

Fiscal Responsibility and Budget Management Bill 2000

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“Physicians say of consumption, that in the early stages of this disease it is easy to cure but difficult to diagnose; whereas later on, if it has not been recognized and treated at the beginning, it becomes easy to diagnose and difficult to cure. The same thing happens in affairs of State.”

Machiavelli

The Fiscal Responsibility and Budget Management Bill 2003, the most recent attempt at controlling fiscal profligacy, has been passed in the Lok Sabha after a lot of debate. The FRBMB 2000 covers wide ground, has numerous angles, dimensions and levels to it. To assess the various measures in the FRBMB, it might be useful to divide its provisions into four categories -- legal statutes, accounting stipulations, numerical targets and ceilings for deficit measures. The implementation of rules to cut spending and/or raise taxes when deficit targets (triggers) are reached, are also included in the measures.

The Bill introduced in December 2000 specified that the Centre should lay annual statements on the medium-term fiscal policy, fiscal policy strategy and macro-economic framework before both Houses of Parliament. In its original form, the Bill sought the elimination of revenue deficit by the end of 2005-06 and proposed reduction in the fiscal deficit to 2 per cent of the gross domestic product. It also prohibited borrowing by the Centre from the Reserve Bank of India after 3 years except by way of advances to meet temporary cash needs in certain circumstances. The Bill had proposed a cap on government guarantees at 0.5 per cent of the GDP in any financial year and restricting the annual liabilities to less than 50 per cent of the GDP every year for 10 years beginning 2001. According to the Bill introduced in 2000, the government was to reduce the revenue deficit by 0.5 percentage points or more of the estimated GDP every year reducing it to nil by March 31, 2006.

The Bill however has been debated in the Lok Sabha since December 2000 and some of its most effective and important clauses have been diluted. The objective of this study is to look at the original and diluted version of the Bill and compare them with measures other countries use to achieve fiscal responsibility.

Experience reveals different approaches to fiscal responsibility legislation. In particular, it is important to distinguish fiscal responsibility legislation that establishes certain reporting standards from that which sets specific fiscal targets and that which involves some combination of both approaches. Autonomy of Central Bank and Accounting Transparency are a few clauses that come up in this context. In India, we have shifted from one approach of fiscal legislation to another, specifying fiscal targets in the former and establishing certain standards in the latter. Due to such a shift, we may end up achieving the objectives of neither.

In the paper, we will track down the bill passed in Lok Sabha and its effectiveness. Alongside understand three different approaches towards fiscal discipline. New Zealand with broad prudential measures establishing certain reporting standards, United States with its various legislations, none of which were as effective as desired and the European Union which used its joint currency as a measure to bring about fiscal discipline.

Why we require such legislation?

The Central Government has been borrowing endlessly from the Reserve Bank of India and its internal debt is among the highest in the world. World Bank says that India has less External debt than most others, with a Debt-GDP ratio of only 20.6. In terms of high Central budgetary deficit in 1997, India ranked tenth, after Greece, Turkey and Pakistan, among others. High deficits at the State Government levels have further compounded the problem. According to the IMF, “Weak revenue performance and lack of expenditure control at both the central and state government levels caused the consolidated deficit of the public sector to rise sharply to around 11 per cent of GDP in FY 1999/00, with public sector debt exceeding 80 per cent of GDP.” The deficit and debt has attracted focused attention with the introduction of the Fiscal Responsibility and Budget Management Bill in the Lok Sabha in December 2000. *Five aspects of the deficit* problem have attracted attention. *First*, is the deficit itself, which is a large proportion of GDP. *Second*, is the composition of the deficit, in particular the sizable revenue deficit that goes to finance current consumption of the government, and the primary deficit, which is the fiscal deficit less interest payments. *Third*, is the growing debt, which is the accumulated deficit from the past. *Fourth*, is the growing interest burden on public debt, which is an obligatory expenditure and constrains the flexibility available with the government in resource allocation. *Fifth*, is the financing a part of the high deficit through borrowings from the Reserve Bank of India.¹ There is a widespread unanimity about the unsustainability of the current Indian fiscal stance. Mounting debt from accumulated deficit of the past resulted in interest expenditure of the Central Government increasing 51 times over the two decades from 1979-80. Center’s interest payments of Rs. 902 Billion preempted 40 per cent of gross tax and non-tax revenues in 1999-2000. Taking into account defense revenue expenditure, major subsidies and transfer to States, there is nothing left after interest payment and the Center has to borrow to meet other items of revenue expenditure. Thus, there is a desperate need for legislation on the ceiling of the expenditure of the Central Government and to put a cap on Government borrowings.

Fiscal Responsibility Provisions in India²

Provisions as introduced in 2000 ³	Amendments ⁴	Effect of these Amendments
<p>3)Fiscal Deficit means-</p> <p>a) The excess of total disbursements, from the consolidated fund of India, excluding repayment of debt, over total receipts into Fund, excluding debt receipts.</p> <p>b) <i>Total expenditure of Consolidated Fund of India (including its loans but excluding repayment of debt) over its tax and non-tax receipts.</i></p>	<p>Fiscal Deficit means -the excess of total disbursements, from the consolidated fund of India, excluding repayment of debt, over total receipts into Fund.</p>	<p>The definition of “fiscal deficit” has been narrowed by excluding debt, which is nowhere close to a negligible figure.</p>
<p>4. Fiscal Management principles.-(1) <i>The Central Government shall respond appropriately to eliminate the revenue deficit and fiscal deficit and build up adequate revenue surplus.</i></p> <p>(2) <i>In particular, and without prejudice to the generality of the foregoing provision, the Central Government</i></p>	<p>The Central government shall take appropriate steps to reduce fiscal deficit and eliminate revenue deficit by the 31 March 2008 and there</p>	<p>All the targets have been removed to achieve the required deficit level and it has been left to the whim of the government to</p>

¹ Kannan, R., and Lahiri, Ashok. 2002. *India’s fiscal deficits and their Sustainability in perspective*. New Delhi: National Institute of Public Finance and Policy.

² Source: Fiscal Responsibility and Budget Management Bill 2000

³ Italicised text has been amended

⁴ Taken from Notice of Amendments

<p>shall—</p> <p>(a) Reduce revenue deficit by an amount equivalent to one-half per cent. Alternatively, more of the estimated gross domestic product at the end of each financial year beginning on the 1st day of April 2001;</p> <p>(b) Reduce revenue deficit to nil within a period of five financial years beginning from the initial financial year on the 1st day of April 2001 and ending on the 31st day of March 2006;</p> <p>(c) Build up surplus amount of revenue and utilise such amount for discharging liabilities in excess of assets;</p> <p>(d) Reduce fiscal deficit by an amount equivalent to one-half per cent. Alternatively, more of the estimated gross domestic product at the end of each financial year beginning on the 1st day of April 2001;</p> <p>(e) Reduce fiscal deficit for a financial year to not more than two per cent. of the estimated gross domestic product for that year, within a period of five financial years beginning from the initial financial year on the 1st day of April, 2001 and ending on the 31st day of March, 2006: Provided that revenue deficit and fiscal deficit may exceed the limits specified under this sub-section due to ground or grounds of unforeseen demands on the finances of the Central Government due to national security or national calamity: Provided further that the ground or grounds specified in the first proviso shall be placed before both Houses of Parliament, as soon as may be, after such deficit amount exceeded the aforesaid limits;</p> <p>(f) Not give guarantee for any amount exceeding one-half per cent. Of the estimated gross domestic product in any financial year;</p> <p>(g) Ensure within a period of ten financial years, beginning from the initial financial year on the 1st day of April 2001, and ending on the 31st day of March 2011, that the total liabilities do not exceed 50% of the GDP.</p>	<p>after build up adequate revenue surplus.</p> <p>a) The annual targets for reduction of fiscal deficit and revenue deficit during the period beginning with the commencement of this act and ending on 31st March 2008.</p> <p>b) The annual targets assuming contingent liabilities in the form of guarantees and the total liabilities as a percentage of GDP; provided that the revenue deficit ad fiscal deficit may exceed such targets due to grounds of national security, national calamity or such other exceptional grounds.</p>	<p>decide for every financial year.</p> <p>It is also not binding in nature i.e. the Central government can exceed the deficit target for the year.</p> <p>Other ways in which the government can bypass the bill are inherent in the bill like in case of national security or calamity, whose definitions are for the central government to be declared and not specified in the bill.</p>
<p>5. Borrowing from Reserve Bank.-(1) The Central Government shall not borrow from the Reserve Bank.</p> <p>(2) Notwithstanding anything contained in sub-section (1), the Central Government may borrow from the Reserve Bank by way of advances to meet temporary excess of cash disbursement over cash receipts during any financial year in accordance with the agreements, which may be entered into by that Government with the Reserve Bank: Provided that any advances made by the Reserve Bank to meet temporary excess cash disbursement</p>	<p>3) The Reserve Bank may subscribe, on or after the period specified in this sub-section, to the primary issues of the central Government securities due to grounds of National security or National calamity.</p>	<p>This amendment allows the central Government to monetise its budget deficit on grounds of national security or calamity even after the prescribed limit of two years, which is in the bill. Therefore, this clause is killing the initial objective of the</p>

<p>over cash receipts in any financial year shall be repayable in accordance with the provisions contained in sub-section (5) of section 17 of the Reserve Bank of India Act, 1934 (2 of 1934).</p> <p>(3) <i>Notwithstanding anything contained in sub-section (1), the Reserve Bank may subscribe to the primary issues of the Central Government securities during the financial year beginning on the 1st day of April 2001 and subsequent two financial years.</i></p> <p>(4) <i>Notwithstanding anything contained in sub-section (1), the Reserve Bank may buy and sell the Central Government securities in the secondary market.</i></p>		<p>bill of putting a cap on government borrowings. This clause removes any kind of ceiling on government borrowing that the bill may have intended to have.</p>
<p>6. Measures for fiscal transparency.-(1) The Central Government shall take suitable measures to ensure greater transparency in its fiscal operations in public interest and minimise as far as practicable, secrecy in the preparation of the annual budget.</p> <p>(2) <i>In particular, and without prejudice to the generality of the foregoing provision, the Central Government shall, at the time of presentation of the annual budget, disclose in a statement as may be prescribed, —</i></p> <p>(a) <i>The significant changes in the accounting standards, policies and practices affecting or likely to affect the computation of prescribed fiscal indicators;</i></p> <p>(b) <i>As far as practicable, and consistent with protection of public interest, the contingent liabilities created by way of guarantees including guarantees to finance exchange risk on any transactions, all claims and commitments made by the Central Government having potential budgetary implications, including revenue demands raised but not realised and liability in respect of major works and contracts.</i></p>	<p>2) The Central Government shall at the time of any such presentation of annual financial statements or demand for grants, make such disclosures and in such form as may be prescribed.</p>	<p>Again, it is left to the central Government at the time of its presentation whether it chooses to stick to the principles of fiscal transparency.</p>
<p>7. Measures to enforce compliance.-(1) The Minister in charge of the Ministry of Finance, shall review, every quarter, the trends in receipts and expenditure in relation to the budget and place before both Houses of Parliament the outcome of such reviews.</p> <p>(2) <i>Whenever there is either shortfall in revenue or excess of expenditure over pre-specified levels during any period in a financial year, the Central Government shall proportionately curtail the sums authorised to be paid and applied from and out of the Consolidated Fund of India under any Act to provide for the appropriation of such sums:</i></p> <p><i>Provided that nothing in this sub-section shall apply to the expenditure charged on the Consolidated Fund of India under clause (3) of article 112 of the Constitution.</i></p>	<p>2) whenever there is a shortfall in revenue or excess in expenditure over pre-specified levels mentioned in Fiscal Policy Strategy Statement and the rules made under this act during any period in the financial year, the central government shall take appropriate measures for increasing revenue or for reducing expenditure.</p>	<p>This amendment enables the government to wipe out the fiscal or revenue deficit by simply increasing the taxes and not necessarily curtailing expenditure as was initially desired while drafting the bill. The definitions of what kind of expenditure can be postponed or curtailed</p>

<p>(3) The Minister in charge of the Ministry of Finance, shall make a statement in both Houses of Parliament explaining—</p> <p>(a) any deviation in meeting the obligations cast on the Central Government under this Act;</p> <p>(b) whether such deviation is substantial and relates to the actual or the potential budgetary outcomes; and</p> <p>(c) The remedial measures the Central Government proposes to take.</p>	<p>Provided that nothing of this expenditure is charged on the CFI under clause 3 of article 112 of the Constitution or to any other expenditure which cannot be postponed or curtailed.</p>	<p>is not specified, thus again leaving it to the whim of the government.</p>
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The above table gives a very clear picture as to how the Lok Sabha has diluted the bill under the pretext of making the rules less stringent for future government, and not curtailing its development expenditure. The various reasons given are that this is binding on all future governments, and post 2001 is not the best time to tie the hands of the government, and all other unforeseen circumstances, which may make it difficult to stick to such legislation. The above bill may work if the government in question is fiscally conscientious and intends to stick to the desired objectives instead of focusing on how to bypass its clauses. Thus, the whole point of a legislation, which will tie the hands of the government as far as non-productive expenditure is concerned is killed. Narrowing the definition of fiscal deficit, excluding all the fiscal and revenue deficit targets, allowing the government to borrow endlessly from the RBI, allowing the government to increase taxes to wipe out revenue deficit and throwing out all the clauses under grounds of national security and calamity is hardly going to achieve the desired results of the legislation unless the government is conscientious. Then again, if the government had been conscientious then there would be no need for such legislation at all! All we can do is wait and watch how the government intends to wipe out its revenue and fiscal deficit and reaching the desired targets. However, there could have been a little more effort in drafting the bill and learning from the mistakes or success stories of other countries. The following are some of the legislations already in place in other countries.

Fiscal targets used in OECD countries⁵

<i>Country</i>	<i>Target</i>
Austria	The goal is, within the legislative period, to reduce the general government deficit to below 3 per cent of GDP. This target is to be met mainly through expenditure cuts, although changes in taxation will also play a role. The size of the expenditure cuts depends on the state of the economic cycle at the time.
Canada	In 1993, the Canadian Government introduced a deficit target of approximately 3 per cent of GDP by 1996-97 and introduced a new expenditure management system aimed at expenditure restraint.
Denmark	The reduction of the deficit is an explicit objective. The target for expenditure growth is a rate significantly lower than long-term growth in GDP. The Danish Government is now proposing a target of surplus on average over the cycle.
Finland	The Finnish Government adopted a new scheme of budget ceilings in 1990 in which the

⁵ Source: OECD, *Budgeting for Results: Perspectives on Public Expenditure Management*, 1995 and various OECD economic surveys.

	Finnish Cabinet decides on expenditure ceilings for each ministry as formal guidance for budget preparation.
France	France has been guided by the need to steadily lower central government deficits and to reduce tax burdens. The five-year fiscal consolidation projections have recently been altered. These projections increase the targeted central government budget deficit by 0.5 percentage points each year to 1999 relative to the projections in the Five Year Fiscal Consolidation Act. New projections indicate a central government deficit of 3 per cent of GDP in 1997. The new projections do not seem to have any claim to legal status. It is unclear whether the Consolidation Act will be repealed to take account of the revised projections.
Germany	The target has been to reduce total public budget deficits from 5.5 per cent of GDP in 1991 to 3 percent in 1995. The Grundgesetz (GG) Basic Law of Germany requires that the budget be balanced with respect to current revenue and current expenditure on average over the economic cycle and limits revenue obtained by borrowing to the amount of investment expenditure.
Greece	The 1991 stabilisation program aimed to decrease the central government's borrowing requirement from 13 per cent of GDP to 4 per cent in 1994.
Italy	The target in the mid-1980s was to reduce the total borrowing requirement of the extended public sector to about 7-8 per cent of GDP by 1990. These targets were not met.
Japan	The Government has not adopted aggregate spending targets since the early 1980s. However, it has pursued fiscal reforms aimed at phasing out deficit financing bonds and reducing the ratio of public debt to GNP. The main instrument of fiscal restraint has been strict guidelines, which every ministry has to follow in preparing budget requests.
Netherlands	The coalition agreement for 1991-94 set the target for the budget deficit at 4¾ per cent of net national income for 1991 declining to 3¼ per cent in 1994.
New Zealand	The Fiscal Responsibility Act does not set specific targets, rather it requires governments to set targets and follow broad principles of economic management. The New Zealand Government's long-term objectives include: reducing net public debt to below 20 per cent of GDP; achieving at least fiscal balance over the economic cycle once net public debt is below 20 per cent of GDP; maintaining a broad-base and low-rate tax environment; reducing current outlays to below 30 per cent of GDP; restoring net worth to significantly positive levels and reducing risks to the fiscal position.
Spain	The medium term objective has been to control the public sector deficit and curtail public expenditure. With the move to a single European market, budgeting in the early 1990s emphasised continued fiscal consolidation and a shift from consumption to investment expenditure.
Turkey	The Five-Year Development Plan specifies targets for economic performance and public finance. The Plan also contains target ratios of public expenditure to GNP.
United Kingdom	Since 1980, the Medium Term Fiscal Strategy has provided the framework for monetary and fiscal policy. In 1992, the New Control Total (which involves the United Kingdom Cabinet establishing a total amount for public spending and then making recommendations on allocations within the total to departments and programs) was to be constrained to a rate that ensured that general government expenditure grew more slowly than the economy as a whole over time. The current medium term goal is to bring the public sector borrowing requirement back towards balance over the medium term and to ensure that when the economy's growth rate is on trend the public sector borrows no more than required to finance its net capital spending.

United States	Congress passed legislation in 1995 (the Balanced Budget Resolution) that required the United States Government to balance the budget by 2002. However, the legislation contains no details of specific spending reductions or receipt increases that would lead to balance.
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Fiscal Responsibility in New Zealand⁶

The New Zealand Fiscal Responsibility Act 1994 is the most notable example of legislation designed to impose fiscal discipline largely through legislated fiscal reporting requirements that increase the transparency of fiscal policy processes. It sets a general range of objectives based on the principles of prudence and stability. France and the United States and now India have been exponents of the other approach of legislation more specific and measurable fiscal objectives.

In keeping with the trade-off between flexibility and the binding nature of constraints, the former approach would enable a more flexible fiscal policy response to changes in economic conditions while the latter approach, in theory, may provide more certainty that fiscal policy will follow a particular course. However, overseas experience to date with targets, especially in the United States at the federal level, suggests that they have not matched the expectations that existed when they were introduced.

New Zealand's legislation principles of responsible fiscal management

- Reduction of Crown debt to prudent levels, to provide a buffer against factors that may affect the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than the total operating revenues.
- Once prudent debt levels are reached, they are to be maintained through ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.
- Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may affect adversely on the Crown's net worth in future.
- Prudent management of fiscal risks facing the Crown.
- Pursuing policies consistent with predictability about the level and stability of tax rates for future years.

The New Zealand Fiscal Responsibility Act allows New Zealand Governments to depart from these principles only if such a departure is temporary. In the event of a departure, the Act requires the government of the day to specify the reason for the departure, how it intends to return to the principles, and the period of time it expects to take to return to the principles.

Treasury's submissions to the JCPA inquiry into fiscal responsibility legislation and the Commission outlined the main features of the New Zealand legislation, including its reporting requirements. Both submissions noted that because 'the legislation has only been in place since late June 1994 it is too early to adequately judge its success'. However, they also noted that, following the first presentation of a Budget Policy Statement to the Finance and Expenditure Committee, as provided for under the Act, the Committee's report suggests it found the process to be beneficial. In addition, while there may need to be a change in government and some strain on New Zealand's fiscal situation before the Act is fully tested, the performance of the legislation to date has been encouraging.

The release of the first Budget Policy Statement early last year encouraged public debate about the fiscal policy framework and the trade-offs between debt reduction, tax levels and government expenditure.

Other benefits from the Act to date, observed by New Zealand politicians, officials, business people and commentators, include:

- enhanced credibility of the fiscal policy process
- improved focus on decision-making

⁶ Clauses obtained from the New Zealand Legislation-Fiscal Responsibility Act 1994.

- a focus by politicians on balance sheet concepts and a related attention to the efficiency of asset use
- A concentration of the minds of New Zealand Ministers on avoiding cost over-runs in their portfolios arising from the Act's regular reporting requirements.
- identification of formerly hidden contingent liabilities
- an acceptance of the principles of risk management in government
- increased pressure on the New Zealand Treasury to improve its forecasting performance arising from the Act's transparency and accountability requirements
- Better appreciation outside the New Zealand Treasury of the processes followed to make economic forecasts.

In addition, the New Zealand Treasury considers that the resource costs of the Fiscal Responsibility Act are not too onerous, as most of the work needs to be done anyway. There are, however, more budget production processes and these slow the budget down by a few weeks.

Various legislations in United States of America⁷

Gramm-Rudman-Hollings 1985 and 1987

In 1985, Congress enacted the Balanced Budget and Emergency Deficit Control Act. This Act is known as Gramm-Rudman-Hollings named after the Senate authors of the original bill (Senators Phil Gramm of Texas, Warren Rudman of New Hampshire, and Ernest F. Hollings of South Carolina). Gramm-Rudman-Hollings established "maximum deficit amounts". **If the deficit exceeded these statutory limits, the President was required to issue a sequester order that would reduce all non-exempt spending by a uniform percentage.** Such sequestration was attempted for the first time by any government and in fact, a few offices were closed down for a few days due to overshooting their expenditure. Gramm-Rudman-Hollings also made a number of changes to the congressional budget process to enforce maximum deficit amounts and to strengthen congressional budget enforcement procedures. Due to the Office's role in implementing sequestration⁸ orders, the Court found it unacceptable from a constitutional perspective for Congress to vest in a congressional entity a duty of the executive branch -- the responsibility for executing a law. **In 1987, Congress enacted the Balanced Budget and Emergency Deficit Control Reaffirmation Act** which corrected the constitutional flaw in Gramm-Rudman-Hollings by assigning all the sequester responsibilities to the Office of Management and Budget (OMB). OMB is part of the executive branch. The 1987 Act also extended the system of deficit limits through fiscal year 1992. Neither act was very successful in lowering out the budgetary deficits.

The Budget Enforcement Act of 1990

Despite Gramm-Rudman-Hollings procedures, the deficit continued to increase. In the spring of 1990, it became clear that the deficit was going to exceed the Gramm-Rudman's maximum deficit limit by nearly \$100 billion. To respond to growing deficits, President signed into law the Omnibus Budget Reconciliation Act of 1990, which represented the budget agreement negotiated between the Bush Administration and Congress. The 1990 Budget Enforcement Act (BEA) effectively replaced the Gramm-Rudman-Hollings system of deficit limits with two independent enforcement regimens: **caps on discretionary spending and a pay-as-you-go requirement for direct spending and revenue legislation.** The BEA also provided for enforcement by both the congressional and executive branch of the discretionary caps and the pay-as-you-go requirement. The spending

⁷ Source: U. S. Senate, http://www.senate.gov/~budget/republican/reference/cliff_notes/cliffc2.htm.

⁸ Sequestrations: Series of automatic spending cuts that would come into play if the federal budget did not fall within \$10 billion of target deficit reductions.

disciplines of the BEA were extended in the 1993 Reconciliation legislation through the end of fiscal year 1998.

Pay as you go and sequestration under the BEA requires the OMB to also enforce a "pay-as-you-go" requirement which has a similar effect as the Senate's point of order: **Congress is required to "pay for" any changes to programs which result in an increase in direct spending, or in this case risk a sequester.** If OMB estimates that the sum of all direct spending and revenue legislation enacted since 1990 will result in a net increase in the deficit for the fiscal year, then the President is required to issue a sequester order reducing all non-exempt direct spending accounts by a uniform percentage in order to eliminate the net deficit increase. Most direct spending is either exempt from a sequester order or operates under special rules that minimize the reduction that can be made in direct spending. Social Security is exempt from a pay-as-you-go sequester and Medicare cannot be reduced by more than 4 percent

Chronology of events ⁹

A. The Gramm-Rudman-Hollings Act

1. Under the Gramm-Rudman-Hollings Act, the federal budget deficit was to be reduced by at least \$36 billion each fiscal year so that the budget would be balanced by fiscal 1991.
2. Prior to the beginning of each fiscal year, estimates of whether and by how much the budget would exceed the deficit target were to be made.
 - a. If the budget exceeded the deficit target, Congress and the president were to agree on spending cuts or across-the-board spending cuts were to be instituted.
3. There were several objections to the Gramm-Rudman-Hollings Act.
 - a. The Act eliminated fiscal policy as a means of stabilizing the economy.
 1. This criticism was less serious than it sounds because more reliance could be placed on monetary policy and because the Act could be suspended during recessions or wartime.
 - b. There was a lack of flexibility regarding both the annual reduction in the deficit and how it could be achieved.

B. President Bush's Deficit Reduction Plan

1. President Bush presented a plan to reduce projected deficits by almost \$500 billion over a five-year span starting with fiscal 1991.
2. Most of the deficit reduction was to come from cuts in government spending.
3. The plan eliminated the annual Gramm-Rudman deficit targets and mandated a pay-as-you-go approach for increasing spending or decreasing taxes.

C. President Clinton's Deficit Reduction Plan

1. President Clinton presented a plan to reduce the estimated budget deficits by \$496 billion over a five-year span starting in fiscal 1994.
2. The reduction was to come through both spending cuts and tax hikes.

D. The Balanced Budget Amendment

1. Proponents of a constitutional amendment requiring the federal government to balance the budget annually are concerned with both the adverse effects of structural deficits and limiting the size of the government sector.
2. Most economists do not support a constitutional amendment requiring a balanced budget.
 - a. They believe such an amendment can cause greater instability in the economy.

⁹ Statement on the United States District Court Decision on the Constitutionality of the Balanced Budget and Emergency Deficit Control Act of 1986

- b. They believe that it is best to leave decisions regarding budget priorities and the balance between the government and private sectors to elected representatives.
- c. They believe that such an amendment may not effectively limit the growth of the federal government.
- 3. There are practical problems associated with balancing the budget.
 - a. Revenues and expenditures must be predicted for the budget year in question.
 - 1. Such forecasts are often inaccurate because of changing business conditions.
 - 4. A balanced budget amendment may have some unintended consequences.
 - a. A balanced budget amendment may result in more off-budget spending.
 - b. A balanced budget amendment may force the private sector to bear the cost of new social programs.

The Budget Enforcement Act was enacted in 1990 in an effort to control future budgetary actions. It did this through two mechanisms: limits on discretionary spending, and the pay-as-you-go process to require that any legislative action on direct spending or revenues, which would increase the deficit, be offset.

Budget Enforcement Act Procedures

The BEA established a pair of mechanisms that were intended to make it difficult for Congress or the President to undo the budget agreement. First, it **established a limit on the level of discretionary spending** (divided into defense, international, and domestic discretionary spending for FY1991-93), to be enforced by a presidential sequester order affecting only discretionary spending (only the specific sub-category for FY1991-93). Second, **the act established the pay-as-you-go procedure, which requires that increases in direct spending or reductions in revenues due to legislative action be offset by other such legislative actions so that there is no net increase in the deficit.** This process is also enforced by a presidential sequester order, one that would affect only non-exempt direct spending programs. The result was that these new mechanisms shifted the focus away from actions Congress and the President exercised no direct control over (the effect of the economy on the deficit) to those they could control (spending and revenue legislation).

Implications for a Balanced Budget

The budget submitted by President Clinton on February 2, 1998, projected a surplus for FY1999 of \$9.5 billion for the consolidated budget). Although this might be regarded as, the achievement of the intended purpose of the BEA, the control mechanisms established by the act would continue to be in force. The control mechanisms established under the Budget Enforcement Act are not based on achieving a specific level of deficit or surplus. The provisions of the pay-as-you-go process focus on the net impact on the budget deficit, rather than on achieving a specific deficit. In other words, as long as the pay-as-you-go process continues to exist in its current form, any legislation, which would increase mandatory spending or decrease revenues, would still have to be fully offset, regardless of whether the projected effect would be a budget deficit or surplus. Similarly, the focus of the discretionary spending caps on a specific level of spending means that the resulting level of a surplus or deficit has no impact on their effect.

Fiscal targets for Member States of the European Union

The Growth and Stability Pact 1999 emphasised that further consolidation is required in most Member States in order to reduce high ratios of general government debt relative to GDP and bring them down to 60% within an appropriate period. The need for stronger fiscal positions contrasts with substantial actual deficits in many countries. A forceful debt reduction within an appropriate period of time is warranted, to make it easier to cope with future budgetary challenges, such as the

increasing fiscal burden arising from the ageing of the population, in particular in the context of unfunded public pension systems, as well as the medium-term challenges arising from the need to reform unprofitable public enterprises and reduce structural unemployment. In addition, reducing budgetary imbalances is necessary to re-establish a degree of flexibility for fiscal policies, which enables countries to respond to adverse cyclical developments, i.e. low fiscal deficits, or surpluses are needed under normal circumstances to allow automatic stabilisers to work during periods of weak economic activity.¹⁰ Reference rates were fixed for fiscal deficits and debt ratios of the member states, 3% being the reference rate for the former and 60% for the latter.

The criterion on the government budgetary position

With regard to the performance of individual Member States in 1997,

- three countries have recorded fiscal surpluses (Denmark, Ireland and Luxembourg)
- Eleven Member States have achieved or maintained deficits at or below the 3% reference value specified in the Treaty (Belgium, Germany, Spain, France, Italy, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom).
- Greece recorded a deficit of 4.0%, which is still above the reference value.
- For 1998, fiscal surpluses or further reductions in deficit ratios are projected by the Commission for nearly all Member States. The Greek deficit is expected to fall to 2.2% of.
- As regards government debt, in the three Member States with debt-to-GDP ratios of above 100%, debt has continued to decline in relation to GDP.
- In Belgium the debt ratio in 1997 was 122.2%, i.e. 13.0 percentage points lower than the peak in 1993;
- in Greece the debt ratio in 1997 stood at 108.7%, i.e. 2.9 7 percentage points below the latest peak in 1996; and
- In Italy, the debt ratio was 121.6%, i.e. 3.3 percentage points below the peak of 1994.
- In the seven countries, which in 1996 had debt ratios significantly above 60%, but below 80% of GDP, debt ratios also declined.
- This was particularly the case in Denmark, Ireland and the Netherlands, where debt ratios in 1997 were 16.5, 30.0 and 9.1 percentage points respectively below their peak levels of 1993, and stood at 65.1%, 66.3% and 72.1% of GDP respectively;
- In Spain the debt ratio in 1997 declined by 1.3 percentage points from its peak level of 1996 to reach 68.8% of GDP;
- In Austria, the corresponding reduction amounted to 3.4 percentage points, taking the debt ratio to 66.1% of GDP.
- In Portugal, the debt ratio was 3.9 percentage points below its 1995 level, bringing the debt ratio to 62.0% of GDP.
- In Sweden, the debt ratio was 2.4 percentage points below its peak level of 1994, reaching 76.6% of GDP in 1997.
- In Germany, which in 1996 had a debt ratio of just above the 60% reference value, the debt ratio continued its upward trend and in 1997 was 19.8 percentage points higher than in 1991, standing at 61.3% of GDP.
- In 1997, four countries continued to have debt ratios of below the 60% reference value (France, Luxembourg, Finland and the United Kingdom).
- In France, the debt ratio continued its upward trend to reach 58.0% of GDP in 1997 (see Table A and Chart B).
- For 1998, further reductions in debt-to-GDP ratios are projected by the omission for all Member States, which had debt ratios of above 60% in 1997.
- In the cases of Denmark, Ireland and Portugal, a reduction to a level at or below the reference value is forecast.

¹⁰ European Union Fiscal Targets.

As regards countries with debt ratios of 50-60% of GDP in 1997, Finland and the United Kingdom are anticipated to reduce their debt ratios further below 60%, whereas in France the debt ratio is expected to increase marginally.

Overall, progress in reducing fiscal deficit and debt ratios has generally accelerated. Thus stating clearly reference values of debt ratios and fiscal and budgetary deficits to strengthen a joint currency worked very well. Therefore, the European Union has been able to bring in fiscal discipline through its monetary policies and clear targets. Though many believe that such a drastic reduction in deficits to comply with the reference values have a lot to do with "creative accounting" on the part of the Member States.

Above we can see that fiscal restraint either has been brought by broadly prescribing objectives as in the case of the New Zealand legislation, or have fiscal and revenue deficit targets as in the case of United States of America and European Union. The European Union has also experimented the concept of bringing in fiscal discipline through a common currency and succeeded to quite an extent. Another method that New Zealand used was to make its central bank independent after giving various prescriptions and targets compatible with the government's fiscal policy.

Autonomy of Central Bank¹¹

One of the important aspects of bringing in such legislation is to give the Central Bank more autonomy. Central bank independence generally relates to three areas viz. personnel matters; financial aspects; and conduct of policy. Personnel independence refers to the extent to which the Government distances itself from appointment, term of office and dismissal procedures of top central bank officials and the governing board. It also includes the extent and nature of representation of the Government in the governing body of the central bank. Financial independence relates to the freedom of the central bank to decide the extent to which Government expenditure is either directly or indirectly financed via central bank credit. Direct or automatic access of Government to central bank credit would naturally imply that monetary policy is subordinate to fiscal policy. Finally, policy independence is related to the flexibility given to the central bank in the formulation and execution of monetary policy. In connection with this, recent literature has stressed the difference between goal independence and *instrument independence*. Goal independence refers to a situation where the central bank itself can choose the policy priorities of stabilising output or prices at any given point of time, thus setting the goal of monetary policy. Instrument independence implies that the central bank is only free to choose the means to achieve the objective set by the Government. First, the most prominent argument for central bank independence is based on the time inconsistency problem. Time inconsistency arises when the best plan currently made for some future period is no longer optimal when that period actually starts. In the context of monetary policy, the time inconsistency problem arises because there are incentives for a politically motivated policymaker to try to exploit the short-run trade-off between employment and inflation. The 'conservative central banker approach' postulates the appointment of a conservative central banker whose aversion to inflation is well known which would result in low inflation because of the economic agents' belief in the reputation of the central banker. The 'optimal contract approach' postulates the existence of an optimal contract between the central banker and the Government. The central banker's tenure in office is conditional upon his performance of achieving low inflation, failure of which would lead to the repudiation of the contract of tenure. Historically, there are successful examples of both types of models of central bank independence while

¹¹ Reddy, Y.V. 2001. *Autonomy of the central bank - changing contours in India*. New Delhi: Reserve Bank of India.

US is often seen as an example of conservative Central Bank, New Zealand is characterised as a follower of optimal contract approach. (Reddy Y V. 2001.)

Indian Scenario

During the post-reform period, the relationship between the central bank and the Government took a new turn through a welcome development in the supplemental agreement between the Government and the RBI in September 1994 on the **abolition of the *ad hoc* treasury bills to be made effective from April 1997**. The measure eliminated the automatic monetisation of Government deficits and resulted in considerable moderation of the monetised deficit in the latter half of the Nineties. At the same time, with gradual opening up of the economy and development of domestic financial markets, the operational framework of the RBI also changed considerably with clearer articulation of policy goals and more and more public dissemination of vast amount of data relating to its operations. Partly because of such institutional changes in recent years, inflation in India has been moderate relative to other developing countries despite high fiscal deficit, and most inflationary episodes have been caused by exogenous supply-side factors. As far as public finances are concerned, the Government generally relied on domestic sources to finance the deficit. It has been pointed out by some experts that the RBI, though not formally independent, has enjoyed a high degree of operational autonomy during the post-reform period. In fact, during the recent period, the RBI enjoys considerable instrument independence for attaining monetary policy objectives. Significant achievements in financial reforms including strengthening of the banking supervision capabilities of the RBI have enhanced its credibility and instrument independence.

Current status

In terms of redefining the functions of the RBI, enabling a movement towards meaningful autonomy, Governor Jalan's statement on Monetary and Credit Policy on April 19, 2001 is a landmark event. First, it was decided to divest RBI of all the ownership functions in commercial banking, development finance and securities trading entities. Secondly, a beginning was made in recommending divestiture of RBI's supervisory functions about cooperative banks, which would presumably be extended to non-banking financial companies and later to all commercial banks. Thirdly, the RBI signaled initiation of steps for separation of Government debt management function from monetary policy. These measures would enable the RBI to primarily focus on its role as monetary authority and enhance the possibility of a move towards greater autonomy.

Recommendations

Thus, we can see that the approach of the government needs to be decided as to whether it wants an establishing report standard approach or a fiscal targets setting approach. Even at the end of it, the initiative lies in the conscience of the government and whether it wants to be fiscally disciplined. These are however recommendations that the Central Government could follow to make this legislation more successful.

1. To make the entire act or some clauses of the act binding on the Central Government such as clause five where Central Government cannot borrow from the RBI.
2. To have Expenditure Reduction Act along with the Fiscal Responsibility and Budget Management Act.
3. To take suggestions from the Expenditure Reforms Commission to cut non-productive expenditure on government departments.
4. To stop State Government guarantees.
5. RBI to make prescriptions to each state on its finances, and follow up strongly.
6. To stop monetising budget deficits in the near future.

7. To change to accrual basis of accounting for all government departments.
8. To rely on other indicators such as interest rates, savings rates, currency rates etc.
9. To sequester government departments expenditure after specifying a ceiling on the non-productive departmental expenditure for each government department.
10. To give the RBI more autonomy in terms of independence from political, executive and legislative power.

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