

RULE-BASED FISCAL CONSOLIDATION PACTS IN INDIA AND EUROPEAN UNION: A RELOOK INTO THE PROCESSES

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The emerging economies including India have shown symptoms of quicker recovery from the world-wide recession than the economies in the global north. The financial sector in euro-zone is still in deep trouble. High deficit countries, for example, Greece, Portugal, Ireland and Spain, among some others, are being blamed for the trouble. If solutions are not found to rescue the troubled zone, the developing countries may be further adversely affected. India's goods export to Europe has already moderated. Although Europe is no longer India's biggest export destination, the economy may be indirectly hit via other trading partners. Structural fiscal imbalances in the European countries are currently being tackled with common strict rules under the European "Fiscal Compact" which is the new version of the Stability and Growth Pact. Until mid-last decade, both the Indian central government and the state governments were found to be trapped into similar chronic problems. To address such structural issues, in India, the central and state governments have enacted the Fiscal Responsibility and Budget Management Acts in the national parliament and state assemblies, respectively. This paper looks into the fiscal consolidation processes in India and the EU and seeks to derive some understandings from the political economy perspectives of the processes.

1. Introduction

At the present juncture in euro-zone, many scholars think that Eurobonds or European Banking Deposit Guarantee (some other ideas are also floating) may quickly rescue the European Union (EU) from the present crisis and further troubles. While it is true that Eurobonds as a cosmetic solution may be a quick remedy for the EU, it seems extremely difficult that such quick measures would be able to find sustainable solutions to the problems that have stemmed from the underlying structural fiscal imbalances and the consequent debt burdens of some member countries. Until mid-last decade, both the Indian central government and the state governments were found to be trapped into the similar chronic problems. To address such structural issues, the central and state governments have enacted the Fiscal Responsibility and Budget Management (FRBM) Act in the national parliament and state assemblies, respectively. This paper looks into

the fiscal consolidation processes in India and EU and seeks to derive some understandings from their political economy perspectives.¹

Following the recommendations of the Twelfth Finance Commission (TFC), most of the states in India undertook a set of fiscal consolidation strategies through the enactment of the FRBM Bill (after the union government enacted it in 2003) which have not only helped them to come out of the structural deficit crisis but also saved them from further trouble -- which could have been much worse than what it has actually been -- amidst global slowdown. In 2003-04 (i.e., just prior to the FRBM era), only Jharkhand had been found to be the revenue surplus state among the non-special category states (special category states are located in hilly terrain and depend heavily on transfers from the Centre; we discuss this later again in this article). Most of the states enacted the FRBM in and around 2005. By 2007-08, a large number of states were found as

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revenue surplus states. They include Bihar, Chhattisgarh, Goa, Gujarat, Haryana, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Tamil Nadu, Uttar Pradesh and Andhra Pradesh [Dutta, 2012a, Pp. 1-41]. After 2007-08, however, states' fiscal situation deteriorated due to global economic slowdown.

Enactments of the FRBM by the states of India were possible largely due to its strong federal construction, with the union government playing the dominant role. On the other hand, although the Stability and Growth Pact (SGP) in the EU has a long history of about 20 years, the EU has failed, at least for the last 10 years, to come up with an impressively successful use of the SGP to get out of its present crisis. At the moment, the EU as a central system is in an existential crisis which has been one main reason for why a new treaty, i.e., Fiscal Compact, has replaced SGP and thereby came into effect on 1 January 2013 for the 16 countries which completed ratification prior to this date. There are some fundamental differences between the Indian federal system and the EU federal system. The EU has a basic "birth defect" in the sense that while it is a monetary union, it is not a fiscal union. India is both a fiscal and monetary Union and the central government has a much more effective mechanism to supervise and monitor the member states. EU is not a fiscal union and there has been no mechanism to effectively supervise, monitor and review the working of the SGP or the Maastricht Treaty. In India, according to the Article 293 of the Constitution, states are not allowed to borrow from outside the country and even their borrowing is domestically restricted (for example, a consent from the central government is mandatory) if they are indebted to the Union government or if they have any outstanding loans in respect of which a guarantee has been given by the Union government.

Following the recommendations of the TFC, the central government disintermediated from the borrowings of state governments from 2005-06 onwards. Loans from the National Small Savings Fund (NSSF) -- granted by the centre to the states -- have also declined substantially after 2006-07. As a result, state governments have increasingly gone for market borrowings in the form of State Development Loans (SDL) from 2007-08 onwards [Ghosh et al., 2012]. In future, some state governments may be able to run their economic affairs without being indebted -- directly or indirectly (e.g., in the form of guarantees) -- to the central government. In that case, there should not be any problem, in principle, for the states to borrow without the consent of the central government. However, according to the Article 293, the states are allowed to borrow within the limits as fixed by the Legislatures of the states concerned. Currently, such restriction is imposed by the FRBM Acts. Before FRBM, the states showed symptoms of chronic revenue deficit problem (which further contributed to the fiscal deficit problem) and high debt accumulation (which in turn kept raising debt-servicing costs). We discuss the contextual issues related to FRBM later at length in this article. But, whether a state should be allowed to borrow (without the central government as a guarantor) from outside the country is a matter for further debate. Many foreign parties may not sign a contract with a state government since a state is not a sovereign body. If the contracting party outside India does not have any problem in this respect, then it may not be imperative for the Indian law to stand as an obstacle and necessary provisions should be made at the constitutional level. But, whether external borrowing would bring in any additional benefit and what might be the risks to the Indian federation on account of the quantum and quality of its total external debt are matters which require a very serious examination and are not addressed here.

Indian central government is a sovereign and powerful entity compared to its sub-national governments, whereas the EU central body is a much weaker entity compared to its sovereign member states. Indian central government is fiscally more powerful than its states, while, in the EU, the real fiscal powers lie in the hands of the member states. So, the two cases are not, in true sense, comparable, and thus we do not propose to undertake a comparative study through this essay; rather we seek to look into the two processes for our better understanding. However, in the light of the present discussion, the question that arises here is: whether the EU needs a tighter fiscal federal system, with stronger European Commission (EC) as a central body which will have greater power, than it currently does have -- in order to streamline the messy fiscal situations and thus to restore, by learning by doing, the very existence of the EU. The current sovereign debt crisis in the euro-zone emphasises that a common monetary policy needs a common fiscal policy as well. For this reason, the EU has repeatedly been engaged in reform debates to reformulate the SGP. What are the central elements that need to be contained in a new fiscal pact? In this paper, we will look into the political economy perspectives as well as main features of the Indian FRBM Act as adopted in its federal system. The political economy perspectives of the reforms of the EU's SGP will also be looked into. Keeping in view the fundamental differences between the institutional relationship of the EU with its largely sovereign member states, on the one hand, and the federal relationship of the Indian sovereign central government with its own states, on the other, we broadly intend to study the two different systems with particular reference to the European "Fiscal Compact" (or the reform process of the SGP) and the FRBM and seek to understand the strengths and weaknesses of the two processes.

Under the great market pressure, the EU is in search of a solution to its current sovereign debt crisis. Along with finding solutions to the urgent,

short-term challenges, the EU, as it is realised, is in need of maintaining long-term, compact discipline as well as coordination in its fiscal domain. Since trust also works backward, a genuine fiscally stable union, which is built on long-term foundation, it is expected, will add to the trust in resolving short-term problems as well. Thus, short- and long-term problem-solving mechanisms are to go hand-in-hand. The EU member countries realise that they need to enhance the scopes for achieving higher competitiveness (for attaining higher growth) through greater social cohesion and a deeper integration in the internal market [European Commission, 2011; European Council, 2011]. In this connection, the Commission has recently laid down its proposals in its publication titled "Single Market Act II: Together for New Growth" and emphasised four drivers for new growth. The drivers which are expected to facilitate new growth in the EU through higher competitiveness of the member countries are (1) developing fully integrated networks in the Single Market; (2) fostering mobility of citizens and businesses across borders; (3) supporting the digital economy across Europe; and (4) strengthening social entrepreneurship, cohesion and consumer confidence.² Moreover, it is imperative to take forward stringent rule-based governance with a view to ensuring clear disciplines in the fiscal domain as some countries in the EU have recently gone messy in relation to their fiscal matters and severely interrupted economic growth of the whole region. We are going to elaborate this in further detail in the following sections. We choose to delve into the issues related to fiscal rules because fiscal domain is considered, by many scholars [see, among others, Cooper, 2011], to be the source of generation of vicious recessionary waves in the present time.

The present situation requires the euro area to have a new deal between its member states and reinforce the same in the form of a new legal framework. Since the principles of the new Fiscal Compact are in the process of being ratified by

the EU member states by 2013,³ it might be useful to look into the fiscal consolidation processes in both India and EU in the light of the natures of their fiscal federalism and see as to what goes in the positive or negative direction in the EU and in India (e.g., India translated necessary fiscal rules into legislation, i.e., FRBM Act)⁴, and under what conditions (e.g., whether or not strong federal structure of India has facilitated its states to have unitary fiscal policies or, more specifically, to follow uniform fiscal rules. In this perspective, this study assumes special significance at the present juncture.

2. From the (Previous) SGP to the (Current) Fiscal Compact: Background, Contents and Problems

While discussing SGP, a brief contextualisation needs to be provided. The EU has grown from six member states in 1957 (at the time of the Treaty of Rome) to its present 27 member states (Croatia is set to become the 28th member in 2013). It has about half a billion inhabitants and, at present, a gross national income (GNI) of over 13 trillion euro (17 trillion U.S. dollars). Presently, 17 member states belong to the euro single currency system. In the euro-zone, a supranational monetary policy is interacting with decentralised fiscal authorities [Leen, 2011, Pp. 203-205]. Since the 2008 sovereign debt crisis in the EU, this region has been experiencing tough time in relation to controlling ever-increasing budget deficits of especially the Southern European countries. This has instigated the EU to reform SGP and incorporate certain clauses into it in order to force the EU member states to maintain their borrowing under control in order to create stable conditions in the EU.

The SGP consisted of a set of rules that aimed at maintaining fiscal discipline in the EU member states. They are described in Articles 121 and 126 of the Treaty on the Functioning of the European Union (TFEU) and Protocol 12 attached to the

TFEU and the *Consolidated Version of the Treaty on European Union* [European Union, 2008]. The rules consist of preventive and dissuasive arms. Under the provisions of the preventive arm, the member states must submit annual stability or convergence programmes. In response, the Union can issue an early warning to prevent the occurrence of excessive deficit and can directly offer policy recommendations to a member state. The dissuasive arm governs the excessive deficit related matters. The budget deficit cannot exceed 3 per cent of GDP. The exemption is allowed if the excess is relatively small, temporary and exceptional. Also, for short-term exemption, the overall trends of the deficit should be regarded as continuously as well as substantially declining. Generally, the government debt cannot exceed 60 per cent of GDP.⁵

Since the time horizon set by the policymakers/politicians (of the ruling party/coalition) is generally short as they are in need of implementing their manifesto and other promises within the mandated timeframe, they may be often seen to be inclined to deviate from what is regarded as optimal fiscal policy. In short, an optimal fiscal policy refers to a policy of choosing taxes and expenditures to maximise social welfare. In order to maximise welfare in a short span of time, the government (the ruling party/coalition) may prefer to increase the level of expenditures which may not be in conformity with tax policy. Thus, government budgets may suffer from deficit bias caused by overspending attached to fulfilment of political ambitions of the politicians. In the Economic and Monetary Union (EMU), fiscal slippage in one of the member states probably has adverse effects on interest rates throughout the union. So, it is even possible that other governments will want to support the offender explicitly or implicitly by undertaking financial transfers or by purchasing the offending government's debt titles [Langenus, 2005, Pp. 65-81]. Despite the presence of an explicit no-bailout clause (Article 125 of the *Consolidated*

Version of the Treaty on European Union, 2008), bailouts are now happening in the EU through a country's temporary emergency fund. For example, for Ireland and Portugal, an amount of 48.5 billion euro is to be disbursed over three years period, i.e., 2011-13. And the European Central Bank (ECB), the only goal of which is to maintain price stability, is, as argued by Buitter [2010, Pp. 12-19], also involved in buying bonds of troubled governments to fulfil the fiscal needs of the latter. In February 2013, the ECB stated that the Italian Government bonds accounted for nearly half of its total holding (the ECB holds bonds of face value of 218 billion euro or 292 billion US dollar). It holds bonds of 44.3 billion euro and 33.9 billion euro for Spain and Greece, respectively.

How did the SGP come about? The rules set in the Maastricht Treaty [1992] in order to achieve the EMU are also seen to be applicable in the euro currency regime that was initiated in 1999. After the euro was launched, fiscal discipline evaporated. Many countries, however, faced difficulty in meeting the SGP rules. In 2003, the two largest economies in the euro-zone -- Germany and France -- broke the rules. They, however, promised to reach the SGP targets as soon as possible. Therefore, no action was taken against them. In general, however, if a country breaks the rules, it has to take harsh measures to reduce its deficit. If it breaks the rules for three consecutive years, an imposition of fine up to 0.5 per cent of GDP may be proposed and institutionalised.

Because the SGP looked weak, the Council of the EU temporarily suspended it.⁶ In 2005, the EU agreed on a reformed SGP with much more flexible rules [Gonzalez-Paramo, 2005]. On the surface level, the key rules pertaining to deficits and debt were maintained, but the reformed pact contained a list of exceptions for certain types of spending that would not be counted as part of the debt, e.g., spending on education, research and

defence (a political fiscal gimmickry in book-keeping). Therefore, it was almost impossible to break the rules. However, even these much simplified rules were challenged when France, in 2007, tried to revitalise the French economy with Keynesian policies.⁷ Of the member states with great budget deficits and accumulated debts, particularly the situation of Greece is critical as it deliberately provided the EC, the executive arm of the Union, with wrong information about its deficit and debt figures.

In 2008, partly because of the global economic crisis, average public debt in the euro-zone began to rise, especially in Ireland, Spain, France, and Greece [Hentschelmann, 2010]. In 2010, to rescue some member states, two temporary emergency funds -- the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) -- with a combined budget of 500 billion euro have been established. Member states can draw low-interest loans from the funds. In May 2010, Greece took the first loan. In late 2010, Ireland got a bailout too and in 2011 Portugal and again Greece got loans. In 2013, Cyprus has got a loan of 10 billion euro. In October 2012, the permanent European Stability Mechanism (ESM) has entered into force with a budget of 700 billion euros. In the new Fiscal Compact, it is stated that countries cannot get bailouts unless they sign and apply the pact.

Both the versions of the fiscal rules -- the SGP and the new Fiscal Compact -- have received critical reactions from different quarters. The SGP was heavily criticised by the German Central Bank and German Government [Stark, 2001, Pp. 77-105], while the reformed version has been criticised by, *inter alia*, Schuknech, et al. [2011]. While the old SGP has been marked as too rigid, the new version is blamed to be containing so many provisions of exemptions that a country, as often argued and just stated, would find it hard to breach the regulations. Moreover, there have been no effective rules to prevent a breach of the SGP

and punish a member state for doing it. Hence, there has been lengthy discussion in the EU to establish a new fiscal pact. Several draft fiscal pacts were proposed and the final version was approved on 2 March 2012.⁸

A major change introduced in the new Fiscal Compact is that the member states are not forced to meet the targets every year; the budget has to be balanced over an economic cycle. The new rule entails, compared to the previous SGP, that the cyclically adjusted budget deficit is to be no more than 0.5 per cent of GDP and a government must run fiscal surplus until its debt level has fallen down to 60 per cent of GDP. As said, a budget needs, in principle, to be in balance. This is a more stringent rule than the previous one which had allowed budget deficit of maximum limit of 3 per cent of GDP. Thus, against the backdrop of much relaxed formulation, the new Fiscal Compact is trying to implement tight policy that is expected to result in greater effectiveness. Also, as has been done in India, the new fiscal rules need to be introduced in the member states' national legal systems at constitutional or equivalent level. We come to this discussion later.

Another change required is that the EU should adopt more stringent principles to effectively penalise the states with excessive deficits or for violating the rules as set in this particular respect. Currently, the Commission has upgraded the theoretical sanctions to real automatic sanctions. The Commission, even without a referral from the Council, would then directly impose sanctions in the event of excessive deficits. Since there is a need for direct intervention in the budgets of member states (as we have experienced SGP violations earlier), there should be a defined mechanism that would assess the degree of violation and ascertain the intervention process. In this respect, as suggestions came from the EC, the post of a European "Stabilisation Commissioner" could be created. The Stabilisation Commissioner would have the right of direct intervention in

national budgets in the event of consistent breaches of the Fiscal Compact. Alternatively, the Stabilisation Commissioner could forward its suggestions to the Council for relevant decisions. Some member states (e.g., UK and Czech Republic), however, do question if the Union has the democratic legitimacy to penalise a member state for its budget directly. The European Parliament is still by far no full-blown democratic parliament [Klaus, 2009].

In short, the present discussion is about effective rules on budget deficits and public debt in the euro-zone countries [Buiter, 2003, Pp. 49-58] or, in other words, a new fiscal pact and strengthened economic policy coordination [European Council, 2011]. It is all about the tightening of the EU budget rules to prevent future crises.

3. Fiscal Crisis and the Much Needed Fiscal Responsibility Legislation in India

Although in sharp contrast to the 1930s, both the credit crunch and the recession have had more impact on the advanced capitalisms of the north than on the global south during the post-2007 global slowdown [Radice, 2011, Pp. 27-31], Indian economy has been exhibiting sluggish growth during the world-wide turmoil [Anonymous, 2011, Pp. 105-143], perhaps partly because of its dependence on foreign private capital and partly due to its internal reasons. There was a time when it was widely held that free trade and unrestricted inflow of foreign private capital would undermine late industrialisation in India and thus protection was seriously taken into consideration at policy levels. Earlier, foreign aid was considered to have an important role to play in development, but presently free trade and foreign private capital are considered essential for development [Ghose, 2011, Pp. 27-31; Govinda Rao and Sen, 2011]. Being a partner of the global trade and a host of the foreign private capital, India could not avert the impact of world-wide

slowdown. For example, the immediate response of mobile global capital was rush to the safe havens of the USA and Europe (especially, to gold and to triple-A securities) and consequently the direct impact upon working people in the global south was far more severe [Radice, 2011]. However, apart from the external environment, internal policy and regulatory matters are also responsible for the moderation in growth, particularly for the significant slowdown in investment activity. High inflation has remained the cause of great concern in the recent time. The annual average of wholesale price index (WPI) and consumer price index (CPI) have increased from 4.7 per cent and 6.2 per cent in 2007-08 to 7.6 per cent and 10 per cent in 2012-13 (April to January), respectively [Government of India, 2013].⁹ The industrial sector has been experiencing a slowdown under the combined impact of high inflation and rising cost of borrowing (caused by rising interest rates). Investment demand and private final consumption expenditure have moderated as a symptom of recession. Besides, the newly elected Government of West Bengal (led by Trinamool Congress Party), instead of raising its revenue level, had been trying to "blackmail" the Centre for a bailout by stalling the latter's every decision of the proposed reforms [Govinda Rao, 2012, p. 12].¹⁰ Failing to achieve the goal, the Party has finally withdrawn its support to the central government on 18 September 2012. However, later (i.e., in 2012-13), the state government has been successful to raise its own revenue level, because, as it seems, that was the only option open to it to combat its current severe financial crunch.

In such a situation, India's growth has shown sluggishness. Although it showed reasonably high growth rates in the early years of global economic crisis (e.g., 8.6 per cent and 9.3 per cent in 2009-10 and 2010-11, respectively), the growth rate fell down drastically in the recent years, to 6.2 per cent and 5 per cent in 2011-12 and 2012-13, respectively [Government of India, 2013]. Nevertheless, it seems that the so called

emerging economies including India have shown symptoms of greater stability / quicker recovery than the economies in the global north [Radice, 2011]. At the same time, it is very clear from the recent trends that, after reaching certain recovery level at the initial phase, the Indian economy has not further been able to get out of the stagnating growth syndromes. India's goods export to Europe has already moderated. Although Europe is no longer India's biggest export destination, the economy may be indirectly hit via other trading partners.¹¹ But, India's fiscal deficit is thought to be a real problem. Recently, the finance minister of India had to announce in the parliament that the government would undertake austerity measures to combat the situation. The Reserve Bank of India (RBI) has expressed great concern about India's fiscal deficit position (for fiscal deficit trends, see Table 1). It has remarked that slippage in the fiscal deficit has been adding to inflationary pressures and could potentially crowd out credit to the private sector [RBI, 2012]. Moreover, in India, the liabilities of the public sector banks are "entirely guaranteed by the central government" and "they present a huge potential fiscal risk, one which India does not have the fiscal space to accommodate" [Bery, 2011, Pp. 10-11].

The government is finding it difficult to get out of the expansionary spending policy in the recession time. Had the governments (both the centre and the states) not enacted the FRBM Bill in 2003 by the centre and in the subsequent years by the states, India would have been in much worse fiscal situation during global slowdown. At least partly, it is the FRBM Act that saved India from falling into much deeper crisis. As it is evident from Table 1 that fiscal deficit of the central government alone had crossed the 6 per cent level in 2001-02 and the combined (both centre and states) fiscal deficit was found to be close to 10 per cent in the same year. The situation started changing sharply after 2003 (the year of FRBM enactment by the Central Government) until the economy was hit by global economic slowdown. So, it is the FRBM which has partly saved India from a far greater crisis during the world-wide recession.

Table 1. India's Fiscal Deficit as Percentage of GDP

Year	Fiscal deficit as percentage of GDP		
	Centre	States	Combined
(1)	(2)	(3)	(4)
2000-01	5.48	3.80	8.87
2001-02	6.00	3.80	9.36
2002-03	5.73	3.76	9.03
2003-04	4.34	4.14	8.10
2004-05	3.88	3.11	7.05
2005-06	3.96	2.33	6.38
2006-07	3.32	1.82	5.10
2007-08	2.54	1.49	3.97
2008-09	5.99	2.26	8.17
2009-10	6.48	2.94	9.38
2010-11	4.90	2.62(RE)	7.81(RE)
2011-12	5.70*	2.16(BE)	6.75(BE)
2012-13	5.20 (RE)*		
2013-14	4.80 (BE)*		

Source: Government of India [2012], p. 42; *Budget at a Glance 2013-14, Government of India.

Notes: RE = revised estimate; BE = budget estimate.

However, contrary to this view, Govinda Rao and Sen [2011] argue that the improvement in the fiscal situation until 2007-08 was not attributable to the FRBM efforts. They argue that the central government adopted various "creative accounting" procedures to keep deficits outside the budget by issuing, for example, oil and fertiliser bonds. They also find that the improvement in fiscal deficit was mainly due to increase in the receipts from the source of income tax and to some extent revenue from service tax. The former went up, as they argue, mainly due to the introduction of tax information network (TIN) and its effective implementation. However, for a high deficit- and debt-stricken country, achieving the final goal seems to be more important than the means, i.e., the way of achieving goal (of course, the spending on social security for the ultra poor and vulnerable sections and the other important social sector expenditures should not be reduced). However, if other studies precisely suggest that such spending is not reaching out to the targeted poor then wastage of precious public resources needs to be immediately prevented and necessary corrective

measures should be undertaken. At the same time, off-budget borrowing (which also accumulates debt burden) by the public sector undertakings should be ceased with immediate effect [Dutta, 2008]. But, as observed in the past, there is not likely to be an easy and short-cut method as far as wiping out of such borrowing is concerned. The Government of Karnataka has made several attempts to eliminate off-budget borrowing primarily by bringing these on the budget and making provisions for the same in the budget for 2008-09 and proposing to avoid all future off-budget borrowing in its Medium Term Fiscal Plan.¹² Earlier, while it has not been possible to stop off-budget borrowing immediately, the Government has made certain decisions: (1) not to allow the list of beneficiaries of off-budget borrowing to expand; (2) to gradually reduce reliance on off-budget borrowing; (3) to stop off-budget borrowing after 2004-05; among others [Khuntia, 2003, Pp. 212-232]. However, another way to reduce such borrowing is to resort to privatisation of the weak or loss-making public sector undertakings. A relatively soft measure is

to replace the public management system of the undertaking by efficient private management system with a view to generating profit. In this regard, it is not easy to deal with off-budget borrowing which is associated with the electricity sector in the states. Strong political decision has to be made to fruitfully sort-out this matter. We would briefly touch upon the economic aspects of the electricity sector later in this article. Let us now focus on a brief background of the fact as to why FRBM was necessary for India.

As far as fiscal management is concerned, India had emphasised the management of price stability and balance of payments and thus could maintain a smooth journey during the first 30 years after independence. The balance between revenue (current) expenditure and revenue (current) receipt used to be maintained by the governments. Due to this balance, the governments were not under pressure to finance their revenue expenditures through borrowing. Thus, governments used to borrow resources to finance capital expenditures only. The combined deficit of the centre and the states was seldom seen to go beyond 4 per cent of GDP. The debt/GDP ratio of the country had gone up but remained below 45 per cent of GDP. Things started deteriorating in the 1980s as growth of government expenditures surpassed revenue growth [for further details, see Bagchi, 2006]. As a consequence of growing deficits, the debt/GDP ratio went up. In 1990-91, the combined fiscal deficit of the centre and the states went above 9 per cent of GDP and the debt/GDP ratio reached nearly 62 per cent level. Consequently, interest payment as percentage of GDP shot up from the earlier level of 2 per cent to 4 per cent. However, debt/GDP ratio continued to rise and reached 65 per cent level in 1999-00 [Rangarajan, 2004]. Once it even reached the level of 81 per cent and became a matter of concern and worry [Bagchi, 2005]. According to a study carried out by Hausmann and Purfield [2004], in terms of debt-to-revenue ratio India appears to be the second most indebted

country in the world (after Pakistan). Initially, fiscal situation of the states did not raise any concern as the deficits in the state budgets remained at reasonable levels. However, from the second half of the 1990s, the level of deficits in the state budgets also started ringing alarm. The focus then shifted to the states [Bagchi, 2006]. Govinda Rao and Sen [2011] argue that "[e]nsuring a stable macroeconomic environment in a multilevel fiscal system requires coordination in stabilisation policies." In such circumstances, the Government of India [2000: paragraph 1.85] has observed the following:

"More effective management of public finances continues to be the central challenge facing all levels of government of India.... The adverse effects of large fiscal and revenue deficits on virtually every important dimension of macro-economic performance are well known.... Furthermore, the continuous series of large deficits lead to inexorably mounting interest payments, leaving a declining share of government expenditure available for essential functions such as defence, law and order, social services and public investment in infrastructure".

Rangarajan [2004] argued that fiscal sustainability should ensure that a rise in fiscal deficit is matched by a rise in the capacity to service the increased debt. Considering this, he argued, borrowing for infrastructure or permanent assets may be justified. He found that a little less than 70 per cent of borrowing was not being spent on capital assets (at least of the physical kind) - and even when there was capital expenditure, the return on assets was negligible.

There are several ways to maintain fiscal balance using the provisions available within the fiscal domain -- one, by increasing revenue; two, by reducing expenditures; and three, by both measures together. According to Bagchi [2006], an easy (and also quick) measure is to adopt an expenditure cut policy. "The axe fell mainly on

capital expenditure and also on expenditure on social and economic services with consequences that unfolded later and are still unfolding" (p. 4118). Reduced capital expenditure is considered to be adversely impacting on backward rural regions which have been acutely suffering from inadequate infrastructure. As the situation reached very critical stage, the need for adopting fiscal responsibility legislation (FRL) through the intervention of the Finance Commission became inevitable.

Table 2. Aggregate Receipts of State Governments

	(amount in Rs. billion)						
	1990-1998 (average)	1998-2004 (average)	2004-08 (average)	2008-10 (average)	2010-11	2011-12(RE)	2012-13(BE)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Aggregate receipt (1+2)	1515.20 (15.00)	3666.20 (15.90)	6496.60 (16.10)	9494.60 (15.70)	11735.70 (15.30)	14259.40 (16.10)	16333.00 (16.10)
1. Revenue receipt (a+b)	1143.50 (11.30)	2400.80 (10.50)	4872.10 (11.90)	7314.00 (12.10)	9353.50 (12.20)	11414.70 (12.90)	13309.80 (13.10)
a. States' own revenue (i+ii)	696.20 (6.80)	1501.20 (6.50)	2921.10 (7.20)	4279.20 (7.10)	5523.60 (7.20)	6578.50 (7.40)	7649.70 (7.50)
i. States' own tax	518.00 (5.10)	1187.80 (5.20)	2333.60 (5.70)	3425.00 (5.70)	4607.10 (6.00)	5514.70 (6.20)	6450.70 (6.30)
ii. States' own non-tax	178.20 (1.70)	313.40 (1.40)	587.50 (1.40)	854.20 (1.40)	916.50 (1.20)	1063.90 (1.20)	1199.00 (1.20)
b. Current transfer (i+ii)	447.30 (4.50)	899.60 (3.90)	1951.00 (4.70)	3034.84 (5.00)	3829.90 (5.00)	4836.10 (5.50)	5660.10 (5.60)
i. Shareable taxes	254.30 (2.50)	517.00 (2.30)	1110.70 (2.70)	1630.30 (2.70)	2194.90 (2.90)	2597.30 (2.90)	3021.90 (3.00)
ii. Grants-in-aid	193.00 (2.00)	382.60 (1.70)	840.40 (2.00)	1404.50 (2.30)	1635.00 (2.10)	2238.90 (2.50)	2638.20 (2.60)
2. Capital receipts (a+b)	371.80 (3.70)	1265.40 (5.40)	1624.50 (4.20)	2180.70 (3.60)	2382.30 (3.10)	2844.70 (3.20)	3023.33 (3.00)
a. Loans from Centre	180.80 (1.80)	260.90 (1.20)	117.40 (0.30)	75.60 (0.10)	94.80 (0.10)	159.90 (0.20)	202.10 (0.20)
b. Other capital receipts	191.00 (1.90)	1004.50 (4.20)	1507.10 (3.90)	2105.10 (3.50)	2287.50 (3.00)	2684.90 (3.00)	2821.10 (2.80)

Source: RBI (2013), p. 29.

- Note: 1. The period averages provided in this table reflect the different fiscal phases of the states;
 2. Figures in parentheses are percentages to GDP;
 3. Capital receipts include public accounts on a net basis;
 4. RE = Revised estimate; BE = Budget estimate.

There is another part, i.e., revenue receipt. During the FRBM regime, how much of the fiscal correction in Indian states has occurred due to the states' own revenue mobilisations? Or, does the credit go to devolutions from the centre only? Fiscal improvement at the state level is attributable to both the central transfers (CT) and states' own tax revenue (OTR). Let us take a look at Table 2 which presents phase-wise data (averages for some phases) on aggregate receipts of the state governments. In the first phase of fiscal consolidation -- i.e., during 2004-08 -- it is not only the CT/GDP ratio that has increased (from 3.9 per cent to 4.7 per cent) against the previous phase of 1998-2004, but OTR/GDP ratio has also increased (from 5.2 per cent to 5.7 per cent) and thus contributed to the consolidation process in the fiscal domain. In the early recession period, (i.e., during 2008-10), the OTR/GDP ratio remained stagnant at 5.7 per cent. But, it has shown increasing trend thereafter (6 per cent in 2010-11, 6.2 per cent in 2011-12 RE, and 6.3 per cent in 2012-13 BE). If the special category states are excluded from these estimations, states' OTR/GDP ratio may perhaps demonstrate greater improvement. The reason is as follows. The typical features of a special category state include hilly terrain, sparsely populated habitation, and high transport costs which lead to high cost of delivering public services. With relatively low level of economic activity in most special category states, their tax base is limited compared to non-special category states. "These States, to a large extent, depend on transfers from the Centre (comprising grants and tax devolutions) for their resource needs" [RBI, 2011: 37].

Loss incurred by the state electric utilities is another major concern as far as improvement in states' fiscal condition is concerned. Electricity is provided to farmers free of charge in some states. In the domestic or residential sector too, electricity is provided at subsidised rates which vary according to different categories of consumers. It has been observed that tariffs are

typically higher for those households that consume more electricity [IISD, 2012]. But, such higher tariffs do not fully offset the costs incurred for distribution of power free of charge or at subsidised rates. So, the governments provide subsidy to the distribution utilities. The actual subsidy that is transferred to the utilities is termed as "subsidy released" and is often lower than the amount of "subsidy booked (the state governments announce this amount beforehand, which is to be disbursed to the utilities as compensation)". According to Government of India [2011], the accumulated losses of the distribution utilities during 2005-10 account for Rs. 820 billion after subsidy has been paid. Part of this loss that is supported by the government guarantees is not reflected in the total public debt/GDP ratio since such guarantees belong to the off-budget accounts. However, they have the potential of becoming budgetary liabilities, in case a company is in deep financial trouble. (For a rough idea, let us make a simple calculation. At the end of March 2010, the states' total outstanding liabilities accounted for Rs. 16,486.50 billion. As a proportion of the national GDP of 2009-10, it accounted for 25.45 per cent. If we include the above-mentioned loss amount, i.e., Rs. 820 billion, in the states' total outstanding liabilities, the proportion goes up to 26.72 per cent.) Around 70 per cent of the financial losses of distribution companies during 2005-10 have been financed through loans from public sector banks. Of the total bank loans outstanding at Rs. 585 billion, as much as 42 per cent is backed by government guarantees. Srivastava et al. [2003] argue that subsidies that arise due to such guarantees extended by governments for loans taken by the public enterprises or distribution utilities are regarded as off-budget subsidies. They point out that these have the potential of becoming budgetary liabilities if there are defaults in loans guaranteed by the government. Keeping this in view, the RBI [2013: 1] has cautioned that "[t]here is ... a need to improve the measurement and reporting of implicit obligations of the states to

reflect their true fiscal positions, particularly in light of increasing off-budget liabilities on account of guarantees to state power distribution companies (discoms)." If this is not kept in view then the states can show themselves to be on the right track in terms of the FRBM, while they are actually not.

4. Market Forces and Fiscal Stability: A Two-way Relationship

The overall goal of the reformed SGP¹³ is to impose discipline on member states with potentially massive budget problems. Structural reforms especially to increase the competitiveness of the deficit countries in the Union are necessary. Stability in a fiscal union cannot be established just on the basis of voluntary principles.

To receive greater degree of fiscally responsible behaviour, another approach, next to better regulation, would be to encourage market forces. Weak market may jeopardise government's efforts of maintaining fiscal discipline. For example, low level of economic transactions in a weak country would not be able to generate desired level of revenues to be contributed to public exchequer. Similar examples can be drawn from other specific markets, such as high interest rate in financial/money market. Institutional obstacles, if found responsible for sluggish growth of an economy, need to be removed. Thus, both approaches -- fiscal disciplines and market forces -- can reinforce each other and be applied simultaneously. If member states know that no bailout is possible, they will show greater willingness to follow the fiscal rules. Articles 122 to 125 of the *Consolidated Version of the Treaty, 2008*, highlight the judicial basis for disciplining market forces [Hentschelmann, 2010: 40]. Article 125, the famous bailout Article, states that no member state, or the Union, is responsible for

what might result into fiscally unsustainable commitments made by some other member state/s. According to Article 125:

The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

Let us now explain the relevance of this Article. The large deficit countries may face higher interest rate on the bonds they have issued to finance the government debt. If the financial markets assume, however, as they did till recently, that in the end the Union will pay the debts, the creditworthiness will be misjudged and interest rates will be lower than what it should actually be. The present sovereign debt crisis can also be diagnosed as a situation that since one mechanism, i.e., the fiscal compact, has failed to maintain its disciplined management/behaviour, the other mechanism in the form of market forces has taken over to the extreme. Govinda Rao and Sen [2011] argue that "[a]n important precondition for market promoting federalism is the hard budget constraint because fiscally responsible decision can come only under such an environment and therefore the policies should be calibrated to avoid bailouts and free-riding behaviour." Further, according to them: It is not uncommon that the countries/states which have more developed markets and have been able to create greater market friendly environment will attract capital and skilled labour and grow faster than others. This requires creation of market-friendly policy environment and institutions.

India has adopted liberalising policies on various fronts since 1991. In the last decade, India realised that both central and state governments have to respond to the globalising environment from the fiscal perspectives as well. Exorbitant government deficit would result in low demand for goods and services since people would save more than before in order to be prepared for the future hike in tax rate (the government would raise the tax rate in the future to finance the present deficit/debt).

As regards strengthening of market forces, one of the possible prescribed solutions, as discussed in many quarters, for the sovereign debt crisis is the creation of so-called Eurobonds [Springford, 2009]. If Eurobonds are issued they will be issued as a combined mechanism and will not be issued separately by the individual member states. Thus, the interest rate will probably become an average of the interest rates that the several member states will have to pay. As a result, the countries with a low government debt would see that the rate of interest they were earlier charged rises now, while the countries with a high debt would experience the opposite phenomenon. The financial market, however, as is probably the intention of issuing Eurobonds, can no longer effectively, in the extreme, take an individual state as hostage, for example, by asking an exceptionally high interest rate on bonds of the troubled member state. Greece would be facing such tough situation if it needed to finance the present deficit with its own bonds. Conversely, Germany has not approved the idea of floating common Eurobonds since it has to pay higher interest rate. However, some may argue that such an arrangement after Germany has said "yes" might weaken the market discipline.¹⁴ Although such a cosmetic solution can be worked out for temporary relief, the EU has to eventually think of radical remedy to gradually get out of its structural problems of deficits and debts. Thus, imposition of some kinds of strict rules assumes special importance.

5. Fiscal Management: Incentivised Legislation in India vis-à-vis Strict Rules in the EU

The TFC, in its recommendations, linked improvement in revenue deficit status of the states to the debt write-off. Thus, the Finance Commission introduced the incentivisation scheme into the fiscal consolidation process in order to woo the state governments in maintaining fiscal discipline and consequently macroeconomic stabilisation [Herd and Leibfritz, 2008]. The recommendation was like this: The states will be awarded debt write-off, only if they enact appropriate legislations to bring down the revenue deficit in the specified period of time and commit to reducing the fiscal deficit in a phased manner. So, there has been an attempt in India to ensure fiscal discipline by introducing incentive and legislation. Most of the states were keen to grab the incentives as they were heavily indebted. But, for grabbing the incentives, they had to go in for the legislation. Once the legislation was done, the states were put into constitutional binding to follow the FRBM rules. Similarly, the present EU treaty called as Fiscal Compact does also contain obligatory provision of legislative enactment. Let us now present some observations as well as suggestions in view of the proper/effective implementation of the new Fiscal Compact.

- A weak point of the previous fiscal pact was that the sanctions were, in fact, only theoretical. Their implication was low from the implementation point of view. Fines should have been imposed on the offending member states. In the new Fiscal Compact, however, sanctions are no longer theoretical but real and automatic. The EC can directly impose the sanctions without referral from the Council (see Article 126 TFEU), which was earlier subject to qualified majority voting in the Council. There are even ideas in the EC to completely suspend the voting rights of countries in the case of the breach of the agreement.

- Since the rules of the previous SGP have been consistently violated, in the preventive as well as the dissuasive arms, there must be strong provision of taking action on the EC and any individual member state as the case may be. The case/s must be taken before the European Court of Justice (ECJ). At present, this provision is not explicitly included in the Treaties. This provision was made in an earlier draft but has been, though not completely yet, deleted in the final versions. Currently, if a state, which has ratified the Fiscal Compact and is thereby bound by the fiscal provisions of the Compact, fails to enact the required "implementation law" in its own parliament within one year of the treaty's entry into force, it can ultimately be fined up to 0.1 per cent of its GDP by the ECJ. This fine will have to be transferred directly to the ESM. As has been indicated earlier, access to the ESM bailout provision would be conditional on signing the new treaty of fiscal disciplines. Thus, member states cannot be bailed-out unless they do sign and apply the pact. A legislation related to implementation of balanced budget should be included in the national constitutions of the member states when there is no major exceptional shock (we discuss this later again). In addition, if failed in maintaining balanced budget, a member state should be taken to ECJ. Due to the present financial turmoil and the consequent political tension, many people are highly apprehensive about the future existence of the EU. However, a chance has now opened up before the EU to find new routes of establishing fiscal discipline through the fiscal treaty and building solidarity through the ESM.

- A post of European Stabilisation Commissioner needs to be created to monitor the national budgets. If a country does not comply with its commitments under the Fiscal Compact, the so-called European Structural and Cohesion Funds could be denied to the member state.

- If a member state has accepted or needs support from the funds of the ESM, the budgetary sovereignty of the member state gets automatically restricted. This is because then a national government has to present its draft budget in the EU (or EC) for approval before it presents the same in its own parliament. And the EU, if necessary, can temporarily reject or refuse it, suggesting some specific spending cuts or the establishments of new revenue streams or the both. In this endeavour, both the ESM and the Stabilization Commissioner can play the necessary roles.

- Chronic deficits (and debt) of a certain country may adversely affect banks located in other countries. This is because of the fact that those banks have purchased bonds of the defaulting countries. To save those banks, some arrangements should be made, otherwise taxpayers' burden in those countries will unnecessarily increase.

- Good rules should be simple and easily verifiable. For Buiter [2003: 4], the earlier SGP rules were "both simple and simply wrong much of the time. It is better to be approximately right than precisely wrong". Some people are strongly arguing to eradicate structural deficit problem,¹⁵ whereas a rule in the new Compact asserts that the budget deficit is normally not to exceed the 0.5 per cent of GDP, which could be further cyclically adjusted. This means that flexibility in the form of cyclical adjustment has been allowed in the Compact. The EU believed that splitting budget deficits into their cyclical and structural components -- although analytical process of such splitting is critical -- determines how much of the deficit is cyclical and will be slowly tackled when the economy recovers and how much is structural and must be eliminated by discretionary fiscal measures such as tax increases and spending cuts [McArdle, 2012]. To calculate the cyclical component, one would need (a) current and historic growth rates, (b) potential growth rates, and (c)

output gaps expressed in terms of difference between these two growth rates, that is (b) - (a). Then, estimating the impact of the output gap (the extent to which the economy is under- or over-heating) on the budget through a regression, one would get the cyclical component of the deficit. Finally, the structural component is the residual when temporary or one-off factors (expenditures and revenues) are excluded from the cyclical component. This mathematically/statistically derived cyclical adjustment notion has some shortfall due to non-incorporation of a subjective variable such as political factor and thus may lead to structural deficit crisis if the process of budget, sometimes politically inflated, is not properly monitored. This might happen due to populist political agenda (greater spending programmes) of the ruling party/coalition, which may be seen to have outweighed the need for maintaining fiscal disciplines. However, it is imperative to allow for cyclical adjustment to tackle unfavourable circumstances. The current treaty states that the countries may temporarily incur deficits only to take into account the budgetary impact of the economic cycle and exceptional economic circumstances such as unusual event (which has a major impact on the financial position) beyond the control of the contracting party or severe economic downturn, provided that this does not endanger budgetary sustainability in medium term. More specifically, in the treaty, the medium-term budgetary objectives (MTOs) allow the structural budget balances to be country-specific, taking into account differences across countries according to their economic fundamentals and risks to public-finance sustainability. Thus, the member states were requested to declare their specific MTOs in view of the following considerations:

- * a balanced or surplus structural budgetary position (for high debt/low potential growth countries);

- * a general limit of a structural deficit of 0.5 per cent of GDP, while the limit can be increased to up to 1 per cent only for countries with a government debt-to-GDP ratio significantly below 60 per cent and with low risks to long-term fiscal sustainability;
- * the above-mentioned tight limits have been designed so that the member states can try to maintain the earlier budget deficit limit of 3 per cent in times of economic downturn (if the deficit is already very close to 3 per cent level, it would shoot up to much higher level during recession).

Hence, there are flexibilities in the Fiscal Compact to make necessary adjustments taking into account different situations.

6. Twelfth Finance Commission and the FRBM in India

It is imperative that in order to keep the fiscal issues of the member states on the right track the EU might need to think of a mechanism of surveillance that would include, among others, formulation of a set of rules, creation of a responsible post, etc. India has already initiated its own mechanism. Considering the alarming fiscal situation (especially the deficit and debt levels) in India, the TFC had recommended a set of fiscal rules (for both the centre and the states). As indicated earlier, it also recommended incentives (to be offered by the centre) for the states which would enact the rules in the state assemblies. Let us now discuss this in a little detail.

Finance Commission is a constitutional body formed after every five years "to undertake a quinquennial review of the resources of the Union and the States, ... and make recommendations on the manner in which the proceeds of Union taxes and duties have to be shared between the Central

Government and the States, and further on the manner in which the share of the states is to be distributed among all the states" [Ramji et al., 2001: 28]. The Eleventh Finance Commission [2000-2005] had recommended the centre and the states to restore fiscal balance and asked the centre to create an incentive fund for the states that would follow the fiscal restructuring plan. However, the plan did not materialize. The focus of the TFC's [2005-2010] report was on fiscal consolidation and enactment of the FRBM Rules. The centre had already enacted the FRBM rules [in 2003] before the TFC came up with its report [in 2004], hence, enhanced emphasis was given in relation to the states in its report. Some of the recommendations are as follows [Government of India, 2004]:

- * Revenue deficit to be eliminated.
- * Fiscal deficit to be brought down to 3 per cent of GDP (for states, 3 per cent of gross state domestic product) and, at a maximum, to be contained at this level.
- * The combined (centre and states) debt-GDP ratio with external debt measured at historical exchange rates should, at a minimum, be initially brought down to 75 per cent (at the time of recommendation it was 81 per cent).
- * The long term goal for the centre and the states for the debt-GDP ratio should be 28 per cent each.
- * The centre's interest payment relative to revenue receipts should be about 28 per cent. In the case of the states, the level of interest payments relative to revenue receipts should be 15 per cent.
- * States should follow a policy of recruitment and wage, in a manner such that the total salary bill relative to revenue (recurring) expenditure net of interest payments and pensions does not exceed 35 per cent.

Rangarajan and Srivastava [2008] observed that, after the enactment of FRBM, the fiscal situation in terms of both fiscal deficit and debt/GDP ratio for both the centre and the states has improved. This improvement continued until the economy was hit by the world-wide recession. However, it was evident that India's strong federal system, with the centre occupying greater financial power, has facilitated by and large smooth enactment and implementation of fiscal responsibility legislations. Let us now briefly discuss this issue in the following section.

7. Has Indian Constitution's Centripetal Bias Played Any Role?

Under the British regime, an Act was passed in 1919 which specified that the provinces should make initial contributions to the Federal Government to cover its deficits for a period of seven years and thereafter make a standard annual contribution. However, the 1935 Act commanded a financially strong Centre, and for Federal Grants-in-aid, conditional or discretionary, to be given to the provinces to meet public purposes. India became independent in 1947. The economic and social conditions prevalent in the wake of the Second World War and the Partition of the country appeared to provide logical support to the emergence of a strong Centre, with the Indian Constitution of 1950, not conferring more powers on the states than was considered under the 1935 Act [Ramji, et al. 2001]. Leftists in India are in favour of transferring more powers to the states. The Left Front has ruled the state of West Bengal for last 34 years (until it was out of power in 2011 assembly election) and largely accused the centre for occupying greater financial power and fostering a condition of underdevelopment in different states.

West Bengal and Sikkim are only two states which had earlier declined to enact the FRBM. West Bengal did not want to lose its borrowing power at greater scale and opposed the centre's

policies of fiscal restructuring from different perspectives. Some arguments that were provided by the earlier Left Front-ruled Government are as follows [Government of India, 2010]:

- * While, on the one hand, in the Constitution the major responsibilities in the sphere of development expenditure (for example, on irrigation, roads, power, education, health, etc.) and administrative expenditure (for example, on law and order, general administration, etc.) have been given to the states, the important revenue-raising powers (such as income tax, corporate tax, union excise duties, customs, service tax, etc.) have remained concentrated in the hands of the centre, on the other.
- * While the states are endowed with less power of resource mobilisation and greater responsibility of development expenditure, the gap is not adequately met through fund transfers from the centre to the states in terms of devolution of central taxes and grants.
- * It may also be noted that the share of total market borrowing to which the states may be entitled is also fixed by the centre. While in 1950s the share of market borrowing of the states and the centre in the total government market borrowings were approximately in the proportion of 50:50, this share of market borrowing of the states has now fallen sharply to about 20 per cent, with more than 80 per cent of the market borrowing being garnered by the centre.

In addition, as some allege, the central government takes the opportunity of raising funds by imposing surcharge rather than altering the rates and thus they can avoid sharing the receipts with the states [Amiya K Bagchi, 2004]. Even though all these are considered as counterarguments, it becomes once again evident that Indian Constitution has a centripetal bias, which has facilitated the FRBM to come into effect. And it has further

been evident that the FRBM has helped the centre and the states to bring the fiscal condition in order. Adoption of incentivisation policy was instrumental. Finally, West Bengal had to bow down and enact the FRBM (little before the Left Front lost power), since such enactment was linked to some incentive schemes awarded by the centre. Incentives facilitated legislation and legislation facilitated fiscal restructuring process. This has been partly, if not largely, possible for the centre's possession of greater financial power, something which is missing in the EU federal structure.

Let us conclude this section by referring to another important issue relevant as an appendage. The Planning Commission is responsible for earmarking the plan size for each state for a Five-Year plan period. Indian state-level politicians, especially the chief ministers and finance ministers, often raise their voice for greater plan size. Approval of a large plan size provides a chief minister with arguments in favour of her/his successful efforts for further development of the state. The ruling party takes the opportunity to publicize the approval of a large plan size and wants to earn political competitiveness. Such approval from the Planning Commission was possible in case the same political party was in power both at centre and at a particular state [Biswas, et al. 2008].

Let us now try to understand about how an approved plan is financed. The expenditure on state plans consists of (1) the balance from current revenues from the state budgets, (2) plan assistance in the form of grants and loans by the central government (the grant-loan ratio is fixed at 30:70),¹⁶ and (3) borrowing from other sources that include the market and different small saving schemes [Government of India, 2004]. Here, the important point to note is that if the balance from current revenues (i.e., money from the first source) appears to be negative, something which the states have experienced for a long period of time before the FRBM regime, "the financing of the plan, apart from a small contribution of the

plan grants from the centre, depends entirely on borrowing by the states" [Government of India, 2004: 20]. Although the main observation is important, part of the explanation seems to be flawed. According to the Thirteenth Finance Commission report, plan grants were 35.80 per cent of the total transfers from the centre to the states during the award period of the Eighth Finance Commission [1984-89]. The share has come down to 28.55 per cent during the Twelfth Finance Commission award period [2005-10]. Although the share has decreased over time, the latest proportion/figure cannot be considered as a "small contribution" (as it has been termed by the Government of India, 2004) compared to the total size of the state plan. However, larger plan size has led the states to greater debt trap. How? The states often considered a larger plan size as a positive reflection on their economic performances [Government of India, 2002: 3]. The states which wanted to increase the 'grant' part, it had to necessarily increase the 'loan' part as well in order to maintain the grant-loan ratio to be 30:70. This means that a larger plan size effectively leads to larger borrowing. This has provoked the TFC to suggest the plan size of every state be linked to the sustainable level of debt. A relatively large plan size is affordable with the less borrowing pressure if revenue surplus goes up. Such linkage needs to be incorporated in the EU fiscal consolidation processes.

8. Some Views, Not Just Conclusion or Summary

Does a rule-based system work in controlling and/or reducing deficit and debt? For the Indian states, the favourable effects of FRBM on deficit reduction were observed until the process was interrupted by the global slowdown [Dutta, 2012a]. FRBM has temporarily been relaxed to combat effects of the slowdown. There are signs that the states will be able to reduce deficits within dates newly fixed by the Kelkar Panel, if not by the earlier ones fixed by the Thirteenth Finance

Commission (for the latest state-wise trends of revenue deficit and fiscal deficit, see Dutta [2012b]). But, turmoil is going on in the EU, especially in countries like Greece, Portugal, Ireland and Spain. Unlike the EU member states, a state government in India is not a sovereign body; rather it is partly but significantly dependent on the central government for resources, since the central government has adequate tax collecting powers. Thus, it has been possible for the central government to make the states enact the FRBM through introducing incentives, e.g., debt write-off scheme, swap of the high cost debt, etc. The EU federal system is very different from that of India. Attempts to bring in changes in the two systems may hint at a trade-off between decentralisation and the requirements of the fiscal union. Can the Indian states prefer greater autonomy at the cost of strong federal system? Can the EU member states prefer stronger federal bond at the cost of their sovereignty or autonomy? May be, extreme surrenders are not feasible or desirable from the perspectives of the concerned stakeholders, but some amount of compromise may result in more favourable outcomes. For example, the Indian centripetal bias may get somewhat loosened and thus a more decentralised fiscal union is produced (through, among others, transfer of some tax collecting powers from the centre to the states). Conversely, the EU member states may compromise their moderate fiscal sovereignty in the interest of stronger federal-fiscal Union.

Currently, if a state, which has ratified the Fiscal Compact and is thereby bound by the fiscal provisions of the Compact, fails to enact the required "implementation law" in its own parliament within one year of the treaty's entry into force, it can ultimately be fined up to 0.1 per cent of its GDP by the ECJ. Questions have already been raised as to whether a sovereign member state can be punished by the EC. Amidst this, there is a proposal from the EC to introduce the "European Union financial transaction tax" (EUFTT)

within some of the member states of the EHYPERLINK "http://en.wikipedia.org/wiki/European_Union" EU by 1 January 2014.¹⁷ Somewhat greater financial power of the EC might create a relatively strong central body in the EU which might be useful in generating stronger federal system in the region.

India's FRBM is a legislation which has been enacted in national parliament and state assemblies, whereas EU's Fiscal Compact is a set of rules that have not been legislated. The EU member states are expected to enact the implementation law of the Compact in their national parliaments within one year after they have ratified the Compact. Violation of SGP rules has been observed earlier. Once the present rules are enacted, violation of the legislation by the government is extremely difficult unless duly amended. Possibility of amendment in the future, without taking any consent from the EC, cannot be totally overruled, since each member state is an independent sovereign country. So, a central mechanism at the EU level is required to be created to discuss whenever any uncomfortable circumstances associated with exercising the Compact arises in any member state, in order to prevent undesirable changes in the law. In India, to respond to cyclical fluctuations in the economy and exogenous shocks, temporary relaxations of FRBM rules -- as has been experienced during the recent recession -- may be necessary from time to time. This is being considered by the Fourteenth Finance Commission as one of the Terms of Reference asks the Commission to address this issue. However, in our opinion, states should not be allowed much autonomy in this regard, because that may be misused under political pressure; rather a permanent post of FRBM Commissioner can be created under the office of the Central Finance Commission to recommend state-specific relaxations from time to time, as necessary, and such provision (i.e., FRBM Commissioner's role) should be included in the FRBM Acts.

Another important issue also needs to be touched upon in this regard. Spending cuts have led to citizens' agitations and demonstrations in some troubled EU countries. In India, it is true that although the states have benefited from the FRBM with respect to deficit reduction, they have, however, experienced a harsh situation as well -- i.e., a fall in their recurring (revenue) expenditures [Dutta, 2012b]. Similarly, as Polychroniou [2012] argues, Greece has been passing through tough time due to its harsh austerity measures, resulting in reduction in social sector expenditures like education, unemployment allowances, etc. While Polychroniou blamed the tough fiscal rules for the Greek social unrest, he did not forget at the same time to tell us that "there are definite specific domestic factors at work which led to the build-up of the crisis both within and outside the context of the financial crisis" (p. 35). Especially, when he states that "under the long and ignominious reign of the socialists, the looting of public wealth became an art form and covering up corruption a science" (p. 38) then we cannot just target the tight fiscal rules for all the odds that have been occurring. Something should have been done to correct the governance deficit as well. Moreover, in the process of fiscal restructuring, it is not always obligatory to reduce expenditures; one can also think of imposing taxes as well. Reducing expenditure, as some argue, could adversely impact on the standard of living of the poor if there is any cut in spending on social security and other social sector such as health and education. Creating a fiscal union to supplement its monetary union is only one of the EU's problems. Part of the problem is also to bring about structural reform and adjustment in many member states in order to improve their competitive position. If the EU, as indicated above, can create greater funds at the exchequer of the EC through tax collecting powers and/or other mechanisms, the member states can receive supplementary funds from the Fiscal Compact on the lines of India's Finance Commission's devolutions, including grants, to tackle adverse

situations when they are in trouble. This would, however, require a degree of cohesiveness and a sense of oneness as a nation, which may be more missing in the EU than in India. From the perspective of Indian situation, Chandrasekhar [2011, Pp. 21-37] argues that India's tax/GDP ratio (11.3 per cent as per 2006 accounts) is extremely low by international standards, including those of many developing countries. He stated:

"In the 1950s and the 1960s, economists concerned with development had concluded that national savings and government revenues in most developing countries were as low as they were not because these countries were poor, but because their governments had failed to adequately tax the rich in their countries. This meant that tax revenues of the government were lower than warranted" (p. 23).

But, when it comes to fiscal restructuring plan, many politicians as well as policymakers talk about austerity (the price of which is mostly borne by the poor), not about a mixed strategy that could offer a scope for maintaining a balance between both austerity and new revenue generation. In addition, fiscal restructuring also engages certain kind of policy shift from unreasonable, huge, recurrent (revenue) expenditure (that often engenders wastage through unproductive as well as unnecessary administrative expenses) to specific number of infrastructure projects through capital outlay.¹⁸ The difference between the two is that the former has a much smaller multiplier effect in generating further income and revenue compared to the latter which is expected to induce new economic activities and thus new avenues for earning revenues. This is what had happened in the USA while the government had been tackling the Great Depression in the 1930s. Beyond the common notion of demand-generating, expansionary, expenditure policy, the US government sought to resort to structural shift from petty local expenditures to large federal projects:

"Before 1932 relative shares for each level were roughly 50% local, 20% state, and 30% federal government. After 1940, 30% of relative shares were local, 24% state, and 46% federal. A major part of increasing government expenditures, 75%, came in programs administered at the federal level but in cooperation with state and local governments" [Bordo et al. 2011: 9].

This clearly indicates a shift of focus from small projects to large projects. Large-scale expenditure in big infrastructure projects not only provided employment and thus helped generate demand through increased purchasing power, but also encouraged new entrepreneurship by linking remote areas with markets and growth centres, something which was also crucially important to get rid of recession first and prosper further.

NOTES

1. For an analysis from a legal point of view of the first draft of a new EU fiscal pact, see Peers [2011]; and Vasconcelos [2012] for an analysis of the third draft.

2. See "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions" published by the EC on 3 October 2012, which is available at http://ec.europa.eu/internal_market/smact/docs/single-market-act2_en.pdf.

3. To come into effect, at least 12 of the 17 euro-zone member states have to ratify this intergovernmental fiscal treaty.

4. Violation of an Act is not permitted without necessary amendment in the national parliament or in a state assembly in question.

5. In the first quarter of 2012, the overall government deficit of the euro-zone countries was 3.2 per cent of GDP. The primary budget deficit of the euro-zone member states, net lending or borrowing excluding interest, as a percentage of GDP was about zero. Government debt as a percentage of GDP was on an average 87.3 per cent. The unemployment rate was about 11 per cent and consumer-price inflation was 2.6 percent. In the first quarter of 2012, there was no growth in the euro-zone. It is to be noted that, for all these figures/parameters, the differences between the individual member states vary significantly. For example, the government deficit for Finland is 0.7 per cent, whereas for Ireland 8.3 per cent.

6. The European Council defines the general political direction and priorities of the Union. The Council consists of the heads of governments of the EU member states, together

with the President of the European Commission and the President of the European Council.

7. The budget of the EU is too small to play any role, in general, in stimulating the economy or, in particular, in solving the present sovereign debt crisis. The total budget (e.g. 147 billion euro in 2012) is about one per cent of the total GNP of the Union and the revenue and expenditure shown in the budget have to be in balance (Article 310, Consolidated Versions of the Treaty, 2008).

8. For the final version, see http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf; for the fourth draft, see <http://openeuropeblog.blogspot.com/2012/01/draft-euro-fiscal-pact-episode-iv.html>; and see <http://www.telegraph.co.uk/finance/financialcrisis/9026142/The-EU-fiscal-draft-treaty-in-full.html> for the first draft.

9. The annual averages of WPI and CPI were found to be 9.6 per cent and 10.4 per cent in 2010-11 and 8.9 per cent and 8.4 per cent in 2011-12, respectively, which appeared to be very high as compared to the 2007-08 levels [Government of India, 2013].

10. For many years, tax receipt of West Bengal, relative to its gross state domestic product (GSDP), has remained the lowest in the country. The tax-GSDP ratio in the state was 4.5 per cent in 2011-12, compared to the all-state average of 5.7 per cent [Govinda Rao, 2012]. The earlier Left Front government was largely responsible for such a situation and the present Trinamool Congress government does not also seem to have adopted corrective mode. The state's debt-burden is huge and so is their burden of annual interest payment.

11. *The Times of India*, 11 June, 2012.

12. See (1) Business Line, *The Hindu*, 19 July 2003, Saturday, <http://www.thehindubusinessline.in/2003/07/19/stories/2003071901291700.htm>; and (2) *The Hindu*, 23 July 2008, Wednesday, <http://www.hindu.com/2008/07/23/stories/2008072354240400.htm>.

13. Recently, the EC has produced four drafts. For the first draft, see Peers (2011); for the second draft, see <http://www.openeurope.org.uk/research/06012012draftfiscalpact.pdf>; for the third, see Vasconcelos (2012); and see <http://www.europolitics.info/penalties-for-botching-debt-brake-fifth-draft-possible-art323899-32.html>, for the fourth draft.

14. Germany has to understand that if the present turmoil keeps growing in the EU then the size of its export in EU countries may go down.

15. In general term, a structural deficit differs from a cyclical deficit in that it exists irrespective of the point in the business cycle due to an underlying imbalance in government revenues and expenditures. Thus, even at a relatively high point in the business cycle (when revenue level should be high) the country may still be in deficit and thereby resort to borrowing. We would now conceptually see how its technicalities are supposed to be dealt with in the European Fiscal Compact.

16. For the special category states (which are located in hilly terrain and have relatively very low level of economic activity as well as limited tax base), the ratio is 90:10.

17. For further details, see <http://en.wikipedia.org/wiki/>

[European_Union_financial_transaction_tax](http://en.wikipedia.org/wiki/European_Union_financial_transaction_tax).

18. "Liberal policies did not and do not stipulate retreat of the state from its basic duties of building up social and economic infrastructure" [Chelliah, 2010, p. 12].

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