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INDIA'S FISCAL DEFICIT-CAUSES, TRENDS AND IMPLICATIONS

Introduction

In economic terms, a deficit is an excess of expenditure over revenue in a given period of time. In public finance, fiscal deficit is the difference between the Government's expenditures and its revenues. A country's fiscal deficit is usually communicated as a percentage of its Gross Domestic Product (GDP).

Fiscal Deficit is considered as a relatively more comprehensive indicator of the Government's deficit. This is the sum of revenue expenditure and capital expenditure less all revenue receipts and capital receipts other than loans taken*. This gives a more holistic view of the Government's funding situation.

A reasonable level of fiscal deficit is regarded by some as a positive economic event. This is because, a fiscal deficit means that Government is spending more and a greater amount of Government spending on various social and welfare schemes will give a stimulus to growth and push demand. This, in normal situations, will lead to growth of the economy as production increases to meet the demand. On the other hand, fiscal conservatives feel that Governments should avoid deficits in favour of a balanced budget policy. However, the problem arises when the fiscal deficit becomes unmanageable or is wrongly timed.

The Government takes various policy measures in order to meet its expenditures in excess of revenues. This is popularly known as 'deficit financing' by the Government. Deficit financing is considered as a necessary evil in a welfare State such as ours as the State often fails to generate sufficient tax revenues to take care of its expenses. Deficit financing allows the State to undertake activities which, otherwise, would be beyond its financial capacity. The basic intention behind deficit financing is to provide the necessary impetus to economic growth by artificial means.

Causes of Fiscal Deficit

Given the developing nature of the Indian economy, while there had been consistently high demand for resources from the various sectors of economy over the years, the capacity of these sectors to produce revenue had a limited scope. In order to facilitate balanced development across the country, the Government had initiated various developmental schemes which consumed, and still continue to consume, a huge amount of resources. Further, ours being a welfare State, the Government owns the responsibility for equitable development of all the sections of society and to meet this objective, various welfare schemes involving huge outlays had to be implemented over the decades. This remained one of the important causes behind imbalance in the Government budget. Rising crude oil imports together with upward trending oil prices further added to India's financial woes. Since, India is almost totally dependent on imports for its crude oil requirements, oil import bills create considerable burden on the exchequer. Besides, the sky-rocketing demand for gold in the country is another important factor behind the Current Account Deficit in India.

*Note:(i) **Revenue Expenditure:** Revenue expenditure refers to expenditure concerned with the cost of doing business/ activities by the Government on a day-to-day basis. They also include interest payments, subsidies and defence expenditure.

(ii) **Capital Expenditure:** Capital expenditure refers to expenditure concerned with the money invested by the Government either to buy fixed assets or to add to the value of the existing fixed assets.

(iii) **Revenue Receipts:** It is revenue without any liability. Revenue receipts of the Government include earning from tax and non-tax incomes.

(iv) **Capital Receipts:** Capital receipts are the funds received by the Government that are not part of its operating activities. They include recovery of loans, receipts from disinvestment, etc.

Huge Government borrowing resulting in high interest payments is also a major factor behind high fiscal deficit in India. Since the gap between the Government expenditures and revenues is financed through loans, both internal and external, the internal and external debts of the Government have increased considerably during the past few decades and a major component of the Government expenditure constitutes the interest payments both on domestic loans and foreign loans.

While the increase in Government expenditure has been the major cause of fiscal imbalance, inadequate rise in revenue receipts also contributed to fiscal imbalance. Over the years, the revenue receipts of the Union Government, consisting of tax revenue and non-tax revenue have increased at slower rate than that of the growth in expenditure. Further, the complex tax system and numerous exemptions lead to tax evasion and hence less collection. In India, weaker sections constitute a large proportion of population and as a welfare measure, the Government has been providing subsidies on a number of items such as fertilizers, exports, food items, etc. Over the years, this has further resulted in a fiscal imbalance causing an increase in fiscal deficit.

In India, the Government has limited scope to reduce defence budget due to security problems across the borders. Therefore, the defence expenditure has increased manifold over the years. Higher proportion of committed expenditure regarding pension payment, establishment cost, interest payment, which is mostly unproductive in nature, have remained important reasons behind the high fiscal deficit in India. The relatively poor performance of some of the public sector undertakings over the years has also resulted in fiscal imbalance. The poor performance of the public sector undertakings has been due to various reasons such as inefficiency, poor management, low labour efficiency, lack of professionalism, surplus staff, etc. On the one hand, due to poor performance of the public sector undertakings, the Government received low revenue by way of dividend from them and, on the other hand, it had to spend huge amount of money to maintain the poorly performing undertakings in running condition.

The trend of India's Fiscal Deficit since 1995-96 has been as under:

Year	Fiscal Deficit (% of GDP)
1995-96	5.9
1996-97	5.2
1997-98	5.7
1998-99	6.4
1999-2000	5.4
2000-01	5.7
2001-02	6.1
2002-03	5.3
2003-04	4.5
2004-05	4.0
2005-06	4.1
2006-07	3.5
2007-08	2.7
2008-09	6.2
2009-10	6.8
2010-11	4.9
2011-12	5.8
2012-13 (Provisional)	4.9
2013-14 (Revised Estimates)	4.6

Fiscal Deficit since 1995-96

Implications of Fiscal Deficit

Implications of fiscal deficit vary with the level of deficit and the nature of the activities, *i.e.*, productive or unproductive financed using it. As mentioned earlier, a reasonable level of fiscal deficit is regarded by some as a positive economic event. This is because, a fiscal deficit means that the Government is spending more and a reasonable spending on various social and welfare schemes gives a stimulus to growth and in normal situations, it leads to growth of the economy. Whereas high fiscal deficits, leading to unsustainable levels of public debt, can cause diverse forms of macro-economic imbalances varying with the means through which the deficit is financed. High fiscal deficits tend to heighten inflation, reduce room for monetary policy stimulus, increase the risk of external sector imbalances and dampen private investment, growth and employment.

High fiscal deficit results in 'Debt Trap'. The Government has to borrow additional funds to solve the problem of fiscal deficit, which puts extra burden on the Government for payment of interest. Thus, increasing non-productive expenditures give rise to higher and higher revenue deficits and, consequently, result in higher fiscal deficit. Because debt service payments form a higher proportion of expenditures, all other public activities of the Government suffer. The main sufferer in this process is Government's capital expenditure in both economic and social infrastructure.

The continued high level of public borrowings has an effect on the rest of the economy through prevalence of high interest rates. The Government may borrow money at high interest rates intending to spend it for boosting economic growth. But doing so in an already high fiscal deficit scenario leads to high interest rate regime which creates a negative impact on the economy as it not only discourages the domestic investors but also leads to outflow of foreign capital. Thus, a fiscal imbalance is created which adversely affects economic growth.

Apart from this, the consequences of not quickly taking credible and effective measures for correcting the fiscal deficit may result in sovereign credit downgrade and, resultantly, flight of foreign capital. As these sovereign ratings are seen as the indicators of economic health of a nation, a downgrade of rating will mean further reduction in investments by foreign companies and agencies in India. This will invariably further weaken the rupee and negatively impact the capital markets and the banking sector. In addition, the situation leaves little head room for counter-cyclical policy measures in the event of financial crisis.

The growing fiscal deficit also leaves limited monetary space for lowering interest rates to stimulate private investment and growth. In a country where millions of young, both skilled and unskilled, enter the labour force each year, a growth slowdown leads to inefficiency, inequality and destabilization. It is the poor and the unemployed who suffer the most in the event of sluggish growth and consequent economic instability. Higher fiscal deficit also has adverse impact on cost of production, savings, balance of payments, etc. It exacerbates inflation and impedes monetary policy transmission.

Government Policy about Fiscal Deficit

Right from the era of planned economic development, the main instruments used by the Government to finance its deficits were through Reserve Bank of India's books either by printing more money or use of its foreign exchange reserves, or through market borrowings (both internal and external). After 1991 financial reforms, in order to make inflation policy more effective, the way of deficit financing by printing more money by RBI has become ineffective and the main instruments for deficit financing in the post reform era is through market borrowings (both internal and external).

The year 1990-91 saw substantial deterioration in the above mentioned fiscal indicators, culminating in the Balance of Payment (BoP) crisis of 1991. The Government of India had to initiate fiscal consolidation programme to enable it to achieve a sharp fiscal correction in terms of improvement in deficit indicators during the first half of 1990s. However, fiscal slippages in the second half of the decade made it obligatory to further strengthen fiscal measures so as to ensure that the negative fiscal position did not impede the growth path in the long run. In view of these fiscal developments and to imbibe good fiscal practices, the Government of India has adopted a rule-based Fiscal Charter by legislating the Fiscal Responsibility and Budget Management Act in 2003.

The Fiscal Responsibility and Budget Management (FRBM) Act was enacted to check deteriorating fiscal conditions, to institutionalize financial discipline, and to improve macro-economic management and the overall management of the public funds by moving towards a balanced budget. The objective of the Fiscal Responsibility and Budget Management Act is to ensure inter-generational equity in fiscal management, long run macroeconomic stability, better coordination between fiscal and monetary policies, and transparency in fiscal operations of the Government.

The FRBM Act provides a legal institutional framework for fiscal consolidation. It is now mandatory for the Central Government to take measures to reduce fiscal deficit, to eliminate revenue deficit and to generate revenue surplus in the subsequent years. The Act also requires the Government to lay before the Parliament three policy statements in each financial year, namely, Medium Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macro-economic Framework Policy Statement.

While India was riding on the path of fiscal consolidation and high GDP growth, the world economy was hit by three unprecedented crises in 2008—first, the

petroleum price rise; second, rise in prices of other commodities; and third, the breakdown of the financial system in developed economies. The reasons for the crises did not emanate from within the boundaries of emerging market economies; however, the combined effect of these crises posed serious threats to emerging market economies including India. Accordingly, the focus of fiscal policy had to be shifted towards providing growth stimulus. This resulted in moving away from the path of fiscal consolidation for temporary period and the fiscal consolidation as mandated in the FRBM Act was put on hold in 2007-08.

In August 2012, the Government appointed a Committee under the Chairmanship of Dr. Vijay Kelkar to suggest a roadmap for fiscal consolidation. The Government accepted several recommendations of the Kelkar Committee on fiscal consolidation and initiated steps to implement them with a view to bridging the revenue-expenditure gap. The Government of India has introduced the 'Medium-Term Expenditure Framework Statement', setting forth a three-year rolling target for expenditure indicators with a view to undertaking a *de-novo* exercise for allocating resources for prioritized schemes and weeding out others that have outlived their utility. It would also encourage efficiencies in expenditure management. Government is also endeavouring to restrict the expenditure on Central subsidies to eliminate this deficit.

Recent Developments

Fiscal developments during 2012-13 were split into two halves—first half and second half. The period of the first half of 2012-13 was characterised by a fiscal slippage to a degree. However, mid-year course correction following fiscal consolidation measures resulted in fiscal corrections in second half of 2012-13. Consequently, Gross Fiscal Deficit (GFD) was contained at 4.9 per cent of GFD in 2012-13 showing marked improvement from 5.8 per cent in 2011-12. The containment of GFD in 2012-13 in the face of a shortfall in tax and non-tax revenue was largely brought about by rationalization of expenditure. The planned reduction of GFD to 4.6 per cent of GDP in 2013-14 (RE) is expected to be achieved through higher mobilization of disinvestment proceeds, tax revenue, telecommunication receipts and rationalization of expenditure. However, revenue-led fiscal consolidation would depend on the revival of disinvestment climate and growth.

On the expenditure side, both capital and plan expenditures are budgeted for a sharp rise in 2013-14. The re-prioritisation of expenditure in favour of capital expenditure indicates an increase in the capital outlay to GFD ratio to 36.39 per cent in 2013-14 (RE) from 34.01 per cent in 2012-13 (Provisional). Although plan expenditure in 2013-14 is budgeted higher, the budgetary support extended to Central Plan Outlay during the first two years of the plan (*i.e.*, 2012-13 and 2013-14) works out to only 24.4 per cent of the total budgetary support envisaged for the entire five-year period of the Twelfth Five Year Plan.

A positive feature on the non-plan expenditure front is the envisaged containment of expenditure on subsidies at 2 per cent of GDP in 2013-14. However, while the phased deregulation in diesel prices would help keep the fuel subsidy under control, the volatility in the exchange rate may exert upward pressure on fuel and fertilizer subsidies in 2013-14. The under-recoveries of oil companies have risen sharply due to exchange rate depreciation and a rise in global crude oil prices, combined with lagged adjustment of prices and vestiges of administered price mechanisms prevailing in the sector. While the impact of National Food Security Act on the food subsidies is manageable for 2013-14, in the years to come it will add to the fiscal pressures. The key concern is that it is difficult to contain food subsidies within budgeted amount even in 2013-14 with the implementation of the Food Security Act.

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