An Economic Analysis on the Impact of the FRBM Act on Central Government Deficits in India

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Abstract
The major purpose of this paper is to analyze the deficits of the Central Government in India since the 1990s, that is during the pre (1990-1991 to 2002-2003) and the post-FRBM Act period (2003-2004-2022-2023). It looks into the extent to whether the execution of the *Fiscal Responsibility and Budget Management (FRBM) Act* has played a positive role in bringing down the overall deficits of the Government or not. The study is based on secondary data and employs Dummy Variable Model for analysis. It is found that the FRBM Act was not successful in minimizing the deficits of the Central Government in India. Thus, it is suggested that it would be advantageous if the Government complies with the targets put down by the FRBM Act as this in turn would help in achieving fiscal discipline, consolidation, growth and stability in the country.

Keywords: *FRBM Act, Deficits, Fiscal Discipline and Consolidation.*

Introduction

Government expenditure is an important fiscal policy instrument used to create employment, enhance socio-economic welfare as well as to foster economic growth and progress of a nation. The expenditure of the Government is financed by revenue. However, when Government expenditure surpasses its revenue, a fiscal deficit problem arises. This fiscal imbalance is counter-balanced by public borrowing. Reckless borrowings can result in substantial interest payments, which are a burden to the Government. In order to keep a check on growing deficits, the Government of India introduced the Fiscal Responsibility Budget Management Act (FRBM) in the year 2000.

The Fiscal Responsibility and Budget Management (FRBM) Act in India was initially suggested as a means to ensure responsible fiscal and financial management within the country. It was also intended to address the issue of inefficient and ineffective resource utilization. The introduction of this bill aimed to align with specific macro fiscal objectives, including the promotion of economic stability by removing fiscal obstacles that hinder the implementation of monetary policy and adopting a prudent debt management policy that aligns with fiscal sustainability. Additionally, the act aimed to facilitate a higher rate of economic growth[1].

Review of Literature

The exploration of real-life studies takes us on a thrilling journey through the intricate world of public debt and economic growth. It unveils the hidden gems of theoretical studies that yearn for empirical validation. Moreover, it uncovers the flaws and shortcomings of existing research, shedding light on the methodology and estimation techniques employed. Theses valuable insights allow us to identify the areas that require a fresh perspective in our current investigation.

Parul Jain (2013) analyzed the fiscal deficit situation in India in three different time periods, viz, the fiscal situation before the economic reforms of 1991, fiscal situation during the pre-FRBMA period (1991-1991 to 2002-2003) and the fiscal situation during the post-FRBMA period, i.e., when the FRBMA became operative in 2004. The research found that the fiscal situation of India at the advent of economic reforms was crucial due to an increase in non-plan expenditure in the form of interest payments and the fall in capital expenditure were the main reasons for the country to fall into the fiscal crises. The gulf crises of 1990 worsened the fiscal situation in India. During the pre-FRBMA period, due to planned development and budget deficits faced by the Government, they relied more on borrowings which increased interest payments and in turn revenue deficits. Finally, during the post-FRBMA period, the act aimed at removing fiscal constraints and achieving efficient debt management. However, D.K. Srivastava stated that the FRBMA did not define the fair range of debt-to-GDP ratio as well the methods to deal with cyclical fluctuations. Finally, it is suggested that the Government should improve its quality of expenditure which in turn would help improve its fiscal position.

Shishir Kumar Gujrati (2017) in his paper entitled "FRBM Act – A Step Towards Fiscal Discipline" highlights the salient features and recommendations of the FRBM Act 2003. The Government borrows to undertake heavy projects to promote the standard of living of its citizens. But, reckless borrowing of funds leads to high interest rates which is unproductive in nature. Research found that during the post-FRBM period, there had been a significant decline in debt-to GDP ratio as well as in fiscal and revenue deficits. Thus, if the Government of India follows the targets and recommendations set by the FRBM Act, it will go a long way in achieving fiscal consolidation.

Amiya Kumar Mohapatra (2017) investigated the fiscal deficit situation in India during the post-FRBMA (2004-2005 to 2017-2018) period and found that the FRBM Act had played a significant role in arresting fiscal imbalances and achieving prudent fiscal management. The FRBM act had reduced fiscal deficits to great extent, i.e., from 5.1% in 2012-2013 to 3.2% in 2017-2018 respectively. Thus, research suggests that effective management of expenditure and enhancing the tax base would help to set the path for fiscal consolidation in India.

Dinabandhu Sethi et al., (2019) explored the relationship between fiscal deficit and economic growth in India from 1970-1971 to 2016-2017 in context of the FRBM Act by employing ARDL co-integration technique. The study included variables such as GDP, investment and electricity consumption. The results revealed that fiscal deficit effects economic growth negatively both during the pre-FRBM period as well as in the post-FRBM period, indicating that the FRBM Act has had only a neutral impact.

[1] Hrushikesh Mallick (2005). *An Economic Analysis of Domestic Debt of the Central Government in India* [Doctoral dissertation/ Ph. D Thesis, University of Mysore]. Institute for Social and Economic Change (ISEC), Bangalore, p. 2. http://hdl.handle.net/10603/92528.

Investments and electricity consumption positively impacts economic growth in the long-run. Thus, it is suggested that the Government of India should cut down unnecessary expenditure and follow the FRBM targets and guidelines.

Santosh Kumar Bhashkar (2020) analyzed the impact of the FRBM Act in reducing Government deficits and debt burden in the last two decades (2000-2001 to 2019-2020) in India. Due to the global recession of 2008, the targets set for the year were relaxed. The researcher is of the view that with the changing circumstances in the economy, there is a need for a systematic review of the targets set by the FRBM Act to maintain fiscal prudence and discipline in the economy.

Banalata Saikia et al., (2022) assessed the impact of the FRBMA on State finances of both special and non-special categories from 1990-1991 to 2019-2020 using trend analysis and structural break through chow tests. The test results revealed that the deficits of most of the states of both categories are performing better after the implementation of the FRBMA, indicating its significant impact on fiscal performance of the States. However, the Chow test results reveals less impact of the Act on special category States. Thus, it is recommended that the States should follow a target-based framework and systematic monitoring of deficits which would help them grow and reduce their dependency on the Centre.

Duragesh Pujari and R.R. Biradar (2022) examined the impact of the FRBM Act on public debt and fiscal balance in India using OLS method for the time period 1980-81 to 2017-18. The test results showed that the FRBM Act had a significant effect on fiscal deficit at 1% level of significance and no effect on public debt. GDP growth rate had a negative effect on fiscal deficit at 5% level of significance, whereas population had a positive effect on fiscal deficit at 10% level of significance. However, GDP growth rate and population growth rates had no effects on public debt. The research suggests that the government of India should adopt prudent debt management policies to maintain financial and debt stability.

A number of studies have explored the impact of the Fiscal Responsibility Budget Management Act on the fiscal performance of India. Few studies found that the Fiscal Responsibility Budget Management Act has been successful in bringing down the deficits of the Government, while some studies found that the FRBM Act only had a neutral impact on Central Government deficits.

Objectives

1. To discuss the causes and consequences of Central Government deficits.
2. To discuss the significance of the Fiscal Responsibility and Budget Management Act and highlight the targets set by it.
3. To analyze the deficits of the Central Government during the pre (1990-1991 to 2002-2003) and post-FRBM Act period (2003-2004 to 2021-2022).

Methodology

The present study attempts to analyze the trends in Central Government deficits during the pre- and post-FRBM Act period as well as to inspect whether the Fiscal Responsibility and Budget Management Act has been successful in bringing down the deficits of the Central Government. The study is based on secondary data which are collected from Union Budget Documents prepared by the Ministry of Finance and Handbook of Statistics on Indian Economy published by the Reserve Bank of India. The study employs Dummy Variable Model to explain and understand the impact of the FRBM Act on Central Government deficits in India.

Causes of Central Government Deficits

There are several factors that are responsible for Government deficits;

1. *Non-development Expenditure:* Increase in non-development expenditure like war, arms and ammunitions, cost of collecting taxes, debt servicing, cost incurred on maintaining law and order in the country as well as cost incurred on unplanned emergencies earthquakes, famines, floods, pandemics and so on are major reasons for a hike in Government deficits.
2. *Rising Unemployment:* Since India is still on the path of becoming a developed country, it faces the problem of unemployment. Unemployment means reduced taxes. For example, in 2008, the Government experienced lower tax revenues due to large unemployment in the country, which contributed to budget deficits.
3. *Development Activities:* Increased Government expenditure on health care, education, buildings, industrial development, infrastructure, defence and other public services contribute to budget deficits as these costs cannot be met by tax revenues alone as the taxable capacity of the people are low.
4. *Demographic Changes:* Every country goes through a transition in its demography and India is no exception. Demographic changes or ageing population calls for increased Government expenditure on healthcare, social overheads as well as social security, thereby contributing to budget deficits.

Consequences of Deficits

Following are the consequences of deficits;

1. The long-term consequences of skyrocketing deficits on the nation's economic growth and development could be seriously disastrous.
2. Deficits have the power to throw the exchange value of the currency into a tailspin, especially when they become chronic and start chipping away at foreign investors' trust, ultimately causing the domestic currency to take a nosedive.
3. Deficits lead to the piling up of public debt and drain the government's financial reserves, creating chaos in the national economy.
4. On top of that, deficits can fuel inflation by encouraging excessive and unproductive government spending, sending prices soaring.
5. Ultimately, deficits can foster an environment of irresponsibility and recklessness within the Government.[2]

Significance of the Fiscal Responsibility and Budget Management Act

The Fiscal Responsibility and Budget Management (FRBM) Act holds great significance in the process of restoring the financial well-being of the Indian economy. This is particularly crucial due to the adverse effects caused by increased government borrowings and mounting debt resulting from escalating expenditures on subsidies, salaries, defense, and various developmental and welfare initiatives. These circumstances have compelled the government to resort to borrowing. Consequently, the heightened borrowing by the Central Government has led to a surge in expenditure in the form of interest payments, which now constitutes the largest expenditure item for the Government. In order to break free from this detrimental cycle of interest payments and borrowing, as well as to address the financial weaknesses in the budget, the FRBM Act was introduced. Its primary objective is to implement substantial deficit

[2] Lekhi, R.K and Joginger Singh (1990), *Public Finance*, Kalyani Publishers, Ludhiana, p. 320.

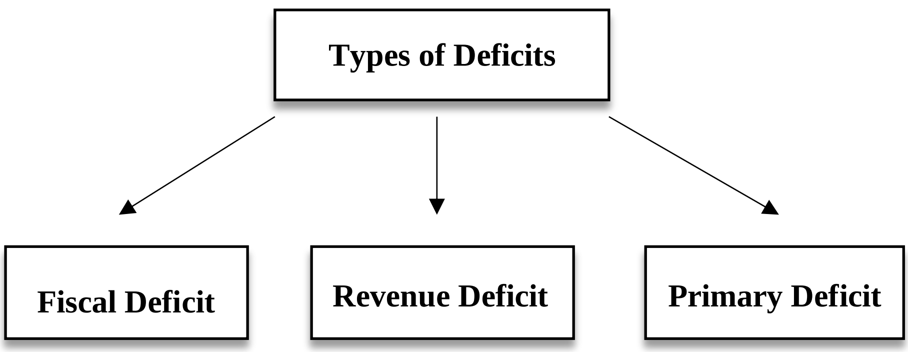
reductions. The FRBM Act is a fiscal sector legislation that was enacted by the Government of India in 2000, under the leadership of the then Finance Minister, Mr. Yashwant Sinha. It came into effect in 2003, with the aim of ensuring fiscal discipline for the Central Government by establishing targets for the reduction of fiscal deficits and the elimination of revenue deficits. Therefore, the FRBM Act represents a legal measure taken to ensure fiscal sustainability and consolidation in India.[3]

Targets of the FRBM Act (Highlights)

Initially, the bill aimed at eliminating Government deficit by March 2006, and to reduce fiscal deficit by 2 percent of GDP. The FRBM Act set a target of bringing down fiscal deficit to 3 percent and revenue deficit to 0.5 percent of GDP by 2008-2009, but due to the global crises, these targets could not be reached by the Government and hence were suspended. The bill was amended several times, and in 2011, a new concept called effective revenue defect was introduced in the budget. In 2012 and 2015, the FRBM Act aimed at reducing effective revenue deficit and also prepared a Medium-term Expenditure Framework to bring about efficiency in Government expenditure. In 2018, the act was amended again which focused on bringing down fiscal and revenue deficits to 2 to 3 percent of GDP. Later, the N.K. Singh committee set new targets to be achieved by the Government, with fiscal deficit being 2.8 percent and revenue deficit being 1.3 percent for the year 2020-2021. It also set targets for the year 2022-2023 with fiscal deficit being 2.5 percent and revenue deficit being 0.8 percent of GDP.

The FRBM Act was amended several times due the changing dynamics of the country and set targets to be achieved accordingly. The Central Government has not been very successful in achieving these targets, due to various reasons. But complying to the norms and guidelines of the act would help to maintain fiscal prudence and management in the country.

Chart 1: Types of Deficits



Fiscal Deficit

Fiscal deficit refers to the difference between Government revenue and expenditure. It is a problem faced by the Government when its expenditure is much more than the revenue. It is calculated by subtracting revenue receipts from total expenditure plus non-debt capital receipts.

$$\boxed{\textit{Fiscal Deficit} = \textit{Total Expenditure} - (\textit{Revenue Receipts} + \textit{Non-debt Capital Receipts})}$$

[3] Nitendrakumar N. Patel (2017). *Impact of Public Deficit on Economic Growth* [Doctoral Dissertation/Ph. D Thesis]. Gujarat University, Ahmedabad, p. 31. *http://hdl.handle.net/10603/286038*.

Revenue Deficit

Revenue deficit refers to the difference between revenue receipts and revenue expenditure. Revenue receipts refers to the revenues received from tax and non-tax revenues. Revenue expenditure can be of two types; plan and non-plan expenditure. Plan expenditure refers to the expenditure incurred on infrastructure, law and order etc., whereas, non-plan expenditure refers to the expenditure incurred on famine relief, war, pandemics etc.

$$\boxed{\textit{Revenue Deficit} = \textit{Revenue Receipts} - \textit{Revenue Expenditure}}$$

Primary Deficit

Primary deficit refers to the difference between fiscal deficit and interest payments of the previous year. It is arrived at by deducting interest payments from fiscal deficit.

$$\boxed{\textit{Primary Deficit} = \textit{Fiscal Deficit} - \textit{Interest Payments}}$$

Table – 1.1: Deficits of the Central Government of India (as percentage to GDP)

Components				
Sl. No.	**Year**	**Revenue Deficit as % to GDP**	**Fiscal Deficit as % to GDP**	**Primary Deficit as % to GDP**
1	**2**	**3**	**4**	**5**
1	1990-1991	3.3	6.6	2.8
2	1991-1992	2.5	4.7	0.7
3	1992-1993	2.5	4.8	0.6
4	1993-1994	3.8	6.4	2.2
5	1994-1995	3.1	4.7	0.4
6	1995-1996	2.5	4.2	0.0
7	1996-1997	2.4	4.1	-0.2
8	1997-1998	3.1	4.8	0.5
9	1998-1999	3.8	5.1	0.7
10	1999-2000	3.5	5.4	0.7
11	2000-2001	4.1	5.7	0.9
12	2001-2002	4.4	6.2	1.5
13	2002-2003	4.4	5.9	1.1
Average		**3.3**	**5.2**	**0.9**
POST-FRBMA PERIOD				
14	2003-2004	3.6	4.5	0.0
15	2004-2005	2.5	4.0	-0.1
16	2005-2006	2.7	4.1	0.4
17	2006-2007	1.9	3.5	-0.2
18	2007-2008	1.1	2.6	-0.9
19	2008-2009	4.5	6.0	2.6
20	2009-2010	5.2	6.5	3.2

21	2010-2011	3.2	4.8	1.8
22	2011-2012	4.3	5.7	2.6
23	2012-2013	3.6	4.8	1.8
24	2013-2014	3.1	4.4	1.1
25	2014-2015	2.9	4.1	0.9
26	2015-2016	2.5	3.9	0.7
27	2016-2017	2.1	3.5	0.4
28	2017-2018	2.6	3.5	0.4
29	2018-2019	2.4	3.4	0.4
30	2019-2020	3.3	4.6	1.6
31	2020-2021	7.3	9.2	5.8
32	2021-2022	4.7	6.9	3.3
33	2022-2023	4.1	6.4	3.0
Average		**3.8**	**4.8**	**1.4**
Source: (1) Union Budget Documents (Compiled from various issues), Ministry of Finance, New Delhi				
(2) RBI, Handbook of Statistics on Indian Economy (Compiled from various issues), Mumbai.				
Note: Data for 2022-2023 are Revised Estimates.				

Dummy Variable Model

Dummy variables are used to substitute encoded category data with numeric values (often zero and one). This study uses a dummy variable as a treatment effects model, i.e., to represent the effect of both times (the effect before and after treatment is applied). That is to check the status of Central Government deficits before and after the implementation of the FRBM Act.

Results of the Dummy Variable Model (Summary Tables)

The following tables represent the impact of the FRBM Act on fiscal deficit, revenue deficit and primary deficit of the Central Government of India.

Following is the Tabular interpretation of the Dummy Variable Model.

Table 1.2:	**Dependent Variable: Fiscal Deficit as % to GDP**			
Variable	**Co-efficient**	**Std. Error**	**t-Statistic**	**Prob.**
Dummy	-0.536923	0.459507	-1.168475	0.2515
C	5.276923	0.357726	14.75130	0.0000
R-Squared	0.042185	**Adjusted R-Squared**	0.011288	
F-Statistic	1.365334	**Prob (F-Statistic)**	0.251523	
Sum Squared resid	51.57108	**Durbin Watson Test**	1.196114	

Table 1.3:	Dependent Variable: Revenue Deficit as % to GDP			
Variable	**Co-efficient**	**Std. Error**	**t-Statistic**	**Prob.**
Dummy	0.041538	0.147057	0.099599	0.9213
C	3.338462	0.324679	10.28235	0.0000
R-Squared	0.000320	**Adjusted R-Squared**	-0.031928	
F-Statistic	0.009920	**Prob (F-Statistic)**	0.921304	
Sum Squared resid	42.48277	**Durbin Watson Test**	1.189381	

Table 1.4:	Dependent Variable: Primary Deficit as % to GDP			
Variable	**Co-efficient**	**Std. Error**	**t-Statistic**	**Prob.**
Dummy	0.444615	0.473004	0.939983	0.3545
C	0.915385	0.368233	2.485886	0.0185
R-Squared	0.027712	**Adjusted R-Squared**	-0.003652	
F-Statistic	0.883569	**Prob (F-Statistic)**	0.354493	
Sum Squared resid	54.64492	**Durbin Watson Test**	1.106339	

Interpretation of Summary Tables

The FRBM Act has had a negative and insignificant impact on fiscal deficit, but a positive and insignificant impact on revenue and primary deficits. The reasons could be that the Government had failed to achieve the targets set by the act in 2008 due to the global crises. Another reason could be the power given to the Government to alter the Act at any given time. To make sure that the Central government did not exceed the predetermined ceiling for the fiscal deficit in a given fiscal year, the FRBM Act was put into effect. However, the Central Government was also given the authority to change the act in special circumstances. In other words, it implied that the Government may freely modify the Act whenever it failed to comply with the targets established by the FRBM Act.

Conclusion

It is evident from the study that the FRBM Act has had only a neutral impact on Central Government deficits and not played a positive role in bringing down the deficits. The results are consistent with the findings of *Parul Jain (2013), Dinabandhu Sethi et al., (2019) and Santosh Kumar Bhashkar (2020).*

Achieving the targets set by the FRBM Act is a major challenge for the Government due to the changing circumstances in the economy. Thus, there is a need for the Government to constantly review the targets put down by the FRBM Act and devise methods to achieve them. Along with this, improvement in the quality and efficiency in Government expenditure, productive investments of borrowed funds, establishment of a long-term fiscal policy, proficient tax administration as well as prudent debt management policies will go a long way in enhancing the fiscal position of the Central Government of India.

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