Kerala sought a relaxation of FRBM rules

Part of: GS Prelims and GS-III- Economics

Kerala is seeking relaxation from the provisions of the Fiscal Responsibility and Budget Management (FRBM) Act.

Kerala Economic package:

- **Kerala had announced an economic package of 20,000 crore rupees** to mitigate the impact on livelihoods and overall economic activity from the steps taken to battle the COVID-19 pandemic.
- To help fund the emergency relief package, Kerala proposes to **borrow as much as 12,500 crore rupees** from the market.

Details:

Fiscal Responsibility and Budget Management (FRBM) Act:

- The FRBM Act was **enacted in August 2003**.
- The FRBM Act is aimed at making the Central government responsible for **ensuring inter-generational equity in fiscal management and long-term macro-economic stability**.
- The Act envisages the setting of **limits on the Central government’s debt and deficits** as well as mandating greater **transparency in fiscal operations** of the Central government and the conduct of fiscal policy in a medium-term framework.
  - Every Budget of the Union government includes a **Medium-Term Fiscal Policy Statement** that specifies the annual revenue and fiscal deficit goals over a three-year horizon.
  - The act envisages a **longer-term glide path to achieve the key objective of reducing the fiscal deficit to 3% of GDP** within a specified time frame. Currently, the government has set a **deadline of March 2023** for ensuring a fiscal deficit target of 3.1%.
- To ensure that the States too are financially prudent, the **12th Finance Commission’s recommendations in 2004 linked debt relief to States with their enactment of similar FRBM acts**.
  - The States have since enacted their **own respective Financial Responsibility Legislation**, which sets the same 3% of Gross State Domestic Product (GSDP) cap on their annual budget deficits.

Kerala seeking flexibility under the FRBM:

- Kerala’s current fiscal position means that it can borrow about **25,000 crores** during the financial year 2020-21.
- Given that Kerala proposes to raise **12,500 crore** through borrowings in April 2020 itself, it could be **severely constrained in its borrowing and spending ability** over the remaining 11 months of the financial year, due to the stringent borrowing cap under the fiscal responsibility laws.
- This could affect **the State’s socio-economic programs** as well as the post-pandemic recovery apart from undermining the state’s continued mitigation efforts against COVID-19.
Kerala has urged the Centre to provide Kerala with flexibility under the Fiscal Responsibility and Budget Management (FRBM) Act.

Relaxation under the FRBM act:

- The FRBM act does contain provisions for relaxation from FRBM clauses. This is commonly referred to as an ‘escape clause’.
- Under Section 4(2) of the Act, the Centre can exceed the annual fiscal deficit target citing grounds that include:
  - National security,
  - War,
  - National calamity,
  - Collapse of agriculture,
  - Structural reforms and
  - A decline in real output growth of a quarter by at least three percentage points below the average of the previous four quarters.

Past precedents of relaxing FRBM norms:

- There have been several instances of the FRBM goals being reset.
  - Recently, the Budget for 2020-21 had cited the recent reductions in corporate tax as structural reforms, triggering the escape clause.
    - This enabled the government to recalibrate the fiscal deficit target for 2019-20 to 3.8%, from the budgeted 3.3%. It also changed the deficit target goal for 2020-21 from 3% to 3.5%.
  - The most significant FRBM deviation happened in 2008-09, in the wake of the global financial crisis, with the Centre resorting to a fiscal stimulus.
    - Tax relief was provided to boost demand
    - Public expenditure was increased to create employment and public assets, to counter the fallout of the global slowdown.
    - This led to the fiscal deficit climbing to 6.2%, from a budgeted goal of 2.7%.
    - Simultaneously, the deficit goals for the States too were relaxed.

Arguments in favor of suspending Fiscal targets:

- The following two aspects could be used for suspending both the Centre’s and States’ fiscal deficit targets.
  - Given the extraordinary circumstances, COVID-19 pandemic could be considered as a national calamity.
  - The ongoing pandemic in conjunction with the ongoing lockdown will cause a severe contraction in economic output.
- This would allow both the Union government and States including Kerala to undertake the much-needed increases in expenditure to meet the extraordinary circumstances.
- Given the past precedents and the unprecedented nature of the pandemic and its devastating impact on the global economy, another significant deviation from the FRBM norms is very likely in the current and next fiscal years.

NK Singh FRBM review committee

The FRBM Review Committee headed by former Revenue Secretary, NK Singh was appointed for the implementation of FRBM. In its report submitted in January 2017, titled ‘The Committee in its Responsible Growth: A Debt and Fiscal
Framework for 21st Century India, the Committee suggested that a rule based fiscal policy by limiting government debt, fiscal deficit and revenue deficits to certain targets is good for fiscal consolidation in India.

Why a rethinking on FRBM was needed?

After nearly twelve years into running of the FRBM (2003) legislation, there was a big debate on whether the deficit target or not. One group argued that in a developing country, government has to make lot of expenditure and an upper ceiling will reduce government involvement. The opposite group countered that loosening of the target will led to excess expenditure, government debt, inflation and several other macroeconomic problems besides creating intergenerational inequality. The Committee thus was to suggest a way out. Specifically, the Committee has to make suggestions on a common fiscal deficit range than a fixed target (like 3% of GDP). Similarly, the committee should suggest changes required in FRBM in the context of rising global uncertainties.

The general perspective of the FRBM Review Committee

Before going into the point-by point presentation of the NK Singh Committee’s suggestions, it is important to look at the overall perspective adopted by it about borrowing run (fiscal deficit) government budget in the Indian context.

The FRBM Review Committee’s philosophy is visible in its report throughout and is that in a country like India, where budgets are framed by accommodating populist pressures, activist or discretionary fiscal policy with high fiscal deficit has limitations.

“The maxim that “you cannot spend your way to prosperity” is now widely accepted. Fiscal policies must therefore be embedded in caution than exuberance. In restraint than profligacy.” The Committee cited evidences that in the recent past, the economy faced troubles whenever the government made high expenditure by shooting over the FRBM targets.

At the same time, when some crisis like the 2007-08 appears, fiscal policy should have some flexibilities. Here, the Committee suggested a carefully crafted escape clause allowing higher fiscal deficit. This escape clause is ‘rule based’ (smart rules) and not ‘discretionary’.

Following are the main recommendations of the NK Singh Committee.

1. Public debt to GDP ratio should be considered as a medium-term anchor for fiscal policy in India. The combined debt-to-GDP ratio of the centre and states should be brought down to 60 per cent by 2023 (comprising of 40 per cent for the Centre and 20% for states) as against the existing 49.4 per cent, and 21% per cent respectively.

2. Fiscal deficit as the operating target: The Committee advocated fiscal deficit as the operating target to bring down public debt. For fiscal consolidation, the centre should reduce its fiscal deficit from the current 3.5% (2017) to 2.5% by 2023. Justifying the target of 2.5% to be realized in the next six years, the Committee observed that debt sustainability analysis (DSA) conducted for the central government suggests such a target (for fiscal deficit) will help to achieve the public debt target of 40% for the centre by 2023.

3. Revenue deficit target

The Committee also recommends that the central government should reduce its revenue deficit steadily by 0.25 percentage (of GDP) points each year, to reach 0.8% by 2023, from a projected value of 2.3% in 2017.

The Committee advised government to follow the golden rule here ie., not to finance government’s day to day activities from borrowings. Revenue deficit implies financing of government’s day today activities from borrowings.

Table: Fiscal roadmap for 2023 and the targets for the Centre (figures are as a percent of GDP) FD is fiscal deficit and RD is revenue deficit.

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt/GDP</th>
<th>FD</th>
<th>RD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Year</td>
<td>GDP Growth</td>
<td>Tax Buoyancy</td>
<td>Commodity Prices</td>
</tr>
<tr>
<td>------</td>
<td>------------</td>
<td>-------------</td>
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</tr>
<tr>
<td>2017</td>
<td>49.4</td>
<td>3.5</td>
<td>2.3</td>
</tr>
<tr>
<td>2023</td>
<td>38.7</td>
<td>2.5</td>
<td>0.80</td>
</tr>
</tbody>
</table>

Source: NK Singh Committee Report

4. Formation of Fiscal Council to advice the government.

The Committee advocated formation of institutions to ensure fiscal prudence in accordance with the FRBM spirit. It recommended setting up an independent Fiscal Council. The Council will provide several advisory functions. It will forecast key macro variables like real and nominal GDP growth, tax buoyancy, commodity prices. Similarly, it will do a monitoring role, besides advising and also specify a path of return.

5. Escape Clause to accommodate counter cyclical issues:

The NK Singh Committee points out that there are disadvantages with set fiscal deficit target if some economic instabilities like an external crisis affects the Indian economy. For example, the government has to spend more during the time of a recession and hence it need not restrict its borrowing to keep the fiscal deficit target. Hence, the committee advocates countercyclical covers in fiscal policy while following the FRBM.

Here, the committee recommends fiscal flexibilities to go above or below the fiscal deficit targets in the form of ‘escape clauses’. The Committee set 0.5% as escape clause for fiscal deficit target.

What is escape clause?

The flexibility to adjust with cyclical fluctuations (boom/recession) is incorporated under the “escape clauses” where temporary and moderate deviations can be made from the baseline fiscal path. This can happen in specific circumstances and in reaction to external shocks. To ensure that these “escape” clauses are not mis-used, the Committee suggests several specific guidelines. The escape clause can be used only during the time of following essential circumstances:

- Over-riding consideration of national security, acts of war, calamities of national proportion and collapse of agriculture severely affecting farm output and incomes.
- Far-reaching structural reforms in the economy with unanticipated fiscal implications.
- Sharp decline in real output growth of at least 3 percentage points below the average for the previous four quarters.

Deviation from the stipulated fiscal deficit target shall not exceed 0.5 percentage points in a year.

The Escape Clauses can be invoked:

(a) by the Government after formal consultations and advice of the Fiscal Council.

(b) with a clear commitment to return to the original fiscal target in the coming fiscal year.

6. Buoyancy: What the government has to do with fiscal deficit target when higher economic growth occurs?

The Committee also advocates that that the policy responses to sharp changes in output growth should be symmetric (to that of the escape clause). This implies that during higher economic growth, fiscal deficit should be reduced accordingly. (Here, in the case of growth fall, fiscal deficit target can be raised using the escape clause).

7. Fiscal consolidation responsibility for states
The Committee observes that state government’s fiscal position is important after greater resource transfer (Fourteenth Finance Commission award). Now, total state expenditures (as a percent of GSDP) is now even greater than the Centre. Hence, fiscal consolidation should also be made by the states. They should bring down their debt target to 20% of GDP from the current 21%.

8. Congruence of Fiscal and Monetary Policy

The FRBM Review Committee observed that both monetary and fiscal policies must ensure growth in a complementary manner. For this, the Inflation Targeting (IT) regime and Fiscal Rules (FRs) have to interact.