Formulation of the Budget

For Prelims: Budget and related constitutional provisions.

For Mains: Components of the Budget, objectives of budget and its impact on economy, Fiscal Policy, FRBM.

Why in News

The Budget, which will be tabled in Parliament by the Finance Minister on 1st February is likely to address concerns around growth, inflation and spending.

- **Budget** is the government's blueprint on **expenditure, taxes it plans to levy, and other transactions** which affect the economy and lives of citizens.
- According to **Article 112** of the Indian Constitution, the Union Budget of a year is referred to as the **Annual Financial Statement (AFS).**
- The Budget Division of the **Department of Economic Affairs in the Finance Ministry** is the nodal body responsible for preparing the Budget.

Key Points

- **Components of the Budget:** There are three major components—**expenditure, receipts and deficit indicators**. Depending on the manner in which they are defined, **there can be many classifications** and indicators of expenditure, receipts and deficits.

Expenditure	**Based on their Impact on Assets and Liabilities:** ▪ **Capital expenditure** is incurred with the purpose of increasing assets of a durable nature or of reducing recurring liabilities. ◦ Consider the expenditure incurred for constructing new schools or new hospitals. All these are classified as capital expenditure as they lead to creation of new assets. ▪ **Revenue expenditure** involves any expenditure that does not add to assets or reduce liabilities. ◦ Expenditure on the payment of wages and salaries, subsidies or interest payments would be typically classified as revenue expenditure. **Depending on the Manner in which it Affects Different Sectors:** ▪ Expenditure is also **classified into (i) general services (ii) economic services, (iii) social services and (iv) grants-in-aid and contribution.** ▪ The sum of **expenditure on economic and social services**

	together form the development expenditure.** ◦ Economic services include expenditure on transport, communication, rural development, agricultural and allied sectors. ◦ Expenditure on the social sector including education or health is categorised as social services. ▪ Again, depending on its effect on asset creation or liability reduction, development expenditure **can be further classified as revenue and capital expenditure.**
Receipts	▪ The receipts of the Government have three components —**revenue receipts, non-debt capital receipts and debt-creating capital receipts.** ▪ **Revenue receipts** involve receipts that are not associated with increase in liabilities and comprise revenue from taxes and non-tax sources. ▪ **Non-debt receipts** are part of capital receipts that do not generate additional liabilities. Recovery of loans and proceeds from disinvestments would be regarded as non-debt receipts since generating revenue from these sources does not directly increase liabilities, or future payment commitments. ▪ **Debt-creating capital receipts** are ones that involve higher liabilities and future payment commitments of the Government.
Fiscal Deficit	▪ Fiscal deficit by definition is the **difference between total expenditure and the sum of revenue receipts and non-debt receipts.** It indicates how much the **Government is spending in net terms.** ▪ Since positive fiscal deficits indicate the amount of expenditure over and above revenue and non-debt receipts, it **needs to be financed by a debt-creating capital receipt.** ▪ **Primary deficit** is the **difference between fiscal deficit and interest payments.** ▪ **Revenue deficit** is derived by **deducting capital expenditure from fiscal deficits.**

- **Implications of the Budget on the Economy:**
  - All **Government expenditure generates aggregate demand in the economy** since it involves purchase of private goods and services by the Government sector.
  - **All tax and non-tax revenue reduces net income** of the private sector and thereby leads to reduction in private and aggregate demand.
  - But except for exceptional circumstances, the **GDP (Gross Domestic Product)**, **revenue receipt and expenditure typically show a tendency to** rise over time.
  - Thus, the trend in absolute value of expenditure and receipts in themselves has little use for meaningful analysis of the Budget.
    - The trend in expenditures and revenue is analysed either by the GDP or as growth rates after accounting for the inflation rate.
    - **Reduction in expenditure GDP ratio or increase in revenue receipt-GDP ratio indicates the Government's policy to reduce aggregate demand** and vice-versa.
    - For similar reasons, **reduction in fiscal deficit-GDP ratio and primary deficit-GDP ratios indicate Government policy of reducing demand** and vice versa.
  - Since different components of expenditure and revenue can have different effects on income of different classes and social groups, the Budget **also has implications for income distribution.**
    - For example, revenue expenditure such as employment guarantee schemes or food subsidies can directly boost the income of the poor. Concession in corporate tax may directly and positively affect corporate incomes.

Fiscal Rules and its Effect on Policy

- **Meaning:** Fiscal rules **provide specific policy targets** on the basis of which fiscal policy is formed.
    - Policy targets can be met by using different policy instruments. There exists no unique fiscal rule that is applied to all countries. Rather, policy targets are sensitive to the nature of economic theory and depend on the specificity of an economy.
    - **Fiscal policy** refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including aggregate demand for goods and services, employment, **inflation**, and economic growth.
- **India's Case:** Its present fiscal rule is **guided by the recommendations of the N.K. Singh Committee Report (set up in 2016).**
    - Allowing for some deviations under exceptional times, it has **three policy targets** - maintaining a specific level of debt-GDP ratio (stock target), fiscal deficit-GDP ratio (flow target) and revenue deficit-GDP ratio (composition target).
    - Though both expenditure and revenue receipts can potentially act as policy instruments to meet specific set of fiscal rules, **tax-rates within the existing policy framework happen to be determined independent of the expenditure requirement** of the economy.
    - Accordingly, in the present institutional framework in India, it is primarily **the expenditure which is adjusted** to meet the fiscal rules at given tax-ratios.
- **Implications:** Such an adjustment mechanism has at least two related, but analytically distinct **implications for fiscal policy.**
    - First, independent of the extent of expenditure needed to stimulate the economy or boost labour income, **existing fiscal rules provide a cap on expenditure by imposing the three policy targets.**
    - Second, under any situation when the debt-ratio or deficit ratio is greater than the targeted level, expenditure is adjusted in order to meet the policy targets.
        - By implication, independent of the state of the economy and the need for expansionary fiscal policy, **existing policy targets may lead the Government to reduce expenditure.**
    - In the midst of the inadequacies of fiscal policy to address the contemporary challenges of unemployment and low output growth rate, the nature and objective of fiscal rules in India would **have to be re-examined.**

N.K.Singh Committee Recommendations

- **Debt-GDP ratio:**
    - The debt to GDP ratio should be **38.7% for the central government, 20% for the state government**s together by **FY 2022 – 23.**
- **Fiscal deficit-GDP ratio:**
    - The government should **target a fiscal deficit of 3% of the GDP** in the years up to 31st March 2020 cut it to **2.8% in 2020-21 and to 2.5% by 2023.**
- **Revenue deficit-GDP ratio:**
    - Revenue deficit-to-GDP ratio has been envisaged to decline steadily by 0.25 percentage points each year from 2.3% in 2016-17 to 0.8% in 2022-23.
- Recommended enacting a new Debt and Fiscal Responsibility Act after repealing the existing **Fiscal Responsibility and Budget Management (FRBM) Act**, and creating a fiscal council.

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