EduTap

SUMMARY SHEET

FRBM

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EduTap Hall of Fame

RBI Grade B 2020 - 21

198 Selections Out of 257

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SEBI Grade A 2020

63 Selections Out of 80

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NABARD Grade A 2020

65 Selections Out of 69

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Important Note: All the Information given in Concept notes is important. So ,we have uploaded the concept notes as it is in the summary sheet. Further cutting down information from concept notes is not possible

1 What is fiscal Policy?

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply. These two policies are used in various combinations to direct a country's economic goals.

1.1 How does the fiscal policy work?

- The governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending (Fiscal policy is based on the theories of British economist John Maynard Keynes).
- This influence, in turn, curbs inflation, increases employment and maintains a healthy value of money.
- The idea, however, is to find a balance between changing tax rates and public spending.

For example:

Case 1:

Stimulating a stagnant economy by increasing spending or lowering taxes runs the risk of causing inflation to rise.

This is because an increase in the amount of money in the economy, followed by an increase in consumer demand, can result in a decrease in the value of money - meaning that it would take more money to buy something that has not changed in value.

So, here the government needs to find a balance. Just because the economy is stagnant, the government cannot arbitrarily increase the spending or lower the taxes. It needs to increase the spending in such a way that the spending leads to creation of jobs and simultaneously decrease the taxes in a well thought out manner so the people have more money in their hands to spend, thus raising the demand.

Case 2:

On the other hand, when inflation is too strong, the economy may need a slowdown. In such a situation, a government can use fiscal policy to increase taxes to suck money out of the economy. Fiscal policy could also dictate a decrease in government spending and thereby decrease the money in circulation.

2 Objectives of Fiscal Policy:

The general objectives of fiscal policy are:

- To maintain and achieve full employment.
- To stabilize the price level.
- To stabilize the growth rate of the economy.
- To maintain equilibrium in the Balance of Payments.
- To promote the economic development of underdeveloped countries.

3 What is Fiscal Consolidation?

- Fiscal consolidation is a process where government's fiscal health is getting improved and is indicated by **reduced fiscal deficit.**
- Improved tax revenue realization and better aligned expenditure are the components of fiscal consolidation as the fiscal deficit reaches at a manageable level.
- Fiscal consolidation is a reduction in the underlying fiscal deficit. It is not aimed at eliminating fiscal debt.
- In India, fiscal deficit is the king indicator to show the fiscal health of the government. Effectively, fiscal deficit indicate the amount of government borrowing for that particular year.

3.1 Fiscal consolidation in India:

- In India, fiscal consolidation or the fiscal roadmap for the centre is expressed in terms of the budgetary targets (fiscal deficit and revenue deficit) to be realized in successive budgets.
- **The Fiscal Responsibility and Budget Management (FRBM) Act gives the targets for fiscal consolidation in India.**

In last few years, India has continued on path of fiscal consolidation due to array of reasons including lesser fuel subsidies, targeted social sector schemes, better tax revenue generation and better aligned expenditure.

In this context, the key highlights of the "Fiscal Monitor" report of IMF are worth mentioning here. These include the following:

- Despite deceleration in the growth causes by demonetisation, India managed to path of fiscal consolidation due to above mentioned reforms.
- The union budget has put in place some growth friendly fiscal adjustment underpinned by expenditure cuts.
- The report expected that nationwide GST would enhance the efficiency of the internal movement of goods and services and will establish a common national market.
- The report recommends to continue on path, keep tab on untargeted subsidies, focus on capital spending, raise taxes on demerit goods and so on

4 Committees on Fiscal Consolidation

With the focus towards fiscal consolidation, governments till date have constituted **two important committees i.e. Vijay Kelkar committee and NK Singh Committee.**

4.1 Vijay Kelkar Committee

- The UPA government had constituted Vijay L. Kelkar committee to devise a fiscal consolidation roadmap for **2012-13 to 2014-15**.
- This committee had made several recommendations including a roadmap for government towards subsidy cuts, oil prices etc. One of the radical recommendations was that the government should raise the prices of food items sold through PDS every time when the minimum support prices are revised. **Most of the recommendations were specific to problems of those times only and were ignored**.

4.2 NK Singh Committee

- In **May 2016, the Modi Government** set up a Fiscal Responsibility and Budget Management (FRBM) Committee headed by N K Singh, former revenue and expenditure secretary and a former MP.
- This was a high level committee whose members included RBI Governor Urjit Patel, Chief Economic Advisor Arvind Subramanian, former Finance Secretary Sumit Bose, and National Institute of Public Finance and Policy Director Rathin Roy.

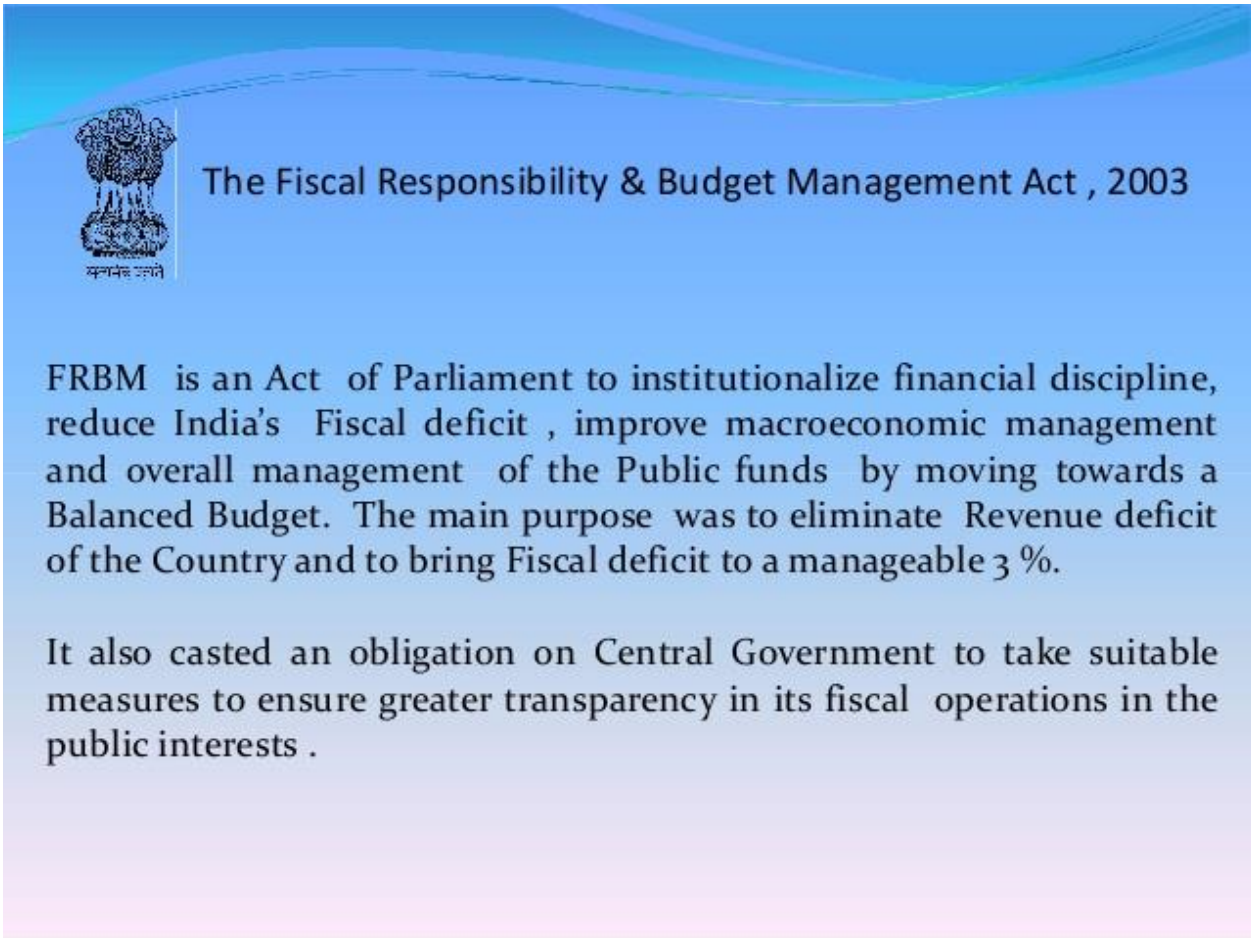
Terms of reference of the committee:

i. Review the working of the FRBM Act, 2003 over last 12 years and suggest the way forward.
ii. The suggestions should be submitted keeping in view the broad objectiv of fiscal consolidation and prudence and the changes required in the context of the uncertainty and volatility in the global economy.
iii. Look into various factors, aspects, considerations going into determinin the FRBM targets.
iv. Consider the possibility of replacing absolute fiscal deficit targets with target range that may be adjusted in line with the overall credit trends the economy.
v. Examine the need and feasibility of aligning the fiscal contraction an expansion with credit expansion or contraction respectively in the economy.

More on NK Singh Committee has been discussed at the end of this document.

4.3 FRBM Act

- **The FRBM Act is a fiscal sector legislation enacted by the government of India in 2003**, aiming to ensure fiscal discipline for the Centre by setting targets including reduction of fiscal deficits and elimination of revenue deficit.
- It is a **legal step to ensure fiscal discipline and fiscal consolidation** in India.
- The targets set under the Act were postponed several times in later years though some other goals of the Act including phasing out of government borrowing from the RBI were implemented.



5 Why FRBM became necessary?

- The FRBM Act was enacted in 2003 as **rising government borrowing and the resultant government debts** had seriously eroded the financial health of the government.
- High revenue deficit due to higher expenditure on subsidies, salaries, defence etc. compelled the government to make big borrowing from early 1990s onwards.
- With inadequate revenues, government resorted to high level of borrowing. The borrowing again produced high interest payments. In this way, interest payments became the largest expenditure item of the government.
- **To arrest this financial weakness in its budget**, the government has taken some serious deficit cut targets by introducing a law in the form of the FRBM.

6 Features of FRBM Act, 2003:

Key features of the FRBM Act are as follows:

- The **revenue deficit** should be reduced to an amount equivalent by 0.5% or more of GDP every year, beginning with the financial year 2004-05 and eliminate revenue deficit by March, 2009,
- The **fiscal deficit** should be reduced by 0.3% or more of the GDP every year, beginning with the financial year 2004-05and bringing it down to 3% of GDP by March 2009.
- The Central Government should **not provide guarantees** in excess of 0.5% of GDP in any financial year, beginning with 2004-05

- The Central Government should **not assume additional liabilities** in excess of 9% of GDP for financial year 2004-05 and progressive reduction of this limit by at least 1 % point of GDP in each subsequent year
- The RBI should **not subscribe to primary issues of Central Government securities** from the year 2006-07.
- The Finance Minister to make a **quarterly review of trends** in receipts and expenditure in relation to budget and place the outcome of such reviews before both the Houses of Parliament.
- The Central Government should **specify four fiscal indicators**- Fiscal deficit as a percentage of GDP; Revenue deficit as a percentage of GDP; Tax revenue as a percentage of GDP; Total outstanding liabilities as percentage of GDP.
- The Central Government **should place in each financial year before houses of Parliament three statements**-Medium Term Fiscal Policy Statement; Fiscal policy strategy statement; Macro-economic Framework statement along with Annual Financial Statement and Demands for grants.
- The FRBM Act States that the **Central Government shall not borrow from RBI except by way of means and advances** to meet temporary excess of cash disbursements over cash receipts.
- The **revenue and fiscal deficit may exceed the targets specified in Rules only on grounds of national security** or national calamity or such other exceptional grounds as the Central Government may specify.
- The Finance Minister has to explain the reasons and suggest corrective actions to be taken, in case of breach.

6.1 What are WMAs

- The Reserve Bank of India (RBI) gives temporary loan facilities to the central and state governments. This loan facility is called Ways and Means Advances (WMA).
- The Ways and Means Advances scheme was introduced in 1997.
- The government can avail of immediate cash from the RBI, if required. But it has to return the amount within 90 days. Interest is charged at the existing repo rate.
- If the WMA exceeds 90 days, it would be treated as an overdraft (interest rate on overdrafts is 2 percentage points more than the repo rate).

6.2 Postponement of Targets under FRBM Act:

- Due to **the 2007 international financial crisis**, the deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009.
- **In 2010-11**, Government gave further blow to this act by including the concept of **Effective Revenue Deficit** in the budget documents.

Effective revenue deficit is the difference between revenue deficit and grants for creation of capital assets. In sum, the change has placed capital expenditure out of the purview of the revenue deficit.

- **In Budget 2012-13**, the finance act changed the FRBM act and dumped the Centre's commitment to eliminate the revenue deficit. Instead, it brought in a new commitment of eliminating the effective revenue deficit rather. The amended rules extended the time for elimination of Effective revenue deficit by March 2015 and bringing down fiscal deficit to 3% by March 2017.

- As per **Finance Act 2015**, the target dates for achieving the prescribed rates of effective deficit and fiscal deficit (3% fiscal deficit) were further extended by 3 years to March 2018.
- **In the 2017-18 budget**, the government extended the timeline for the achievement of the 3% target to 2018-19.
- **In the 2018-19 budget, a Fiscal Deficit of 3.3% of GDP for the year 2018-19 has been proposed. The Revised Estimates has put the Fiscal Deficit for the year 2017-18 at 3.5% of GDP. The Budget has also proposed the acceptance of the key recommendations of the Fiscal Reform and Budget Management Committee to bring down Central Government's Debt to GDP ratio to 40%.**
- In the 2020 Budget speech India's fiscal deficit settled at 3.8 percent in 2019-20 and will be targeted at 3.5 percent in 2020-21
- So fiscal deficit targets kept on getting extended

6.2.1 What is Effective revenue deficit:

- **Effective Revenue deficit** is a new term introduced in the Union Budget 2011-12.
- While **revenue deficit** is the difference between revenue receipts and revenue expenditure.
- The present accounting system includes all grants from the Union Government to the state governments/Union territories/other bodies as revenue expenditure, even if they are used to create assets.
- Such assets created by the sub-national governments/bodies are owned by them and not by the Union Government.
- Nevertheless they do **result in the creation of durable assets.**
- According to the Finance Ministry, such revenue expenditures contribute to the growth in the economy and therefore, should not be treated as unproductive in nature.

❑ **If this methodology is taken into account**, the effective revenue deficit (revised estimates) for 2010-11 is only 2.3 per cent as against the revenue deficit of 3.4 per cent of GDP.

❑ **The Act defines grants for creation of capital assets as grants-in-aid given by the Central Government to**

- state governments
- Autonomous bodies
- local bodies
- Other scheme implementing agencies for creation of capital assets

Which are owned by these entities.

7 Impact of FRBM Act

7.1 Impact on Deficits:

FRBM act has been violated more than adhered to since its enactment.

- Since its enactment, the act has been paused for four times including a reset of the fiscal deficit target in 2008-09 following the global financial crisis.
- In 2010-11, Government replaced revenue deficit with the concept of Effective Revenue Deficit in the budget documents.
- In Budget 2012-13, the finance act changed the FRBM act and it brought in a new commitment of eliminating the effective revenue deficit. The amended rules extended the time for elimination of Effective revenue deficit by March 2015 and bringing down fiscal deficit to 3% by March 2017.
- **The Act has helped on the issues relating to fiscal consolidation due to the mandatory medium-term and strategy statements which are required to be presented annually before Parliament**. Implementing the Act, the government had managed to cut the fiscal deficit to 2.7% of GDP and revenue deficit to 1.1% of GDP in 2007–08.

7.2 Impact on Development:

- While we notice a drastic fall in deficits, it has largely been on account of reductions in critical sectors of the economy.
- The Union Government's development expenditure as proportion of GDP declined in the post FRBM era from 7.49% in 2002-03 to 6.42 % in 2005-06.
- An analysis of revenue account of the development expenditure by states shows that in **almost all sectors there has been a decline in the post FRBM** era. In case of education, it declined from around 2.5 % of GDP in 2002-03 to less than 2.2 % of GDP in 2005-06. In Health sector, the decline has been from 0.6% to 0.49 % and in agriculture, from 0.67 % to 0.58 %. In overall Social sectors, it declined from 4.5 %of GDP to 4.16 % of GDP during the period.

7.3 Impact on Credit Growth

- Further the FRBM Act ignores the possible inverse link between fiscal deficit (fiscal expansion) and bank credit (monetary expansion).
- That is, if credit growth falls, fiscal deficit may need to rise and if credit rises, fiscal deficit ought to fall — to ensure adequate money supply to the economy.
- Data on money supply growth, bank credit and GDP establishes that, in the last six years, both money supply growth and credit expansion have halved absolutely and in relation to GDP growth.
- Even the combined fiscal deficit (fiscal expansion) and credit growth (monetary expansion) as a percentage of GDP has halved from 17.4 per cent in 2009-10 to 8.8 per cent, which is less than nominal GDP growth. Thus the FRBM Act has not only reduced fiscal deficit but also starved the growing economy from much needed investment.

However, despite so much criticism that the act has attracted over the years, the fact remains that it is an important milestone in the nation's journey towards fiscal consolidation.

7.4 FRBM Review Committee (NK Singh Committee on Fiscal Consolidation)

- The FRBM Review Committee **(Chairperson: Mr. N.K. Singh)** submitted its report in January 2017.
- The Report was made public in April 2017.
- The Committee proposed a **draft Debt Management and Fiscal Responsibility Bill, 2017** to replace the Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act).
- This committee had submitted its **4 volume report** covering different focus areas.

- The **first volume** of the report addresses the issue of the fiscal roadmap, fiscal policy, international experience and recommendations therein.
- The **second volume** refers to international experience especially from a lot of international organizations particularly OECD, the World Bank, ILO.
- The **third volume** deals with Centre-State issues.
- The **fourth volume** deals with views of domain experts both from national and international appropriate for fiscal policy.

In these reports, it largely confined itself to fiscal consolidation and prudence and suggested some changes.

7.5 Key recommendations of the committee:

Debt to GDP ratio:

- The Committee suggested using debt as the primary target for fiscal policy.
- A debt to GDP ratio of 60% should be targeted with a 40% limit for the Centre and 20% limit for the states.
- It noted that majority of the countries that have adopted fiscal rules have targeted a debt to GDP ratio of 60%.
- **The targeted debt to GDP ratio should be achieved by 2023.**
- **To achieve the targeted debt to GDP ratio, it proposed yearly targets to progressively reduce the fiscal and revenue deficits till 2023.**
- Note that debt indicates the total outstanding liabilities of the government, while the fiscal deficit indicates new borrowings made in the year, and the revenue deficit indicates what part of these new borrowings have been used to cover revenue expenses.

Year	Fiscal Deficit	Revenue Deficit	Debt
2017-18	3.0%	2.1%	47.3%
2018-19	3.0%	1.8%	45.5%
2019-20	3.0%	1.6%	43.7%
2020-21	2.8%	1.3%	42.0%
2021-22	2.6%	1.1%	40.3%
2022-23	2.5%	0.8%	38.7%

Fiscal Council:

- The Committee proposed to create an autonomous Fiscal Council with a Chairperson and two members appointed by the Centre.
- To maintain its independence, it proposed a non-renewable four-year term for the Chairperson and members.
- Further, these people should not be employees in the central or state governments at the time of appointment.

The role of the Council would include:

- Preparing multi-year fiscal forecasts,
- Recommending changes to the fiscal strategy,
- Improving quality of fiscal data,
- Advising the government if conditions exist to deviate from the fiscal target,
- Advising the government to take corrective action for non-compliance with the Bill.

Deviations:

- The Committee noted that under the FRBM Act, the **government can deviate from the targets in case of a national calamity, national security or other exceptional circumstances notified by it**.
- Allowing the government to notify these grounds diluted the 2003 Act.
- The Committee suggested that grounds in which the government can deviate from the targets should be clearly specified, and the government should not be allowed to notify other circumstances.

Further, the government may be allowed to deviate from the specified targets upon the advice of the Fiscal Council in the following circumstances:

- Considerations of national security, war, national calamities and collapse of agriculture affecting output and incomes,
- Structural reforms in the economy resulting in fiscal implications, or
- Decline in real output growth of at least 3% below the average of the previous four quarters. These deviations cannot be more than 0.5% of GDP in a year.

Debt trajectory for individual states:

- The Committee recommended that the 15th Finance Commission should be asked to recommend the debt trajectory for individual states.
- This should be based on their track record of fiscal prudence and health.

Borrowings from the RBI:

The draft Bill restricts the government from borrowing from the Reserve Bank of India (RBI) except when:

- The Centre has to meet a temporary shortfall in receipts,
- RBI subscribes to government securities to finance any deviations from the specified targets, or
- RBI purchases government securities from the secondary market.

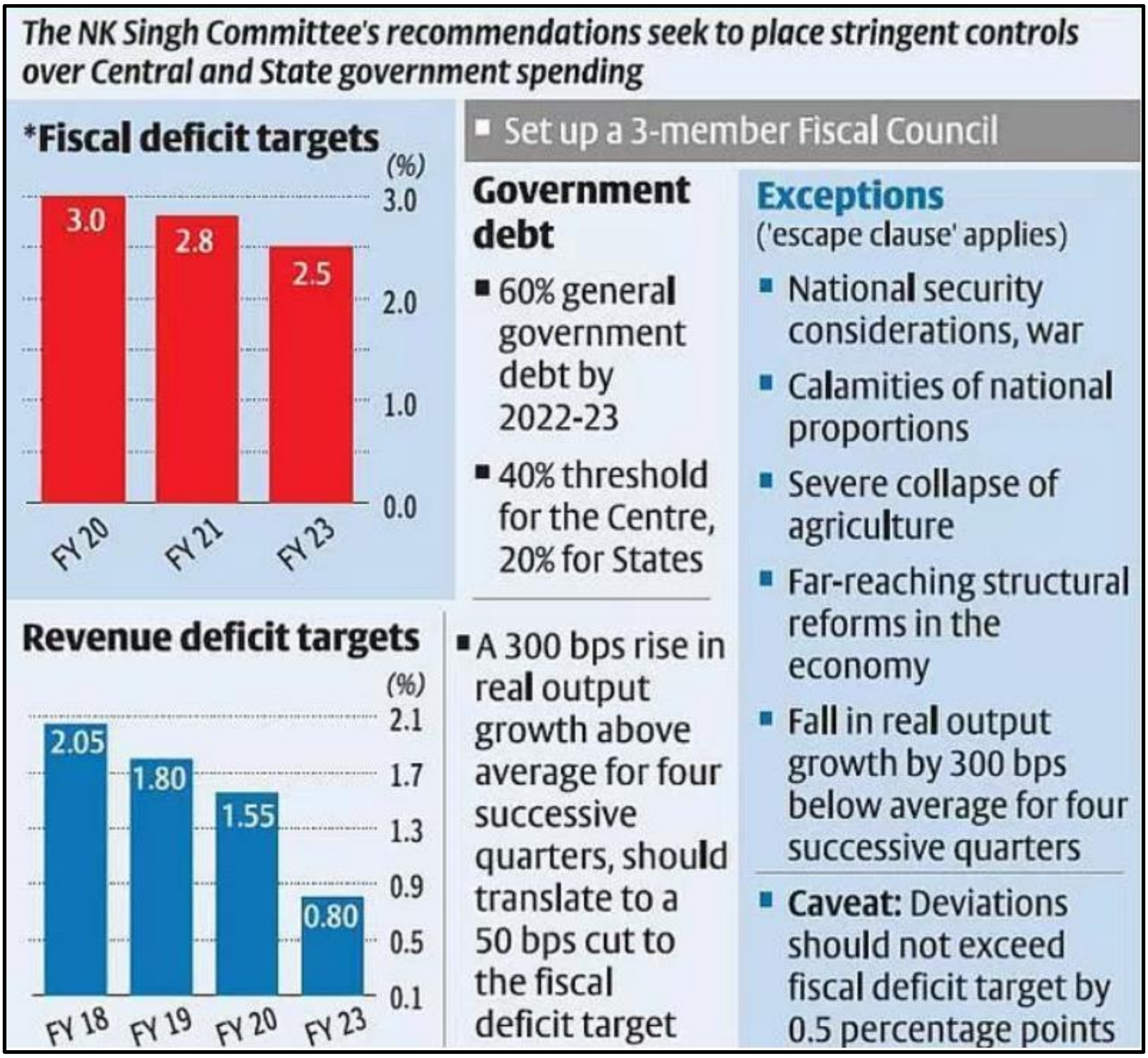
Review Committee:

The draft Bill requires the Centre to establish a committee to review the functioning of the Bill in 2023-24.

Dissent Note:

Mr. Arvind Subramanian submitted a dissent note. He stated that:

- Allowing for deviations if the output is 3% lower than the four quarter average, may not leave flexibility to tackle economic downturns and growth booms, and
- Having multiple targets (debt, fiscal deficit and revenue deficit) with precise limits may make it difficult to achieve them all. He suggested having a single objective, i.e. placing debt on a declining trajectory, and proposed alternate limits to reduce debt and deficits till 2023. Further, he argued against specifying a revenue deficit target.



Latest Changes in FRBM Act

The original fiscal deficit target for 2020-21 was 3.5%. However, in reality, the deficit has shot up to a high of 9.5% of the GDP due to:

1. The impact of the COVID-19 pandemic.
2. Low revenue flows due to the lockdown.
3. Negative economic growth clubbed with high government spending to provide relief to vulnerable sections of society.

As a result, Government has pegged the fiscal deficit for **2021-22 at 6.8%** of the GDP and aims to bring it back below the **4.5% mark by 2025-26.**

Table 8: Deficits (as % of GDP)

	Actuals 2019-20	Revised 2020-21	Budgeted 2021-22
Fiscal Deficit	4.6%	9.5%	6.8%
Revenue Deficit	3.3%	7.5%	5.1%

Sources: Union Budget 2021-22; PRS.

Recommendations by the 15th Finance Commission related to FRBM Act

1) **Fiscal Deficit:**

- **Target for Centre:** It recommended that the Centre brings down its fiscal deficit to 4% of Gross Domestic Product GDP by 2025-26 against 6.8% in FY22.
- **Target for States:** For states, it recommended **fiscal deficit at 4% of Gross State Domestic Product (GSDP) in 2021-22,** 3.5% in the following year and 3% for the next three years.

2) **Borrowing Ceilings for States:**

- Because of **Article 293 of the Constitution,** State Governments operate under borrowing limits and, hence, budget constraints, approved by the Union Government.
- The normal limit for **net borrowing may be fixed at 4% of Gross State Domestic Product (GSDP) in 2021-22, 3.5% in 2022-23** and be maintained at **3% of GSDP from 2023-24 to 2025-26.**
- **An additional borrowing of 0.5% of GSDP** to be allowed to the States in case they meet the criteria for **power sector reforms.**

3) **New FRBM Framework:**

- The Fiscal Responsibility and Budget Management Act (**FRBM Act, 2003**) **needs a major restructuring** and recommended that the time-table for defining and achieving debt sustainability may be examined by a **High-powered Inter-governmental Group.**
  - This High-powered Group can craft the **new FRBM framework** and oversee its implementation.
- **State Governments may explore formation of independent public debt management cells** which will chart their borrowing programme efficiently.