CHAPTER-2

OBJECTIVES, METHODOLOGY AND MAJOR THEORETICAL ISSUES

The study aims at analysing the pattern and factors accountable for high fiscal deficits at the Union from 1990-91 to 2009-10. It is therefore relevant to understand the various concepts pertaining to the fiscal deficits.

2.1 Objectives of the Study

The major objectives of the study are as follows:

- To analyse the trends of fiscal deficit of the Union Government, during the period under reference.
- To understand the significance of the fiscal deficit in the macro economic framework.
- The components responsible for ever increasing Fiscal Deficit both on expenditure and revenue side.
- To analyse the measures adopted so far to curb fiscal deficit.
- To examine the Efficacy of FRBM (Fiscal Responsibility and Budget Management), Act, 2003 in curbing fiscal deficit.
- To identify areas of budget both on the revenue and expenditure side where a reasonable adjustment can be made to keep fiscal deficit within limits without adversely affecting growth and equity considerations.

The study would be confined to the analysis of trends and issues of Fiscal deficit in Government of India during the period 1990-91 to 2009-10 only.

2.2 Research Methodology

The proposed research study is mainly based on analysis of secondary **data,** the main source of which are following:

- **Publications** of Ministry of Finance, Government of India as well as Reserve Bank of India like Annual Budget Estimates and Indian Public

Finance Statistics, Report on currency and Finance, RBI Bulletin etc.

- **Plan documents** of various Five-Year Plans published by Planning Commission,
- **Reports** of 12th and 13th Finance Commissions
- **Publications, Research studies and occasional papers** issued by institutes like IIPA, National Institute of Public Finance and Policy (NIPFP) and National Council for Applied Economic Research (NCAER) and
- Relevant information from various research journals, newspapers, reports and publications of IMF and World Bank etc.
- Related articles on various websites on Internet.

Major **parameters** that are used in the study are revenue deficit/GDP ratio, primary deficit/GDP ratio, fiscal deficit/GDP ratio, revenue deficit as a percentage of fiscal deficit, expenditure/GDP ratio, savings/GDP ratio and others as required

The **statistical tools** proposed to be applied to analyse the trends of revenue and expenditure are various graphical representations, averages, correlation and extrapolation.

2.3 Major Theoretical Issues

The deficit measures have become extremely relevant in the context of macroeconomic stabilization in India, primarily as an indicator of macroeconomic consequences of the fiscal policy. Their management is extremely crucial for the overall management of the macroeconomy. The reduction in the relative size of fiscal deficit became one of the fundamental objectives of the economic policy being pursued since 1991 in India. With liberalization of the economic policies and receding role of the state, it became important that the government's claim over economic resources be brought down gradually.

Various deficit measures try to gauge the net use of resources of the government. There is no uniform and universally accepted way to measure deficit. Actually there are a number of alternative measures each having its own merits and demerits. The set of consequences that the policymakers desire to assess may itself determine the particular deficit measure that will be employed.

In India, until the mid eighties, the macroeconomic consequences of the fiscal policy were primarily judged in relation to deficit financing or overall budgetary deficit which was equal to the sum of running down of cash balances by RBI itself and the sale of short term treasury bills to RBI. It thus referred to the creation of reserve money by RBI leading to a net addition to the money supply in the country. It was perceived that the inflationary impact of the budget would depend upon how much money has been created by the RBI during that financial year.

In USA and other industrialized countries a different concept was being utilized which is still the most common and conventional measure of deficit. It is defined as the difference between government's total expenditure and government's current revenue. It is termed as **fiscal deficit** and IMF has adopted it as a major policy target in its macroeconomic stabilization programme. The excess of expenditure over revenue is covered by borrowings therefore fiscal deficit refers to the net borrowings by the government. Positive net borrowings lead to net additions to public debt. This is why fiscal deficit is considered a true measure of the indebtedness of the government.

2.3.1 Types of Deficit

The different types of deficit used in bringing about fiscal adjustment or restoring fiscal balance are described below--

i) **Revenue Deficit**[1] is defined as excess of revenue expenditure over revenue receipts.

REVENUE DEFICIT = Expenditure on Revenue Account - Revenue Receipts

Receipts on revenue account include net tax revenue, non-tax revenue (like interest receipts, dividends and profits) and grants including grants from abroad. Expenditure on revenue account includes both plan and non-plan expenditure. The latter includes interest payments, defence expenditure on revenue account, subsidies, debt relief, postal deficit, police, pensions, other general services, social services, economic services, non-plan grants to states and UTs, expenditure on UTs without legislatures and grants to foreign governments. Expenditures on revenue account are broadly defined as those expenditures which do not lead to capital formation. This deficit concept measures government's contribution to total savings of the economy and thus to growth.[2] It is a measure to ascertain whether the recurrent expenditures of the government on account of public consumption and current transfers are fully met out of current revenues. Meeting current expenditures out of the current revenues is good Economics because it ensures that the capital receipts will be used only for meeting capital expenditures. It also ensures maintenance of fiscal discipline but all capital expenditures may not necessarily lead to growth and likewise all current expenditure may not be consumption expenditure. Vito Tanzi feels that investment may be wasteful as current expenditure.

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1 definition as given in budget documents

2 Tanzi, Vito, Fiscal deficit measurement : Basic issues in *How to measure the Fiscal deficit* Ed. Mario Blejer and Adrianne Cheasty, IMF, Washington D.C. 1993, p.16

ii) **Fiscal Deficit[3] is the difference between revenue receipts (net) plus certain non debt capital receipts and the total expenditure including loans net of repayments.**

Fiscal Deficit = Total Expenditure - (Revenue Receipts + Certain Non - Debt Capital Receipts)
= Net Borrowing by the government

This gives the total borrowing requirement from all sources.

While an increase in the volume of public debt in itself may not be a great cause of concern, rapid growth of public debt would result in increasing debt-GDP ratio which after a point has very harmful consequences. It may also be termed as **Gross Fiscal Deficit.**

iii) **Primary Deficit[4]** owes its existence to the reasoning that interest payments reflect a spill over of the past borrowings of the government. It is measured by fiscal deficit less interest payments i.e.

Primary Deficit = Fiscal Deficit - Interest Payments

All the above stated alternative measures differ from each other in the way they are estimated and in their analytical importance in understanding the fiscal situation of the country. For example Revenue Deficit is a measure of government's inability to meet its expenditure on revenue account from its revenue receipts. Prudent fiscal management demands that the expenditure on revenue account should be fully met through revenue receipts Actually , there should be surplus on revenue account, which should be used for financing productive projects, earning assets such as those included in Five-year plans in our country. Unfortunately in India, revenue deficits have

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3 definition as given in budget documents
4 definition as given in budget documents

been rising which implies that more and more borrowed resources are being used to finance current recurring expenditures. Higher borrowings create pressure on revenue expenditures in subsequent years as interest payment liabilities go up. This necessitates further borrowings if tax revenue fails to keep pace with growing expenditure requirements. The difficulty of repayment is compounded by the fact that a part of market borrowings has in fact been spent on some unremunerative capital projects such as on loss making public sector units. As a result the little that was left for investment expenditure simply could not yield a high enough return for a net income inflow to the government by way of dividends and interest.[5]

Fiscal deficit measures the total resource gap and as such fully reflects the impact of the fiscal operations on the indebtedness of the government. It equals the difference between the aggregate expenditure and revenue receipts, loan recoveries and other recoveries from capital account also included. In other words it is the sum of borrowings (internal and external) and other liabilities (like small savings, provident fund deposits etc.).

It is a better concept of measuring imbalance because it measures excess expenditure over what may be termed as government's own income.[6] It gives an exact measure of the extent by which the government has gone beyond its means. International Monetary Fund shows its concern with this all inclusive concept of Fiscal deficit. In the Indian context the concepts of Revenue deficit, Fiscal deficit and Primary deficit all are relevant in the analysis of the fiscal position of the government.

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5 Agarwal, A.N.: 'Central finances and New Fiscal Policy in '*Indian Economy*' 22nd edition, Vikas Pub. House, 1996, p.516.

6 Ibid.