurred revenue deficits between 2004-05 and 2012-13, while Punjab had revenue deficits during these years except in 2006-07. Arunachal Pradesh, Assam, Bihar, Goa, Himachal Pradesh, Jammu & Kashmir, Karnataka, Kerala, Mizoram, Nagaland, Rajasthan, Tripura, and West Bengal incurred fiscal deficit in excess of 3 per cent of GSDP.
* With the discontinuation of the practice of giving Central loans for State Plans from 2005-06, the share of loans from the Union in the total debt of the States witnessed a steady decline from 18.8 per cent in 2004-05 to 6.7 per cent in 2012-13 and further to 6.3 per cent in 2013-14 (RE). Market borrowings have emerged as the major source of borrowings for State Governments, particularly after 2008, with their share in total debt rising from 23.2 per cent in 2007-08 to 42.6 per cent in 2013-14 (RE).

**Extending the definition of Debt**

* A sizeable proportion of guarantees extended to State public sector entities is on account of short-term debt facilities which do not get reflected in the long-term PSE debt. Thus, to get an approximation of the aggregate public sector borrowing of the States, commission looked at the sum of public debt, State PSE debt and the ratio of guarantees to GDP as an indicative number.
* All long-term debt of State PSEs accounted for 4.6 per cent of GDP in 2011-12. When this was combined with the aggregate public debt of States, the extended debt of all States for that year ballooned to 26.4 per cent of GDP. Similarly, in the case of the Union Government, extended debt defined as the sum of Union public debt and the long-term debt of Central public sector enterprises' (CPSEs) stood at 52.4 per cent of GDP in 2011-12.
* Commission’s analysis indicates that while the all-State aggregate extended debt for 2011-12 was below the debt target set by the FC-XIII for 2014-15, there were some States which were slipping from a position of relative comfort towards debt-stress due to significant exposure to guarantees of loss-making power sector companies. Thus, it is important to keep such risks in mind when assessing the debt position of States while preparing fiscal management roadmaps for them, even though insufficient data prevents us from making firm policy inferences. In our view, it would be possible, and useful, to conduct a similar exercise with more contemporaneous data in the future. To this end, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document.

**Views of the State Govt.**

* The States, in their memoranda, covered several issues and made suggestions regarding fiscal consolidation, fiscal sustainability, debt relief and the existing FRBM framework. One suggestion was to recommend a flexible model of fiscal consolidation that takes into account recent fiscal trends, the overall accumulated debt, and the requirements of counter-cyclical measures, with the revenue and fiscal deficit targets being adjusted in line with the growth expectations each year. Some States argued that in view of the uneven levels of economic growth and development across the country, the fiscal target-setting methodology should be modified to reflect the true fiscal situation of different States.
* Most States were of the view that the rule-based fiscal framework has achieved its purpose and needs to be continued. However, they felt that the fiscal rules should apply equally to both the Union Government and State Governments. In view of the large fiscal and revenue deficits of the Union Government, the States stressed the need for building disincentives in the FRBM Act to restrain it from breaching the numerical targets.

**Views of the Union Govt.**

* The Ministry of Finance pointed out that the process of fiscal consolidation had to be paused in 2008-09 in order to cushion the economy from the impact of the global economic slowdown. It said that a revised roadmap for consolidation has been adopted following the amendments to the FRBM Act in 2012 and that the Union Government is committed to abide by rule-based fiscal prudence.
* The Ministry stated that there was a need to improve the quality of fiscal consolidation at the state level by incentivizing revenue generation, reducing committed liabilities and improving the quality of expenditures as measured against forward looking outcomes.
* The Ministry categorically opposed the request by States for prepayment of NSSF, pointing out that any sudden change in the asset base of NSSF on account of draw down by the States would pose a threat to the viability of the fund. Small savings, it argued, serve a specific public policy purpose and should not be viewed as another source of debt financing by either the Union or the States.

**Views of CAG**

* The C&AG proposed measures to deepen the elements of FRBM reporting in order to enhance fiscal marksmanship. It pointed out the need for improvements in budgetary forecasts, efficient tax mobilization and the cost of compliance.

**Issues and Approach**

* The FC-XII defined debt sustainability in terms of debt-GDP ratio and in terms of interest payments relative to revenue receipts. This was considered an easier target to follow, as both revenue receipts and interest payments are part of budgetary data, which is readily available, as compared to GSDP data, which comes with a lag.
* However, the debt sustainability position of States changes on extending the definition of debt, with a few States moving from a position of relative comfort to vulnerability, largely because of the drag of power sector losses. Commission noted that there were varying degrees of fiscal stress among States and it is difficult to draw a line and categorize some as seriously debt stressed.
* The debt that is owed to the Union Government is amenable to traditional measures of debt relief through rescheduling and write-offs, it needs to be noted that the outstanding debt of the States to the Union is not a very large part of the debt portfolio of State Governments. In view of this, we find that the scope for rescheduling debt is very limited, compared to the past when previous Commissions undertook such exercises.

**Fiscal Consolidation: Assessment and Issues**

* Review shows that, at an aggregate level, States made significant improvements in complying with the FRBM targets prescribed by the FC-XII and FC-XIII. In the pre-crisis period, fiscal consolidation at the State level was aided by a number of factors, including implementation of state-level fiscal responsibility acts, debt waiver and restructuring recommended by Finance Commissions, and improvement in revenues on account of buoyancy of Central taxes and introduction of value-added tax (VAT) at the state level. Despite States experiencing pressure on their fiscal balances in the post-crisis period due to lower buoyancy of Central taxes and increased expenditure commitment due to the implementation of the recommendations of Pay Commissions, they largely continued to comply with the FRBM targets.
* A uniform and rigid fiscal rule not only undermines the fiscal autonomy of the States, but also results in undesirable cuts in development expenditure in order to comply with numerical targets. The structural issues relating to fiscal imbalances in the Union Government as well as in some of the States do not get addressed through these rules alone. Acknowledging the asymmetry in the fiscal consolidation path at the Union and the State levels so far, we are proposing different rules and roadmaps and targets for the Union and State Governments. Keeping in view the fiscal position of the States and the need to provide headroom for the fiscally prudent ones, we have developed a multiple-indicator approach to fiscal consolidation.
* The basic parameters of fiscal consolidation adopted by the FC-XIII were reasonable and appropriate to our conditions. They have worked well as far as the States are concerned, though some operational flexibility has been desired by the States. They would have worked well for the Union Government also, but for the unforeseen external developments and, possibly, certain domestic policies.

**Fiscal Rules**

* In the light of the commission’s approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, the following rules for the Union and the States are recommended. For the Union Government, the ceiling on fiscal deficit will be 3 per cent of GDP from the year 2016-17 onwards up to the end of our award period. It is expected that an improvement in the macroeconomic conditions and revival of growth as well as tax reforms should enhance the total tax revenues of the Union Government, enabling it to eliminate the revenue deficit completely much earlier than 2019-20.
* Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year. States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year.
* Recognizing that the fiscal environment should be conducive to equitable growth, we recommend that the Union and all the States should target improving the quality of fiscal management encompassing receipts and expenditures while adhering to the roadmap outlined.
* **The challenge is to design a basic incentive-compatible framework for the Union and State Governments to hold each other accountable over agreed fiscal targets.**

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