Fiscal Deficit and its Management

For Prelims: Fiscal Deficit and its Management, Interim Budget 2024-25**,** Fiscal Deficit**,** Gross Domestic Product (GDP).

For Mains: Fiscal Deficit and its Management, Impact of Fiscal Deficit on Indian Economy.

Source: TH

Why in News?

Since India has been faring with the **fiscal challenges** in dealing with the National Debts, the Ministry of Finance in its **Interim Budget 2024-25** has decided to reduce India's **Fiscal Deficit** to 5.1% of Gross Domestic Product (GDP) **in 2024-25.**

What is Fiscal Deficit?

- **About:**
  - Fiscal deficit refers to the **shortfall in a government's revenue** when compared to its expenditure.
  - When a government's **expenditure exceeds its revenues,** the government will have to **borrow money or sell assets** to fund the deficit.
  - Taxes are the **most important source of revenue** for any government. In 2024-25, the government's tax receipts are expected to be Rs 26.02 lakh crore while its total revenue is estimated to be Rs 30.8 lakh crore.
  - When a government **runs a fiscal surplus,** on the other hand, its revenues exceed expenditure.
    - It is, however, **quite rare for governments to run a surplus**. Most governments today focus on keeping the **fiscal deficit under control rather than on generating a fiscal surplus** or on balancing the budget.
- **Projections:**
  - Government estimates that the Fiscal Deficit would be pared to below **4.5% of GDP by 2025-26** announced in **Budget 2021-22.**
  - The government's **revised estimates** also lowered the **fiscal deficit projection for 2023-24 to 5.8% of** GDP**.**
- **Fiscal Deficit and National Debt:**
  - The **National Debt** is the total amount of money that the government of a country **owes its lenders** at a particular point in time.
    - **Government debt encompasses various liabilities**, including domestic and external loans, alongside obligations to schemes such as small savings, provident funds, and special securities.
    - These liabilities entail both **interest payments and repayment of principal amounts**, imposing a considerable financial burden on the government's finances.
  - It is usually the amount of debt that a government has accumulated over many years of **running fiscal deficits and borrowing** to bridge the deficits.

- The **higher a government's fiscal deficit** as a share of GDP, the **less likely its lenders will be paid back** without trouble.
  - Countries with larger economies can run **higher fiscal deficits.** As of 2022, the leading deficit holders included Italy -7.8%, Hungary -6.3%, South Africa -4.8%, Spain -4.7%, France -4.7%.
- **Trends in National Debt:**
  - The debt-GDP ratio stood at **84.4% in 2003-04**, witnessing subsequent declines and rises under different administrations.
  - Post 2014, the government witnessed a **surge in the debt-GDP ratio,** reaching a peak of **88.5% in 2020-21,** driven primarily by the economic disruptions caused by the **Covid-19 Pandemic.**
  - Despite slight improvements in subsequent fiscal years, the ratio remains elevated, projected at **82.4% for 2024-25**, posing significant challenges for fiscal management.

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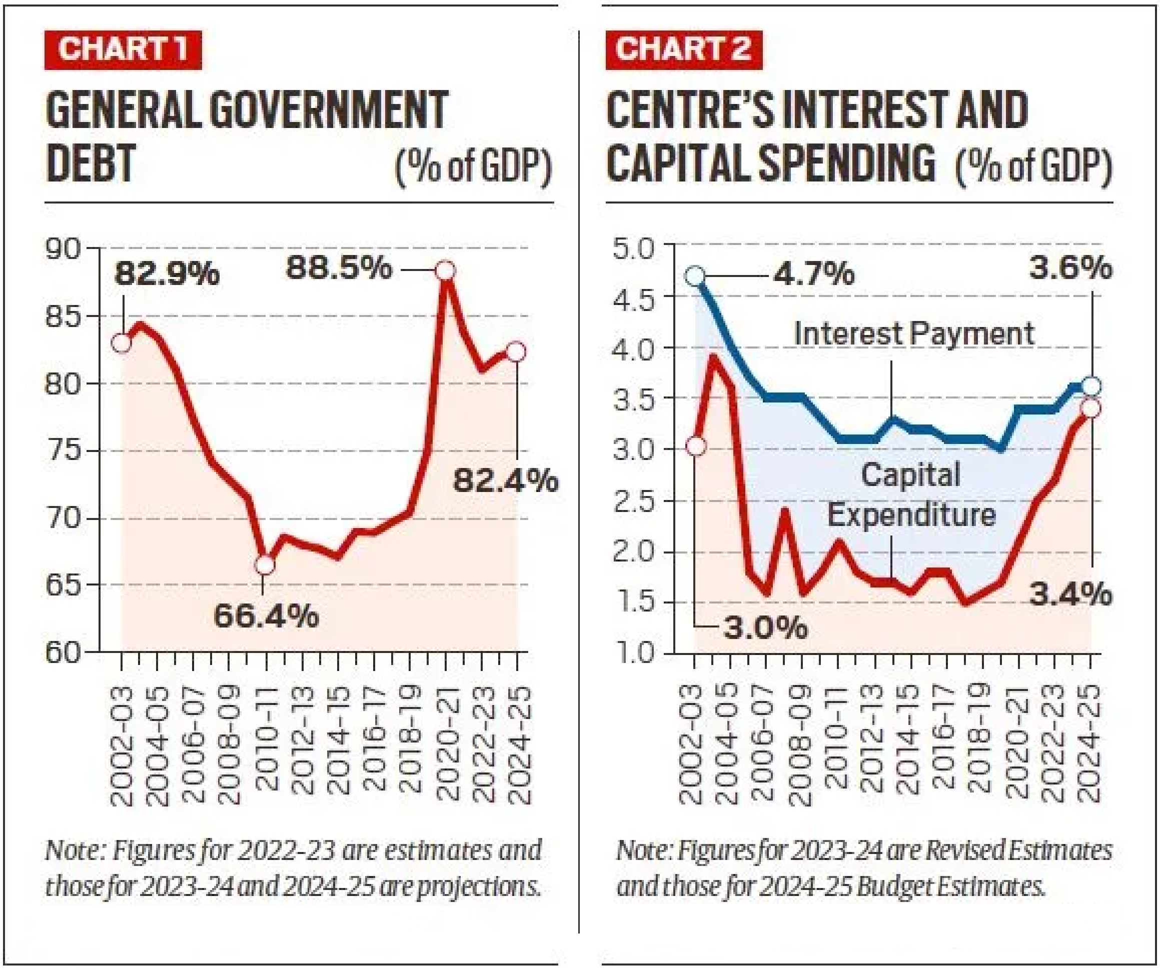

Key Formulas

- **Fiscal Deficit= Total Expenditure- Total Receipts (excluding borrowings)**.
- **Revenue Deficit:** This deficit of a government or business can be determined by subtracting the total revenue receipts from the total income expenditure.
  - **Revenue deficit= Total revenue receipts – Total revenue expenditure.**
- **Debt to GDP Ratio:** It It measures how much a nation owes in relation to its GDP
  - **Debt to GDP= Total Debt of Country/Total GDP of Country**

How does the Government Fund its Fiscal Deficit?

- **Borrowing from Bond Market:**
  - In order to fund its fiscal deficit, the government mainly borrows money from the bond market where **lenders compete to lend to the government** by purchasing bonds issued by the government.
    - In 2024-25, the Centre is expected to **borrow a gross amount of Rs 14.13 lakh crore from the market,** which is lower than its borrowing goal for 2023-24, as it expects to fund its spending in 2024-25 through higher GST collections.
  - As a government's finances worsen, demand for the government's bonds begins to drop forcing the government to offer to pay a higher interest rate to lenders, and leading to higher **borrowing costs for the government.**
- **Role of Reserve Bank of India:**
  - The RBI plays a **significant role in the credit market**, indirectly facilitating government borrowing. While central banks may not directly purchase government bonds from the primary market, they **engage in** Open Market Operations (OMO) **to acquire bonds from private lenders** in the secondary market.
  - This infusion of liquidity by central banks **effectively supports government borrowing efforts.**
    - **Central bank interventions through OMO** involve creating fresh money, potentially leading to increased money supply and inflationary pressures in the economy over time.
- **Monetary Policy:**
  - Monetary policy also plays a crucial role in reducing the c**osts for governments to borrow money from the market.**
  - Central bank lending rates which were near zero in many countries before the pandemic have **risen sharply in the aftermath of the pandemic.**
    - This makes it more expensive for governments to borrow money and could be one reason why the Centre is keen to bring down its fiscal deficit.

What is the Legislation Related to Fiscal Management in India?

- **Fiscal Responsibility and Budget Management (FRBM) Framework:**
  - **The FRBM Act**, instituted in 2003, set ambitious targets for debt reduction, aiming **to limit the general government debt to 60% of GDP by 2024-25.**
  - However, subsequent fiscal trajectories deviated from these targets, with the Centre's outstanding debt surpassing the originally envisioned thresholds.
    - **FRBM Review Committee Report** has recommended a debt to GDP ratio of **60% for the general (combined) government** by 2023, comprising **40% for the Central Government** and **20% for the State Governments.**

Why is it Important to Worry About Fiscal Deficit?

- **Impact on Inflation:**
  - There is a strong direct relationship between the government's fiscal deficit and Inflation in the country.
  - When a country's government runs a persistently high fiscal deficit, this can eventually **lead to higher inflation** as the government will be **forced to use fresh money issued by the central bank to fund its fiscal deficit.**
    - The **fiscal deficit in 2020 reached a high of 9.17% of GDP** during the pandemic. It has since decreased significantly and is **expected to reach 5.8% in 2023-24.**
- **Fiscal Discipline Improves Ratings:**
  - A lower fiscal deficit indicates better government fiscal discipline. This can lead to higher ratings for Indian government bonds.
  - When the government relies more on tax revenues and borrows less, it boosts lender confidence and lowers borrowing costs.
- **Management of Public Debt:**
  - A **high fiscal deficit** can also adversely **affect the ability of the government to manage its overall public debt.**
  - In December 2023, the IMF warned that India's public debt could rise to more than 100% of

GDP in the medium term due to risks.
    - A lower fiscal deficit may help the government to more **easily sell its bonds overseas and access cheaper credit** from the international bond market.

What can be Done to Manage Fiscal Deficit and National Debt in India?

- **Fiscal Discipline and Consolidation:**
    - Adhering to fiscal consolidation targets, as outlined in the FRBM Act is crucial.
    - The government should aim to **gradually reduce the fiscal deficit-to-GDP ratio to ensure sustainable public finances.**
    - Implementing prudent fiscal policies, including expenditure rationalisation, revenue enhancement measures, and subsidy reforms, **can help in reducing the reliance on borrowing** and mitigating fiscal imbalances.
- **Enhancing Revenue Mobilisation:**
    - Strengthening tax administration and **compliance to broaden the tax base** and improve revenue collection.
    - Exploring avenues for **diversifying revenue sources,** such as introducing new taxes or levies on luxury goods, wealth, or environmental taxes.
- **Rationalising Expenditures:**
    - Conducting a comprehensive review of government expenditures to identify inefficiencies and prioritise spending in key areas such as healthcare, education, and infrastructure.
    - Implementing measures to **curb non-essential spending and subsidies,** while **ensuring targeted support for vulnerable populations.**
- **Debt Management Strategies:**
    - Developing a prudent debt management strategy to **optimise borrowing costs and minimise refinancing risks.**
    - **Diversifying the investor base and sources of financing,** including domestic and international markets, to mitigate exposure to market volatility.
- **Long-Term Structural Reforms:**
    - Undertaking structural reforms aimed at **improving the efficiency and competitiveness of the economy,** including labour market reforms, **ease of doing business** initiatives, and governance reforms.
    - Addressing **structural bottlenecks and challenges in sectors** such as agriculture, manufacturing, and services to unleash growth potential and enhance fiscal sustainability.

Conclusion

- By implementing a combination of Fiscal Consolidation measures, India can effectively manage its national debt and fiscal deficit, ensuring fiscal sustainability, economic growth, and long-term prosperity.
- However, it's essential to strike a balance between short-term stabilization efforts and long-term structural reforms to achieve sustainable fiscal outcomes.

UPSC Civil Services, Previous Year Questions (PYQ)

Prelims

Q1. In the context of governance, consider the following: (2010)

1. Encouraging Foreign Direct Investment inflows
2. Privatization of higher educational Institutions
3. Down-sizing of bureaucracy
4. Selling/offloading the shares of Public Sector Undertakings

Which of the above can be used as measures to control the fiscal deficit in India?

(a) 1, 2 and 3

(b) 2, 3 and 4
(c) 1, 2 and 4
(d) 3 and 4 only

Ans: D

Q2. Which one of the following is likely to be the most inflationary in its effect? (2021)

(a) Repayment of public debt
(b) Borrowing from the public to finance a budget deficit
(c) Borrowing from the banks to finance a budget deficit
(d) Creation of new money to finance a budget deficit

Ans: (d)

Q3. Which of the following is/are included in the capital budget of the Government of India? (2016)

1. Expenditure on acquisition of assets like roads, buildings, machinery, etc.
2. Loans received from foreign governments
3. Loans and advances granted to the States and Union Territories

Select the correct answer using the code given below:

(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (d)

Mains

Q1. One of the intended objectives of the Union Budget 2017-18 is to 'transform, energise and clean India'. Analyse the measures proposed in the Budget 2017-18 to achieve the objective. **(2017)**

Q2. Distinguish between Capital Budget and Revenue Budget. Explain the components of both these Budgets. **(2021)**

Q.3 Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. **(2019)**