Understanding deviations from the fiscal responsibility law in India

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Abstract

The Parliament enacted the Fiscal Responsibility and Budget Management Act (FRBM Act) in 2003. In most of the following years, union public finance has deviated from the strictures of the law. Was it poor drafting of the statutory escape clause in the *FRBM Act*, 2003 that led to these deviations? We show that this is not the correct diagnosis. The escape clause that flows from the *Constitution of India* - the special procedure for money bills - gives the union government the ability to get around shackles placed under Parliamentary legislation. If fiscal rules are sought to be implemented through laws, the legal strategy needs to take this constitutional framework into account.

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Contents

1 Introduction

A government has a fiscal deficit if in a given year it spends more that what it earns through its non-debt creating receipts (revenue and capital).[1] This gap is financed through borrowing, which adds to the public debt.

Deficits are merely deferred taxes. If deferring taxes today can, as a side effect, induce enhanced GDP, then it is in the interests of the people. However, the incentives of ruling politicians are different from those of the people. Politicians may want to spend much more than what the revenue can sustain in the long-term, in a bid to woo their electorate for short-term gains like winning an election.[2] This may get reflected in successively higher and persistent public debt, thus imposing a higher financial burden in the form of taxes on future generations of citizens or a cutback in essential public expenditure.

Every liberal democracy faces these questions, and a variety of checks and balances are part of the institutional design, to help improve the decision making in the fiscal process. Fiscal rules embedded in laws can be one component of this framework.

Simplistic rules that impose absolute restrictions on the government's discretion to borrow could be counter-productive. When there is a pressing need to borrow (to defer taxation), e.g. in a war, simple rules can create poor outcomes. As an example, in the US, fiscal rules have created occasional shutdowns of the federal government.[3] For instance, on October 17, 2013, former US President Barack Obama signed a bill to temporarily suspend the debt limit of the US government, ending a two-week partial shut down of the US federal government. Fiscal responsibility law needs to balance these considerations.[4]

There is a legitimate debate, among public finance economists, about the choice of the optimal fiscal rule, one that achieves debt stability while preserving a certain extent of counter-cyclical fiscal policy (i.e. the ability to enlarge the deficit in bad times). This public finance research program involves identifying optimal paths for fiscal policy, and judging the extent to which the Indian experience diverged from this. In contrast, in this paper, we focus on law. When the union government violated the requirements of a stated fiscal responsibility law, we consider this a deviation *from the law* and the associated 'invisible infrastructure' of the legal

[1] Ministry of Finance 2023.

[2] Electorates can sometimes be tempted to compromise their interest (and the interest of future generations) in democratic governance over the long term for (often illusory) short-term promises. Khaitan, T. 2020, p. 7.

[3] Datta and Pandey 2019.

[4] Pratik Datta, Radhika Pandey 2017.

system. In this paper, we engage in a root cause analysis of the observed deviations.

Fiscal thinkers in India built towards the *FRBM Act*, 2003. This imposed limits on central government borrowings, debt and deficits, and brought in greater transparency in the fiscal operations of the union government. It is now widely acknowledged that in most years following the law, the budgeted and then actual values were in violation of the law.[5] Economists and policymakers have often blamed the poorly drafted statutory escape clause in the *FRBM Act*, 2003 as one of the reasons for this failure. This analysis implies the need for amendments to the escape clause, as was suggested in the *FRBM Review Committee Report*. Accordingly, the *Finance Act*, 2018 amended the statutory escape clause in the *FRBM Act*, 2003 to make it more precise and narrow. In this paper, we show that the failure of *FRBM Act*, 2003 was not because of the statutory escape clause.

The main idea of this paper is that the escape clause in-built within the *Constitution of India* - the special procedure for money bills - gives the union government the full ability to bypass the constraints imposed by Parliamentary law. There is a small literature in India on the difficulties of money bills as enshrined in the Constitution.[6] This paper constitutes one additional element of that literature.

Since India follows the *Westminster* model of parliamentary democracy, the legislature has weak control over the budgetary process. The cabinet approves the budget framed by the executive and also enjoys the confidence of the Lok Sabha. Because of this inherent lack of separation of powers, the executive wields immense influence in the Lok Sabha to get a Finance Bill enacted as a money bill. Consequently, any provision of a fiscal responsibility statute, which is not to the liking of the executive government, could be amended by the government using the money bill route through the Lok Sabha alone. The fact that a money bill that loses in the Parliament is tantamount to the collapse of a government ensures that the ruling party will ensure that this wins. This crowds out debate and discussion on fiscal responsibility violations. Therefore, even the most well-drafted fiscal responsibility statute is unlikely to constrain the government's fiscal discretion.

The remainder of this paper is organised as follows. Section 2 explains the journey to the *FRBM Act*, 2003, its key features, and their evolution through various amendments. Section 3 explains the problem of money bills in the context of the *Constitution of India*. Section 4 shows the evidence on how the money bill route has been used to break past fiscal responsibility restrictions in the past. Section 5 situates India's constitutional system in a conceptual framework to help identify

[5] The claim that the deviation from fiscal deficit target during 2008-09 was due to the fiscal stimulas provided during the global financial crisis has been contested. Roy and Kotia 2017.

[6] Datta, P., Malhotra, S., Tyagi, S. 2017.

the fundamental challenges in imposing fiscal constraints on the Indian government through legal instruments. Section 6 concludes that in order to effectively restrain the Indian government's ability to amend fundamental fiscal rules unilaterally, alternative mechanisms need to be devised, taking into account the existing constitutional framework of India.

2 The journey to FRBM Act, 2003

2.1 Background

The source of the fiscal reponsibility law in India is embedded in Article 292 of the *Constitution of India*, which states:

> The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.

The framers thus intended the union government to have the power to raise finances for any purpose within the domain of the union.[7] The Parliament could impose limitations and conditions on this borrowing power of the union government.[8] However, the Parliament did not enact any such law for more than five decades since independence.

Conceptually, the government could either borrow from the market or the Reserve Bank of India (RBI). From the RBI, the government could borrow in two ways. First, the government could issue treasury bills or government securities to the RBI. Second, the government could enter into a Ways and Means agreement with the RBI for its borrowing needs to overcome short-term liquidity constraints. In practice, the government used the first route - it would borrow from the RBI

[7]Initially, the Cabinet Mission's Plan, commonly known as the *White Paper*, had proposed the Union of India should only deal with foreign affairs, defence and communications; and it should have the power to raise necessary finances for those subjects only. However, after the withdrawal of the Muslim League and the partition, the framers preferred a strong central government in order to maintain peace and to ward off external aggression. Consequently, the Second Report of the Union Powers Committee recommended that the Union List be expanded and residuary powers be vested with the Centre. Rao 1967b, pp. 776.

[8]This arrangement was originally proposed by the Cabinet Mission's Plan in 1946. There was hardly any disagreement on this arrangement subsequently, although the items to be covered under the Union, State and Concurrent Lists were extensively debated. Rao 1967a, pp. 213.

against treasury bills in an *ad hoc* manner. This essentially led to automatic monetisation of fiscal deficit.

Successive Estimate and Public Accounts Committees of the Parliament repeatedly urged the government to fix borrowing limits for the union government. In the early 1990s, the RBI also repeatedly urged the government to place restrictions on union government deficits and consider a ceiling on public debt. However, the Ministry of Finance emphasised operational difficulties in setting fiscal deficit targets, given lags in the availability of Gross Domestic Product (GDP) numbers. This viewpoint changed over time. Only the Comptroller and Auditor General of India (CAG) was of the view that no fresh fiscal responsibility legislation was needed since a ceiling on government borrowings could be prescribed by law under Article 292.[9]

The second half of the 1990s saw a steep surge in the fiscal deficit of both the union and state governments. The combined fiscal deficit widened to 8.6% in 1984-1985 and breached 9% of GDP in the following years.[10] Other variables such as interest payments to revenue receipts and interest payments as a proportion of total revenue expenditure also saw a deterioration.[11] These factors shifted the climate of opinion on the need for formal fiscal rules that constrain the union government.

2.2 Sarma Committee

In the year 2000, the then Indian Finance Secretary, Dr. E.A.S. Sarma, chaired a ten-member committee to study the various aspects of the Centre's fiscal architecture and to prepare a draft legislation on fiscal responsibility. This committee submitted its report in July 2000. The recommendations of this committee could be classified across four dimensions: targets, borrowing constraints, escape clause and institutional reforms.

On targets, the committee recommended three targets - the fiscal deficit, revenue deficit and debt-to-GDP. The committee recommended a progressive reduction in the fiscal deficit by 0.33 percent of GDP at the end of each financial year so as to reduce the fiscal deficit to no more than 3% of GDP in five years, ending on March 31, 2006.[12] The committee also prescribed the complete elimination of revenue deficit over this period, through annual reductions of 0.5 percent of GDP,

[9] Roy and Kotia 2017, p. 5.
[10] FRBM Review Committee 2017.
[11] Roy and Kotia 2017.
[12] This was provided in clause 4(2)(d)-(e) of the draft bill. E.A.S Sarma 2000, pp. 8-9, 15.

and build up an adequate revenue surplus after that.[13] For the Union Government, the committee recommended a debt-to-GDP ratio of 50% of GDP in a period of 10 years commencing on April 1, 2001.[14] The draft bill, which formed part of the *Sarma Committee Report*, limited guarantees to 0.5% of GDP in any given financial year.[15]

On borrowing constraints, the committee suggested that the proposed fiscal responsibility law would proscribe union government borrowing from the RBI except through the Ways and Means Advances repayable within the same financial year to meet short-term mismatches between cash receipts and expenditures.[16]

On escape clause, the committee appreciated the need to provide flexibility in fiscal management in the event of unforeseen shocks. It recommended an escape clause in the proposed law to allow the government to deviate from the targets on grounds of national security and natural calamity. It also mandated that grounds for breaching the targets shall be immediately placed before both Houses of Parliament.[17]

On institutional reforms, the committee proposed a Fiscal Management Review Committee (FMRC). The primary remit of the FMRC would be to conduct *ex post* reviews of government budgets. Additionally, the FMRC may be tasked with intra-year reviews, particularly in light of the trend of unusually large supplementary grants that induce large differences between budget estimates, revised estimates, and actuals, and thus, undermine the budget-making process itself.[18] However, the CAG opposed the idea and held that the existence of Parliamentary and Constitutional institutions such as the Public Accounts Committee, the Estimates Committee, and the CAG itself, obviated the need for a separate FMRC.[19]

The draft bill proposed in the *Sarma Committee Report* underwent two major amendments by the Union Cabinet before being tabled in the Lok Sabha on December 20, 2000. First, the Cabinet reduced the fiscal deficit target from 3% to 2% of GDP. Second, the Cabinet deleted all references pertaining to the FMRC.

[13] This was provided in clause 4(2)(a) of the draft bill. The committee distinguished between deficit for financing current expenditure and deficit for financing capital assets. Accordingly, it suggested complete elimination of deficit for financing current expenditure and discouraging excessive deficit for building up capital assets. E.A.S Sarma 2000, pp. 8-9, 15.

[14] This was provided in clause 4(2)(g) of the draft bill. E.A.S Sarma 2000, p. 16.

[15] This was provided in clause 4(2)(f) of the draft bill. E.A.S Sarma 2000, p. 16.

[16] This was provided in clause 5(1) read with clause 5(2) of the proposed bill. E.A.S Sarma 2000, p. 16.

[17] This was provided in the proviso to clause 4(2)(f) of the draft bill. E.A.S Sarma 2000, p. 16.

[18] This was provided in the proviso to clause 7 of the draft bill. E.A.S Sarma 2000, p. 17.

[19] See the detailed comments of the CAG's representatives on the proposed Fiscal Responsibility and Budget Management Bill, 2000. E.A.S Sarma 2000, p. 34.

This new version of the bill found mention in the budget speech of 2000-01, where the Finance Minister stated:[20]

> As promised in my earlier Budget Speeches, I appointed the Expenditure Reforms Commission last year and introduced the Fiscal Responsibility Bill in this House in the last session. The bill seeks to reduce the fiscal deficit to 2 per cent and completely eliminate the revenue deficit over the next five years.

The *FRBM Act*, 2003 was enacted by the Parliament in August, 2003.

3 Key features and evolution of FRBM, 2003

The *FRBM Act*, 2003 requires the union government to ensure prudential debt management through limits on borrowings, debt, and deficits.[21] The statute gives powers to the union government to make rules to carry out the provisions of the statute.[22] Using those powers, the union government issued the *FRBM Rules*, 2004. The *FRBM Act*, 2003 itself has been amended four times through the *Finance Act*, 2004, *Finance Act*, 2012, *Finance Act*, 2015, and *Finance Act*, 2018.

Some of the crucial amendments to the statute were brought in through the *Finance Act*, 2018, based on the recommendations of the *FRBM Review Committee Report*.[23] For the limited purposes of this paper, it would be useful to focus on two fundamental features of the *FRBM Act*, 2003: targets and escape clauses.

[20] Finance Minister 2001.

[21] This is based on the preamble to the Act, which states: *An Act to provide for the responsibility of the Central Government to ensure intergenerational equity in fiscal management and long-term macro-economic stability by removing fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on the Central Government borrowings, debt and deficits, greater transparency in fiscal operations of the Central Government and conducting fiscal policy in a medium-term framework and for matters connected therewith or incidental thereto. FRBM Act* 2003, in this context, 'borrowing' is flow, while 'debt' is stock.

[22] Among other things, the Union Government has the power to prescribe the annual targets for fiscal deficit and the fiscal indicators in the rules. Before the amendment in 2018, the Union Government had the power to even prescribe the long-term fiscal deficit target. However, since the 2018 amendment, the long-term fiscal deficit target of 3% to be achieved by March 31, 2021, is now in the statute and not in the rules. *FRBM Act* 2003, sections 8, 4(1)(a).

[23] FRBM Review Committee 2017.

3.1 Targets

Till 2018, the *FRBM Act*, 2003 and the rules framed thereunder specified three targets and a time path for eliminating or containing those targets. These targets were: revenue deficit, effective revenue deficit and fiscal deficit.[24]

'Revenue deficit' meant the difference between revenue expenditure and revenue receipts, which indicates increase in liabilities or draw down of the assets of the government. In other words, increase in revenue deficit would indicate that the government is spending more on current expenditure (such as salaries, pensions etc. which do not result in long term asset creation) as against its revenue receipts (such as tax revenue, dividends and profits from PSUs etc.).[25] 'Effective revenue deficit' meant the difference between the revenue deficit (mentioned above) and the grants to states for creation of capital assets. In other words, effective revenue deficit excluded from revenue deficit the grants made by the union government to the state governments, constitutional bodies etc. that may be used for creating capital assets.[26] 'Fiscal deficit' means the excess of total disbursements from the consolidated fund of India excluding repayment of debt, over total receipts into the fund (excluding the debt receipts), during a financial year.[27] These targets are usually expressed as a percentage to GDP of the country.

Till the amendments in 2012, section 4(1) of *FRBM Act*, 2003 used to state:

> The Central Government shall take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by the —- and thereafter build up adequate reserve surplus.

The blank space was originally March 31, 2008. The *Finance Act*, 2004 changed it to March 31, 2009.

Subsequently, in 2009, the implementation of the *FRBM Act*, 2003 itself was sus-

[24] From 2003 to 2012, there were only two targets - fiscal deficit and revenue deficit. However, the fiscal deficit target was mentioned only in the rules prescribed by the union government under the statute. In 2012, the third target - effective revenue deficit - was introduced in the statute. In 2018, the fiscal deficit target was moved from the rules to the statute itself. A new target - debt-to-GDP was added. The earlier two targets - revenue deficit and effective revenue deficit - were discontinued. *FRBM Act* 2003, section 4(1).

[25] Revenue deficit is no more targeted since 2018. *FRBM Act* 2003, Section 2(e).

[26] The concept of effective revenue deficit was introduced through the Finance Act, 2012. It was removed in 2018. *FRBM Act* 2003, Section 2(aa).

[27] Fiscal deficit is still a target and is now in the statute. *FRBM Act* 2003, Section 2(a).

pended.[28] The Finance Minister in his 2009-10 interim budget speech noted:[29]

> Extraordinary economic circumstances merit extraordinary measures. Now is the time for such measures. Our Government decided to relax the FRBM targets, in order to provide much needed demand boost to counter the situation created by the global financial meltdown.

The *FRBM Act*, 2003 remained in suspension from 2008-09 to 2012-13.[30] The budget speech of 2012-13 terminated the suspension of the *FRBM Act*, 2003 and proposed certain amendments to the statute.[31] Accordingly, the *Finance Act*, 2012 once again amended the *FRBM Act*, 2003 to push the deadline for numerical targets from March 31, 2009 to March 31, 2015. It also introduced the third target - 'effective revenue deficit' (that is, revenue deficit excluding grants for creation of capital assets). The amended statute sought to eliminate effective revenue deficit (in place of revenue deficit) by March 31, 2015. The target for revenue deficit was raised to 2%.[32]

Subsequently, the *Finance Act*, 2015 once again amended the *FRBM Act*, 2003 to shift the date for achieving the 3% fiscal deficit target from March 31, 2015 to March 31, 2018. The revenue deficit target of 2% of GDP was also shifted to March 31, 2018. The elimination of 'effective revenue deficit' was also shifted to March 31, 2018.[33]

After 2015, a new methodology for addressing violations of the FRBM Act commenced. Certain deviations from fiscal targets were carried out without amending the *FRBM Act*, 2003 at all. The *CAG Report*, 2017 cited two instances where the fiscal targets were deviated from without corresponding amendments to the

[28] The legality of this suspension is unclear. The escape clause at that time merely allowed deviation from annual fiscal targets in the rules and did not provide for suspension of the entire statute. The appropriate method of suspending the statute would have been to revoke the government notification dated July 5, 2004, by virtue of which the statute was brought into force. *FRBM Act* 2003, sections 1(3), 4(5).

[29] Finance Minister 2009, para 20.

[30] Since the interim budget speech for the year 2009-10 was made on February 16, 2009, the suspension affected the fiscal deficit for the financial year 2008-09. Finance Minister 2009.

[31] Finance Minister 2012.

[32] The amendment to section 4 of the FRBM Act, 2003 was as follows: *In section 4 of the Fiscal Responsibility Act,: (a) for sub-section (1), the following sub-section shall be substituted, namely: "(1) The Central Government shall take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit to eliminate the effective revenue deficit by the 31st March, 2015 and thereafter build up adequate effective revenue surplus and also to reach revenue deficit of not more than two per cent. of Gross Domestic Product by the 31st March, 2015 and thereafter as may be prescribed by rules made by the Central Government." Finance Act* 2012, section 148.

[33] *Finance Act* 2015, section 152.

FRBM Act, 2003:[34]

1. In the Medium Term Fiscal Policy Statement placed along with the budget of 2016-17, the target date for elimination of effective revenue deficit was deferred from March 2018 to March 2019. Further, the *CAG Report* noted that no exceptional ground as required by the *FRBM Act*, 2003 was furnished by the government.

2. In the Medium Term Fiscal Policy Statement of 2017-18, the achievement of fiscal deficit target of 3% of GDP by 2017-18 was deferred to 2018-19. The target date for elimination of effective revenue deficit was pushed beyond 2019-20.

Taking note of the deviations, the *CAG Report*, 2017 recommended that:[35]

> ...deferment of fiscal targets need to be carried out through appropriate amendments to the Act.

Finally, the *Finance Act*, 2018 brought in substantial changes to the fiscal framework enshrined in *FRBM Act*, 2003. The revenue deficit and effective revenue deficit targets were discontinued. Instead, the *Finance Act*, 2018 amended *FRBM Act*, 2003 to require the union government to do the following:[36]

(a) take appropriate measures to limit the fiscal deficit upto 3% of GDP by the March 31, 2021;

(b) endeavour to ensure that the general government debt does not exceed 60% of the GDP by the end of financial year 2024-2025;

(c) endeavour to ensure that the Central Government debt does not exceed 40% of the GDP by the end of financial year 2024-2025;

(d) not give additional guarantees with respect to any loan on security of the consolidated fund of India in excess of 0.5% of GDP in any financial year;

(e) endeavour to ensure that the fiscal targets specified in clauses (a) and (b) are not exceeded after stipulated target dates.

The law however empowered the union government to issue rules prescribing the annual glide path for reduction of fiscal deficit to reach the long-term stipulated fiscal deficit target of 3% by March 31, 2021.[37]

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[34] Comptroller and Auditor General of India 2017, p. 9.
[35] Comptroller and Auditor General of India 2017, p. 10.
[36] *FRBM Act* 2003, section 4(1).
[37] *FRBM Act* 2003, section 4(2).

While the government proposed to bring down the fiscal deficit to 3.5% of GDP by 31st March, 2021, an economic slowdown worsened by the Covid-19 pandemic sent government's fiscal position to disarray. The fiscal deficit target was revised to 9.5% of GDP for the year ending March 31, 2021. For the next financial year, the fiscal deficit target was budgeted at 6.8% of GDP. The revised estimates pegged this number to 6.9% of GDP. The fiscal deficit worked out to be 6.7% of GDP for 2021-22. The Finance Minister in her budget speech proposed a revised glide path for achieving fiscal consolidation. According to the revised glide path, the Government will bring down the fiscal deficit to below 4.5% of the GDP by 2025-26. However, the Medium Term Fiscal Policy Statement placed along the budget of 2021-22 mentioned that the Government will amend the FRBM Act, hence no fiscal projections for the year 2022-23 and 2023-24 were provided in the Statement.[38] For FY 2022-23, the fiscal deficit narrowed to 6.4% of GDP.[39] For the current financial year, the fiscal deficit is estimated at 5.9% of GDP.[40]

3.2 Escape clause

A crucial feature of the *FRBM Act*, 2003 is the escape clause. An escape clause is a key feature of any robust fiscal responsibility legislation. Such a clause allows for temporary deviation from fiscal targets in the event of unforeseen circumstances. It provides for deviations from the fiscal rules according to a limited number of well-defined exceptional circumstances; time-limits on how long fiscal policy can deviate from the targets specified in the rule, and a requirement for fiscal policy to return to the targets after the operation of the escape clause is terminated. While escape clauses provide flexibility to deal with extraordinary events, such clauses should be precise and only a limited set of events should allow the escape clauses to be triggered.

Originally, the *FRBM Act*, 2003 allowed the union government to frame rules to specify the annual targets for reduction of fiscal deficit and revenue deficit.[41] In that context, the statutory escape clause in the *FRBM Act*, 2003 permitted deviation from those annual targets set down by the union government through rules. It stated:[42]

> Provided that the revenue deficit and fiscal deficit may exceed *such targets* due to ground or grounds of national security or national calamity

[38] *Medium Term Fiscal Policy cum Fiscal Policy Strategy Statement* 2021.
[39] Finance Minister: Budget speech 2022.
[40] Finance Minister: Budget speech 2023.
[41] *FRBM Act* 2003, section 4(2)(a).
[42] This was the position from 2003 to 2012. *FRBM Act* 2003, Proviso to section 4.

> or such other exceptional grounds as the *Central Government may specify.*

The *Finance Act*, 2012 added effective revenue deficit as a third fiscal target in the *FRBM Act*, 2003. Consequently, it also amended the statutory escape clause to permit deviation from the annual target for reduction of effective revenue deficit prescribed in the central government rules.[43]

Overall, the statutory escape clause merely allowed deviation by the union government from three annual targets set out by the union government itself under its own rules. Even without the statutory escape clause, the union government could have deviated from the targets by simply amending its own rules. For example, the *FRBM Rules*, 2004 were amended by the union government in 2013 to change the numerical annual targets.[44] Therefore, the escape clause in the *FRBM Act*, 2003 was never of much practical significance till 2018.[45]

The *FRBM Review Committee Report* noted that this statutory escape clause in the *FRBM Act*, 2003 was very opaquely defined and was liable to misuse.[46] Instead, it proposed a more specific escape clause and restrictions on when the escape clause could be invoked.[47] Accordingly, the escape clause in the *FRBM Act*, 2003 was amended by the *Finance Act*, 2018.

Currently, the annual targets for reduction of fiscal deficit are prescribed by the union government through its rules.[48] The statutory escape clause allows the union government to deviate from such annual fiscal deficit target due to ground or grounds of national security, act of war, national calamity, collapse of agriculture severely affecting farm output and incomes, structural reforms in the economy with unanticipated fiscal implications, decline in real output growth of a quarter by at least 3% points below its average of the previous four quarters.[49] However, any

[43] *Finance Act* 2012, section 148.

[44] *FRBM (Amendment) Rules* 2013.

[45] Prior to 2018, the 'fiscal deficit' target was in the Rules, while the 'revenue deficit' target was in the Act. In 2018, the 'revenue deficit' target was discontinued and the 'fiscal deficit' and debt targets were brought back in the Act. *FRBM Act* 2003, section 4(1).

[46] FRBM Review Committee 2017, p. 10.

[47] It proposed escape clauses for: (a) over-riding consideration of national security, acts of war, calamities of national proportion and collapse of agriculture severely affecting farm output and incomes; (b) far-reaching structural reforms in the economy with unanticipated fiscal implications; (c) sharp decline in real output growth of at least 3 percentage points below the average for the previous four quarters. FRBM Review Committee 2017, p. 10.

[48] The other two targets - revenue deficit and effective revenue deficit - were discontinued from 2018. *FRBM Act* 2003, section 4(2).

[49] *FRBM Act* 2003, proviso to section 4(2).

deviation from fiscal deficit target shall not exceed 0.5% of the GDP in a year.[50] Further, the central government shall, in case of increase in real output growth of a quarter by at least 3% points above its average of the previous four quarters, reduce the fiscal deficit by at least 0.25% of the GDP in a year.[51] Essentially, in good economic times, the government should endeavour to reduce fiscal deficit. However, in case of any deviation from the target, a statement explaining the reasons for such deviation and the path of return to the annual prescribed targets must be laid before both houses of the parliament.[52] Therefore, the current statutory escape clause permits the government to set the annual fiscal deficit targets but constrains its discretion to deviate from such targets drastically and arbitrarily.

While presenting the budget for 2020-21, the finance minister used the escape clause to deviate from the fiscal deficit target of 3.3% for 2019-20. The escape clause was also used to deviate from the target for the next financial year, that is, 2020-21. Using the escape clause, the fiscal deficit was relaxed by 0.5% to 3.8% for the financial year ending 31 March 2020, and to 3.5% for the financial year ending 31 March 2021.[53] The achievement of 3% of fiscal deficit target was shifted to 31 March 2023.[54]

Despite such a well-drafted statutory escape clause, the Indian union government still retains the ability to dilute any restriction in the *FRBM Act*, 2003 itself. This is because of a peculiar feature of the *Constitution of India* - the special procedure for enacting money bills. The *FRBM Review Committee Report* overlooked this unique escape clause embedded in the Indian constitutional system, which effectively allows the executive government to dilute any fiscal constraint imposed on it by the most well-drafted parliamentary statute. The next section elaborates this problem in detail.

[50] *FRBM Act* 2003, section 4(3).

[51] Section 4(4) *FRBM Act* 2003.

[52] *FRBM Act* 2003, section 4(5).

[53] Finance Minister: Budget speech 2020.

[54] The relevant text of the speech is as follows: "Section 4 (2) of the FRBM Act provides for a trigger mechanism for a deviation from the estimated fiscal deficit on account of structural reforms in the economy with unanticipated fiscal implications. Therefore, I have taken a deviation of 0.5%, consistent with Section 4(3) of FRBM Act, both for RE 2019-20 and BE 2020-21.". While the target date for achieving fiscal deficit was shifted to 31 March, 2023, the *FRBM Act* was not amended to reflect this change. Section 4(1) of the Act still shows the target as 3% to be achieved by March 31, 2021.

4 The problem of money bills

Under the *Constitution of India*, for an ordinary bill to be enacted into a law, it has to be passed by a simple majority of both Houses of the Parliament - the Lower House (Lok Sabha) and the Upper House (Rajya Sabha). Money bill is an exception to this general rule. A money bill can be introduced only in the Lok Sabha.[55] The role of the Rajya Sabha is merely consultative. Unlike ordinary bills, the Rajya Sabha cannot block the enactment of a money bill into law. It can only recommend amendments to a money bill, that too within 14 days from the date of receipt by the Rajya Sabha. In case the Lok Sabha refuses to accept the recommendations or if the Rajya Sabha fails to make recommendations within 14 days, the money bill could be directly sent for Presidential assent, after which it becomes a law.[56]

Under Article 110(1), a money bill could contain *only* provisions dealing with all or any of the following matters:

a) the imposition, abolition, remission, alteration or regulation of any tax;

b) *the regulation of the borrowing of money or the giving of any guarantee by the Government of India, or the amendment of the law with respect to any financial obligations undertaken or to be undertaken by the Government of India;*

c) the custody of the Consolidated Fund or the Contingency Fund of India, the payment of moneys into or the withdrawal of moneys from any such Fund;

d) the appropriation of moneys out of the Consolidated Fund of India;

e) *the declaring of any expenditure to be expenditure charged on the Consolidated Fund of India or the increasing of the amount of any such expenditure*;

f) the receipt of money on account of the Consolidated Fund of India or the public account of India or the custody or issue of such money or the audit of the accounts of the Union or of a State; or

g) any matter incidental to any of the matters specified in sub-clauses (a) to

[55] At the time of introduction of the bill in Lok Sabha, it may not be clear if it is being introduced by the government as a money bill or not. Therefore, if any question arises as to whether a bill is a money bill or not, the decision of the speaker is final. Further, when the bill is transmitted to the Rajya Sabha and when it is presented to the President, a certificate from the speaker is endorsed on the bill marking it as a money bill. *Constitution of India* 1949, Articles 109, 110.

[56] *Constitution of India* 1949, Article 109; *Rojer Mathew* 2019, par. 94-95.

(f).

The *FRBM Act*, 2003 could be amended through a money bill by virtue of clauses (b), (d), (e) and (g). This arrangement creates a peculiar problem in India.

India is a parliamentary democracy of the *Westminster* type.[57] The effective head of the executive government (the Prime Minister and most of his Cabinet Ministers) are members of Lok Sabha and usually belong to a major political party or a coalition with majority in the Lok Sabha.[58] If the government has a majority in the Lok Sabha, the Prime Minister and his Cabinet can decide on the shape and size of the budget, introduce it as bill in the Lok Sabha, get the bill certified as a money bill by the Speaker of the Lok Sabha, and get it enacted into law.[59] Any fiscal constraints on the government under the *FRBM Act*, 2003 could similarly be amended by the government through a money bill by the Lok Sabha alone.[60]

Effectively, the money bill provision acts as a *constitutional escape clause* in India. This is not a mere theoretical apprehension but a severe shortcoming of practical significance, as explained in the section below.

[57] As will be discussed in detail later, legislatures under the Westminster model suffer from weak budgetary powers. Lienert, I. 2005.

[58] Unlike a presidential system, in a parliamentary system the Prime Minister is technically first among equals. The cabinet members usually exercise some restraint on her powers. Recent literature on India however suggests that the cabinet may not have acted as an effective check on the Prime Minister. Khaitan, T. 2020, pp. 19-20; moreover, strong internal discipline within the ruling political party may have also diminished the restraining power of the cabinet on the Prime Minister. Sethia, A. 2019.

[59] The speaker cannot always act as an effective check because the speaker can be removed from his office by a resolution of the Lower House passed by a majority of all the then members of the Lower House. *Constitution of India* 1949, Article 94; the Indian Supreme Court had traditionally been hesitant in reviewing the speaker's decision to classify a bill as money bill be reviewed by the Supreme Court. See Datta, P., Malhotra, S., Tyagi, S. 2017; this judicial trend may be changing since the Supreme Court recently held that it has the power to exercise judicial review over the Speaker's decision, explicitly overruling earlier precedents on this issue. *Rojer Mathew* 2019, par. 109.

[60] Of late, the Indian government has used the money bill route to enact several laws, bypassing potential opposition in the Rajya Sabha. Examples include Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016, Specified Bank Notes (Cessation of Liabilities) Bill, 2017 and amendments to various financial sector statutes have been passed as money bills. Datta, P., Malhotra, S., Tyagi, S. 2017; in 2019, with the elections due within a couple of months, a lame-duck government used interim budget procedure to present a full, populist budget. A former finance minister of India referred to it as a 'mockery of the Constitution'. Khaitan, T. 2020, p. 16.

5 The practical experience

For fiscal deficit, the *FRBM Act* 2003 had prescribed a target of 3% of GDP that was to be achieved by March 31, 2009. From 2003-04 to 2007-08, the government was successful in reducing the fiscal deficit. As evident from Figure 1, the union government's fiscal deficit declined from 4.34% of GDP in 2003-04 to 2.54% of GDP in 2007-08.

However, when the global financial crisis unfolded in the second half of 2008-09, the union government chose to diverge from the law. The operation of the *FRBM Act* 2003 was suspended from 2008-09 to 2012-13.[61] The fiscal deficit shot up during this period, and then reduced marginally after 2012-13 as is evident from Figure 1. Even before the onset of the Covid crisis, fiscal deficit shot up to 4.6% (in 2019-20). In the Covid year, the fiscal deficit surged to 9.2% before gradually moderating to 6.7% in 2021-22 and to 6.4% in 2022-23.[62]

As emphasised at the outset, public finance researchers are required, to debate the extent to which this deficit experience constituted optimal economic policy. These debates could well conclude that the design of the original FRBM Act was an incorrect one. For the present analysis, we are narrowly focused on the legal analysis. There was a law, it was flouted, and we should carefully understand the sources of this deviation. Perhaps at a future date there will be a fresh attempt in economic policy design (to choose an optimal fiscal rule), and then the full knowledge will be required on how to design the legal constraints around which this can be made to bind.

Since the global financial crisis, there have been many instances of deviation from fiscal targets enshrined in the *FRBM Act*, 2003. As discussed in the earlier sections, year after year the Indian government has consistently used the money bill route to

[61] Since the suspension was implemented through the interim budget speech for the year 2009-10 on February 16, 2009, the suspension affected the fiscal deficit for the financial year 2008-09. Finance Minister 2009; The legality of this suspension is unclear. The escape clause at that time merely allowed deviation from annual fiscal targets in the rules and did not provide for suspension of the entire statute. The appropriate method of suspending the statute would have been to revoke the government notification dated July 5, 2004, by virtue of which the statute was brought into force. *FRBM Act* 2003, sections 1(3), 4(5); before the amendment in 2018, unlike in international best practices, neither the escape clause (first proviso to Section 4) of the FRBM Act nor the associated FRBM Rules mandated a clearly defined correction path that would facilitate return to fiscal consolidation following a breach in adherence to the fiscal rules. FRBM Review Committee 2017.

[62] Figure 1 shows the fiscal deficit each year along with the 3% target. As discussed in the paper, achievement of the 3% target was shifted multiple times since the enactment of the FRBM Act.

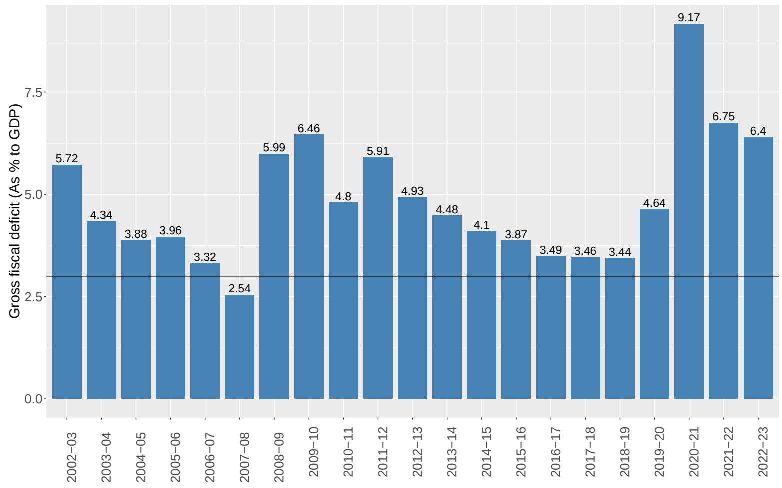

Figure 1: Fiscal deficit as percent to GDP

amend the *FRBM Act*, 2003. Amendments were inserted through various Finance Acts, which were passed by the Lok Sabha as money bills.[63] These amendments have continuously delayed the timeline for meeting the fiscal targets under the *FRBM Act*, 2003.[64]

For instance, section 4(1) of the *FRBM Act*, 2003 orginally required the union government to take appropriate measures to eliminate revenue deficit by March 31, 2008. The *Finance Act*, 2004, which was enacted as a money bill, extended the deadline to March 31, 2009. Similarly, *Finance Act*, 2012, which was enacted as a money bill, changed it to March 31, 2015. Subsequently, *Finance Act*, 2015, which was enacted as a money bill, changed it to March 31, 2018. Effectively, the money bill route has been consistently used as a *constitutional escape clause* by successive governments to dilute the statutory restraints under the *FRBM Act*, 2003.

Indian policymakers reviewing the *FRBM Act*, 2003 have long overlooked this *constitutional escape clause*. For instance, the *FRBM Review Committee Report* made detailed suggestions to overcome the problems associated with the statutory

[63] Ajay Shah 2017; Pratik Datta, Radhika Pandey 2017.

[64] Most of the other targets have been modified through amendments to rules by the union government itself. *FRBM (Amendment) Rules* 2013; Another instrument through which the true extent of fiscal targets have been masked is through increased reliance on off-budget financing. The government has increasingly resorted to off-budget financing for revenue as well as capital spending. While such off-budget financing do not feature in the calculations of fiscal targets, they have fiscal implications. It has therefore been recommended that the government should put in place a policy framework for off-budget financing with transparent disclosures to Parliament. Comptroller and Auditor General of India, Indian Audit and Accounts Department 2018, p. 33.

escape clauses in *FRBM Act*, 2003 and proposed a new Debt Management and Fiscal Responsibility Bill (DMFR Bill).[65] However, it overlooked the fact that the DMFR Bill, if enacted, could be similarly diluted by the government using the money bill route. Unless an alternative legal mechanism is devised to check potential misuse of this *constitutional escape clause*, no amount of precision in statutory drafting would be able to constrain absolute government discretion in deviating from the path of fiscal consolidation in India.[66] In this backdrop, it is important to situate India's constitutional system in a conceptual framework to identify the fundamental challenges in imposing fiscal constraints on the government through legal instruments.

6 Contrasting international experience

The state is made up of three branches, the legislative, executive and judicial. The doctrine of separation of powers suggest that these three branches must be separate. While there is broad consensus about the need to ensure independence of the judiciary by keeping it separate from the other two branches, the degree of separation between the legislature and executive varies across different constitutional systems. Constitutional systems could be broadly classified into two categories - the presidential system and parliamentary system. This can be sub-divided further into five different sub-categories in total, as described below.[67]

1. *Presidential system*: In presidential systems, the head of the executive, the president, is directly elected by citizens. Presidential systems could be further classified into two types:
   (a) *Pure-presidential system*: In this system, there is no Prime Minister. The President appoints Cabinet comprising of people chosen from outside the elected legislators. The President is both the head of State and the head of executive.
   (b) *Semi-presidential system*: In this system, there is both a Prime Minister and President. The Prime Minister is generally drawn from the legislature and is responsible for it. The sharing of powers between the President and the Prime Minister however may vary widely across different countries.

[65] See, FRBM Review Committee 2017.
[66] See, Pratik Datta, Radhika Pandey 2017.
[67] Lienert, I. 2005.

2. *Parliamentary system*: In parliamentary systems there is a clear differenciation between the head of the executive (the Prime Minister) and the head of the State. Moreover, there is no clear separation of powers between the legislative and the executive. Parliamentary systems could be further classified into three types:

   (a) *Parliamentary republic*: In this system, the President is directly or indirectly elected by Parliament. This category includes countries like Germany and Italy.

   (b) *Parliamentary monarchy: non-Westminster*: In this system, the President is elected. The position of head of state is primarily ceremonial. This category includes countries like Denmark, Netherlands, Norway and Sweden.

   (c) *Parliamentary monarchy: Westminster*: In this system, the effective head of the executive branch is both a member of parliament and the leader of a major political party - usually the party with the most seats in the lower house.

The separation of powers is extremely strong in *pure* presidential system, which tend to have powerful legislatures. In contrast, the separation is extremely weak in parliamentary systems based on the *Westminster* model. Between these two extremes, are the *Semi-Presidential system*, *Parliamentary republic* system and *non-Westminster parliamentary monarchy* system. The differences in separation of powers across these three systems are small. Overall, there is a broadly linear relationship between the separation of powers and the control of the executive by the legislature across these five forms of government. Figure 2 illustrates this linear relationship.

The weakness of the *Westminster* model arises because the effective head of the executive is both a member of legislature and the leader of a major political party - usually the party with the most seats in the lower house.[68] The Council of Ministers or Cabinet virtually controls both the lower house and the executive. The Indian Supreme Court has referred to the Cabinet as 'a hyphen which joins, a buckle which fastens the legislative part of the State to the executive part'.[69] Consequently, the executive essentially controls the lower house in the *Westminster* model.

Further, the budgetary powers in the *Westminster* model usually vest with the direct representatives of the people in the lower house.[70] The lower house alone can

[68]Lienert, I. 2005, p. 3.
[69]*Ram Jawaya Kapur* 1955, par. 16.
[70]This arrangements developed in United Kingdom over time and has been adopted by many

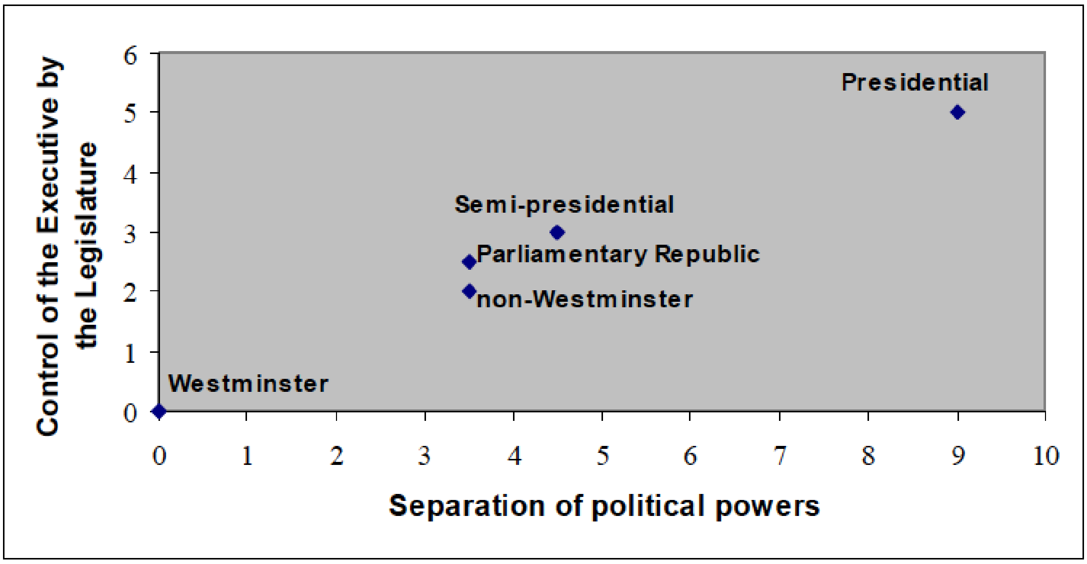

Figure 2: Separation of powers *versus* control of executive by legislature (Source: Linert (2005)

enact laws on revenue (taxation, borrowing etc) as well as expenditure by the state. This arrangement originally evolved to empower the British House of Commons to restrain the fiscal authority of the Crown. When the Crown's resources were depleted (such as during wars etc.), the Crown would call upon the Commons to replenish his treasury. The Commons could replenish the resources only by appropriating public money. This required them to vote upon an appropriation bill to allow or disallow such approrpriation. This mechanism acted as a financial control on the fiscal authority of the Crown. When the government replaced the Crown as the spender, this arrangement lost it's original utility.[71]

Now, the *Westminster* cabinet virtually controls both the government and the lower house. Due to this inherent lack of separation of powers and the lower house's exclusive budgetary powers, the executive effectively controls the budgetary powers in the *Westminster* model. Overall, the legislature tends to have lesser influence on the budgeting process. This explains why legislatures of *Westminster* heritage in South Africa, Australia, United Kingdom and Canada score low in the index of legislative budget institutions, as evident from Figure 3.[72] Figure 4 shows that UK as well as some of its erstwhile colonies in South Asia such as India, Pakistan and Bagladesh, tend to exhibit higher fiscal deficit in comparison to the average

of its former colonies. Datta, P., Malhotra, S., Tyagi, S. 2017.

[71]Schick, A. 2002, pp. 16-17.

[72]Wehner, J. 2006.

fiscal deficit in the Euro Area over the same period of time.

In this context, it is hardly surprising that since India follows the *Westminster* model of constitutional system, the Indian legislature exercises weak control over the budgetary process. This is because the Indian cabinet approves the budget framed by the executive (that is, the Finance Ministry) and also enjoys the confidence of the Lok Sabha.[73] Because of this inherent lack of separation of powers, the executive through the cabinet wields immense influence in the Lok Sabha to get the Finance Bill enacted as a money bill. Consequently, any provision of a fiscal responsibility statute which is not to the liking of the executive government, could be amended by the executive government through the cabinet and the Lok Sabha using the money bill route. In fact, this is precisely how the *Finance Act*, 2004, *Finance Act*, 2012, *Finance Act*, 2015, and *Finance Act*, 2018 have been used to amend the *FRBM Act*, 2003. By this reasoning, Parliamentary law is unlikely to constrain the union budget process.

If fiscal responsibility law is desired, alternative legal mechanisms need to be devised that are fully cognisant of the legal context. One possibility is to insert the fundamental principles of fiscal rules in the *Constitution of India* itself.[74] This is an important area for future constitutional law research.

These difficulties of formal fiscal rules that ensure fiscal prudence suggest that it would be more useful to go down the route of emphasising market discipline. At present, the Indian government borrowing program is funded largely through forced borrowing from financial firms.[75] Through this, the lenders have no voice on the soundness of fiscal planning. Advanced economies rely heavily on the voice of the bond market, which drives up interest rates when faced with an unsound fiscal strategy. The path to fiscal prudence then lies in the establishment of the Public Debt Management Agency, a range of financial regulatory reforms, and the unwinding of the system of financial repression.[76]

[73]The Cabinet has a joint responsibility to the Lok Sabha. *Constitution of India* 1949, Article 75(3).

[74]Unlike common law origin countries, countries of French or Spanish legal origin often have a consitutional requirement to specify public finance related provisions in an 'organic law' - a higher rank law, who adoption procedure is more demanding than that of ordinary laws. Similar features could also be explored while considering constitutional reforms in this space in India. Lienert, I. and Fainboim, I. 2010.

[75]This phenomenon is referred to as 'fiscal repression'. This helps keep the interest rates on government borrowing low to reduce the cost. For example, the statutory liquidity ratio (SLR) stipulated by the RBI requires the banking system to hold 18% of their demand and time liabilities in government securities. Besides, the RBI intervenes in the market through open market operations around the time when government borrowing is taken up to keep the interest rates on government borrowing repressed. M. Govinda Rao 2023.

[76]Pandey and Patnaik 2017; Patnaik and Shah 2018.

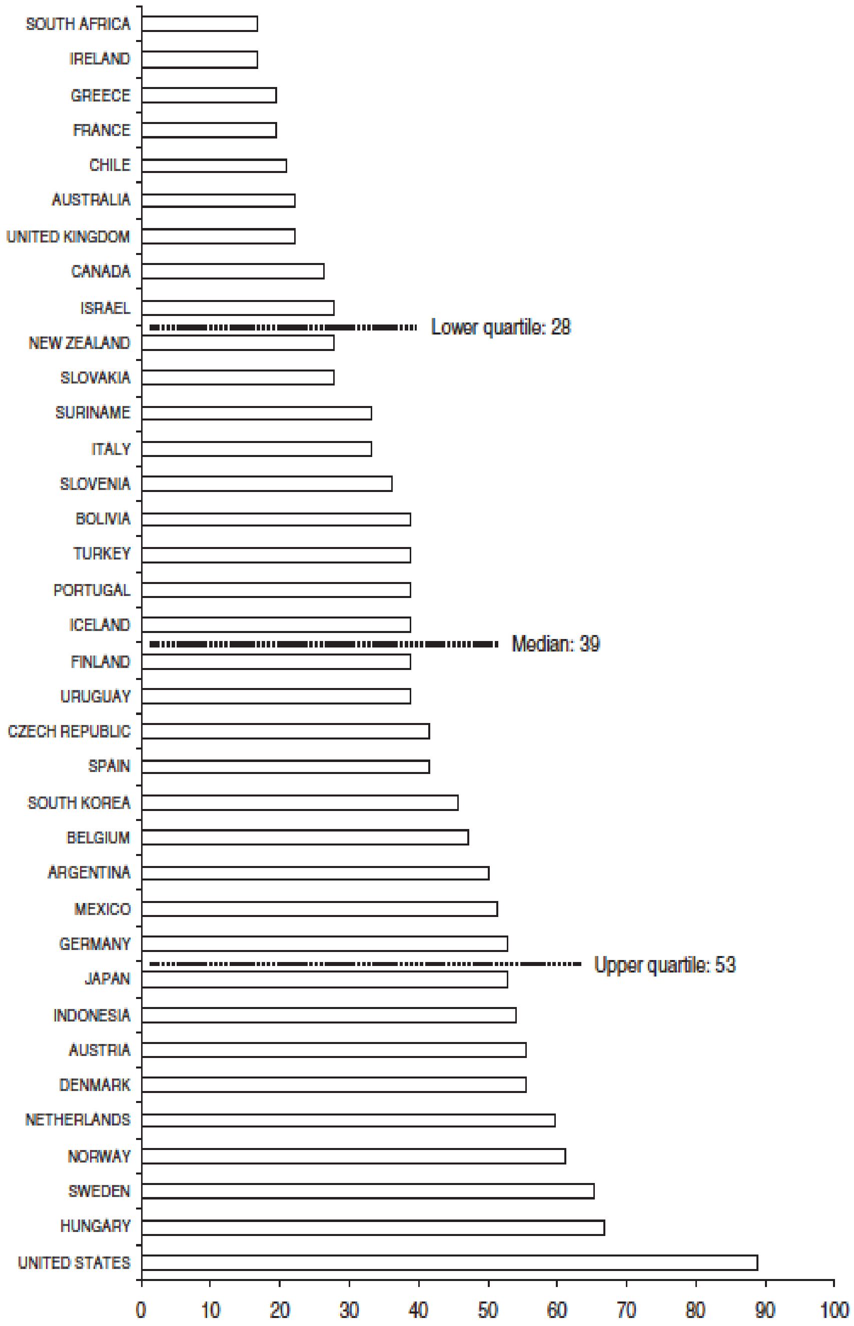

Figure 3: Index of Legislative Budget Institutions (Source: Wehner (2006)

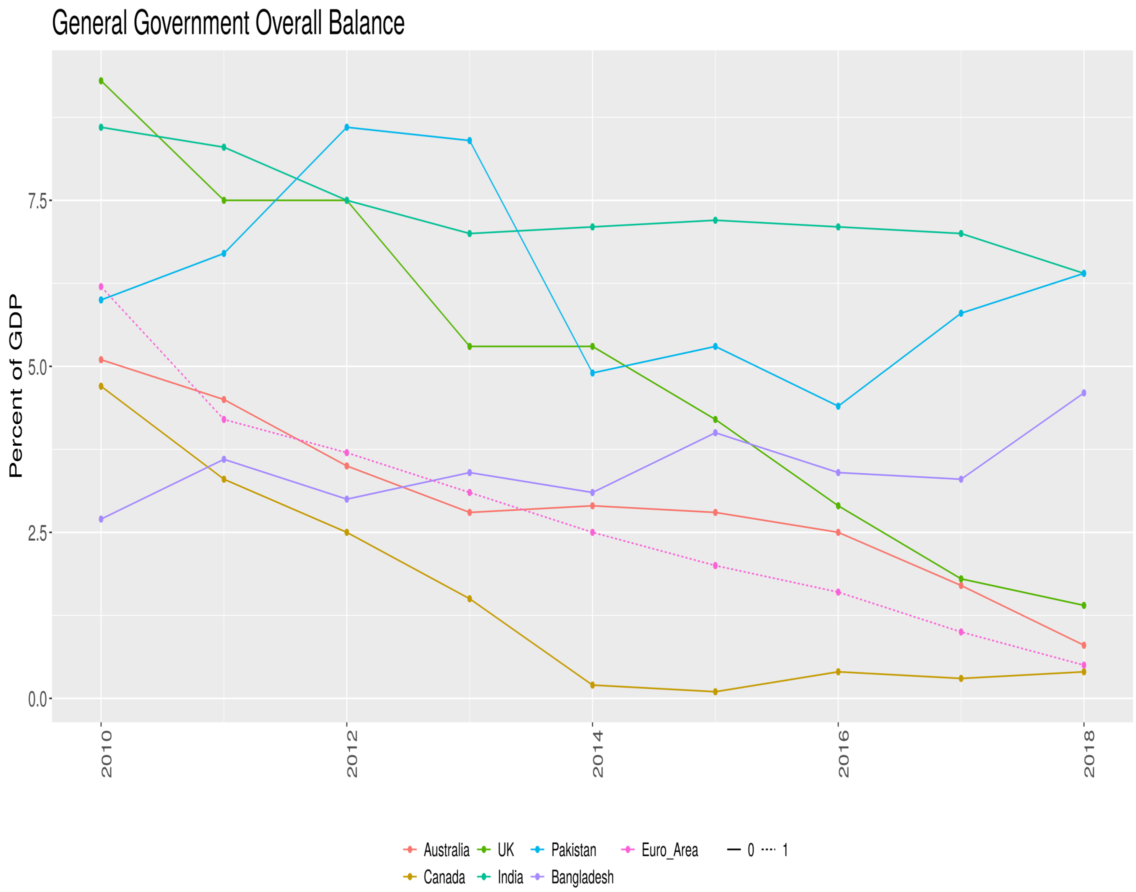

Figure 4: Union Government Deficit: Cross country comparison

7 Conclusion

Policymakers and economists working on India's fiscal rules have focused on the statutory escape clause in the *FRBM Act*, 2003. They have overlooked the escape clause in-built within the Indian constitution - the special procedure for money bills, which could be used by the union government at its discretion to dilute any fiscal rule imposed on it by any law enacted by the Indian parliament.

We show that since India follows the *Westminster* model of parliamentary democracy, the legislature has weak control over the budgetary process. The Cabinet approves the budget framed by the executive and also enjoys the confidence of the Lok Sabha. Because of this inherent lack of separation of powers, the executive through the cabinet wields immense influence in the Lok Sabha to get the Finance Bill enacted as a money bill. Consequently, any provision of a fiscal responsibility statute, which is not to the liking of the executive government, could be amended by the government using the money bill route. Under this constitutional arrangement, Parliamentary law cannot constrain the budget process. We conclude that in order to effectively restrain the Indian government's ability to amend fundamental fiscal rules, alternative mechanisms need to be devised taking into account the existing constitutional framework of India.

* * * * * * *

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