GS FOUNDATION FOR CSE 2024
ECONOMY-12
FISCAL POLICY-2
BUDGET, FISCAL DEFICIT, GOVERNMENT DEBT, FRBM ETC.

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2. TYPES OF BUDGETS

- Different kinds of budget follow different accounting principles to measure the results.

1. **Performance and Program Budgeting**:
   - In a performance budget, both the input of resources and the **output** of services are reflected in each unit of organization.
     - Performance of a program will be evaluated based on weather expected output was achieved or not.
     - So, it involves stage wise planning and standard fixation to assess performance of programs. It establishes a **correlation between physical (output) and financial (input) aspects** of each program and activity.

   - It was introduced in India in 1968 for four ministries on the recommendations of the 1st ARC. In 1975-76, it was introduced for all developmental departments.

   - **Advantages:**
     - Objective evaluation of performance
     - Employees can be kept motivated to achieve the outcome

2. **Outcome Budget**
   - The first outcome budget in India was introduced on Aug 25, 2005 by finance minister P. Chidambaram.

   - The outcome budget is a progress card on what various departments have done with the amount assigned in the previous budget.
     - It measures outcome of all government programs and weather money was spent for the purpose in was sanctioned.
     - Outcome refers to the **benefits that arise out of physical output f**rom the respective financial inputs.
       - For e.g. when roads are constructed, roads are the physical output. The rise in productivity of industries, transport sector etc. are the outcomes.

3. **Zero Based Budget (ZBB)**
   - In this system, all the schemes and programs are not included in every year's budget just because they already exist.
     - Here, **every scheme is reviewed critically and re-justified** as to why they have to be included in the coming budget.
     - It involves **consideration that there are no existing schemes/programs** and the budget has to be started from scratch/zero base.
     - So, it is called Zero based budget. The finance ministry has the plan to introduce it in future.
   - **Three essential principles of ZBB** (or three essential questions)
     - **Should we spend?**
     - **How much should we spend?**
     - **Where should we spend?**

- **Three essential features of ZBB:**
  1. **Conventional Aggregate approach is not applied.** In conventional approach every department prepares its own budget for many activities in aggregate from. Here, scrutinizing each and every activity is difficult.
     - » In **ZBB**, **every scheme/department needs to justify its existence** in the budget based on mathematical technique of econometrics i.e. cost benefit analysis.
     - » In simple terms, every scheme/activity by every department is scrutinized and once justification is validated, fund is allocated.
  2. ***Economy in public expenditure***, is a core principle followed here and budgetary allocations are cut to the extent it doesn't effect benefits of various service delivery to public.
  3. **Prioritizing of competing needs** is another special feature of ZBB. Different programs and given priority and the programs with least priority are allocated funds at the last. This may even lead to some very low priority schemes not getting any allocations.

- **Limitations of ZBB:**
  - » Services like 'Defence', 'Law and Order' etc. defy cost-benefit analysis i.e. no matter the cost, these services have to be mantained.
  - » Parliament can't scrutinize some expenditures like expenditures charged on the Consolidated Fund of India.
  - » ZBB is affected by biases of the scrutinizer as scrutiny is a subjective matter.
  - » It may give a lot of power to Finance Ministry as scrutinizer and weaken other ministries

- **Conclusion**:
  - » Despite some challenges, ZBB sounds a good step towards long term budgetary reform. It will promote both economy and efficiency in the budgetary process and functioning of the government.

- **Zero Based Budgeting in India**:
  - » ZBB was introduced for Department of Science and Technology in 1983. In 1986, it was adopted by the Indian government as a technique for systematic regulation of the expenditure budget. However, as of today, India has limited applications of ZBB.

3. MAJOR REFORMS IN INDIA'S UNION BUDGET OVER THE LAST FEW YEARS

– **Introduction**:
  - » A transparent, comprehensive and realistic budgetary process enables better fiscal management.
  - » To achieve efficiency in public spending, several reforms have been introduced in the Union Budget over the last few years:

– **Key Reforms:**

1. **Improved Fiscal Transparency and realistic revenue assumption in the budget**:
    - **It has been achieved by bringing below the line expenditures above the line and making revenue projections on realistic assumptions.**
        - For e.g. the extra-budgetary borrowings of the government were brought down from Rs 1.48 lakh crore in FY20 and Rs 1.21 lakh crore in FY21 to Rs 750 crore in FY22. No extra budgetary resources were estimated for FY23 in the budget.
    - **These measures demonstrated the government's commitment to sound fiscal management and provide an adequate buffer to deal with global challenge.**
2. **Discontinuation of Plan and non-Plan Classification**:
    - The Budget FY18 discontinued Plan and Non-Plan classification of government expenditure. It thus gave a greater emphasis to **revenue and capital classification** of Government expenditure.
    - Over the years, a broad understanding had developed that plan expenditure was good and non-plan expenditures were bad, resulting in skewed allocations in the Budget. The reform enabled effective planning and allocation of resources in the budget.

3. **Merger of Railway Budget with the Main Budget**:
    - It was done from FY18.
    - It gives a **holistic picture** of the government's financial position.
    - It also envisaged **facilitating multimodal transport planning** between highways, railways, and inland waterways, which has been strengthened in subsequent years with Gatishakti.
    - It has also enabled the Ministry of Finance to **ensure a coherent emphasis on capital expenditure** across sectors in recent years.

4. **Shifting the date of the Budget to 1st Feb**
    - This was done from the Budget FY18.
    - It paved the way for early completion of the budget cycle and enabled ministries to ensure better planning and execution of schemes from the beginning of the financial year.

– **Suggestions for further improvement** by **the Estimates Committee of Parliament** chaired by Mr. Girish Bhalachandra Bapat.
1. **Incorporate the state wise allocation details** in the Union Budget documents to bring transparency in transfer funds to states.
    - Currently, the Union Budget at a Glance document provides an overview of the budget, including the allocation of major schemes by the central government. However, the funds allocated to different states don't reflect in this document.
    - But, people are interested in knowing the amount of money allocated to different states by the central government.

2. **Increasing readability of Union Budget** documents: The Union Budget documents are very voluminous and common man and public representatives don't have the time required go through it. Government should organize a briefing session for the MPs immediately after the presentation of the budget in Lok Sabha and highlight details from the budget documents.

3. **Regulating the use of interest income made by states** using central grants:
    - Grants transferred by central government to state remain in treasuries till they are transferred to implementing agencies. In the process they also earn interest on it. The Central government should identify the interest income made by various states and frame guidelines for utilization of funds earned by them.

4. **Underspending has to be dealt with**: Despite advancement of the budget cycle, as per the estimates committee there was underspending/under utilization of resources which occurred in around 100 departments in FY20 in the first six months. Steps need to be taken to ensure that union budget are optimally and fully utilized.

5. **Monitoring the implementation of Schemes**: Department of Economic Affairs (DEA) should develop a mechanism to track the progress of Ministries/Departments on implementation of projects/schemes, so that habitual defaulters who have not updated the progress can be identified while allocating the budget.

4. FISCAL CONSOLIDATION

- **Example Question:**
    - Discuss the key steps that needs to be taken in India to achieve fiscal consolidation [10 marks, 150 words]

- **Fiscal consolidation** refers to long term permanent strategies to reduce deficit by increase the revenue and reducing expenditure.

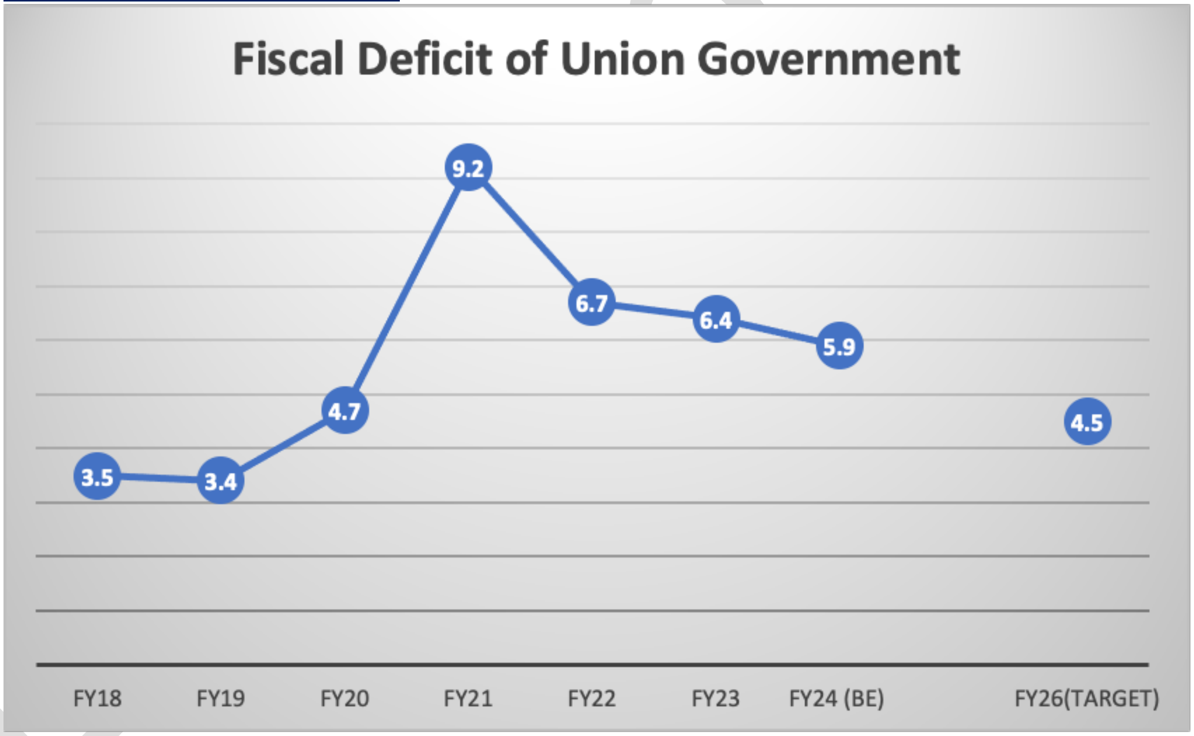
- **Why is Fiscal Consolidation** (i.e. reduction of fiscal deficit) **needed / Negative Impacts of High Fiscal Deficit**:
    - » **Inflationary Spiral**: Borrowing from RBI leads to increased money supply in economy which leads to higher inflation
    - » **Increased national debt**: This will impact future economic growth as a large part of the expenditure will go in paying interest for the debt rather than for capital investment.
    - » **Vicious Cycle of high Fiscal Deficit and Low GDP Growth**
    - » **Crowding out Effect**: This is the situation when high borrowing by the government (due to high fiscal deficit) leads to reduction in availability of funds for private investors. Accordingly overall investment in the economy reduces.
    - » **Erosion of government credibility**: High fiscal deficit (thus high debt of government) erodes credibility of the government in domestic as well as international money market. It may also lead to reduction in the 'Credit Rating' of the government (and the economy). Lower credit rating may lead to global investors withdrawing their investment from the domestic economy.
    - » **High Burden on Future Generation** as they are the ones who have to bear the brunt of higher interest rates.

- **Therefore**, fiscal deficit shouldn't be allowed to go beyond manageable limits (about 3% of the GDP is considered manageable).

- » **High deficit** also signifies fiscal indiscipline. It points to a situation when GDP growth is low and unemployment is high. The economy slips into stagnation and revival becomes difficult with FDI.

– **However**, some amount of fiscal deficit may be crucial for developing economies like India.
  - » Promote capital expenditure (fiscal deficit with high capex)
  - » Revitalize the business cycle (Counter-cycle fiscal policies)
  - » Promote crowding in investment (if better infrastructure is created -> fall in cost of production)
  - » Spending have higher fiscal multipliers during slowdown.

– **Thus, fiscal deficit may be ok, if following things are kept in mind:**
  - » Loan interest shouldn't become very high. Rate of growth of interest shouldn't be higher than the rate of growth of the GDP.
  - » Loans shouldn't be used to fund revenue deficit. It should go on **capital expenditure**.

– **Current Situation of India**:
  - » Structural reforms in FY20 (reduction in corporate taxes) and COVID-19 lockdowns in FY21 and FY22, diverted India from the track of fiscal consolidation.
  - » But, currently India is back on track with target of fiscal deficit to be **4.5% by FY26** and the current target of **5.9%** by FY24.
  - » 

– **Key steps that need to be taken**
  - » **Improving Tax System** (GST reforms, Direct Tax Reforms)
  - » **Reduce/Remove Perverse Subsidy** (e.g. Urea Subsidy; Electricity subsidy in agriculture; Electricity subsidy in urban areas; Subsidizing higher end travelling in Railways;)
    - **Replace these expenses** with better irrigation facilities; better marketing facilities etc.
  - » **Reduce Wasteful Expenditure** (delay in projects)
    - Timely project completion can reduce cost over run.

» **Rationalization of government schemes programs** (Central Sector Schemes/ Centrally Sponsored Programs)
» **Government exiting from nor core areas** in Public Sector Enterprise.
  - Work on this front has been slow. Rather than dispensing with activities such as telecom to the private sector, the government continues to pour money into BSNL.
» **Avoid socialization of loss** (for e.g. taking of equity by Vodafone): Loss socialization is basically some type of government intervention either through bailouts or subsidies.

– **Conclusion**1:
  » With these steps, India should be able to comfortably move towards the target of the fiscal deficit of 4.5% of the GDP by FY26 and further consolidation later.

– **Conclusion2:** (Accepting missed target of fiscal deficit)
  » Economic Survey of India 2020-21 had concluded that in India, it is eventually growth which would create debt sustainability and not vice-versa. So, India should focus more on economic growth, even if fiscal deficit targets get missed for sometimes.

5. PUBLIC EXPENDITURE AND ITS KEY ROLE IN ECONOMY

– **What is public expenditure?**
  » Expenses incurred by the public authorities - central, state and local self-government - are called public expenditure. In 19th century Europe, Public expenditure was believed to be wasteful. This conservative thinking died down in the twentieth century, especially after the second world war.

– **Why has public expenditure kept on increasing in recent years in India:**
1. **Increasing Population**: With increase in population of the country there is an expansion in the administrative activities of the government (like defence police and judiciary) which would lead to growth of public expenditure.
2. **Defence Expenditure**: As a country develops, it enhances its defence capabilities. In case of India, situation is more precarious and geographically India is located in a turbulent surrounding, thus needing to spend much more on defence.
3. **Welfare State:** Various socio-economic programs are undertaken by modern governments for the socio-economic uplift of the masses.
4. **Economic Development**: Modern government has a huge role in the growth of economy. Specially, in situations like COVID-19, government has to provide stimulus support. (e.g. various Atmanirbharta related initiative)

– **Freebie expenditure vs Fiscal Consolidation**
  ▪ Government may be giving a lot of subsidy/benefits which can be classified in following types:
    i. **Subsidy/benefit for improving economy** (e.g. PLI schemes, MUDRA yojna etc.). It also included foregoing of tax expenditure to promote sectors which are affected by sudden changes (e.g. recent reduction in taxes on crude oil)
    ii. **Subsidy for distributional efficiency** (e.g. subsidy like food subsidy, fertilizer subsidy, subsidy for insurance, subsidy for pension funds etc.)
    iii. **Expenses to stabilize economy** (e.g. provisions to control inflation; spending on capital formation etc.)

iv. **For improving Current Account Deficit** (e.g. export promotion related subsidies)

- **Now, not all freebies/government expenditure can be done away with.**
  - Services like law and order, defence, judicial services etc. have to be available free of cost.
  - **Merit goods** like health, education, water supply etc. could be subsidized for vulnerable groups
  - **Public Utilities** like railways, public transport, electricity can be run on cost recovery basis.
  - **Commercial activities** like running of steel plants, manufacturing of capital goods etc. should either be given up by government and should be run on profit motive/basis.

6. MONETIZATION OF DEFICIT

- **Introduction**
  - The need for monetization of deficit was widely debated in the light of COVID-19 pandemic and need to provide stimulus to economy, in which both government's efforts and RBI's easing were found to be inadequate.

- **What is Monetization of Deficit?**
  - In simple terms, monetization of deficit means **printing more money i.e. RBI buys government securities from the primary market to fund the government's expenses**. It thus means increase in RBI credit to government.
  - **Note:** Monetization of deficit doesn't mean that government is getting free money, rather it is highly subsidized money.

- **Monetization of Deficit in India**
  - Till 1997, monetization of deficit was a **common practice in India** and RBI used to automatically monetize government's deficit through the issue of ad-hoc treasury bills.
    - But, through **agreements in 1994 and 1997 t**he funding through ad-hoc treasury bills was completely phased out. Later, **FRBM act** completely prohibited RBI from subscribing to the primary issuance of the government from 1st April 2006.
    - **Now**, RBI only buys government bonds in secondary market through open market operations. Here RBI is indirectly monetizing the deficit.

    - **Note:** FRBM Act has an escape clause which permits monetization of the deficit under special circumstances.

- **Advantages of the above decision to prohibit/phase out monetization of deficit** i.e. of prohibiting RBI from subscribing to the primary issuance of the government.
  - Since the government started borrowing in the open market, **interest rates went up** which **incentivised saving and thereby spurred investment** and growth
  - Also, the **interest rate that the government commanded** in the open market acted as a critical **market signal of fiscal sustainability**.
  - Importantly, the agreement shifted **control over money supply, and hence over inflation, from the government's fiscal policy to the RBI's monetary policy.**
  - The **India growth story** that unfolded in the years before the global financial crisis in 2008 when the economy clocked growth rates in the range of 9 per cent was at least in part a consequence of the high savings rate and low inflation which in turn were a consequence of this agreement

- **Advantages/ Need of Monetization during recessionary face**
    - **Fiscal Stimulus**
    - **Reducing cost of borrowing**

- **Limitations**
    - It triggers **inflation**. In long run, the increased money supply would definitely add to the inflationary pressure.
    - **Increased supply of Rupee** may also lead to **depreciation of the value of Rupee**. This makes imports expensive and exports cheap.
    - It gives rise to **unproductive spending**.
    - **Impacts credibility of government ->** portrays government as unable to meet its own financial needs.
    - Finally, it also **erodes RBI's control over monetary policy** (and thus its independence). If RBI agrees to monetize the deficit, it is effectively agreeing to subordinate monetary policy to the financing policy of the government.

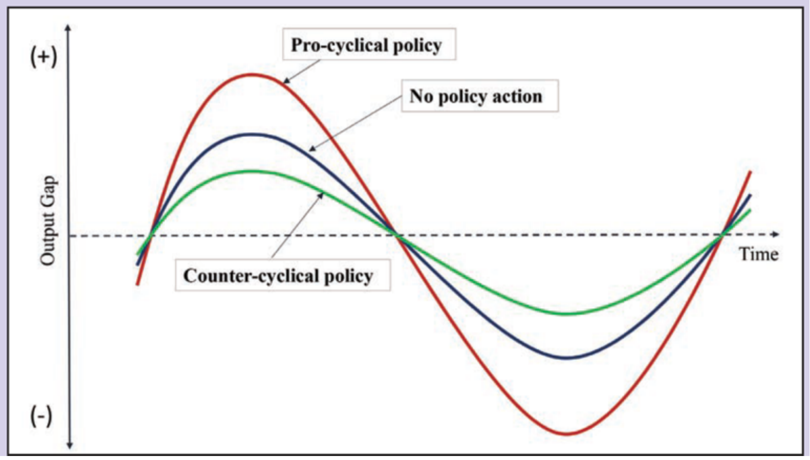
- **Conclusion**
    - Monetization of deficit is something that should be avoided in normal circumstances. Only in very extreme situations, government/RBI may resort to this.

7. COUNTERCYCLICAL FISCAL POLICY

- **What is Countercyclical Fiscal Policy?**
    - **During slow-down or recession**, government should allow slippage of fiscal target and reduce taxes and increase expenditure. This creates more demand and brings economic upswing.
    - **During Boom Period**, government should perform fiscal discipline, increase taxes and reduce government expenses. Otherwise, the growth would not be sustainable, high inflation may result and the amplification of boom can be disastrous in long run.

- **Pro Cyclic Fiscal Policy**
    - It is opposite of counter cyclic policy. During Boom, government may further increase the expenditure to allow further growth of the boom.

- **Why counter-Cyclic Fiscal Policy is crucial?**



- At the time of recession, **private consumption (C) reduces, and private investment (I) also go down.** In such scenario, **increasing government expenditure** – both consumption and expenditure – **will support GDP and minimize the output gap**. This happens primarily through the **following mechanism**:
    i. Increased government expenditure **cushions the contraction in output by contributing to the GDP growth** and offsetting the decline in consumption and investment.
    ii. During recession **spending multiplier is higher** which leads to boosting of private investment and consumption.
    iii. Higher spending by government **compensates for 'risk aversion' by private sector** and brings back 'animal spirits'.
    iv. It also **enhances expectation multiplier** by building confidence in tough times. Since government is able to exhibit their commitment to sound fiscal management, the *rational players in the economy would not expect the economy* to fluctuate as much and therefore private players will further increase the investments and reinforce this expectation multiplier.

- Numerous studies in economic literature have established the same conclusion both **theoretically as well as empirically**.

    Ozkan and McManus (2015) study the impact of fiscal policy on macroeconomic outcomes for 114 countries over 1950-2010. They found that a counter-cyclical fiscal policy stance with policy action against the cycle acts as a stabilizer by reducing output volatility and keeping growth on a steady path.

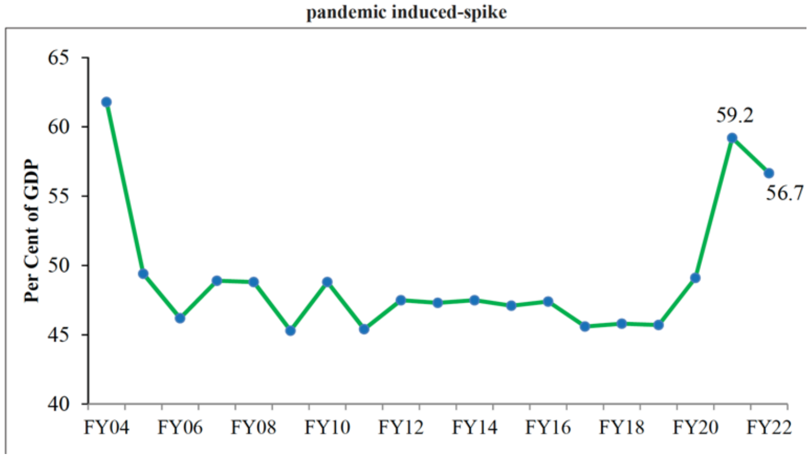
- **Conclusion: For India** too, in recessionary scenario of COVID-19, when the private consumption (which contributes to 54% of the GDP) was contracting, and private investment (which contributed to 29% of the GDP) was uncertain, the **relevance of counter-cyclical fiscal policies was paramount**.

8. GOVERNMENT DEBT

- The Covid-9 crisis has led to rise in government debt all over the world. IMF projected the **global government debt** at **91% of the GDP** in 2022, about 7.5% points above pre-pandemic levels. In Europe, even in FY23 government debt went up as government provided relief to households and small businesses from mounting energy bills.

- **India's Situation**: **Situation of Union Government**:

Figure III.14: Moderating Union Government's Debt-GDP ratio after the pandemic induced-spike



- In FY22 the total debt of Indian Government was **134.08 lakh crores** which includes:
  - **Public Debt** (121.21 lakh crore in FY22) of which:
    - **Internal Debt** (Rs 114 lakh crore in FY22): Borrowings using debt securities like dated securities treasury bills etc from domestic market.
    - **External Debt** (Rs 6.59 lakh crore in FY22): Borrowings from other governments (bilateral); multilateral agencies like WB, ADB, etc and FPI purchasing Governemnt securities.
  - **Public Accounts Liabilities** (11.8 lakh crores in FY22)
    - It includes National Small Savings Schemes.

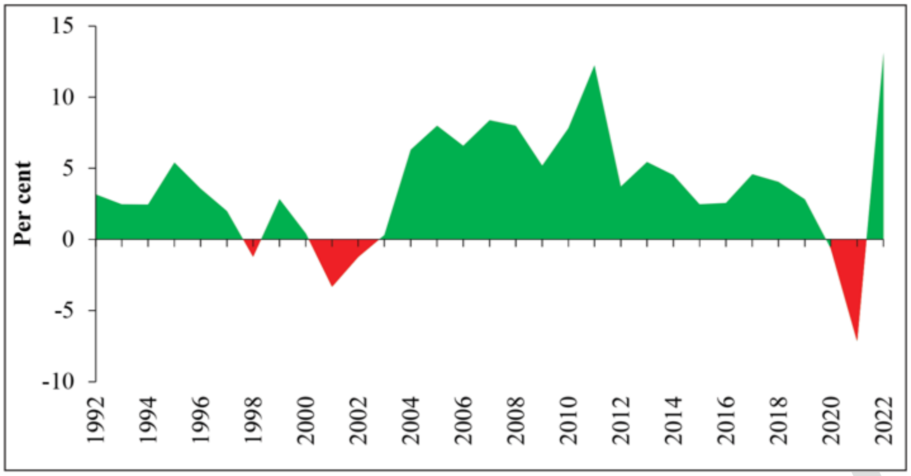
- **Extra Budgetary Liabilities** (1.39 lakh crores in FY22)
  - Extra Budgetary Liabilities are those financial liabilities that are raised by PSUs for which repayment of entire principal and interest is done from Government budget; Such borrowings are made by state-owned firms to fund government schemes but are not part of the official budget calculations.
  - They are excluded from fiscal deficit calculations, but at the same time, are added to the total debt of the government.

- **Note:** Share of external liability in public debt is **only 4.9%**. Thus, India's public debt profile is relative stable and is characterized by **low currency and interest rate risks.**
- Further, public debt in India is primarily contracted at **fixed interest rate**.

– **India's Situation: General** Government (Central + State): Debt to GDP Ratio
  - **Current Situation**
    - India's Public Debt to GDP ratio shot up from 75% in FY20 to **88.5%** in FY21.
    - Then it gradually reduced to **82.8% in FY23**.
  - **Future Estimate**
    - IMF says that the debt to GDP ratio may rise again in FY24 and FY25. After that it may start going down and reach 80.5% in FY29.
  - It clearly shows that Government debt is not going to return to pre-pandemic levels in medium term.

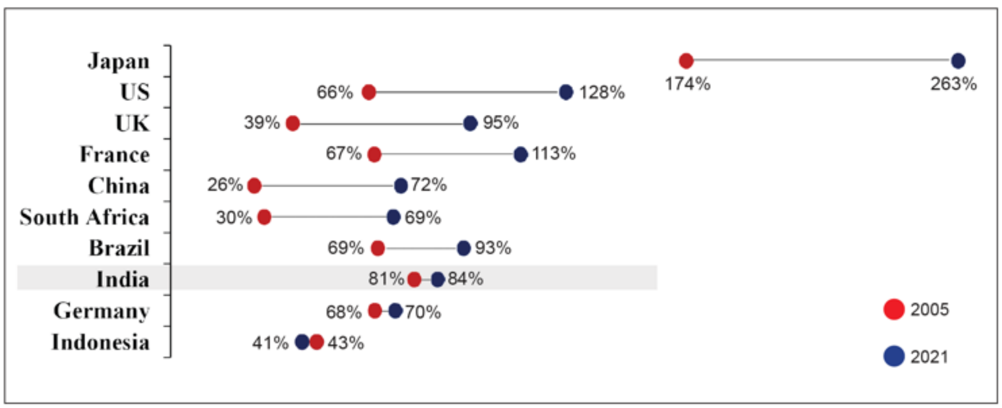
– **Sustainability of Government Debt**:
  - **A Positive Growth-Interest Differential Keeps the Government Debt sustainable.** In India, this differential has historically been positive.
  - **Increased capital expenditure** -> Higher growth -> Higher Revenue -> Sustainable fiscal path
    - The emphasis on capex led growth will enable India to keep the growth-interest differential positive.

Figure III.18: Growth-interest rate differential for India

» 

» In general, globally, between 2005-2021, there has been a substantial increase in debt to GDP ratio for most countries. But in case of India, the increase is **modest**. It has been possible due to resilient economic growth over the last fifteen years.

Figure III.19: Comparing General Government debt to GDP ratio in 2005 with 2021 across the countries

» 

Source: World Economic Outlook, October 2022.

- **High level of public debt is a cause of concern**:
  - » **High interest payment:** Interest payment constitute around 5% of India's GDP which is higher than the government expenditure on health and education put together. This crowds out government expenditure on infrastructure, human development etc.
  - » **Distortion of Financial Markets**: To keep the interest rates on government borrowings low, some financial repressions are imposed. For e.g. under SLR regime banks hold around 18% of NTDL in government securities. Similarly, RBI may intervene in the market through open market operations.
  - » **High level of debt also makes it difficult to calibrate counter-cyclical fiscal policy** and constraint the ability of government to respond to shocks.
  - » **Rating agencies keep the sovereign ratings low** when deficits and debt are high, and this increase the cost of external commercial borrowings.
  - » **Hampers Inter-Generational inequality**: Today's borrowing is taxing tomorrow.

- **Way Forward:**
  - » **Fiscal Consolidation** (already discussed with fiscal consolidation topic)

» **At the state level**, guard against the return to the **old pension scheme** and indulge in large-scale giveaways for electoral reasons.

» **Impose hard budgetary constraints** by enforcing **Fiscal Responsibility and Budget Management Rules** in allowing states to borrow.

9. OVERVIEW OF THE STATE GOVERNMENT FINANCES

1) FISCAL DEFICIT:

- In the pandemic year (FY21), the **Gross Fiscal Deficit (GFD) of the states** increased to **4.1% of GDP**. This was brought **down to 2.8%** in FY22 and FY23.
- This deficit is much lower than the budgeted estimate of 3.4% for FY23. **What are the reasons for swift** consolidation?
  - » **Decline in revenue expenditure.**
  - » **Increase in state's tax revenue** (led by GST collections)
- **For FY24,** States have budgeted a GFD-GDP ratio of **3.2%,** which is significantly lower than the indicative targe of 3.5% set by central government.

2) DEBT:

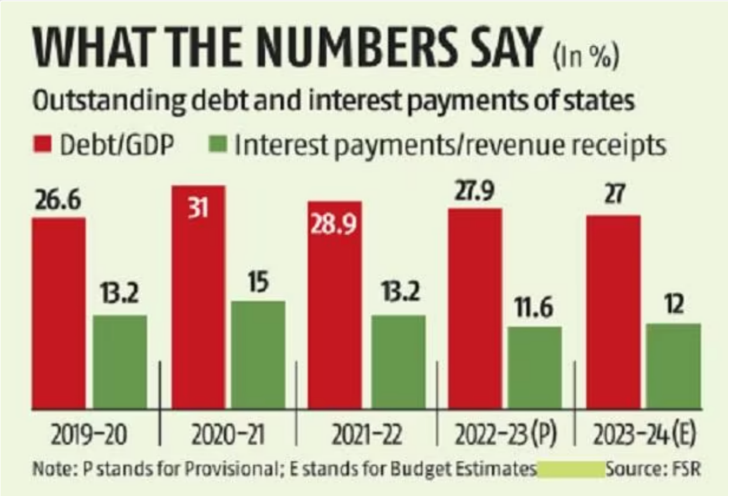
- After reaching a 15-year high of **31% of GDP** at the end of FY21, they came down to **27.9% of GDP** by the end of FY23.

- The **debt service burden** of the states, measured in terms of the **interest payment to revenue receipts ratio**, has also moderated during the period.

- **Are the above numbers good?**

  - No.

  - At 27.9%, it is higher than **the 20% limit recommended by the FRBM Review Committee (2018)** and warrants further consolidation.

- 

3) ENHANCED LIMIT OF BORROWING FOR THE STATES AND INCENTIVES FOR REFORMS

- Since the outbreak of the pandemic, the Centre has kept the Net Borrowing Ceiling of the state government **above the Fiscal Responsibility Legislation (FRL) threshold**.

- It was fixed at **5% of GSDP in FY21, 4% of GSDP in FY22 and 3.5% of GSDP in FY23**. A part of the additional borrowing was **linked to reforms** encouraging the states to undertake them.
  - For instance, in FY21, a part of the additional borrowing ceiling was conditional on implementing the '**ONORC' System, EODB** reforms, **ULB/utility** reforms, and power sector reforms. This led to implementation of these reforms in many states.
  - Similarly, **in FY22** a part of additional borrowing was earmarked for **incremental capital expenditure** and 16 states accessed the additional borrowing upon meeting the capex target.

- In addition, the Fifteenth Finance Commission had recommended performance based additional borrowing space of **0.5% of GSDP** to the states in the power sector.
- **Note:** States had unutilized borrowing limits during the last three years.

- **Budget 2023-24**: States will be allowed a fiscal deficit of 3.5% of GSDP of which 0.5% will be tied to power sector reforms.

4) COOPERATIVE FISCAL FEDERALISM DRIVES A WELL-TARGETED FISCAL POLICY:

A) TRANSFER FROM CENTRE TO STATES:

- Transfer of funds to states comprises the Share of States in Union Taxes (41%) devolved to the states, Finance Commission Grants, Centrally Sponsored schemes, and other transfers.
- **Total transfer to states** has risen between FY19 and FY23.

B) SUPPORTING THROUGH GST COMPENSATION PAYMENTS DURING CRISIS:

- **GST Compensation to States Act, 2017**
  - » As per section 7 of the GST (Compensation to States) Act 2017, loss of revenue to the state on account of implementation of GST should be payable during the **transition period of five years**.
  - » States' tax revenue of FY16 was considered as the base year and 14% growth every year was assumed to measure the compensation to each state.
  - » **Generation of this extra revenue** was done through **GST Compensation Cess**. It is levied on luxury and sin goods.
    - ○ SUV Vehicles (more than 4 meters) are charged 50% of tax, of which GST rate is 28% and the compensation cess is 22%.
    - ○ Aerated drinks, Pan Masala, tobacco products are also covered under this cess.
    - ○ The collected compensation cess flows to the Consolidated Fund of India and then transferred to the Public Account of India, where a GST Compensation Cess Fund has been created.
- **End of GST compensation regime but continuation of Compensation Cess till March 2026:**

- But GST council has decided to **extend the time for levy of GST compensation cess** by nearly 4 years till 31st March 2026. This has been done to repay the loans taken in the last two fiscal years to make up for the shortfall in their revenue collection.
- Note: In order to meet the resource gap of states due to short release of compensation, the Centre has **borrowed and released Rs 1.1 lakh crore in 2020-21 and Rs 1.59 lakh crore in 2021-22** as back-to-back loans to meet a shortfall in cess collection.

C) CENTRE'S SUPPORT TOWARDS STATES' CAPITAL EXPENDITURE

- **Scheme for Special Assistance to States for Capital Expenditure**: Under this scheme the centre has provided 50-year interest free loans to state governments in last four years (FY21, FY22, FY23 and FY24)
  - **Budget 2023-24 (FY24):** Budget presented in Feb 2023 announced to continue 50-year interest free loans to state governments from one more year to spur investment in infrastructure and to incentivize them for complementary policy actions, with a significantly advanced outlay of **Rs 1.3 lakh crore.** This amount includes an unconditional component and smaller components linked to specific reforms/initiatives.

Table III.8: Details of Scheme for Special Assistance to States for Capital Investment' for FY23

(₹ crore)

Component	Basis	Allocated	Approved	Released
1	Allocation proportional to the share of tax devolution for FY23	80000	68,592	31,571
II	PM Gati Shakti-related expenditure	5,000	1,458	1,458
III	PMGSY	4,000	1,616	1,616
IV	Incentive for digitisation	2,000		
V	Optical fiber cable		2,215	2,011
VI	Urban reforms	6,000		
VII	Disinvestment and monetisation	5,000		

Source: Department of Expenditure

  - Note: During FY23, the allocation was 1.05 lakh crore.
  - **Advantages of this mechanism**:
    - Centre's loan is cheaper (then if state had borrowed at its own)
    - Entire money goes in capital expenditure (If state had borrowed, it could have spent some money in revenue expenditure)

10. FRBM ACT

- **Background: Need to institutionalize a new fiscal discipline framework:**
  - In 1980s, India saw a sharp deterioration in fiscal situation, which ultimately culminated in the balance of payment crisis of 1991. Within a decade of economic liberalization, the fiscal deficit and debt situation again seemed to head towards unsustainable level around 2000. At that time, a need to **institutionalize a new fiscal discipline framework**.

- **FRBM Act** was passed in 2003 and became effective from July 5, 2004. It enjoins government to conform to a pre-set fiscal target, and in the event of failure to do so, to explain the reasons for deviation.

- » The **aims** of the act are to:
  - Introduce **transparency in India's fiscal management** systems.
  - Achieve **inter-generational equity** by ensuring equitable distribution of debt over the years.
  - Ensure **long term macro-economic stability** through fiscal stability

- » **To promote transparency** in fiscal management, s**ection 3 of the act** provides that Union government will place **three more documents on fiscal policy** along with the budget:
  1. Macroeconomic framework Statement
  2. Medium Term Fiscal Policy Statement
  3. Fiscal Policy Strategy Statement

- » Later, through an amendment a fourth statement, **Medium Term Expenditure Framework (MTEF)** needs to be presented.

- » At the end of the second quarter, the finance minister would make a statement on the trend of fiscal indicators and corrective measures taken thereof.

- » The Act requires the central government to progressively reduce outstanding debt, revenue deficit, and fiscal deficit.
  - The central government gives three year rolling targets for these indicators when it presents the Union Budget each year.

- » It says that the **Central Government shall not borrow from the RBI** except by way of advances to meet temporary excess of cash disbursements over cash receipts.
  - Further, **RBI shall not subscribe to the primary issue of the Central government securities** from the year 2006-2007.

– **Originally, the following targets were set under the act and FRBM rules.**
  - Revenue Deficit -> 0 by 2007-08; Fiscal Deficit -> 3% by 2007-08.
  - **Total liabilities of** central government should **not rise by more than 9% a year**.
  - Union government will not give guarantee to loans raised by PSUs and state governments for more than **0.5%** of the GDP aggregate.

– **2008 Financial crisis and its aftermath**
  - Deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009. In the next few years, the act was largely neglected.

– **NK Singh Committee to review FRBM Act (Report submitted in 2017): Key Recommendations:**
  - The committee said that **debt should be considered primary targe**t. It suggest Public Debt to GDP ratio as a medium term anchor for fiscal policy in India.
  - It also gave targets of (Fiscal Deficit, Revenue Deficit and debt) to be achieved by 2022-23.
  - Creation of a **Fiscal Council**: It is a proposed 3 member body which will have functions like preparing multi-year fiscal forecast; preparing fiscal sustainability analysis; providing

independent assessment of the central government's fiscal performance; and improving quality of data.
    - **Escape Clause and Buoyance Clause**

- **In 2018, the FRBM Act was amended to specify three conditions upon which the escape clause can be invoked**.
    - **First**, over-riding considerations of **national security, acts of war, and calamities of national proportion** and **collapse of agriculture severely affecting farm output and incomes**.
    - Second, far-reaching **structural reforms in the economy** with unanticipated fiscal implications.
    - Three, a **sharp decline in real output growth of at least 3 percentage points** below the average for the previous four quarters.
    - The FRBM amendments also mentioned that the **deviation from the stipulated fiscal deficit target must not exceed 0.5 percentage** points in a year.
    - **Note:** the term "escape clause" hasn't been used in the act. It was used by the FRBM review committee chaired by NK Singh.
    - In Budget 2020-21, the finance minister Nirmala Sitharaman has used the escape clause provided under the act to relax the fiscal deficit target. It was done on the grounds of reduction in corporate tax (structural reform)
        - The fiscal deficit of FY19-20 was 3.8% (BE was 3.3%, therefore the 0.5% relaxation)

- **Recommendations of the 15th Finance Commission**
    - The 15th Finance Commission for 2021-26 suggested a path for fiscal consolidation for the centre by reducing **fiscal deficit to 4%** of GDP and **outstanding debt liabilities** to 56.6% of the GDP by 2025-26**.**

- **Current Scenario:**
    - » Due to COVID-19 scenarios, the targets were against missed. Therefore, FRBM Act should have been amended to set new targets.
    - » But the revisions to the FRBM Act Medium Term Fiscal Policy Statement for 2021-22 and 2022-23 omitted the rolling targets for budget deficits.
        - o Government wants a fiscal flexibility to respond to emerging contingencies till the pandemic induced uncertainties ease.
    - » However, government has said that it would pursue **a broad path of fiscal consolidation** reaching the target **of 4.5% of Fiscal Deficit by 2025-26**.

        In Aug 2023, the Finance Ministry conveyed its inability to release **Medium Term Expenditure Framework (MTEF)**, mandated by FRBM Act, 2003. It said that since the presentation of Union Budget for FY24 in Feb, there hasn't been any significant and favourable change in global headwinds and associated risks. Therefore, the **medium-term projections are not feasible**. Further, effective management of exogenous shocks and global uncertainties **necessitated additional flexibility** for the Government in terms of expenditure management and fiscal consolidation.

- **Critical Analysis of FRBM Act**

- The act was passed to make the central government and finance minister accountable to parliament for fiscal discipline. However, **due to a lack of autonomous Fiscal Management Review Committee (as proposed originally)** the act more or less became like a Directive Principle of State Policy which is not enforceable by court. Its mandate was diluted and even today we find both revenue deficit and fiscal deficit targets regularly being missed.
- Some economists consider 3 percent target as arbitrary, and more suited to the west where the growth has tapered off.
- **Some suggestions for improvement**
    - The problem lies in the act itself. The FRBM rules can be simply amended by gazette notification. They lack transparency and adequate monitoring and compliance by the government.
    - **Some changes that would help are:**
        - **i.** Move the annual numerical targets from FRBM rules (which are framed and amended by central government at whim by gazette notification) to the FRBM act itself (so that atleast parliamentary approval is needed to make changes)
        - **ii.** Do away with the ambiguous concept of Effective Revenue Deficit which is nothing but a jugglery to rewrite revenue expenditure as capital expenditure.
        - **iii.** There is a need to institute an independent review and monitoring of implementation of the FRBM law.