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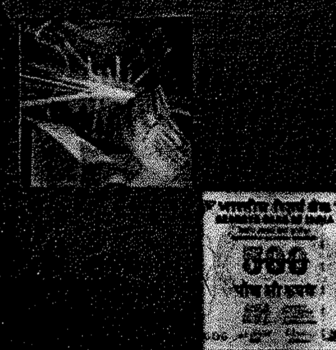

edited by
Edgardo M. Favaro • Ashok K. Lahiri

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EDGARDO M. FAVARO
ASHOK K. LAHIRI

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11

State Finances in India
Towards Fiscal Responsibility

STEPHEN HOWES AND SHIKHA JHA

INTRODUCTION

It is clearly recognized that the fiscal position of the states has seriously deteriorated and requires immediate and substantial correction (Lahiri, 2000). Some steps have already been taken to promote fiscal discipline and transparency at the state level. A Reserve Bank of India (RBI) committee has issued guidelines to the states on the capping of guarantees (RBI, 1999). The RBI has also established a committee to recommend ways in which state budgets can be made more transparent (RBI, 2001). The Godbole Committee has undertaken a similar task for the state of Maharashtra (Godbole, 2001).

Some states have begun to implement the recommendations of these committees. Several states are now regularly publishing summary critical fiscal indicators in their budgets along the lines of *Budget at a Glance* as presented by the GoI to enhance transparency in their budgetary practices. Some have gone further in presenting to the public fiscal information previously not in the public domain: for example, Karnataka now publishes information about tax expenditures and arrears and about off-budget borrowing (Government of Karnataka, 2001a). Moreover many states including Andhra Pradesh, Assam, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Orissa, Rajasthan, Tamil Nadu and Uttar Pradesh

The paper has benefited from comments of W. McCarten, S. Schiavo-Campo, P.V. Srinivasan and R. Zagha, as well as conference participants in Delhi and Bangalore. For the full version of the paper see Howes and Jha (2002): write to showes@worldbank.org

have brought out White Papers presenting their fiscal status and, often, measures to deal with persisting problems.

No Indian state has as yet introduced measures to cap deficits, borrowing or debt.[1] Many countries around the world, and many states in other federations, have introduced such measures, known as Fiscal Policy Rules (FPRs). The list of countries with FPRs is increasingly long, and includes Argentina, Australia, Brazil, Canada, Colombia, all members of the European Union (EU), Indonesia, Japan, New Zealand, Sri Lanka, Switzerland and the United States. State (sub-national) governments have introduced FPRs in Argentina, Australia, Canada and the US. Many other countries have proposed the introduction of FPRs, including Costa Rica, and Pakistan. The Government of India (GoI) has tabled a Fiscal Responsibility and Budget Management Bill (FRB) in Parliament (GoI, 2000b). The question naturally arises as to whether state governments would benefit from introduction of some sort of FPR.

This chapter discusses the benefits of alternative FPRs in the context of India. 'Fiscal Policy Rules for a Federation: Options for India' discusses whether India's states should introduce FPRs. 'Design Issues in Introducing FPRs at the State Level' considers design issues which will arise should a state decide to introduce an FPR. The section 'Beyond State Level FPRs: Scope for Coordination' outlines complementary institutional reforms at the national level to FPR adoption at the state level. The final section concludes.

FISCAL POLICY RULES FOR A FEDERATION: OPTIONS FOR INDIA

FPR OPTIONS FOR FEDERATIONS

Ter-Minassian and Craig (1997) provide a summary of rules governing the borrowing of sub-national entities around the world. However, with respect to FPRs, their focus is only on rules laid down by the central government. Kopits (2001) classifies FPR arrangements in federations into two categories: under the coordinated approach, 'all sub-national governments are subject to uniform rules to ensure a degree of fiscal discipline under the surveillance of a central authority (p. 752)'. Under the autonomous approach, 'the initiative for establishing rules arises from individual sub-national governments (p. 752)'.

In general, it can be observed that federations with strong sub-national

[1] Since the completion of this paper, the Indian Parliament has passed the Fiscal Responsibility and Budget Management Act 2003, and several states have also passed Fiscal Responsibility Acts (Karnataka, Punjab, Tamil Nadu).

entities take the autonomous approach (US, Canada, Australia), while those with only local governments or fairly weak provincial or regional governments (Belgium, Japan, Germany) follow the coordinated approach. There are exceptions to this. One is the EU, which imposed a coordinated approach to fiscal policy making on strong, national governments. Its ability to do this can be understood from the perspective of nation states willing to subject themselves in a range of areas to supranational rules to achieve a greater union. Another exception is the case of Brazil, whose states are normally considered strong and independent. In this case, the country's history of macro crises and, specifically, state-level debt-crises and bail-outs, as well as a long-standing tradition of central control (or, rather, attempted control) over state borrowing behaviour, may explain its recent adoption of a highly coordinated approach to subnational fiscal management.

Although Kopits' coordinated/autonomous distinction is certainly a useful one, it is important to recognize that, in fact, one observes around the world a spectrum of arrangements between the two extremes of fully coordinated (Brazil) and completely autonomous (the US or Canada). In between are a variety of arrangements in which both the individual initiative of autonomous states and the coordinating effort of the central government help encourage fiscal discipline at the state level. While state governments can pass laws, central governments can play an important role in terms of helping states to pass such laws, in monitoring compliance and in ensuring uniform accounting treatment.

The Coordinated or Autonomous Approach for India?

Under the Indian Constitution, the government enjoys extensive powers over state borrowing. Article 293 empowers the states to borrow upon the security of their respective Consolidated Funds. These borrowing powers, however, are subject to the following conditions: (a) external borrowing is barred; (b) limits may be imposed by the state legislature on borrowing; and (c) if the central government has advanced or guaranteed a loan to a state which remains outstanding, no fresh loans can be raised by that state without the consent of the central government. It could, therefore, be argued that the Constitution provides GoI with the authority to introduce a coordinated FPR into India, i.e., one which would bind the centre as well as states indebted to GoI, which at present means all states. Two considerations point in the opposite direction, however. First, GoI's actual control of states' borrowing behaviour is far below its constitutional limit. Much borrowing by states is formula-based, and so not linked at all to a state's borrowing capacity. This applies to the block

loans that a state is entitled to from the GoI in accordance with the modified Gadgil formula (based largely on population and income), and the loans raised through Small Savings Schemes (80 per cent of net collections in a state). Access to market borrowings is determined by the RBI in consultation with the Planning Commission and appears to be based on historical precedent (with typical annual increases of about 10 per cent).[2] The RBI also provides ways and means advances and an overdraft facility, linked to state revenue levels (RBI,1998).

The second factor which argues against the coordinated approach in India is that even if the centre were to fully exercise its constitutional powers it would still only control a portion of state debt. First, a substantial amount of state-level borrowing is from the Public Account. Borrowing from the Public Account is not regarded as borrowing against the Consolidated Fund of the states. And so it is presumably not subject, under Article 293, to central control—in any case, even if the Constitution were to support such control, the centre has never made any attempt to exercise it. In theory, the Public Account consists of accounts in relation to which the government acts as a banker. In practice, these accounts are just one more borrowing source for the states, and a very large one at that. Borrowing from the Public Account has been rising over time and now amounts to about one-third of total state borrowing (see Table 11.1).[3]

For GoI to move from a practice of low-level control of state debt to a legislative coordinated FPR would imply a massive increase in central control.[4] This is unlikely to pass the test of political feasibility given India's federal traditions and the increasing assertiveness of the states.

[2] See Rao (1997) for a clear explanation of the various loans and grants states get from GoI. The loans come under the head of 'Plan Transfers'.

[3] The largest component of the Public Account is the Provident Fund (PF)—a savings scheme for state employees, the net proceeds of which automatically flow to the government. Provident Fund flows can be manipulated by state governments by changes to PF rules—this occurred recently with the requirement introduced by many states that salary arrears arising from 5th Pay Commission increases were to be credited to employees' PF accounts. There are also additional important Public Account sources which states have discretion over, including some which enable governments to borrow from the following year's revenue (Personal Deposit Accounts and suspense accounts). Public Account balances of debt, deposit and remittances are carried forward whereas the account for budgetary grants under the Consolidated Fund is closed annually.

[4] Note that GoI does exercise its powers under Article 293 in the sense that it is reluctant to agree to any requests from a state for additional borrowing on top of its normal allocation. But this reluctance is uniform across all states, and not linked to creditworthiness considerations. As a result, as explained later, many states have gone off budget in their search for additional borrowing.

TABLE 11.1
Financing of the Combined States' Fiscal Deficit

	Average		
	1985–9	*1990–4*	*1995–8*
	(Rs billion at current prices)		
Loans from the Centre	62	105.1	217.7
States share of net small savings collections	32.5	62.9	146.9
Others	25.1	42.2	70.8
Market-financed	18	44.6	94.3
Bond issues	15.9	34.1	75.4
Loans from financial institutions	2.1	10.4	19
Public account	30.3	64.1	155.8
Provident fund (PF) and insurance etc.	15.9	37.4	71.2
Non-PF public account	14.4	26.6	84.6
Fiscal deficit	110.2	213.7	467.8
	Per cent of total		
Loans from the Centre	57.8	49	47.4
States share of net small-savings collections	33.1	29.2	31.4
Others	26.3	19.8	16
Market-financed	15.9	20.1	20.6
Bond issues	14.2	16	16.7
Loans from financial institutions	1.7	4.1	3.9
Public account	26.3	30.9	32
Provident fund (PF) and insurance etc.	14.2	17.5	15.1
Non-PF public account	12.2	13.4	16.9
Fiscal deficit	100	100	100

Source: RBI (2000a, b).

The second limitation on the constitutional powers of the central government over state borrowing is that state government guarantees are not subjected by the constitution to central control. This provides a borrowing loophole for state governments. In addition to using guarantees to create contingent liabilities to assist their public enterprises to borrow more widely and at lower cost, state governments have also started to issue guarantees to create actual but off-budget government liabilities which substitute directly for government on-budget borrowing. Governments are able to issue guarantees for special purpose vehicles, the proceeds from which either substitute for government investments or indeed are transferred to general government revenues. Debt-servicing

for such liabilities is then fully met by the budget in later years. An increasing number of states are following such routes, including, for off-budget investments (Gujarat, Maharashtra, Karnataka) and for transfer to the budget (HP, Punjab, AP). The amounts involved can be quite substantial. The Government of Karnataka has announced that it plans to undertake Rs 1900 crore of off-budget borrowing in 2001–2 equal to about 2 per cent of Gross State Domestic Product (GSDP). Consolidating off-budget with budget borrowing for Karnataka increases the budgeted fiscal deficit from 4.3 per cent (taking into account on-budget-borrowing only) to 5.9 per cent of Gross State Domestic Product (GSDP) for 2001–2 (Government of Karnataka, 2001b).

Both the above considerations imply that the coordinated approach to FPRs is likely to be a non-starter in India, as it is highly unlikely that GoI would either want or be able to claim for itself a greatly enhanced role in determining state-borrowing levels. Some effort has admittedly been made in recent years to link federal transfers and state-level fiscal performance more closely—first in 1999 through the Memoranda of Understanding (MoU) signed between GoI and several states for advance release of funds (subsequently converted into medium-term loans) and then in 2001 through the Fiscal Reforms Facility, that links a mixture of Finance-Commission-mandated transfers and additional discretionary transfers to state efforts in reducing their revenue (current) deficits. However, the modest size of these initiatives, the telling fact that they are linked more to additional resources than current entitlements, and the limited success of the MoU process all point to the limited, albeit useful, role the GoI can play in disciplining the states.

ARGUMENTS FOR AND AGAINST THE INTRODUCTION OF FPRS BY INDIA'S STATES

General Considerations

Various arguments have been advanced against the introduction of FPRs. The targets chosen could be arbitrary.[5] FPRs can adversely affect important expenditure in the social sector and for capital formation. They can tie down the hands of future governments, and reduce the scope for counter-cyclical fiscal stabilization.[6] The introduction of FPRs may only have symbolic value, and, while it might articulate the seriousness of the government about fiscal adjustment, it may do very little to help bring

[5] For example, Buiter (1998) argues that the blanket 60 per cent debt limit under the Maastricht Treaty is arbitrary.

[6] This point has been made against the EU stability pact, with calls to scrap it to allow for a more expansionary fiscal policy.

that fiscal adjustment about. Indeed, one could take this line of thinking to its logical conclusion and argue that the introduction of FPRs, prior to successful fiscal adjustment, might do more harm than good.[7] If appropriate policies are not introduced and if the FPR cannot then be adhered to, credibility is lost rather than gained.

The last line of argument against FPRs advanced above, concerning the risks of introducing FPRs prior to fiscal adjustment, is a serious one. Consider the experience of India's states with respect to the power sector. The Electricity Supply Act of 1948 requires states to ensure a 3 per cent return on assets for their power utilities. If this legislative provision had been observed, we would not see the bankruptcy evident in the power sector today (where power-sector deficits routinely approach some 2 per cent of state GDP). Will FPRs in India suffer the same fate as the Electricity Supply Act and, if so, what is the point of introducing them? One can in fact note three lacunae associated with the Electricity Supply Act, and its application. First, it had no reporting requirements. Non-compliance with the Act could go on unnoticed for years. Second, there was no automatic application of corrective actions or sanctions should the target rate of return be not achieved. Third, and by far the most important, there were insufficient policy efforts to ensure conformity with the law. It cannot be over-emphasized that, without supportive policies, introduction of FPRs will indeed be meaningless or, worse, counterproductive. FPRs should, therefore, only be introduced by states which are serious about reforms. FPRs introduced by such states and which include strong reporting requirements and sanctions/corrective actions do have a good chance of escaping the fate of irrelevance suffered by the Electricity Supply Act.

International experience shows that FPRs are neither necessary nor sufficient for fiscal adjustment. Nevertheless, the consensus of the literature is that they are useful in catalysing, supporting and/or sustaining fiscal adjustment. Their widespread adoption among OECD countries, combined with the much improved fiscal position in these countries, reinforces this view, as do several country-specific studies (IMF, 2001). The extensive survey of Poterba (1996) concludes that 'fiscal institutions do matter': (see also Alesina and Perotti, 1996).

Although the evidence is not conclusive, the preponderance of studies suggests that institutions are not simply veils that are pierced by voters, but are important constraints on the nature of political bargaining ... The evidence from empirical studies of fiscal institutions and budget outcomes suggests that tightly-drawn anti-deficit rules, especially when coupled with limits on government borrowing, induce smaller deficits and more rapid adjustment of taxes and spending to unexpected fiscal shortfalls. (p. 47)

[7] Kopits and Symansky (1998), while generally in favour of FPRs, argue that they should preferably be introduced after successful fiscal adjustment. See also Schick (1998) for a discussion why basic reforms are first required in developing countries before they adopt successful models of public administration from industrial countries.

Perhaps the most important argument in favour of introduction of FPRs is the failure in the last ten years to produce fiscal adjustment in India both at the central and at the state levels. India cannot afford the luxury of waiting for fiscal adjustment to take root before the introduction of an FPR—as the experience of the last decade is that the adjustment may never come then. After a decade of failure, it is time for a new approach.

To see the benefits of the FPR in the Indian context, again an analogy can be sought from the power sector. Politicians know that power tariffs need to be increased if fiscal solvency is to be regained, but rather than increasing tariffs they set up regulatory commissions. Why? Because politicians are unable, for political reasons, to increase tariffs on their own. But they can, and do, set up regulatory commissions, a move which has rarely been contentious. But this in effect means that they are transferring power to a body which is able to increase tariffs. Similarly, politicians might recognize that fiscal adjustment is necessary, but are unable to implement the required policies, since these would be unpopular and ignite protests. Hence, they can pass an FPR that would be difficult to object to and that would then force appropriate policy adjustments. Of course, governments can still overrule tariff orders issued by regulators, and there are cases of this. Nevertheless, few would use such cases to argue for the futility of establishing regulatory bodies or, more broadly, for improving the institutional environment for reform.

Specific Considerations at the State Level

Even if one accepted the above arguments and was persuaded, perhaps, that the central government should introduce an FPR, one might still hold out against the states following suit. We have already dealt with the (invalid) argument that states have no control over their borrowing powers. Even for borrowing sources where this is the case (such as market loans), the access provided to the states by GoI to such sources is not based on affordability or sustainability criteria, and states typically borrow whatever is provided, rather than what they can afford. One of the main reasons for state adoption of FPRs is to encourage a move to

borrowing on the basis of affordability for all loan sources, both those controlled by GoI and those that are not.

A more credible argument against state-level FPRs is that the huge resource flows from GoI to the states put the latter at the mercy of the former. Since states cannot control their fate, how can they be expected to adhere to an FPR? While this argument has some validity, it is easily exaggerated. Resource flows from the centre to the states are in fact fairly stable. States in other federations, which are also dependent on central government revenue have managed to introduce and adhere to FPRs.

Another argument in the same line against state-level FPRs in India is that, unless the distortions in the fiscal federal system are removed, any attempts at fiscal correction at the state level are doomed to failure. It is commonly argued that budget constraints at the state level are 'soft' and that this results in perverse incentives for the states. In general, this argument is misplaced. Falling behind schedule on debt repayment to GoI is not unheard of, but it is rare, and only temporary in nature. Ultimately, GoI has the balance of power since the net flow of transfers is strongly in the direction of the states: thus the centre cannot be held to ransom. Of course this may change in response to the current fiscal stress. Whether GoI would ultimately move to bail out in a significant way a state unable, say, to pay its salaries remains to be seen. So far, one has seen a lot of suffering at the state level, without a breakdown of the basic discipline of debt repayment, but certainly with some fraying at the edges. Small bail-outs have been provided in recent years, though mainly in the nature of liquidity support.

There is, however, one major area of softness in state fiscal affairs about which there can be no dispute, and this is the huge power sector deficit which states run. In many states, the power-sector deficit (that is, revenue from the sale of power minus operational costs, interest and capital expenditure) is about 2 per cent of GSDP. Under law, this gap should be made good by government subsidy, but payment of such subsidies is more promised than made, and utilities are forced to resort increasingly to borrowings and the accumulation of arrears to fill the gap. Some borrowings can be made by utilities, typically with state-government guarantees, from banks, development institutions and specialized power-sector financial institutions, such as the Power Finance Corporation (PFC). But arrears, largely to GoI-owned enterprises, are heavily relied on.

Finally, it is clearly the case that if states borrowed less from the centre, and more from the markets, market discipline could be brought to bear more on state finances through credit ratings.[8] While some states have

moved in this direction, market-borrowings are neither a guarantee of fiscal discipline (Shah, 1998) nor a substitute for FPRs: many states around the world borrow from the market under the discipline of an FPR.

Even authors such as Anand, Bagchi and Sen (this volume, chapter 3) who launch a trenchant attack on the weaknesses of India's fiscal federalism, nevertheless come out in favour of the states disciplining themselves through voluntarily-imposed FPRs as one part of the solution to the current malaise. This is exactly the position we take.

DESIGN ISSUES IN INTRODUCING FPRs AT THE STATE LEVEL

Whether state legislators take the GoI Fiscal Responsibility Bill (FRB) or any other FPR as their starting point, they will need to consider a number of important questions in designing an FPR for their state. We identify below, a number of such questions, grouped under three themes: targets, reporting requirements, and sanctions or corrective mechanisms.

TARGETS

We assume in what follows that states, if they move on the FPR front, will adopt a *prescriptive* FPR, that is, one that prescribes detailed, quantitative targets to be achieved by a fixed date. Such an approach, international experience and common sense combine to suggest, is appropriate for governments yet to achieve fiscal adjustment, which need to be bound by targets, and which do not have the credibility for the legislative enshrinement of principles of fiscal prudence and transparency to be meaningful (Howes and Jha, 2002). However, in setting specific targets various questions need to be considered.

There is a need to go beyond the budget in setting FPR targets, in particular to incorporate off-budget borrowing and the power sector deficit. We consider various targets (different deficit and other fiscal ratios), how quantitative levels for these could be set, whether a time path to the final targets should also be set, what 'let out' clauses for unforeseen calamities, such as war, should be allowed, and what restrictions should be placed on states' relationship with India's central bank, RBI.

[8] See Poterba (1996) on the credit rating of US governments; Sabourin (1999) for Canada, and Petersen (1999) on the credit rating of local governments. The introduction of credit ratings for the overseas borrowings of Australian state governments had a huge impact on state finances, especially in Victoria, when the state's rating was downgraded by the international rating agencies.

How Can Off-budget Borrowing be Incorporated?

Some states now incur more capital expenditure financed by off-budget borrowing than they do on the budget. Note that this is not a problem of contingent liabilities, but actual, though off-budget, liabilities. Simply capping guarantees will not, therefore, provide a solution to this problem, though a cap on contingent liabilities created through debt guarantees would be an important part of, or addition to, any FPR.[9] However, when the probability of a guarantee being called is 100 per cent, and known to be so from the start, the amount guaranteed should be subject to the same caps as debt incurred through the budget by consolidating off-budget and budget borrowing.[10]

There are at least three technical issues which would require resolution in extending an FPR to cover off-budget borrowing. First, in measuring the consolidated fiscal deficit one should be concerned with off-budget capital expenditure rather than off-budget borrowing, so that the capital expenditures financed by off-budget borrowings will have to be monitored. Second, a rule would be needed to decide which guaranteed borrowing would be counted as off-budget borrowing. A small probability that the borrowing firm will be able to repay a small amount of the loan should not be sufficient for the liability to be classified as contingent rather than actual from the perspective of the government. Guidelines for classification of off-budget liabilities as actual or contingent would need to be developed. Third, other debt-equivalent financing devices, such as leasing, should also be covered by the FPR.

How Should the Power Sector Deficit be Tackled?

A more complicated issue concerns the treatment of states' large power sector deficits. In theory, a FPR could target the public sector consolidated deficit or debt stock. However, with states often owning fifty or more enterprises, and poor financial information flows, this approach is hardly practical in the Indian context.

It could make sense to target the consolidated budgetary, off-budget and power deficit.[11] This would put the power-sector deficit on the same footing as the budgetary deficit, eliminate the incentive to achieve FPR

[9] Some states have already legislated to limit guarantees: Assam, Gujarat, Karnataka.

[10] Interestingly, guarantees as a percentage of GSDP were roughly constant over the 1990s (Bannerji, 2000). However, there was definitely a change in the riskiness of these guarantees, with a higher proportion of guarantees having a high, if not a 100 per cent, likelihood of reverting to the government.

[11] To the best of our knowledge there are no FPRs that target the consolidated public-sector deficit.

targets by not meeting power subsidy obligations, and support financial restructuring of the power sector.

But there would also be disadvantages in targeting a consolidated fiscal-power deficit. One, it is a complex target, which politicians and the public may find difficult to understand, though simply labelling the target the 'consolidated deficit' or 'overall deficit' may help. Two, it is unclear that some states will be able to eliminate, or even reduce, their power sector deficit. Arrears, like debt, once accumulated, attract interest; unlike debt, the interest on arrears is penal. It may, thus, not be possible to bring down the current deficit without a write-off of past arrears or, at least, the interest charged on those arrears.

On balance, we would recommend in most cases targeting of a consolidated fiscal-power deficit as the key variable for any state-level FPR.

What Should be the Target Variables?

Even assuming a focus on consolidated expenditure and revenue, the target itself still needs to be defined. Would it be a fiscal deficit, or revenue (current) deficit target, or a target for debt, debt-service or interest? And would these targets be expressed as a ratio, and, if so, of what, state output or revenue, for example?

We consider first the choice between targeting the fiscal versus the revenue or current deficit. Targeting revenue balance enjoys widespread support in India and may help to protect capital spending. On the other hand, targeting revenue balance can lead to budgetary distortions.[12] These can already be observed as states, for example, classify their budgetary support to the power sector as equity investments to avoid counting them as revenue expenditures.[13] Another reason for targeting the fiscal rather than the revenue deficit is the need to cap off-budget borrowing much of which finances capital expenditure. With capital expenditures uncapped, states could continue to bankrupt themselves by shifting capital expenditure, and borrowing for the same, off-budget.

An alternative would be to cap not a deficit, but a debt-related variable such as debt stock, debt service or interest payments. The problem with these variables is that they are backward-looking rather than current

[12] Kopits (2001) comments that caution is needed to prevent leakages (by financing camouflaged current expenditure) associated with the golden rule, which have been prevalent in Germany and in some US states (p. 751).

[13] Another distortionary disincentive from targeting the revenue deficit arises from the fact that increasing grants to local bodies increases the revenue deficit even if such grants are used to execute capital works.

indicators of a state's fiscal sustainability as the deficit variables are. Nevertheless, they can be useful supplementary indicators as they directly correspond to one of the central objectives of any FPR, namely to contain the debt-burden.

Should the deficit target be cyclically-adjusted? Some countries have chosen this route,[14] but it adds to complexity and raises the risk of abuse. Moreover, we are not aware of any sub-national entities which have taken this route, suggesting that, given the limited role that any individual state government can play with respect to fiscal stabilization, it is unlikely that the benefits of cyclical-adjustment will outweigh the costs.

Expressing the fiscal target variable as a ratio of output is a conventional approach for countries, but not so for states—typically, either a current balance is assumed (so the question of denominator does not arise) or ratios of revenue are used as the target (for example, in Salta, Argentina, the ratio of debt/revenue is targeted). India's statistical data has given rise to increasing concerns, and state-level output data (GSDP) has long been thought to be suspect. For all the difficulties in using GSDP, its use might still be acceptable bearing in mind that the aim of the FPR legislation is to set targets, and that, within any year, fiscal targets would be translated into nominal values and tracked accordingly. Alternatively, revenue could be used as the denominator, or nominal (absolute) values could be chosen as targets.

How to Choose the Quantitative Targets?

Finally, whatever target variables are chosen, numerical targets will be needed. The appropriateness of various targets depends on assumptions concerning growth rate, interest rate and the long-run debt stock. States vary a great deal with respect to real growth (from 2 to 9 per cent) and debt-stocks (from 20 to 50 per cent of GSDP). States face a common effective interest rate of 13 to 14 per cent, well above the GoI effective interest rate of less than 10 per cent. For instance, a state facing an interest rate of 13.5 per cent, growth of 12 per cent and debt stock of 30 per cent of GSDP can run a sustainable fiscal deficit of 3.6 per cent of GSDP. A state facing the same interest rate, but lower growth, say 8 per cent, and higher debt, say 50 per cent, can run a higher sustainable deficit of 4.2 per cent.

States will need to decide whether they simply want to stabilize the debt stock at its current level (of GSDP) or target a reduction in the debt

[14] For example, New Zealand, EU, the UK and Switzerland use cyclically-adjusted fiscal rules. Of these, EU specifies clear quantitative targets.

stock, and thus the interest burden, in which case tighter targets will be needed. Given the uncertainty behind medium-term forecasts, it is also likely a quantitative FPR would require revisions after, say, five years.

Should the FPR Define a Path to the Final Targets?

GoI's FRB requires annual reductions of at least 0.5 percentage points a year in the fiscal and revenue deficit targets (as a percentage of GDP). This is a feature of some but not all pre-adjustment, prescriptive FPRs. For example, the Argentina and Peru FPRs specify declining annual budget deficit limits; the Maastricht Treaty, by contrast, simply gave a final target to be achieved after five years; the Brazilian targets became valid with immediate effect (Kopits, 2001, p. 756). Having annual targets adds to the credibility and bite of the FPR, since it avoids the risk of postponement: that any fiscal adjustment scheduled to take place over several years will be presented as on track subject to substantial adjustment in the outer years. At the same time, use of annual targets, increases the importance of choosing the correct underlying variable to target.

What Scope for Exemptions?

Once quantitative targets are specified, the need arises for a let-out clause. The extent to which targets can bind governments is inversely related to the generosity of any provisions for exemptions. The GoI FRB includes a let-out clause under which the targets may be exceeded on grounds of 'unforeseen demands on the finances of the central government due to national security or natural calamity'. This is, in fact, a rather wide-ranging exemption since India, being such a big country, is afflicted most years by serious security problems or natural disasters. Security issues, as distinct from law-and-order, are presumably not relevant at the state level,[15] but states are also prone to natural disasters, and many states suffer from adverse climatic conditions of one type or another in at least some part of the state every year (drought, flood, hurricane, etc.). The regular flooding of Bihar comes to mind for example, as does the succession of flooding and drought conditions Orissa has been subjected to.

One solution to the problem that the current wording could give states an almost annual 'let-out' from having to achieve the prescribed targets would be to retain a let-out clause for declared state-level calamities, but to require that the net fiscal costs of the calamity be identified (on a net

[15] Security issues could become relevant to states in case of a large war; possibly in such cases, the FRB could be temporarily suspended by ordinance, or the state could legislate for suspension in the event of suspension by GoI.

basis since states typically receive fiscal support from central-level contingency funds). The amount in excess of the annual average could then be added to the annual targets.

Should State Borrowing from the Reserve Bank of India be Regulated?

The GoI FRB includes a target of zero borrowing from RBI by 2003. In general, RBI does not subscribe to the primary issues of state government securities. Nevertheless, there would be no harm in codifying that practice in law. States do use RBI to solve cash-flow problems. And for some states reliance on ways and means and overdraft facilities has in fact become a source of borrowed revenues (i.e., states are unable to improve their cash balances and so continually have to resort to ways-and-means advances and overdraft facilities). However, the amounts involved are small, and it would not make sense for individual states to legislate these arrangements, as RBI would presumably like to have common arrangements with all states. Nevertheless, the fiscal reports which states produce should clearly show reliance on ways and means and overdraft facilities, as these are important indicators of fiscal distress.

Reporting Requirements

Do States Have the Capacity to Meet the Reporting Requirements of an FPR?

If states held themselves to the standards of the GoI FRB, they would be required to present three annual fiscal reports to the legislature (a Medium-Term Fiscal Policy Statement, a Fiscal Policy Strategy Statement and a Macroeconomic Framework Statement) as well as annual statements on guarantees and, much more difficult, on levels of arrears in payments and receipts. They would also be required to present quarterly progress reports and reports on deviations and remedies. These proposals are all well conceived. But fiscal analysis capacity is extremely limited at the state level. Passage of a FPR will require an institutional deepening of financial capabilities at the state level, with additional hiring of qualified staff an essential part of this.

One of the biggest challenges the states will face is to produce the annual FPR report(s) at budget time since this is the busiest time of the year for finance. However, the discipline of presenting this report at the time of budget should remain since (a) it can then feed into the budget debate and (b) it will help impose greater discipline on the budgetary process and prevent last-minute changes.

Quarterly reporting should be feasible, though it will suffer from a lag. Of course, most states do not keep their own accounts, but rely on the Comptroller and Auditor General (CAG), a national agency, for this purpose. The CAG does produce monthly accounts, though with a lag. Moreover, several states have computerized their treasuries, and so can compile their own provisional accounts on a parallel basis.

States will also need to develop models of intra-year fiscal forecasting. Taxes and especially expenditures are both highly seasonal. Intra-year forecasts, to be credible, could be based on comparisons using cumulative monthly to annual ratios of say the five preceding years.

On arrears, the FRB takes a realistic approach and advocates reporting of arrears rather than a switch to accrual accounting. However, while most states can report tax arrears (monies owed to the government) few, if any, track arrears in payments (monies owed by government). It should not be hard to devise a supplementary system which does so, either by tracking commitments or by tracking when bills presented become overdue. The first state to devise such a system will be making a major contribution to fiscal transparency in India.

Should There be Provision for External Review?

The draft FRB submitted by the Sarma Committee contained provision for a Fiscal Management Review Committee of 'experts in the field of macroeconomic management, banking, accounts, audit and law', appointed by a bipartisan political committee, which would submit reports reviewing adherence to the FRB, once passed, to GoI, who in turn would present them to the legislature. This proposal was dropped from the GoI FRB, perhaps on account of the objections of the CAG appended to the Sarma report (see Government of India, 2000a and 2000b). While external review is not a feature of FPRs around the world, there is a trend discernible in that direction. In the UK, the Fiscal Stability Code lays down that the Treasury 'shall invite the National Audit Office to audit any changes to the key assumptions and conventions underlying the fiscal projections'. In Victoria, Australia, budgetary assumptions are audited by the state's Auditor General under the 1994 Audit Act. In the US, there are two official bodies which provide competing forecasts of tax, expenditure and deficits, the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB).

In India, external scrutiny would definitely help strengthen any FPR. This task could be given to the CAG itself, though the latter would then need to strengthen its capacity for economic analysis. States could also

establish fiscal advisory councils, which could submit periodic, public reports on adherence to the adopted FPR.

Should the States Require Pre-budget and Pre-election Fiscal Reports?

Some recent FPRs, though not the FRB, have contained a provision for two sorts of reports: pre-budget and pre-election fiscal reports (see Box 11.1). The run-up to elections is an important incubator of fiscal indiscipline in India. Publication of neutral fiscal forecasts prior to assembly elections would help bolster the fiscal responsibility of incumbent governments, as such forecasts would reveal to the electorate the likely future impact of fiscal profligacy. Similarly, neutral costing of electoral promises would help restrain the tendency towards populism in the election promises of both the incumbent and opposition parties.

The motive for pre-budget reports is quite different. Here the idea is that about three months before the budget a preliminary fiscal forecast and set of aggregate budgetary proposals would be made public by the government. The aims would be: (a) to establish aggregate targets at an early stage within which different sectoral bids can be contained, (b) to encourage public debate and (c) to remove the perennial problem of last-minute entry of new activities into budgets. Such an approach promotes transparency ahead of budget secrecy, though provisions can be allowed to prevent pre-disclosure of sensitive tax policy changes.

BOX 11. 1
PRE-BUDGET AND PRE-ELECTION REPORTS

Both pre-budget and pre-election reports are becoming increasingly common around the world, and are increasingly found in FPRs.

Pre-election Reports

The Australian Charter of Budget Honesty as well as the NZ FRA require the government to publish a set of fiscal updates prior to all elections. Under the Australian Charter, Secretaries of the Departments of the Treasury and the Department of Finance and Administration are required, jointly, to publicly release a pre-election economic and fiscal outlook (PEFO) report within ten days of the issue of a writ for a general election. The Australian Charter also provides for public servants to cost election promises. During the caretaker period for a general election the Prime Minister may request the Secretaries of the Treasury and Department of Finance and Administration to prepare costings of publicly-announced Government policies. The leader of the Opposition may also request costings of publicly-announced Opposition policies. (See http://www.dofa.gov.au/budgetgroup/Other_Guidance_Notes/ charter_of _budget_honesty.html; http://www.treasury.gov.au/publications/ CharterOfBudgetHonesty/ provides guidelines for costing election promises.) Brazil's Fiscal Responsibility Law doesn't require pre-election reports, but does restrict expenditure and borrowing during the last six months to one year of a government's life.

Pre-budget Reports

The NZ FRA was perhaps the first to formally require pre-budget reports. A Budget Policy Statement is required about three months before the annual budget to enumerate the government's broad strategic priorities for the forthcoming budget, and short- and long-term fiscal objectives. At the time of the budget, a Fiscal Strategy Report is published: this compares budget figures and policies with those of the latest Budget Policy Statement, and explains inconsistencies. The UK has since gone well beyond this in its Code of Fiscal Stability. It now publishes a Pre-Budget Report three months prior to the budget. This is required to include 'so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the budget', as well as multi-year forecasts of key fiscal variables. This Pre-Budget Report is in addition to the medium-term and annual fiscal strategy and forecast reports, which, in the UK, are both required at the time of the budget. The Pre-Budget Report has a let-out clause for tax policy changes. The Government is not expected to pre-announce these if such an announcement might lead to significant postponement of economic activity in anticipation of tax gains, or other significant distortions in taxpayer behaviour. Sweden has perhaps taken the concept of two-stage budgeting the furthest of all Organization for Economic Cooperation and Development (OECD) countries. In Sweden, in the first budget stage, the legislature actually votes on spending totals. 'Several months later the government compiles the estimates for the next fiscal year. These spending amounts must be within the aggregates previously set by the government' (Schick, 2001).

Sanctions and Corrective Mechanisms

There are various international examples of FPRs with financial and even individual penalties, as in the case of Brazil and the EU (Howes and Jha, 2002). However, these are cases where a coordinated approach is taken, so that a supervising body is able to impose penalties on a subordinate one. There are no cases, at least so far as the authors are aware, of an

entity committing to punish itself for non-compliance. However, compliance can be sought through other means, particularly the use of automatic corrective mechanisms, as explored below.

Should There be Provision for Intra-year Auto-corrections?

Automatic expenditure cuts if fiscal targets are unlikely to be achieved are characteristic of a prescriptive FPR. Since there is a serious risk that targets will not be met, mechanisms are proposed to mitigate this risk. The underlying structural problem is poor fiscal marksmanship or lack of budgetary realism. The chronic nature of this problem can be illustrated from analysis of a single state, Karnataka, which is in fact one of India's better-managed states. For the last four years for which data is available (1996/97–1999/2000), actual revenues have been on average only 89 per cent of budgeted revenues. The shortfall is fairly uniform: the ratios for each of the four years are 92 per cent, 90 per cent, 87 per cent, 89 per cent. Expenditures have partially adjusted (the ratio of actual to budgeted expenditures is 97 per cent), but not enough to prevent a blow out in deficit targets by 40 per cent on average (the actual deficit is 132 per cent, 122 per cent, 146 per cent, and 162 per cent of the budgeted deficit in each of the four years).

This lack of budgetary realism has several sources, apart from perennial optimism. First, the ambitious revenue targets are a mechanism to accommodate unaffordable expenditure proposals. Since the proposals cannot be rejected *ex ante*, they are included in the budget, financed by fictitious revenue and then never implemented, or under-financed, during the year. Second, in a context of severe corruption and non-compliance, tax revenues depend on collection effort, and finance departments try to induce tax effort by setting ambitious or 'stretch' targets—against the principle of 'prudent' or conservative budgeting followed by most Western treasuries.

The introduction of quarterly reporting and the requirement for corrective measures would do a lot to promote budgetary realism. It would ensure a greater expenditure response to tax shortfalls and would make the process of expenditure cuts much more transparent. A useful complement to quarterly reviews would be a requirement of 'pay-as-you-go' provisions for policies introduced between budgets. At budget time, the presence of legislated targets would ensure that deficit-increasing policies are neutralized by deficit-reducing offsets, but many deficit-increasing policies are announced in the course of the year without any offset.

BEYOND STATE-LEVEL FPRs: SCOPE FOR COORDINATION

While we have rejected the fully 'coordinated approach' to fiscal responsibility in India as unfeasible and undesirable, we have, nevertheless, noted the scope for coordinated action, initiated by GoI, to supplement the states' own efforts at promoting fiscal responsibility. In this section, we briefly outline what some of these actions might entail. Various merits of a cooperative approach include promotion of 'dialogue and exchange of information' across various levels of government and making sub-national governments more aware of the macroeconomic consequences of their budgetary policies (Ter-Minassian and Craig, 1997).

Increased Reliance on Market Borrowings

Increased reliance of the states on market borrowings would help depoliticize the lending process, and strengthen market incentives for creditworthy behaviour. This could be done in several ways. GoI could cease lending to states. All transfers could be through grants. State plans would then be supported by GoI grants (untied and conditional) and market borrowing, but not by GoI loans as at current.[16] Small savings could also be channelled to the capital markets, rather than being captive to states. Since states are debarred from external borrowing, a statutory body could be created to enter into arrangements with official funding agencies for state projects. It could be required to be self-funding, to set interest rates accordingly and, if necessary, to cross-subsidize poorer states.

Greater use by GoI of its powers under Article 293

GoI is under-utilizing the powers given to it under Article 293 to control state borrowing. It could significantly strengthen conditionality for access to new loans. For example, GoI could require that all states wanting new loans produce a medium-term fiscal policy statement showing borrowing requirements and how sustainability will be achieved. Even under the current regime, such a statement could be a precondition for (a) accessing market loans or (b) receiving loan support for a state's plan.

Enhanced Cooperative Controls over Borrowing and Reporting

Emulating Australia's example, India could create a Loan Council, either as a coordinating and reporting mechanism (as the Loan Council in

[16] More radical alternatives would be abolition of state plans and plan funds, which would leave all untied funds flowing to the states through the National Finance Commission.

Australia now is) or as a body which sets borrowing ceilings for the states. At a minimum, such a Council would report and consolidate central and state borrowing and lending plans and outcomes. It could also serve as a vehicle for common improved accounting standards and reporting requirements, including the evolution of a common states' FPR. Article 293 could be used, if necessary, to provide backing to the Loan Council and provide incentives to the states to improve accounting and reporting. In the interim, prior to creation of some sort of Loan Council, the welcome efforts being made by the RBI and some states to improve fiscal accounting and reporting should be accelerated.

CONCLUSION

Prospects for India's much-needed fiscal adjustment would be enhanced by the introduction of legislated fiscal policy rules at the levels of the state as well as that of the central government. While institutional reforms such as the introduction of FPRs cannot substitute for the policies needed to realize fiscal adjustment, they can help catalyse and complement these reforms.

The chapter draws on international experience with FPRs in federations and the spectrum between a fully coordinated approach, at one extreme, at which the central government lays down the law for sub-national fiscal policy, and a fully autonomous approach, at the other extreme, in which each sub-national entity lays down its own rules. India's best hope lies somewhere between these two extremes, with a combination of state-level FPRs and coordinated national actions to promote fiscal responsibility.

Introduction of an FPR should only be contemplated by a reforming government and as part of a reform package. Complementary actions will be needed to make the FPR a success. We are referring here not to the introduction of fiscal reforms, though of course this is crucial, but to complementary institutional measures. Of the various ones mentioned earlier, we would highlight the following:

1. Urgent attention needs to be given to establishing a system for tracking and determining the quantum of payment arrears. While a move to accrual accounting may be some years off, there are so many and so many different sorts of arrears at the state level, that it is difficult to see an improvement in fiscal discipline without a better handle on this problem.[17]

[17] The Ahluwalia report on fiscal transparency (RBI, 2001b) gives useful suggestions for steps towards accrual accounting.

2. Improved forecasting, both inter- and intra-year, will also need to be part of the reform package. States generally have no estimate of their current year's GDP growth, let alone a forecast of the next year's. Tax forecasting models, like economic models, simply don't exist at the state-level in India, though they are taken for granted in states in developed-country federations.
3. Expanded capacity within finance departments will be critical to enable these changes to be introduced and to cope with the reporting requirements of any FPR.
4. Widespread public education and publicity campaigns should accompany FPR introduction. In particular, the budget should be accompanied by dissemination of fiscal targets and budget details through different media to educate the public about the budget, its objectives, assumptions and implications for the economy to avoid making policy mistakes. It is a striking fact that many budget speeches still fail to make any reference at all to a state's fiscal or revenue deficit.

Finally, while this chapter stresses the need for introduction of FPRs by states, it also outlines some of the coordinating actions which the central government could take the lead in to supplement the states' own efforts. These include incentivizing the states to borrow more from the market and less from the central government; using existing powers under Article 293 to nudge states towards more responsible fiscal behaviour and establishing an institutional mechanism on which all states would be represented to promote fiscal coordination and discipline. Last, but by no means least, though there is no need for the states to wait for the centre, the GoI will need to lead by example if fiscal responsibility is to become both law and practice at the state level.

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