Public Economics and Finance

"Nobody spends somebody else's money as wisely as he spends his own – Milton Friedman"

Topics Covered

- ***Public Economics and Finance***
- ***Role of Government in and Economy***
- ***What is Fiscal Policy***
- ***Objectives of Fiscal Policy***
- ***Expansionary and Contractionary Fiscal Policy***
- ***Accounts of the Government***
- ***Budget***
- ***Components of Budget***
- ***Types of Budgets***
- ***Deficits***
- ***Financing Deficits***
- ***Monetization of Deficits***
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- ***Public Debt***
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- ***FRBM Act, 2003***
- ***FRBM Review Committee - N K Singh Panel Recommendations***
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- ***Gender Budgeting***

Public economics is the study of government policy through the lens of economic efficiency and equity. At its most basic level, public economics provides a framework for thinking about whether or not the government should participate in economics markets and to what extent its role should be.

In order to do so, microeconomic theory is utilized to assess whether the private market is likely to provide efficient outcomes in the absence of governmental interference.

Inherently, this study involves the analysis of government taxation and expenditures. This subject encompasses a host of topics including market failures, externalities, and the creation and implementation of government policy.

Public economics builds on the theory of welfare economics and is ultimately used as a tool to improve social welfare.

Public Finance or Fiscal policy:

Fiscal policy refers to the policy of government with relation to taxation, public expenditure, and management of public debt. In other words, fiscal policy refers to the financial activities undertaken by government to correct either inflation or deflation and promote growth of an economy.

Fiscal policy is,

- Budgetary policy of the government.
- It uses public expenditure and taxation as instruments; and
- Its objectives are to influence production and employment favorably.

Objectives of fiscal policy:

- Full employment
- Price stability and Economic stability

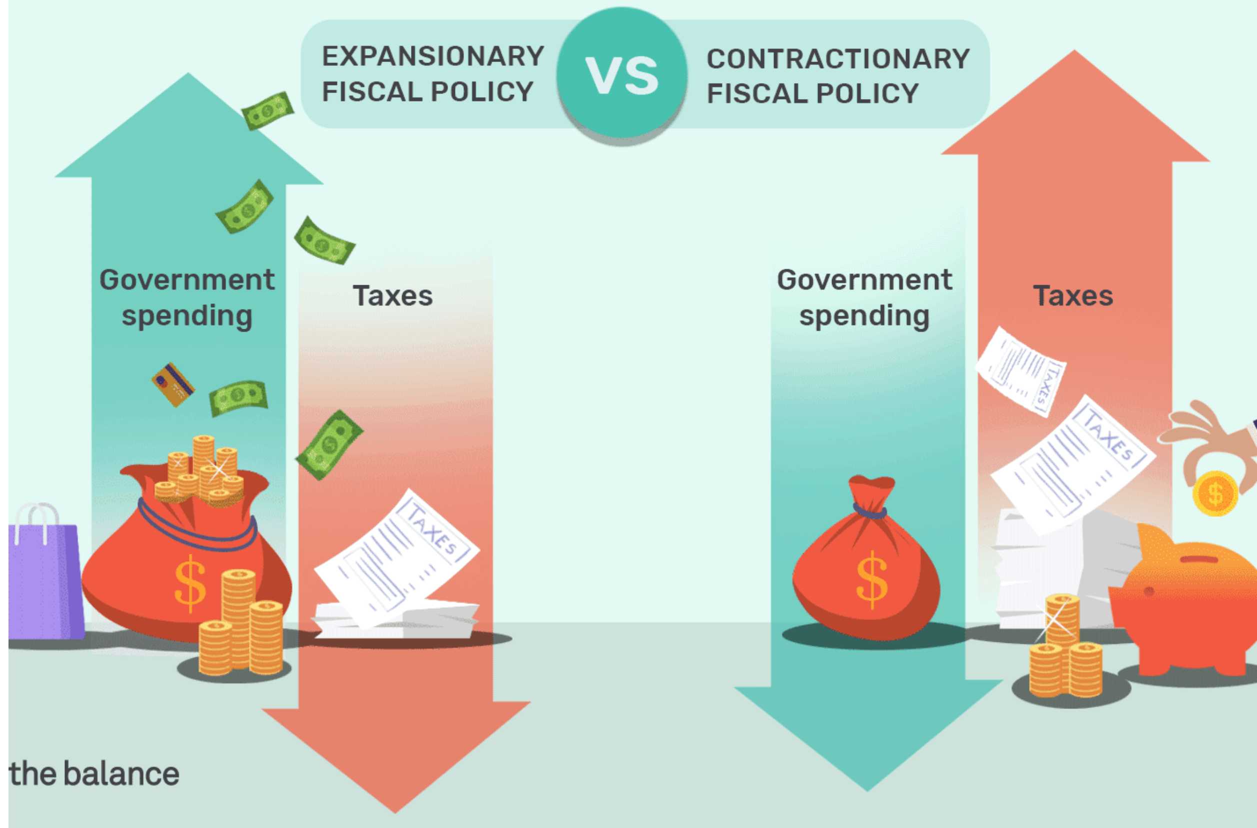
- Optimum allocation of resources
- Equitable distribution of income and wealth
- Capital formation and growth

Expansionary and Contractionary Fiscal Policy

Expansionary fiscal policies are those that are used to “expand” economy (economic activity) and contractionary ones are those used to “contract” an economy (economic activity).

Fiscal policies are implemented by the government and is independent of actions by the central bank (monetary policy) in most cases although when both are implemented in a complimentary manner, goals can be achieved more efficiently and smoothly.

- Expansionary fiscal policies include measures such as reducing tax rates, increasing direct payments to consumers via tax refunds and increase government spending in order to increase economic activity when the economic activity via the private sector slows down.
- These policies contribute to an increase in aggregate demand and hence increasing aggregate supply leading to increased production and hence increased economic output.



Expansionary policies are usually accompanied by expansionary monetary policies such as reducing interest rates and increasing money supply in money markets thus making access to money easier. These policies are mainly used to maintain economic activity or boost it during a downturn (i.e., Recession).

Q) Consider the following actions by the Government:

1. Cutting the tax rates

2. Increasing the government spending

3. Abolishing the subsidies in the context of economic recession

Which of the above actions can be considered a part of the "fiscal stimulus" package?

(a) 1 and 2 only.

(b) 2 only

(c) 1 and 3 only.

(d) 1,2 and 3

Pump priming

- Pump priming is the action taken to stimulate an economy, usually during a recessionary period, through government spending and interest rate and tax reductions. The term pump priming is derived from the operation of older pumps - a suction valve had to be primed with water so that the pump would function properly.
- Pump priming assumes that the economy must be primed to function properly once again. In this regard, government spending is assumed to stimulate private spending, which in turn should lead to economic expansion.
- It involves introducing relatively small amounts of government funds into a depressed economy to spur growth. This is accomplished through the increase in purchasing power experienced by those affected by the injection of funds, with the goal of prompting higher demand for goods and services.

Q) Which one of the following statements appropriately describes the "fiscal stimulus”?

(a) It is a massive investment by the government in manufacturing sector to ensure the supply of goods to meet the demand surge caused by rapid economic growth.

(b) It is an intense affirmative action of the government to boost economic activity in the country.

(c) It is government's intensive action on financial institutions to ensure disbursement of loans to agriculture and allied sectors to promote greater food production and contain food inflation.

(d) It is an extreme affirmative action by the government to pursue its policy of financial inclusion.

Contractionary Policy

- Contractionary fiscal policies on the other hand are used to slow down an economy by measures such as increasing taxes and decreasing government spending.
- One main reason to use this type of policy is to control inflation. This is also known as “cooling down” an economy as rapid economic growth induces higher inflation rates that could ultimately curtail economic activity in the long run.
- Contractionary policies reduce the aggregate demand and hence reducing the aggregate supply and in turn reducing production and, hence reducing economic output.
- Once again, contractionary policies are usually accompanied by contractionary monetary policies such as increasing interest rates and decreasing money supply in the money markets thus making access to money more difficult.

Government Accounts

Consolidated Fund of India: All sums of money. All revenues of the govt. the loans raised by it, receipts by way of repayment of loans. All expenditures are also incurred out of this fund. No amount can be withdrawn from this fund without the sanction of the parliament.

The Contingency fund of India: The fund is placed at disposal of the President to enable the government to meet the unforeseen emergencies. Prior sanction of the parliament is not required to spend from the fund.

Public Account of India: Certain transactions are not included in the contingency fund. These include transactions relating to provident funds, small savings collections, other deposits etc. The money thus received is kept in public account. This money does not belong to the government. It has to be paid back to the persons and authorities who have deposited it. Hence, parliamentary approval is not required for payments.

Budget

The most important instrument of government intervention in the economy today is that of fiscal or budgetary policy.

Union Budget, which is a yearly affair, is a comprehensive display of the Government's finances. It is the most significant economic and financial event in India. The Budget is the most extensive account of the Government's finances, in which revenues from all sources and expenses of all activities undertaken are aggregated. It comprises the revenue budget and the capital budget. It also contains estimates for the next fiscal year called budgeted estimates.

Barring a few exceptions — like elections – Finance Minister presents the annual Union Budget in the Parliament on the first working day of February.

The budget of a government is a summary of the item wise intended/expected revenues and anticipated expenditures of the government during a fiscal year/financial year.

The term budget has been derived from a French word 'bougette' which means a leather bag or purse. As per *Article 112 of Indian Constitution* the Govt. has to present in the Parliament an annual financial statement showing estimates of revenue and expenditure.

Article 112 of the Indian Constitution says that every year "the President of India shall cause to be laid before both the houses of the parliament" the "Annual Financial Statement". This is popularly known as Budget. "Cause to be laid" here means that the person through whom President acts, is Finance Minister of the country, who is known as the custodian of the nation's Finances. The Budget gives the complete picture of the estimated receipts and expenditures of the Government of India for that year. This picture is actually based upon the budget figures of the previous years.

There are three main features of a government budget:

- It is a consolidated financial statement of expected expenditures and various sources of revenue of government.
- It relates to a financial year. And
- The expenditures and the sources of revenue are planned in accordance with the declared policy objectives of government.

Q) Who of the following shall cause every recommendation made by the finance Commission to be laid before each House of Parliament?

(a) The President of India

(b) The Speaker of Lok Sabha

(c) The Prime Minister of India

(d) The Union Finance Minister

Q) Which one of the following is responsible for the preparation and presentation of Union Budget to the Parliament?

(a) Department of Revenue

(b) Department of Economic Affairs

(c) Department of Financial Services

(d) Department of Expenditure

Vote on Account and Interim Budget:

An interim budget is; a budget presented by the government in the parliament going through a transition period, while a vote on account is passed through the interim budget to meet small expenditures.

Vote on account: According to Article 116, a vote on account is a grant for the central government to meet short-term expenditure needs. This amount is from the consolidated fund of India. The consolidated fund of India is where most of the revenue is retained. This grant generally lasts for a few months until the new financial year kicks in. Some key features of the vote on account are listed below.

- The vote on account is a formality and is passed without any discussion.
- A vote on account is a grant in advance for the government to function properly during a transition period or the final leg before elections.
- It allows the government to meet its required expenses.

Interim budget

An interim budget comes into play when the existing government cannot present an entire union budget. Thus, the ruling government presents the interim budget. An interim budget is usually set into motion during an election year or a transition period. Some key features of the interim budget are listed below.

- The interim budget is a complete set of accounts that include; both receipts and expenditures.
- The finance minister presents the interim budget during a joint sitting of Rajya Sabha and Lok Sabha in the parliament.
- Until the government passes the interim budget, the government passes a vote on account to allow them to meet its expenses.

Q) What is the difference between "vote-on-account" and "interim budget”?

1. The provision of a "vote-on-account" is used by a regular Government, while an "interim budget" is a provision used by a caretaker Government

2. A "vote-on-account" only deals with the expenditure in Government budget, while an "interim budget" includes both expenditure and receipts.

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Budget Documents

Apart from the speech of the Financial Minister, the budget contains total around 14 to 16 documents. Among these, four documents are mandatory as per constitution of India, while four other documents are mandatory as per FRBM Act, 2003. Rest of the documents are either explanatory or as per recommendations of NITI Aayog or under some other initiatives.

Thus, we can divide these documents in three parts as follows:

Documents Mandated by Constitution

Annual Financial Statement [Article 112]: This document comprises the receipts and expenditures of the government of current year, previous year and budget year in three separate parts viz. Consolidated Fund of India, Contingency Fund of India and Public Account of India.

Demands for Grants [Article 113]: The estimates of expenditures are presented to Lok Sabha in the form of Demands for Grants. General there is one demand for grants per ministry but there can be more than one demands for grants also for a ministry depending on the type of expenditure. Further, the government presents separate demands for grants for union territories along with the ministries' demands for grants.

Appropriation Bill [Article 114(3)]: The article 114(3) stipulates that no amount can be withdrawn from the Consolidated Fund of India without enactment of a law by parliament. So, once the demands for grants are vetted by the Lok Sabha, the Appropriation Bill is presented to withdraw amount from Consolidated Fund.

Finance Bill [Article 110(a)]: It is presented to enact a law for imposition, abolition, remission, alteration or regulation of taxes proposed in the Budget. A Finance Bill is a Money Bill as defined in Article 110 of the Constitution.

Q) Along with the Budget, the finance minister also places other documents before the Parliament which include 'The Macro Economic Framework Statement'. The aforesaid document is presented because this is mandated by

(a) Long standing parliamentary convention

(b) Article 112 and Article 110(1) of the Constitution of India

(c) Article 113 of the Constitution of India

(d) Provisions of the Fiscal Responsibility and Budget Management Act, 2003

Q) Which of the following are the methods of Parliamentary control over public finance in India?

1. Placing Annual Financial Statement before the Parliament

2 Withdrawal of moneys from Consolidated Fund of India only after passing the Appropriation Bill

3. Provisions of supplementary grants and vote-on-account

4. A periodic or at least a mid-year review of programme of the Government against macroeconomic forecasts and expenditure by Parliamentary Budget Office

5. Introducing Finance Bill in the Parliament

Select the correct answer using the codes given below:

(a) 1,2,3 and 5 only

(b) 1,2 and 4 only

(c) 3,4 and 5 only

(d) 1, 2, 3, 4 and 5

Q) Economic Survey in India is published officially, every year by the:

(a) Reserve Bank of India

(b) Planning Commission of India

(c) Ministry of Finance, Govt. of India

(d) Ministry of Industries, Govt. of India

Q) All revenues received by the Union Government by way of taxes and other receipts for the conduct of Government business is credited to the?

(a) Contingency Fund of India

(b) Public Account

(c) Consolidated Fund of India

(d) Deposits and Advances Fund

Q) With reference to the National Investment Fund to which the disinvestment proceeds are routed, consider the following statements:

1. The assets in the National Investment Fund are managed by the Union Ministry of Finance.

2. The National Investment Fund is to be maintained within the Consolidated Fund of India.

3. Certain Asset Management companies are appointed as the fund managers.

4. A certain proportion of annual income is used for financing select social sectors.

Which of the statements given above is/are correct?

(a) 1 and 2

(b) 2 only

(c) 3 and 4

(d) 3 only

Q) With reference to 'National Investment and Infrastructure Fund' which of the following statements is/are correct?

1. It is an organ of NITI Aayog.

2. It has a corpus of 4,00,000 crore at present.

Select the correct answer using the code given below:

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Structure of Budget:

The budget consists of two parts:

(1) Receipts (2) Expenditure

Receipts: The receipts of government show the different sources from which government raises revenue. These receipts are of two kinds:

Revenue receipts and Capital receipts.

Revenue receipts are current income receipts from all sources such as taxes, profits of public enterprises, grants, etc. Revenue receipts neither create any liability nor cause any reduction in the assets of the government. Capital receipts, on the other hand, are the receipts of the government which either create liability or cause any reduction in the assets of the government. e.g., borrowings, recovery of loan and disinvestment etc.

Revenue Receipts: Revenue receipts are current incomes of government, which neither create liabilities nor cause any reduction in the assets of the government. These receipts are classified into

(i) Tax Revenue and
(ii) Non-tax Revenue.

Tax Revenue: It is the revenue collected from different items like corporation tax, income tax, wealth tax, customs, union excise, service, Taxes collected from both direct and indirect tax are considered in Tax Revenue.

Non-Tax Revenue: The incomes accruing to government from sources other than taxes are *non-tax revenues*. The major sources of non-tax revenues of the central government of India are:

(a) Commercial Revenue: It is received by government in the form of prices paid by people for goods and services that government provides e.g., people pay for electricity and for services of Railways, postal stamps, toll etc.

(b) Administrative Revenue: It arises on account of administrative services of the government.

They are as follow:

- fees in the form of passport fees, government hospital fees, education fees, court fee, etc.
- Fine and penalties: charged by government on lawbreakers for disobeying rules and regulations. License fee and permit
- Escheat: Income that government get by taking possession of property which has no legal claimant or legal heir.
- Interest receipts
- Profits of public sector undertakings.

(B) Capital Receipts: As stated earlier, capital receipts are those receipts of the government which either create liability or cause any reduction in the assets of the government. The major sources of capital receipts of the central government are: (i) Borrowings (ii) Recovery of Loans and (iii) Disinvestment - Resale of shares of public sector undertakings.

(i) Borrowings: There are two sources from which the central government borrows. These borrowings are also called 'Public Debt'.

Important Sources of Public Debt

- Borrowing from individuals.
- Borrowing from Non-Banking Financial Institutions. (Insurance companies, investment trusts, mutual funds etc.,)
- Borrowing from commercial banks.
- Borrowing from central banks.
- Borrowing from External sources (IMF, IBRD, ADB, Foreign Governments)

Important Sources:

(a) Domestic Borrowings: The government borrows from domestic financial market by issuing securities and treasury bills. It also borrows from people through various deposit schemes such as Public Provident Fund, Small Savings Schemes, and National Savings Scheme etc. These are borrowings of the government within the country.

(b) External Borrowings: In addition to domestic borrowings the government also borrows from foreign governments and international bodies like International Monetary Fund (IMF), World Bank etc. Foreign borrowings by the government bring in foreign exchange into the domestic economy.

(ii) Recovery of Loans: Quite often state and local governments borrow from the central government. The loans recovered by the central

government from state and local governments are capital receipts in the budget because recovery of loans reduces debtors (assets).

(iii) Disinvestment - Resale of shares of public sector undertakings: This is a very recent source of capital receipts by which the central government has been mobilizing financial resources since 1991. Prior to 1991, the central government owned 100 percent of the shares of public sector undertakings. From 1991, the government adopted the policy of privatization of public sector undertakings. Consequently, it started selling its shares to general public and to financial institutions. This selling of shares of public sector undertakings by the government is known as 'disinvestment of public sector undertakings.

Disinvestment

"Investment refers to the conversion of money or cash into securities, debentures, bonds or any other claims on money. As follows, disinvestment involves the conversion of money claims or securities into money or cash."

Disinvestment is defined as the action of an organization(or government) selling or liquidating an asset or subsidiary.

The following main objectives of disinvestment were outlined:

- To reduce the financial burden on the Government
- To improve public finances
- To introduce, competition and market discipline
- To fund growth
- To encourage wider share of ownership
- To depoliticize non-essential services

Q) Why is the Government of India disinvesting its equity in the Central Public Sector Enterprises (CPSEs)?

1. The Government intends to use the revenue earned from the disinvestment mainly to pay back the external debt.

2. The Government no longer intends to retain the management control of the CPSEs

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Different approaches to disinvestments are:

- A minority disinvestment is one such that, at the end of it, the government retains a majority stake in the company, typically greater than 51%, thus ensuring management control.
- A majority disinvestment is one in which the government, post disinvestment, retains a minority stake in the company i.e., it sells off a majority stake.
- Complete privatization is a form of majority disinvestment wherein 100% control of the company is passed on to a buyer.

Importance of Disinvestment

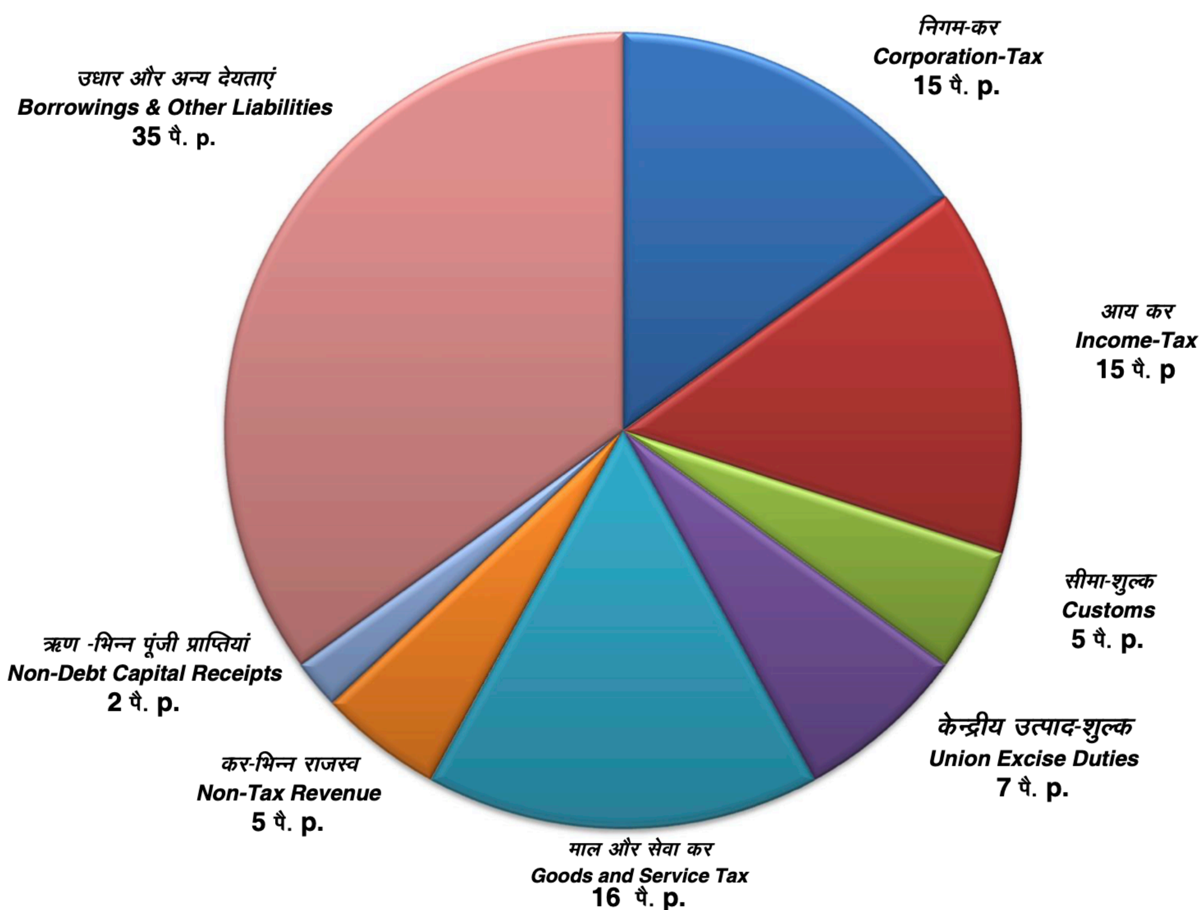
Presently, the Government has about Rs. 2 lakh crores locked up in PSUs. Disinvestment of the Government stake is, thus, far too significant. The importance of disinvestment lies in utilization of funds for:

- Financing the increasing fiscal deficit
- Financing large-scale infrastructure development

- For investing in the economy to encourage spending
- For retiring Government debt- Almost 40-45% of the Centre's revenue receipts go towards repaying public debt/interest
- For social programs like health and education

Disinvestment also assumes significance due to the prevalence of an increasingly competitive environment, which makes it difficult for many PSUs to operate profitably. This leads to a rapid erosion of value of the public assets making it critical to disinvest early to realize a high value.

Rupee Comes From



(2) Expenditure: Government expenditure is classified in two ways:

(a) capital expenditure and revenue expenditure

(b) as plan expenditure and non-plan expenditure.

Capital Expenditure and Revenue Expenditure: When government incurs expenditure to create assets such as school and hospital buildings, roads bridges, canals, railway lines etc., or reduce its liability such as repayment of loan etc., such expenditure is known as capital expenditure. But when government incurs expenditure that neither creates any asset nor reduces any liability, such expenditure is known as revenue expenditure. For Example, payment of salaries to government employees, maintenance of public property, providing free education and health services to people, etc. constitute revenue expenditure. These do not create any public asset.

Plan Expenditure and Non-Plan Expenditure: After independence, our country adopted the path of planning to achieve economic development. Under planning, provisions were made in the government budget for expenditure that was to be incurred every year according to the priorities laid down in the five-year plans. Such expenditure is known as plan expenditure.

Beside plan expenditure, government also incurs routine expenditure such as expenditure on police, judiciary, water supply, sanitation and health, legislatures, defence, various government departments, etc. Such routine expenditure is termed as non-plan expenditure.

Q) With reference to Union Budget, which of the following is/are covered under Non-Plan Expenditure?

1. Defence expenditure
2. Interest payments
3. Salaries and pensions
4. Subsidies

Select the correct answer using the code given below.

(a) 1 only

(b) 2 and 3 only

(c) 1,2,3 and 4

(d) None

Why Plan and Non-plan expenditure classification had done away with:

In 2010, a panel led by the former Prime Minister's Economic Advisory Council Chairman C Rangarajan had also suggested doing away with the artificial classification and it said the focus should be on improving the quality of government spending by focusing on the end use of the funds. It means that under plan and non-plan expenditure focus is mainly on the expenditure targets not on the end use of the funds.

The 14th Finance Commission, headed by the former Reserve Bank of India (RBI) governor YV Reddy, has been pitching for the distinction to go.

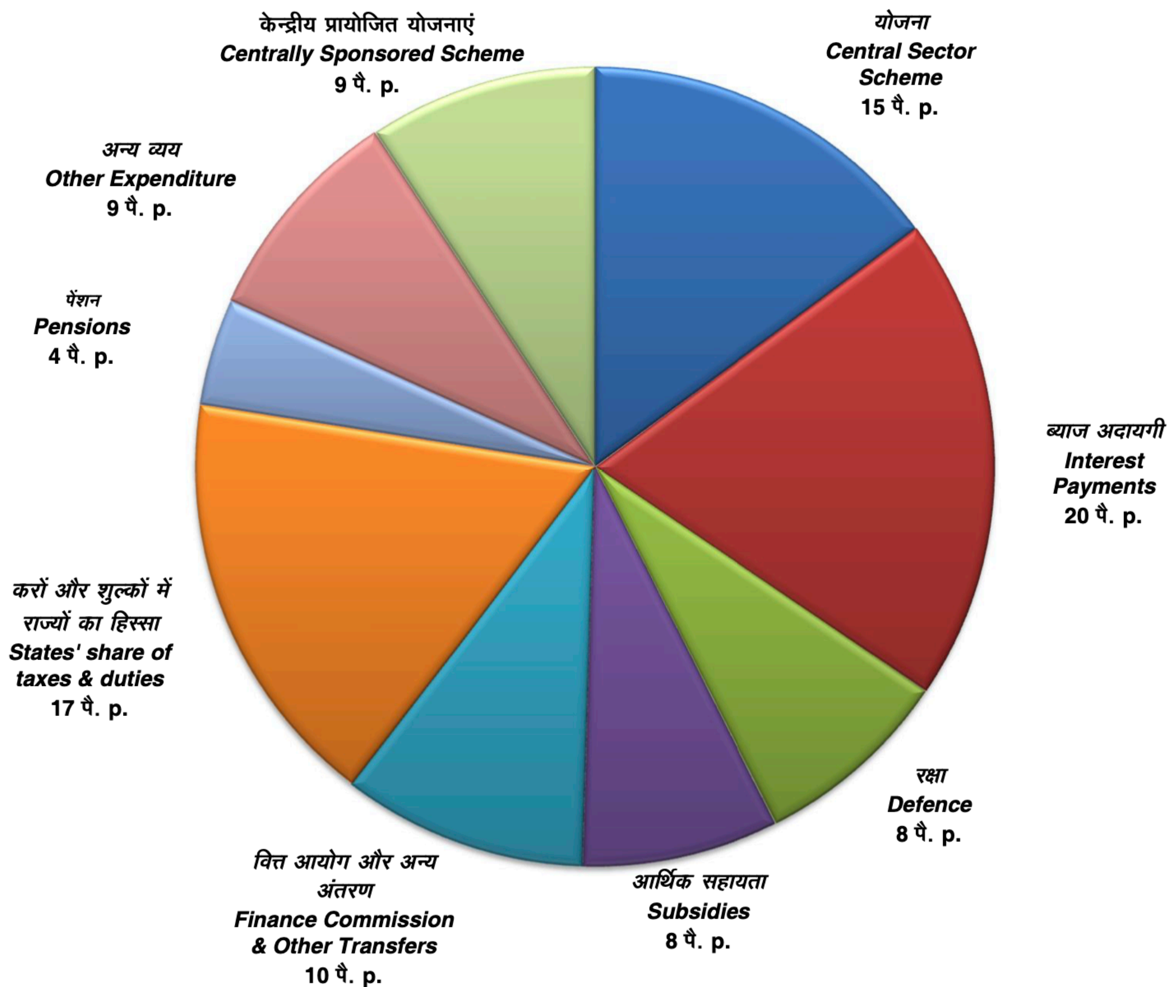
Earlier, the plan expenditure was estimated after discussions with all ministries and the Planning Commission, now the government had dismantled the Planning Commission. So, there are no Five-year plans and government replaced them with medium- and long-term planning

system under NITI Aayog. This new planning is not linked to budget expenditure targets but on end goals of development to reach.

Switching to capital and revenue spending classifications will help to create a clear and effective link between the government's earnings, spending and outcome.

Hence from the financial year of 2017-18, the classification of Expenditure into plan and non-plan has been stopped and it is categorized as Scheme based and Non-Scheme Based Expenditure.

Rupee Goes to



Q) Which of the following is/are included in the capital budget of the Government of India?

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

Rationalization of Central Sponsored schemes (CSS):

The changes in CSS started last financial year with higher tax devolution of 42 % recommended by the Fourteenth Finance Commission (FFC). This higher tax devolution without a corresponding increase in revenue receipts meant that the Union government restructured its approach of running a plethora of central schemes under state plans.

In response to the question of CSS restructuring, states had submitted to the FFC that proliferation of CSS impinges upon their fiscal autonomy as they do not have any say in design of these schemes and face many restrictions in their implementation.

To resolve this paradox on CSS, a sub-group of chief ministers on the rationalization of centrally sponsored schemes was constituted as part of NITI Aayog in March 2015.

The Sub-Group had examined 66 CSSs and a consensus was reached on many contentious issues not only between the States represented on the

Sub- Group but other States/UTs also through regional consultations and meetings with Union Ministries/Departments.

The Guiding Principles of the Sub-Group had been to resolve the issues between Union and the States /UTs and to work as Team India in the spirit of Cooperative Federalism towards realization of the goals of VISION 2022 when we will celebrate the 75th year of Independence.

The objectives of the VISION are broadly:

(a) providing basic amenities to all citizens in an equitable and just manner for ensuring a life with self-respect and dignity, and

(b) providing appropriate opportunities to every citizen to realize his/her potential.

The rationalization of the CSSs would ensure optimum utilization of resources with better outcomes through area specific interventions. This would also ensure wider reach of the benefits to the target groups.

The major recommendations of the Sub-Group are as under:

a) No. of Schemes: The total number of schemes should not exceed 30.

b) Categorization of Schemes: Existing CSSs should be divided into Core and Optional Schemes.

Core schemes: Focus of CSSs should be on schemes that comprise the National Development Agenda where the Centre and States will work together in the spirit of Team India.

Core of the Core Schemes: Those schemes which are for social protection and social inclusion should form the core of core and be the first charge on available funds for the National Development Agenda.

Optional Schemes: The Schemes where States would be free to choose the ones they wish to implement. Funds for these schemes would be allocated to States by the Ministry of Finance as a lump sum.

Funding Pattern would be as follows:

Core of the Core Schemes: Existing Funding pattern of the Core of the Core Schemes would continue.

Core Schemes:

a) For 8 North Eastern States and 3 Himalayan States: Centre: State: 90:10

b) For other States: Centre: State: 60:40

c) For Union Territories (without Legislature): Centre 100% and for UTs with legislature existing funding pattern would continue.

Optional Schemes:

- For 8 North Eastern States and 3 Himalayan States: Centre: State: 80:20
- For other States: Centre: State: 50:50
- For Union Territories: (i) (without Legislature) - Centre 100 (ii)Union Territories with Legislature: Centre: UT:80:20

Flexibility and Flexi-funds to the States/UTs:

- While designing the CSS, the Central Ministries shall permit flexibility in the choice of components to the States as available under the Rashtriya Krishi Vikas Yojana (RKVY).
- Moreover, the flexi-funds available in each CSS has been raised from the current level of 10% to 25% for the States and 30% for the UTs of the overall annual allocation under each Scheme so that the implementation can be better attuned to the needs of individual State /UT.

Types of Budgets

Based on the balancing of revenue and expenditure, budgets are divided into Balanced Budget and Unbalanced Budget.

1. Balanced Budget: - A balanced budget is that over a period of time, revenue does not fall short of expenditure. i.e., revenue is equal to expenditure. (Revenue= Expenditure).

2. The Budget imbalance may be due to an excess of expenditure over income or an excess of income over expenditure. In other words, budget may either be surplus or deficit.

A budget is said to be surplus when public revenue exceeds public outlay. (Revenue>Expenditure).

3. A Deficit budget means a budget when expenditure exceeds revenue. (Revenue<Expenditure).

Deficits:

Revenue deficit: Revenue deficit is “the difference between revenue expenditure and revenue receipts which indicates increase in liabilities of the Central Government without increase in the assets of that Government.

Effective revenue deficit: It has been prescribed by an amendment to the FRBM Act by the Finance Act, 2012. Effective revenue deficit has been defined as the difference between “the revenue deficit and the grants for creation of capital assets”.

Revenue Deficit vs Effective Revenue Deficit: revenue expenditure indicates expenditure to finance day to day functions of the government. They are not productive. But according to the government some revenue expenditure creates assets and hence is productive. This revenue

expenditure which creates assets is deducted to get Effective Revenue Deficit.

Problems related to revenue deficit:

- It indicates the inability of the government to meet its regular and recurring expenditure in the proposed budget.
- It implies that government is dissaving, i.e., government is using up savings of other sectors of the economy to finance its consumption expenditure.
- It also implies that the government has to make up this deficit from capital receipts, i.e., through borrowings or disinvestments. It means, revenue deficit either leads to an increase in liability in the form of borrowings or reduces the assets through disinvestment.
- Use of capital receipts for meeting the extra consumption expenditure leads to an inflationary situation in the economy. Higher borrowings increase the future burden in terms of loan amount and interest payments.
- A high revenue deficit gives a warning signal to the government to either curtail its expenditure or increase its revenue.
- According to far-sighted approach, revenue receipts should always be more than revenue expenditures so that surplus can be used for development projects. However, Indian Budget is facing revenue deficit for the past several years.

Fiscal Deficit: The difference between total revenue and total expenditure of the government is termed as fiscal deficit. It is an indication of the total borrowings needed by the government.

Q) Assertion (A): Fiscal deficit is greater than budgetary deficit.

Reason (R): Fiscal deficit is the borrowing from the Reserve Bank of India plus other liabilities of the Government to meet its expenditure.

(a) Both A and R are true, and R is the correct explanation of A

(b) Both A and R are true, but R is not a correct explanation of A

(c) A is true but R is false

(d) A is false but R is true

Implications of fiscal deficit:

Debt Trap: Borrowings not only involve repayment of principal amount, but also require payment of interest. Interest payments increase the revenue expenditure, which leads to revenue deficit. It creates a vicious circle of fiscal deficit and revenue deficit, wherein government takes more loans to repay the earlier loans. As a result, country is caught in a debt trap.

Q) A country is said to be a debt trap if:
(a) It has to borrow to make interest payments on outstanding loans
(b) It has to abide by the conditionalities imposed by the International Monetary fund.
(c) it has been refused loans or aid by creditors abroad
(d) the World Bank charges a very high rate of interest on outstanding as well as new loans

Foreign Dependence: Government also borrows from rest of the world, which raises its dependence on other countries.

Hampers the future growth: Borrowings increase the financial burden for future generations. It adversely affects the future growth and development prospects of the country.

Crowding - out effect: Crowding out effect refers to a situation when increased interest rates lead to a reduction in private investment spending such that it dampens the initial increase of total investment spending.

Sometimes, government adopts an expansionary fiscal policy stance and increases its spending to boost the economic activity. This leads to an increase in interest rates. Increased interest rates affect private investment decisions. A high magnitude of the crowding out effect may even lead to lesser income in the economy.

With higher interest rates, the cost for funds to be invested increases and affects their accessibility to debt financing mechanisms. This leads to lesser investment ultimately and crowds out the impact of the initial rise in the total investment spending. Usually, the initial increase in government spending is funded using higher taxes or borrowing on part of the government.

Q) There has been a persistent deficit budget year after year. Which action/actions of the following can be taken by the Government to reduce the deficit?

1. Reducing revenue expenditure

2 Introducing new welfare schemes

3. Rationalizing subsidies

4. Reducing import duty

Select the correct answer using the code given below.

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1,2,3 and 4

Q) In the context of governance, consider the following:

1. Encouraging Foreign Direct Investment inflows

2. Privatization of higher educational Institutions

3. Down-sizing of bureaucracy

4. Selling, off-loading 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

Primary Deficit: Primary deficit refers to difference between fiscal deficit of the current year and interest payments on the previous borrowings.

Primary Deficit = Fiscal Deficit – Interest Payments

The total borrowing requirement of the government includes the interest commitments on accumulated debts. Primary deficit reflects the extent to which such interest commitments have compelled the government to borrow in the current period.

Implications of Primary Deficit: It indicates how much of the government borrowings are going to meet expenses other than the interest payments. The difference between fiscal deficit and primary deficit shows the amount of interest payments on the borrowings made in past. So, a low or zero primary deficit indicates that interest commitments (on earlier loans) have forced the government to borrow.

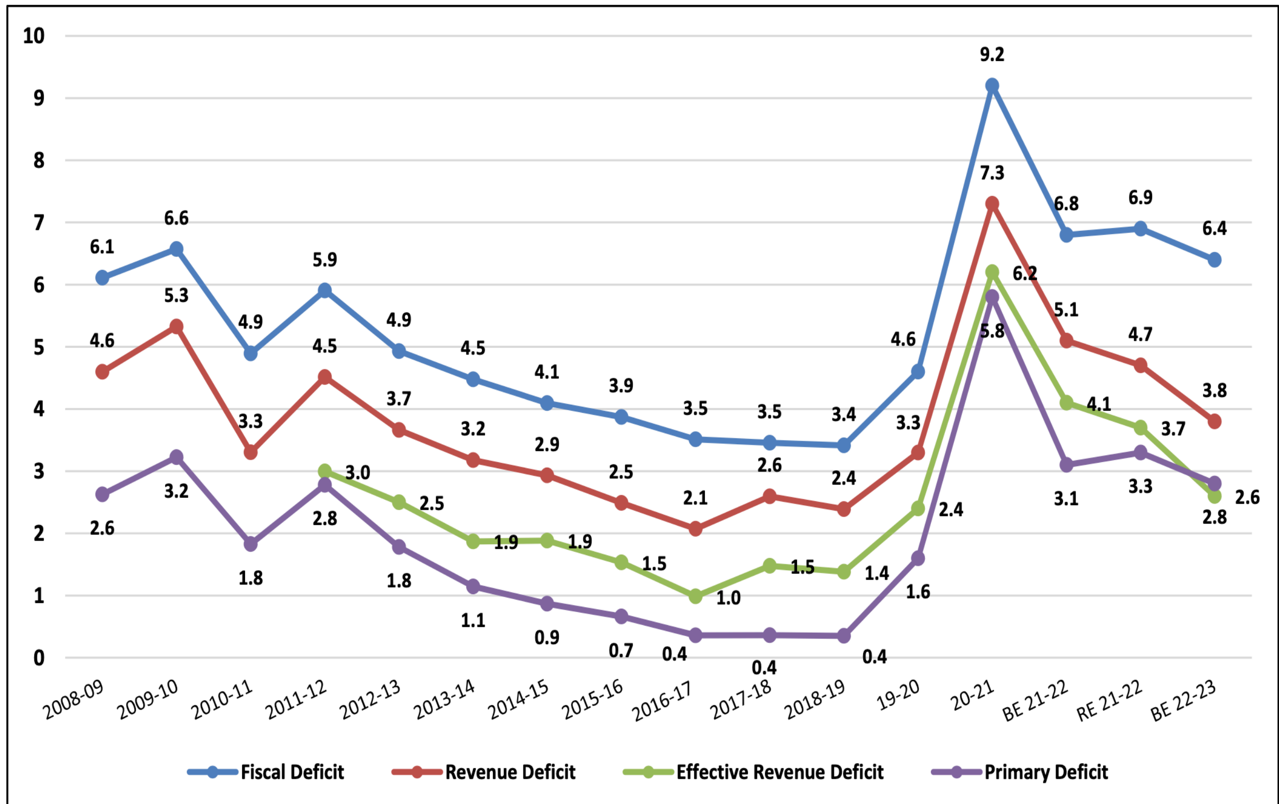
Primary Deficit is the root Cause of Fiscal Deficit: In India, interest payments have considerably increased in the recent years. High interest payments on past borrowings have greatly increased the fiscal deficit. To reduce the fiscal deficit, interest payments should be reduced through repayment of loans as early as possible.

Various indicators of deficit in the budget are:

- ***Revenue deficit = Revenue expenditure – Revenue receipts***
- ***Fiscal Deficit = Total expenditure – total receipts except borrowings***
- ***Primary Deficit = Fiscal deficit- Interest payments***
- ***Effective revenue Deficit-= Revenue Deficit – Grants for the creation of capital assets***
- ***Monetized Fiscal Deficit = that part of the fiscal deficit covered by borrowing from the RBI.***

DEFICIT TRENDS

(% of GDP)



बजट का सार Budget at a Glance

(₹ करोड़) (In ₹ crore)

	2020-2021 वास्तविक Actuals	2021-2022 बजट अनुमान Budget Estimates	2021-2022 संशोधित अनुमान Revised Estimates	2022-2023 बजट अनुमान Budget Estimates
1. Revenue Receipts	**1633920**	**1788424**	**2078936**	**2204422**
2. Tax Revenue (Net to Centre)	1426287	1545396	1765145	1934771
3. Non Tax Revenue	207633	243028	313791	269651
4. Capital Receipts	**1875916**	**1694812**	**1691064**	**1740487**
5. Recovery of Loans	19729	13000	21975	14291
6. Other Receipts	37897	175000	78000	65000
7. Borrowings and Other Liabilities[1]	1818291	1506812	1591089	1661196
8. Total Receipts (1+4)	**3509836**	**3483236**	**3770000**	**3944909**
9. Total Expenditure (10+13)	**3509836**	**3483236**	**3770000**	**3944909**
10. On Revenue Account of which	3083519	2929000	3167289	3194663
11. Interest Payments	679869	809701	813791	940651
12. Grants in Aid for creation of capital assests	230865	219112	237685	317643
13. On Capital Account[2]	426317	554236	602711	750246
14. Effective Capital Expenditure (12+13)[3]	**657182**	**773348**	**840396**	**1067889**
15. Revenue Deficit (10-1)	**1449599 (7.3)**	**1140576 (5.1)**	**1088352 (4.7)**	**990241 (3.8)**
16. Effective Revenue Deficit (15-12)	**1218734 (6.2)**	**921464 (4.1)**	**850667 (3.7)**	**672598 (2.6)**
17. Fiscal Deficit [9-(1+5+6)]	**1818291 (9.2)**	**1506812 (6.8)**	**1591089 (6.9)**	**1661196 (6.4)**
18. Primary Deficit (17-11)	**1138422 (5.8)**	**697111 (3.1)**	**777298 (3.3)**	**720545 (2.8)**

Budgetary Deficit: Budgetary Deficit is the difference between all receipts and expenditure of the government, both revenue and capital.

This difference is met by the net addition of the treasury bills issued by the RBI and drawing down of cash balances kept with the RBI. The budgetary deficit was called deficit financing by the government of India. This deficit adds to money supply in the economy and, therefore, it can be a major cause of inflationary rise in prices.

Q) In India, deficit financing is used for raising resources for

(a) Economic development

(b) Redemption of public debt

(c) Adjusting the balance of payments

(d) Reducing the foreign debt

The concept of budgetary deficit has lost its significance after the presentation of the 1997-98 Budget. In this budget, the practice of ad hoc treasury bills as source of finance for government was discontinued. Ad hoc treasury bills are issued by the government and held only by the RBI. They carry a low rate of interest and fund monetized deficit. These bills were replaced by ***ways and means advance***. Budgetary deficit has not figured in union budgets since 1997-98. Since 1997-98, instead of budgetary deficit, Gross Fiscal Deficit (GFD) became the key indicator.

Q) Match List I with List II and select the correct answer using the codes given below the lists:

List-I (Term). List-II (Explanation)

A. Fiscal deficit 1. Excess of Total Expenditure over Total Receipts

B. Budget deficit 2. Excess of Revenue Expenditure over revenue receipts

C. Revenue deficit 3. Excess of Total Expenditure over Total Receipts less borrowings

D. Primary deficit 4. Excess of Total Expenditure over Total Receipts less borrowings and Interest Payments

Codes:

(a) A-3 ; B-1 ; C-2 ; D-4

(b) A-4 ; B-3 ; C-2 ; D-1

(c) A-1 ; B-3 ; C-2 ; D-4

(d) A-3 ; B-1 ; C-4 ; D-2

How Budget Deficit leads to Automization of Deficits and Monetization of Deficits?

The **Monetized Deficit** is the extent to which the RBI helps the central government in its borrowing programme. In other words, monetized deficit means the increase in the net RBI credit to the central government, such that the monetary needs of the government could be met easily.

In Indian context, the origin of 'automatic monetization' can be found from the agreement made in January 1955 regarding creation of ad hoc Treasury Bills(91-day) between the central government and the RBI. This agreement specified that the central government shall maintain a certain

minimum cash balance with the RBI and if the balance falls below the minimum agreed limit, the account would be automatically replenished by the creation of adhocs in favour of the RBI.

Over time, issuance of such adhocs became a continuously increasing means of financial support to the central government from the RBI. These adhocs constituted 19.0% of reserve money in 1982 and 77.3% of reserve money in 1991. As rising monetized deficit has implications for price level, the central government and the RBI felt the need to limit such credit extension. As a result, an agreement was signed in September 1994 to phase out the creation of adhocs by end of fiscal year 1996–97.

Monetized Fiscal Deficit is that part of the fiscal deficit financed out of borrowing from the RBI. It indicates borrowings form the RBI to run the budget. This practice was phased out in 1997. Hence, the MFD is not relevant now. MFD is highly inflationary.

The monetized deficit results in the increase in the net holdings of treasury bills by the RBI and also the RBI contribution towards the government's market borrowings increases. With the issue of more money to the government, the money supply in the economy increases, as a result of which the inflationary pressure prevails. Hence, we can say that monetized deficits are the part of a fiscal deficit that leads to the inflation in the economy.

Thus, it can be concluded that monetized deficit occurs when the government takes a monetary support from the RBI to finance its debt obligations.

Ways and Means Advances (WMA)

The Reserve Bank of India gives temporary loan facilities to the centre and state governments as a banker to government. This temporary loan facility is called Ways and Means Advances (WMA).

The WMA for the Central Government

The WMA scheme for the Central Government was introduced on April 1, 1997, after putting an end to the four-decade old system of adhoc (temporary) Treasury Bills to finance the Central Government deficit. The WMA scheme was designed to meet temporary mismatches in the receipts and payments of the government.

This facility can be availed by the government if it needs immediate cash from the RBI. The WMA is to be vacated after 90 days. Interest rate for WMA is currently charged at the repo rate. The limits for WMA are mutually decided by the RBI and the Government of India.

Overdraft

When the WMA limit is crossed the government takes recourse to overdrafts, which are not allowed beyond 10 consecutive working days. The interest rate on overdrafts would be 2 percent more than the repo rate.

The minimum balance required to be maintained by the Government of India with the Reserve Bank of India will not be less than Rs.100 crore on Fridays, on the date of closure of Government of India's financial year and on June 30, the date of closure of the annual accounts of the RBI, and not less than Rs.10 crore on other days.

The cash management of GoI has considerably deteriorated in the recent past, with situations of large surplus and large deficit. This has put

tremendous pressure of RBI with respect to liquidity management and conduct of monetary policy.

WMA Scheme for State Governments

Under the WMA scheme for the State Governments, there are two types of WMA - Special and Normal WMA.

- Special WMA is extended against the collateral (mortgaging) of the government securities held by the State Government. After the exhaustion of the special WMA limit, the State Government is provided a normal WMA.
- The normal WMA limits are based on three-year average of actual revenue and capital expenditure of the state.

The withdrawal above the WMA limit is considered an overdraft. A State Government account can be in overdraft for a maximum 14 consecutive working days with a limit of 36 days in a quarter. The rate of interest on WMA is linked to the Repo Rate. Surplus balances of State Governments are invested in Government of India 14-day Intermediate Treasury bills in accordance with the instructions of the State Governments.

"Deficits mean future tax increases, pure and simple. Deficit spending should be viewed as a tax on future generations, and politicians who create deficits should be exposed as tax hikers" – Ron Paul

Deficit Financing: Deficit financing is the budgetary situation where expenditure is higher than the revenue. It is a practice adopted for financing the excess expenditure with outside resources. The expenditure revenue gap is financed by either printing of currency or through borrowing.

Nowadays most governments both in the developed and developing world are having deficit budgets and these deficits are often financed

through borrowing. Hence the fiscal deficit is the ideal indicator of deficit financing. There are several methods of Deficit Financing such as:

1. Borrow from domestic or foreign sources

2. Draw upon its foreign exchange reserves

3. Print an equivalent amount of money.

How these factors influence the other economic factors:

- If the **government borrows too much from abroad**, it leads to a debt crisis. The money that has been borrowed from abroad comes on sovereign guarantee and is called Sovereign Debt. Governments usually borrow by issuing securities, government bonds and bills. However not all governments can borrow by these methods. The less creditworthy countries need to borrow directly from World Bank or other financial institutions. The debt may be short term or long term. Inability to service the debt may result in Sovereign Default which is another name of Debt Crisis.
- **Excessive domestic borrowing** by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the "crowding out" of private investment.
- If the government **draws down on its foreign exchange reserves**, a Balance of Payments crisis may arise. Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers. A BOP crisis, also called a currency crisis, occurs when a nation is unable to pay for essential imports and/or service its debt repayments. Typically, this is accompanied by a rapid decline in the value of the affected nation's currency.

- In a general sense, excessive **printing of money** leads to inflation. This is because when government prints too much money, its purchasing power goes down and a situation of too much money choosing too few goods.

Why printing of currency is used as a last resort: Printing Currency is used by the Government as last resort in deficit financing. The printing of currency has its own side effects such as increasing inflation and pressure on the Government for upward revision of the wages. Further, printing currency does not meet the expenditures which are needed to be met with foreign currency only.

From the above discussion it makes clear that it is not prudent for a government to run an unduly large deficit. But at the same time, for a developing country like India, it is also not prudent to have surpluses at the cost of long-term growth.

This is because the need for infrastructure and social investments is substantial. So, the most developing country governments have the biggest challenge to meet infrastructure and social needs while managing the government's finances in a way that the deficit or the accumulating debt burden is not too great.

Q) Which one of the following is likely to be the most inflationary in its effects?
(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

Why in India we have deficit always:

- India is a developing country. It has not reached the limits of growth. There is a huge percentage of population that earn in the subsistence level. If India can increase the earnings of these people, it can increase

its GDP per person. Now to increase the earning potential of these people India needs to make some investments in infrastructure and provide capital to the industries to provide employment for these people. The funds for such investments can either be sourced through fractional banking i.e., printing notes or through public debts. That is why India always has a deficit budget to make public investment.

- Moreover, with large proportion of people under Below Poverty Line (BPL) and making sure that all the necessary support be provided to them so that they can live a meaningful and just life is always a priority for any government. Because of this subsidies bill is increasing year-on-year. In recent times the discretionary subsidies have becoming duty-based subsidies (rights-based approach).

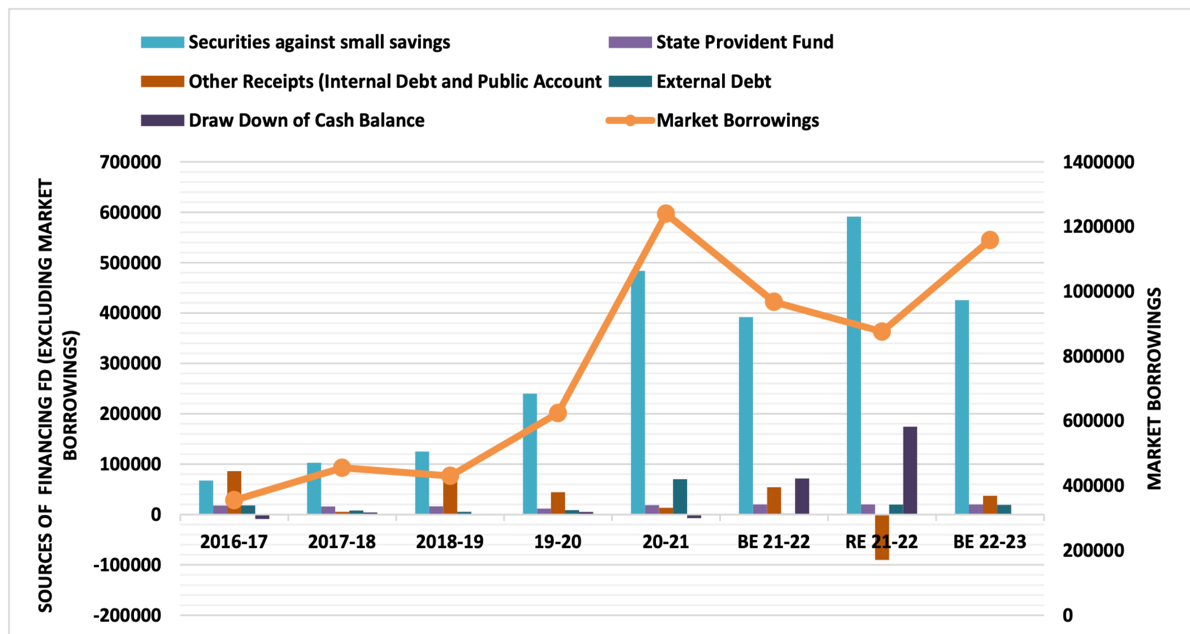
Example: Right to Education, Right to Work (MGNREGA) etc.

Another reason is fiscal populism practiced by many central and state governments, especially before the upcoming election.

Problems in the long run:

- This Fiscal Populism in the long run would effectively erode the effectiveness of the fiscal policy and especially subsidies.
- As deficit bill is increasing, which simply equals to "borrowings", these borrowings have to be financed by the future generations. So that the resources available for their own consumption will be less.
- Populism is a very dangerous act in Democratic Country especially country like India where large section of population is poor, for the reason that if any govt. reduces the subsidy bill for prudence considerations that particular govt. will be punished in the next elections. So, subsidies many times locked in upward spiral.
- On the other hand, taxpayers will somehow try to avoid paying taxes due to mindless nature of subsidies and lack of trust in the Govt. spending.

- **Financing Deficits**



What is Fiscal Populism: It means revenue and capital expenditure programs aimed at subsidizing a large, preferably majority, of the voting population. The "mindless" nature of populism that as per capita incomes have increased manifold, so has the percentage of the population subject to income tax. So, this financing class worries about the efficacy of the delivery of subsidies to the poor, and to themselves.

Generally, subsidies are for the poor and to some sections of the middle class. Indian subsidies are framed so obscurely that rich, poor and middle class are treated alike and, in the end, due to lack of effective delivery system poor does not get their quota and rich receiving a major part of subsidies.

Example: In India according to Tendulkar Committee (2005) 22% of people are Below Poverty Line (BPL). The national food Security Act (2013), which provides subsidized food grains less than 2 rupees, is for the 50% of the Urban population and 75% of Rural population which aggregately equals to 67% of the total population. This explains the

"mindless" nature of the subsidies. Instead of providing subsidized food grains to only 22% BPL families, the act provides for 67% Population.

Fiscal Profligacy: Fiscal profligacy would be when the government doesn't care about its revenues and keeps borrowing money to spend. It would lead to a larger fiscal deficit which is not good for any economy. Fiscal profligacy is opposite of fiscal prudence.

The government policy of spending more than its tax revenues and the shortfall is met by taking loan (debt) from public. The shortfall continues to increase because of additional burden of interest and repayment of earlier loans. The government's such a fiscal policy is called fiscal profligacy.

Fiscal Consolidation:

Fiscal consolidation is a term that is used to describe the creation of strategies that are aimed at minimizing deficits. In simple terms when govt try to reduce their unnecessary expenditure to improve the condition of govt account and save money this is called fiscal consolidation.

According to OECD "**Fiscal consolidation** is a policy aimed at reducing government deficits and debt accumulation."

Fiscal consolidation is a process where government's fiscal health is getting improved and is indicated by reduced fiscal deficit. Improved tax revenue realization and better aligned expenditure are the components of fiscal consolidation as the fiscal deficit reaches at a manageable level. In India FRBM act 2003 is the example of fiscal consolidation.

Q) There has been a persistent deficit budget year after year. Which of the following actions can be taken by the government to reduce the deficit?

1. Reducing revenue expenditure
2. Introducing new welfare schemes
3. Rationalizing subsidies
4. Expanding industries

Select the correct answer using the code given below.

(a) 1 and 3 only

(b) 2 and 3 only

(c) 1 only

(d) 1,2,3 and 4

Fiscal Consolidation Vs Austerity

Fiscal Consolidation:

Fiscal consolidation is a process where government's fiscal health getting improved indicated by reduced fiscal deficit which is manageable and bearable for the economy. Improved tax revenue realization and better aligned expenditure are thus components of fiscal consolidation.

In India, fiscal consolidation or the fiscal roadmap for the centre is expressed in terms of the budgetary targets (fiscal deficit and revenue deficit) to be realized in successive budgets. The Fiscal Responsibility and Budget Management (FRBM) Act gives the targets for fiscal consolidation in India. According to FRBM, the government should eliminate revenue deficit and reduce fiscal deficit to 3% (medium term) of the GDP.

Austerity:

Austerity measures are reductions in government spending, increases in tax revenues, or both. These harsh steps are taken to lower budget deficits and avoid a debt crisis.

Governments are unlikely to use austerity measures unless forced to do so by the bond holders or other lenders. These measures act like contractionary fiscal policy. They slow economic growth. That makes it even more difficult to raise the revenue needed to pay off sovereign debt.

Austerity measures require changes in government programs. For example, they:

- Limit the terms of unemployment benefits.
- Extend the eligibility age for retirement and health care benefits.
- Reduce government employees' wages, benefits, and hours.
- Cut programs for the poor.
- Austerity measures also include tax reforms. For example, they:
- Raise income taxes, especially on the wealthy.
- Target tax fraud and tax evasion.
- Privatize government-owned businesses. These are industries considered vital to the state's interest. They include utilities, transportation, and telecommunications. Selling them will raise revenue to pay off debt.
- Increase value-added taxes.
- Other austerity measures reduce regulations to lower business costs. They require governments to:
- Lower or eliminate the minimum wage.
- Increase workers' hours.
- Austerity measures may not include all of these changes. It depends on the country's situation.

Fiscal prudence

Fiscal prudence is Spending within budget. Fiscal prudence means when your expenses are according to your planned expenditure and your budget doesn't suffer a deficit. Fiscal prudence has a lot in common with fiscal consolidation and/or "austerity", where government takes stringent steps to curb the inflation and correct fiscal deficit. Governments around the globe follow 'prudent fiscal policies' such as Cutting government spending, increasing tax rate, limiting perks and allowances to government employees and trying to make PSUs profitable.

Public Debt

In India, public debt refers to a part of the total borrowings by the Union Government which includes such items as market loans, special bearer bonds, treasury bills and special loans and securities issued by the Reserve Bank. It also includes the outstanding external debt.

The difference between receipts and disbursals is the net accretion to the public debt. Public debt can be split into internal (money borrowed within the country) and external (funds borrowed from non-Indian sources).

Internal debt comprises treasury bills, market stabilization schemes, ways and means advance, and securities against small savings.

Types of Public Debt: Government loans are of different kinds, they may differ in respect of time of repayment, the purpose, conditions of repayment, method of covering liability etc.

The kinds are:

Productive and Unproductive debts: The debts which are productive for the economy are known as productive, similarly the debts which do not benefit the economy are unproductive.

Voluntary and Compulsory Debt: Generally, the debts taken are voluntary, on the part of the government, known as voluntary debts whereas in times of wars or crisis there is a mandatory loan taken by the government known as compulsory debt. It is a rare phenomenon.

Internal and External Debt: Internal debt refers to public debt floated within the country; While external debt refers loans floated outside the country.

Short-Term, Medium-Term & Long-Term Debts: The debts maybe for short, medium, or long periods. Redeemable and Irredeemable Debts The debts which the government promises to pay at a future date are known as redeemable and Irredeemable is vice-versa. It does not have a maturity period.

Funded and Unfunded Debts: The funded debts are those which are paid after a long period of time with a fixed rate of interest. Unfunded debts are incurred to meet the temporary needs of the government. They are of a comparatively short period say a year.

Internal Debt: Market loan Treasury bills Bonds Special securities issue by RBI Ways and Mean Advances (To meet the short-term expenditure) Special floating and other loans.

Q) Consider the following:

1. Market borrowing

2. Treasury bills

3. Special securities issued to RBI

Which of these is/are components(s) of internal debt?

(a) 1 only

(b) 1 and 2

(c) 2 only

(d) 1,2 and 3

External Debt: Bilateral borrowings multi-lateral borrowings Loans from international organizations like IMF, World Bank etc.

Q) Consider the following statements:

1. Most of India's external debt is owed by government entities.

2. All of India's external debt is denominated in US dollars.

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Who manages public debt?

The Constitution of India gives the executive branch of Government the powers to borrow upon the security of the Consolidated Fund of India. Reserve Bank as an agent of the Government (both Union and the States) used to implement the borrowing program. The Reserve Bank draws the necessary statutory powers for debt management from Section 21 of the Reserve Bank of India Act, 1934.

While the management of Union Government's public debt is an obligation for the Reserve Bank, the Reserve Bank undertakes the management of the public debts of the various State Governments by agreement.

The jurisdiction of various institutions responsible for public debt management is given below:

1. Reserve Bank of India – Domestic Marketable Debt i.e., dated securities, treasury bills and cash management bills.

2. Ministry of Finance (MOF); Office of Aid and accounts Division – external debt

3. Ministry of Finance; Budget Division and Reserve Bank of India – Other liabilities such as small savings, deposits, reserve funds etc.

For monetary and fiscal coordination, there is a cash and debt management committee which meets regularly.

The members comprise of officials from RBI and MOF.

Q) With reference to the Indian Public Finance, consider the following statements:

1. External liabilities reported in the Union Budget are based on historical exchange rates

2 The continued high borrowing has kept the real interest rates high in the economy

3. The upward trend in the ratio of Fiscal Deficit of GDP a. recent years has an adverse effect on private investment

4. Interest payments is the single largest component of the non-plan revenue expenditure of the Union Government

Which of these, statements are correct?

(a) 1,2 and 3

(b) 1 and 4

(c) 2,3 and 4

(d) 1,2,3 and 4

Debt Trap

A debt trap is a situation in which an entity borrows money but does not have enough money to make the interest payments on the loan, so it takes out another loan—with its own interest payments—to cover the first loan's payments. They will likely have to borrow again to pay off the second loan, creating a crippling cycle.

Grexit

Grexit, an abbreviation for "Greek exit," refers to Greece's possible withdrawal from the eurozone, which made frequent news headlines from 2012 to 2015 and occasional news thereafter. The term first gained notoriety in early 2012, as many pundits, and even some Greek citizens, proposed that Greece leave the eurozone and return to the drachma as its currency instead of the euro as a way to deal with the country's debt crisis.

Leaving the euro and bringing back the drachma was thought to be a way to allow Greece to recover from the brink of bankruptcy. A devalued drachma was considered as a way to encourage overseas investment and allow other Europeans to visit Greece on the cheap by paying in more-expensive euro. In this way, proponents argued that the Greek economy would suffer in the near term but could eventually recover with far less assistance from other eurozone countries and the IMF, perhaps even quicker than via eurozone bailouts.

However, opponents argued that a return to the drachma would lead to a very rough economic transition and far-lower living standards, which could result in even more civil unrest. Some in Europe worried that Grexit could even cause Greece to embrace other foreign powers that might not align with interests of the eurozone.

Opponents to Grexit have seemingly won out, at least in the roughly six years since Grexit entered the discussion. As of mid-2018, Greece remains in the eurozone, with help from bailout loans in 2010, 2012 and 2015. However, the term Grexit has continued to make headlines on occasion. As Greece continues to attract foreign investment and with austerity measures, some have argued as recently as February 2018 that Grexit remains an eventual possibility.

Initiatives taken by GOI for Fiscal Consolidation

Fiscal Responsibility and Budget Management Act (FRBM)

What is the need of the act: In 1980s, India saw a sharp deterioration of the fiscal situation, which ultimately culminated in the balance of payments crisis of 1991. Within a decade of economic liberalization, the fiscal deficit and debt situation again seemed to head towards unsustainable levels around 2000.

At that time, there was a need to institutionalize a new fiscal discipline framework. The FRBM Bill 2000 was introduced by previous NDA government in the parliament to institutionalize the fiscal discipline at both the centre and state level. However, the bill took three years to become an act and during this process, it lost most of its teeth.

The key provisions of the FRBM Act:

- Every year the government will bring down revenue deficit by 0.5% and eliminate it by 2007-08.
- Every year, the government will bring down fiscal deficit by 0.3% and bring it down to 3% by 2007-08.
- Total liabilities of the Union Government should not rise by more than 9% a year.
- Union Government would not give guarantee to loans raised by PSUs and State governments for more than 0.5% of the GDP in aggregate.
- Union Government would place three more documents along with the budget documents viz. Macroeconomic Framework Statement, Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement.
- At the end of second quarter, the finance minister would make a statement on the trend of fiscal indicators and corrective measures taken thereof.

However, due to the 2007 international financial crisis, the deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009. In last few years, the act has been largely neglected.

Q) Which one of the following statements is correct? Fiscal Responsibility and Budget Management Act (FRBMA) concerns:

(a) Fiscal Deficit only

(b) Revenue deficit only

(c) Both fiscal deficit and revenue deficit

(d) Neither fiscal deficit nor revenue deficit

Amendments to the FRBM Act

Amendments to the Act were made after its initial version in 2003. This includes revision of the target realization year and introduction of the concept of effective revenue deficit. In 2012 and 2015, notable amendments were made. As per one provision of the amendment, a "Medium-term Expenditure Framework" statement should be prepared which will set a three-year rolling target for expenditure indicators.

As per the amendments in 2012, the Central Government has to take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit to eliminate the effective revenue deficit by the 31st of March, 2015 and thereafter build up adequate effective revenue surplus and thereafter as may be prescribed by rules made by the Central Government.

As per Finance Act 2015, the target dates for achieving the prescribed rates of effective deficit and fiscal deficit (3% fiscal deficit) were further extended by 3 years to March 2018.

Q) Consider the following statements

1. The Fiscal Responsibility and Budget Management (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.

2. The Central Government has domestic liabilities of 21 % of GDP as compared to that of 49 % of GDP of the State Governments.

3. As per the Constitution of India, it is mandatory for a State to take the Central Government's consent for raising any loan if the former owes any outstanding liabilities to the latter.

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1,2 and 3

Expenditure Management Commission

In the 2014-15 budget speech, Finance Minister Arun Jaitley announced the constitution of Expenditure Management Commission (EMC). The Commission had been conceived as a recommendation body with the primary responsibility of suggesting major expenditure reforms that will enable the government to reduce and manage its fiscal deficit at more sustainable levels.

The EMC was formed as a five-member body composed of the former Reserve Bank of India (RBI) Governor Bimal Jalan, who has been appointed to Head the Commission, former Finance Secretary Sumit

Bose, former Deputy RBI Governor Subir Gokarn and two other members.

The commission was mandated to evaluate proposals for reducing the three major subsidies (i.e., food, fertilizer and oil). The commission was to submit an interim report before the presentation of the Budget for 2015-16. The final report was to be submitted before the 2016-17 budget. But the Commission took a little more time.

The expenditure management commission, headed by former Reserve Bank of India (RBI) governor Bimal Jalan, submitted its first interim report in January 2017 to Finance Minister Arun Jaitley. The finer details will take time till Finance Minister and a team of policymakers examine it and make it public. However, the broad proposals suggest ways for the government to reduce administrative costs and disburse funds for various schemes more efficiently.

The Commission is anticipated to give following broad proposals in the report

- Ways for the govt to cut administrative costs
- Panel has suggested ways to spend budgetary allocation effectively
- Delivery mechanisms, technology, accounting methods being studied.

The Indian economy is facing demand and supply side shocks due to demonetization and a sluggish development in exports and Industrial sector which has reduced the growth forecast a little bit for the year 2017 and 2018. Government has implemented and OROP for defence personnel and the seventh pay commission for the government employees, which would have repercussions for the government expenditure.

Also, government's announcement of recapitalization of banks in view of mammoth Non- Performing Assets as well proposal of increase in public sector investment in infrastructure, railways as well as rural

development would also put pressure on government exchequer apart from various subsidies. The additional proceeds from Public Sector disinvestment is also uncertain.

Committee to review FRBM targets

As per the Union Budget 2016-17, the government constituted a committee headed by N K Singh to review the implementation of the FRBM Act. This was after a widely held view among experts that instead of fixed fiscal deficit targets.

During Budget speech in 2016, Mr. Jaitley expressed this debate: "There is now a school of thought which believes that instead of fixed numbers as fiscal deficit targets, it may be better to have a fiscal deficit range as the target, which would give necessary policy space to the government to deal with dynamic situations. There is also a suggestion that fiscal expansion or contraction should be aligned with credit contraction or expansion, respectively, in the economy."

The committee submitted its report in January 2020 and it was made public in April that year. The major recommendations of the N.K.Singh Committee are discussed below.

- It proposed to replace the FRBM Act, 2003 with a Debt Management and Fiscal Responsibility Bill, 2017.
- Debt to GDP Ratio
    - The debt to GDP ratio should be 38.7% for the central government, 20% for the state governments together by the FY 2022 – 23.
- Fiscal deficit
    - By FY 2022 – 23, the fiscal deficit should be 2.5% of GDP.

- The committee recommended achieving the above targets by a 'glide path', that is, a steady progress towards them, by achieving annual targets until 2023.
- Fiscal Council
  - It recommended the setting up of an autonomous Fiscal Council, whose role would be:
    - To prepare multi-year fiscal forecasts.
    - To improve fiscal data quality.
    - To suggest changes to the fiscal strategy.
    - To advise the government on fiscal matters.
- The committee recommended that the government could deviate from the targets in the following scenarios:
  - National calamity, war, in considerations of national security, agricultural collapse affecting incomes and outputs.
  - Structural reforms in the economy having fiscal implications.
  - A decline in real output growth of at least 3% below the average of the previous four quarters.
- The 15th Finance Commission should recommend the debt trajectory for each state based on their track record of fiscal health and prudence.
- The centre should borrow from the Reserve Bank of India only when:
  - It has to meet a temporary shortfall in receipts.
  - RBI subscribes to g-secs to fund any deviation from the prescribed targets.
  - RBI buys g-secs from the secondary market.
- Compatibility of monetary and fiscal policies
  - The committee recommended that both the monetary and fiscal policies must ensure macroeconomic stability and growth in a complementary manner.
  - To this end, the inflation targeting regime and fiscal rules have to interact with each other.

Rail Budget:

The origin of the railway budget goes back to a report by British politician William Ackworth in 1924. He recommended a separate railway budget, given that most of the infrastructure spending by the British government went towards building railway lines. Now, the railway budget size is quite small at Rs.1.21 trillion compared to India's overall budget of Rs.19.8 trillion.

A committee headed by Niti Aayog member Bibek Debroy in his report on restructuring the public transport behemoth last year had recommended that the railway budget should be phased out progressively and merged with the general budget.

How is it beneficial:

- Railways will get exemption from payment of dividend to General Revenues and its Capital-at-charge would stand wiped off.
- The Capital at charge of the Railways on which annual dividend is paid by the Railways will be wiped off. Consequently, there will be no dividend liability for Railways from 2017-18 while Ministry of Railways continue to get Gross Budgetary support for capital expenditure. This will save Railways from the liability of payment of approximately 10,000 crore as annual dividend to the Government of India which after adjusting the subsidy in payment of dividend would give a net benefit of about 5000 crore to the Railways.
- The presentation of a unified budget will help present a holistic picture of the financial position of the Government
- Merger of Rail Budget with Union Budget would facilitate multimodal transport planning between highways, railways and inland waterways.

What is Gender Budgeting (GB)?

- GB is concerned with gender sensitive formulation of legislation, Programmes and schemes; allocation of resources; implementation and execution; audit and impact assessment of Programmes and schemes; and follow-up corrective action to address gender disparities.
- A powerful tool for achieving gender mainstreaming so as to ensure that benefits of development reach women as much as men.
- Does not seek to create a separate budget but seeks affirmative action to address specific needs of women.
- Monitors expenditure and public service delivery from a gender perspective.
- Entails dissection of the Government budgets to establish its gender differential impacts and to ensure that gender commitments are translated into budgetary commitments.

The Five-Step Framework for Gender Budgeting

- **Step 1:** An analysis of the situation for women and men and girls and boys (and the different sub-groups) in a given sector.
- **Step 2:** An assessment of the extent to which the sector's policy addresses the gender issues and gaps described in the first step.
- **Step 3:** An assessment of the adequacy of budget allocations to implement the gender-sensitive policies and Programmes identified in step 2.
- **Step 4:** Monitoring whether the money was spent as planned, what was delivered and to whom.
- **Step 5:** An assessment of the impact of the policy/programme/scheme and the extent to which the situation described in step 1 has changed.

Rationale Behind Gender Budgeting

- According to the 2011 census, women account for 48 per cent of the total population of the country.
- Women face disparities in access to and control over services and resources.
- Bulk of the public expenditure and policy concerns are in "gender neutral sectors".
- Implications on women in the above sectors are not recognized or identified.
- Gender responsive budgets policies can contribute to achieving the objectives of gender equality, human development, and economic efficiency.

Gender Budgeting in India

- Gender Budget Statement (GBS) was first introduced in the Indian Budget in 2005-06. This GB Statement comprises two parts–
- Part A reflects Women Specific Schemes, i.e., those which have 100% allocation for women.
- Part B reflects Pro Women Schemes, i.e., those where at least 30% of the allocation is for women.
- India's gender budgeting efforts stand out globally because they have not only influenced expenditure but also revenue policies (like differential rates for men and women in property tax rates and reconsideration of income tax structure) and have extended to state government levels.
- Gender budgeting efforts in India have encompassed four sequential phases: (i) knowledge building and networking, (ii) institutionalizing the process, (iii) capacity building, and (iv) enhancing accountability.
- Gender budgeting in India is not confined to an accounting exercise. The gender budgeting framework has helped the gender-neutral ministries to design new programs for women.

Gender Budgeting Cells (GBC) as an institutional mechanism have been mandated to be set up in all Ministries/Departments.

GBCs conduct gender-based impact analysis, beneficiary needs assessment and beneficiary incidence analysis to identify scope for re-prioritization of public expenditure and improve implementation etc.

Shortcomings

- Not only has the magnitude of the gender budget as a proportion of the total expenditure of the Union Budget decreased, the budgetary allocations for promoting gender equality and women's empowerment have also shown a decline.
- There are only a few "big budget" women exclusive schemes of the Ministry of Women and Child Development (MWCD) like the Nirbhaya Fund and the Beti Bachao Beti Padhao campaign.
- Lack of dedicated human resources to implement the interventions identified by the GBCs.
- Monitoring remains one of the weakest links in the GRB work with no designated mechanism for monitoring it at the national level.
- Assumptions behind reporting allocations under Part B of the GBS remain questionable.

Way Forward

- An assessment of gender responsive budgeting in India reveals a mixed picture.
- There are number of positive developments, such as changes in select planning and budgeting processes and creation of gender budget cells.
- However, restricted reach of GB and stagnant or even declining allocations for the gender agenda are stumbling blocks.

- The adoption of the GB should be accompanied by multifaceted and interrelated improvements to budgets in general and the gender sensitivity of budgets.
- There needs to be shift from mere "reporting" of gender allocations to “purposive planning” with wider participation of women.

China’s debt trap policy

China’s Belt and Road Initiative (BRI) which seeks to invest about $8 trillion in infrastructure projects across Asia, Europe and Africa, has come under intense scrutiny, not least due to suspicions over China’s intent behind the ambitious project. A study by the Centre for Global Development, a Washington-based think tank, analyses one important consequence of BRI i.e., debt.

The debt trap

- The BRI will potentially span 68 countries and could have implications for each of these countries’ public debt.
- It is found that eight countries could potentially face difficulties in servicing their debt because of the Belt and Road Initiative. These include Pakistan, Djibouti, the Maldives, Laos, Mongolia, Montenegro, Tajikistan and Kyrgyzstan.
- These countries are either low GDP or are distressed by their internal problems like terrorism or communal clashes or are underdeveloped. These are the countries which need international help and funds but that help shouldn’t be coming from China as it’s more of a trap.
- China has a pattern of funding infrastructure projects in poorer countries in exchange for better relations and regional access, a trend hence called debt-trap diplomacy.

- The loans can have exorbitant interest rates or natural resources are used as collateral that China can control if a country defaults on its payments.
- One example is China's acquisition of Sri Lanka's Hambantota port after the Sri Lankan government failed to service its debt.
- The same pattern can be seen in Djibouti. The loans to Djibouti amount to at least US$1.1 billion, which is more than Djibouti could ever dream of repaying. It is about to cede control of another key port to Beijing.
- The Maldives, a small economy heavily reliant on tourism, is one of the most at-risk countries of any involved with the BRI to the distress of debt.

Creditor China not bound by rules

- Unlike most of the world's other major creditors, China is not bound to a set of rules on how it addresses debtor repayment problems.
- Currently, China is only an ad hoc participant of the Paris Club, a collection of creditor nations which follow a set of rules in dealing with debtor nations.

Dealing with the Chinese debt trap

- It is recommended that globally accepted creditor disciplines and standards be applied to the Belt and Road Initiative.
- Further, it is recommended that the World Bank and other multilateral banks increase their participation in the Belt and Road Initiative and work with the Chinese government to set the lending standards for the BRI projects.
- Another recommendation is to establish a new creditor's group which would maintain the core principles of the Paris Club but with China playing a more meaningful role.
- To mitigate lending risks, China is also recommended to provide technical and legal support to developing countries.

- Finally, the think tank proposes that China should offer debt swap arrangements in support of environmental goals where borrowing country debt is forgiven in exchange for a commitment to an environmental objective, for instance, forest preservation.

Public Debt Management

Background:

- Long-pending proposal to set up an independent agency to manage Central government borrowings.
- Setting up of Public Debt Management Agency (PDMA) will require amendments to the RBI Act.
- The need for an independent debt manager for the Centre is becoming more underlined as its borrowings cross over Rs 6 lakh crore and it is trying to lower its fiscal deficit to less than 4 per cent this fiscal.
- The rationale for PDMA is simple – it would permit the RBI to focus more fully on its responsibility of setting the monetary policy as well as do away with the conflict of its twin roles as the manager of government debt as well as its banker.
- The model is followed internationally in most developed economies including the United Kingdom and Sweden.

Setting up of Public Debt Management Cell:

Government has set up a Public Debt Management Cell (PDMC) with the objective of deepening bond markets in the country. PDMC will streamline government borrowings and better cash management for deepening bond markets.

Key Facts

- PDMC is an interim arrangement and will be upgraded to a statutory Public Debt Management Agency (PDMA).
- Thus, it is a requisite preparatory work for PDMA.
- It will allow separation of debt management functions from RBI to PDMA in a gradual and seamless manner, without causing market disruption.
- The Middle Office of the Budget Division in the Union Finance Ministry will be subsumed into PDMC with immediate effect.
- The Joint Secretary (Budget), Department of Economic Affairs of the Finance Ministry will be the overall in-charge of the PDMC.
- PDMC will have only advisory functions in order to avoid any conflict with the statutory functions of RBI.

Functions of PDMC

- Plan government borrowings, including market borrowings and other borrowings, like Sovereign Gold Bond (SGB) issuance.
- Manage government's liabilities, improve cash forecasting, monitor cash balances, foster a liquid and efficient market for government securities.
- Advise government on matters related to capital market operations, investment, administration of interest rates on small savings etc.
- Develop an Integrated Debt Database System (IDMS) as a centralised data base for all liabilities of government, on a near real time basis.
- IDMC will be an integral part of PDMC.

Why needed?

- With establishing PDMA, Government seeks to divest the RBI of its dual and often conflicting roles as the banker and manager of the Central Government's borrowing.

- It will also facilitate in better planning and management of domestic and foreign market borrowings of Central Government.
- It will help in strengthen bond market and help to promote investment.
- It will be in pursuance global practice of shifting public debt management from central bank to a debt management office.

Recently there was controversy regarding the proposal to establish the Public Debt Management Agency (PDMA) by the government. Many economists argue that it is prudent to leave debt management to the RBI alone. Analyse the issue. (200 Words)

Why PDMA needed?

Fragmented jurisdiction in public debt management: Before the creation of PDMA, the central Bank or RBI used to manage the market borrowing programmes of Central and State Governments. On the other hand, external debt was managed directly by the Central Government. Establishing a debt management office would consolidate all debt management functions in a single agency.

PDMA can be the catalyst for wider institutional reform, including building a government securities market, and bring in transparency about public debt.

It is considered as an internationally accepted best practice that debt management should be disaggregated from monetary policy, and taken out of the realm of the central bank.

Arguments for PDMA

If debt management is with RBI, there will be conflict of interest. RBI has to reduce the cost of govt. debt (lower interest rate) and also manage inflation levels (higher interest rates)

Reports of **Narsimhan committee**, **Vijay Kelkar** and **Percy Mistry** committees, there is an emphasis on the formation of a separate agency.

Arguments against PDMA/ Challenges:

Previously RBI too had handled the debt management in a transparent and efficient manner. The present system of debt management is working good, as it has helped in maintaining debt at a manageable level always.

RBI is already prohibited from interfering in the primary market according to the FRBM act, and the govt. bonds are solely auction driven. So, a separate agency is not needed

Other countries like UK, had also reverted to assigning the debt management activity to national banks, after forming similar separate agencies

Mutual coordination can become difficult

RBI also manages states' debts and the PDMA is not very clear on what happens to that function. PDMA under central government have implication for federal structure of India.

Even though if a separate public debt management agency is to be created, it must be done gradually and systematic fashion

This agency should be independent. Proposed agency is under the supervision of central government.

Mains Previous Questions

Women empowerment in India needs gender budgeting. What are the requirements and status of gender budgeting in the Indian context?

Distinguish between Capital Budget and Revenue Budget. Explain the components of both these Budgets

The public expenditure management is a challenge to the Government of India in the context of budget-making during the post-liberalization period. Clarify it.

What were the reasons for the introduction of Fiscal Responsibility and Budget Management (FRBM) Act, 2013? Discuss critically its salient features and their effectiveness.