Fiscal Deficit

Reading :Depak Dasgupta and Supriyo De(2012),

- Definitions
- Major sources of financing fiscal deficit
- India’s fiscal deficit stages
- Lessons learned and challenges.

- Fiscal deficit : is the difference between governments total expenditure (revenue expenditure + capital expenditure) and its total receipt (revenue receipts + capital receipts{excluding debt creating receipts}).
- Fiscal Deficit Gross Fiscal Deficit(GFD) is defined as the excess of total expenditure of the government over the total non-debt creating receipts.
- Net Fiscal deficit : gross fiscal deficit – net lending by government
- Revenue deficit : revenue expenditure – revenue receipts
- Primary deficit : gross fiscal deficit – Interest payments.

Gross fiscal deficit is **financed** majorly from :

- Borrowing from central bank by printing new currency.

If government finances deficit through creating money it is an ‘inflation tax’ because monetization will lead to higher inflation.

- Raising reserve requirement for banks.

If the government forces banks to hold more securities , the impact is of taxing financial intermediates.

- By domestic market borrowing.

Borrowing from markets could lead to ‘crowing out’ of private investment.

- External borrowing

It would be impacted by capital inflows, exchange rate changes etc.

Effects of financing fiscal deficit.

- Fiscal deficit = Total expenditure – Total receipts excluding borrowings = Borrowing
- Fiscal deficit shows the borrowing requirements of the government during the budget year.
- Financing fiscal deficit by these options create vulnerabilities and it is not easy to sustain such a high debt as it involves high interest cost and rates rise with high deficits and debts
- So Government has to reduce fiscal deficit and debts during its good times.
- Effectiveness of the public spending is sustainability of fiscal deficit, that is whether such spending generates higher social and economic rates of return than the cost of borrowing and crowds in rather than crowds out private spending and growth.

India’s fiscal deficit(studied in five different phases)

Phase 1: The first three decades after independence

- Fiscal deficit remained manageable and largely current receipts were used to finance current expenditure and capital expenditure was usually financed by relatively limited borrowings.
- Despite the rapid increase in expenditure due to growth in public sector, the GFD of centre and states generally did not exceed 4 percentage of GDP.
- In 1973-94 the central government even had revenue surplus of 0.36 percentage of GDP and GFD at 2.61 percentage of GDP
- However by 1978-79 due to oil shocks to India the revenue surplus fell to 0.26 percentage of GDP fiscal deficit increased to 5.13 percentage.

Phase 2: Fiscal deterioration of the 1980's

- Public expenditure grew rapidly while revenue did not rise.
- The combined gross fiscal deficit grew and reached record high of 9.78 percentage in 1986-87, while the centres gross fiscal deficit was 8.37 percentage the same year.
- Increasing revenue deficit were the reasons as revenue deficit reached 2.48 percentage in 1988-89
- Capital expenditure were squeezed as interest payments took a large share of expenditure.
- Deficits was being monitzed with persistently high inflation.
- All these factors paved the way for 1990-91 crises.
- Other factors that contributed to crisis was gulf war which caused a jump in oil bill.

Phase 3: Resurgence of Deficits in 1990's

- Wide ranging reforms were undertaken by new government after 1990-91 crisis like opening up the economy and measures to spur private investment by dismantling the 'licence-raj' system.

- Fiscal reforms include (i)stopping of automatic monetisation of deficit, reducing inflation and shifting to domestic market borrowings (ii)cutting back on current spending, while improving tax administration.

- The initial measures were favourable as the combined GFD fell to 6.28 percentage by 1996-97 and inflation was moderated at 5 percentage.

- However the combined GFD of centre and states peaked to 9.86 percentage in 2001-02 majorly due to soaring state government deficit.

- The result was sharp increase in the combined debt-GDP ratio which exceeded 80 percentage of GDP.

- The impact on balance of payments was modest and the situation was very different from 1990-91 crisis due to rapid increase in exports(including services) as well as remittances.

- Nevertheless there are large fiscal deficits and raising debts much of it because of rising revenue deficit to finance current spending and raising interest rates.

- Revenue deficit majorly due to pay revision following recommendations of fifth pay commission and there were raising subsidy bills especially due to electricity utilities at state level and food, fertiliser, and fuel at central level.

Phase 4: Successful fiscal consolidation from 2003 till 2007-08

- Political consensus was achieved on improving target based fiscal management.

- Several fiscal reforms were taken, firstly central Fiscal Responsibility and Budget Management Act was enacted in August 2003. It mandated a reduction in fiscal and revenue deficits. The expenditure on subsidies and other current spending was much tightly constrained with FRBM Act.

- Secondly value added tax (VAT) was agreed and adopted by 2004.

- Third reform include measures adopted to improve tax administration and widen the tax base especially with electronic information systems.
- Under the rule based targeting of FRBM Act, the annual minimum revenue deficit reduction at centre was targeted at 0.5 percentage and annual fiscal deficit reduction was targeted at 0.3 percentage of GDP.

- The results were evident, the fiscal year 2007-08 was the ‘golden year’ of fiscal discipline with central governments GDP being bought down to 2.56 and revenue deficits to 1.06 percentage of GDP. The combined debt-GDP ratio was lowered by 10 percentage points during the same year.

Phase 5: Global Financial crisis and Counter-Cyclical fiscal policy.

- Since India was much better placed in in 2008-09 it had more room for counter-cyclical actions.
- Several global financial crisis contributed to fiscal actions that reversed the previous trends of fiscal consolidation.
- In 2008-09 central government planned expansionary fiscal measures like expansion of National Rural Employment Guarantee Act, and additional subsidies and farm loan waivers.
- As a result the combined gross fiscal deficit shot up to 8.5 percentage of GDP in 2008-09 where the centres GFD went up to 6.05 percentage with revenue deficit of 4.55 percentage of GDP.
- The most important impact of this sharp expansion in fiscal spending and reduced taxes, estimated at over 3 percentage of GDP, was to set up a floor to the dropping India's growth due to global crisis. In the event, the GDP growth was moderated at about 6.8 percentage in 2008-09 a much smaller decline than feared, thanks to counter-cyclical fiscal actions as well as monetary policies that cut policy rates and injected large liquidity.
- Two challenged for policy makers are to maintain the growth recovery and also to moderate inflation which short up to 11 percentage in 2009-10 in the wake of severe drought.
- The government announced a fiscal consolidation path largely with the recommendations of thirteenth finance commission.
- With faster growth, disinvestments and enhanced proceeds from new rounds of 3G telecommunications spectrum licences and broadband helped in faster reduction of fiscal defict than planned to 4.7 percentage.

Lessons learned and challenges:

- Fiscal consolidation matters and it delivers better results in terms of faster growth, lower inflation and more spending ability.

- The raising revenue through broadening of tax base, lowering and simplified tax rates, reducing exemptions and improving tax administration can work very efficiently.

- The important role for counter-cyclical fiscal policy and related to that, the ability to quickly revert back to fiscal prudence once the goal of stabilization has been achieved.

- The success private provision of public services especially in physical infrastructure.

- Some things have not been fully resolved. These are realization of public spending on welfare activities and subsidies characterized by ‘leakages’ . Reforms have begun towards targeting with more reliable technology and shift towards cash based, rather than kind-based.
- Second challenge is how to price public services better everything from water, to power, fuel, fertilizers and other public services, such as tertiary education and healthcare.
- The third challenge is improving service delivery and accountability by decentralizing public services and related budgets and budgetary management.