CHAPTER

18

PUBLIC FINANCE IN INDIA

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*How the modern governments manage all money they get–the public money–is the subject matter of public finance. The policy stance taken in this regard is declared annually by the governments via their 'fiscal policy' popularly known as the Budget.**

** See Amaresh Bagchi (Ed.), **Readings in Public Finance**, Oxford University Press, N. Delhi, 2005. Also see Paul A. Samuelson and William D. Nordhaus, **Economics**, The McGraw-Hill Company, New York, 2005, pp. 412, 711. Also see Joseph E. Stiglitz and Carl E. Walsh, **Economics**, W. W. Norton, New Yok, 4th Edition, 2006, p. 695–697.*

INTRODUCTION

Public finance is a much wider title which includes all those matters which are connected with public money, the money a government gets, spends, borrows, lends, raises or prints. Public finance, i.e., finances of the government, now named as *public economics*, does not only discuss the issue that how much of the country's resources the government should acquire for its own use but also discusses the 'efficiency' with which the money should be used. Public finance gets reference in the ancient treatise ***Arthashastra***[1] of Kautilya which covers 'treasury, sources of revenue, accounts and audit' in a very detailed way. However, the subject has gathered much significance in the post Second World War period once the governments' role in the economy started expanding[2] due to various reasons namely, the rise of public sector, delivery of public goods, law and order, defence, etc. By the Second World War, the importance of the government's role in the economy was uagenthy felt and it was believed that all needs of the people cannot be met if the economy is left to the market (i.e., private sector) in its entireity. For example, national defence, law enforcement and other major areas which must be cared for by the national government besides the supplies of ***affordable or free*** healthcare, education, social security measures, etc., could only be taken care of by the governments (***as they are not profit driven)***. This is why there was an agreement among the experts and the policymakers to expand the government's role in the economy. This led to the ultimate rise of the public sector around the world.[3] Here we will be looking into the major concepts related to the area of public finance with special reference to India.

BUDGET

An annual financial statement of income and expenditure is generally used for a government, but it could be of a firm, company, corporation etc.[4] The 'word' has its origin in the British parliamentary exercise of preparing such statement way back in the mid-18th century from the French word *'Bugeut'* meaning a leather bag out of which the financial statement was brought out and presented in the parliament. Today, this word is used to mean the annual statement in all economies around the world.

The Constitution of India has a provision (Art. 112) for such a document called Annual Financial Statement to be presented in the Parliament before the commencement of every new fiscal year—popular as the Union Budget. Same provision is there for the states too.

DATA IN THE BUDGET

The Union Budget has ***three sets***[5] of data for every concerned sector or sub-sector of the economy:

(i) Actual data of the preceding year (here preceding year means one year before the year in which the Budget is being presented. Suppose the Budget presented

1. L. N. Rangarajan (ed.), ***The Arthashastra,*** Penguin Books, N. Delhi, 1992.
2. The size of government expenditure for the developed economies stood at almost 10 per cent of their GDPs at the begining of the 20th century—which could rise to 18 per cent only at the outbreak of the Second World War—went for a steep rise by 1980 to 40 per cent. The government expenditure was barely 9 percent of the GDP in India at the time of Independence, nearly doubled in 1970s and reach 75 per cent in the 1980s—when questions were raised about their sustainability as revenue receipts failed to grow adequately resulting in rising budgetary deficits (see Amaresh Bagchi (ed.), ***Readings in Public Finance,*** Oxford University Press, N. Delhi, 2005, pp. 1–4).
3. It should be noted here that the world which had the form of the state economy (i.e., the Socialist countries at this time, majority of the economic activities were under government control. As the communist form of the state economy emerged by the late 1940s (i.e., Peoples Republic of China, 1949), it had 100 per cent state control over the economic activities.
4. *Collins Dictionary of Economics,* op. cit., & ***Oxford Dictionary of Business,*** op. cit.
5. Based on the Budgetary documents of the Ministry of Finance, Government of India, N. Delhi.

is for the year 2008–09, the Budget will give the final/actual data for the year 2006–07 because the Budget is presented in February end of financial year 2007–08. After the data either we write '**A**', means actual data/final data or write nothing (India writes nothing).

(ii) Provisional data of the current year (since the Budget for 2008–09 is presented at the end of the fiscal 2007–08, it provides Provisional Estimates for this year (shown as '**PE**' in brackets with the data).

(iii) Budgetary estimates for the following year (here following year means one year after the year in which the Budget is being presented or the year for which the Budget is being presented, i.e., 2008–09. This is shown with the symbol '**BE**' in brackets with the concerned data.).

One comes across certain other kinds of data, too in day-to-day government economic literature. There are such three other kinds of data—

(i) Revised Estimate (RE)

Revised Estimate is basically a current estimation of either the budgetary estimates (BE) or the provisional estimates (PE). It shows the contemporary situation. It is an interim data.

(ii) Quick Estimate (QE)

Quick Estimate is a kind of revised estimate which shows the most latest situation and is useful in the process of going for future projections for some sector or sub-sector. It is an interim data.

(iii) Advance Estimate (AE)

Advance Estimate is a kind of quick estimate but done ahead (is advance) of the final stage when data should have been collected. It is an interim data.

DEVELOPMENTAL AND NONDEVELOPMENTAL EXPENDITURE

Total expenditure incurred by the government is classified into two segments—developmental and non-developmental. All expenditures of productive nature are developmental such as on the heads of new factories, dams, bridges, roads, railways, etc.—all *investments*.

The expenditures which are of consumptive kind and do not involve any production are non-developmental, i.e., paying salaries, pensions, interest payments, subsidies, defence expenses, etc.

This classification is not used in the Indian public finance management now (see *Plan* and *Non-Plan Expenditure,* in the next entry).[6]

PLAN AND NON-PLAN EXPENDITURE

Every expenditure incurred on the public exchequer is classified into two categories—the plan and the non-plan. All those expenditures which are done in India in the name of *planning* is the *plan expenditure* and rest of all are *non-plan expenditures*. Basically, all asset creating, and productive expenditures are plan and all consumptive, non-productive, non-asset building are non-plan expenditures and are developmental and non-developmental expenditures, respectively.

Since the financial year 1987–88, there was a terminology change in Indian public finance literature when developmental and non-developmental expenditures were replaced by the new terms plan and non-plan expenditures, respectively. (It was suggested by the Sukhomoy Chakravarti Committee.)[7]

6. ***Union Budget 1987–88,*** MoF, GoI, N. Delhi.
7. ***Review of the Working of the Monetary System,*** headed by Sukhomoy Chaktravarthy, RBI, GoI, N. Delhi, 1985.

Meanwhile, a high-power panel headed by Dr. C. Rangarajan (Chairman, Prime Minister's Economic Advisory Council), in *September 2011* suggested for redefining ***Plan*** and ***Non Plan*** expenditures as ***Capital*** and ***Revenue*** expenditures, as the former set of terms 'blur the classification' —this will facilitate linking expenditure to 'outcomes' and better public expenditure, the panels suggested. *Major* suggestions of the Panel are:

(i) *Plan* and *Non-Plan* distinction in the Budget is neither able to provide a satisfactory classification of 'developmental' and 'non-developmental' dimensions of government expenditure nor an appropriate budgetary framework. It has therefore become 'dysfunctional',

(ii) Suggests for *redefining the roles* of the Planning Commission (PC) and the Finance Ministry (FM). According to which the PC should be responsible for formulation of the five-year plan and the task of firming up the annual budgets should be entrusted to the FM.

(iii) The PC should dispense with the exercise of approving annual plans of states and it could hold a strategy or review meeting with representatives of the states.

(iv) Public expenditures should be split into *capital* and *revenue* expenditures.

(v) Public expenditure should have 'management approach' based on measurable 'outcomes', indicating that the reponsibility should be assigned to the FM.

Analysis of the Situation: While the need for looking beyond the budget is well accepted, there are many factors raising doubts on the 'efficacy' and 'relevance' of the five-year plans as the instrument. The division of expenditure between *Plan* and *non-Plan* is artificial and creates problems, such as :

(i) Plan expenditure tends to get priority especially when austerity and expenditure reduction has to be done periodically for fiscal consolidation. Non-Plan expenditure gets the ***cut*** even if it is vitally needed for economic development, an example is budget provision for maintenance of assets such as hospitals, schools and irrigation dams already created under Plan, but whose maintenance is treated as non-Plan.

(ii) Review and implementation of schemes is another area of direct responsibility for the Ministry of Finance and the Ministry of Statistics and Programme Implementation. The Finance Minister himself had, in the budget speech for 2005–06, promised to ensure that programmes and schemes were not allowed to continue indefinitely from one Plan period to another without an independent and in-depth evaluation. The Planning Commission, serving as the *focal point for Plan allocations*, dilutes the role of the Finance Ministry in this case.

(iii) 'Output' and 'Outcome Budgeting' was introduced by the Central Government from the Budget for 2005–06. Non-Plan expenditure remains out of its purview. This means, for example, the outcome of expenditure on running schools and hospitals will not be evaluated. This again is another fallout of the artificial division into Plan and non-Plan.

The ***dichotomy*** results in *dual* and *confusing* responsibility of the Ministry of Finance and the Planning Commission and adversely affects the whole budget process, formulation and implementation. The Ministry of Finance is responsible for fiscal consolidation, containing the fiscal deficit and abiding to the FRBM Act. But in formulating the Budget its role in Plan expenditure budgeting is *diluted* by the discussions which the ministries have with the Planning Commission. The finalisation of Plan allocations for the state budgets also suffers from this weakness. Ultimately, the Central Government has to fix the market borrowing by state governments taking the overall sustainable borrowing limits, including the requirements of the Central Government. The Planning Commission tends to have a more optimistic estimate of resources likely to be available for financing the Plan expenditure as 'fiscal deficit' management and control is not its direct responsibility.

REVENUE

Every form of money generation in the nature of income, earnings are revenue for a firm or a government which do not increase financial liabilities of the government, i.e., the tax incomes, non-tax incomes along with foreign grants.

NON-REVENUE

Every form of money generation which is not income or earnings for a firm or a government (i.e., money raised via borrowings) is considered a non-revenue source if they increase financial liablities.

RECEIPTS

Every receiving or accrual of money to a government by revenue and non-revenue sources is a receipt. Their sum is called *total receipts.* It includes all incomes as well as non-income accruals of a government.

REVENUE RECEIPTS

Revenue receipts of a government are of two kinds—Tax Revenue Receipts and Non-tax Revenue Receipts—consisting of the following income receipts in India:

TAX REVENUE RECEIPTS

This includes all money earned by the government via the different taxes the government collects, i.e., all direct and indirect tax collections.

NON-TAX REVENUE RECEIPTS

This includes all money earned by the government from sources other then taxes. In India they are:

(i) *Profits* and *dividends* which the government gets from its public sector undertakings (PSUs).

(ii) *Interests* recieved by the government out of all loans forwarded by it, be it inside the country (i.e., internal lending) or outside the country (i.e., external lending). It means this income might be in both domestic and foreign currencies.

(iii) *Fiscal services* also generate incomes for the government, i.e., currency printing, stamp printing, coinage and medals minting, etc.

(iv) *General Services* also earn money for the government as the power distribution, irrigation, banking, insurance, community services, etc.

(v) *Fees*, *Penalties* and *Fines* received by the government.

(vi) *Grants* which the governments receives—it is always external in the case of the Central Government and internal in the case of state governments.

REVENUE EXPENDITURE

All expenditures incurred by the government are either of *revenue kind* or *current kind* or *compulsive kind.* The basic identity of such expenditures is that they are of consumptive kind and do not involve creation of productive assets. They are either used in running of a productive process or running a government. A broad category of things that fall under such expenditures in India are:

(i) *Interest* payment by the government on the internal and external loans;

(ii) *Salaries, Pension* and *Provident Fund* paid by the government to government employees;

(iii) *Subsidies* forwarded to all sectors by the government;

(iv) *Defence* expenditures by the government;

(v) *Postal Deficits* of the government;

(vi) *Law and order* expenditures (i.e., police & paramilitary);

(vii) Expenditures *on social services* (includes all social sector expenditures as education, health care, social security, poverty alleviation, etc.) and *general services* (tax collection, etc.);

(viii) *Grants* given by the government to Indian states and foreign countries.

REVENUE DEFICIT

If the balance of total revenue receipts and total revenue expenditures turns out to be negative it is known as revenue deficit, a new fiscal terminology used since the fiscal 1997–98 in India.[8]

This shows that the government's *Revenue Budget* (see the next topic) is running in losses and the government is earning less revenue and spending more revenues—incurring a deficit. Revenue expenditures are of immediate nature (this has to be done) and since they are consumptive/non-productive they are considered as a kind of expenditure which sums up to a heinous crime in the area of fiscal policy. Governments fulfil the gap/deficit with the money which could have been spent/intvested in productive areas.

A government might have its revenue expenditures less than its revenue receipts, i.e., having (*revenue surplus*) budget. Such fiscal policy is considered good where the government has been able to manage some money out of its revenue budget which could be spent for the creation of productive assets. Yes, another thing that should be kept in mind, as how the government has managed this surplus and whether the policies which made this happen are judicious enough or not. In the Second Plan, India emerged as a revenue-suplus state, but experts did not appreciate it as it had many bad impacts on the economy—higher tax rates culminated in tax evasion, corruption, creation of black money, etc.

Revenue deficit may be shown in the quantitative form (as how much the gross/total deficit is in currency terms) or in percentage terms of the GDP for that particular year (shown as percentage of GDP). Usually, it is shown as a percentage of the GDP for domestic as well as international analyses.

EFFECTIVE REVENUE DEFICIT

Effective revenue deficit (ERD) is a new term introduced in the *Union Budget 2011–12*. Conventionally, 'revenue deficit' is the difference between revenue receipts and revenue expenditures. Here, revenue expenditures includes all the grants which the Union Government gives to the state governments and the UTs—some of which ***create assets*** (though these assets are not owned by the GoI but the concerned state governments and the UTs). According to the Finance Ministry (Union Budget 2011–12), such revenue expenditures contribute to the growth in the economy and therefore, *should not be treated as unproductive* in nature like other items in the revenue expenditures. And on this logic, a new methodology was introduced to capture the 'effective revenue deficit', which is the Revenue Deficit 'excluding' those revenue expenditures of

8. Raja J. Chelliah, 'The Meaning and Significance of the Fiscal Deficit' in Amaresh Baghi (ed.), ***Readings in Public Finance,*** op. cit., pp. 387–88. Also see ***Union Budget 1997–98,*** MoF, GoI, N. Delhi.

the GoI which were done in the form of **GoCA** (grants for creation of capital assets).

The GoCA includes the GoI grants forwarded to the states & UTs for the implementation of the centrally sponsored programmes such as Pradhan Mantri Gram Sadak Yojana, Accelerated Irrigation Benefit Programme, Jawaharlal Nehru National Urban Renewal Mission, etc., these expenses though they are shown by the GoI in its Revenue Expenditures they are involved with *asset creation* and cannot be considered completely 'unproductive' like other items put in the basket of the Revenue Expenditures—the reason why a new 'terminology' has been created.

As per the ***Union Budget 2013–14***, by the fiscal 2016-17, the Revenue Deficit to be 1.5 per cent and the 'effective revenue deficit' to **zero** per cent [it means that by that year the total GoCA forwarded by the GoI will stand at 1.5 per cent of the GDP of the year. The *Union Budgets* of 2014–15 (Full) and 2015–16 do not mention anything about this concept.

REVENUE BUDGET

The part of the Budget which deals with the income and expenditure of revenue by the government.

This presents the annual financial statement of the total revenue receipts and the total revenue expenditure—if the balance emerges to be positive it is a revenue surplus budget, and if it comes out to be negative, it is a revenue deficit budget.

CAPITAL BUDGET

The part of the Budget which deals with the receipts and expenditures of the capital by the government. This shows the means by which the capital is managed and the areas where capital is spent.

CAPITAL RECEIPTS

All non-revenue reciepts of a government are known as capital receipts. Such receipts are for investment purposes and supposed to be spent on plan-development by a government. But the receipts might need their diversion to meet other needs to take care of the rising revenue expenditure of a government as the case had been with India. The capital receipts in India include the following capital kind of accruals to the government:

(i) Loan Recovery

This is one source of the capital receipts. The money the government had lent out in the past in India (states, UTs, PSUs, etc.) and abroad their capital comes back to the government when the borrowers repay them as capital receipts. The interests which come to the government on such loans are part of the revenue receipts.

(ii) Borrowings by the Government

This includes all long-term loans raised by the government inside the country (i.e., internal borrowings) and outside the country (i.e., external borrowings). Internal borrowings might include the borrowings from the RBI, Indian banks, financial institutions, etc. Similarly, external borrowings might include the loans from the World Bank, the IMF, foreign banks, foreign governments, foreign financial institutions, etc.

(iii) Other Receipts by the Governments

This includes many long-term capital accruals to the government through the Provident Fund (PF), Postal Deposits, various small saving schemes (SSSs) and the government bonds sold to the public (as Indira Vikas Patra, Kisan Vikas Patra, Market Stabilisation Bond, etc.). Such receipts are nothing but a kind of loan on which the government needs to pay interests on their maturities. But they play a role in capital raising process by the government.

CAPITAL EXPENDITURE

All the areas which get capital from the government are part of the capital expenditure. It includes so many heads in India —

(i) Loan Disbursals by the Government

The loans forwarded by the government might be internal (i.e., to the states, UTs, PSUs, FIs, etc.) or external (i.e., to foreign countries, foreign banks, purchase of foreign bonds, loans to IMF and WB, etc.).

(ii) Loan Repayments by the Government of the Borrowings Made in the Past

Again loan payments might be internal as well as external. This consists of only the *capital* part of the loan repayment as the element of interest on loans are shown as a part of the *revenue expenditure*.

(iii) Plan Expenditure of the Government

This consists of all the expenditures incurred by the government to finance the planned development of India as well as the central government financial supports to the states for their plan requirements.

(iv) Capital Expenditures on Defence by the Government

This consists of all kinds of *capital* expenses to maintain the defence forces, the equipment purchased for them as well as the modernisation expenditures. It should be kept in mind that *defence* is a non-plan expenditure which has capital as well as revenue expenditures element in its maintenance. The revenue part of expenditure in the defence is counted in the revenue expenditures by the government.

(v) General Services

These also need huge capital expenditure by the government—the railways, postal department, water supply, education, rural extension, etc.

(vi) Other Liabilities of the Government

Basically, this includes all the repayment liabilities of the government on the items of the Other Receipts. The level of liabilities depends on the fact as to how much such receipts were made by the governments in the past. How much payment liabilities in which year also depends on the fact as to which years in the past the governments had other receipts and for what duration of maturity periods. As for example, the *PF liabilities* were not an item of such liabilities for almost first three decades after the independence. But once the government employees started retiring, it went on increasing. Future India (specially 1960s and 1970s) saw expansion of the PSUs and excessive employment generation in them (devoid of the logic of labour requirement). We see the PF liabilities expanding extensively throughout the 1990s—the governments had been under pressure to manage this segment either by cutting interest on PF or at present trying to make it a matter of market economy. Same thing happened with the element of *pension* and we have been able to devise a market mechanism for it once pension reforms took place and the arrival of a pension regulatory authority for the area.

CAPITAL DEFICIT

There is no such term in public finance or in economics as such. But in practice one usually hears the use of the term capital crunch, scarcity of capital in day-to-day economic news items. Basically, the government in the news is facing the problem of managing as much funds, money, capital as is required by it for public expenditure. Such expenditure might be of revenue kind or capital kind. Such difficulties have always been with the developing economies due to their high level requirement of capital expenditures. Had there been a term to show this situation, it would naturally have been *Capital Deficit*.

FISCAL DEFICIT

When balance of the government's total receipts (i.e., revenue + capital reeipts) and total expenditures (i.e., revenue + capital expenditures) turns out to be negative, it shows the situation of fiscal deficit, a concept being used since the fiscal 1997–98 in India.[9]

The situation of fiscal deficit indicates that the government is spending beyond its means. To be more simple, we may say that the government is spending more than its income (though in practice all receipts of the government are not income. Basically, receipts are all forms of money accruing to the government, be it income or borrowings).

Fiscal deficit may be shown in the quantitative form (i.e., the total currency value of the deficit) or in the percentage form of the GDP for that particular year (percentage of GDP). In general, the percentage form is used for domestic or international (i.e., comparative economics) studies and analyses.

India has been a country of not only regular but higher fiscal deficits. Moreover, the composition of its fiscal deficit has been more prone to criticism (we will see this in the forthcoming sub-title ahead).

Primary Deficit

The fiscal deficit excluding the interest liabilities for a year is the primary deficit, a term India started using since the fiscal 1997–98.[10] It shows the fiscal deficit for the year in which the economy had not to fulfil any interest payments on the different loans and liabilities which it is obliged to—shown both in quantitative and percentage of GDP forms.

This is considered a very handy tool in the process of bringing in more transparency in the government's expenditure pattern. Any two years for example might be compared and so many things can be found out clearly such as, which year the government depended more on loans, the reasons behind higher or lower fiscal deficits, whether the fiscal deficits have gone down due to falling interest liabilities or some other factors, etc.

Monetised Deficit

The part of the fiscal deficit which was provided by the RBI to the government in a particular year is Monetised Deficit, this is a new term adopted since 1997–98 in India.[11] This is shown in both the forms—in quantitative as well as a percentage of the GDP for that particular financial year.

It is an innovation in the fiscal management which brings in more transparency in the government's expenditure behaviour and also in its capabilities concerning its dependence on market borrowings by the RBI. Basically, every year both central and state governments in India had been depending heavily on market borrowings (internal) for its long-term capital requirements. Market borrowings of the government are done and managed by the RBI. Besides, the RBI is also the primary customer for government securities—yet another means of the government to raise long-term capital. This has been a major area of fiscal concern in India. After the process of **fiscal consolidation** was started by the government by the early 1990s, we see a visible improvement in this area. This term is itself arrived as the part of fiscal reforms in India (we will visit the issue of fiscal consolidation in India in the coming pages).

Deficit and Surplus Budget

When the budgetary proposals of a government for a particular year proposes higher expenditures than the receipts, it is known as a *deficit budget.*

9. Raja J. Chelliah, op. cit., pp. 381 & 387. Also see ***Union Budget 1997–98,*** MoF, GoI, N. Delhi.
10. ***Union Budget 1997–98,*** op.cit.
11. Raja J. Chelliah, op. cit., P. 389. Also see ***Union Budget 1997–98,*** op.cit.

Opposite to this, if the budget proposes lesser expenditures than the receipts, then it is a *surplus budget.*[12]

In practice, governments the world over usually do not present a surplus budget as it symbolises government's lower concerns towards development. But at times as a political weapon a government might come out with such a budget (for example the Uttranchal Budget for 2006–07 was a surplus budget). How can a government propose for a surplus budget in a developing state when even developed countries still need development and are going for deficit budgets? The Union Budget in India had never been presented as a surplus budget.

DEFICIT FINANCING

The act/process of financing/supporting a deficit budget by a government is deficit financing. In this process, the government knows well in advance that its total expenditures are going to turn out to be more than its total receipts and enacts/follows such financial policies so that it can sustain the burden of the deficits proposed by it.

First used in the area of public finance in the early 1930s in USA,[13] today the term is being used by the corporate sector, too and such a financial management of a firm might be followed by it as part of its business strategy. Again, a sick firm might need to follow deficit financing route for many years to come as required by the firm to make it come out of the red (i.e., doing away with the losses).

Need of Deficit Financing: It was in the late 1920s that the idea and need of deficit financing was felt. It is when government needs to spend more money than it was expected to earn or generate in a particular period, to go for a desired level of growth and development. Had there been some means to go for more expenditure with less income and receipts, socio-political goals could have been realised as per the aspirations of the public policy And once the growth had taken place the extra money spent above the income would have been reimbursed or repaid. This was a good public/government wish which was fulfilled by the evolution of the idea of deficit financing.

It was by the early 1930s that the US first tried its hand at deficit financing soon to be followed by the whole Euro-American governments.[14] Through this route the developed world was able to come out of the menace of the Great Depression (1929).[15] The idea became popular around the world by the 1960s. India tried its hand at deficit financing in 1969 and since the 1970s it became a routine phenomenon, till it became wild and illogical, demanding immediate redressal. The fiscal deficits in India did not only peak to

12. In the US economy if tax revenue falls short of government expenditures, the government has a *fiscal deficit,* and it means that the government needs to borrow in the capital market to cover the difference. Opposite to it, if the government runs a *fiscal surplus* (i.e. its tax revenues exceed its expenditure) then the government, like the household sector, will be a net saver and will represent a source of saving for the economy (see Stiglitz and Walsh, ***Economics,*** op.cit., p. 549)

13. J. K. Galbraith, ***A History of Economics,*** Penguin Books, London, 1987, p. 226. (*The whole Chapter XVII on J.M. Keynes pp. 221–36 is interesting to refer on the topic.*)

14. For a detailed discussion on the topic one may refer to Joseph. E. Stiglitz, ***Economics of the Public Sector,*** W.W. Norton, 3rd Ed., New York, 2000.

15. It should be noted here that although the governments had run deficits (i.e., budget deficit) even before the Keynesian idea of the deficit, the pre-Keynesian thinking was that in peacetime the budget should generally be *balanced* (i.e., neither deficit nor surplus), or even in surplus so that the government debt created by wartime deficits could be paid off. For further reference on the topic and its constraints, Stanley Fischer and William Easterly, ***Economics of the Government Budget Constraints,*** World Bank Research Observer, Vol. 5, No. 2, July 1990, pp. 127–42 see (also reproduced in Amaresh Bagchi (ed.), ***Readings in Public Finance,*** op. cit., pp. 301–19).

unsustainable levels but its composition was also not justified and not based on sound fundamentals of economics. Finally, India headed for a slow but confident process of fiscal reforms that is also known as the process of fiscal consolidation (to be discussed in the coming pages).

Means of Deficit Financing: Once deficit financing became an established part of public finance around the world, the means of going for it were also evolved by that time. These means, basically are the ways in which the government may utilise the amount of money created as the deficit to sustain its budget for developmental or political needs. These means are given below in order of their suggested and tried preferences.

(i) *External Aids*[16] are the best money as a means to fulfil a government's deficit requirements even if it is coming with soft interest. If they are coming without interest nothing could be better.

When India went to borrow from the IMF in the wake of the financial crisis of 1990–91, the body advised India to keep its fiscal deficit to the tune of 4.5 per cent of its GDP and noted it to be sustainable for the economy. What was the rationale behind this data? Basically, in those times with the foreign aids (soft loans either from the *WB* or from the *Aid India Forum*) India was able to manage its budget to the tune of 4.5 per cent of its GDP. In 2002, when India's fiscal deficit was around 6 per cent (5.7 per cent to be precise) the IMF validated it to be sustainable, the reasons were two—first, India was able to show a check on fiscal deficit and secondly, at the same time the forex reserves of the country were suitably higher to neutralise the negative impacts of the higher fiscal deficit than the suggested levels (4.5 per cent).

External Grants are even better element in this case (which comes free—neither interest nor any repayments) but it either did not come to India (since 1975, the year of the first Pokhran testings) or India did not accept it (as happened post-Tsunami, arguing grants/aids coming with a tag/conditions). That is why here this segment has not been discussed as a means to manage deficit.

(ii) *External Borrowings*[17] are the next best way to manage fiscal deficit with the condition that the external loans are comparatively cheaper and long-term.

Though external loans are considered an erosion in the nations sovereign decision making process, this has its own benefit and is considered better than the internal borrowings due to two reasons:

(a) External borrowing bring in foreign currency/hard currency which gives extra edge to the government spending as by this the government may fulfil its developmental requirements inside the country as well as from outside the country.

(b) It is prefered over the internal borrowings due to 'crowding out effect'. If the government itself goes on borrowing from the banks of the country, from where will others borrow for investment purposes?

(iii) *Internal Borrowings*[18] comes as the third preferred route of fiscal deficit management. But going for it in a huge

16. Ibid. (*Amaresh Bagchi* ed. op. cit., pp. 305–10).
17. *Ibid.*
18. *Ibid.*

way hampers the investment prospects of the public and the corporate sector. It has the same impact on the expenditure pattern in the economy. Ultimately, economy heads for a double negative impact—lower investment (leading to lower production, lower GDPs and lower per capita income, etc.) and lower demands (by the general public as well as by the corporate world) in the economy—the economy moves either for *stagnation* or for a *slowdown* (one can see them happening in India repeatedly throughout the 1960s, 1970s, 1980s). The situation improved after the mid-1990s.

(iv) *Printing Currency* is the last resort for the government in managing its deficit.[19] But it has the biggest handicap that with it the government cannot go for the expenditures which are to be made in the foreign currency. Even if the government is satisfied on this front, printing fresh currencies does have other damaging effects on the economy:

(a) It increases inflation proportionally. (India regularly went for it since the early 1970s and usually had to bear double digit inflations.)

(b) It brings in regular pressure and obligation on the government for upward revision in wages and salaries of government employees—ultimately increasing the government expenditures necessitating further printing of currency and further inflation—a vicious cycle into which economies entangle themselves.

Now, it remains a matter of choice and availability of the above-given means, and which means a government adopts and in what proportion, for fulfilling its deficit requirement.

Composition of Fiscal Deficit

The Keynesian idea of deficit financing, though he advocated it, had a catch in it also which was usually missed by third world economies or intentionally overlooked by them. The catch is related to the question as to why an economy wants to go for fiscal deficit. And thus it becomes essential to go for an analysis of the composition[20] of the fiscal deficit of a government.

Out of the two broad expenditure obligations of a government—revenue expenditure and capital expenditure—the following combinations of expenditure composition are suggested:

(i) A fiscal deficit with a surplus revenue budget or a zero revenue expenditure is the best composition of fiscal deficit and the most suitable time for deficit financing.

(ii) The deficit requirements for lower revenue expenditures and higher capital expenditures are the next best situation for deficit financing, provided revenue deficit is eliminated soon.

(iii) The last could be the situation when major part of deficit financing is to fulfil revenue expenditures and a minor part to go for capital expenditures. The total money of the deficit might go to fulfil revenue expenditure, which could be the worst form of it.

Basically, there should be a judicious mix of plan and non-plan expenditure as well as revenue

19. L.N. Rangarajan, op. cit., pp. 259–62.
20. J. Cullis and P. Jones, ***Public Finance and Public Choice,*** Oxford University Press, New York, 2nd Ed., 1998.

and capital expenditures in India. Lesser non-plan expenditure or higher plan-expenditure are better reasons behind deficit financing in India (though India has a typical feature of capital expenditure which makes this combination of deficit financing not a suggested form—discussed ahead).

Third world economies (including India) though went for higher and higher fiscal deficits and deficit financing, they either did not address or failed to address the composition of deficit favourable towards capital and non-revenue expenditures.

FISCAL POLICY

The real meaning, significance and impact of fiscal policy emerged in the wake of the Great Depression and the Second World War. Fiscal policy has been **defined** as 'the policy of the government with regard to the level of government purchases, the level of transfers, and the tax structure'—probably the best and the most acclaimed definition among experts.[21] Later, the impact of fiscal policy on macro-economy was beautifully analysed.[22] As the policy has a deep impact on the overall performance of the economy, fiscal policy is also **defined** as the policy which handles public expenditure and tax to direct and stimulate the level of economic activity (numerically denoted by the Gross Domestic Product).[23] It was J. M. Keynes, the ***first*** economist who developed a theory linking fiscal policy and economic performance.[24]

Fiscal policy is also **defined** as 'changes in government expenditures and taxes that are designed to achieve macroeconomic policy goals'[25] (such as growth, employment, investment, etc.). Therefore, we say that 'fiscal policy denotes the use of taxes and government expenditures'.[26]

How the taxes and the government expenditures influence the overall economy, has been explained in a brief discussion here.[27] Let us first discuss the ***taxes*** and their impact on the economy:

(i) Taxes have a direct bearing on people's income affecting their levels of disposable incomes, purchase of goods and services, consumption and ultimately their standard of living;

(ii) Taxes directly affect the savings of individuals, families and firms which affect investment in the economy—as investment affects the output (GDP) thereby influencing the per capita income;

(iii) Taxes affect the prices of goods and services as factor cost (production cost) is affected thereby affecting incentives and behaviour of economic activities, etc.

Government expenditures affect/influence the economy in two ways:

(i) There are some expenditure on government purchases of goods and services, for example construction of roads, railways, ports, foodgrains, etc., in

21. The acclaimed definition first came up in the widely used work *Macroeconomics* by Dornbusch and Fisher which is now available as R.S. Dornbusch, S. Fisher and Richard Startz, *Microeconomics,* Tata McGraw-Hill, N. Delhi, 8th Ed., 2002.
22. John Hicks, the British Nobel Laureate did show it referring changes in taxes and government expenditure using the framework of the famous IS-LM model (*Ibid*).
23. S. R. Maheshwari, ***A Dictionary of Public Administration,*** Orient Longman, N. Delhi, 2002, p. 227.
24. In his acclaimed work ***The General Theory of Employment, Interest and Money,*** 1936.
25. Stiglitz and Walsh, ***Economics,*** op. cit., p. 729.
26. Samuelson and Nordhaus, ***Economics,*** op.cit., p. 412.
27. Based on the elaboration by Samuelson and Nordhaus, ***Economics,*** op. cit., pp. 412–13.

the goods category and salary payments to government employees in the services category; and

(ii) There are some expenditure due to government's income support, to the poor, unemployed and old-age people (known as government ***transfer payments***).

DEFICIT FINANCING IN INDIA

India was declared to be a planned economy right after Independence. As development responsibilities of the government were very high, there was a need of huge funds in rupee as well as in foreign currency forms. India faced continuous crises in managing the required fund to support its Five Year Plans—neither foreign funds came nor internal resources could be mobilised in sufficient amount. (Due to lower tax collections, weaker banks that too privately owned, and negligible saving rate, etc.)[28]

By the late 1960s, the government headed for deficit financing and from the 1970s onwards, India started going for higher and higher fiscal deficits and became more and more dependent on increased deficit financing with every fresh year. We may classify dificit financing in India into three phases.

THE FIRST PHASE (1947–1970)

This phase had no concept of deficit financing and the deficits were shown as Budgetary Deficits. Major aspects of this phase were—

(i) Trying to borrow from inside and outside the economy but unable to meet the target.

(ii) In the 1950s, a serious attempt was made to increase tax collections and check revenue expenditures to be ultimately able to emerge as a surplus revenue budget economy. But huge cost was paid in the form of tax evasion, rise in corruption, stagnating standard of life and a neglected social sector.

(iii) Taking recourse to heavy borrowings from the RBI and finally nationalisation of banks so that their money could be used by the government to support the plans. This not only increased the interest burden of the governments but also ruptured the whole financial system in coming years—banks did not remain commercial entities and became part of the government's political statement.

(iv) Establishing giant PSUs with higher revenue expenditures (salaries) which increased the revenue expenditures of the future governments when the pensions and the PFs needed to be serviced.

(v) Unable to go for the required level of investment even after taking recourse to all the above given means.

THE SECOND PHASE (1970–1991)

This is considered the period of deficit financing, follow up of unsound fundamentals of economics and finally culminating in severe financial crisis by the year 1990–91. Major highlights of this phase may be summed up as follows—

(i) This phase saw the nationalisation policy and simultaneous revival of an increased emphasis on expansion of the PSU (two points should be noted here specially—*first*, many of the South East Asian economies have, officially declared their acceptance of capitalism and privatisation. *Secondly*, China had declared that investment in the government-controlled

28. For data-based detailed discussion refer to Sudipto Mundle and M. Govinda Rao, *'Issues in Fiscal Policy'* in Bimal Jalan (ed.), ***The Indian Economy: Problems and Prospects,*** Penguin Books, N. Delhi, Revised Edition, 2004, pp. 258–85.

companies are a loss of money at this time).

(ii) Upcoming PSUs increased the total expenditure of the government's revenue as well as capital.

(iii) Existing PSUs were taking their own due from the economy—the illogical employment creation excessively increased the burden of salaries, pensions and PF; many of them had started fetching huge losses by this time; as the public sector does not have profit as its primary goal; there was a lack of profit and loss analysis; as the PSUs had no connection between their need of labour force and the existing labour force. Ultimately, the responsibility of profit or loss did not remain the onus of the officers, thus making them centres of intentional losses and an institutionalised centre of corruption; etc.

(iv) The governments have failed on both the fronts—checking population rise and mass employment generation—the burden of different *subsidies* went on increasing making them unmanageable and highly illogical. Self-employment programmes could not pick up, or better said, it was politically suitable to go for piece-meal wage-employment programmes with different names.

(v) Planned development remained highly centralised and devoid of any place for local aspirations—frustrations of masses started showing up in the form extremist and radical organisations raising their heads creating a law and order problem and excessive expenditure on them. The outcome was a burdened police force and lagging judicial set up.

(vi) The plan expenditure which governments were going for were through investments in the PSUs which were not committed to profit motive, deficit financing for the PSUs was not based on sound economics. Majority of the plan expenditure in a sense turned out to be non-economic, i.e., non-plan expenditure at the end.

Due to the above-given reasons, it was tough to say whether it was sound to go for huge fiscal deficits in India.[29]

THE THIRD PHASE (1991 ONWARDS)

This started with the initiation of the economic reforms process under the conditionalities put forth by the IMF (controlling fiscal deficit was one amongst them). As the economy moved from government dominance to market dominance, things needed a restructuring and public finance also needed a touch of rationality. Till date, the government had been doing pure politics with the public money in the name of development. Now the IMF dictated and the economy headed towards greater and greater fiscal responsibility in the coming times. India is better today in this regard but we cannot say that public finance is based today on the sound principles of economics. But the rigorous process of fiscal reforms aiming at fiscal consolidation started in India.

INDIAN FISCAL SITUATION: A SUMMARY

In December 1985, the Government of India presented a discussion paper in the Parliament titled 'Long-term Fiscal Policy'. It was for the ***first time*** in the fiscal history of India that we see a long-term perspective coming on the fiscal issue from the government. This also included the policy of government expenditure. The paper was bold

29. This was the general feeling among the experts, policymakers and the IMF, alike.

enough to recognise the deterioration in India's fiscal position and accepted it among the most important challenges of the eighties—the paper set specific targets and policies to set the things right. This paper was followed by a country-wide debate on the issue and it was in 1987 that the government came ahead with ***two*** bold steps in the direction—

(i) a virtual freeze was announced on government expenditure, and

(ii) a ceiling on the budgetary deficit.

The above steps had a positive impact on the situation but it was temporary as since mid-1988 the situation again started deteriorating. The BoP crisis at the end of 1990 was generated partly by the alarmingly high ***fiscal deficit***[30] and due to a high level of external borrowings. The IMF support to fight the crisis came in but with many macro-economic conditionalities, checking the fiscal meance being a major one among them. With the process of economic reforms which started in 1991–92, the government also announced its commitment to reduce fiscal deficit to 3–4 per cent (of GDP) by the mid-1990s (from the level of about 8 per cent during 1987–90). This step was among the many measures which the government started with the objective of stabilising the economy. We may have a look at India's fiscal situation upto the 1990–91 in the following way:

(i) The fiscal deficits of the central government, after averaging below 4 per cent of the GDP till the 1970s started climbing up by being 5.77 per cent in 1980–81, 8.47 per cent in 1986–87 ending up at 7.85 per cent in 1990–91 after being above 7 per cent in the second half of the 1980s.[31]

(ii) The revenue (i.e., current) expenditure of the government (Centre and states combined) increased from 11.8 per cent of GDP to 23 per cent between 1960 and 1990. The revenue receipts of the government also went up on an average of 14.6 per cent in 1971–75 to 20 per cent in 1986–1990. But the gap between revenue receipts and expenditures remained negative—financed largely by domestic borrowings (as a result the interest payments on domestic debt increased from 0.5 to 2.5 per cent of the GDP during 1975–90.[32] The revenue deficit went on increasing after 1979–80 and reached the highest level of 3.26 per cent of the GDP in 1990–91.[33]

(iii) The fiscal situation of the states was not good either. State governments which are primarily responsible for health, education and other social services had an aggregate revenue expenditure of 5 per cent of GDP on these accounts while their capital expenditure accounted for 2.5 per cent on social and other sectors.[34] The states' expenditure on the social sector went down while their interest payments

30. The proximate cause of the payment crisis in the mainstream perspective, was faulty macroeconomic policies, specially large fiscal deficits of the government during 1984–91, deficits that spilled over in country's current account of the balance of payment. (Mihir Rakshit, 'The Micro-economic Adjustment Programme: A Critique', ***Economic and Political Weekly*** *26,* no. 34 (August), quoted by Mihir Rakshit, *'Some Microeconomics of India's Reform Experience'* in Kaushik Basu (ed.), ***India's Emerging Economy: Performance and Prospects in the 1990s and Beyond,*** Oxford University Press, N. Delhi, 2004, p. 84.

31. S. D. Tendulkar and T.A. Bavani, ***Understanding Reforms,*** Oxford University Press, N. Delhi, 2007, p. 73.

32. Bimal Jalan, ***India's Economic Policy,*** Penguin Books, N. Delhi, 1992, p. 48.

33. ***Handbook of Statistics on the Economy 2002–03,*** RBI, Table 221 (cited by **Tendulkar** and **Bhavani,** 2007, op. cit., p. 74)

34. Bimal Jalan, 1992, op. cit., p. 50

had increased during the 1980s.[35]

As per the experts, the debt situation in the states would have been even worse, but for the fact that the states, unlike the Centre, did not have independent powers to borrow either from the RBI or the market because of the statutory overdraft regulatory scheme.[36] Thus, their deficits have been self-limiting—whenever the states tried to cut down their deficits the care of the social sector and capital expenditure suffered and development prospects in the states also suffered.

Now the question arises that why the government has not been able to check the menace of fiscal deficits even though there has been a consensus to do so? ***There are reasons***[37] which can be cited for it:

(i) Political factor: The political lobbies and sectional politics as well as the subsidies are supposed to be one big factor for rising government expenditure. We see this on a higher scale if there is a probable mid-term election or closer to a general election.

(ii) Institutional factor: The administrative size combined with the processes of reporting, accounting, supervising and monitoring getting greater importance than the production and delivery of goods and services.[38]

(iii) Ethical factor: This is a more powerful factor as it easily generates wide public support for the government expenditure. There are many heads of such expenditures such as subsidies (food, power, fertilizer, irrigation, etc.) poverty alleviation programmes, employment generation programmes, education, health and social services. The logic for such expenditure comes from the idea that the government should function as protector of the poor and provider of jobs for them implying that such government expenditures benefit the poor.

It was in 2000 that the double menace of revenue and fiscal deficits got attention from the government at the Centre and some constitutional/statutory safeguards looked necessary. Consequently, the Fiscal Responsibility and Budget Management Bill, 2000 was proposed in the Parliament.

FRBM ACT, 2003

The fiscal policy of an economy has been considered as the building block for enabling macro-environment by economists, policymakers and the IMF, alike. It does not only provide stability and predictability to the policy regime, but also ensures that national resources are allocated in terms of their defined priorities through the tax transfer mechanism.

Unproductive government expenditures, tax distortions and high deficits are considered to have constrained the Indian economy from realising its full growth potential. At the begining of the fiscal reforms in 1991, the fiscal imbalance was identified as the ***root cause*** of the twin problems of inflation and the difficult balance of payments (BoPs) position.[39] Since then the ***medium-term fiscal policy stance*** of the government has been on the following lines:[40]

35. ***The Report of Tenth Finance Commission,*** N. Delhi, 1994 (**quoted by Bimal Jalan, 1992, op. cit., p. 50).**
36. This scheme has changed now. After the implementation of the suggestions of the ***12th Finance Commission*** states are now allowed to go for market borrowings to take care of their plan expenditures once they have passed and enacted their Fiscal Responsibility Acts (FRAs) in consonance with the FRBM Act, 2003.
37. Based on the points raised by Bimal Jalan, 1992, op. cit., p. 49.
38. This factor seems getting redressal with the starting of ***outcome*** and ***performance*** budgeting 2004–05 onwards.
39. ***Economic Survey 2006–07,*** MoF, GoI, N. Delhi, p.18.
40. Ibid.

(i) reducing the deficits (revenue and fiscal);
(ii) prioritising expenditure and ensuring that these resulted in intended outcomes; and
(iii) augumenting resources by widening tax base and improving tax-compliance while maintaining moderate rates.

The fiscal consolidation which followed in 1991 failed to give the desired results as there was no defined mandate for it. Neither was there any statutory obligation to do so.[41] This is why the Fiscal Reforms and Budget Management Act (FRBMA) was enacted on August 26, 2003 to provide the support of a strong institutional/statutory mechanism. Designed for the purpose of medium-term management of the fiscal deficit, the FRBMA came into effect on July 5, 2004.

The FRBM Bill, 2000 was passed by the Parliament with all political parties voting in favour, and is considered a watershed in the area of fiscal reforms in the country. Main highlights of the FRBMA, 2003 are as given below:[42]

(i) GoI to take measures to reduce fiscal and revenue deficit so as to eliminate revenue deficit by March 31, 2008 (which was revised by the UPA Government to March 31, 2009) and thereafter build up adequate ***revenue surplus.***
(ii) Rules to be made under the Act to specify ***annual targets*** for the reduction of fiscal deficit (FD) and revenue deficit (RD) contingent liabilities and total liabilities (***RD to be cut by 0.5 per cent per annum and FD by 0.3 per cent p.a.***).
(iii) FD and RD may exceed the targets only on the grounds such as national security, calamity or on exceptional grounds.
(iv) GoI not to borrow from RBI except by Ways and Means Advances (WMAs).
(v) RBI not to subscribe to the primary issue of the GoI securities from 2006–07 (it means that these government bonds/papers will become market—based instrument to raise long-term funds by the government).
(vi) Steps to be taken to ensure greater transparency in fiscal operations.
(vii) Along with the Budget and Demands for Grants, the GoI to lay the following ***three statements*** before the Parliament in each financial year:
   (a) Fiscal Policy Strategy Statement (FPSS);
   (b) Medium Term Fiscal Policy Statement (MTFPS); and
   (c) Macroeconomic Framework Statement (MFS).
(viii) The Finance Minister to make ***quarterly review*** of trends in receipts and expenditure in relation to the Budget and place the review before the Parliament.

FOLLOW-UP TO THE FRBMA

The process of fiscal consolidation under FRBMA has been continuous and essentially an incremental one. Some of the important fiscal measures[43] that are being implemented by the government are as given below:

(i) reducing the peak rates of custom duties;
(ii) rectifying anomalies like ***inverted duty structure;***

41. Ibid.
42. ***Economic Survey 2003–04,*** MoF, GoI, N. Delhi.
43. ***Economic Survey 2006–07,*** op. cit., p. 18.

(iii) rationalising excise duties with a movement towards a ***medium CENVAT rate;***

(iv) revisiting the tax ***exemptions;***

(v) relying on voluntary tax compliance through taxpayer ***facilitation;***

(vi) introduction of state-level VAT for achieving a ***non-cascading, self-enforcing,*** and ***harmonised*** commodity tax regime;

(vii) increasing productivity of expenditure through an ***outcome budget*** framework (which seeks to translate outlays into better outcomes through monitorable performance indicators);

(viii) innovative financing mechanism like creation of Special Purpose Vehicle (SPV) for infrastructure projects; and

(ix) states have also joined the process of fiscal consolidation in line with the Twelfth Finance Commission's (TFC) recommendations and are complementing the efforts of the central government.

In 2006–07, in case of the ***central government,*** proposed reduction in revenue and fiscal deficits were put at 0.6 per cent and 0.5 per cent, respectively (higher than the FRBMA Rules), though the reduction suffered in 2005–06 due to higher devolution to states by the Centre on account of the TFC recommedations.[44]

States also showed considerable improvement (in fact, even better then the central government). The fiscal deficit of the states declined by 1.6 per cent post FRBMA from 4.5 per cent in 2003–04 to 2.6 per cent in 2006–07 of their GDP. Revenue deficit, on an aggregate basis, was budgeted to get eliminated by 2006–07, two years ahead of the target. (***A strong incentive-based restructuring scheme of fiscal transfers to states suggested by the TFC appears to have succeeded.***)[45]

LIMITING GOVERNMENT EXPENDITURE

Elected governments are composed of different interest groups and lobbies. At times, such governments might intend to use its economic policies in a highly populist way for greater political mileage without caring for the national exchequer. Such acts might force the governments to go in for excessive internal and external borrowing and printing of currency. Governments generally avoid to increase tax or impose new taxes for their revenue increase as such acts are politically unpopular. On the other hand, borrowings and printing of currency impose no immediate economic or political costs. A government in the election-year usually spends money frugally by borrowings (from the RBI in India) because it is the coming government after the elections who is supposed to repay them. Government expenditures remain higher and expanding due to some economic reasons also—by doing so extra employment is generated and the output (GDP) of the economy is also boosted. If governments go for anti-expansionary fiscal and monetary policies with the objective of reducing its expenditures the employment as well as the GDP both will be hampered. This is considered a ***bias*** in the economic policies of the elected governments. But there has always been a consensus among the experts and policymakers that an external (i.e., outside the government) and some form of a statutory check must be over the government on its powers of money creation (i.e., by borrowings or printing). With the objective of removing the bias—to make fiscal policy less sensitive to electoral considerations, several countries had introduced some legal provisions on their governments before

44. Ibid.
45. Ibid.

India enacted its FRBMA. We see mainly ***three variants*** of it around the world:

(i) It was *New Zealand* which ***first*** introduced such a legal binding on the government's powers of money creation. Here the central bank is legally bound to ensure that money creation by the government does not increase the rate of ***inflation target***—it means that the central bank has the overriding powers on the government there in the area of extra money creation.[46]

(ii) The ***second variant*** is putting some firm legal or constitutional limit on the size of government deficits or the power of the government to borrow. *Germany* and *Chile* had such an arrangement—today Germany is bound to the fiscal limits prescribed by the Maastricht Treaty. In the late 1990s, an upper limit on the government's powers to create deficit was introduced.[47]

(iii) Some countries introduced the so-called ***'Currency Board'*** type of arrangement to serve the same purpose—this is the ***third variant.*** In this arrangement, money supply in the economy is directly linked to changes in the supply of foreign assets—neither the government nor the central bank has any independent powers to create money, as growth in money supply is not allowed to exceed growth in the foreign assets.[48]

It was in 1994 that India took the first step in this direction when the central government had a formal agreement with the RBI to limit its borrowing through ***ad hoc*** treasury bills to a predetermined amount (Rs. 6,000 crores in 1994–95).[49] However, it was a highly liberal arrangement with the government having the ultimate powers to revise the aforesaid predetermined amount by a fresh agreement with the RBI. The importance this beginning had was finally in the enactment of the FRBMA 2003—a historic achievement in the area of fiscal prudence in the country.

FISCAL CONSOLIDATION IN INDIA

The average combined fiscal deficits, of the Centre and states after 1975, had been above 10 per cent of the GDP till 2000–01. More than half of it had been due to huge revenue deficits. The governments were cautioned by the RBI, the Planning Commission as well as by the IMF and the WB about the unsustainability of the fiscal deficits. It was at the behest of the IMF that India started the politically and socially painful process of fiscal reforms, a step towards fiscal consolidation.[50] A number of steps were taken by the government at the Centre in this direction and there had been incessant attempts to do the same in the states' public finances too. Major highlights in this direction can be summed up as given below:

46. Opposite to it, in the U.K., the government has overriding powers on the central bank and there is absence of any legal checks on money creation powers of the government. Once the UK becomes part of the European Union it will come under such a check through the Maastricht Treaty. Before the enactment of the FRBMA, 2003. India was like the U.K, however, the Constitution of India has a provision for imposing a statutory limit on the centre's borrowing powers under *Article 292*. But the Article is not mandatory and has not been invoked by any of the governments till date.
47. By the Congress passing the Balanced Budget Act, 1997 which promised to eliminate federal deficit spending by 2002 (see Nicholas Henry, ***Public Administration and Public Policy,*** Prentice-Hall, N. Delhi, 8th Ed., 2003, p. 217).
48. Argentina introduced this arrangement in the late 1990s.
49. ***Economic Survey 1994–95,*** MoF, GoI, N. Delhi.
50. IMF imposed some macro-economic conditions on the economy while India borrowed from it for its BoP correction in 1990–91. One among the conditions was cutting down the government expenditure (i.e., salaries, pensions, interest and subsidies, etc.) by 10 per cent every year.

1. Policy initiatives towards cutting revenue deficits:

(i) Cutting down expenditure—

(a) Cutting down the burden of salaries, pensions and the PFs (down-sizing/right-sizing of the government, out of every 3 vacancies 1 to be filled up, interest cut on the PF, pension reforms-PFRDA, etc.);

(b) Cutting down the subsidies (Administered Price Mechanism in petroleum, fertilizers, sugar, drugs to be rationalised, it was done with mixed successes);

(c) Interest burden to be cut down (by going for lesser and lesser borrowings, pre-payment of external debts, debt swaps, promoting external lending, minimal dependence on costlier external borrowings, etc.);

(d) Defence being one major item of the expenditure bilateral negotiations initiated with China and Pakistan (the historical and psychological enemies against whom the Indian defence preparedness was directed to, as supposed) so that the defence force cut could be completed on the borders, etc.;

(e) Budgetary supports to the loss-making PSUs to be an exception than a rule;

(f) Expenditure reform started by the governments in different areas and departments;

(g) General Services to be motivated towards profit with subsidised services to the needy only (railways, power, water, etc.);

(h) Postal deficits to be checked by involving the post offices in other areas of profit;

(i) Higher education declared as non-priority sector; fees of institutions of professional courses revised upward; etc.

(ii) Increasing *revenue receipts*:

(a) Tax reforms initiated (Cenvat, VAT, Service Tax, GST proposed, etc.);

(b) The PSUs to be disinvested and even privatised (if a political concensus reached which alludes today);

(c) Surplus forex reserves to be used in external lending and purchasing foreign high quality sovereign bonds, etc.

(d) State governments allowed to go for market borrowing for their plan expenditure, etc.

2. The borrowing programme of the government:

(i) The Ways and Means Advances (WMA) scheme commenced in 1997 under which the government commits to the RBI about the amount of money it will give as part of its market-borrowing programme, to bring transparency in public expenditure and to put political responsibility on the government.

(ii) The RBI will not be the primary subscriber to government securities in the future—committed way back in 1997.

3. The fiscal responsibility on the governments:

(i) The Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2003 (voted by all political parties) which puts constitutional obligation on the government to commit so many things as fiscal responsibility comes in the public finance—fixing annual targets to cut revenue and fiscal deficits; the government not to borrow from the RBI except by the WMA; government to bring in greater transparency in fiscal operations; along with the Budget the government to lay statements regarding fiscal policy strategy in the House and Quarterly Review of trends of receipts and expenditures of the government.

(ii) A mechanism (to include state governments under the umbrella of fiscal responsibility) was advised (now implemented, too) by the 12th Finance Commission which allows the state governments to go for market borrowing (without central permission) for their need of plan development provided they pass their fiscal responsibility acts (FRAs) and commit to the fiscal responsibility regarding cutting their revenue and fiscal deficits. As many as 19 states have already passed their FRAs by now.

At present, we cannot conclude that once the FRBM Act is passed the fiscal abberations will be automatically checked. At the same time, we cannot say whether it will hamper the social cause. But experts agree upon that at least a legislative beginning has taken place and the opposition in the House must have got a tool (and so the people) to create enough democratic pressure on the governments of the time regarding fiscal prudence.

ZERO-BASE BUDGETING

The idea of zero-base budgeting (ZBB) first came to the privately owned organisation of the USA by the 1960s. This basically belonged to a long list of guidelines for managerial excellence and success, others being Management by Objectives (MBO), Matrix Management, Portfolio Management, etc to name a few.[51] It was the US financial expert ***Peter Phyrr*** who first proposed this idea for government budgeting and Jimmy Carter, Govornor of Georgia, USA was the first elected[52] executive to introduce ZBB to the public sector. When he presented the US Budget in 1979 *as the US President* it was the first use of the ZBB for any nation state. Since then many governments of the world have gone for such budgeting.

Zero-base budgeting is the allocation of resources to agencies based on periodic re-evaluation by those agencies of the need for all the programmes for which they are responsible, justifying the continuance or termination of each programme in the agency budget proposal—in other words, an agency reassesses what it is doing from top to bottom from a hypothetical ***zero base.***[53]

There are three essential principles of ZBB. Some experts say it in a different way, there are three essential questions which must be answered objectively before going for any expenditure as per the techniques of ZBB:

(i) Should we spend?
(ii) How much should we spend?
(iii) Where should we spend?

51. George R. Terry and Stephen G. Franklin, ***Principles of Management,*** AITBS, N. Delhi, 8th Ed., 2002, pp. 9–10.
52. See Peter A. Phyrr, ***The Zero Base Approach to Government Budgeting,*** Public Administration Review, 37 (Jan./Feb., 1977), p. 7 and Thomas P. Lauth, ***Zero-Base Budgeting in Georgia State Government: Myth and Reality,*** Public Administration Review, 38 (Sept./Oct., 1978) pp. 420–30 (cited in Nicholar Henry, ***Public Administration and Public Affairs,*** Prentice-Hall, N. Delhi, 8th Ed., 2003, p. 217).
53. Nicholas Henry, 2003, op. cit., p. 218.

There are *three* special features of this budgeting which distinguishes it from the traditional budgeting. These features, in brief, are as under:

(i) The conventional aggregate approach is not applied in it, in which each department of the government prepares their own budget for many activities in the aggregate and composite form, making it difficult to scrutinise each and every activity. In place of it every department needs to justify its existence and continuance in the budget document by using the mathematical technique of econometrics, i.e., cost-benefit analysis. In a nutshell, every activity of each department is 'X-rayed' and once the justification is validated they are allocated the funds.

(ii) *Economy* in public expenditure is the *raison d'etre* of this budgeting. This is why the ZBB has provisions of close examination and scrutiny of each programme and public spending. Finally, the public spending is cut without affecting the current level of benefits of various public services accruing to the public.

(iii) *Prioritising* the competing needs is another special feature of ZBB. Before allocating funds to the different needs of the economy, an order of priority is prepared with utmost objectivity. As the resources/funds are always scarce, in the process of prioritised allocation, the item/items at the bottom might not get any funds.

Side by side its benefits, there are certain ***limitations*** too before the ZBB which prohibits its assumed success, according to experts. These limitations have made it subject to criticisms. The limitations are as given below:

(i) There are certain expenditures upon which the government/parliament does not have the power of scrutiny (as the 'Charged Expenditure' in India).

(ii) There are certains public services which defy the cost-benefit analysis—defence, law and order, foreign relations, etc.

(iii) Scrutiny is a subjective matter and so this might become prey to bias. Again, if the scrutinisers have a complete utilitarian view many long-term objectives of budgeting and public policy might get marginalised.

(iv) It has scope for emergence of the Ministry of Finance as the all-powerful institution dictating other ministries and departments.

(v) Bureaucracy does not praise it as it evaluates their decisions and performances in a highly objective way.

Despite the above-given strong limitation, the ZBB has a sound logic and should be considered a long-term budgetary reform process. The basic idea of this form of budgeting is to optimise the benefits of expenditure in every area of activity and in this sense it is exceptional. To the extent the corporate world is concerned, this has been a very successful financial management tool.

In India, it is believed to be in practice since 1997–99. We cannot say that India is a success in ZBB, but many of the profit-fetching PSUs have been able to use it successfully and optimise their profits.

RESULTS-FRAMEWORK DOCUMENT (RFD)

In September 2009, the Indian PM approved the outline of a ***Performance Monitoring and Evaluation System (PMES)*** for government ministries/departments. Under PMES, each ministry/department is required to prepare a

Results-Framework Document (RFD). It has been adopted by the GoI to monitor the performance management of various ministries/departments. The RFD system is being implemented in various ministries/departments in phased manner – was implemented to 59 ministries/departments for the year 2009–10, increasing every year in 2013–14 it will get implemented in 84 ministries/departments. ***Performance Management*** in the government is a *new concept* which determines the performance index based upon the agreed objectives, policies, programme and projects/schemes. To ensure the success in achieving the agreed objectives and implementing agreed policies, programme and projects, the RFD also includes a commitment for required resources and necessary operational autonomy.

'RFD provides a summary of the most important results that an organisation expects to achieve during the financial year'. The document has two main purposes :

(i) Move the focus of the organisation 'from process-orientation to results-orientation'; and

(ii) provide an objective and fair basis to evaluate the organisation's overall performance at the year-end.

The RFD Guidelines are divided into ***three broad sections:*** **1.** Format of RFD; **2.** Methodology for Evaluation; and **3.** RFD Process and Timelines

1. Format of RFD

An RFD is essentially a record of understanding between a department/ministry representing the people's mandate, and the head of the organisation responsible for implementing this mandate. This document contains not only the agreed objectives, policies, programme and projects but also success indicators and targets to measure progress in implementing them. To ensure the successful implementation of agreed actions, RFD may also include necessary operational autonomy. In the case of the Responsibility Centres (attached offices, subordinate offices, and autonomous organisations), the RFD will represent a record of understanding between the parent department/ministry and the Responsibility Centre. The RFD seeks to address ***three basic questions***:

(i) What are organisation's main objectives for the year?

(ii) What actions are proposed to achieve these objectives?

(iii) How would someone know at the end of the year the degree of progress made in implementing these actions? That is, what are the relevant success indicators and their targets?

The RFD should contain the following ***five sections***:

(i) Organisation's vision, mission, objectives and functions.

(ii) *Inter se* priorities among key objectives, success indicators and targets.

(iii) Trend values of the success indicators.

(iv) Description and definition of success indicators and proposed measurement methodology.

(v) Specific performance requirements from other departments/organisations that are critical for delivering agreed results.

2. Evaluation Methodology

At the end of the year, the parent ministry/department will look at the achievements of the organisation, compare them with the targets, and determine the composite score. The composite score shows the degree to which the organisation in question was able to meet its promised results, i.e., *objective*. Various agencies will have diverse sets of objectives and corresponding success indicators.

Yet, at the end of the year every organisation will be able to compute its composite score for the past year.

3. RFD Process and Timelines

Beginning of the Year: At the beginning of each financial year, each organisation to prepare a RFD. And as per the priorities listed in the RFD, proposed activities and the corresponding success indicators to be approved. The RFDs draft has to be completed by 5th of March for feedback and finalised by 31st March every year – the final versions of all RFDs to be put on the websites by 15th of April each year. The final RFD to take into account budget provisions and in particular the *Outcome Budget*. The RFDs to be drawn up in such manner that quarterly monitoring is possible.

During the Year: After six months, the Results-Framework as well as the achievements to be reviewed—the RFDs may be reviewed and the goals reset, taking into account the priorities at that point of time (this will enable to factor in unforeseen circumstances such as drought conditions, natural calamities or epidemics). Cabinet Secretariat to select about 24 RFDs using a stratified random sampling procedure to examine them.

End of the Year: At the end of the year, all RFDs to be reviewed, a report listing the achievements of their respective organisations against the agreed results in the prescribed format. This report is required to be finalised by 1st of May each year. After scrutiny by the concerned administrative ministry/department, these results will be placed on the website by 1st of June each year.

The RFD is among the attempts by which the government have been trying to bring in higher performance in its ministries/departments together with 'transparency', 'accountability' and 'responsibility'. This is in the series of other such initiatives like 'Outcome Budgeting' and 'Performance Budgeting'. The 'Zero-Base Budgeting' was a similar and first such initiative in this direction taken by the GoI in mid-1990s.

CHARGED EXPENDITURE

It is the public expenditure which is beyond the voting power of the Parliament and is directly withdrawn from the Consolidated Fund of India.[54] The emoluments of the President, Speaker and Deputy Speaker of the Lok Sabha, Chairman and Deputy Chairman of the Rajya Sabha, Judges of the Supreme Court and the High Courts, etc., in India, for example.

TYPES OF BUDGETS

GOLDEN RULE

The proposition that a government should borrow only to invest (i.e., plan expenditure in India) and not to finance current spending (i.e., revenue expenditure in India) is known as the golden rule of public finance. This rule is undoubtedly prudent but provided spending is honestly described as investment, investments are efficient and does not crowd out the important private sector investments.[55]

BALANCED BUDGET

A budget is said to be a balanced budget when total public-sector spending equals total government income (revenue receipts) during the same period from taxes and charges for public services.[56] In

54. In the Constitution of India it is deliberated in the *Article 112 (3), a - g* where it is referred as *'expenditure charged'* on the consolidated fund of India—popular as the 'charged expenditure' (see ***The Constitution of India,*** Ministry of Law, Justice and Company Affairs, GoI, N. Delhi, 1999, pp. 38–39).
55. See Samuelson and Nordhaus, ***Economics,*** op.cit., p. 710; Stiglitz and Walsh, ***Economics,*** op. cit., pp. 552–54.
56. Mathew Bishop, ***Pocket Economist,*** op. cit., p. 104.

other terms, a budget with zero revenue deficit is balanced budget. Such budget making is popularly known as *balanced budgeting*.

Gender Budgeting

A general budget by the government which allocates funds and reponsibilities on the basis of gender is gender budgeting. It is done in an economy where socio-economic disparities are chronic and clearly visible on a sex basis (as in India).

Gender budgeting started in India with the Union Budget 2006–07 which proposed an outlay of Rs. 28,737 crore dedicated to the cause of women and created gender budgeting cells in 32 ministries and departments.[57]

Outcome and Performance Budgets [58]

The concepts are part of result-oriented budgeting. While outcome budget is presented by different departments and divisions of a ministry or the government, the performance budget is presented by the Ministry of Finance on behalf of the government. Both go for 'quantitative' as well as 'qualitative' progress reports of the performance. The outcome budget is a micro level process while performance budget is a macro level process in budgeting. There are many outcome budgets in any one performance budget.

The basic objective of such budgeting is to bring in transparency and thereby making the government more and more responsible to the House and the public. Naturally, they bring in prudence and optimisation elements in public spending (also see entry 'Outcome Budget' in Chapter 23).

Cut Motion

In democratic political systems, there is a provision of Cut Motion in the House/Parliament (usually it is the opposition but floor might be crossed by members of the House belonging to the government due to presence of inner-party politics). In the US, the budget provisions presented by the government must be passed by the Congress. Only then they can be enacted. Unlike this, in the British parliamentary system though the budget of the government is voted by the House usually this is considered a political document and passed unchanged. India has mixed provisions of voting on the budget after discussion in both the Houses. There are different constitutional provisions by which the Parliament starts discussion to reduce the demands, grants, etc. proposed by the government in the Budget[59]—

(i) Token Cut: This motion intends to *'reduce the demand by Rs. 100'*. Such a motion is moved in order to express a specific grievance which is within the sphere of the responsibility of the Government of India—the discussion remains confined to the particular grievance specified in the motion.

(ii) Economy Cut: This motion intends to *'reduce the demand by a specified amount'* representing the economy (in expenditure) that can be affected. Such specified amount may be either lump sum reduction in the demand or omission or reduction of an item in the demnd—the discussion remains confined to the matter in which the economy can be affected.

(iii) Disapproval of Policy Cut: This motion intends to *'reduce the demand to Re. 1'*.

57. ***Union Budget 2006–07,*** MoF, GoI, N. Delhi.
58. Based on the notes released by the Ministry of Finance, GoI, October 2006 while releasing the ***Quarterly Review*** of the Union Budget 2006–07.
59. Rules of Procedure and Conduct of Business in Lok Sabha, Parliament Secretariat, N. Dehli.

This represents *disapproval* of the policy underlying the demand—the discussion remains confined to the particular policy and is open to members to advocate an alternate policy.

(iv) **Guillotine** is the process in which the Speaker puts all the outstanding demands made by the Budget *directly to vote* in the House—ending further discussions (intended to cut short the discussion on the Budget). Through this, the Speaker may put the whole Budegt to vote (i.e., allowing 'no discussion' on the Budget by the House). In recent years, this route was taken time and again by the Government of India, to avoid the aggressive mood of the Opposition.

Though, this is a *short route* to get the Budget passed by the House (avoiding criticism by the Opposition benches), it may turn out to be very dangerous —as the voting process may take the form of 'no confidence motion' and the government may be routed out of power. But, till date, *Guillotines* never resulted into routing a government out of power in India (as India follows the British Model of Parliamentary system).

TRILEMMAS

Putting the right kind of fiscal policy has always been the most challenging policy decision to be taken by the democratic governments around the world, there are some famous 'trilemmas' related to this aspect. Economics have by now many 'trilemmas' developed and articulated by economists from time to time and the process still continues. Let us see some highly popular and newsmaking ones:

(i) The **'financial stability trilemma'** put forward by Dirk Schoenmaker[60] (2008), explains the incompatibility within the Euro zone of: **(a)** a stable financial system, **(b)** an integrated financial system, and **(c)** national financial stability policies.

(ii) By far the most high profile current trilemma of the Eurozone (by Edward Chancellor[61]) was believed to be the seeming irreconcilability between its **three wishes,** namely, **(a)** a single currency, **(b)** minimal fiscal contribution to bail outs, and **(c)** the ECB's commitment to low inflation.

(iii) Martin Wolf[62] spoke about the US Republican Party's **fiscal policy trilemma: (a)** large budget deficits are ruinous; **(b)** a continued eagerness to cut taxes; and **(c)** an utter lack of interest in spending cuts on a large enough scale.

(iv) Then we have the **Earth Trilemma** (EEE), which posits that for: **(a)** economic development (E), **(b)** we need increased energy expenditure (E), **(c)** but this raises the environmental issue (E).

(v) Above all these more recent trilemmas in economics, the prima donna of all of them is Mundell's **'impossible trinity'**. This old trilemma asserts that a country cannot maintain, simultaneously, all three policy goals of – **(a)** free capital flows, **(b)** a fixed exchange rate, and **(c)** an independent monetary policy. The impossible trinity, has seen enough waters flowing down the time since it was articulated almost five decades ago which has a strong theoretical foundation in the

60. Dirk Schoenmaker, "A New Financial Stability Framework for Europe", ***The Financial Regulator,*** Vol.13 (3), 2009.
61. Edward Chancellor, "Germany's Eurozone trilemma", ***Financial Times,*** Nov. 6, 2011.
62. Martin Wolf, "The political genius of supply side economics", ***Financial Times,*** July 25, 2010.

Mundell-Fleming Model developed in the 1960s.

Dani Rodrik [63] argued that if a country wants more of globalisation, it must either give up some democracy or some national sovereignty. Niall Ferguson[64] highlighted the **trilemma** of a choice between commitment to globalisation, to social order and to a small state (meaning limited state intervention).

TREASURY COMPUTERISATION OF STATE GOVERNMENTS

A scheme for implementation of the mission mode project[65] 'Computerisation of State Treasuries' was put in place by the GoI in June 2010 under the ***National e-Governance Plan (NeGP)***. The states and UTs are required to complete their projects in about three years beginning 2010–11. The funds are released against deliverables. The scheme will support states and UTs to fill the existing gaps in their treasury computerisation, upgradation, expansion and interface requirements, apart from supporting basic computerisation. The scheme covers installation of suitable hardware and application software systems in a networked environment on a wide area basis and building of interfaces for data sharing among various stakeholders.

The scheme for treasury computerisation is expected to make the budgeting process more efficient, improve cash flow management, promote real-time reconciliation of accounts, strengthen management information systems (MIS), improve accuracy and timeliness in accounts preparation, bring about transparency and efficiency in public delivery systems, help bring about better financial management along with improved quality of governance in states and UTs. The overall estimated cost of the scheme is Rs. 626 crore at Rs. 1 crore per district in existence on April 1, 2011. Financial support is up to 75 per cent (90 per cent in case of northeastern states) of the individual project cost of admissible components limited to Rs. 75 lakh per district (Rs. 90 lakh per district for north-eastern states). Funds will be released as central assistance in three instalments of 40 per cent, 30 per cent, and 30 per cent each, subject to satisfactory receipt of utilisation certificates.

CRIS OF INDIA

The Finance Ministry of India has developed and released *(January 31, 2012)* the ***Comparative Rating Index of Sovereigns (CRIS)*** – *a new index of sovereign credit rating.* Together with it, the ministry has also released an estimation of CRIS over the **last five years**, for **different nations** belonging to different blocks of the global economy.

Major credit rating agencies give out the sovereign credit rating of each nation as an absolute grade. How other nations fare does not matter in a particular nation's rating score. The CRIS is very different from a comparative rating. An example of comparative rating is the percentile score – the way *GRE (Graduate Record Examination)* results are at times given. If a student is described as belonging to the 99th percentile, it clearly says something about this student's performance vis-á-vis other students.

It is arguable that even for sovereign credit ratings, there is a case for providing some kind of

63. Dani Rodrik, "The inescapable trilemma of the world economy", June 27, 2007, *(rodrik.typepad.com/dani_rodriks_weblog.)*
64. *Niall Ferguson,* "Conservatism and the Crisis: A Transatlantic Trilemma", Centre for Policy Studies, Ruttenberg Lecture, March 24, 2009.
65. ***Economic Survey 2011–12,*** op. cit., p. 69

a comparative score. When an investor searches across nations for a place to put her money, the relative rating of nations is important. If nation **y's** rating remaining the same, other nations' ratings improve over time, there may well be a case to invest less in nation **y.**

The computation of CRIS is based on nothing apart from ***Moody's*** ratings and data on the GDPs of different nations as given by the ***IMF***. In the paper, the ministry defines the CRIS formally and then track how nations have done over time. In order to capture this impact, the Ministry of Finance developed a new system for comparing the relative ratings of sovereign debt based on the historical evolution of their ratings over five years and the volume of their economic activity as measured by their GDP (not adjusted for Purchasing Power Parity (PPP)). The Finance Ministry develops a relative rating index and rank 101 economies according to this for the years 2007 to 2011. The index uses external data on GDP and ratings combined in terms of pure mathematical and statistical methods without interventions or interpretations.

DIRECT BENEFIT TRANSFER (DBT)

The DBT plan was introduced on ***January 1, 2013*** with seven schemes in 20 districts. India has embarked on a DBT scheme in selected districts wherein it has been envisaged that benefits such as scholarships, pensions, and MGNREGA (Mahatma Gandhi National Rural Employment Guarantee Act) wages will be 'directly credited' to the bank or post office accounts of identified beneficiaries. The DBT scheme *will not substitute* entirely for delivery of public services for now. It will replace neither food and kerosene subsidies under the TPDS nor fertilizer subsidies. The DBT is ***designed*** to—

(i) improve targeting,
(ii) reduce corruption,
(iii) eliminate waste,
(iv) control expenditure, and
(v) facilitate reforms.

Electronic transfer of benefits is a simple design change and transfers that are already taking place through paper and cash mode will now be done through electronic transfers. This has been enabled by rapid roll out of *Aadhar* (Unique Identity) now covering 200 million people and rapidly growing to cover 600 million (nearly half of our population), with the *National Population Register (NPR)* covering the other half of the populace. The DBT in tandem with such unique identification will ensure that the benefits reach the target groups faster and minimize 'inclusion' and 'exclusion' errors as well as 'corruption' that are associated with manual processes.

EXPENDITURE MANAGEMENT COMMISSION

By early September 2014, the GoI constituted an Expenditure Management Commission (EMC) through a Resolution. The EMC will look into various aspects of expenditure reforms to be undertaken by the Government and other issues concerning Public Expenditure Management. The Commission has one full time, one part time and one ex-officio members other than Chairman (of Cabinet rank). Dr Bimal Jalan is its first Chairman. The terms of reference of the Commission are as given below:

(i) Review the major areas of Central Government expenditure, and to suggest ways of creating fiscal space required to meet developmental expenditure needs, without compromising the commitment to fiscal discipline.

(ii) Review the institutional arrangement, including budgeting process and FRBM rules, for enforcing aggregate fiscal discipline and suggest improvements theirin;

(iii) Suggest measures to improve allocative effeciencies in the existing expenditure classification system, including focus on capital expenditure;

(iv) Design a framework to imrpove operational efficiency of expenditures through focus on utilization, targets and outcomes;

(v) Suggest an effective strategy for meeting reasonable proportion of expenditure on services through user charges;

(vi) Suggest measures to achieve reduction in financial costs through better Cash Management Ssystem;

(vii) Suggest greater use of IT tools for expenditure management;

(viii) Suggest improved financial reporting systems in terms of accounting, budgeting, etc., and

(ix) Consider any other relevant issue concerning Public Expenditure Management in Central Government and make suitable recommendations.

The Commission submitted its *interim report* before the *Union Budget 2015–16* (as per the mandate given to it). The *final report* is to be submitted before the *Union Budget 2016–17*.

FISCAL PERFORMANCE OF STATES

States have been performing[66] better on their fiscal fronts since they put in place their respective fiscal responsibility acts (FRAs). Fiscal consolidation of states during recent years was largely *revenue-led*, with significant increases in both own tax revenue as well as current transfers from the centre, the latter reflecting the enhancements recommended by the 13th Finance Commission. However, some deterioration in state government finances was seen in 2013–14, while improvement is budgeted in 2014–15. The fiscal performance of states has been as given below (as per the *Economic Survey 2014–15*):

- Revenue surplus as a proportion of GDP during 2013–14 (RE) was negligible compared to the previous year's 0.2 per cent. For the year 2014–15, the consolidated revenue surplus is projected to increase to 0.4 per cent of the GDP.
- Capital outlay-GDP ratio during 2013–14 (RE) increased marginally by 0.4 per cent over the previous year, indicating improvement in the quality of expenditure.
- Gross fiscal deficit (GFD) and primary deficit as proportions to GDP are budgeted to decline to 2.3 per cent and 0.8 per cent respectively in 2014–15 from 2.4 per cent and 0.9 per cent respectively in 2013–14 (RE) pointing out the intent for fiscal consolidation by states.
- The projected decline in GFD-GDP ratio in 2014–15 is mainly due to an increase in the revenue receipts resulting from current transfers from the centre.
- The expenditure pattern shows that the committed expenditure-GDP ratio (comprising interest payments, administrative services, and pension) will broadly remain unchanged during 2014–15 (BE), while overall expenditure as a ratio to GDP is budgeted to increase.

After the recommendations of the *14th Finance Commission* are implemented, the fiscal

66. Based on Budgets of 26 states (five based on Vote on Account.). *Source:* ***Economic Survey 2014–15.***

space and performance of states are expected to get strengthened.

CONSOLIDATED GENERAL GOVERNMENT

The fiscal performance of the economy (centre and states taken together) have shown improvements in recent years. The fiscal deficit of the centre was estimated to be **4.6** per cent in 2013–14. With the fiscal deficit of states at **2.4** per cent of GDP in RE 2013–14, the fiscal deficit of consolidated general government (centre and states combined) was placed at 7.0 per cent of GDP in 2013–14 (RE) and estimated to decline to **6.4** per cent of GDP in 2014–15(BE).

MAJOR ISSUES IN 2015–16

As per the *Economic Survey 2014–15*, the following concerns and prospects in the area of Public Finance in the fiscal 2015–16:

1. The GoI adhered to fiscal consolidation in 2013–14, despite domestic challenges and external vulnerabilities. The 4.1 per cent fiscal deficit target of 2014–15 seems achievable in spite of slow growth of revenues and delayed disinvestment. Though, to meet this target, the some expenditure compression might be needed (which has been seen in the *Union Budget 2015–16*).
2. *Fuel subsidy* bill is expected to fall in 2015–16, led by the following factors:
   (a) declining global oil prices,
   (b) diesel-price deregulation and
   (c) direct transfer of domestic LPG subsidies to bank accounts,
   (d) inncreased revenues via increase in excise duties on petroleum and diesel.
3. Enhanced *revenue generation* is a priority for the government. To some extent this will be helped by raising the growth rate of the economy. The implementation of a well-designed GST and other tax reforms would also play a crucial role in this regard.
4. *Expenditure rationalization* is the need of the hour. In this regard, the subsidy regime of India needs 'overhauling'. The following steps can play a big role towards this aim—
   (a) Further reduction in fuel (LPG and Kerosene) subsidies,
   (b) Tackling fertilizer subsidies, and
   (c) Moving to Aadhaar-based direct cash transfers of food subsidy and other transfers.
5. *Fiscal consolidation* is a necessity but the quality of consolidation is imperative to make it sustainable. To achieve this end, it would be necessary to put in place a medium-to-long-term fiscal policy framework with explicit revenue, expenditure, and deficit targets.

NEED OF PUBLIC INVESTMENT

We see the new government at the Centre initiating several reforms. Together with the experts, the GoI also believe that this has revived the *investor sentiment*. But a real investment flow is yet to pick-up, especially from the private sector. The cause for such a situation has been identified as the "balance sheet syndrome with Indian characteristics". The *Economic Survey 2014–15* has analysed this situation in greater details.

In such a scenario, together with other measures, the most important action which has been suggested is "boosting the public investment". Merit of such an action has been emphasised by the *Mid Year Economic Analysis 2014–15,* too. The document says that reviving 'targeted public investment' will work as an engine of growth in short-term and will lead to investment flows coming in from the private sector. It has not suggested public investment as a substitute for private investment but as a means to complement and kick start investment flows from the latter.

Role of Public Investment

Several recent studies, from India and abroad, have been quoted by the Economic Survey 2014–15 to suggest an increase in the public investment—in a targeted way. Here, 'tergeted' public investment means, government investment in the sector which can generate the largest 'spillover effects' to the economy. In present time, the Railways has that level of spillover potential. The Survey agrres with the famous observation of W. W. Rostow – 'the introduction of the railways has been historically the most powerful single initiator of take-offs'[67]. The rational for such a policy action has been emphasised by referring to the follwoing documents and studies:

1. It has been found that there has been a 'link' between public and private investment in past which caused either rise or fall in the growth rate. The Central Statistics Office (CSO) data indicate that a 'boom' in private corporate investment in the high growth phase of 2004–08 was accompanied by an increase in public investment by about 1.5 per cent.

   Similarily, a decline in public investment by more than 1 percentage point between 2008–13, is accompanied by a general decline in private corporate investment by more than 8 percentage points (except an increase during 2009–10 and 2010–11).

2. The *World Economic Outlook-2014* (an IMF report)[68] noted that increases in public infrastructure investment, if efficiently implemented, affects the economy in two ways:
   (i) In the short run it boosts aggregate demand and crowds in (increases) private investment due to the complementary nature of infrastructure services.
   (ii) In the long run, a supply side effect also kicks in as the infrastructure built feeds into the productive capacity of the economy (infrastructure being the lifeline of an economy that bringing positive effects to all sectors).

   The studies of the *IMF* confirm that increase in public investment can have positive effects on output. The medium-term public investment multiplier for developing economies is estimated to be between 0.5 and 0.9, however, the magnitudes depend on the efficiency of implementation.

3. In order of boosting public investment there are the *two challenges* in this regard are—
   (i) Mobilisation of the financial resources to enhance public investment, and
   (ii) Implementation capacity.

   To the extent implementation capacity is concerned, a sector with the maximum positive 'spillovers' together with proven capacity for investing quickly and efficiently, can serve the purpose. Two such sectors are: rural roads and

67. W. W. Rostow, ***The Process of Economic Growth***, Oxford, Clarendon Press, 2d edition, 1960, pp. 302-303 cited in B. R. Mitchell,The Coming of the Railway and United Kingdom Economic Growth, ***The Journal of Economic History,*** 24(3), September 1964.

68. ***World Economic Outlook-2014,*** IMF, *Is it Time for an Infrastructure Push? The Macroeconomic Effects of Public Investment*, Chapter 3, October 2014.

railways. Enhancing road connectivity can have a huge positive spillover on the economy—this has been shown by recent studies[69]—the examples in case are the National Highways Development Project and the PM Gram Sadak Yojana of early 2000s. These public investment moves encouraged rurl employment and earnings.

The *Survey* believes that the present government should encourage public investment in the hetherto neglected railways sector—it has the potential to have similar effects on the economy as the road sector could do in past. This has the potential to *crowd in* greater private investment and without jeopardising India's public debt dynamics.

4. Public investment has direct positive bearings on the growth prospects, as per the empirical studies. India's productivity surge around 1980 was due to boost in productivity led by enhanced public investments in the infrastructure sector (in contrast to the demand creating effects).[70] The study analyses the effects on overall growth using a framework[71] where government infrastructure services are an input into private production. The results of the study indicate that allowing for the appropriate lag (of around five years) between public infrastructure spending and growth, the former can explain around 1.5-2.9 percent of overall growth.
5. A study[72] by the RBI reports the *long run* multiplier (of capital outlays on GDP) to be 2.4. The study also confirms that the effect of revenue expenditure on GDP, though high, fades out after the first year, suggesting gains from reprioritizing expenditures.

Thus, the Survey has emphasised abig role of enhancing public investment in the railways sector. It could be started as only public investment. But soon, the impetus given by the government will generate enough avenues and new possibilities that the sector will start attracting enough investment flows from the privates sector. Once such an effect is visible then there are several possible alternatives to promote investment—the PPP to dedicated private inevstments. Railways being a lead infrastructure sector it will bring in multi-dimensional positive spillovers in the economy. Linking people and places has great potential in creating great many numbers of openings in the economy.

69. Asher, Sam & Paul Novosad, *The Employment Effects of Road Construction in Rural India*, 2014, Working Paper, quoted by the ***Economic survey 2014-15***.
70. Rodrik, D. & A. Subramanian, *From* 'Hindu Growth' to Productivity Surge: The Mystery of the Indian Growth Transition, 2005, ***IMF Staff Papers,*** 52(2).
71. Robert Barro ("Government Spending in a Simple Model of Endogenous Growth", 1990, ***Journal of Political Economy,*** 98(5))
72. Reserve Bank of India, *Fiscal Multipliers in India,* Box II.16, ***Annual Report 2011-12***.