**A**

**Background Paper***

**on**

# *FISCAL AND MONETARY POLICIES*

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## FISCAL AND MONETARY POLICIES

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### 1. OVERVIEW: ISSUES

1.1 Are any basic features of the Constitution inconsistent with sound fiscal and monetary policies?

None of the basic features of the Constitution are inconsistent with sound fiscal and monetary policies.

Nevertheless, there appear to be some features where strengthening of the Constitution would be conducive to improved fiscal and monetary policies.

1.2 Whether the experience with working of the Constitution so far and the changing needs of global development and technological progress warrant fundamental or drastic changes in any of the provisions in the Constitution?

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There appear to be no provisions, which can be construed as reflective of inherent weaknesses in the Constitution. There have been several instances where Parliamentary or legislative actions as contemplated were not taken such as enactment of law relating to ceilings on borrowings by

Government. The procedures for amendment of the Constitution are reasonable and several amendments have already been made to meet evolving situations. Furthermore where judicial pronouncements warranted constitutional amendments in public interest, such amendments did take place.

Thus there is no evidence warranting fundamental changes in the provisions relating to fiscal and monetary policies, though improvements are possible by refinements of some provisions or inclusion of some other enabling or clarificatory provisions.

1.3 What should be extent of changes in the Constitution, minimal or comprehensive or intermediate?

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As already mentioned, there are no inherent weaknesses in the Constitution and hence no case for comprehensive changes. Wherever Constitution has worked reasonably well, there should be no changes. In any case, constitutional provisions cannot be a substitute for Parliamentary actions or inactions. Similarly, judicial interpretations are based on legal provisions, inaccuracies, infirmities. Constitutional provisions cannot be invoked to correct what may be perceived as Parliamentary inaction or judicial activism. Constitutional provisions cannot be a substitute for good public-policy or for sound legal framework or effective judiciary? Merely because some institutions are not as effective as was expected one should not lead to suggest a review of constitutional provisions though a reform of such bodies may be in order. Finally, the Constitution is expected to provide basic framework and should not reflect ideological biases of the day.

Hence, changes in the Constitution at this stage should be confined to those which are essential.

1.4 Whether Parliamentary procedures enshrined in the Constitution need a review to enable appropriate fiscal and monetary policy frame?

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First, it has been argued that several legislative measures concerning economic reform involving repeal of laws, amendments to existing laws or bringing about new legislation are not being attended to leading to fiscal and economic costs.

The question that arises is whether the Constitution should make it incumbent on Parliament/ Legislative to ensure prompt legislative actions that assure prudent fiscal and monetary situation.

While addressing these issues, it would need to be recognized that Parliament/ Legislature is supreme and any safeguards should be such that the sovereignty of Parliament/ Legislature is not eroded.

1.5 Expenditure liabilities have increased while at the same time there are inherent delays in judicial processes inhibiting rapid economic development and social change and as such is it desirable to review the functioning of judiciary?

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It has been observed that in major party of litigation, Government or public enterprise is a party and often litigation is within public sector. Further, it was noticed that in a major part of litigation involving public sector, employees are a party. Thus, a major benefit of public sector, namely, coordination appears to have been lost in the Indian situation. The question that would arise is whether solution lies in reforming judiciary or in scope and functioning of public sector itself.

Secondly, it has been held that judicial activism is often warranted by Parliamentary inertia, and as such ensuring Parliamentary activity in law-making and holding executive wing accountable are appropriate solutions.

Thirdly, some jurists have indicated that judiciary has generally been responsive to policy changes as reflected in the constitutional amendments or spirit behind the laws passed from time to

time. If there is an impression that judicial pronouncements appear to be outdated it is a reflection of inadequate reflection of changing economic policy frame in the laws of the land.

Hence, there seems to be no ground for any review of judicial frame work.

1.6 Keeping in view the prevailing situation, whether Constitution should lay down in greater detail the framework for dynamic fiscal and monetary area ?

First, there is a danger that detailing of economic framework in the Constitution would invite judicial interpretation leading to avoidable rigidities.

Second, detailed prescriptions will be difficult to practice without being too contextual and this could render it ineffective and sometimes even a hindrance to evolving appropriate policies suited to the evolving milieu.

Third, the Constitution cannot and should not take the place of Laws and Regulations. In fact, there is a view that present Constitution may have elements of over prescription in regard to financial provisions.

Hence, there seems to be no case for greater detailing of the framework, but focus may be to fill in the gaps and rationalize the existing prescriptions relating to fiscal and monetary areas.

## 2. REIVEW OF FINANCIAL PROVISIONS

Articles 109 and 110 relate to Money Bills and Legislative Procedure governing such Bills, Articles 112 to 117 relate to procedures in regard to financial matters in so far as Parliament is concerned.

2.1 Whether the coverage of Annual Financial Statement should be broadened and formal approval of Parliament prescribed to improve transparency and accountability of budgetary process ?

First, as per Article 112, the Annual Financial Statement (AFS) which corresponds to the popular conception of a budget refers to estimated receipts with no distinction between current or capital; and estimated expenditure divided into charged and otherwise. In regard to the latter, however, a distinction is made between revenue expenditure and others. The AFS is not meant for approval and as such the deviations also do not require parliamentary approval on expenditure or ratification. Since taxes require approval of Parliament and expenditure needs Parliamentary authorization, it can be argued that AFS for information is adequate. The proposed Fiscal Responsibility Bill by seeking placement of medium-term fiscal framework etc., before Parliament party addresses the issues.

Second, it can be argued that what goes into AFS should be decided by Parliament from time to time as long as it broadly relates to Public Finance. Thus, even existing stipulations in the Constitution could be reviewed to provide flexibility to Parliament.

Third, it is possible, on the other hand, to suggest amendments to reflect changing scope of pubic sector.

Hence, there are several options for rationalizing the AFS keeping in view the above considerations (see item 1 of Annexure-I for a technical option).

2.2 Is Parliamentary control over incurring of Government-debt both domestic and eternal, adequate as per present budgetary procedures enshired in the Constitution or should it be reviewed?

To the extent that only demands for grants as per Article 113 and Appropriation Bill as per Article 114, as also supplementary grants as per Article 115 are approved by Parliament, all expenditures need

to be authorized by Parliament. In incurring of debt, both domestic and external, however, Parliament has no direct role. In fact, the entire debt servicing is charged as per Article 112 (3) (c) and is thus not a subject matter of Parliamentary approval. In brief, Parliament has no role in approving the incurring of public debt or its servicing as per budgetary procedure in the Constitution.

There are separate provisions in the constitution on the question of limits to borrowing and is dealt with separately in paragraphs below.

The Fiscal Responsibility Bill which is under consideration broadly addresses the issue of limits to fiscal deficit, the revenue deficit and overall debt and thus meets the issue to some extent.

2.3 Since there may be occasions when a Government may not have a cash-balance in its account, the purpose of charged expenditure may not be served and hence whether the arrangements need to be reviewed?

The budgetary procedures refer to charged items under Article 112(3), which may be discussed but do not, require Parliamentary approval and these refer to debut servicing, payment to judiciary, etc. The budgetary procedures do not however, contemplate a situation where Government does not have cash balance in its account. Thus, the purpose of 'charged' expenditure in terms of prompt payment may be served only when there are cash balances in the account of the government concerned.

To the extent charged expenditure needs no Parliament approval, the present arrangements do serve the purpose in normal times.

2.4 Whether constitutional provisions on pubic debt and guarantees are adequate or should provide for enabling or compelling limits on public debt and if so, whether public debt should relate only to borrowings or to total liabilities including or excluding contingent liabilities and further whether sinking fund arrangements be made mandatory?

First, debt is defined in Article 366 to include all liabilities to repay capital sums or liability under guarantee.

Secondly, Article 112(3)(c) includes a reference to Sinking Fund charges also but establishment of such a fund is not mandatory. It is interesting to note that Sinking Fund is not being operated now except by a few States, since it is not obligatory under the Constitution. In fact the practice which was in vogue earlier was given up.

Thirdly, Article 292 provides for an enabling legislation by Parliament fixing limits on borrowing and issue of guarantees. In this connection, the following factors are worth noting. (a) First, Parliament has not passed any such legislation so far. (b) The Article does not cover "other liabilities" which constitute debt but are not borrowings upon the security of the Consolidated Fund of India. (c) Borrowing from the Reserve Bank of India was apparently not envisaged other than for very transient periods. (d) The Constituent Assembly debates show that borrowing for revenue expenditures was never considered to be a possibility. (e) The Fiscal Responsibility Bill (FRB) envisages a ceiling on debt which includes total liabilities, though not contingent liabilities. Thus the FRB (see Annexure-I) covers some ground and in some ways goes beyond what Article 292 envisaged. The report of the committee on Fiscal Responsibility Legislation (appendix-A) recognizes the need to have the report as an input for the National Commission to Review the Working of the Constitution.

There is merit in reviewing the above and making an explicit provision in the Constitution enabling the fixing of a ceiling on total liabilities of the government, and making the setting up of sinking funds mandatory.

2.5 In view of importance of cost-recovery, whether there is a case for constitutional obligation to legally define parameters for charging fees for services rendered by Government, ensuring subsidized changes only in clearly identified deserving cases?

There is no clear cut provision to define parameters for charging a 'fee' for rendering services, though a reference to fee is found in the Seventh Schedule, List III, Item 47. Such provision should have found place in delegated legislation. It is a moot point whether constitutionally obligated parameters will serve the purpose.

Hence, a view may be taken on whether Constitution could prescribe transparency in regard to cost recovery and subsidization in regard to fee.

2.6 Since cess levied for specific purpose are not being utilized whether it should be mandated in the Constitution.

Extensive recourse is taken to 'cess' in both Union and state budgets, but receipts under cesses may be appropriated under general revenues without necessarily ensuring that expenditures are incurred from the cesses as per the original intentions of levying of a cess as approved by Parliament or legislature. Budgetary procedures prescribed under delegated legislation do not explicitly provide for accountability in regard to cesses. In fact, in regard to oil cess barely 3 per cent of the cess is utilized for development.

Though mandating in the Constitution may not necessarily be superior to use of budget regulations, in view of the experience of using cess as a tax, mandating the use of proceeds of cess may be considered.

2.7 Whether articles governing financial provisions for states should be different from those governing union?

Articles 199 to 207 of the Constitution relate to legislative procedures in financial matters insofar as they relate to States legislatures and are broadly similar to those governing Parliament.

Thus, the changes contemplated for Union should continue to be equally applicable to states.

2.8 Whether current arrangements in respect of Comptroller and Auditor General (CAG) are adequate?

Articles 148 to 151 relate to Comptroller and Auditor General of India. A view needs to be taken, keeping in view experience so far on the composition, manner of appointment, functioning etc. including in particular the jurisdiction over public sector entities other than Government itself. Public enterprises, to the extent they carry out purely commercial activities, may not warrant anything more than commercial audit; this is particularly so with diversified ownership.

The coverage of Article 12 is linked with jurisdiction of the CAG.

Hence, there is a case for review of current arrangements.

2.9 Whether existing provisions relating to public-debt of states and borrowing by states are adequate?

First, Article 293 relates to borrowing by States. Article 293(1) provides an enabling framework for legislature of States to pass a Law similar to that of Union. While a few States have passed laws on guarantees none has passed a law on borrowings. There seems to be a case to review provisions relating to borrowings by states on par with the Union and make it similar. Second, Article 293(2) incorporates the enabling provision for the Government of India to make loans or give guarantees in respect of loans raised by the State, subject to such conditions as may be laid down by or under any law made by the Parliament. In fact, a major part of Central assistance for plans which is distributed as loan is under this article. Thirdly, Article 293(3) stipulates that no State can borrow as long as it has an outstanding loan or guarantee with the Government of India without the latter's consent. This is a

standard requirement of a lender, though a transparent framework is, not available as to the factors governing such consent.

Thus, constitutional provisions relating to ceilings on debt, guarantees, etc. may continue to be on par with those of Union, even after the proposed changes and the provisions relating to consent, etc. may also continue.

## 3. REVIEW OF PROVISIONS RELATED TO FINANCIAL MATTERS

3.1 Whether the provisions relating to divisions of Legislative powers between Union and States need a review?

Articles 245 to 255 govern the distribution of legislative powers, and the distribution has a bearing on the financial relations also. Substantive part of the legislative relations is listed in the Seventh Schedule. There have been several suggestions for a review of Seventh Schedule and illustratively the following issues could be explored.

First, there may be a case for explicit recognition of tax on services and appropriate jurisdiction.

Secondly, differentiation between agricultural and non-agricultural incomes becomes difficult with commercialization of agriculture. Hence, the distinction could be reviewed.

Third, there are several Entries in List II, that is State List which have significant implications for integrating the national economy such as stamp duty, taxes on entry of goods and services.

Fourth, there are some Entries in List III i.e. concurrent list such as contracts, bankruptcy, which again may need to be squarely in List i.e. Union List.

Firth, several Entries in List III that ought to be in List II have in effect resulted in significant centralization, as for example in Agriculture, Education, Health etc. Incidentally, there are some Entries, which may need review in the light of experience gained. For example, incorporation and regulation and winding-up of cooperatives that undertake banking or financial business are in List-II and has resulted in problems of dual authority as banking is in List-I. Suggestions have been made that they should be brought under List-I and III.

Sixth, the expenditure responsibilities of States are increasing while revenue potential appears to be diminishing.

Hence, there is a case for review on the lines indicated.

3.2 Whether there is need to review provisions relating to distribution of revenues?

Articles 264 to 267 in chapter on Finance, relate to general issues, while Articles 268 to 274 govern distribution of revenues between the Union and the States. The possibility of rationalization of these could be explored and Annexure I makes some illustrative suggestions.

3.3 Whether the present arrangements relating to Finance Commission are adequate?

Article 280, relates to the Finance Commission which incidentally indicates that Parliament may by law, prescribe the qualifications for appointment of the Chairman and also prescribe powers and functions to perform their functions. Issues have been raised in regard to the working of the Commission, but an important area relates to the role of States (as affected parties) in the presentation of terms of reference, composition and appointment of the Commission. A second issue relates to the desirability of a permanent Finance Commission as against a periodic one as presently prescribed. The third related issue is whether the work of the Planning Commission be integrated with Finance Commission. Fourthly, grants-in-aid under Article 275 are given on the recommendations of the Commission, which are more or

less gratis grants even though charged on the Consolidated Fund of India. Finally, and related to this issue is the desirability or otherwise of conditionality in statutory transfer of finances from Union to states.

There is a case for considered view on all the above these issues.

3.4 Whether Planning Commission should be made a statutory body since it plays a critical role in financial analysis between Union and States?

First, discretionary growth for public purpose by Union to States under Article 282 are generally made as per recommendations of the Planning Commission, a non-statutory body. The first issue is whether there ought to be a more formal mechanism, especially if they were meant to be as per recommendation of Planning Commission?

Second, in the past, most allocation was based on a formula approved by National Development Council, though of late, there have been significant deviations.

Third, planning is meant to be rationalist in approach. But, operationalisation has to be, in a democratic set up, within parliamentary accountability. Currently, recommendations of Planning Commission on financial allocations are operationalised through budget, though State-wise allocations are not spelt out in the budget document.

Fourth, several centrally sponsored schemes relating to List II or III are also funded by the Union, often bypassing the States, and directly to local bodies or district agencies.

Firth, whether the Article needs to be reviewed to impart great transparency, involving parliamentary approval of State-wise allocations and ensuring that States are not bypassd in the process. The emerging realities of relevance of nature of planning need to be assessed in considering statutory backing for Planning Commission.

Sixth, if a statutory backing for planning function is considered, should there be a state-level commission, a central-level commission and / or national level commission?

On balance, there seems to be no need to consider statutory backing for a commission meant for planning when economic role of Government is being redefined to make it more flexible and present arrangements appear to serve the flexibility objectives satisfactorily.

3.5 Whether any review needs to be made in regard to provisions governing local bodies?

Articles 243G to 243J relate to powers of Panchayats, including powers to impose taxes, constitution of finance commissions and audit of accounts. The Eleventh Schedule lists the matters in respect of which the responsibility for implementation of schemes may be entrusted to Panchayats by the State concerned. Articles 243W to 243Z and Twelfth Schedule contain corresponding provisions in regard to Municipalities. In addition, Articles 243ZD and 243ZE provides for committees for District and Metropolitan Planning, respectively.

Experience so far has been somewhat limited in this regard. However, the major issues relate to the adequacy of resources, including control over institutions and personnel apart from financial, to be able to effectively discharge the functions at Panchayat and Municipal levels.

Most issues appear to be beyond the immediate scope for constitutional changes.

## 4. RELEVANT PROVISIONS WITH FISCAL IMPLICATIONS

The Preamble and Articles 12 to 51A are of significance to the fiscal management of the Union and State governments, though they do not directly relate to fiscal policy or financial sector.

4.1 Since Article 12 has been interpreted widely especially in the context of public enterprises, whether a review is warranted ?

The interpretation of Article 12, (definition of State) though varying has led to overall erosion of flexibility for government needed in commercial operations undertaken by public enterprises and uneven treatment between public or private, merely on the basis of extent of public ownership. The concept of 'State' could exclude "other authorities "or" instrumentality of State" specially while determining the liability when it performs commercial or semi-commercial functions. Since government itself wants the public enterprises to be autonomous and run on commercial lines, extension of Article 12 to include public enterprises is inhibiting the process. Should it be formulated to clarify the intent viz. that it applies only in the conduct of sovereign and demonstrably non-commercial functions ?

In view of the above, a review seems necessary.

4.2 Since equality before Law is a basic feature of the constitution could it be reviewed ?

While Article 14 (equality before Law) is critical, its application in an unfettered way has tended to extend benefits to specific classes at the expense of totality of public interest. Thus, if extending a benefit, at public expense, on grounds of equality, involves disproportionate benefit, could there be a provision to deprive those who are already enjoying a benefit in an unequal manner ? If so, what should be the nature of compensation for such deprivation ?

Perhaps a legal approach is superior to constitutional change.

4.3 Similarly, equality of opportunities is a basic feature and should that be revisited?

While Article 16 (Equality of opportunities in public employment) has been interpreted to extend equality of opportunity to cover deployment (posting, transfer, allocation of work, etc.) thus making the government give greater weight to the rights of its employees rather than to the obligations to the poor or the society. Should it be restricted to recruitment and promotion avenues only ? Further, a significant part of the time of the judiciary is taken on matters relating to services under this Article and whether some other form of relief could be found.

These may ideally be approached through legislative route only.

4.4 Should there be greater emphasis on freedom of trade and profession in view of growing importance of services ?

Even though Article 19.1 (g) dealing with freedom to practice profession or trade etc. is subject to Article 19(6) enabling imposition of reasonable restrictions, clause (ii) thereof gives unfettered powers to government to give a monopoly to a corporation owned or controlled by the State. Such monopoly, for instance even in printing textbooks which are made available after half the year, may not necessarily be in public interest. Should 'public interest' be established for any restriction on trade ? Similarly, should prescription of professional or technical qualification be considered as a duty to be encouraged or enabled by the government and not necessarily performed by it ?

There is an increasing recognition of the need for promoting trade while ensuring appropriate regulation. In the past, three has been a significant role for Government and Government-owned enterprises, including monopoly power in addition to severe restrictions on domestic trade. Thus, provisions in Article 298, 302, 303 and 304 have diluted Article 301 on freedom of trade, commerce and intercourse. Further, Parliamentary legislation for creating authority to give effect to Article 301 to 304, as provided in Article 307, perhaps conspicuous by its absence. There are two important considerations in the role of Government in regard to trade, viz., possibly promoting competition (including removal of obstructions to competitions) and essentially protecting interests of consumer. Ownership or regulation by a Government ought to address these two

considerations. However, many state monopolies incur heavy losses with large fiscal burden and often with hidden subsidies. A revisit to all the constitutional provisions relating to trade and commerce may be, therefore, useful.

Article 366 gives definitions of various terms and these are also worth reviewing to capture emerging realities, as for example, current need for recognition of “services” as a significant part of trade and “guarantee” to include implicit guarantees. For example, a letter of comfort by a sovereign is treated, by international credit rating agencies, as tantamount to a sovereign guarantee.

A revisit to the matters mentioned above appears necessary to remove possible frictions to freer trade and services.

4.5 Whether there are constitutional provisions whose interpretations require a review of clarification?

Article 21 relating to protection of life and personal liberty has been interpreted in several ways. For example, it has been held that right to life includes the right to health, and that right to work can be claimed after employment. There are several issues arising out of the interpretations conferring benefits to individuals at the cost of society at large. Article 32 (enforcement of rights) has resulted in cases where revival of a private company was ordered to ensure living for workers; and court ruled even in matters related to service of public sector employees. However, it can be argued that there is need for consideration by the Courts of fiscal costs involved in the case while ordering enforceable individual rights.

Article 51A relates to fundamental duties, which are laudatory. However, one issue that needs to be explored is whether exercise of fundamental rights in a court of law should be subject to there being no blatant violation of a fundamental duty. Else, there could be asymmetries between rights, which are enforced through writs and, duties which are not.

The desirability of clarifications through constitutional changes or legal enactments may be considered.

4.6 Whether constitutional protection of service conditions etc. to Government servants has been detrimental to public interest warranting review ?

In view of experience gained so far, the impact of Article 308 to 312 relating to public services and the need for changes could be examined, inasmuch as the provisions appear to limit freedom to manage finances of the Union and the States.

This review may have to be considered along with a view on scope of Article 12.

## 5. MONETARY POLICY ISSUES

5.1 Whether there is need for reviewing the extant Constitutional Provisions regarding monetary policy issues ?

The Reserve Bank of India (RBI) Act predates the Constitution. In the Constitution, there is only one reference to the RBI, viz. to place it in the Union List (Entry 38).

In the light of the developments during the last fifty years as also the evolving role of central banks the world over there could be some merit in a review of certain aspects in relation to the Constitution.

5.2 Does a review of the constitutional provisions relating to central banks in various countries offer some lessons for India ?

The international position regarding the need for Constitutional provisions is not unambiguous. A comprehensive survey by the International Monetary Fund of the Constitution of 88 countries reveals that there are provisions in 30 countries. These provisions relate to central bank objectives, political and economic autonomy, safeguards relating to the appointment and termination of appointment of top management and central bank accountability. In countries where the institutional framework is weak there is merit in bolstering the position of the central bank by having certain constitutional safeguards. The underlying rationale for providing a special status for the central bank in the Constitution is that the power to spend should be separated from the power to create money.

The main issue is whether operational autonomy for monetary policy should be ensured through Law or through constitutional safeguard also.

5.3 Should there be any safeguards for the tenure of the top management of the RBI?

Some countries do have constitutional safeguards for the top management of central banks: Under the extent legislative stipulations, the RBI Governor and Deputy Governors are appointed by government and their continuing in position is entirely at the pleasure of government.

The feasibility of providing a special status under the Constitution for the RBI Governor and Deputy Governor akin to the Election Commission needs to be considered.