

Legislation on Fiscal Responsibility and Reserve Bank's Role: Some Issues *

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I am thankful to Mr. Mathur for giving me this opportunity to participate in this workshop. Mr. Mathur's letter of invitation stated that "In India there is an urgent need for improved management of national finances", and the Reserve Bank of India has been advocating fiscal prudence, especially since the reform process started about a decade ago. The subject is vast and complex, and in this speech, the issues relevant for a legislation on fiscal responsibility in India will be addressed with special reference to the role of the RBI.

Context and Urgency

The urgency for improving the management of public-finance, both at the Centre and States has been well-recognised and articulated. However, there are two recent developments that necessitate urgent actions.

First, the Central Statistical Organisation has released a fortnight ago, Quick Estimates of National Income, Consumption Expenditure, Saving and Capital Formation for 1998-99. There had been a fall in the rate of Gross Domestic Saving as a percentage of GDP at current market prices from 24.7 per cent in 1997-98 to 22.3 per cent in 1998-99. All the three constituent sectors, viz., household, private corporate and public experienced lower saving rates. The fall in saving-rate is most marked in case of public sector to almost zero from 1.4 per cent of GDP in 1997-98. The dis-saving of Government administration at Rs.71, 939 crore rose so high, as to nullify the savings of both departmental and non-departmental enterprises resulting in a negligible contribution of public sector of Rs.572 crore. Private Final Consumption Expenditure as a percentage of GDP, at current market prices fell from 64.5 per cent in 1997-98 to 63.6 per cent while there has been a corresponding increase in Government Final Consumption Expenditure from 11.3 per cent to 12.3 per cent.

Further, the fiscal situation, especially fiscal transparency is no longer a matter of domestic concern alone. India is important in the world-economy, and has been recognised as such in view of its membership in G-20. Clearly, we not only influence but are also influenced by global economic developments. We need to benchmark our codes and practices with best international practices. We are doing it through a Standing Committee constituted by Governor Jalan, in which both the RBI and Ministry of Finance are represented. Fiscal aspects are an extremely significant component of the transparency regime. Whether through specific legislation or otherwise, our fiscal processes have to meet global standards, while the quality of fiscal management would influence both our growth-prospects and standing in the world-economy.

Peep into the past

It will not be appropriate to conclude from the above considerations alone that there is a

sudden provocation or realisation in favour of sound fiscal management.

Mr. Premchand, world-renowned expert on the subject mentions that in the late nineteenth century, a Royal Commission on Expenditure in India called Welby Commission explored reductions in Government expenditure.

There must be many reasons why the strategy has not succeeded, and here also, a reference to nineteenth century India may not be out of place: and I quote from a footnote of Mr. Premchand's book on Government Budgeting and Expenditure Controls (page 276). Writing about the Indian Government's efforts towards economy in expenditure, Sir Richard Temple observed "some who preach economy as a rule seem to think that a favourite project is to be the exception; the sense of its particular merits causes the general maxims to be forgotten" (India in 1882 (London: Macmillan), p. 449).

Even in pre-independent India, there was a piece by Mahatma Gandhi in Young India, in Financial and Economic Supplement, Ahmedabad, Thursday May 10, 1923, which reads as follows:

"In every modern civilised community the outlay of public funds, collected by contributions from the community in a variety of forms, calls forth the liveliest interest from the tax-payers, and demands the greatest carefulness from the authorities entrusted with the outlay. In theory, at least, the layout of these monies must be, like the sowing of the seed by the farmer, in the hope and with the intention that it would be returned a hundred-fold to the sower. But this supreme principle of public expenditure seems never to have been learnt by the Government in India".

As brought out by Mr. Pandey of Ministry of Finance, who has worked extensively on the subject, the issue of fiscal management had come up for detailed discussion in the Constituent Assembly also while debating Articles 292 and 293, enabling ceilings on borrowings to be imposed by Parliament. Among those who advocated more stringent provisions was Mr. H.V. Kamath who said that "the purpose of the loan goes to the root of the matter", and hoped that "not merely the financial limits but also the purpose of every loan will come before Parliament for its approval".

The issue appears to have been clinched by the eloquence of Dr. B.R. Ambedkar when he said, "this article specifically says that the borrowing power of the executive shall be subject to such limitations as Parliament may by law prescribe. If Parliament does not make a law it is certainly the fault of Parliament and I should have thought it very difficult to imagine any future Parliament, which will not pay sufficient or serious attention to this matter and enact a law. We hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the Union. I go further and say that I not only hope but I expect that Parliament will discharge its duties under this article".

The issue of fixing borrowing limits by the Parliament was no doubt, raised time and again, by Estimates Committee in 1957-58, and in some of the subsequent reports of

Estimates Committee and Public Accounts Committee. However, no Parliamentary or legislative action to fix a limit on borrowing has been taken so far.

However, the present thinking on Fiscal Responsibility is slightly different from debt-ceiling and could go either beyond a mere ceiling on borrowings or could fall short of it by focussing on transparency-issues. There is a link between ceiling on debt and fiscal responsibility, but they are not the same and in that sense, the present proposal is different from the debates in past.

Role of RBI in the Process

It is useful to explain the role of the RBI in the events leading up to the current proposal for a legislation on Fiscal Responsibility (FR). Firstly, the RBI has been in the forefront of sensitising the policy makers to the consequences of fiscal dominance. Secondly, automatic monetisation of budget deficit by the RBI was discontinued. Thirdly, some caution, if not a limit, on the RBI's net support to Government's borrowing programme has been accepted in the arrangements leading to the scheme of Ways and Means Advances for Government of India. Fourthly, the RBI had already highlighted the importance of a statutory ceiling on debt through a Technical Paper published in the RBI Bulletin of December 1997. Fifthly, the RBI has been trying to advocate prudence in extending sovereign guarantees, which has resulted in some States passing legal enactments and Government of India creating a guarantee fund. Sixthly, State Finance Secretaries are already working as a Committee assisted by the RBI, on issues relating to integrity of budget process and transparency in budget. Seventhly, RBI conducted a seminar a few months ago, in which senior officials of Centre and State participated, on matters relating to fiscal rules and related international practices.

More recently, Finance Minister announced a decision to pilot a Bill on Fiscal Responsibility, and Government of India, therefore, desired that the RBI which is not only the monetary authority but also a banker to Government, and a debt manager to Government should have a Working Group to assist in the preparation of Fiscal Responsibility Bill. In the light of the deliberations of the Working Group, a Government of India committee on FR has been constituted with Secretary (Economic Affairs) as Chairman and Deputy Governor, RBI as one of the members. The working group of RBI is still expected to provide technical inputs to this process, with two experts, viz. Dr. Lahiri of Institute of Public Finance and Policy and Dr. Mitra of National Institute of Law, being members in both the Working Group of the RBI and the Government Committee.

Objectives

The thrust of FR in a specific context could be several of the many possible objectives such as: (a) inter-generational equity, (b) macro-stability, (c) fiscal sustainability and fiscal solvency, (d) elimination of deficit bias, (e) fiscal transparency, (f) fiscal accountability, including penalties, (g) autonomy of monetary policy, including limits on access of Government to central bank credit, and (h) choice of fiscal measures to achieve

efficient or optimal outcomes.

A legislation on FR may have to focus on a medium term framework in addition to annual budget, methods of promoting prudent fiscal behaviour, enhancing transparency in all government policies having a bearing on fiscal management and finally, accountability.

Further, such a legislation should address the core issue of enhancing fiscal efficiency in terms of resource mobilisation and allocation of expenditures.

The issues for us are: how to meet these objectives without eroding supremacy of Parliament itself in matters relating to fiscal management; and with suitable flexibility needed to meet emerging situations. The Parliamentary system and federal nature of our polity would add to the complexities in the design and implementation of a legislation, and some of these have been alluded to in the debates of Constituent Assembly.

Institutional Issues

The more important institutional issues would perhaps be: (a) whether there is a need to bring about FR through a new constitutional provision, or a mere law, and if it is the latter, whether it should be linked to the existing constitutional provisions on ceilings on debt and guarantees; (b) whether the FR would be passed by Parliament to cover only the Centre or whether it should be made applicable to all States in addition, by obtaining necessary authorisations, or whether it should leave the matter to the concerned States with or without some persuasion or through a model law by Centre; (c) whether the law should be so designed as to avoid or limit judicial interpretation and jurisdiction; (d) whether the convention of secrecy of budgetary process is consistent with the most significant aspect of FR, namely transparency. It can be argued that, except where anticipatory actions are possible, such as specific tax-measures, secrecy is not warranted and indeed secrecy of budget process stifles transparency of not only annual exercise, but also medium-term, and perhaps intra-year measures.

Fiscal Policy Rules

There are universally recognised fiscal policy rules, and legislation incorporates one or several specific targets or ceilings or conditionalities or even prohibitions. There are broadly three types of rules, balanced-budget or deficit rules; borrowing rules and debt or reserve rules.

Of direct relevance to the RBI is a borrowing rule that prohibits or limits borrowing by government from a central bank.

The FR has to balance between a credible rule, quantitatively determined and need for flexibility in fiscal management. Yet another aspect relates to the time frame within which these rules can be implemented. It is possible to visualise milestones, on these rules, incorporated into the legislation or enabling provisions made in FR to fix

milestones from time to time.

Accounting Issues

Significant operational issues relate to accounting principles and practices. These would include budget coverage, adoption of accrual system to some degree, projections or medium term parameters, explanations for short-term deviations, valuation of assets at market value or foreign currency liabilities at current rate of exchange, contingent liabilities accounting and providing therefor, etc.

Fiscal Management Issues

Illustratively, fiscal management issues in our country comprise: (a) the fact that a significant part of liabilities is not covered by assets even as per current valuation methods; (b) a significant part of current expenditure is “charged”; (c) there is passive growth of salaries, pensions, dearness allowance etc.; (d) there are also vertical and horizontal issues. If FR is imposed rigidly on Centre there can be impact on States and differential impact among States, (e) the overhang of the past makes corrections possible only over the medium term, and hence need for delineation of transition path from the current situation to full-fledged fiscal responsibility.

Procedural Issues

The most important procedural issue relates to defining a trigger for what constitutes non-compliance with fiscal responsibility, warranting corrective action, and if so what are the corrective actions. At one extreme, there may just be reputational risk, while at the other extreme, there could be automatic revenue enhancement, or expenditure containment.

Apart from defining trigger and options of automatic sequestration or revenue surcharges, since the budget is annual, the tracking of intra-year situation becomes critical. This is particularly relevant in view of the acute intra-year mismatches observed between receipts and expenditures both at Centre and States.

The penalty for non-compliance should be built into the process, recognising that repudiation through revision of law itself is not impossible, since this was done by Parliament in several cases. Further, a view has to be taken on who should be the monitoring authority or authorities to track and disclose degree of compliance – Comptroller and Auditor General, Parliamentary Committee or Oversight Committee of eminent experts.

Whether and how budget documentation needs to be altered and intra-year reporting documentation introduced (say every quarter) to Parliament would also have to be considered. In particular, a case is made out by some experts for periodical reporting directly to public, with remarks of Oversight Committee of experts in addition to reporting and accountability to Parliament.

Another issue is whether Oversight Committee, without prejudice to Parliamentary Committee, should indulge in a pre-budget review or only post-budget review, and whether it should be concerned with intra-year reviews.

There is, in cases of some countries, personal accountability, of say the Minister for the estimates and adherence to it. It has to be seen whether such accountability is feasible in India.

Finally, there are a set of issues relating to the RBI itself. Recognising that the ultimate fiscal authority is with Parliament and that cannot be constrained except by self imposition, should FR bar automatic monetisation by the RBI or prescribe rules for it and should the RBI be banned from participating in primary issues of Government stock and finally should FR promote effectiveness of monetary policy by divesting it of its role as Public Debt Manager?

Procedural Coordination with States

Inevitably, there would be need for a coordination in many areas of fiscal management, between Centre and States. This could conveniently extend to even procedures relating to tax administration, which may be desirable irrespective of a view on FR.

Let us take an example. States have recently agreed to adopt uniform floor rates of tax in respect of sales tax. This is only the first step towards having uniform rates of taxation. However, neither uniform floor rates nor uniform rates of tax would be meaningful unless there is a standard and universally accepted classification of goods. The customs and Excise Departments of Government of India adopted the Harmonised System of Nomenclature at the eight-digit classification, though not the twelve-digit classification currently in use in Europe.

Perhaps, Central Government should urge all the States to adopt a standard and universally accepted classification of goods for effective coordination of revenue-administration. Government of India may have to consider several such initiatives to ensure what may be termed as sound all-India fiscal management.

Concluding Remarks

It is a matter of satisfaction that the issue of sound fiscal management has gained national attention.

The proposal for a Fiscal Responsibility Act has gained significant national consensus and needs to be pursued with great care, so that it is not too rigid inviting circumvention, it is not too flexible defeating the purpose and it does not envisage too rapid a change lest it becomes disruptive.

From the Reserve Bank's point of view, this initiative for FR provides an opportunity to realise a suggestion made, in its Annual Report of 1991-92 which reads as follows:

“To ensure that the monetised deficit does not have deleterious effects on the economy, there is a need for a law restricting the extent to which the Centre can run a deficit and moreover there should be a legal ban on the Government borrowing from all sources beyond a certain ceiling with a sub-ceiling on borrowing from the Reserve Bank of India”.

* Speech delivered by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at the Workshop on Fiscal Responsibility of Government, organised by National Institute of Financial Management, Faridabad, Haryana, at India Habitat Centre, New Delhi, on February 15, 2000.