FRBM: A DISSENT NOTE, OUTLINING AN ALTERNATIVE ARCHITECTURE OF FISCAL RULES

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I. INTRODUCTION

It has now been thirteen long years since the FRBM was enshrined in law and the basic principles of prudent fiscal management elaborated. Over this period, the situation in India has changed utterly. Back in 2003, the economy was fairly small and still relatively closed to the outside world, generating per capita incomes that lagged far behind that of other emerging markets. Today, India has become a middle income country. Its economy is large, open, and growing faster than any other major economy in the world.

Amidst these dramatic changes the fundamental insight of the FRBM has endured. The country should always endeavour to strengthen its fiscal position, so as to ensure medium-term debt sustainability and contain macro-economic imbalances. If this is done, credibility will be preserved, borrowing costs will be kept low, and – most importantly – crises can be averted.

A strong fiscal position also supports growth. It generates the savings needed to allow high levels of private investment to be sustained over the medium term. And it provides room for counter-cyclical policies, allowing public investment to be stepped up when growth is temporarily weak.

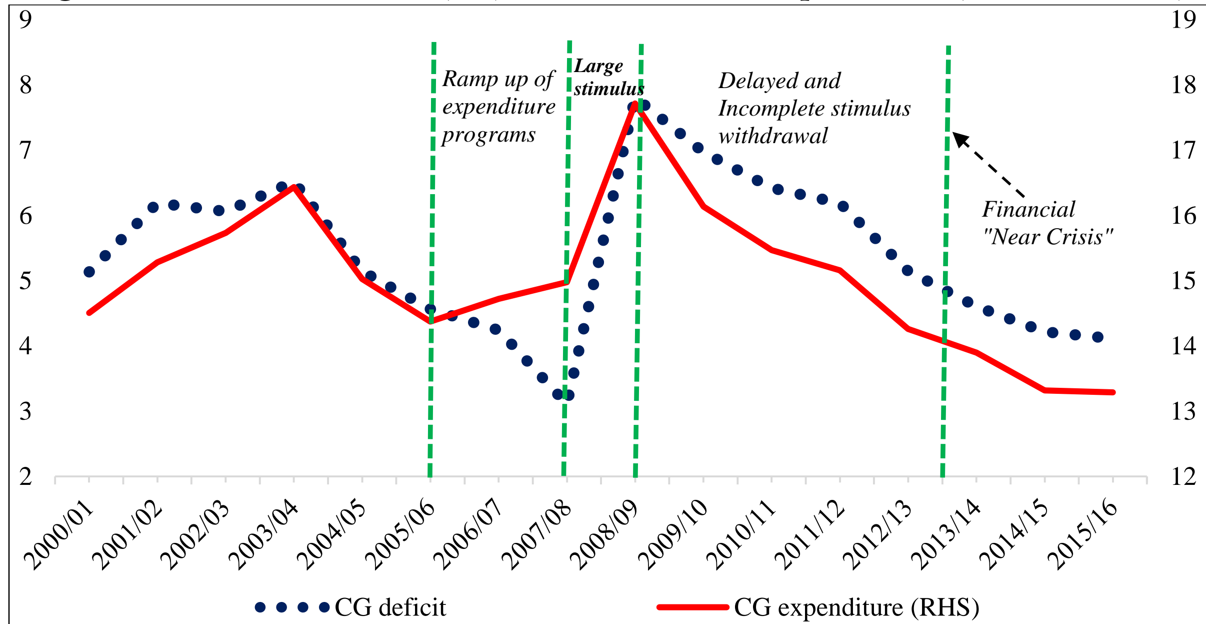
These basic principles of fiscal rectitude are ever-enduring. At the same time, the transformation of India's economy means they will need to be translated into a very different fiscal framework from the one envisaged 13 years ago. The broad objectives, longer-term targets, and glide paths must all be rethought, as those that were appropriate for the small and vulnerable economy of long ago are surely no longer valid for the large and strong economy of today.

The new framework will also need to take account of the experience gained during the first decade of the FRBM's operation. The FRBM has served a vital role in promoting the concept of fiscal discipline. It was also successful for a time in ensuring that fiscal discipline was actually maintained. But it failed in two important ways.

First, it failed in flow terms, in the sense that it failed to prevent a build-up of dangerous fiscal imbalances. During the growth and revenue booms of the mid-2000s, it allowed new spending programs to be introduced, which could not be sustained when receipts fell back to more normal levels (Figure 1). Then after the Global Financial Crisis the FRBM failed to prevent an

excessively large stimulus, which was withdrawn neither adequately nor on time. The end result was the financial-currency "near-crisis" in the autumn of 2013.[1]

Figure 1: Central Government (CG) Fiscal Deficit and Expenditures (Percent of GDP)



Source: International Monetary Fund.

Second, the FRBM failed in stock terms, in that it failed to place the country's debt securely on a downward path. To be sure, the stock of central and general government debt initially followed a declining trajectory (Figure 2). But after 2010-11 the trend was first interrupted, then actually reversed. This failure ultimately stemmed from the reliance on rapid growth rather than fiscal adjustment to do the "heavy lifting" on debt reduction. Such a strategy worked well when nominal GDP was increasing rapidly. But it proved unsuccessful when nominal growth slowed.

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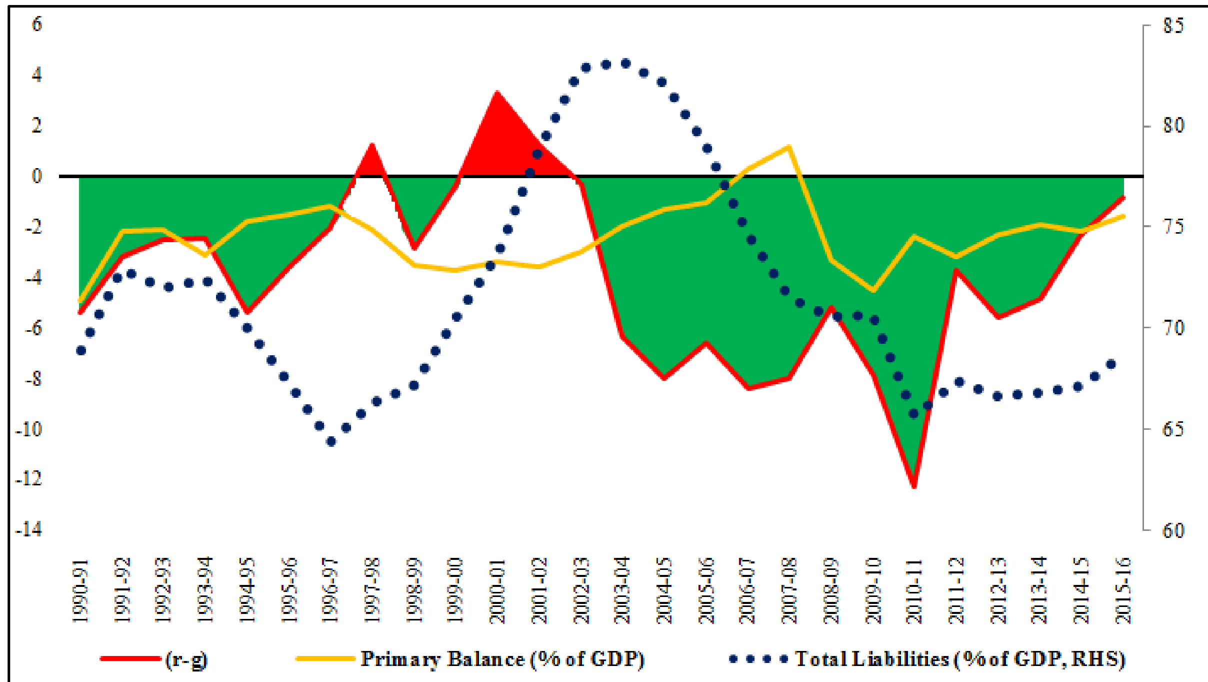
[1] A similar flow failure, stemming from a large increase in the fiscal deficit, led to the 1991 balance-of-payments crisis. The pattern in Figure 1 holds broadly at the general government level as well.

Figure 2: General Government Debt, Primary Balance and Interest Rate-Nominal Growth Differential



Note: r is the average nominal cost of government borrowing, g the nominal GDP growth rate; and primary balance is total government revenue minus non-interest costs. Green (red) areas denote periods of favorable (unfavorable) debt dynamics.

From this experience, two important lessons can be drawn. The fiscal rules need some flexibility, so that large cyclical swings can be handled within the framework—rather than by abandoning it—thereby disciplining departures from fiscal rules during these swings. And the rules need to be reformulated, to ensure that this time debt is placed firmly on a downward trajectory.

The Committee's report accordingly focuses on these issues. On the first, it proposes an "escape clause" to deal with the cyclicality problem. Ideally, this problem should be handled by cyclically adjusting the deficit targets. But as the report points out, calculating such adjustments is not possible at the present time. So instead the Committee has formulated an escape clause, with a number of carefully defined triggers, a bounded adjustment to the target, and a sensible timeframe for returning to the adjustment path. Notably, and to address the flow problem

described above, the clause is symmetric, curtailing spending in booms as well as curbing prolonged and unduly large fiscal expansions in response to downturns.[2]

The Committee's recognition that the FRBM needs an escape clause is welcome. However, the formulation of this clause is problematic. The key trigger relating to growth would only be activated in exceptional circumstances, when growth departs by 3 percentage points or more from its latest 4-quarter average. As a result, two distinct problems are likely to arise. The government would have no flexibility to relax the fiscal stance to combat ordinary recessions, yet it would simultaneously have too much room to expand spending during growth booms.

Some simple examples make the problem clear. If real GDP growth declined from 5 percent to just above 2 percent, causing revenue growth to falter, the government would be required to cut spending to achieve the fiscal deficit target. Similarly, if growth increased from say 6 percent to just below 9 percent, all of the increased revenue could be spent. Such behavior would produce a dramatically pro-cyclical fiscal policy, aggravating the slumps and booms, thereby running the risk of generating macroeconomic instability. To avoid such an outcome (especially to escape from the straitjacket of no flexibility even in the face of a serious downturn), the government would likely abandon the FRBM framework, as it did after the Global Financial Crisis.

In other words, the design of the escape clause risks ignoring the lessons from the Indian experience during the period 2007-08 to 2014-15 discussed earlier.

On the basic architecture of the Committee's recommendations – the proposed objectives and operational targets – I have serious reservations.

In effect, the Committee is proposing three targets: stock (debt-GDP ratio), flow (fiscal deficit-GDP ratio), and composition (revenue deficit-GDP ratio, with the revenue deficit defined as current expenditures less current revenues). This is a problem, because multiple targets force policymakers to aim at too many, potentially inconsistent objectives and analytical frameworks, running the risk of overall fiscal policy being difficult to communicate for the government and comprehend for market participants, and the risk of the government not achieving any of its goals.

Moreover, each of the targets is questionable. The debt target is set at an arbitrary 60 percent of GDP for general government. The medium-term fiscal deficit target is set an equally arbitrary 2.5 percent of GDP for the central government. The revenue deficit target, whose very rationale is debatable, is nonetheless set at an extremely precise 0.8 percent of GDP for the central government. Perhaps, oddest of all is the fiscal deficit path, which calls for a deep cut in the first

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[2] It is worth noting that while the international consensus is moving toward providing greater scope for counter-cyclical policy (Furman, 2016), the Indian experience highlights the need to judiciously circumscribe counter-cyclical policy.

year (2017-18) to 3 percent of GDP for the central government, then a pause for two years, then a resumption of deficit cutting, this time by moderate amounts. No real rationale is provided for such a serpentine path, and it is difficult to find one.
In contrast, I would propose a simpler architecture, comprising just one objective: placing debt firmly on a declining trajectory. To achieve this, the operational rule would aim at a steady but gradual improvement in the general government primary balance (Non-debt receipts minus non-interest expenditures), until the deficit is entirely eliminated. This strategy would ensure that debt will remain on a downward path even over the longer term, when India's debt dynamics turn less favorable.

These points are elaborated below.

2. OBJECTIVE: DEBT LEVEL OR TRAJECTORY?

The lodestar of this report is the level of government debt. In this respect, it echoes the reviews by rating agencies, which have repeatedly claimed that debt is India's main fiscal problem. Indeed, the level of concern expressed in this report is such that, while debt is invoked to be an "anchor" for fiscal policy, this anchor hovers uneasily between being a "ceiling" and a "target." Clearly, it cannot be a ceiling because in that case the government would be in violation of the FRBM from the moment the revised framework is introduced. So, it must be something more akin to a target.

But it has never been obvious that the current level of debt is such a problem, much less such a pressing one that it needs to be brought down to 60 percent of GDP within the next five years. To begin with, India has carried much higher debt ratios in the past, as much as 83 percent of GDP, without encountering debt servicing difficulties or finding that the debt posed obstacles to growth. In fact, the country experienced its greatest-ever period of growth in the mid-2000s when the debt was as much as 10 percentage points higher than it is today. So, the public might well ask why the debt ratio is suddenly considered such an impediment to India's aspirations that it merits a legal response taking the form of a "debt ceiling" well below levels of the recent past.

The answer given in the report is that India needs to reduce its debt to a safe level, which is confidently asserted to be 60 percent of GDP. But increasingly, economists are doubting whether it is really possible to identify "optimal" or even "safe" levels of debt. Different studies have identified very different thresholds of debt danger, ranging from 20 percent of GDP to 90 percent of GDP. Moreover, all of these studies, most prominently Reinhart and Rogoff (2010), have been criticized as methodologically questionable. The negative relationship they find between the level of public debt and growth turns out to be sensitive to many factors, most importantly the direction that debt is heading.

Recent developments have only underscored the doubts. Earlier, it was assumed that debt levels exceeding 100 percent of GDP would surely be dangerous. Yet after the Global Financial Crisis, debt ratios in many advanced countries crossed this threshold – and interest rates simultaneously

fell to historically low levels. As a result, it is now unclear to policymakers whether debt in Europe really needs to be reduced to the 60 percent of GDP level specified in the Maastricht treaty. Certainly, EU authorities are no longer making any serious efforts to enforce this rule.

In the end, the safe level of debt is more a matter of the willingness of the political system to service its debt than any innate ability to do so. And India has always demonstrated any exceptionally high determination to repay, most famously in 1991 when it shipped gold out of the country as collateral for foreign loans, to prove that it was committed to repaying them.

For India, indeed for any country, what matters far more than the precise level of debt is the *direction* the debt is heading. If investors see that debt is on a declining path, they are reassured. If it is instead rising explosively, they might worry that the commitment to fiscal discipline has been eroded. In that case, they would demand higher interest rates on government securities, which would quickly feed through into higher borrowing costs for the private sector, damaging investment and growth. In a worst case scenario, markets might completely refuse to purchase government debt, forcing the government to default, and triggering a financial crisis.

A loss of debt sustainability is extremely unlikely in India. But the country does have an underlying vulnerability, which needs to be addressed, lest such a scenario one day come to pass. This vulnerability is the country's primary deficit. Put simply, India's government (Centre and states combined) is not collecting enough revenue to cover its running costs, let alone the interest on its debt obligations.

There is nothing extraordinary about running a primary deficit, *per se*. Most of the other large emerging markets do so, having fallen into this situation after the Global Financial Crisis when GDP growth and revenues slowed, while stimulus spending was increased (Table 1). Even so, India stands out both for the size of the deficits that it has run over the past decade, especially when compared with its rate of growth. At such rapid rates of growth, substantially greater than those of its peers, its primary deficit should have been much lower than others; instead it has been significantly greater (Figure 3).

As a result of running a primary deficit, the government is dependent on growth and favourable interest rates to contain the debt ratio.[3] In recent years, the growth-interest rate [g-r] differential has been just sufficient to keep the debt ratio stable. It follows that if one day growth were to falter and interest rates to rise, the debt ratio could start to spiral upwards. A debt explosion would admittedly require a large, unlikely shock. But it is not just a completely theoretical possibility, either: it is exactly what happened to Greece.

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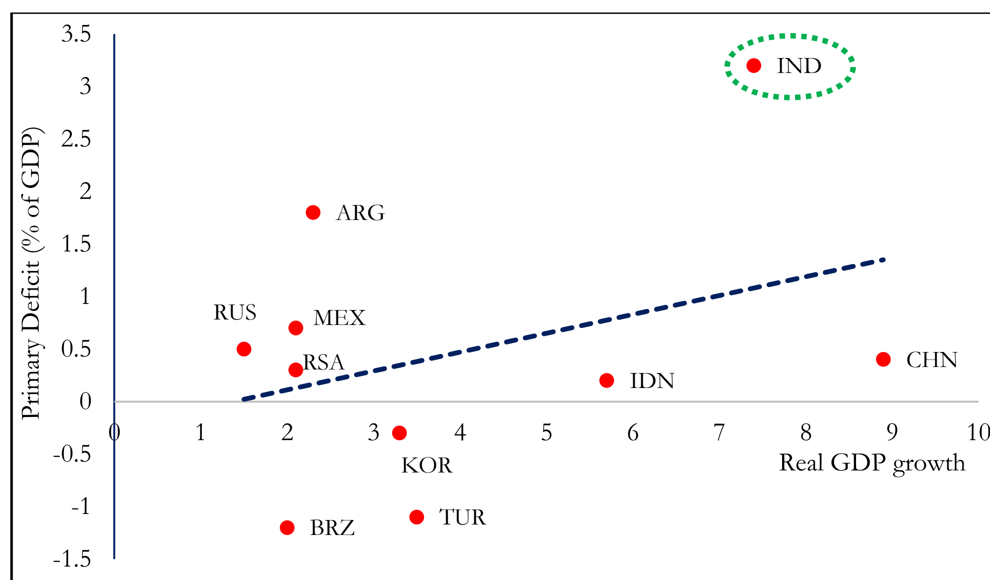
[3] Recall that the condition for a declining debt path is for the primary balance (pb) to be greater than [(r-g)*d]/[1+g], where r is the nominal cost of borrowing, g the nominal growth rate, and d the debt-GDP ratio.

Table 1: General Government Primary Balance (% of GDP) & Real GDP Growth (%)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Average	Real GDP growth (%)
Argentina	1.7	1.8	-1.1	-0.4	-1.4	-1.5	-2.4	-3.2	-5.4	-5.6	**-1.8**	**2.3**
Brazil	3.2	3.8	1.9	2.3	2.9	1.9	1.7	-0.6	-1.9	-2.8	**1.2**	**2.0**
China	0.4	0.4	-1.3	1.1	0.4	-0.2	-0.3	-0.4	-2.1	-2.2	**-0.4**	**8.9**
India	0.4	-5.3	-5.2	-4.2	-3.9	-3.1	-3.1	-2.8	-2.3	-2.1	**-3.2**	**7.4**
Indonesia	0.9	1.7	-0.1	0.0	0.5	-0.4	-1.0	-0.9	-1.2	-1.0	**-0.2**	**5.7**
Mexico	1.5	1.7	-2.3	-1.4	-1.0	-1.2	-1.2	-1.9	-1.2	0.1	**-0.7**	**2.1**
Russia	5.6	4.7	-6.2	-3.1	1.7	0.7	-0.8	-0.7	-3.2	-3.4	**-0.5**	**1.5**
South Africa	3.9	2.1	-2.5	-2.1	-1.1	-1.3	-0.9	-0.6	-0.6	-0.4	**-0.4**	**2.1**
South Korea	1.4	1.2	-0.7	0.8	0.9	0.8	-0.2	-0.3	-0.4	-0.3	**0.3**	**3.3**
Turkey	2.9	1.7	-1.4	0.3	2.1	1.1	1.4	1.4	1.2	0.3	**1.1**	**3.5**

Source: IMF Fiscal Monitor, October 2016.

Figure 3: Real GDP Growth and Average Primary Deficit (% of GDP), 2007-16



Source: IMF, World Economic Outlook, October 2016

There is another consideration that needs to be kept firmly in mind. Both theory and evidence show that highly positive [g-r]—economic growth exceeding interest rates--is a feature of emerging markets. For advanced countries, the differential is typically close to zero; and indeed, growth theory suggests that in the long run, there should not be a substantial wedge between the two. If [g–r] is zero, then the primary balance must also be zero (or in surplus); otherwise, the debt will not be sustainable.

Since India is converging rapidly toward the West, it should prepare for the day when the growth-interest differential turns unfavorable sustainedly. It is certainly better to take pre-emptive action, rather than wait until a problem arises. The central objective of the fiscal framework, consequently, should not be to achieve an arbitrary debt objective. Rather, the framework should aim at eliminating the primary deficit so that debt will continue to decline steadily, even in the longer run when favorable [g- r] dynamics fade away.

Admittedly, a primary deficit objective may sound unusual, for so far there has been little focus on this problem in India. But in other countries, particularly those in Latin America such as Brazil, it has long been the linchpin of the fiscal framework. Moreover, in recent years the primary balance has become quite a standard concept internationally Over the past decade, there have been 16 IMF lending programs in which the primary balance—and not the overall balance—was the operational target, including important cases such as Greece and Ireland.

It will doubtless take some effort to accustom India to this framework. For example, the government would need to explain that adopting a primary deficit objective does not mean that the bulk of the deficit is being ignored. Rather, it means the government is focusing squarely on the part of the budget that the government can control, as opposed to interest payments, which are largely predetermined. The government would also need to explain why eliminating the primary deficit is so important. This can be done simply, by pointing out that a zero deficit is needed to end the current Ponzi scheme-like situation in which the government is borrowing merely to pay its running costs, leave alone the interest on its debt.

In the meantime, until these principles sink into the public consciousness, a primary deficit path can always be translated into the more familiar yearly objectives for the fiscal balance.

3. PATH: UNEVEN OR SMOOTH?

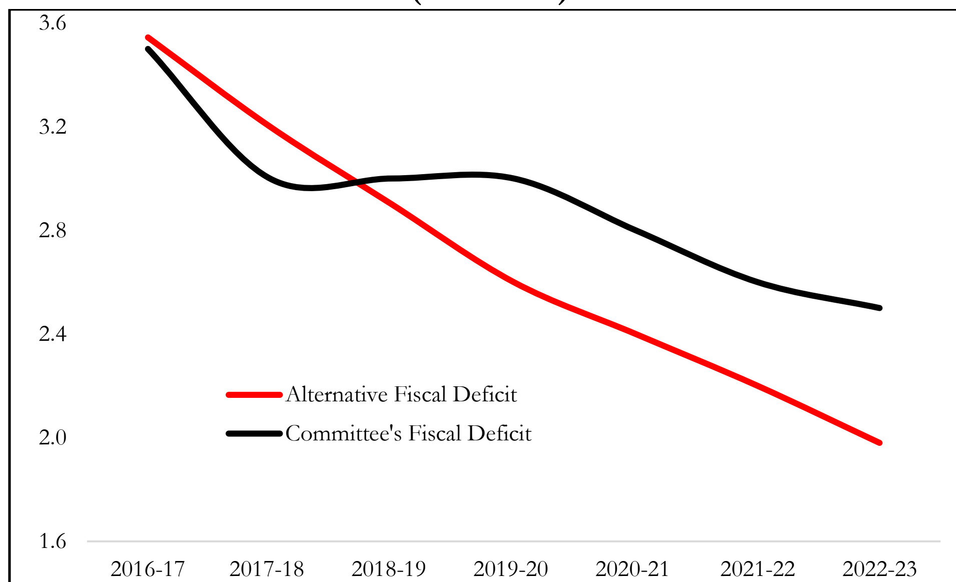
Any glide path needs to be grounded in India's past experience and its prospects for the future. Here, three distinct features must be kept in mind. First, over the medium term (the likely horizon for the revised FRBM), forces of convergence combined with steady reforms should deliver robust growth averaging around 8 percent. By the same token, these forces may well lead to a slowdown thereafter. Consequently, the next decade should be viewed as a golden opportunity to "fix the roof while the sun is shining".

A second related point is that India like most emerging markets normally undertakes policy-related fiscal adjustment only gradually. Aside from crisis periods, the fiscal position has only improved sustainedly when it has benefitted from windfalls, arising from exceptional growth (as in the mid-2000s) or major declines in oil prices that allow for lower petroleum-related subsidies and higher excise taxes. For example, between 2014-15 and 2016-17, lower oil prices will have contributed about a percentage point to fiscal adjustment. Figure 2 illustrates the point, showing that the primary balance has remained relatively stable, apart from the growth boom around 2007-08 and the oil-related improvement more recently.

Third, there is no clear and present danger that demands a sharp response. To the contrary, the standard macroeconomic indicators – growth, inflation, current account balance, reserves – are all at the best level they've been in years.

These three considerations suggest that that the fiscal strategy should aim at modest but steady improvements that over the course of this decade will gradually transform the fiscal position. But this is not what the Committee proposes. Instead, it recommends a serpentine path for the Centre's fiscal deficit, starting with an exceptionally large 0.5 percentage point reduction to 3 percent of GDP in 2017-18, followed by no further change for two years, then a further gradual reduction to 2.5 percent of GDP by 2022-23 (Figure 4). In other words: cut sharply, pause, cut moderately. It is difficult to imagine a path that is more uneven, and more difficult to justify or explain to the public.

Figure 4. Fiscal Deficit: Committee's Recommendation and Alternative Proposal (% of GDP)



Instead, I would propose a trajectory much more consistent with India's experience and prospects. The Centre's primary deficit should be put on a gentle glide path, whereby it is reduced by 0.2 percentage points a year until a modest surplus of around half a percent of GDP is attained. If this path were followed, by 2022-23 the Centre's fiscal deficit would have narrowed to 2 percent of GDP.

4. STRATEGY: APPROPRIATELY AMBITIOUS?

The problems with the Committee's proposal go far beyond than the shape of the glide path. The deeper problem is that the envisaged strategy is at once excessively ambitious, and insufficiently so. Excessive, in the sense that there is no reason why such a large and disruptive

adjustment would be needed next year. Insufficient, in the sense that over the longer term it fails to deal decisively with the true fiscal vulnerability, namely the primary deficit.

Short Term Problems

Consider first the short run problem. Not only is there no threat of imminent crisis, but such a large adjustment would be inappropriate from a cyclical point of view, as it would impart a contractionary impulse to an economy that remains in the early stages of a recovery, with export demand weak, and investment and real credit actually falling.

Invocations of 7 percent real GDP growth to justify a sharp fiscal contraction should be seen in the light of the fact that growth remains below potential. Moreover, growth projections are subject to higher-than-normal confidence margins because the demonetization exercise in November 2016 was an unprecedented event. There are no guideposts from the past that allow one to confidently forecast the extent or duration of its impact on GDP.

Nor is it convincing to argue that credibility demands that the fiscal deficit be reduced sharply to 3 percent next year. The government has already demonstrated its commitment to fiscal probity by continuing to cut the fiscal deficit even in the face of tepid economic activity.[4]

Medium-term Problems

Clearly, then, the Committee's framework is not adequate to assess the desirability of the medium-term strategy. So let's employ the one set out in Section 2. From this perspective, one can see that the proposed path is insufficiently ambitious, as it manifestly fails to "fix the fiscal roof".

Over, the next five years, the ratio of the Centre's interest obligations to GDP is likely to fall by around 0.5 percentage points of GDP, as high-cost debts from the previous decade are repaid. This will create considerable room for additional spending during the period when the Committee calls for the fiscal deficit to be kept at 3 percent of GDP, meaning that for two years the primary balance would actually be deteriorating, rather than improving (Table 2). This deterioration would ultimately be reversed, assuming that the adjustment resumes as scheduled.

What about the overall (general government) balance? Even assuming that the states succeed in curbing their deficit to around 2 percent of GDP[5], it would not achieve the needful: the general government primary balance would remain in deficit throughout the medium term. In contrast, the alternative proposal would indeed eliminate, or come close to eliminating, the general government primary deficit by 2021-22.

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[4] Any fiscal windfall from demonetization—either in the form of unreturned high denomination notes or tax revenues under the Pradhan Mantri Garib Kalyan Yojana--should not affect the path of consolidation going forward as it is one-off in nature.

[5] See the chapter in the Committee's Report on "State-level Fiscal Responsibility Legislation," Table 5.

Table 2. Medium-Term Fiscal Deficit, Primary Deficit, and Debt Paths for Central Government: Committee's Recommendation vs. Alternative Proposal

	Primary deficit; Alternative	Primary deficit; Committee	**Fiscal deficit; Alternative**	Fiscal deficit; Committee	**Debt; Alternative**	Debt; Committee
2016-17	**0.3**	0.3	**3.5**	3.5	**49.4**	49.4
2017-18	**0.1**	-0.3	**3.2**	3.0	**47.6**	47.3
2018-19	**-0.1**	-0.1	**2.9**	3.0	**45.6**	45.5
2019-20	**-0.3**	0.0	**2.6**	3.0	**43.3**	43.7
2020-21	**-0.5**	-0.1	**2.4**	2.8	**40.7**	42.0
2021-22	**-0.6**	-0.1	**2.2**	2.6	**38.2**	40.3
2022-23	**-0.7**	-0.1	**2.0**	2.5	**35.7**	38.7

The Committee's strategy may also fall short of its own debt objective. It may seem that adhering to fiscal deficit targets could ensure achieving a debt target. After all, stocks (such as debt) are merely the sum of flows (such as deficits). But this is not true when the targets are expressed as ratios to GDP, as they must be since the economy is growing. In this case, the precise relationship between deficits and debt depends on how fast the economy is growing.

Under the Committee's scenario, growth is sufficient to ensure the debt target will be achieved, as long as the deficit targets are respected. But in a slightly more adverse scenario, where real growth falls to 5 percent for a few years before recovering—as indeed occurred a few years ago—the debt/GDP target at the end of the decade would be missed by no less than 3-4 percentage points. This alternative scenario underscores India's basic vulnerability: as long as the primary balance remains in deficit, progress in reducing the debt ratio will remain hostage to the vagaries of the growth-interest differential, factors outside the government's control.

The need for ambition in the medium term is reinforced by the situation of state government finances, which has been adversely affected by slower growth, the need to assume debt of the discoms (under the Ujwal DISCOM Assurance Yojana [UDAY] scheme), and the need to implement the Seventh Pay Commission recommendations.

5. Consistency Between Debt Objective and Operational Fiscal Deficit Rule

Further, there is a consistency problem between the debt objective recommended by the Committee and the operational flow targets proposed. The debt objective hovers uneasily between a "ceiling," a "target," and an "anchor." In places, the Committee refers to this objective as a "ceiling". But clearly this wording cannot be taken literally, for in that case the government would be in violation of the FRBM from the moment the revised framework is introduced because the current level of debt is above this ceiling.

Alternatively, the debt target could be interpreted as notional (an "anchor"), something to be achieved "one day," similar to the 60 percent objective in Europe. In this case, it would not be adding much to the framework: the binding constraint would remain the fiscal deficit path.

These considerations suggest a third interpretation, namely that the debt objective should be seen as a target, meant to be achieved over the next decade. In this case, a number of serious questions arise.

If debt is indeed a target, the operational rules for the fiscal deficit should have flowed from the debt objective. But they do not as the Committee makes clear that the operational target instead flows from an alternative (and orthogonal) framework based on macro-economic balances.

The well-known standard equation that relates the steady state debt ratio (D) with the constant fiscal deficit (FD) and constant nominal growth rate (g) is given by:

FD = D times [g/(1+g)]

This was the equation that led to the famous Maastricht Stability and Growth Pact (SGP). In Europe, the objective of a debt target of 60 percent of GDP (arrived at because that was close to the average prevailing then in Europe) combined with a medium-term nominal growth assumption of 5 percent, led to the choice of the fiscal deficit target of 3 percent of GDP (60 times 5).

Taking the Committee's debt target of 40 percent (for the central government) and the assumed nominal growth rate of 11.5 percent, yields a central government fiscal deficit target of about 4.1 percent of GDP (11.5/1.115 times 40). But the Committee has proposed a resting place for the fiscal deficit of 2.5 percent of GDP by 2022-23, substantially lower than dictated by the debt objective. So, the operational target does not stem from the debt objective.

Where does the medium term fiscal deficit target of 2.5 percent of GDP come from? The Committee has used a simple macro balance equation to arrive at this number. The report assumes a current account deficit target, adds on the latest data for household financial saving to get a figure of 10 percent of GDP in available resources, then divides this amount equally between the government and the private sector, and divides the government share equally between the Centre and the states. Hence, the 2.5 percent of GDP.

There is some rationale for the last step, in that an equal division between the Centre and states follows a long-established precedent. But the other steps are arbitrary and the assumptions fragile.

It is not obvious that domestic saving should be predicted on the basis of the latest data. Saving fluctuates widely and is endogenous to growth: household financial saving was around 10 percent of GDP in the early 2000s, then surged to around 11.5 percent of GDP during the

boom, and fell sharply during the recent years to around 7 percent of GDP. So the latest reading forms a slender reed on which to base legally binding medium-term fiscal targets.

Finally, the division of resources equally between the public and private sector is not only arbitrary but seems normatively wrong. Should the state really aim to take half the available household financial saving? On what basis?

Next, consider the implications of adding a hard debt (stock) objective to the fiscal deficit (flow) targets.

Consider how the government would need to respond if inconsistencies develop between the deficit and debt targets. Recall that the change in the debt-GDP ratio depends essentially on two factors: the fiscal deficit-GDP ratio, which essentially measures the flow of new debt[6], and the rate of growth of nominal GDP, which effectively inflates away the old debt. To see this, imagine the case where the fiscal deficit is zero, real growth is zero, but inflation is 10 percent. The debt-GDP ratio will shrink because the debt will stay the same but the denominator will increase by 10 percent.

This situation creates a potential inconsistency between the deficit and debt targets. If inflation turns out to be lower than anticipated, the deficit targets would need to be tightened to ensure the debt-GDP target is respected. If these adjustments were to occur frequently (say every year) all predictability of the framework would be lost. But if adjustments were made infrequently, then large and disruptive adjustments would be needed.

In fact, even if targets were adjusted frequently, the adjustments might need to be large, if the deadline for achieving the debt target were approaching. For example, if the target were one year away, and debt still needed to be reduced by 1 percentage point, then spending might need to be cut by 0.3-0.4 percentage point of GDP in the middle of the fiscal year (about Rs 45,000-60,000 crores in today's terms), if inflation fell just a percentage point short of what was projected.

Such cuts would not only be disruptive and difficult to achieve: they would also be unwise. For if inflation was falling short of target, this could well be occurring because the economy was in a cyclical slump—which would be exactly the wrong time to be tightening the fiscal stance.

Summing up, a meaningful debt target requires the operational rules to flow from the target. But they don't. Instead, they flow from an alternative and orthogonal framework based on macro-economic balances. And the numbers that stem from this framework are based on fragile assumptions about saving in the future and ad-hoc choices on how that saving should be allocated between the public and private sectors.

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[6] Ignoring valuation changes and the assumption of debts from other branches of government.

Moreover, a hard target would quickly run into operational problems, forcing frequent reassessments of the fiscal deficit path and occasional large, pro-cyclical spending cuts. At some point, many will begin to wonder why these adjustments are necessary, why it is so important to reduce debt to 60 percent of GDP. And when that happens, it will be impossible to give a credible answer, in which case the framework will be abandoned.

6. A REVENUE DEFICIT TARGET?

There is a valid reason to focus on the revenue deficit, namely that capital expenditure should not be viewed in the same way as current spending. Capital spending is an addition to the nation's capital stock, which should bear future dividends that will counterbalance the interest costs of the debts incurred to finance it. Current spending yields no such future dividends. For this reason, the UK government attempted until the Global Financial Crisis to follow a "golden rule" of borrowing only for investment, and such a concept was built into the original FRBM as well.

That said, there are stronger reasons why the revised FRBM should eschew a revenue deficit rule. The most obvious one is that it is simply not true that capital spending is always better than current spending. Both types of expenditure can be wasteful. At the same time, both types can be useful. There is a lot of context-specificity to actual choices between the two which would be constrained by a blanket rule. There is a strong critique that India underspends dramatically on health and education, arguably to an even greater extent than on capital expenditure.

Moreover, one could argue that since future generations of Indians will be vastly richer than current ones, it would be optimal to borrow some consumption from the future for the benefit of those Indians alive today. And the way to do this would be by running a revenue deficit. Accordingly, it makes little sense to place arbitrary limits on the share of the revenue deficit in the overall deficit.

One could even go further. It might actually be counterproductive to establish a revenue deficit target. The reason is that the greater the proliferation of targets, the greater the chance that the government will ignore some of them, damaging the credibility of the entire framework. This is not just a theoretical point: it is exactly what has happened over the past decade. The existing FRBM already contains revenue deficit objectives, but these have been routinely ignored, so much so that this objective has essentially been forgotten. The problem is not one of negligence; it is inherent to any framework where the objectives are many and potentially conflicting.

So, adding a revenue deficit rule would further add to complications that already stem from having both a debt and fiscal deficit rule, as described above.

7. CONCLUSION

The existing FRBM has served several important purposes. It has brought to the fore the vital importance of fiscal discipline, underscoring its central role in keeping the country on its rapid growth path, which is raising living standards toward those in the West. It has also provided a valuable framework for budgetary discussions.

That said, India has changed substantially since 2003. The FRBM consequently needs to be updated in the light of the country's distinctive experience and its unique prospects going forward. After all, fiscal rules gain their force not so much from their legal strategy as from the consensus that lies behind them, in the economic, political, and wider social communities. For such a deep consensus to be forged, the rules themselves need to be simple, consistent, and broadly feasible.

Unfortunately, the Committee's proposed architecture falls short on all these counts. There are multiple targets on stock, flow, and composition, diffusing the focus, complicating communication and comprehension, and risking non-compliance. Further, the targets themselves are arbitrary. A 60 percent debt-GDP rule cannot command broad consensus. Nor can a revenue deficit target of 0.8 percent of GDP. And the medium-term fiscal deficit target of 2.5 percent of GDP is based on a conceptual framework that is unrelated to the debt objective and based on calculations that are hard to justify**.**

Most critically, the fiscal deficit path follows an odd sequence of cut-sharply, pause, and cut again that is: difficult to explain or justify; inappropriate in the short run because of cyclical considerations; and insufficiently ambitious in the medium term in placing India's debt on a sustainable long term trajectory.

Finally, the key trigger for invoking the escape clause (growth to exceed the recent trend by 3 percentage points) is so demanding that it would fail to provide enough flexibility during severe downturns and enough discipline during growth booms. In other words, the new architecture would be a corset on fiscal policy, resulting in extreme procyclicality—aggravating booms and busts--with adverse effects on the economy.

Instead, I propose a simple and consistent architecture that reflects India's fiscal realities of the past, and its prospects for the future. There should be one target: a steady glide path that eliminates the general government primary deficit within five years. This would ensure a declining debt trajectory, which would reassure investors and ensure that India's debt remains sustainable even when India's debt dynamics turn less favorable in the medium term. And the escape clause should have a more reasonable growth trigger that allows for some relaxation of the deficit targets during recessions, and some tightening of these targets during booms.

Such a simple, clear, and consistent architecture would truly be an FRBM for the 21st century.

References

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