Rethinking fiscal rules: Need for a consultative process

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Rethinking fiscal rules has often been a key issue in the debate over cooperative federalism in India. The Centre has recently determined that contingent liabilities or off-budget borrowings will be included in estimating the Net Borrowing Ceiling (NBC) of the states. This has considerably reduced the fiscal space of the state governments and has turned into a big issue in the Centre-State relations. Many states have been vocally pointing out how this decision has reduced their fiscal space amidst macroeconomic uncertainties and increased volatility in intergovernmental fiscal transfers.

Over the years, the states have innovated ways to expand fiscal spaces, often going beyond the limits of the fiscal rules. For instance, Kerala has created the Kerala Infrastructure Investment Fund Board to enable capital and social infrastructure projects to support economic growth and maintain high human capital formation. To meet the challenges related to maintaining robust growth, Telangana has innovated a debt maturity strategy by buying more long-term bonds to postpone the refinancing risks.

The finance minister of Kerala recently highlighted that the changed approach by the central government in calculating the Net borrowing ceiling (NBC) incorporating the off-budget borrowing will affect the fiscal space of the state in planning the economic growth path and economic development of the state.

If revenue receipts can finance the entire revenue expenditure, the revenue deficit remains zero and whatever State borrows can go for capital expenditure. Though substantial tax rate revisions have been announced in the 2023-24 budget of Kerala, tax financing alone cannot cover the entire revenue expenditure of the state. Hence, the revenue deficit is not zero in the state. The revenue deficit to GSDP (Gross State Domestic Product) ratio however has declined from 2.6 per cent in 2020-21 (accounts) to 2.1 per cent (2023-24 B.E.). Further, a reduction in revenue deficits might be possible only through revenue expenditure compression. In the post-pandemic fiscal strategy, revenue expenditure compression has detrimental effects on economic growth and human development.

Fiscal rules and the way ahead

To put the matter in perspective, we need to know the existing fiscal rules, which stipulate a threshold ratio or value for debt and deficits. In the United States, it is stipulated as an ‘absolute’ debt ceiling, while in Europe and India, the deficit is stipulated as a percentage of the GDP. Globally, there is a rethinking about these fiscal rules against the backdrop of geopolitical risks and uncertainties.

In India, recently fiscal rules are articulated in an ad hoc and arbitrary manner without any change in legislation. For instance, in the post-pandemic fiscal consolidation roadmap, the deficit is visualised as 4.5 per cent of the GDP instead of the stipulated 3 per cent as per the FRBM (Fiscal Responsibility and Budget Management Act). This articulation indeed has helped the government to maintain an accommodative fiscal policy stance for the economic growth recovery process. The fiscal deficit of the central government has mounted to over 9 per cent of the GDP when the pandemic hit. The government has consistently reduced the deficit in the post-pandemic years.

At the sub-national government levels, in the post-pandemic fiscal strategy, the states of India are instructed to maintain the fiscal deficit at the level of 3.5 per cent GSDP, with 0.5 per cent extra borrowing powers tied to mandatory power sector reforms. The fiscal rules threshold of zero revenue deficit is considered a 'golden rule' as it translates that the entire revenue spending needs to be financed through revenue receipts. This implies that the borrowing is entirely used for capital spending. However, empirical analysis shows that the states have over the years over-adjusted to fiscal rules by maintaining a deficit to GDP at 3 per cent at the cost of capital spending. This definitely has severe repercussions on the economic growth process.

Against this backdrop, a few states have started innovating fiscal space through “off-budget borrowings”. For instance, the borrowings through public sector entities were not calculated as part of the fiscal deficit. To capture the entire borrowing requirements, the PSBR (Public Sector Borrowing Requirement) is a better measure. The PSBR measures the “general government” deficit plus borrowings of public sector entities. However, there is no continuous time series data on the PSBR in India.

Budget transparency and accountability

The central government argues that fiscal profligacy and freebie spree need to be contained. The inter-generational inequities of high debt burden are highlighted as today's debt is tomorrow's taxes, implying that this put the future generations in perpetual debt. However, what needs to be taken into account is that the high capital and social infrastructure spending can create inter-generational 'equities'.

Budget transparency is an important aspect of fiscal rules. The opaqueness of 'off-budget borrowings' by the Centre and the states is an issue of concern. The Union Budget documents have revealed the off-budget borrowings in an annexure, not as part of the fiscal deficit. However, asking the states to maintain a fiscal deficit to GSDP ratio at 3.5 per cent, linking the extra borrowing space of 0.5 per cent to power sector reforms and counting the contingent liabilities as part of the Net Borrowing Ceiling may not leave the state finance ministers with the fiscal space they require to operate. The financial and operational efficiency parameters of the DISCOMs – including the AT&C (Aggregate Technical and Commercial) losses and Average Cost of Supply (ACS) - Average Revenue Realised (ARR) gap and tariff revisions – are in the doldrums across the states.

The political economy

The plausible way out could be introducing the PSBR in India, although data challenges appear to be huge. Yet another plausibility is the upward revision in fiscal rules threshold of the states from the stipulated 3.5 per cent if the centre is keen on budget transparency by incorporating off-budget borrowings into fiscal space calculations. However, the political economy of this issue is compelling and the ultimate solution needs to be arrived at through a consultative process with state governments rather than instructing the new fiscal rules as a top-down technocratic exercise driven by deficit debt thresholds.

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