COOPERATIVE FEDERALISM IN INDIA

RESETTING THE FISCAL ARCHITECTURE: LESSONS FOR INDIA

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RESETTING THE FISCAL ARCHITECTURE: LESSONS FOR INDIA

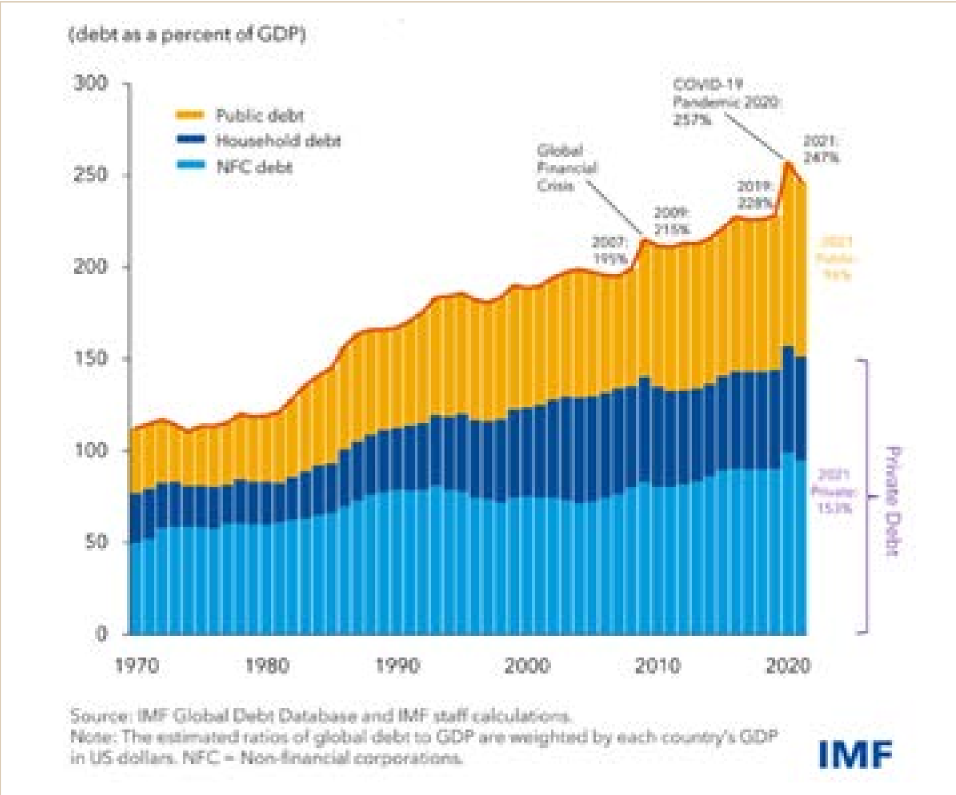
ABSTRACT

The COVID-19 pandemic brought significant challenges to public finances, raising global debt to record-high levels and necessitating the suspension of fiscal rules across the globe. As we approach the aftermath of the pandemic, the challenge is to reset the pillars of the fiscal architecture and better manage public finances across all levels of government—as the lynchpin of any successful growth strategy in a post-pandemic world. This situation offers an opportunity to rethink fiscal rules and make fiscal policy more agile in responding to crises, without undermining fiscal sustainability. A risk-based medium-term fiscal framework that combines standards, rules, and strengthened institutions would strike a better balance between flexibility and credibility. Overall, for India to achieve its full potential for economic growth and development, it needs to improve the quality and efficiency of public spending and financial management across all levels of government. In doing this, India should consider moving toward a new principle-based fiscal strategy, complemented with public financial management reforms and setting up an independent fiscal institution. This process will need to be undertaken in close collaboration with the States.

CONTEXT

The COVID-19 pandemic brought significant challenges to public finance across the world. The magnitude of fiscal costs needed to deal with the pandemic—well beyond the fiscal stimuli during the 2008 global financial crisis (GFC)—and the fall in revenues due to lower economic activity has raised global government debt to record-high levels. Private debt has also risen sharply across countries, as successive lockdowns have closed businesses and accommodative policy measures supported credit extension. This has resulted in a landscape with much higher public and private debt across the global economy, with growing differences in borrowing costs across countries (Figure 1).

Figure 1. Global Public and Private Debt



This is mirrored by the growing role and expenditures of the public sector, which had to dramatically expand the social safety net during the pandemic. Advanced economies especially reflect their exceptional policy support over the last couple of years. For instance, U.S. general government debt rose to over 130 percent of gross domestic product (GDP) in 2020; some European countries even exceeded that, compared to their pre-pandemic levels.[1]

In emerging markets and developing countries, debt has also been growing very rapidly—it is now generally well above where it was after the 2008 crisis. Recent estimates point to debt in emerging markets and developing economies now being at the highest level in half a century[2]. Average gross government debt in emerging markets is up by almost 10 percentage points since 2019, reaching an estimated 64 percent of GDP by the end of 2021, with large variations across countries. Debt in low-and middle-income countries has also jumped above previously recorded levels. Importantly, the pandemic has exacerbated pre-existing debt vulnerabilities, particularly in low-income and developing countries. So far, their debt

1 IMF Fiscal Monitor Database.

2 Ayhan Kose, Franziska Lieselotte Ohnsorge, Carmen M. Reinhart, and Kenneth Rogoff, "The Aftermath of Debt Surges," World Bank Policy Research Working Paper, WPS 9771 Washington, D.C.

servicing burden has been helped by the availability of market access. However, growth risks would rise if financial market conditions turn less supportive and debt distress becomes apparent in many more cases.

Looking ahead, better management of public finances across all levels of government has become a crucial lynchpin of the growth strategy in a post-pandemic framework. As the world recovers, steady and sustained catch-up growth will not be automatic. Rather, it will need to incorporate the creation of institutions and incentives to reduce uncertainty, promote efficiency, and attract investment. In this context, more countries are now nurturing the growth of relatively independent fiscal institutions to ensure that the overall fiscal governance and institutional setting remains conducive to such reforms. Often, these centre around rebuilding the overall fiscal architecture and strengthening the credibility of public finances.

In this article, we look at the lessons and implications of resetting fiscal architecture for India in the post-pandemic context.

FISCAL ARCHITECTURE

Fiscal architecture is the framework that supports fiscal sustainability. It comprises two main pillars: the fiscal strategy—as specified in numerical rules or qualitative standards, supported by budget procedures—and fiscal institutions. The thinking on fiscal architecture is now shifting globally, as each pillar is reassessed for the post-pandemic world. Among these, a key lesson from history is that an accountable and efficient public financial management (PFM) system becomes more critical during crises—which was fully evident during the COVID-19 crisis. Without improving the adaptability and responsiveness of fiscal management, misdirected resources and inefficient resource use will cost the economy, compound the effects of a crisis, delay the recovery, and hold back sustainable growth.

As we approach the aftermath of the COVID-19 pandemic, resetting the pillars of the fiscal architecture presents a new challenge. A growing number of countries are quickly putting in place new and innovative coordination mechanisms, involving governance and fiscal tools, to adapt and strengthen their fiscal architecture. Amid the jump in global debt and a rapidly changing global economy, recommitting to fiscal responsibility, with a credible set of supportive institutions, is necessary to facilitate fiscal policy decisions at the current juncture.

Thus, setting a credible commitment to an updated medium-term fiscal strategy would help boost investor and market confidence and provide valuable time for fiscal consolidation to take hold. This is particularly important for emerging market and developing countries, where the recovery process has been delayed compared with the advanced countries. More fiscal support—especially through carefully directed public investment—will be needed to help rebuild economic growth in the aftermath of the COVID-19 crisis. When markets believe that governments are fiscally responsible, it becomes easier and cheaper for countries to finance deficits. This buys time and makes eventual debt stabilization less painful.

Such a strategy has at least three elements: (1) updating the fiscal architecture with fiscal responsibility principles for the medium term; (2) building procedures that govern how annual budgets linked to the fiscal responsibility principles at all levels of government should be prepared, approved, and implemented, including transparent reporting of fiscal statistics; and (3) nurturing fiscal institutions that can act independently to review fiscal performance. Depending on a country's situation, complementary measures could include gradually increasing tax revenues, implementing structural fiscal reforms such as pension and subsidy overhauls, building outcome-based transfers to improve spending efficiency, or adopting global practices for standardized and consolidated data collection of public debt and relevant budgetary magnitudes at all levels of government.

India's Fiscal Architecture

India's Fifteenth Finance Commission (XVFC), in its terms of reference, was specifically mandated to develop elements of a medium-term fiscal strategy. It included the need to improve the quality of public spending and to promote savings by adopting a PFM system. The commission clearly recognized that if India were to achieve its full potential for economic growth and development over the medium term, it must set standards for fiscal responsibility and improve the quality and efficiency of public financial management across all levels of government.

The Fifteenth Finance Commission highlighted that India's twenty-first-century fiscal architecture must have three pillars that reinforce each other: setting the institutional and budgetary framework for fiscal sustainability; a PFM system that provides complete, consistent, reliable, and timely reporting of fiscal indicators; and fiscal institutions, particularly an independent assessment mechanism that would provide assurance and advice on the working of the other two pillars.

For India in particular, the legacy of budgetary laxity, non-transparency, and unreliable or dated statistics must be overcome at all levels of government. Under the existing structure, the published monthly figures are too narrow in scope to provide an accurate picture, while the consolidated accounts appear with a long lag and are difficult to interpret. Greater transparency in the provision of fiscal data in accordance with the new fiscal responsibility strategy would greatly enhance market discipline.

India needs to rethink and improve all three pillars to build a fiscal architecture that can sustain the post-pandemic growth recovery.

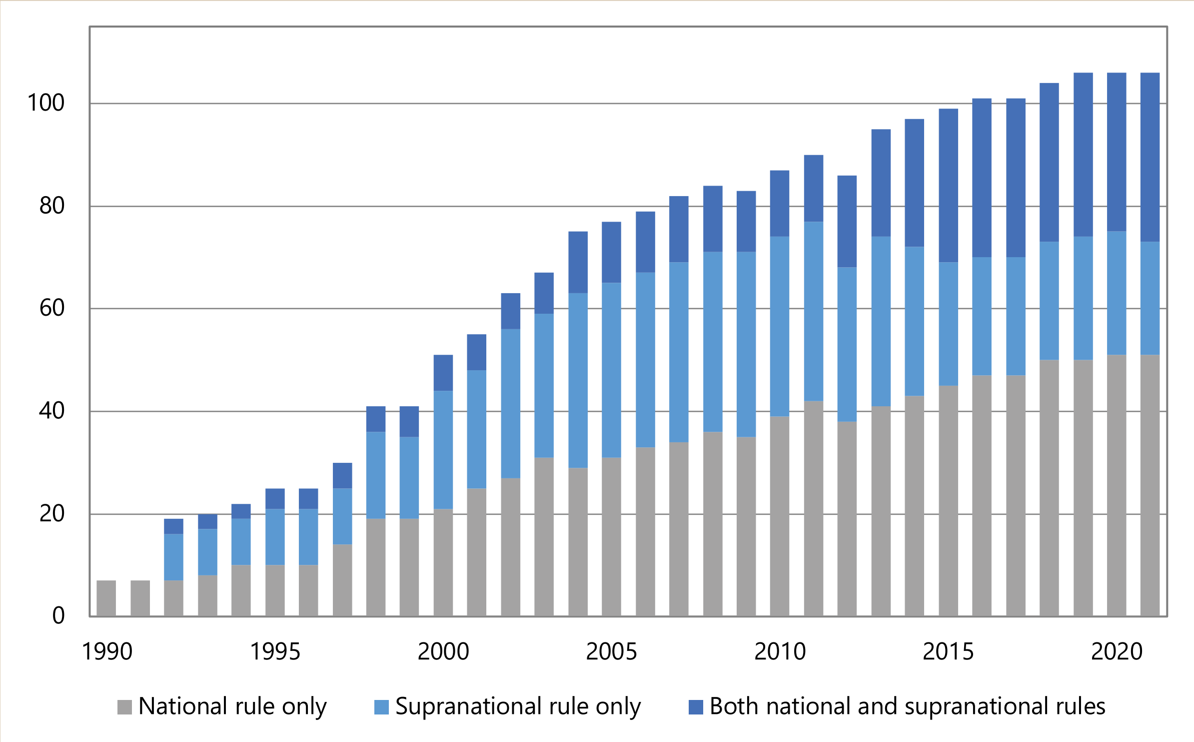
FISCAL RULES

Large scale crises, such as economic depressions and financial shocks, constitute critical junctures that are often followed by transformative changes in the fiscal architecture. With respect to the fiscal rules being used as a legislated measure of fiscal responsibility, are we at that stage now in the aftermath of the COVID-19 pandemic?

In recent decades, over a hundred countries have introduced fiscal rules—a trend accentuated by the 2008 financial crisis (Figure 2). The high and rising levels of public debt brought about by the financial crisis prompted more governments to introduce and tighten fiscal rules and, in many cases, bring them into their national constitutions. In light of the experience, fiscal rules were also adapted, especially to address concerns about their flexibility, and evolved into a broader 'second-generation fiscal-framework'.

Figure 2: Fiscal Rules Waves, 1990–2021

(Number of countries with at least one rule)



Source: Davoodi et al., IMF 2022

Until recently, international experience supported the view that well-designed and well-implemented fiscal rules generally help contain the 'deficit bias', strengthen market credibility of the commitment to fiscal sustainability, and allow the enabling of counter-cyclical fiscal management. By increasing the predictability of fiscal policy, they also supported the view that fiscal rules help lower output volatility and raise sustainable growth.

However, challenges to achieving these outcomes became increasingly apparent even before the pandemic. Among them, the gains achieved were increasingly at the cost of the fiscal rules becoming asymmetric and pro-cyclically biased[3]. Importantly, pre-pandemic evidence demonstrated that fiscal rules did not prevent a large debt build up over time—from persistent deviations from deficit and debt rules across countries—especially after the 2008 financial crisis. Thus, deviations from the fiscal rules did not result in the return to the rules in a time-bound manner. The resultant debt accumulation added to the pressures on debt as the pandemic unfolded. Fiscal rules were already losing their relevance and credibility before the pandemic.

Fiscal rules have now all been tested during the pandemic, in response to the unprecedented and much-needed fiscal response to the crisis. As the pandemic has shown, one size does not fit all when it comes to discretionary fiscal spending, and overly rigid numerical measures of fiscal stability can do more harm than good. This has prompted a raft of reforms in virtually every case, including the modification of existing rules, revamping of escape clauses, and reconsideration of procedures and practice. Toward this, many economies adopted 'emergency bills' to suspend their fiscal rules and enhance flexibility in regulatory frameworks as they address the fiscal challenges from the pandemic. As a result, almost all

3 Martín Ardanaz, Eduardo Cavallo, Alejandro Izquierdo, and Jorge Puig, "Growth Friendly Fiscal Rules? Safeguarding Public Investment From Budget Cuts Through Fiscal Rule Design," Inter-American Development Bank Working Paper No. 1083, February 2020.

countries have deviated from pre-crisis numerical objectives and fiscal rules, with continuing uncertainty about the nature and timing of their possible return. Media and market reaction to these changes have depended, in part, on the fiscal transparency of the countries involved, their public communications about why the changes occurred, and assessments by independent fiscal institutions (where they existed).

The activation of many escape clauses and suspensions is set to expire soon. Countries are now considering whether and how to converge back toward their old targets or recalibrate them in a newly designed fiscal framework that would accommodate higher debt levels in the aftermath of the pandemic and provide more flexibility in moving toward longer-term debt sustainability. The fiscal impact of the COVID-19 crisis makes these reforms unavoidable. Certainly, circumstances have changed in a way that justifies a rethinking of fiscal rules and fiscal frameworks. Resetting fiscal policy anchors will be important to credibly signal the government's strategy for fiscal responsibility. The reality is that the reduction of public debt is now far down on the priority list of many countries where the recovery is still nascent.

It's instructive to note that even in the European Union (EU), where their supranational rules are different from member states' national fiscal rules, similar conclusions apply. It has been well recognized for some time that the union's fiscal rules lack transparency and political ownership in the member states. In the EU, the suspension of the debt brake in March 2020—with the activation of the so-called 'general escape clause'—came as the fallout of the crisis entailed increased discretionary fiscal expansion. In the current macroeconomic scenario, with debt levels exceeding 100 percent of GDP, it compounds the existing problems of the Stability and Growth Pact. A return to the current pact does not seem realistic. The European Commission has announced that it is relaunching its review of the fiscal rules of EU economic governance, intending to reform the framework by 2023[4].

Fiscal Rules in India

India was an early adopter of fiscal rules among emerging market countries. The Central government adopted fiscal rules first in 2003, which were subsequently mirrored by the States. Hence, the Center as well as all States have their fiscal rules and numerical targets in place. Over time, India has generally seen its fiscal discipline improve at both the Centre and State level. In 2018, through several amendments, Parliament updated the Fiscal Responsibility and Budget Management (FRBM) Act that is applicable to the Central government and adopted multiple fiscal indicators as target indicators—an attempt to bring India into the second generation of fiscal rules as adopted across countries.

However, there are gaps and inconsistencies in these rules and their compliance. For instance, the fiscal deficit defined in the FRBM Act (as the balance of operations incurring into the Consolidated Fund of India) falls short of the newly legislated debt ceiling that covers a broader definition of accounts and implementing agencies that deliver public services on behalf of the government. In practice, this has led to the fiscal rules being effectively circumvented, using off-budget fiscal operations, inconsistent budget classification and accounting standards, and improper use of the public accounts for budgetary purposes. In addition, variability in the definitions of key targets across the State governments and the Centre, such as fiscal deficit or public debt, makes them noncomparable in aggregate. Effectively, this is because the underlying PFM system meets only a fraction of best-practice standards and cannot check misclassification of accounts for compliance.

4 Enrique Feás, Carlos Martínez Mongay, Miguel Otero-Iglesias, Federico Steinberg, and Jorge Tamames, "A Proposal to Reform the EU's Fiscal Rules," Real Instituto Elcano Policy Paper, December 2021; and Olivier Blanchard, Alvaro Leandro, and Jeromin Zettelmeyer, "Redesigning EU Fiscal Rules: From Rules to Standards," Economic Policy 36, no. 106 (April 2021): 195–236.

For all these reasons India's fiscal rules need a rethink. The FRBM Act also needs a major restructuring, given the current challenges both in relation to debt and fiscal deficit. Reinstating the FRBM Act will require modification to account for the much-higher level of debt at present, and of the deficit as defined by the act. Given continuing uncertainties, including the inconsistent definitions of the debt and deficit targets, the architecture of the FRBM Act needs to be fundamentally restructured, keeping in mind contemporary realities and based on evolving international practice.

Similar concerns apply to the targets set for the States as part of the overall fiscal discipline framework. Given the large, reported variance of State-level debts, the Fifteenth Finance Commission expressed difficulties in prescribing common individual targets for each of the States with debts much above and much below the prescribed overall average target. Enabling counter-cyclical fiscal policy must become an important point of emphasis, especially during the post-crisis recovery.

India's experience also demonstrates that setting multiple rules can be internally inconsistent and complex to monitor, verify, and communicate. The FRBM Act has six fiscal rules covering debt, budget balance, revenue, and guarantees, which effectively constrain the use of counter-cyclical fiscal policy in the face of shocks. International experience now tells us that simple, numerical fiscal rules provide an unsatisfactory assessment of the commitment to fiscal sustainability. From a practical perspective, it has been infeasible to codify all possible future economic conditions into single or multiple numerical rules. There is also a wide consensus now that the fiscal rules in many countries have not been very successful and need reform. The research and historical record show that formal and numerical fiscal rules are neither necessary nor sufficient to obtain sound public finances.

Resetting Standards of Fiscal Responsibility

The main steps toward adopting a different framework are:

- Moving from numerical fiscal rules to adopting enduring principles of fiscal responsibility that ensure with high probability that the public debt remains sustainable.
- Setting criteria and procedures to decide whether the standards are met.
- Specifying which institutions will be responsible for its surveillance and determine ex post the compliance with the fiscal responsibility principle.

Such a framework involves developing qualitative prescriptions of fiscal sustainability together with an institutional framework that leaves room for judgement, as well as a process to decide whether the standards are met. In particular, the fiscal responsibility principles should not be time-bound but allow the government to manage shocks such as the current pandemic.

As part of the process of establishing standards, the criteria, procedures, and methods that describe how to apply such standards must be developed and explained for both the Centre and the States. In India, States are responsible for close to two-thirds of general government expenditure and for collecting one-third of general government revenues. States are also relatively autonomous in raising their own resources, including through domestic market borrowing. In this context, it is critical that the proposed move toward a principles-based fiscal rule is adopted both at the Central and State level.

From the international experience, such a framework would enhance the credibility of fiscal responsibility while allowing government flexibility to respond to unexpected shocks. It is intended to ensure responsible fiscal policies that safeguard long-term sustainability while allowing for short-term macroeconomic stabilisation. With principles and standards, rather than numerical fiscal rules, the framework is designed to give much more room to the government in office to exercise its judgement and explain its consistency with the overall objective of fiscal sustainability. Such a framework would require the government to specify the institutional steps to increase transparency and strengthen risk analysis that are key aspects of the fiscal standards framework. For example, governments can exercise the judgement to undertake additional public investment, and associated public borrowing, if the economy is operating below capacity, such as the situation faced by many countries in the post-pandemic phase. In this case, public spending can then be used explicitly to 'crowd in' additional investment by improving incomes and profit prospects.

Such a fiscal standards framework recognizes the reality that it is very difficult to set and justify a particular fiscal target that can be maintained unchanged over a period. As we have seen, judgements on the appropriate level of fiscal aggregates vary over time and depend on the economic circumstances currently prevailing.

Overall, in response to a shock like the pandemic, it would allow the government to monitor and manage its balance sheets going forward, as part of the debt sustainability strategy.

New Zealand has shown the benefits of moving to a principles-based fiscal framework that is based on principles of fiscal responsibility and supported by an institutional framework of transparency, surveillance, and adjudication over disputes (Box 1). New Zealand's Public Finance Act (PFA) included the principal framework for the budget balance and debt. Under the framework, the government is committed to run operating surpluses annually until so-called prudent debt levels are achieved. Once these are reached, total operating balances should not exceed total operating revenues on average. New Zealand's long-term objective for net worth is defined as a measure of the public sector balance sheet. Measuring the net worth requires a PFM standard that assures the sound valuation of public assets and liabilities using credible fiscal accounting.

Other countries are starting to adopt New Zealand's approach, including Australia's Charter of Budget Responsibility Act (1998) and the United Kingdom's Office of Budget Responsibility. In late 2021, the British government introduced a new post-pandemic fiscal framework. This included a target to balance the current budget by the third year of the rolling five-year forecast period. It also stated that public sector net investment should not exceed 3 percent of GDP on average over the rolling forecast period. Its new debt rule applies to public sector net debt, excluding the Bank of England, and requires a declining public sector net debt by the third year of the rolling forecast period.

Box 1: New Zealand's Principles-Based Fiscal Rules

New Zealand enacted the Fiscal Responsibility Act (FRA) in 1994, with the objective of safeguarding improvements in government finances and increasing policy credibility. Under this legislation, New Zealand's fiscal policy has to comply with principles of responsible fiscal management. These principles set out, at a general level, what good fiscal policy means. Each government has to articulate how its fiscal strategy is consistent with these principles. This stands in contrast to the legislated numerical fiscal rules that exist in many countries. Subsequently, the FRA was incorporated into the Public Finance Act and additional principles were added. This framework has endured over the decades and across governments.

The principles of responsible fiscal management are:

Principles to address fiscal sustainability

- Reduce public debt to prudent levels to provide a buffer against factors that may adversely impact the level of debt in the future.
- Maintain debt at prudent levels by balancing operating revenue and operating expenses on average over time.
- Achieve and maintain net worth as a buffer.
- Manage fiscal risks prudently.
- Have regard to the likely impact of the fiscal strategy on present and future generations.

Principles to address fiscal structure

- Raise revenue with regard to efficiency and fairness, and reasonable predictability about the level and stability of tax rates.
- Manage resources effectively and efficiently.

Principles to address stabilisation

When formulating fiscal strategy, have regard to the interaction between fiscal policy and monetary policy.

As New Zealand's experience has demonstrated, such a principles-based fiscal strategy would require India to adopt certain practices to make them workable and credible, including:

- Political commitment to the standards and principles of responsible fiscal management—for example, a medium- to long-term fiscal sustainability report—and its main elements, including an investment statement and prioritized medium-term programmes and projects.
- Publication of a credible annual fiscal strategy that explains why and how its fiscal plans are consistent with the fiscal standards set out in the law and backed up by comprehensive medium-term budgets consistent with objectives[5].

5 These typically include the budget policy statement, the fiscal strategy report, economic and fiscal updates, audited financial statements, and the statement of the long-term fiscal position.

- Transparent and regular public reporting and periodic public review of the government's fiscal plans by Parliament and independent fiscal institutions to provide information to markets.
- Most importantly, clear impetus and incentives for the States to be fully part of the process.

Experience has shown that opting for a principles-based framework, rather than enforcing legislated numerical rules, is more likely to provide effective incentives for governments to conduct responsible fiscal policy. Another advantage of a principles-based fiscal framework is that it is likely to contribute to better fiscal forecasts. With numerical rules, fiscal policymakers might have an incentive to produce optimistic forecasts—Frankel (2011) found a general trend of positive average bias in forecasts of budget balances made by official government agencies among thirty-three countries. Fiscal marksmanship studies also demonstrate this clear trend at the Union and State levels in India. Transparency about fiscal policy and performance is the main lever to judge fiscal performance relative to fiscal intentions.

In context, whether or not the fiscal standards in the law have been met by the government would be determined ex post at the point of application. In some way, this brings fiscal policy discipline closer the process now followed by central banks when targeting inflation. By adopting the fiscal standards, governments can decide the nature of the external review and assessment, including by the establishment of an independent and accountable fiscal council. The framework thus allows the government to exercise discretion in the short run while demonstrably delivering fiscal sustainability in the long run[6].

The greater flexibility that this will afford, compared to the present regime of legislatively fixed numerical limits, might help to convince governments at the Central and State levels to adopt this framework. Given the constitutional division of powers, the present scheme of having separate fiscal rules for the Centre and each State is likely to continue. Hence, to ensure that all governments similarly adopt this critical reform, it should only be carried out after extensive negotiations and consultation. Existing intergovernmental fora should be leveraged for this purpose, with the aim to move forward in a coordinated, consistent fashion as far as possible[7].

PUBLIC FINANCIAL MANAGEMENT SYSTEMS

International experience has made clear that a strong PFM system is an essential part of fiscal architecture. Public financial management covers key fiscal indicators including revenue, expenditure, assets, liabilities, and risks. It refers to the set of laws, rules, systems, and processes used to mobilize revenue and to allocate and account for the use of public funds. As we have seen, the need for its institutional underpinning is not new. Previous weaknesses in PFM systems have prevented credible assessments of compliance with fiscal rules, undermining institutional frameworks for effective public service delivery. Having fiscal rules has also raised the bar on the necessary strength of the underlying PFM processes and fiscal institutions. Whether countries move to fiscal standards-setting or not, the need to adopt international PFM practices is essential.

The first step towards better fiscal management is improving the coverage, timeliness, quality, and integrity of fiscal reporting (Figure 3).

6 Charles Wyplosz, "Fiscal Policy: Institutions vs. Rules," National Institute Economic Review, no. 191 (2005): 64–78.

7 In the event that the centre decides to go ahead with this reform for itself, it could also consider opting for the Article 293(4) route to ensure that states also move in this direction. Under this provision, the centre can impose conditions when granting consent for subnational borrowing (to states that are indebted to it). Thus, it could make states amending their fiscal rules to make them principles-based as a necessary condition for them to borrow.

Coverage
All public sector entities should be part of fiscal reports within a consistently defined framework, in order to provide a comprehensive picture of the country's fiscal operations and reduce the incentive to use entities for off-budget fiscal activity.

Timeliness
Regular publication of fiscal reports allows for timely comparison of planned and actual fiscal performance. It helps ensure an up-to-date assessment of the government's financial operations.

Figure 3:
Public Financial Management

Quality
Information in fiscal reports should be relevant, internationally comparable, and internally and historically consistent.

Integrity
Fiscal statistics and financial statements should be subject to external scrutiny and accountability.

Towards this end, many advanced and larger emerging-market countries have, in the past decade, established legal frameworks for PFM that set out the budget, reporting, accounting, and audit processes, and define the roles and responsibilities of key stakeholders (Table 1). These laws are aimed at aligning fiscal policy to resource allocations and have paved the way for implementing standards in the fiscal rules in a credible manner. As we have seen, New Zealand set a high bar for transparency and lucidity in its budget documents with its adoption of the fiscal standards framework through law. Among middle-income countries, South Africa's budget documentation, under its Public Finance Management Act (1999), is highly transparent and accessible, with extensive debt reporting and clear fiscal risks reports.

Table 1: PFM Legislations in Selected Countries

Country	PFM Legislation	Year
Argentina	Public Financial Management	1992
Australia	Financial Management and Accountability Act	1997
	Charter of Budget Honesty	1998
Brazil	Fiscal Responsibility Law	2000
Canada	Financial Administration Act	1985
Indonesia	State Treasury Law	2004
	State Financial Management and Accountability Law	2003
Mexico	General Government Accounting Act	2008
Russia	Budget Code	1998
South Africa	Public Finance Management Act	1999
United Kingdom	The Government Resources and Accounts Act	2000
	Budget Responsibility and National Audit Act	2011

India's PFM systems at the Union and State levels lag significantly behind international best practices, despite the last several finance commissions recommending a range of reforms. India does not compile or monitor general government fiscal deficit and debt aggregates in line with the Government Finance Statistics Manual, even though State deficits and debts accounts for a large share of the overall general government deficit and debt. In contrast, the number of countries providing general government data has nearly doubled in the past decade, per the International Monetary Fund[8]. In addition, extra-budgetary resources are neither consolidated nor monitored, even though they have become an important vehicle to deliver public services at the Union and State levels.

India needs to address these reforms to bring its PFM processes up to international standards and ensure that public and private resources are efficiently deployed for sustainable growth. Equally importantly, international experience conveys that PFM best practices are critical for the effective implementation of fiscal rules or fiscal standards.

India's current PFM processes are defined at the highest level—i.e., in the Constitution itself. However, many policies and operational details have evolved over time through a plethora of practices. Consequently, there is a significant gap between the broad PFM structure in the Constitution and the operational PFM guidelines that have evolved over time (Table 2). As a result of this gap, compliance with best practices envisaged in the fiscal rules remains challenging because most of the practices that affect budget formulation, execution, and reporting lack legislative strength—instead, they are governed by a multiplicity of constitutional provisions, executive rules, orders, and manuals. There is also a lack of consistency in practices across the levels of government, resulting in marked differences in the way Centre and State PFM systems have emerged .

8 Patrick Blagrave and Fabien Gonguet, "Enhancing Fiscal Transparency and Reporting in India," IMF Working Paper, November 13, 2020.

Table 2: Significant Gaps in India's Existing PFM Structure

PFM Dimension	Present Coverage	Existing Gaps/Inconsistencies in Legislation	Existing Gaps in Implementation
Fiscal discipline and management of risks	Present fiscal responsibility legislations (FRLs) cover a lot of ground for numerical fiscal targets, mandatory disclosures, escape clauses, and more.	**Centre FRL**: Definitions of deficit and debt are inconsistent with each other. General government debt target is not consistent with the wider definition of 'Central Government Debt'. **State FRLs**: Many states lack wider definitions of debt and deficit to cover extra-budgetary operations. Many state FRLs do not have debt as an anchor. Even where debt is a target anchor, it is not defined in alignment with the general government debt target adopted by the Centre.	Central government debt is not calculated with full cognisance of the revised definition of debt in the FRBM Act. Medium-term expenditure frameworks and fiscal risk statements are not published by the Centre or the States.
Budget formulation	Constitutional provisions under Articles 112–117 cover the budgetary process in the parliament. General Financial Rules, 2017 (GFR) Delegation of Financial Powers Rules, and Budget Manual cover rules governing appropriations, sanctions, and allocations.	The Constitution covers only a broad mandate and basic framework. However, downstream operational budgetary processes have no specific legal framework governing them. Documentation requirements and timelines for budget making are not legally defined	Budgetary processes are not oriented towards performance budgeting or outcome budgeting. Outcome budget documents are prepared without much of a link to the main budget outlay and performance.
Public procurement	GFR, Receipt and Payment Rules, 1983 and various orders issued by Department of Expenditure, MoF presently cover certain aspects of public procurement.	There is no overarching legal framework for public procurement. Fragmented rules, guidelines, and manuals make it difficult for public agencies to follow them comprehensively.	Rules hamper effamperurement rather than aiding competitive, transparent, and efficient public procurement
Monitoring and reporting	Ex-post review and audit are conducted by the CAG under Article 151 and the CAG (Duties, Powers and Conditions of Service) Act, 1971.	**Centre and States**: External assessment and evaluation mechanisms for fiscal plans, performance, and government macroeconomic and fiscal forecasts are not in place. There is no provision or mechanism for mid-term review or correction of expenditure plans.	There is only an ad hoc mechanism for near year-end expenditure review (at revised estimates stage), and only when driven by a pressing need. Year-end expenditure cuts are not effective, as payments get postponed to the next financial year.

India needs to clearly define its PFM framework, strengthen budgetary institutions at key stages of the fiscal process, prescribe the accounting framework and precise definitions for target fiscal indicators, and ensure consistency of fiscal rules across all levels of government. The lack of progress in these areas continues to distort the alignment of the budget and expenditures with government policy priorities, hinder effective expenditure control, raise the public costs of inefficiency on fiscal management, and create opportunities for creative accounting and biased forecasts. In this regard, it helps that progress is being made in bringing the food subsidy more fully on-budget in the recent budget for 2021–22.

Looking ahead, PFM reforms at the subnational level should be consistent with reforms at the Central government level, especially in terms of a clear PFM framework. At all levels, India must ensure consistent and well-defined targets and accounting standards, provide timely and reliable reporting on subnational fiscal operations, and strengthen automatic correction mechanisms and sanctions for noncompliance. States should seek to define subnational debt targets that are consistent with general government debt reduction targets.

Box 2: Key Elements of the PFM Legal Framework in India

Both for the Centre and the States, the critical gaps and reform priorities in the PFM framework include:

- Strengthening the fiscal responsibility framework and ensuring that the FRBM Act is fully supported by the institutional framework for PFM at different levels of government.
- Building fiscal reporting by aligning the public investment programmes of the Centre and the States, wherever applicable, through a medium-term prioritization of programmes and projects, within a medium-term expenditure framework.
- Ensuring the fiscal strategy and fiscal risk exercises that are already part of the FRBM Act are closely aligned with the annual budget exercises of the Centre and the States.
- Ensuring uniformity in the definition of fiscal indicators and the standard reporting framework of the Centre and States.
- Building outcome budgeting by linking the budget with performance in terms of outputs and outcomes, and by modernizing and enabling the underlying budget structures and processes.
- Enabling key elements towards outcome-based budgeting, including: (a) adoption of an outcome-oriented stance to budgeting by reforming the budget classification and chart of accounts; (b) according legislative appropriation at the programme level instead of 'object head'; (c) allowing freedom to the executive to move funds within predefined rules; and (d) introducing a 'carry over' practice to allow for flexibility to pay for expenditure incurred till the last day of the financial year during a predefined window in the next financial year.
- Introducing enhanced and standards-based financial reporting, including: (a) bringing government accounting in line with internationally accepted accounting and reporting standards by standard-setting by an independent accounting standards body and providing for progressive implementation, including the transitionfrom cash to accrual based accounting; (b) strengthening executive ownership over the maintenance of accounts; and (c) setting clear timelines for production of accounts, completion of audits, and tabling before the Legislature.
- Bringing appropriate legislative oversight on these and related PFM functions based on consensus among all stakeholders.

Such a PFM framework in India would bring clarity to the roles and responsibilities of various functionaries and entities, fill the gaps in accountability, enhance the oversight by the legislature and civil society, and strengthen areas of fiscal responsibility, budget management, and financial management including accounting and reporting. Such an overarching framework—backed by legislative strength—would improve accountability and transparency, thereby improving governance.

India's Fifteenth Finance Commission specified the main elements of necessary PFM reform (Box 2). A suggested legal framework was also prepared by an expert group.[9] It is important to note that this framework has a principles-based approach, with fiscal responsibility principles and measurable fiscal objectives to be specified in the fiscal strategy. Presently, this version suggests a periodic review by the Comptroller and Auditor General of India (CAG) as prescribed in the FRBM Act. Since the CAG's core work comes after the audit, it would be much better to have a fiscal council do *ex ante* monitoring, (as also proposed by the commission and explained in the next section).

India has tried, over time, to make ad hoc and incremental reforms to successive parts of the PFM system. These have generally been stand-alone in nature, focusing on particular (and dispersed) dimensions of PFM that have been difficult to integrate and sustain. What is needed now is a comprehensive and consolidated reform effort that fills and bridges all the gaps, resolves inconsistencies, updates outdated provisions, and is benchmarked to international standards. The best way to move towards this kind of integrated reform is by enacting a new, overarching PFM legal framework, applicable to the Centre as well as the States. The gamut of existing operational guidelines can then be aligned with this single primary PFM legislation. This approach has been highlighted by the Fifteenth Finance Commission and, as mentioned, has been adopted by many countries.

Even though 'public debt of the State' forms part of the State List, an overarching central law on PFM—to ensure that the Centre and State governments report fiscal information honestly, consistently, and comprehensively—can still be constitutionally viable. States will remain free to take their own substantive fiscal decisions (like setting their specific fiscal deficit target), subject to their own fiscal rules. The PFM law would represent more of a procedural requirement, ensuring that uniform processes are followed by governments at the Centre as well as the States. It is worth noting, in this context, that the Constitution provides for the President, acting on the advice of the CAG, to determine the form of Centre and State accounts (as per Article 150). This demonstrates that the Constitution itself recognizes the importance of having uniform and consistent fiscal processes, which is what the proposed PFM law ultimately seeks to bring about.

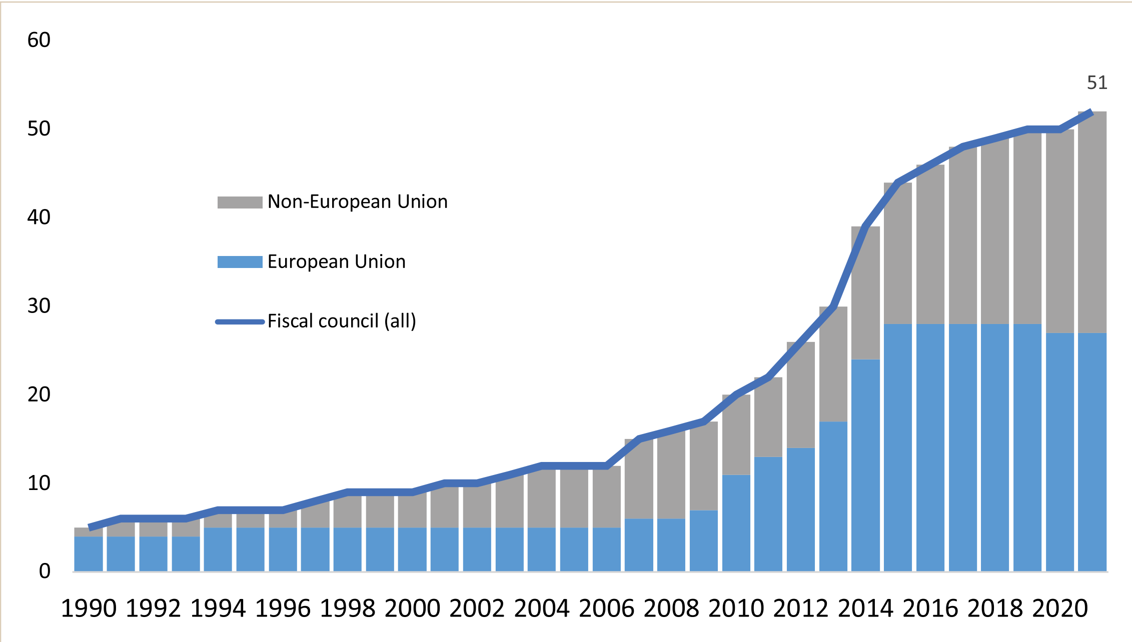
With a PFM law in place, improvements in the coverage, timeliness, quality, and integrity of fiscal reporting can also contribute to better compliance with fiscal targets and norms. It will enable Parliament and State legislatures, particularly the Parliamentary Standing Committee on Finance and Public Accounts and State-level budget committees, to hold their respective governments accountable for their fiscal intentions, decisions, and performance. Likewise, markets will also be in a better position to judge governments in an informed and effective manner. This might come to be reflected in yield rates, for example, where more fiscally prudent States might be able to avail of lower yield rates compared to their more profligate counterparts. The PFM law should clearly and comprehensively specify the roles and responsibilities of the relevant ministers and civil servants (and possibly also public sector enterprise officials). It can also prescribe institutional sanctions, as well as create an offence of financial misconduct, applicable to public servants, and set appropriate penalties for it.

9 More detail of the reforms needed to establish a PFM law are explained in Kevin James, Kandarp Patel, and Anoop Singh, "India's Public Financial Management System: Need for Reforms and Way Forward," Indian Public Policy Review 3, no. 4 (2022): 30-58.

INDEPENDENT FISCAL INSTITUTIONS

Over the past decade, one emerging global trend has been to set up independent public bodies that provide nonpartisan oversight and analysis of fiscal policy and performance to inform public decision-making. Independent fiscal institutions, otherwise termed fiscal councils, are now a common element in the modern fiscal architecture of most advanced economies and in a rising number of emerging markets. In many cases, this trend resulted from pressures in the aftermath of the 2008 financial crisis or during the pandemic. As such, the number of countries with fiscal councils, set up either through a statutory or executive mandate, has more than doubled over (Figure 4).[10]

Figure 4: Number of fiscal councils



Source: Davoodi et a.l, IMF 2022.

Fiscal rules and fiscal councils have developed as complements. This important correlation is even more critical for fiscal frameworks based on fiscal standards. Good councils typically learn how to better interpret fiscal indicators and reports, and to suggest improvements as part of their fiscal oversight. Thus, effective rules- or principles-based fiscal frameworks and functioning councils are expected to reinforce each other.

These councils have an important remit, both *ex ante* (reviewing fiscal policy and forecasts) and *ex post* (monitoring the delivery of fiscal policy intentions, conducting sustainability analysis, and reviewing the use of escape clauses). Evaluating compliance with fiscal standards or rules is a key feature of the established councils. Empirical evidence suggests that countries with established fiscal councils have been able to reduce budget forecast errors, limit deficit bias, and strengthen governmental capacity to comply with numerical fiscal rules.

10 Hamid R. Davoodi, Paul Elger, Alexandra Fotiou, Daniel Garcia-Macia, Andresa Lagerborg, W. Raphael Lam, and Sharanya Pillai, "IMF Fiscal Rules Dataset Update: 1985–2021," International Monetary Fund, Washington, DC, 2022.

As countries emerge from the pandemic, fiscal councils can help governments focus on rebuilding sustainable public finances in a number of ways.[11]

- **Independent and nonpartisan nature:** Fiscal councils are expert bodies staffed by technical personnel, for oversight, guidance, and advice on fiscal policies, plans and performance.
- **Ex ante role in fiscal policies:** The *ex ante* role of fiscal councils in policy-making could help the Ministry of Finance and legislative committees better understand the medium-term implications of fiscal policy targets. Fiscal councils can improve the credibility of projected figures by validating macroeconomic and fiscal forecasts in the budget process.
- **Help build trust in government:** In response to the COVID-19 crisis, countries have adjusted traditional budget spending oversight or taken recourse to escape clauses in their fiscal rules for greater and faster emergency spending and to reassure the public that their actions are objective. A fiscal council could provide an added layer of objective impartial oversight and inform the public that their government is, indeed, planning and spending resources in an accountable manner.
- **Coordinate fiscal policies:** In countries where substantial authority over fiscal policies is also discharged by subnational governments, fiscal councils can play the role of coordinating between them.
- **Improve the quality of financial reporting:** Fiscal policies are informed by financial information about the past as well projections into the future. A well-structured financial reporting system based on a credible accounting system (aligned with International Public Sector Accounting Standards) could help fiscal councils understand government assets, liabilities, revenue, and expenditure, as well as the medium-term impact of the COVID-19 response on the government's balance sheets.
- **Strengthen the public accountability chain:** Supreme audit institutions (SAIs) are increasingly playing a key role in providing oversight on governments' commitment to fiscal discipline. SAIs' *ex post* audit reports on government finances provide a key source of input for fiscal councils in their assessment of fiscal policies and performance. Effective functioning and complementary roles of SAIs and fiscal councils could also contribute to enhanced transparency and accountability in public finances.

Many countries' existing fiscal councils have already played critical roles during the COVID-19 crisis. As part of their fiscal oversight, they provide quick and credible assessments of the economic and budgetary impact of the pandemic, and weigh financing options and their longer-term fiscal sustainability implications. For instance, the UK Office of Budget Responsibility helped determine the appropriateness of fiscal measures that would raise debt levels in response to the pandemic. Some countries, such as Uruguay, established a fiscal council during the pandemic. Others, such as Colombia, extended more operational independence to their fiscal council to provide greater fiscal oversight.

Though establishing a fiscal council is a move in the right direction, it might not be enough to achieve fiscal sustainability without a strong political commitment to make them effective. However, it is a desirable step that can enable governments to pursue better informed fiscal policies for a post-pandemic world.

11 Kandarp Patel and Srinivas Gurazada, "Six Reasons Why Fiscal Councils Can Help Create Sustainable Public Finance in the Post-Pandemic World," Governance for Development (blog), January 14, 2021, https://blogs.worldbank.org/governance/six-reasons-why-fiscal-councils-can-help-create-sustainable-public-finance-post-pandemic.

A variety of institutional models already exist to illustrate how fiscal councils can be set up and placed within a government system (Figure 5).

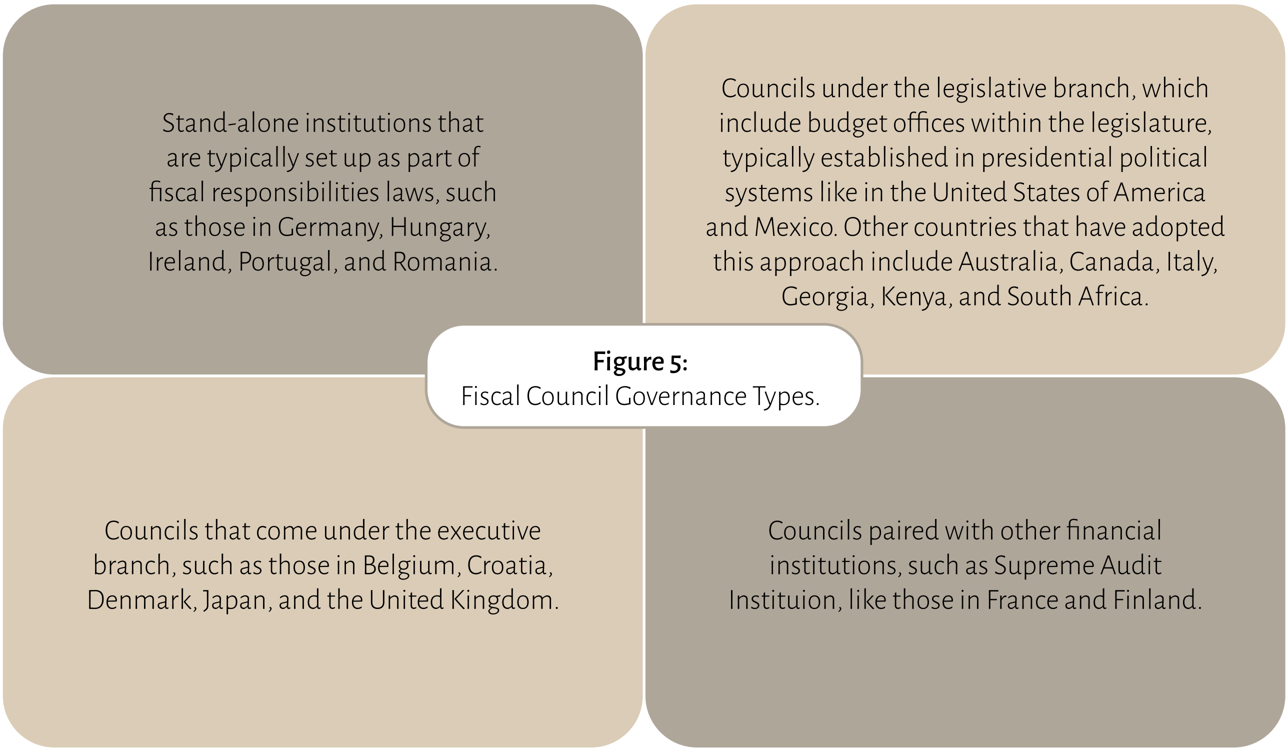


Figure 5:
Fiscal Council Governance Types.

In summary, effective fiscal councils should have: (a) legal and operational independence; (b) a strong media presence; and (c) chair and board members with nonpartisan affiliations. Key safeguards for operational independence include secured funding sources, access toinformation on a timely basis, and ability to manage their own staff. Effective fiscal councils establish contact with the media in line with the budget cycle and at the time their reports are published.

Several expert bodies and committees have recommended setting up an independent fiscal council in India. India's Thirteenth Finance Commission proposed that the Central government institutionalize independent review and monitoring of its own FRBM process. In this context, the 2015 amendment to the Rules under the FRBM Act incorporated a set of provisions requiring the CAG to periodically review the implementation of the act. However, this is being done as a periodic *post facto* review. A better approach would be a fiscal council that, among other functions, performs *ex ante* monitoring and assessment of the internal consistency and effective implementation of revenue, expenditure, and deficit targets under the FRLs of the Centre and States.

The Fourteenth Finance Commission also made a strong case for legally institutionalizing an independent fiscal institution. The case was reaffirmed recently by the FRBM Review Committee and the National Statistical Commission.[12]

The Fifteenth Finance Commission recommended establishing an independent fiscal council with powers to access records as required from the Centre as well as the States. We endorse that view and propose a single statutory body discharging functions of a fiscal council for both the Centre and the

12 The FC-XIV also advocated the case for performance grants for gram panchayats and municipalities to promote the availability of reliable data on local bodies' receipt and expenditure through audited accounts; and, for the urban local bodies, publication of information on provision of basic services.

States. Such models do exist in other federal countries; the German Stability Council, for example, monitors the budgets of both the federal government and the states.[13] In any case, the fiscal council would have only an advisory role clearly separated from enforcement, which is the prerogative of other organs of the government.

Based on international experience, some indicative functions of the proposed fiscal council include:

(i) Providing multi-year macroeconomic and fiscal forecasts

(ii) Evaluating fiscal performance vis-à-vis targets across all levels of government

(iii) Assessing the appropriateness and consistency of fiscal targets in the States

(iv) Carrying out an independent assessment of long-term fiscal sustainability

(v) Assessing fiscal policy statements by governments under FRLs

(vi) Advising on the conditions for using escape clauses under FRLs

(vii) Policy costing new measures with significant fiscal implications

(viii) Providing analytical support to the finance commissions, including at the State level

(ix) Publishing all their reports and underlying methodologies

The mandate of a fiscal council could be broadened to cover the production of macroeconomic and fiscal forecasts to test the official forecasts, advising on setting and recalibrating fiscal targets and rules at the national and subnational levels, and monitoring compliance with such targets and rules. The fiscal council could also work towards improving the quality of fiscal statistics at all levels of the government.

THE WAY FORWARD

The fiscal impact of the COVID-19 crisis has put a premium on strengthening the institutional anchor for sustainable public finances. As the crisis continues to cast a long shadow over the public finances of many countries, there is an acute need to rebuild market confidence and lower borrowing costs. Restoring fiscal credibility encourages further reforms of fiscal frameworks. Our sense is that moving to a principles-based framework of fiscal responsibility has many advantages over numerical fiscal rules. Among other benefits, it would give greater flexibility to setting annual budgetary targets.

In many countries, efforts are already being made to address pre-existing weaknesses and bottlenecks in PFM systems, to set up improved reporting mechanisms to ensure financial transparency and accountability, and to lay a better foundation for building outcome-based spending. However, proper sequencing of various elements is essential for a credible transition to a standards- or principles-based fiscal responsibility regime.

It is crucial to ensure full transparency and good governance in all fiscal measures, especially given their size, exceptional nature, and speed of deployment. Strong budget rules and institutions, backed by clear communication and fiscal transparency, enhance credibility. That, in turn, improves access to credit and

13 José Luis Escrivá, Eckhard Janeba, and Geert Langenus, "Fiscal Councils in Federal or Decentralised Countries: Belgium, Germany and Spain," in Roel M.W.J. Beetsma and Xavier Debrun, eds., Independent Fiscal Councils: Watchdogs or Lapdogs? (London: CEPR Press, 2018): 85-101.

secures more room for manoeuvre in times of crisis. Ultimately, fiscal frameworks are only effective if they have sufficient political support. Even so, they help focus discussions and can thus help reach political consensus on credible fiscal policies.

For India to achieve its full potential for economic growth and development, it needs to improve the quality and efficiency of public spending and financial management across all levels of government. India should work towards benchmarking its fiscal architecture to its peers, learning from the experiences of other federal countries, and adopting best practices. We have identified some of the steps needed to align India's fiscal architecture with twenty-first-century international standards.

The reforms we have outlined may take several years to be fully implemented. Regular monitoring will help decision-makers keep track of reforms over time. It will also help track progress and performance across the States. Hence, there is a need for an institutional mechanism to drive budgetary and PFM reforms in a coordinated, transparent, and inclusive way across all levels of government.

Towards this end, as recommended by the Fifteenth Finance Commission, the Ministry of Finance could launch the process of stakeholder consultations soon and prepare a time-bound plan for the revision of India's fiscal architecture. It should work towards developing a comprehensive PFM law, with a principles-based approach to fiscal responsibility, and establishing a fiscal council. It will be crucial to bring the States into these discussions. Such a process could also become part of the discussion agenda of existing Centre-State consultory fora, such as the Inter-State Council or the governing council of the National Institution for Transforming India (NITI Aayog).

Across countries, for such major transitions to succeed, a redesigned fiscal architecture must be agreed upon by a broad political coalition and communicated comprehensively to civil society.

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