FISCAL DEFICIT

Sridhar Kundu

Fiscal Deficit refers to a gap in government's budget; a gap that arises in any financial year when the government's total expenditure exceeds its total income in that year and consequently it borrows money to cover that gap. Although the term 'income' is not used in the context of government's budget, the more accurate term being 'receipts', there are various kinds of receipts which the government does not have to repay (e.g. tax revenue, revenue from fees / service charges / penalties, proceeds from disinvestment, and recovery of loans given earlier to other entities) and hence they are in the nature of its income. Money borrowed for covering the Fiscal Deficit (i.e. debt) is also a receipt for the government, but the same has to be repaid.

Fiscal Deficit in a government's budget is not necessarily bad for the economy. In fact, according to many economists, Fiscal Deficit, or borrowing by the government, is an integral part of fiscal policy and hence is inevitable. We must note here that unlike the budgets of individuals or households (where income determines our expenditure), in the government budget – it's the expenditure commitments that should determine its income (i.e. tax revenue and other receipts, which don't have to be repaid) and the amount to be borrowed (if needed). Borrowing by the government does not necessarily induce any adverse effect on the state of the economy (i.e. on investment, production, employment and prices etc.); on the contrary, in some cases (for instance, when there is a problem of inadequate demand in the economy for goods and services), higher government expenditure, financed by borrowing, can have a favourable effect on the economy. Recently, during 2009-10 and 2010-11, the Union Government's borrowing was increased, i.e. the Fiscal Deficit was higher than the previous financial years, as the government wanted to follow a number of fiscal policy measures (like, higher spending on infrastructure, higher spending in rural areas, greater concessions in taxes and hence lower tax revenue) to boost economic activities in the country to deal with the impact of the global financial crisis.

However, many economists and policy analysts do raise a concern when the level of borrowing by the government, i.e. the magnitude of its Fiscal Deficit in any financial year, is considered to be 'too high'. Although it is difficult to define what level of government borrowing is 'too high', as it would depend on the context in which the government is borrowing and the purpose of such borrowing, high levels of borrowing over the years do increase the accumulated stock of debt of the government and the latter could be perceived by some people as 'unsustainable'. Hence, 'very high' levels of Fiscal Deficit over the years could be a matter of concern for a country, depending on a number of factors. Such concerns have been expressed in the Indian context by a section of the economists and policymakers and the government (particularly the Union Government) has been urged to cut down the magnitude of its Fiscal Deficit.

The concept of Fiscal Deficit explained earlier is technically referred to as the Gross Fiscal Deficit (GFD); there is also a concept of Net Fiscal Deficit (NFD), which is smaller than the GFD since in the calculation of the NFD the net lending by the government in the financial year concerned is excluded from the total expenditure. In this article, all figures for Fiscal Deficit, which would be mentioned in the following, are the figures for GFD. For the financial year 2012-13, the Union Government's / Centre's Fiscal Deficit stood at 5.2 % of GDP while that of all States combined was 2.1 % of GDP. The combined Fiscal Deficit of the Centre and all States stood at 7.25 % of GDP in 2012-13. The Centre includes the Union Government and Union Territories, while the States include 28 State Governments. In 1990-91, the combined Fiscal Deficit of the Centre and States was over 9 % of GDP. Over the last two decades, the combined Fiscal Deficit of 4 % of GDP for 2007-08 has been one of the lowest.

As explained at the outset, deficit is a gap in the government budget, and it is covered by borrowing or taking debt. However, the total borrowing or debt taken by the government in a financial year could be more than the level of the Fiscal Deficit; this is because some of the financial liabilities (or amounts that have to be repaid) under government designed mechanisms like National Small Savings Fund (NSSF) and Market Stabilization Scheme (MSS) do not come under Fiscal Deficit (as those mechanisms operate outside the government budget) but those are considered to be the government's liabilities or debt.

The Central and State Governments in India both finance their deficits mostly through borrowing from domestic sources. Until 1997, the Centre also had the exclusive right of printing currency notes (through the Reserve Bank of India) to finance a part of its Fiscal Deficit; however, this mechanism has been discontinued since then for its possible inflationary implications. Thus, at present, the government covers the Fiscal Deficit primarily through market borrowings. The Centre can also borrow from external sources, which the State Governments are not entitled to do. On the other hand, the States can raise some resources through loans from the Centre for financing their deficit. Since 1999-2000, the State Governments are also generating some funds for financing their deficit by issuing special securities to NSSF.

Both the Centre's and the State Governments' Fiscal Deficits are influenced to some extent by the international market dynamics. India is a large importer of crude oil; rise in oil prices in international market raises the domestic price level and the government steps in to check the domestic prices by increasing the subsidy expenditure on oil and thus incurs a higher Fiscal Deficit. Secondly, volatility in currency market also puts pressure on domestic prices.

Depreciation of domestic currency increases the import bills for a number of goods besides crude oil. In such a scenario, the higher import costs of certain goods might also lead to a higher than estimated level of expenditure by the government and hence a higher Fiscal Deficit.

Since 2004-05, the Fiscal Responsibility and Budget Management (FRBM) Act has been serving as a legal check on the level of government borrowing at the Central level and similar FRBM legislations have also been put in place in all States in the subsequent years. In addition to these, the recommendations of the last three Finance Commissions (i.e. 11^{th}, 12^{th} and 13^{th}) have also required both the Centre and States to reduce their Fiscal Deficits over time. It is evident that the post FRBM Act era has witnessed ardent efforts by the governments at both the Centre and States to cut down their deficits. However, such a policy of fiscal conservatism has been challenged by a number of economists. Moreover, it has been pointed out that the attempts to reduce the Fiscal Deficit could be pursued through efforts to increase the tax revenue (as India's tax-GDP ratio at below 17 % is considered to be low for a large developing country) instead of efforts solely to check the growth of government expenditure (or a compression of government expenditure in constant prices over the years). During 2003-04 to 2011-12, in the case of State Governments, the growth in revenue was 36.7 % per annum whereas the growth in their expenditure was 28.8 % per annum; this reveals the expenditure compression implications of the strategies adopted to reduce the deficits of States.

[The author works with Centre for Budget and Governance Accountability (CBGA), New Delhi (*www.cbgaindia.org*); he can be contacted at *sridhar@cbgaindia.org*]