

# Sustainable Fiscal Policy in India: Post-Pandemic Challenges

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## Abstract

The burgeoning fiscal deficit and debt sustainability in India have been a matter of concern for a long time. The levels of deficit and debt in India have been much higher than the levels seen in emerging economies. The Coronavirus Pandemic has brought the issue to the fore once again. The Russian invasion of Ukraine and the consequent sanctions have only worsened the situation. The attempts to control them by implementing rule-based fiscal policy, like in most other countries, have not been successful. The numerical targets on deficit and debt recommended by successive Finance Commissions and taken in FRBM Acts have been observed in their breach rather than compliance. The targets have been repeatedly revised and suspended, escape clauses have been invoked, and compliance, when shown, is done through creative accounting. To impart greater effectiveness to fiscal management, the paper argues for reforms in budget management and the creation of an independent institution to monitor the implementation of rule-based fiscal policy – the Fiscal Council as recommended by the Finance Commissions.

**Keywords:** Fiscal Policy, Fiscal Council, Fiscal Rules, Debt sustainability.

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## I. Introduction

The question of debt sustainability in India has been on the radar of policymakers for a considerable period of time. This was considered to be the main cause of the economic crisis in 1991. Despite several attempts to control deficits and debt, the problem has continued to haunt us.

Although the Constitution under Article 292 requires the Parliament to fix the volume of borrowing from time to time, formally, the rule-based fiscal policy came to be followed after the Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2004. Even this could not prevent the governments from incurring large deficits and accumulating debt.

The Coronavirus pandemic, emerging from the last week of March 2020, has rendered the situation uncontrollable. The severe lockdowns in the first phase of the pandemic in the first half of 2020-21, and the reimposition of restrictions on economic activity in the second phase, drained the sources of revenue; at the same time, the large public intervention to save lives and livelihoods and the nation-wide roll-out of vaccination required significant increases in public spending, causing both deficit and debt to climb to unsustainable levels.

It is not merely the large deficits and debt that are cause for concern – the quality of deficits is equally important. The revenue deficit, which was just about 35-40% of the fiscal deficit in the early 1990s, has shot up to 70% in 2020-21. This implies that almost 70% of the borrowed funds are now used for meeting current expenditures.

Besides, even the projects financed by capital expenditures suffer from severe cost and time overruns. The Ministry of Statistics and Programme Implementation shows that, of 1521 projects worth more than Rs. 150 crore each, 380 had cost overruns and 642 were delayed. As against the original total cost estimate of Rs. 21.2 lakh Crore, the revised cost is estimated at 25.8 lakh Crore. The attempts to implement rule-based fiscal policy by enacting the FRBM Act have not been successful, and the targets recommended by the successive Finance Commissions have been observed in their breach rather than compliance.

Recent developments – both global and domestic – have only worsened the situation. The burden of saving lives and livelihoods of the people during the pandemic has pushed the deficit and debt to unsustainable levels. The flooding liquidity globally has caused a spurt in inflation rates worldwide, requiring sharp increases in interest rates in the US, UK, and Europe, with an outward surge in foreign institutional investments. The disruptions caused by the Russian invasion of Ukraine and the sanctions associated with it have sharply increased international commodity prices, causing the inflation rate to surge beyond the tolerable limit set by the inflation-targeting policy framework. Together with the liquidation of foreign portfolio investment, resulting in increased external outflows, this has set the cycle of increasing interest rates. In addition, global slowdown and recession in some advanced western countries are likely to impact exports adversely.

Given the difficult economic environment, even as the economy recovers, one of the most pressing policy imperatives will be to bring deficits and debt down to sustainable levels. The economy is in

recovery mode, and this is the time to work out a new fiscal restructuring and implementation plan. The next section discusses the question of the need for ensuring sustainable deficits and debt and gives a historical account of the problem. The third section discusses the impact of the pandemic on fiscal deficits and debt. The fourth examines the fiscal restructuring plan and the strategy to make the plan effective. Concluding remarks are presented in the last section.

## II. Why Should We Worry About Large Fiscal Deficits?

Accumulation of debt creates a future liability (interest payments and repayment of the principal). If the borrowed funds are utilised to generate assets to yield returns in the future, the liability can be taken care of. Otherwise, revenues will have to be utilised for debt servicing (i.e. making interest payments), which crowds out productive expenditures. When borrowing is resorted to even to meet debt servicing, the debt will go on accumulating and the situation becomes unsustainable.

To analyse the debt dynamics, most studies apply the Domar (1944) condition, derived from the basic debt equation as below:

$$D_t = P_t + D_{t-1} [(1 + i_t) / (1 + G)] \dots\dots\dots(1)$$

Where:

- 'D<sub>t</sub>' denotes the outstanding debt to GDP ratio in the current year,
- 'D<sub>t-1</sub>' is the outstanding debt to GDP ratio in the previous year,
- P<sub>t</sub> is the primary deficit to GDP ratio in the current year,
- 'i' is the nominal interest rate, and
- 'G' is the nominal growth rate of the economy.

The equation shows that when the primary deficit is zero, the debt-to-GDP ratio will remain stationary if the growth rate of GDP is equivalent to the effective rate of interest payable. It will decline if the growth of GDP exceeds the interest rate, and will increase if GDP growth is lower than the interest rate. The policy implication is that, to prevent a secular increase in debt-to-GDP ratio, it is necessary to compress the primary deficit and/or accelerate the growth of GDP to a level higher than the effective interest rate.

At what level is debt sustainable? This an issue on which the policymakers have to make a judgment. The ideal volume of debt depends on the capacity of the government to service the debt. In a downturn, the economy is faced with large unemployment and excess capacity, and expansionary fiscal policy supported by an increase in borrowing can result in the acceleration of growth and a reduction in unemployment. In contrast, when the economy is in the upward phase of the economic cycle, additional public spending financed by borrowed funds can put pressure on prices. The policy

stance in such an economy should be to reduce the deficits by increasing revenues or reduction in public spending.

The above discussion on debt sustainability misses the distortionary consequences of financial repression. The lower effective rate of interest on government borrowing could be the result of financial repression. The government borrows at a lower than the market rate of interest, and sustainability is achieved by distorting the financial market. Acharya (2020), in his analysis of the quest for financial stability, has convincingly shown that fiscal dominance can be the cause of several distortions in both monetary and real sectors of the economy. Government 'dissaving' in excess of the household sector's financial savings adversely impacts monetary policy, banking regulation, external balance, and exchange rates.

Often, questions are raised as to why we should worry about large deficits and growing debt. Martin Feldstein (2004) provides an insightful analogy to answer this. He states:

“Fiscal deficits are like obesity. You can see your weight rising on the scale and notice that your clothing size is increasing, but there is no sense of urgency in dealing with the problem. That is so even though the long-term consequences of being overweight include an increased risk of a sudden heart attack as well as of various chronic conditions like diabetes. Like obesity, government deficits are the result of too much self-indulgent living as the government spends more than it collects in taxes. And, also like obesity, the more severe the problem, the harder it is to correct: the overweight man has a harder time doing the exercise that could reduce his weight and the economy with a large deficit and debt is trapped by increasing interest payments that cause the deficit and debt to rise more quickly. I emphasize the analogy to stress the point that budget deficits need attention now even when their adverse effects may not be obvious”.

There are at least four reasons why governments should worry about bloating debt.

1. Fiscal deficits add to the debt and increase the interest burden crowding out expenditures on productive sectors. In India, the interest payment constituted 25% of total revenues and 21% of revenue expenditures in 2019-20.
2. With an increasing proportion of the household sector's financial savings pre-empted to finance the fiscal deficit, a lower volume of savings will be available to the private sector, thereby increasing the cost of their borrowing and financially crowding out private investments.
3. Financing the fiscal deficits through monetization can add to inflation. In India, the sharp rise in inflation in the early 1990s was attributed to the building up of large fiscal deficits due to the expansionary policy followed in the second half of the 1980s, which led to the economic crisis (Little and Joshi, 1994). The high inflation rate in the early part of the current millennium is also attributed to the burgeoning fiscal deficit following the implementation of pay commission recommendations and the increase in oil prices. This led to the adoption of rule-

based fiscal policy with the enactment of the FRBM Act in 2004. Despite this, the problem arose once again after 2008-09 when the decision was made to implement the farm loan waiver, implement Pay Commission's recommendations, and expand the coverage of the National Rural Employment Guarantee from 200 districts to the whole country.

4. Finally, credit rating agencies do not take kindly to self-indulgent governments, and downgrading can affect the cost of borrowing from abroad to the private sector.

The trend in deficits and debt are summarised in Table 1. The aggregate revenue deficit during 2015-18 was hovering around 2.5% of GDP, and with the onset of the pandemic, it increased to 3.9% in 2019-20 and 9.3% in 2020-21, before declining to 5.4% in 2021-22. The fiscal deficit increased from 7.1% in 2019-20 to 13.3% in 2020-21 due to the pandemic, and total liabilities shot up from 74.3% in 2019-20 to 90% in 2020-21.

To put the choice of India's debt ceiling in perspective, it is important to compare the evolution of India's debt with that in other emerging markets. The International Comparison of deficit and debt by the IMF in its April 2020 Fiscal Monitor shows that, even before the pandemic in FY 2019, India's fiscal deficit (at 7.4%) of GDP was the highest among emerging market economies except for Venezuela (8%). It was much higher than the average of emerging market economies (4.8%), an average of G-20 countries (5.4%), emerging market economies in Asia (6%), Europe (0.7%), and even Latin America (4.8%).

The outstanding debt in India, at 71.9% of GDP, is also an outlier and among the emerging market economies; only Brazil (89.5%), Argentina (86.8%), and – nearer home – Pakistan (83.5%) and Sri Lanka (86.8%) had higher debt-to-GDP ratios. The Debt-GDP ratio average for EMEs is 53.2%, and only Latin American EMEs had an average debt-to-GDP ratio of 70.5% which was close to India's outstanding debt.

**Table 1: Trends in Deficits and Debt in India (Per Cent of GDP)**

Year	Revenue Deficit			Fiscal Deficit			Liabilities		
	Centre	States	Total	Centre	States	Total	Centre	States	Total
1995-96	2.47	0.72	3.15	5.00	2.56	6.44	58.34	20.70	68.46
2000-01	3.98	2.58	6.49	5.55	4.11	9.34	60.40	27.77	74.96
2010-11	3.30	-0.04	3.26	4.89	2.11	7.00	53.17	23.96	66.88
2011-12	4.51	-0.27	4.24	5.91	1.93	7.84	53.46	22.82	67.36
2012-13	3.66	-0.20	3.46	4.93	1.97	6.88	52.55	22.23	66.65
2013-14	3.18	0.09	3.27	4.48	2.21	6.67	52.16	22.00	67.06
2014-15	2.93	0.37	3.30	4.10	2.62	6.71	51.42	21.69	66.58
2015-16	2.49	0.04	2.53	3.87	3.05	6.92	51.54	23.37	68.53
2016-17	2.06	0.26	2.32	3.48	3.47	6.92	49.54	24.75	68.77
2017-18	2.60	0.11	2.71	3.46	2.40	5.83	49.47	25.12	69.57
2018-19	2.41	0.09	2.50	3.44	2.45	5.84	49.65	25.34	70.58
2019-20	3.28	0.60	3.87	4.59	2.58	7.12	51.97	26.29	74.31
2020-21*	7.34	2.00	9.37	9.21	4.72	13.34	63.02	31.14	89.66
2021-22**	4.69	0.51	5.42	6.85	3.53	9.81	60.87	29.93	85.69
2022-23	3.84			6.44			61.01		

Note:

\* denotes revised estimates for the Centre and budget estimate for the states.

\*\* denotes budget estimate.

Source: Handbook of Indian Statistics: Reserve Bank of India (Various Issues)

### III. The Pandemic, Economic Contraction and Fiscal Impact:

The lockdown brought the economy to a grinding halt, and the contraction in the economy drained the tax revenues. The fast spread of the virus has made it imperative to impose restrictions on economic activities. Besides, supply chain disruptions (partly due to restrictions on imports from China) and the unavailability of skilled migrant labour in urban agglomerations constrained full-scale recovery.

The RBI was quick in announcing a slew of measures immediately when the first wave broke out, mainly to ease supply-side constraints (in terms of ensuring liquidity, regulatory forbearance, and moratorium), and to initiate some additional measures to advance loans and extend regulatory forbearance during the second wave as well. However, the lack of fiscal space constrained the government from providing stimulus, which was just about 1.5% of GDP in the first phase and less than 1% during the second.

The most important measure by the government has been the distribution of free food grains to the vulnerable sections. The fiscal measures announced include an additional allocation to the Mahatma Gandhi National Rural Employment Guarantee and providing the Kissan Samman Nidhi,

which was already in the budget, and providing 2% of GDP additional borrowing space to the State governments in 2021-22. Of course, additional expenditures had to be incurred to augment healthcare facilities to take care of the population affected by the virus, and for the universal provision of vaccination. The free foodgrain distribution to the low-income groups has helped reduce the distress and destitution of these groups, and has been extended until December 2022.

The pandemic caused the economy to contract by 6.6 per cent during 2020-21, and the government revenues remained flat during this period. As compared to the budget estimate, the actual collection of aggregate revenue receipts in 2020-21 was lower by 11.6%. Not surprisingly, the fiscal deficit increased from 7.1% of GDP in 2019-20 to 13.3% in 2020-21, and the outstanding liabilities increased from 74.3% of GDP to 90%.

The economy was on the recovery path during 2021-22, but the second wave of the pandemic with its adverse impact on contact-intensive sectors constrained the recovery process. Nevertheless, due to the low base effect, the GDP in the economy is estimated to have grown at 8.9% in 2021-22. Consequently, the fiscal deficit-to-GDP ratio is estimated to have declined from 13.3% to 9.8% in 2020-21, and the debt-to-GDP ratio declined from 90% to 85.6% during this period.

#### **IV. Limited Fiscal Consolidation under Rule-Based Fiscal Policy.**

##### **(i) Towards a rule-based fiscal policy**

Notably, the founding fathers of the Constitution did envisage that it may be necessary for the Parliament to fix the limits on the borrowing powers of the Union government. Article 292, while assigning borrowing power to the Union government, states that the Parliament may fix the limit from time to time. In fact, since 1957, recommendations were made to fix statutory limits on the public debt of the Union government by the Estimates Committee, Public Accounts Committee, and the Reserve Bank of India; however, these were not implemented. Even after suffering the crisis in 1991, the government's attempt to control the fiscal deficit was unsuccessful and, by 2001, the fiscal deficit stood elevated at 10.3% of GDP, almost as much as the level in 1991-92.

In this situation, the government decided to appoint a Committee under the Chairmanship of the then Secretary, Economic Affairs (E. A. S. Sharma), which prepare a blueprint for a fiscal restructuring plan. The issue of restructuring public finances in both the Union and the States was also included in the Terms of Reference to the Twelfth Finance Commission India, 2004). The Commission was asked to *"...review the state of the finances of the Union and the States and suggest a plan by which the governments, collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth."*

The Commission recommended that both the Union and State governments should pass the FRBM Acts, and beginning in 2004-05, progressively reduce revenue deficits to eliminate it and reduce the fiscal deficit to 3% of GDP at Central as well as State levels by 2008-09 (Twelfth Finance Commission, 2004).

**(ii) Experience with rule-based fiscal policy.**

These recommendations were accepted, and the rule-based fiscal policy started from 2004-05, with the enactment of FRBM in 2004 at the Union level. All the States except Sikkim and West Bengal too legislated their respective FRBM Acts. There was significant progress in the implementation of the restructuring plan until 2007-08; however, the gains in fiscal consolidation achieved until 2007-08 were frittered away in 2008-09, with the union government implementing the farm loan waiver, extending national rural employment guarantee from 200 districts to the entire country, and implementing the pay increases of government employees as recommended by the Sixth Pay Commission recommendations.

In addition, with oil prices hitting an all-time high of USD 143/barrel in July 2008, combined with the government's reluctance to increase the prices of distillates in the election year, the petroleum subsidy bill rose by almost 2.5% of GDP, putting the entire fiscal restructuring plan in jeopardy. Thus, the Centre's revenue deficit increased from 1.1% in 2007-08 to 4.5% in 2008-09, and the fiscal deficit increased by over five percentage points, from 3.1% to 8.2%.

The problem was further exacerbated by the decline in the Centre's tax-GDP ratio by more than two percentage points, from 11.8% in 2007-08 to 9.6% in 2010-11. Consequently, the consolidated revenue and fiscal deficits in 2008-09 increased to 4.4% and 10.6% respectively.

The 13th Finance Commission was asked to review the state of finances of the Union and State governments and "*...suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth*" (2009, P. 12). The Commission's recommendations covered the period from 2009-10 to 2014-15. The fiscal roadmap in its recommendations required the Centre to bring down the revenue deficit from 4.8% in 2009-10 to create a surplus of 0.5% in 2014-15. The fiscal deficit was to be reduced from 6.8% to 3% during the same period, with non-debt capital receipts targeted at 1% in the terminal year; with a 3% fiscal deficit, the capital expenditure was targeted at 4.5%.

By taking into account the recommended targets and the assumption about the growth of GDP, the outstanding debt was supposed to come down from 54.2% in 2009-10 to 44.8% in 2014-15. None of these targets was achieved, with the global financial crisis, elevated prices of crude oil, and consequently large current account deficits.

As far as the States were concerned, the target of 3% GSDP worked out to 2.4% of GDP of the country, as GSDP then was estimated at factor cost and the deficit estimates did not include Union Territories. The aggregate debt-to-GDP ratio of the States was to be brought down from 27.1% in 2009-10 to 24.3% in 2014-15.

While most States had complied with the targets of phasing out revenue deficits and reducing their fiscal deficit to 3% of GSDP by 2008-09, three states (Kerala, Punjab, and West Bengal) continued to have sizeable revenue deficits in 2007-08. To avoid an abrupt cut in capital expenditures on enforcing the 3% fiscal deficit target, they were given slightly relaxed targets to phase out the revenue deficits and reach the target of 3% of GSDP in fiscal deficits by 2014-15.



The Fourteenth Finance Commission (2013) was also asked to review the state of finances of the Union and State governments, keeping in view the roadmap recommended by the previous Commission, and suggest measures for maintaining a stable and sustainable fiscal environment to promote equitable growth and amendments needed in the FRBM Act. The Commission recommended that the Union government should compress its fiscal deficit to 3% of GDP by 2016-17 and thereafter maintain it at that level. It also recommended that improvement in macroeconomic conditions and tax reforms (implementation of GST) would enhance the tax revenues and would enable the government to eliminate completely the revenue deficit by 2019-20.

For the States, the Commission recommended that the fiscal deficit target would be 3% of GSDP and revenue deficit should continue to be zero. However, the commission allowed an additional borrowing space of 25 basis points to those States with debt-to-GSDP ratio of less than 25% and another 25 basis points to those States with interest payments of less than 10% of their revenue receipts.

Despite a sharp reduction in the price of crude oil, the Central government could not reduce revenue and fiscal deficits to the targeted levels. A new FRBM Review Committee was appointed in 2016 to revise the roadmap for consolidation; it recommended that debt should be the target and fiscal deficit should be the anchor to achieve the target. The debt target was set at 60% of GDP, to be achieved by 2023-24 (2017).

The FRBM Committee recommended that the Central government should reduce its debt-to-GDP ratio to 40%, and the States to 20%, considering that the financial saving of the households was just about 7.6% of GDP. Furthermore, the government could deviate from the target when (i) there are overriding considerations such as natural calamity and war; (ii) the government has undertaken far-reaching reforms with fiscal implications and (iii) there is a sharp decline in the output of at least 3 percentage points for 4 successive quarters. The symmetric approach was to be adopted when there is a case of increases in output.

The Fifteenth Finance Commission (India, 2020) followed an approach similar to the previous Commissions. However, it had to work under severe uncertainties posed by the pandemic, and it recommended an indicative fiscal restructuring path that was much too liberal. Even by 2025-26, as a ratio of GDP, the consolidated debt will have to be reduced (from 90% in 2020-21) to 86%, the fiscal deficit from 11.6% to 6.8%, and the revenue deficit from 5.8% to 0.4% (Table 2).

As the economy recovers from the impact of the pandemic, the nominal GDP is set to increase by about 10-12% every year. Even without much fiscal correction, the targets may be reached. Without any substantial adjustment, it is not clear how debt sustainability can be achieved by 2025-26.

**Table 2: Deficit and Debt Restructuring Path by Fifteenth Finance Commission.**

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue Deficit – Union	5.9	4.9	4.5	3.9	3.3	2.8
Revenue Deficit-States	-0.1	-0.4	-0.8	-1.1	-1.6	-2.4
Revenue Deficit-Total	5.8	4.5	3.7	2.8	1.7	0.4
Fiscal Deficit – Union	7.4	6.0	5.5	5.0	4.5	4.0
Fiscal Deficit – States	4.2	3.3	3.3	2.8	2.8	2.6
Fiscal Deficit – Total	11.6	9.3	8.8	7.8	7.3	6.8
Total Liabilities – Union	62.9	61.0	61.0	60.1	58.6	56.6
Total Liabilities – States	31.1	30.7	31.3	31.1	30.9	30.5
Netting (*)	4.2	3.4	2.7	2.1	1.7	1.4
Total Liabilities – Total	89.8	88.3	89.6	89.1	87.8	85.7

(\*) The netting is done to exclude Union loans to States, the stock of NSSF and treasury bills held by State Governments.

Source: Report of the Fifteenth Finance Commission. Government of India; p. 375,

The Fifteenth Finance Commission (India, 2020) itself was unsure of the impact of the pandemic and the path of economic revival and stated, “*In view of the uncertainty that prevails at the stage that we have done our analysis, as well as the contemporary realities and challenges, we recognise that the FRBM Act needs a major restructuring and recommend that the time-table for defining and achieving debt sustainability may be examined by a High-powered Inter-governmental Group.*” The time is opportune for the government to work on the restructuring plan towards achieving debt sustainability.

The outbreak of the pandemic has thrown the entire fiscal adjustment process to the back burner. Now that the pandemic has been brought under control and the economic recovery has been in progress, the process of fiscal correction has to take precedence. The real GDP is expected to reach the 2019-20 level this year. However, the external environment continues to be disturbing. The Russian invasion of Ukraine and accompanying economic sanctions have not only created supply disruptions, but also have sharply increased international commodity prices. The policy responses, in terms of raising interest rates in many developed countries, have led to a surge in capital outflows from many emerging developing economies including India. The looming fear of recession in advanced economies has caused a slowdown in exports, and along with capital outflows, has caused both exchange rate instability and elevated current account deficit.

The foregoing discussion underlines the need for the Union and State governments to work on the fiscal restructuring path and time frame towards achieving sustainable public finances. Two important features seen from the experience of implementing rule-based fiscal policy so far are: (i) The governments have not shown urgency in implementing the targets set by them and (ii) the quality of adjustment leaves much to be desired.

There have been attempts to show progress in fiscal consolidation by resorting to off-budget borrowings and creative accounting. Despite recommendations by several agencies, including the Finance Commissions, to adopt accrual accounting, the cash budget system has continued.

The budgets set ambitious and often, unrealistic targets on compressing revenue and fiscal deficits; this results in unplanned expenditure cuts, unrealistic tax demands, off-budget borrowings, and postponements of accrued expenditures including contractors' bills, with overall adverse impacts on revenue and expenditure efficiency and credibility of the budgetary process.

Thus, rule-based fiscal policy, in terms of compressing the deficits and debt targets, has not been very successful in India. That said, this is not unique to India. In fact, by 2021, as many as 105 countries have adopted a least one fiscal rule and most countries have rules on debt limits and limits on expenditures and /or budget balance. However, the experiences with fiscal rules over the last three decades have not guaranteed fiscal sustainability. Frequent changes in the rules, deviations from the fiscal targets, and suspension of the rules and resorting to exceptional clauses have been common. This has raised questions on credibility.

With deficits and debt reaching unprecedented levels, the time is opportune to design new rules taking into account the lessons from the experience of implementing the rule-based policy, to make the rules simple, enforceable, and flexible in meeting exigencies. This depends on ensuring a system of proper budget management, transparency, comprehensiveness, and an effective monitoring system. Effective implementation of rule-based fiscal policy must be done within the overall system of scientific budget management and a realistic medium-term fiscal policy (Davoodi et. al, 2022, Caselii et. Al. 2022b)

## **V. New Framework for Comprehensiveness, Credibility and Transparency:**

### **(i) Independent Fiscal Institutions: Worldwide Experience**

Creating an independent fiscal institution to monitor the conduct of fiscal policy and reporting to the Parliament is an important innovation to impart greater effectiveness in implementing sustainable fiscal policy. This strengthens with clear commitments to fiscal adjustment path and transparent medium-term fiscal framework (Kumar and Ter-Minassian, 2007). In cases where political commitment is not strong, numerical fiscal targets could turn out to be mechanical, and may not address the quality of adjustment; it may also not be possible to stipulate counter-cyclical numerical rules. Therefore, to make the system comprehensive and transparent, and to depoliticise fiscal policy calibration, an independent fiscal institution is recommended

Fiscal councils or IFIs are given a statutory (or executive) mandate to promote stable and sustainable public finances. Hagemann (2011; p. 76) defines a fiscal council as, “...a publicly-funded entity staffed by non-elected professionals mandated to provide non-partisan oversight of fiscal

*performance and/or advice and guidance – from either a positive or normative perspective – on key aspects of fiscal policy”.*

These institutions assist in calibrating sustainable fiscal policy by making independent, objective and scientific analyses of fiscal policies for achieving the objectives of macroeconomic stability and sustainability. Their unbiased report to the Parliament helps to raise the level of debate and brings in greater transparency and accountability. They estimate the costs of various projects, programmes and policies and this helps to promote transparency and discourages populist shifts and improves accountability. Objective estimation of costs of programmes and realistic evaluation of budget forecasts help to raise public awareness about their fiscal implications and make the politicians and the public understand the extent and nature of the budget constraint.

At the end of 2021, 51 Fiscal Councils in 49 countries have been appointed to oversee the implementation of rule-based fiscal policy. While the common agenda of these institutions has been to promote sound fiscal policies as watchdogs, there is considerable diversity in the structure and functions they are assigned to perform. The important tasks they are assigned to perform include (i) independent analysis, review and monitoring and evaluation of government’s fiscal policies and programmes; (ii) developing or reviewing macroeconomic and /or budgetary projections; (iii) costing of budget and policy proposals and programmes, including the proposals in the election manifestos; and (iv) advising the policymakers on various policy options.

The concept of “independence” in the case of the fiscal council is different from the one used in the case of the Central Bank. In the case of the fiscal council, independence does not imply legal separation but simply refers to operational autonomy necessary for a non-partisan approach in performing its tasks. The Councils are required to benchmark their assessments against the policy objectives of the executive. It cannot set the objectives, unlike in the case of the independent Central Banks.

While the fiscal council has the oversight objective, its functions are different from that of the auditor (comptroller and auditor general). The fiscal council plays an ex-ante role of planning and policy formulation whereas, the focus of the audit is ex-post evaluations. The fiscal council follows a macroeconomic approach whereas the auditor follows legal or microeconomic approaches.

The OECD (2013) has documented the important principles needed for successful fiscal councils under nine broad heads and these are: (i) local ownership; (ii) independence and non-partisanship; (iii) mandate; (iv) resources; (v) relationship with legislature; (vi) access to information; (vii) transparency; (viii) communication and (ix) external evaluation. These principles are important to ensure autonomy, unbiasedness, transparency, effective, and accountability of Councils. A fiscal council can be successful only when there is a broad national commitment and ownership and consensus across the political spectrum.

Independence and non-partisanship of the council are extremely important preconditions for a successful IFI. In fact, a majority of the IFIs enjoy legal protection against partisanship (IMF, 2013). Merit and technical competence are the keys to successful IFIs. They should earn respect for

professional excellence in their reports. The budget allocation to the IFIs depends upon its remit. Regardless of whether the IFI is under the authority of the legislature or the executive, it should be made accountable to the legislature.

Hagemann (2011) makes a detailed review of the country-specific studies on the effectiveness of IFIs in improving fiscal performances. The case studies of Belgium, Chile and United Kingdom show that fiscal councils contributed to improved fiscal performances. In Belgium, he concludes that the government is legally required to adopt the macroeconomic forecasts of the Federal Planning Bureau, and this has significantly helped to reduce bias in these estimates. In Chile, the existence of two independent bodies on Trend GDP and reference copper price has greatly helped to improve budget forecasts. In the United Kingdom, the Office of Budget Responsibility played an important role in restoring fiscal sustainability when the new government came to power after 2010. The cross-country evidence shows that fiscal councils exert a strong influence on fiscal performances, particularly when they have formal guarantees of independence.

## **(ii) Fiscal Council for India.**

The 13th Finance Commission, while recommending the revised roadmap for fiscal consolidation, underlined the need for making the FRBM process more transparent and comprehensive, sensitive to exogenous shocks, and introducing mechanisms to improve monitoring and compliance. The Commission recommended the setting up of a committee to conduct an independent review of FRBM compliance, including the fiscal impact of policy decisions on the FRBM roadmap, to be presented along with the annual budget and medium-term strategy. The Commission recommended that the committee should, over time, transform itself into a full-fledged Fiscal Council (India, 2009; Para 9.65). The FRBM Review Committee too made a similar recommendation.

However, the Council appointed by the Finance Ministry would not have legislative scrutiny. Therefore, the Fourteenth Finance Commission recommended that the FRBM Act should be amended to enable the Parliament to appoint a Fiscal Council to monitor the fiscal management in the country. The Fiscal Council is supposed to bring out ex-ante fiscal implications of the budget proposals and their consistency with the Medium Term Fiscal Plan (MTFP) and rules (India, 2014, Para 14.101).

The Fifteenth Finance Commission went into the issue of strengthening the institutional process. It surmised that the previous Commissions have underlined the need to (i) strengthen the budgetary process; (ii) move towards accrual accounting and (iii) standardise and consolidate the information on key fiscal variables across all levels of government to make it comprehensive.

The indicative functions suggested for the Fiscal Council are: (i) providing multi-year fiscal forecasts; (ii) evaluating fiscal performance in relation to the targets; (iii) appropriateness and consistency of fiscal targets in the states; (iv) Independent assessment of fiscal sustainability; (v) making the assessment of fiscal policy statements under fiscal responsibility legislations; (vi) advising on the applicability of conditions applicability of escape clauses under fiscal responsibility legislations;

(vii) costing of policies and programmes with significant fiscal implications; (viii) providing analytical support to the Finance Commissions; (ix) dissemination of their report and methodology employed to arrive at conclusions to the public. It made detailed recommendations to improve the budgeting and public finance management system and an independent fiscal council. Unfortunately, this recommendation has not found favour with the Government.

## **VI. Concluding Remarks:**

The problem of high deficits and debt continues to threaten fiscal stability and sustainability in India. The deficit and debt targets set by the Finance Commissions have seen slippages, suspensions, dilutions, modifications, and creative accounting to show better than actual results. The budget has ceased to be comprehensive, transparent, and accountable. Various types of obfuscations are done, year after year, to show lower deficits.

With the outbreak of the Coronavirus Pandemic, the entire process of debt consolidation and deficit correction has taken a beating. Now that normalcy has returned, the government will have to work out a new fiscal consolidation roadmap and implement it in a credible manner. In order to increase the credibility of the budgets, the government should make the deficit and debt numbers comprehensive and transparent. The rule-based fiscal policy should take into consideration the features of simplicity, enforceability, flexibility and comprehensiveness.

As recommended by the 15<sup>th</sup> Finance Commission, the budgetary reform should be driven by the objective of evolving a new fiscal architecture for the 21<sup>st</sup> Century, involving three important pillars namely: (i) fiscal rules across all levels of government towards achieving sustainability; (ii) a scientific public finance management system to provide comprehensive, consistent, reliable, and timely reporting of fiscal indicators that are a part of the fiscal rules; and (iii) an independent fiscal institution to assess and advise on the working of the first two pillars mentioned above.

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