SYBCOM.(SEM IV)
UNIT 2

Macro Economic Issues and Policies

India's Fiscal Deficit and Economic Growth

Introduction

- Government expenditure on goods and services and resources mobilised by it through taxes, etc., are important factors that determine aggregate demand in the economy. Whenever the government spends more than the resources it collects through taxes and non-tax revenue, there is a deficit in the budget of the government.
- When there is an overall budget deficit of the Government, it has to be financed by either borrowing from the market or from the Reserve Bank of India, with one important difference.
- RBI has the power to create new money, that is, to issue new notes. Thus, to finance its fiscal deficit, the government may borrow from Reserve Bank of India against its own securities.
- This is only a technical way of creating new money because the government has to pay neither the rate of interest nor the original amount when it borrows from the Reserve Bank of India against its own securities.

- **What does the term “Fiscal Deficit” mean?**

- *It implies that government incurs more expenditure on goods and services than its normal receipts from taxes and non-tax revenue*.

- This excess government expenditure is financed by either borrowing from the market or by newly created money which leads to the rise in incomes of the people.

- As a result, the aggregate demand of the community rises to a greater extent than the actual amount of government expenditure through the operation of the “***government expenditure multiplier”.***

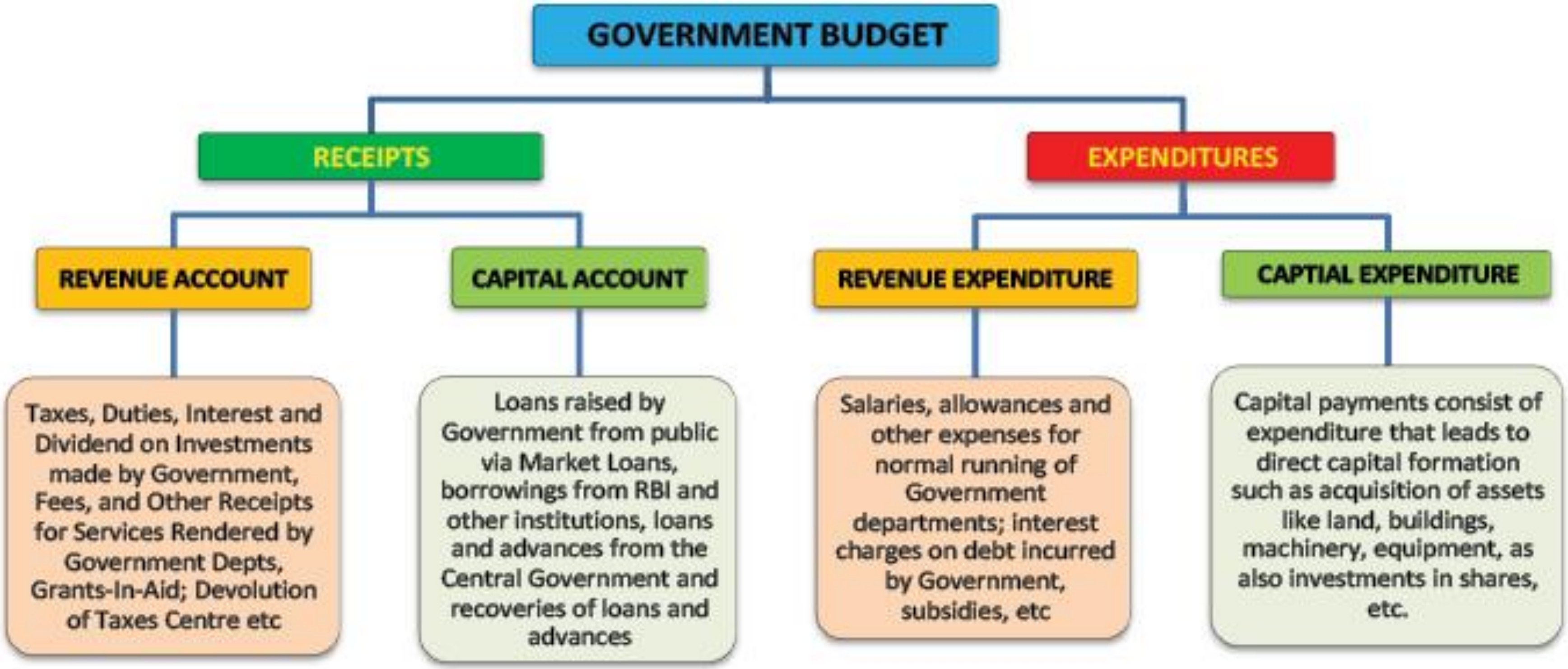
- ***We first take a look at the government’s revenue-expenditure statement, or the government budget, and the associated deficit measures.***

BUDGET

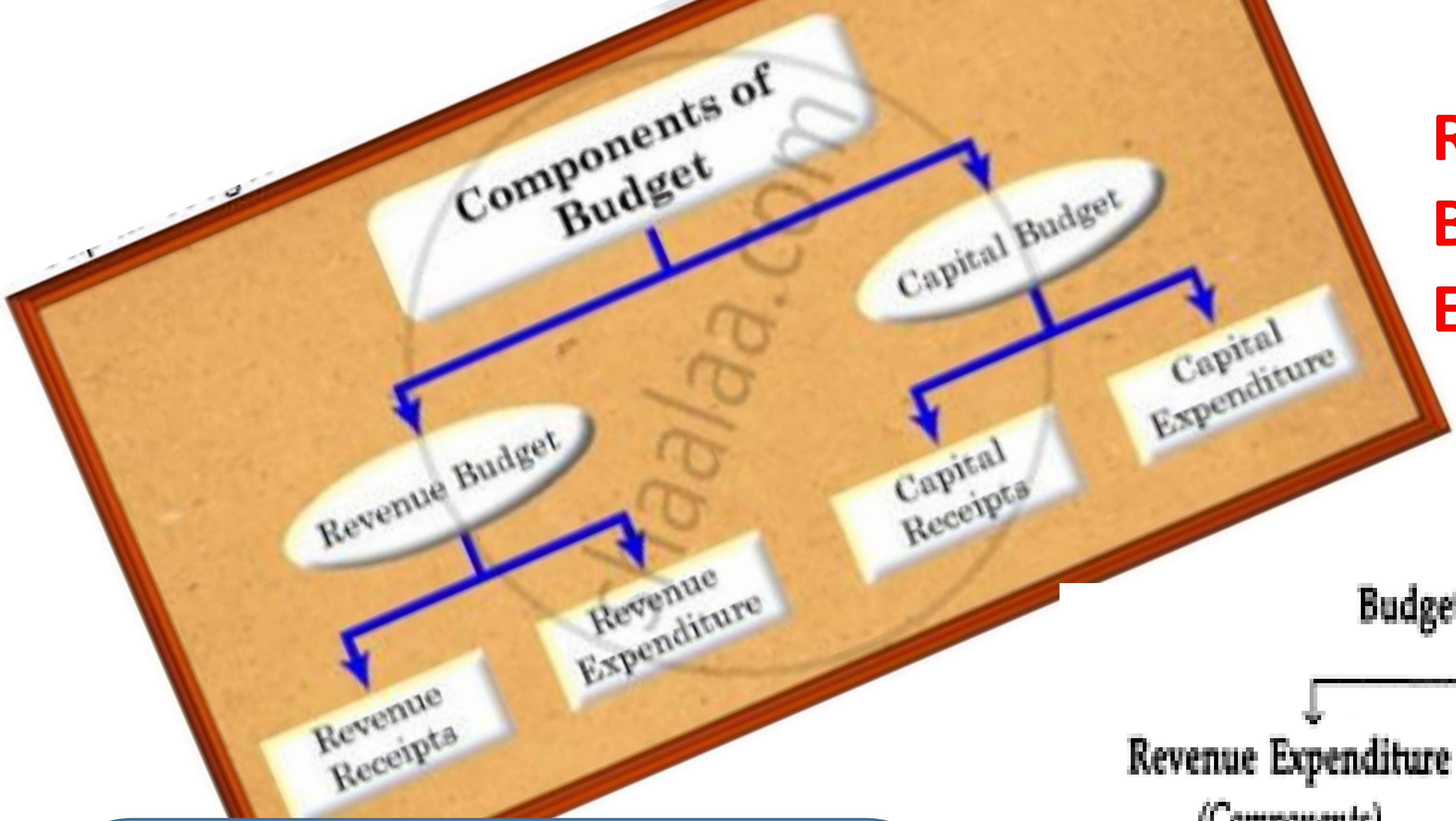
REVENUE BUDGET

CAPITAL BUDGET

Unlike in the US, budgets in India have always been presented separately in revenue and capital accounts



Revenue and Capital Budget: Types of Receipts & Expenditure



Revenue Receipts→ Taxes / Non-Tax Receipts like Fees/ Other Current Receipts

Capital Receipts→ Borrowings on Various Accounts (E.g., Small Savings, PPF), and some Non-Debt Receipts

Budget (Government) Expenditure

Revenue Expenditure
(Components)
(Expenditure which neither creates assets nor reduces liabilities)
(i) Payment of interest
(ii) Payment of salaries and pensions
(iii) Grants and subsidies
(iv) Education and health services
(v) Defence services

Capital Expenditure
(Components)
(Expenditure which creates assets or reduces liabilities)
(i) Construction of roads, bridges, buildings
(ii) Purchase of land and machinery
(iii) Investment in shares
(iv) Loans to states and foreign government
(iv) Repayment of loans

Revenue Receipts / Revenue Expenditure→ Those types of receipts/ spending which do not create or extinguish any liabilities/ assets.

On the other hand, Capital account items typically involve change in the Government's asset-liabilities position.

Examples of Capital A/c Receipts include market loans, external loans, small savings, Government Provident Funds, Accretions to various Deposit Accounts, Depreciation and Reserve Funds of various departments like Railways.

May be Debt / Non-Debt in nature.

Government's Budgetary Transactions: Review of Concepts

Consider the following government transactions.

Suppose the government borrows 30 mn dollars from the IMF

Does this create any asset/ liability?

Is this a Revenue account or Capital account item in the Government Budget?

Government invests Rs. 500 crores in building infrastructure.

Is this a Revenue account or Capital account item?

Does this have any asset/liabilities implications?

Government pays salary to public sector employees

Is this a Revenue account or Capital account transaction?

Any assets/ liabilities implications?

Government receives Income Tax of 50 thousand crores.

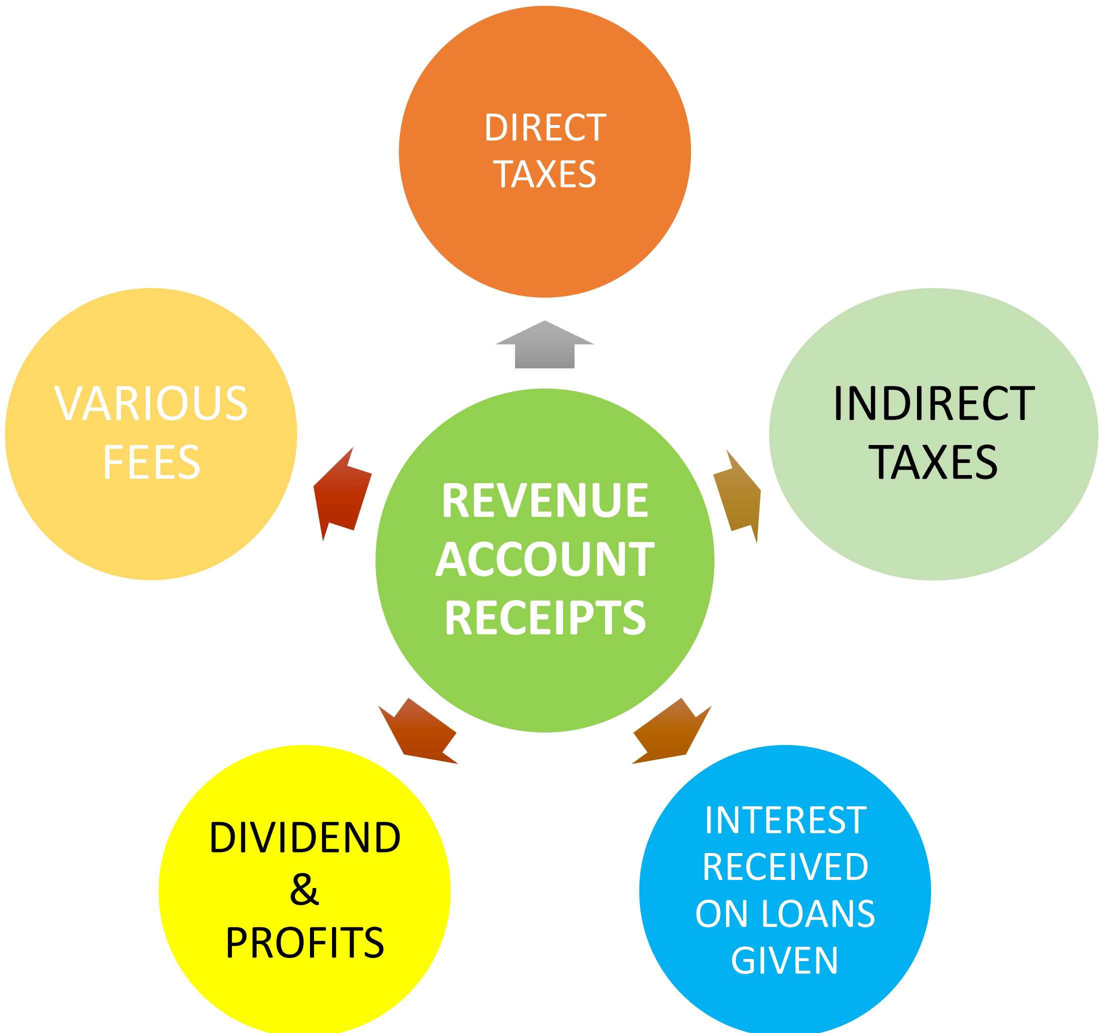
Is this a Revenue account or Capital account item?

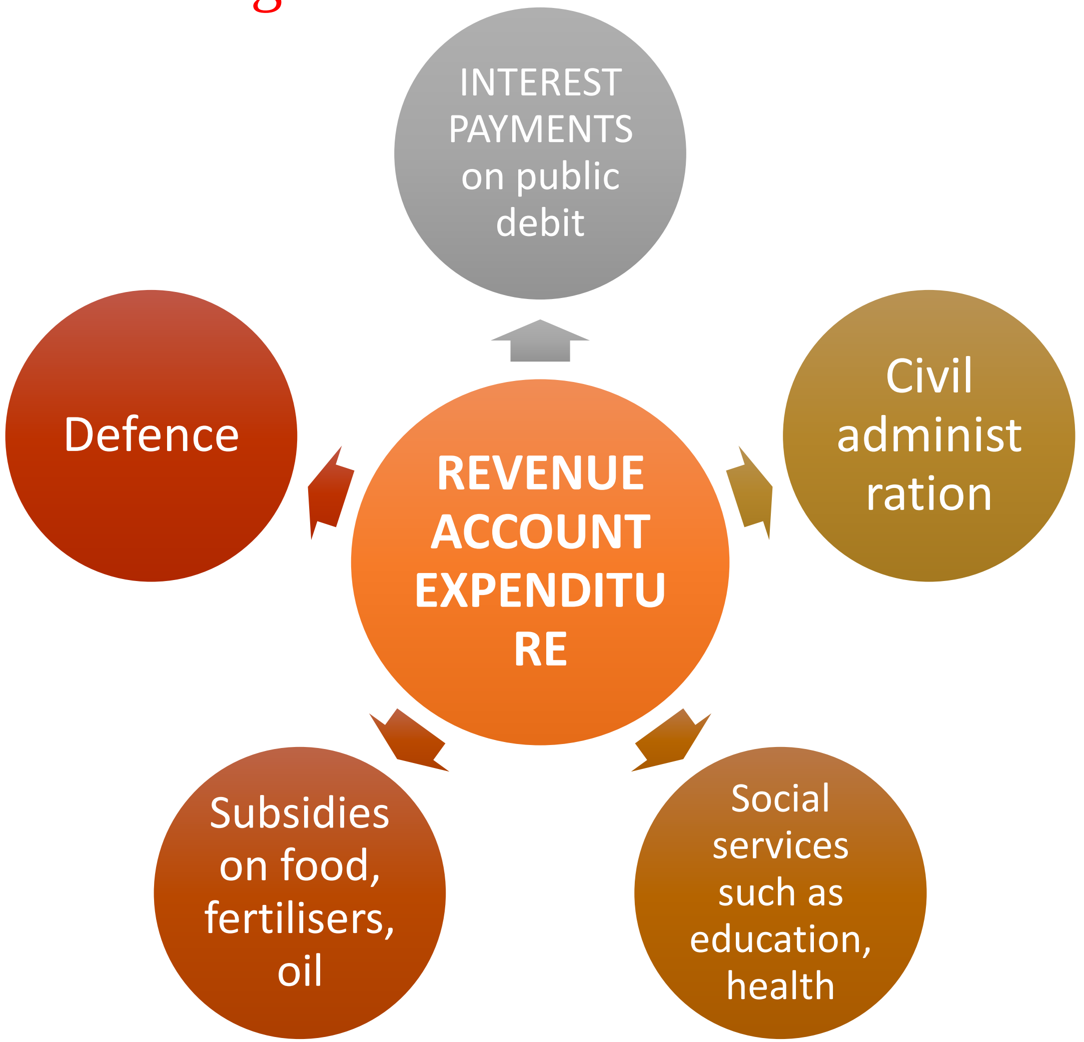
Government receives back repayment of the loan it had given previously.

Is this a Revenue account or Capital account item?

Is this a debt or non-debt item?

- Hence, receipts in the revenue account come from such sources as various types of direct and indirect taxes and also from non-tax sources such as interest received on loans given, dividend and profits of public enterprises.
- The items of expenditure in the revenue account are of the type that represents collective consumption of the society and therefore, creates no earning assets.





Revenue Deficit = Revenue Expenditure – Revenue Receipts

- Surplus on revenue account of the budget represents public or government savings which can be used for financing developmental activities.
- In India, there has been *government dissaving* for the last some years in India. Therefore, borrowed funds from the capital account have been used to meet a part of revenue or consumption expenditure of the government. This has bad consequences for the economy. Revenue deficit as percentage of gross domestic product (GDP) has been quite high in recent years.

India's Fiscal Deficit and Economic Growth

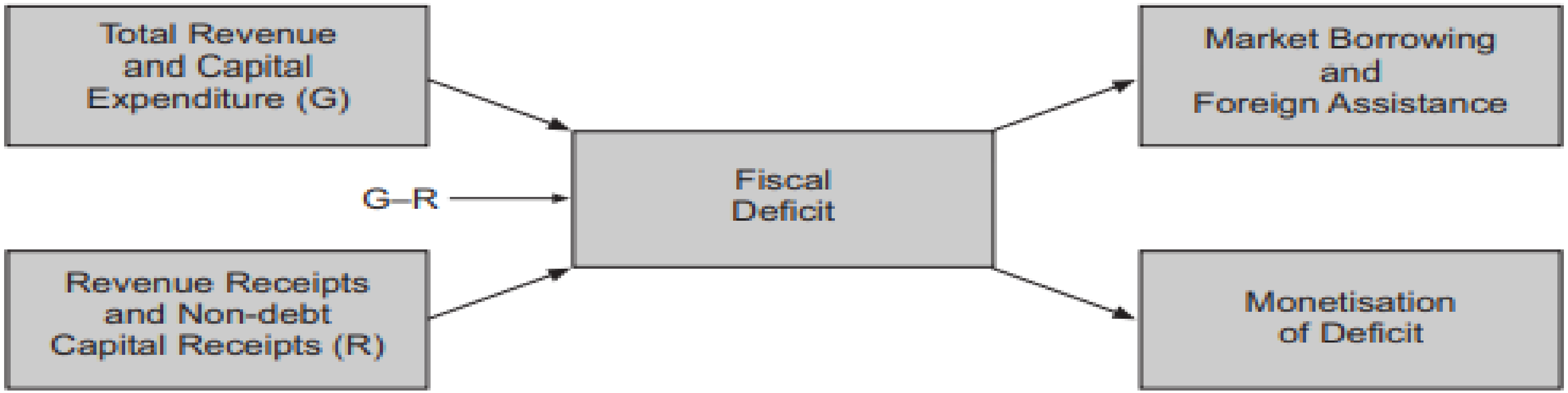


Fig. 33A.1. *Financing of Fiscal Deficit*

FISCAL DEFICIT: MEANING

- From 1991 onwards**,** a measure of the fiscal deficit is being reported in the Indian Budgets, replacing the conventional budget deficit**.** IMF and World Bank generally prescribe targets for budget deficit in terms of fiscal deficit.
- Fiscal deficit is the excess of total expenditure (both on revenue and capital accounts) over revenue receipts and non-debt type of capital receipts such as recoveries of loans.
- When the government's total expenditure, both revenue and capital expenditure, exceeds its receipts from taxes and other normal non-revenue and non-debt capital resources, a fiscal deficit is created.

Fiscal deficit can be financed in two ways:

- **First,** through borrowing by the government from the market, both inside and outside the country.
- **Secondly**, the government can finance the fiscal deficit by borrowing from the Reserve Bank of India which issues new notes against government securities.

Fiscal Deficit = (Total Expenditure both on Revenue Account and Capital Account) – (Revenue Receipts + Non-debt Capital Receipts)

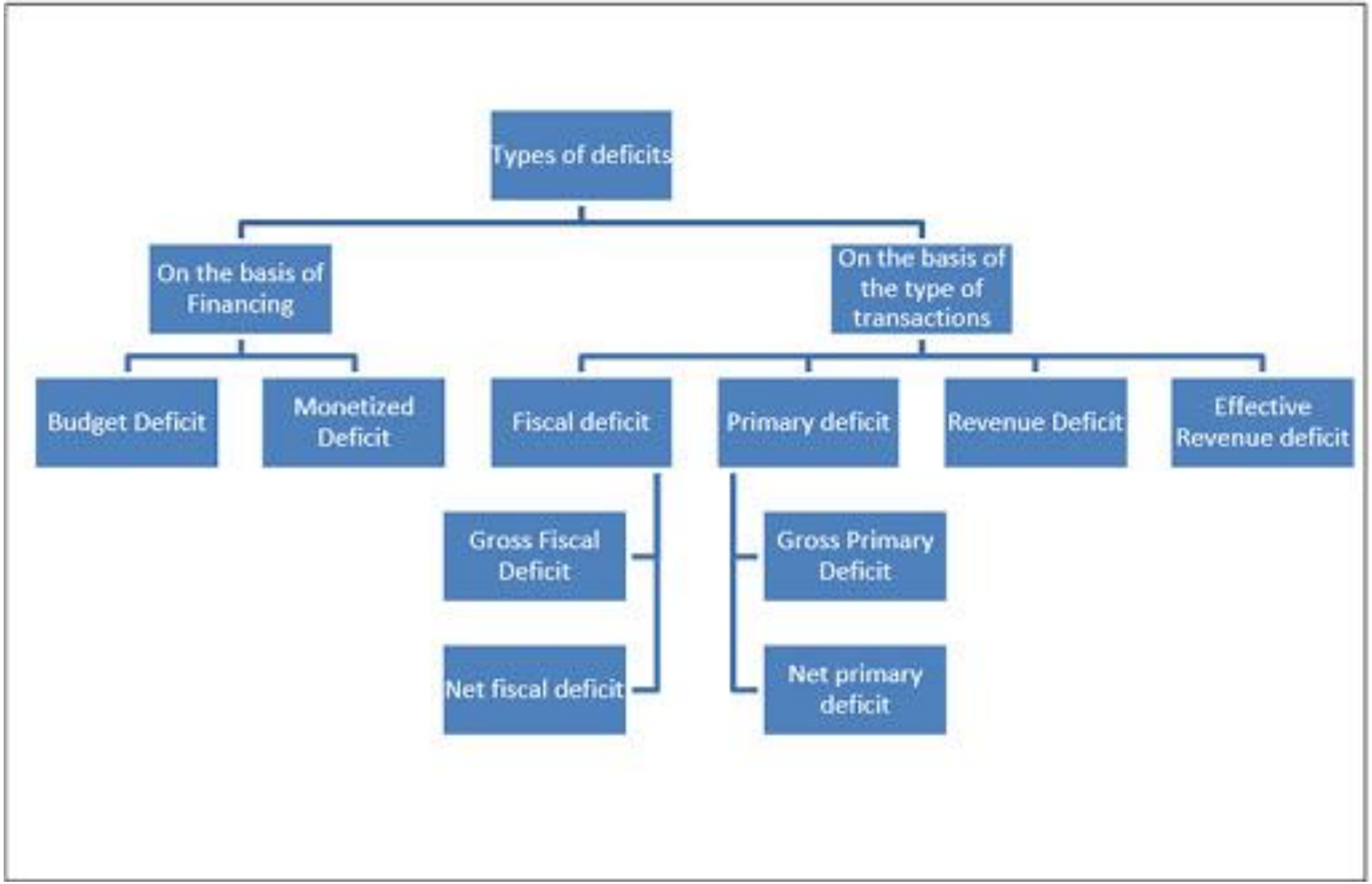
Gross Fiscal Deficit = (Total Expenditure both on Revenue Account and Capital Account) – (Revenue Receipts + Non-debt Capital Receipts)

Net Fiscal Deficit = Gross Fiscal Deficit- Government Net Lendings

Gross (/Net) Primary Deficit = Gross (/Net) Fiscal Deficit- Interest Payments

From 2010-11 budgets, a measure of the "Effective Revenue Deficit" is being reported in the budgets.

Effective Revenue Deficit= Revenue Deficit – Grants for Creation of Capital Assets


Types of deficits
On the basis of Financing
On the basis of the type of transactions
Budget Deficit
Monetized Deficit
Fiscal deficit
Primary deficit
Revenue Deficit
Effective Revenue deficit
Gross Fiscal Deficit
Net fiscal deficit
Gross Primary Deficit
Net primary deficit

Implications of Large Fiscal Deficit.

- A good part of it is financed through borrowing from within and outside the country. This leads to the increase in public debt and its burden.
- **A** part of fiscal deficit is financed through *monetisation* of fiscal deficit which leads to the creation of new money and, therefore, rise in prices or inflation.
- Again, when the fiscal deficit is financed by borrowings, or drawing on the private sector's savings, if the government's intended borrowing exceeds the private sector's willingness to spare, the fiscal deficit will create excess demand.
- Aggregate demand in the economy would be in excess of the supply of goods and services, resulting in a combination of price rise and a wider current account deficit (CAD), which can be contained only by reigning in fiscal deficit.

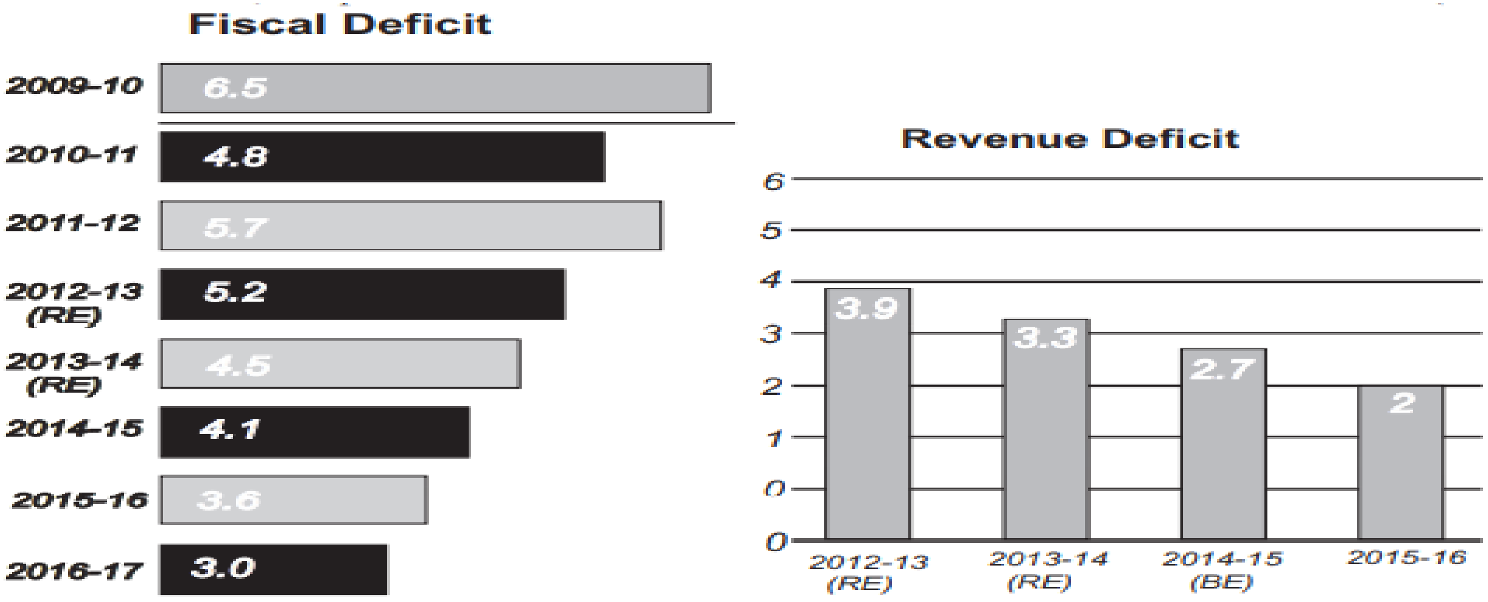


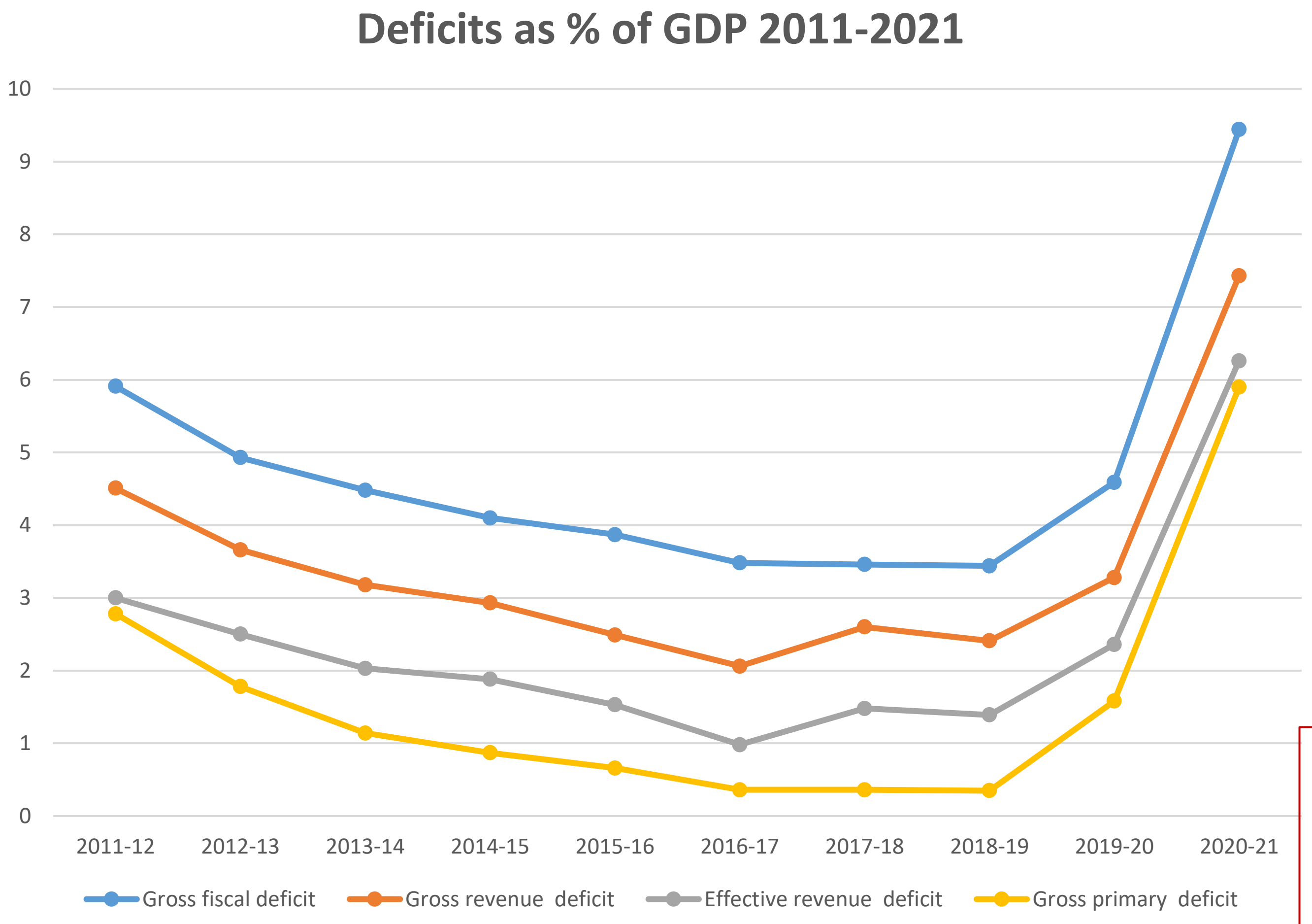
Fig. 33A.2. *Roadmap of Reduction in Fiscal and Revenue Deficits as per cent of GDP*

- To keep inflation under control and achieve price stability, IMF and World Bank have recommended that fiscal deficit of central government in India should be reduced to 3 per cent of GDP in a phased manner.

Recent Scenario: Central Government Deficits as % GDP: 2016-17 to 2020-21

Year	Gross Fiscal Deficit	Revenue Deficit	Effective Revenue Deficit	Gross Primary Deficit
2007-08	2.59	1.07		-0.9
2008-09	6.11	4.6		2.63
2009-10	6.57	5.32		3.23
2016-17	3.48	2.06	0.98	0.36
2017-18	3.46	2.6	1.48	0.36
2018-19	3.44	2.41	1.39	0.35
2019-20	4.59	3.28	2.36	1.58
2020-21	9.44	7.43	6.26	5.9

Source: Centre for Monitoring Indian Economy (CMIE), March 2021



All deficit-GDP ratios, which had been showing a downward trend till 2019, rose inexorably over 2020 following the covid-19 Pandemic.

Source: Based on Centre for Monitoring Indian Economy (CMIE), March 2021

- A large revenue deficit adversely affects economic growth. A high revenue deficit implies that the larger part of borrowed funds is being used by the Government to finance current consumption expenditure, leaving smaller resources for productive investment in infrastructure and social capital (i.e., education and health).
- This lowers the rate of economic growth.
- Lastly, more borrowing by the Government leaves less resources for private sector investment.

In India, to reduce fiscal deficit of the central government to 3 per cent, requires a drastic cut in non-productive revenue expenditure, which is a difficult task.

- In attempting to reduce fiscal deficit, the axe has often fallen on capital expenditure, which is incurred on projects of capital formation and other developmental activities. But this adversely affects economic growth, and is clearly not a desirable way of reducing fiscal deficit.
- *For sound management of Government finances there is need to cut revenue expenditure and raise revenue receipts by mobilising resources through taxation.*

Primary Deficit

Primary Deficit = Fiscal Deficit – Interest Payments

- Primary deficit is the measure of budget deficit obtained by deducting interest payments from fiscal deficit.
- Interest payments on public debt are transfer payments made by the government. The difference between the fiscal deficit and primary deficit shows the importance of interest payments on public debt incurred in the past. Huge interest payments are very largely responsible for causing a large fiscal deficit.
- The higher interest payments on the past borrowings by the Government has greatly increased the fiscal deficit. Therefore, primary deficit is much lower than the fiscal deficit.

Monetisation of Fiscal Deficit

- When the Reserve Bank finances the fiscal deficit by issuing new money against government securities (in other words, when the government finances the fiscal deficit through borrowing from the Reserve Bank), it is called monetisation of fiscal deficit or money financing.

MEASURES FOR FISCAL CONSOLIDATION.

- The term fiscal consolidation means raising more resources and cutting government expenditure so as to reduce fiscal deficit to a reasonable level.

- ***To check the inflationary consequences of fiscal deficit, it has to be reduced through both raising revenue of the government and reducing government expenditure***

Measures to Reduce Public Expenditure.

In August, 2015, an expenditure commission under the chairmanship of Dr Bimal Jalan was appointed by Government to suggest measures to reduce public expenditure, especially on subsidies. The Committee recommended the following:

1. A drastic reduction in expenditure on major subsidies such as food, fertilisers, and petroleum products which caused a huge drain on government resources.
2. Cutting back on the huge expenditure by the government on LTC (Leave Travelling Concessions), bonus, leave encashment etc.
3. Reduction of interest payments on past debt. In India, interest payments account for about 40 per cent of expenditure on revenue account of the central government. Funds raised through disinvestment in the public sector should be used to retire a part of old public debt rather than financing current expenditure.
4. Budgetary support to public sector enterprises other than infrastructure projects should be substantially reduced.
5. Austerity measures should be adopted to curtail non-plan expenditure in all government departments

Increasing Revenue from Taxation

To reduce fiscal deficit and thereby check rise in inflation rate, apart from reducing government expenditure, government revenue has to be raised.

- To increase public revenue , moderate taxes with simple tax structure needs to be followed.
- High marginal rates of taxes should be avoided as they serve as disincentives to work more, save more and invest more and high marginal rates of direct taxes cause evasion of taxes.
- To increase revenue from taxation, tax base should be broadened by taxing agricultural incomes and incomes derived from unorganised industrial and services sectors. The various exemptions and deductions provided in the income and wealth taxes should be withdrawn to broaden the tax base and collect more revenue.
- The current huge black money through tax evasion that is generated every year has to be prevented by strict enforcement of the tax laws.
- Past experience has shown that various tax concessions which have been given in income and indirect taxes for promoting employment, industrial development of backward regions and for other such social objectives do not actually serve the intended purposes and are largely used for evading taxes.
- *These concessions should therefore be withdrawn to collect more revenue from taxes and the social objectives should be served by adopting more effective policy instruments.*
- Lastly, there should be restructuring of public sector enterprises so that they should make some surpluses at least for their own growth so that their dependence on government's budgetary resources should be dispensed with. For this purpose, their pricing policy should be such that it recovers at least user cost