INDIAN DEMOCRACY AT WORK

FDR
FOUNDATION for DEMOCRATIC REFORMS

National Round Table

A VIABLE FRAMEWORK FOR FISCAL PRUDENCE

4TH NOVEMBER, 2023

Key Issues for Consensus-building

BACKGROUND

India stands at a pivotal juncture in its journey of economic progress and development. The collective efforts of successive governments at both the Union and State levels have steered our country onto a robust growth trajectory. Today, India ranks as the fastest-growing among emerging economies, and within a few years, it is poised to be the third-largest economy in the world. At this juncture, there is a genuine opportunity for the country to unlock human potential, improve the lives of millions of Indians, and achieve global recognition befitting our vast size and demographic diversity. However, this priceless opportunity is not without its challenges, as the perilous state of India's public finances necessitates immediate and concrete course corrections. Debt-GDP ratios consistently breach the Fiscal Responsibility and Budget Management (FRBM) norms, even without accounting for off-budget borrowings and unpaid bills of governments. In this backdrop, the looming threat of States reverting to the unfunded Old Pension Scheme (OPS) will have far-reaching consequences on the country's fiscal health. We need constitutionally permissible measures and a viable framework to secure the country's long-term fiscal health, foster intergenerational equity, and ensure the financial stability and credit of India. In light of these challenges, the Indian Democracy at Work National Round Table on 'A Viable Framework for Fiscal Prudence' brings together the foremost experts on public finances, thinkers, policy analysts, and public opinion leaders to deliberate and reach a consensus on short-term and long-term measures needed to institutionalise fiscal prudence in the country.

ISSUES AT HAND

ISSUES	NO. OF SUB-ISSUES
Issue 1: Is it sustainable to borrow in perpetuity for current expenditure without creating assets for the future?	3
Issue 2: What is the impact on inter-generational equity when the burden of deferred liabilities is passed onto future generations in a cash-accounting system?	3
Issue 3: What are the approaches available to institutionalise effective monitoring and oversight of public expenditure even as the autonomy of elected governments is respected?	5
Issue 4: What are the possible approaches to ensure independent, transparent and non-partisan exercise of authority under Article 293(3)?	4
Issue 5: What mechanisms can be implemented to ensure that funding for pension commitments under a non-contributory, defined benefit pension plan is concurrent with the active service years of employees, including those in the defence forces?	4
Issue 6: What viable approaches can be employed to strike a balance between the genuine social security needs of government employees and the long-term, sustainable health of public finances?	3
Issue 7: Exploring the design of a comprehensive social security system that initially covers the organised sector and gradually extends to the unorganised sector, encompassing the entire population.	4

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 1: **Is it sustainable to borrow in perpetuity for current expenditure without creating assets for the future?**

Background: The fiscal health of governments, both at the Union and State levels, currently faces significant threats due to rising current expenditure and persistent revenue deficits. Within current spending, a notable division emerges – discretionary and non-discretionary expenditure. Discretionary expenditure includes Individual Short-Term Welfare (ISW) measures. While these programs hold political appeal, they lack a legal mandate, allowing for adjustments based on changing priorities, economic conditions, or poverty reduction. However, non-discretionary expenditure, comprising salaries, pensions and interest payments, absorbs a substantial share of States' revenues and presents a distinct challenge. The recent reversal of policy in several States, transitioning from the defined contribution-based National Pension System (NPS) to the unfunded, index-linked, defined benefit-based Old Pension Scheme (OPS), is set to increase States' committed expenditure requirements manifold in the future. Unlike ISW's, OPS is a legally mandated expenditure that cannot be revoked, creating a permanent, long-term liability. At this time, it is essential to circle back to the fiscal target of a 'golden rule' as recommended by the 13th Finance Commission. This target is based on the idea that in the absence of economic emergencies, no economic agent should borrow to finance current consumption, and therefore a long-term target for governments should be to maintain a zero revenue deficit. Hence, borrowing should be undertaken for investment purposes only, and the government is not to use national savings to finance consumption (paras 9.18, 9.19, 9.70, 13th Finance Commission 2009). Ultimately, the rule ensures that all items of consumption expenditure are financed from current receipts; a widely successful fiscal reform in most countries. The application of the 'golden rule' should be mandated in both the Union and the States to lay down a sound future fiscal roadmap.

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 1: **Is it sustainable to borrow in perpetuity for current expenditure without creating assets for the future?**

1. How do we institutionalise the 'golden rule' – or the norm of zero revenue deficit, i.e. current expenditure shall not exceed current revenues of the government at the Union and State level?
2. What is a reasonable period to meet the zero revenue deficit target at the Union and State levels?
3. Revenue deficit grants to States create a perverse incentive encouraging fiscal profligacy. Can revenue deficit grants to States be phased out with the end of the 15th Finance Commission period in line with point 'a' above?

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 2: **What is the impact on inter-generational equity when the burden of deferred liabilities is passed onto future generations in a cash-accounting system?**

Background: Amidst high government spending, States as well as the Union are borrowing to meet current expenditures. As a result, mounting fiscal deficits have led to an unsustainable debt-to-GSDP ratio surpassing FRBM debt limits. It is pertinent to note that these estimates do not take into account the off-budget borrowings of many States that do not come under legislative oversight. Through Special Purpose Vehicles or other entities, governments manage to raise off-budget loans that often carry a high interest burden of 10-12% per annum. It is estimated that these off-budget loans constitute about 3.5 to 4% of the GDP. Further, reports indicate that States are deferring expenditures that add liabilities on future budgets. Dues to contractors for completed projects, arrears of wages and allowances and other payments due are often deferred to succeeding years. The Old Pension Scheme operates under a similar framework transferring the burden to future generations. Owing to the OPS's unfunded nature, States that choose to revert to the scheme are deferring payment obligations in the present while imposing liability on future generations. Not only does the OPS present a grave danger for fiscal management, but also disrupts inter-generational equity by imposing a tax burden on future generations. In order to promote more openness in fiscal management, the 12th Finance Commission (paras 14.15, 14.16, 12th Finance Commission 2004) explored the benefits of switching to an accrual accounting system that records a more accurate flow of resources. Accrual System helps present a complete picture of debt and other liabilities, and focuses policy attention on financial position; giving essential information to the public, the legislature and statutory and constitutional authorities for an accurate assessment. The FRBM Review Committee Report (Chapter 2, FRBM Review Committee Report, 2017) echoes similar recommendations, making reference to the Sarma Committee's emphasis on the importance of the government's openness on its fiscal projections. In line with the same, the report recognises the benefits of the introduction of an accrual accounting system as the cash-accounting system does not recognise hidden liabilities arising out of unpaid bills, or potential gains.

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 2: **What is the impact on inter-generational equity when the burden of deferred liabilities is passed onto future generations in a cash-accounting system?**

1. What are the possible approaches – constitutional and legal – to ensure that deferred liabilities, including those arising from unfunded pension liabilities, are accounted for in the current year?
2. In light of frequent recourse to deferring committed expenditure and obscured liabilities from off-budget borrowings, what measures are needed to provide an authoritative estimate of the actual liabilities of governments?
3. What constitutional levers are available with the Union to implement a system of accrual-based accounting and give effect to points ‘a’ and ‘b’ above?

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 3: **What are the approaches available to institutionalise effective monitoring and oversight of public expenditure even as the autonomy of elected governments is respected?**

Background: To enhance fiscal responsibility and transparency in a growing economy, the 13th Finance Commission proposed the establishment of an independent body that could initially conduct an annual public review of the implementation of FRBM processes including a review of the fiscal impact of policy decisions. Eventually, the Commission hoped that this body could evolve into a full-fledged Fiscal Council that acts autonomously. The Commission noted that similar arrangements in other countries have proven to be highly effective in medium-term fiscal policy and design (paras 9.65 and 9.66, 13th Finance Commission 2009). The 14th Finance Commission expanded on the Fiscal Council's role to undertake an ex-ante assessment of fiscal policy and fiscal implications (paras 14.100 and 14.101, 14th Finance Commission 2015). These bodies – Congressional Budget Office (CBO) in the United States (US), Office for Budget Responsibility (OBR) in the United Kingdom (UK) and Parliamentary Budget Office (PBO) in Australia serve as fiscal watchdogs, and impart greater transparency and accountability to the legislature and public at large. The Commission recommended an amendment to the FRBM Act to mandate the establishment of an independent Fiscal Council. The 15th Finance Commission underscores the need for such a mechanism as the third pillar of fiscal architecture (paras 13.51 to 13.58, 15th Finance Commission 2020). While the structure of these bodies varies globally, there is a consensus on the need for an effective, independent, non-partisan, and clear legal framework for ex-ante assessment. The Commission suggests that the key functions of the Council should include ex-ante monitoring and assessment, as well as an evaluation of the effective implementation of the revenue, expenditure and deficit targets, with powers to access records as required. The FRBM Review Committee Report emphasised the direct contribution of Fiscal Councils in strengthening public information and discourse about fiscal policy (Chapter 7, FRBM Review Committee, 2017).

Independent, accurate and credible analysis, forecasts and costings of programs are vital for a viable framework for fiscal prudence. In the UK, OBR was created in 2010, and given statutory status as a non-departmental public body under the Budget Responsibility and National Audit Act 2011. The OBR is a central part of the UK's fiscal framework, with a main duty to examine and report on the sustainability of the public finances.

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 3: **What are the approaches available to institutionalise effective monitoring and oversight of public expenditure even as the autonomy of elected governments is respected?**

(contd.)

Its primary role is to carry out independent and authoritative analysis of the UK's public finances. Its core functions include forecasts of the economy and public finances, evaluation of the government's performance against its fiscal targets, scrutiny of government's policy costings, assessment of the long-term sustainability of the public finances, and welfare spending analysis. OBR does not take any position on the policies or welfare programs proposed, and does not make any policy recommendations. Its role is limited to independent and authoritative analysis, forecasts and costing. Similarly, the US created the CBO in 1974 as a nonpartisan body to produce independent analysis of budgetary and economic issues to support the Congressional budget process. With similar functions and on the same lines, the establishment of independent and credible institutions warrants serious consideration.

1. Can an independent body on the lines of Office Budget Responsibility (OBR) in the United Kingdom be constituted to provide an ex-ante review of government policies and programs, and cost-estimates for large, public infrastructure projects?
2. How do we extend the scope of these bodies to include States ensuring fiscal transparency at both Union and State levels?
3. What mechanisms are needed for transparent reporting of public debt from all creditors, including Scheduled Commercial Banks, and can a law or a directive mandate this disclosure?
4. Explore other viable options for institutionalising fiscal transparency.
5. Explore the legal mechanisms available to discourage practices like tax revenue flowing directly into an escrow account towards debt repayment.

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 4: **What are the possible approaches to ensure independent, transparent and non-partisan exercise of authority under Article 293(3)?**

Background: In light of our federal framework, the Constitution recognised that a threat to the financial stability of any part of the country is a threat to the financial stability and credit of the nation as a whole. Accordingly, certain constitutional arrangements have been made that reinforce the role of the Union as the ultimate guarantor and guardian of fiscal stability. Broadly aimed at regulating the fiscal health and financial discipline of the States, Article 293 requires prior consent of the Union before a State incurs any debt, provided the State owes any outstanding debt to the Union. Under Article 293(4), the Union may grant to States such consent to borrow subject to such conditions as the Union may think fit to impose. While it may be a sound principle to leave each subnational unit responsible for its own fiscal decisions, Constitution-makers recognised the impracticality of such an arrangement in our federal democracy, implying that the Union is the ultimate guarantor of all public debt in the country. Unlike the United States, States cannot go bankrupt in India; all public debt is general government debt, and there is an implicit guarantee of all public debt. The powers of the Union under Article 360 of the Constitution, including giving "directions to any State to observe canons of financial proprietary as may be specified" place a significant responsibility on the Union to ensure that States do not take on more debt than they can handle. A fiscal crisis in one State affects other States and the credibility of the Union as a whole. The constitution-makers acknowledged that the Union and the States in India are one economic unit and that the Union's role in monitoring and imposing fiscal discipline on States is crucial in ensuring that the country's public debt remains sustainable in the long run.

However, our federalism is robust and political competition is fierce. In this backdrop, with different parties elected to office at the Union and State levels, the Union's exercise of functions under Article 293 will be viewed through partisan lenses, creating mistrust and discord. Hence, transparency, fairness and credibility in the undertaking of such a process are vital for the harmonious functioning of a complex and robust federal democracy such as ours. While the Union's role in protecting the financial stability and credit of India is ingrained in our constitutional framework, certain safeguards are necessary to prevent the process from turning into partisan political control of public management at the State level. To protect federalism and prevent partisan considerations from playing a role, we require robust mechanisms that are independent, transparent, credible, and universally acceptable. Considering the political sensitivity and economic seriousness of the matter, the entrustment of functions under Article 293 with a non-partisan, independent, and credible authority requires serious consideration.

Theme 1

Constitutional Mechanisms to Safeguard Public Finances in a Federal Polity

Issue 4: **What are the possible approaches to ensure independent, transparent and non-partisan exercise of authority under Article 293(3)?**

1. Can an independent Fiscal Council be created to monitor the fiscal health of States and approve loans under Article 293(3), subject to fulfillment of conditions under Article 293(4)?
2. Can the Finance Commission be made a permanent body and entrusted with the responsibility?
3. In light of the fact that Article 293 empowers the Union to grant consent for State borrowing when the State has prior debt to the Union, what safeguards are imperative to prevent States from evading fiscal oversight?
4. Is there a case for extending transfers under Centrally Sponsored Schemes as soft loans and exempting them from fiscal deficit norms, so that the Union's role under Article 293 will always be extant in order to promote fiscal discipline while providing financial support?

Theme 2

A Sustainable Pension System for Government Employees

Issue 5: **What mechanisms can be implemented to ensure that funding for pension commitments under a non-contributory, defined benefit pension plan is concurrent with the active service years of employees, including those in the defence forces?**

Background: OPS has created an unsustainable burden on the exchequer, notably as a share of States' own revenues and total revenues (including Union transfers). Between 1990-91 and 2020-21, the pension expenditure as a share of States' own revenues surged from 7.9% to 27.4%, and as a share of total revenues increased from 4.7% to 14.3%. In a mere seventeen years (from 2004 to 2021), States witnessed an elevenfold increase in pension expenditure, and tripling in just nine years. An astonishing 18% of general government revenues are now devoted solely to pensions for merely 3.2% of the workforce and for past services rendered. The pension liability under OPS violates the principle of intergenerational equity, as it unfairly burdens future generations for past services rendered. The impact of periodic pay revision commissions on pension outlays and the linkage of retirement benefits under OPS to the wage index raise significant concerns. The Bhattacharya Committee (Group to Study the Pension Liabilities of State Governments 2003) report noted that, on average, approximately 90% of government employees in India (particularly in Group 'D' and 'C' categories) earn more than their counterparts in the private sector and are thus better placed to save for their future (para 6.18 of the report of the Committee). Furthermore, pegging the pension of past employees to the salaries of today's workforce is an unreasonable proposition. Consequently, India witnesses multiple times the per capita income as the average annual pension payments to retired employees, as against the average annual social security benefit for retired employees or families in the US, which amounts to about 25% of the per capita income! The rising life expectancy will further compound the future burden of unfunded pensions.

Theme 2

A Sustainable Pension System for Government Employees

Issue 5: **What mechanisms can be implemented to ensure that funding for pension commitments under a non-contributory, defined benefit pension plan is concurrent with the active service years of employees, including those in the defence forces?**

1. What constitutional levers can be employed to ensure that unfunded pension liabilities are reflected in current budgets? Can we create a sinking fund to meet future pension obligations?
2. Alternatively, what fiscal adjustments can be considered if a unit chooses to revert to unfunded pension liabilities? If a unit refuses to allocate for future pensions in current budgets, can the Union treat it as deferred public debt, and apply revenue deficit, fiscal deficit, and debt to GDP norms accordingly?
3. Given the increasing life spans and declining ratios of active workers to retired workers in the future, can we consider a progressive increase in retirement age to ensure the sustainability of pension commitments over time?
4. What mechanisms can be employed to exclude wage indexation from defined-benefit plans, even as price indexation is included to protect the purchasing power?

Theme 2

A Sustainable Pension System for Government Employees

Issue 6: **What viable approaches can be employed to strike a balance between the genuine social security needs of government employees and the long-term, sustainable health of public finances?**

Background: The NPS has faced resistance from a section of government employees, with the argument revolving around the returns from the pension fund being market-linked and therefore considered to be lacking assurance. The Bhattacharya Committee (Group to Study the Pension Liabilities of State Governments 2003) report considers the alternative option of State Governments adopting a Defined Contribution-Defined Benefit (DC-DB) scheme. The Committee report illustrates a pension scheme that will be contributory in its nature, while guaranteeing a reasonable level of pension, with the shortfalls between the returns being met by the State Governments (para 6.11 of the report of the Committee). Recently, the Andhra Pradesh Government enacted a law called the Andhra Pradesh Guaranteed Pension System, aiming to "ensure financial security and welfare of the government employees...while also ensuring fiscal sustainability and inter-generational equity". For any pension plan to be adopted, it is imperative that the differential arising from the government's guarantee is accounted for in the current budget. We must find a healthy balance between sustainable fiscal strategy and addressing the concerns of employees.

1. How do we design a limited guaranteed pension plan to address the social security concerns of government employees while ensuring that there is no imposition of unsustainable burden on the future?
2. What modifications to the National Pensions System can be considered to make it a viable option for government employees as long as future generations are not burdened?
3. Can employees be given the choice of mode of investment of the pension fund in their account, in accordance with their risk appetite and personal preferences?

Theme 3

A Viable Roadmap for Universal Social Security Coverage

Issue 7: **Exploring the design of a comprehensive social security system that initially covers the organised sector and gradually extends to the unorganised sector, encompassing the entire population.**

Background: The essence of social security lies in the reassurance that it provides to individuals, empowering them to live a life of dignity. In our society, the vast majority of workers in the unorganised, informal sectors of the economy are eking out a precarious livelihood with no social security in old age, denying them access to a stable income and decent livelihood. Currently, only 3.2% of the workforce constituting government employees are beneficiaries of a steady social security coverage, assuring them with a comfortable life after retirement. An astonishing 89% of the workers operate in the informal and unorganised sectors and are left without any form of economic security. Most of these unorganised workers are poor, and live in a constant state of fear and insecurity after their working lives, struggling to make ends meet, let alone leading lives of dignity and comfort. While presently there exist a number of Union and State-wide programs that aim to address this concern, the coverage under such schemes has been extremely inadequate. The total coverage under the National Social Assistance Program (including beneficiaries covered by State-run programs) remains less than five crore. Programs such as the Atal Pension Yojana and Pradhan Mantri Shram Yogi Man-dhan Yojana provide coverage to 5.2 crore and 49 lakh beneficiaries respectively, together covering less than 10% of workers. Clearly, over time we need to move towards a more viable and accessible mode of social security coverage. We need to establish a roadmap for the next 15-20 years which includes the designing and delivery of a secure and sustainable mode of social coverage, ensuring a decent life in old age. The path to providing similar benefits to the informal-organised sector as exists within the formal-organised sector may be straightforward. But it is essential to note the criticality of paving a path for the vast unorganised sector covering 43.99 crore individuals. Such a programme as this would require considerable financial resources and a commitment to a hefty fiscal allocation for welfare. Therefore, sustainable and viable funding mechanisms need to be designed. Currently, the Union is saddled with a structural deficit of over ₹2.57 lakh crore (the deficit after transfers to States, wages, pensions and interest burden). The financial strain of growing revenue expenditure and mounting debt does not give much fiscal room. It is essential to come up with a feasible and financially viable, long-term model of social security coverage. It may take 15-20 years to roll out, but long-term design and process should begin now.

Theme 3

A Viable Roadmap for Universal Social Security Coverage

Issue 7: **Exploring the design of a comprehensive social security system that initially covers the organised sector and gradually extends to the unorganised sector, encompassing the entire population.**

1. What are the possible approaches for extending social security coverage to the informal workers in the organised sector?
2. Can the existing social security arrangements for the unorganised sector be consolidated into a unified system?
3. What federal arrangements are necessary for the effective delivery of social security programs?
4. What is a viable mechanism for funding social security programs?

About FDR

Foundation for Democratic Reforms (FDR) is one of India's leading think-tanks and research-resource centres for studying, formulating and promoting fundamental reforms in political, electoral and governance spheres and in critical areas of state policy. The objective is to promote holistic, peaceful and democratic transformation of the Indian polity, by creating a suitable environment for the democratic functioning of all institutions of governance.

It was established in 1996 and is based in Hyderabad, Telangana.

About Dr. JP

Dr. Jayaprakash Narayan is a physician by training who joined the Indian Administrative Service in the aftermath of the Emergency. He had a tremendously successful tenure spanning 16 years and held many important positions in the government of erstwhile state of Andhra Pradesh. He was elected as a Member of the Legislative Assembly of (the erstwhile) Andhra Pradesh from the Kukatpally constituency in Hyderabad for the 2009-2014 term.

Dr. JP is a former Member of the 2nd Administrative Reforms Commission of India, and a former Member of the National Advisory Council to the Govt. Of India. Dr. JP has been instrumental in driving three constitutional amendments (91st, 97th and 99th Amendments to the Constitution) and over 15 landmark legislative Acts in India, including disclosure of candidate wealth and criminal details, Lokpal Act and the Right to Information Act.

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