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INSTITUTE FOR CIVIL SERVICE EXAMS

SOUTH INDIA'S PREMIER INSTITUTION FOR
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ECONOMY

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FISCAL POLICY

Types of Fiscal policy

Revenue and Expenditure of Government

Union Budget

Revenue Budget

Capital Budget

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FRBM Act 2003

Ways and Means Advance

Fiscal Policy

Any actions taken by government on Economic control is called **Fiscal policy** Ex: Budget, Tax, Subsidy changes, Disinvestment, Investment, etc.

Any action taken by Central Bank RBI in money supply/ control is **Monetary Policy** Ex: Bank control, Licensing, Rate changes, etc.

Types of Fiscal policy

Neutral

- * Government budgeting is without any deficit. Tax Revenue = Expenditure

Expansionary

- * Government budgeting is in Deficit. Tax Revenue < Expenditure.
- * Expansionary mostly in developing economy or during times of recession.
- * This mostly involves lesser taxes and more subsidies to make business profitable and increased money supply in Economy.

Contractionary

- * Government budgeting is in Surplus. Tax Revenue > Expenditure.
- * Mostly in Developed countries, well established business enables reduced government spending in social sector and increased tax from business.

Revenue and Expenditure of Government

General Classification of Taxes

- * Distinction between ad-valorum and specific taxes
- * Direct and Indirect taxes
- * Progressive and Regressive taxes

Advalorum tax

- * Tax based on the value of the Commodity
- * Ex: Producer produces 1000 pens each costing 10 Rs. So total value is $1000 * 10 = 10,000$ Rs. Tax is imposed on this value.

Specific tax

- * Tax based on specific attribute of the Commodity.



- * Ex : Volume, Weight, Length, etc. (Per pen tax)

Direct tax

- * Tax burden is borne by the person on whom it is imposed. It cannot be transferred.
- * Ex: Income tax, Wealth tax, Expenditure tax

Indirect tax

- * Tax imposed on someone but transferred to someone else
- * Ex: Excise duty, Entertainment tax, Sales tax, Service tax etc.

Progressive Tax

- * Tax Rate increases as income increases
- * Reduce inequality

Regressive Tax

- * Tax rate goes down as income goes up
- * Increases inequality

Proportional Tax

- * Tax rate remains same as income goes up.

Union Budget

Union Budget has two parts namely

1. Revenue Budget

- * Involves budgetary parts of Taxational and Non Taxational revenue and its spending
- * Which is divided into Revenue Income(Receipts), Revenue Expenditure

2. Capital Budget

- * Involves budgetary part of revenue and expenditure on asset creation (capital account)
- * Which is divided into Capital Income(Receipts), Capital Expenditure

Revenue Budget**Revenue Income (Receipt)****(i) Tax Income**

- * Direct tax
- * Indirect tax

(ii) Non Tax Income

- * Income from PSU's
- * Interest Receipts on loans (internal/ external borrowers)
- * User charges and Stamps etc
- * Fees, penalties and fines
- * External grants from abroad (remember British fiasco) (for state govt. its from central govt.)

Revenue Expenditure:

(i) Development expenditure (No creation of any meaningful /productive assets)

- * Expenditure on maintenance of existing assets infrastructure

(ii) Non- development expenditure

- * Salaries, pension
- * Subsidies
- * Interest payments
- * Defence (Note: Equipments procurement come under capital as they are asset)
- * Civil administration
- * Grants (not loans) to states and foreign countries

Capital Budget
Capital Income (Receipt)

Long term sources of income

- * Recovery of loans
- * Disinvestment of PSU'S
- * Sale of assets (ex: land)
- * Market Borrowings

Capital expenditure

Long term liabilities of government involving creation of asset with considerable investment of money and time.

- * Investment on infrastructure
- * Loans to state government
- * Repayment of loans

Union Budget has 3 types of figures

1. **Actual** figures – Previous year
2. **Budgeted** figures or Revised figure – Current year
3. **Budget estimates** – Forthcoming year.

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Deficits /Surplus

- * Though Deficit and Surplus are a component to be dealt, Indian budget is a deficit budget being a developing country and lets deal about deficit only.

(Note: Indian budget was a surplus budget only during British period)

Revenue deficit = [Revenue Expenditure – Revenue Income]

Budget deficit = [Total Expenditure(Revenue + Capital) – Total Income(Revenue + Capital)]

Fiscal deficit = [Total expenditure – {Revenue income + Non debt creating capital income}]

Or

FD = [Budgetary deficit + Total Borrowing] (according to Chakravarthy committee)

Fiscal Deficit,

- * In addition to budget deficit government borrow additionally to meet expenditure
- * It means for all purposes Fiscal Deficit is Borrowings, because non debt creating capital income does not include market borrowings.
- * It shows the indebtedness of the government
- * In India, fiscal deficit is primarily because of high Revenue deficit, which is due to high Non Developmental, Expenditure.

Primary Deficit = Fiscal deficit – Interest payments

Monetised deficit

- * Net addition of RBI credit to the government of India by way of contribution to the market or financing government programmes.
- * In other words, it is creation of fresh currency by RBI, which leads to monetization of the economy by adding to money supply in the economy
- * This additional money supply is in excess of market borrowings.
- * Hence deficit financing is now called as Monetised deficit which implies RBI printing fresh currency.
- * But this way financing can lead to inflation rise as the economies worth as not increased but money (as paper) is increased which will lead to less worth of money.



- * This way financing can meet only internal needs as external trade is based on foreign currency which grows only when economy does.

Twin deficit

- * Budget deficit + Current Account Deficit (CAD) as in USA. (CAD is dealt in Planning article)

Budgeting Methods**Laffer curve**

- * Establishes relationship between Tax rates and Tax Revenues
- * If tax rates are too high, it must be progressively reduced to a point so as to optimize tax revenue by ensuring better compliance and minimizing evasion

Gender Budgeting

- * Introduced in 2004-05 budget year
- * Budget allocations made to reflect clearly 'Gender sensitivities' and its 'Differential impact' on men and women
- * Requires Disaggregation of budgetary data by every dept into 2 heads to bring about gender sensitivity.
- * Ex: Nirbhya fund etc.

Impact Budgeting

- * Will analyze the (Macro) economic implications of each Financial proposal included in the Budget.
- * Analyses cost of each proposal in the budget and the government sacrifices to be made for want to resources
- * It helps to government to put Resources in its command and for optimum benefit of people.

Zero Based Budgeting:

- * Each year a fresh budget, under which each item of Expenditure is treated on merit and sound rationale for fund allocation
- * It weeds out unnecessary expenditure and also fine tunes different Government programmes in the light of prior experience.
- * ZBB, to succeed has to have a professional and unbiased budget maker.

Outcome Budgeting:

- * Introduced in 2005-06 Budget year



- * Each Ministry/Department has to present in a tangible form the outcome of outlays, allocated for various schemes
- * Outlays to outcomes
- * Quantifiable output/outcomes for public money
- * Introduced 'accountability as a built in measure'
- * Value for public money
- * It is expected to end the practice of March rush {Not more than 40% of allotted funds in last quarter}
- * A programme outcome and Response monitoring unit has been setup under planning commission.

FRBM Act 2003

Fiscal Responsibility and Budget Management act 2003

- * Borrowed from New Zealand
- * In the light of growing fiscal deficit to achieve Macroeconomic Stability and Fiscal correction and consolidation at Union level by rationalizing mainly government 'Non development expenditure'.

The intention of the Fiscal Responsibility and Budget Management Act was to bring -

- * fiscal discipline.
- * efficient management of expenditure, revenue and debt.
- * macroeconomic stability.
- * better coordination between fiscal and monetary policy.
- * transparency in the fiscal operation of the Government.
- * achieving a balanced budget.

Additionally, the act was expected to give the necessary flexibility to Reserve Bank of India (RBI) for managing inflation in India.

Provisions of the Fiscal Responsibility and Budget Management Act

- The FRBM rules mandate four fiscal indicators to be projected in the medium-term fiscal policy statement. These are:
 1. Revenue deficit as a percentage of GDP
 2. Fiscal deficit as a percentage of GDP.
 3. Tax revenue as a percentage of GDP.
 4. Total outstanding liabilities(Borrowings) as a percentage of GDP.

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The FRBM act also provided for certain documents to be tabled in the Parliament of India, along with Budget, annually with regards to the country's fiscal policy. This included the

1. Medium-term Fiscal Policy Statement
2. Fiscal Policy Strategy Statement
3. Macro-economic Framework Statement
4. Medium-term Expenditure Framework Statement.

Initial FRBM Targets (to be met by 2008-09)

To achieve the commitment of government towards fiscal correction, consolidation and Macroeconomic stability.

1. **Revenue Deficit:** To reduce Revenue deficit by 0.5% percentage points starting from 2004-05 upto 2008-09 and bring it to Zero.
2. **Fiscal Deficit:** To reduce Fiscal deficit by 0.3% percentage points starting from 2004-05 upto 2008-09 and to keep it below 3% of GDP.
3. **Contingent Liabilities (Liability may occur on uncertain future) (Borrowings:** Central Government shall not give incremental guarantees aggregating an amount exceeding 0.5 per cent of GDP in any financial year beginning 2004-05.
4. **Additional Liabilities (Borrowings) -** Additional liabilities (including external debt at current exchange rate) should be reduced to 9% of the GDP by 2004-05. The minimum annual reduction target in each subsequent year to be 1% of GDP.
5. **RBI purchase of government bonds -** to cease from 1 April 2006. This indicates the government not to borrow directly from the RBI.

All these Targets were revised Due to GLOBAL FINANCIAL CRISIS 2008

FRBM Targets after Amendment to FRBM Act in 2012 (to be achieved by 2015)

- **Revenue Deficit Target** -should be completely eliminated by March 31, 2015. Minimum annual reduction target was 0.5% of GDP.
- **Fiscal Deficit Target** -should be reduced to 3% of GDP by March 31, 2015. Minimum annual reduction target was 0.3% of GDP.



FRBM Targets after Amendment to FRBM Act in 2015 (to be achieved by 2018)

- **Revenue Deficit Target** – revenue deficit should be completely eliminated by March 31, 2018. Minimum annual reduction target was 0.5% of GDP.
- **Fiscal Deficit Target** – should be reduced to 3% of GDP by March 31, 2018. Minimum annual reduction target was 0.3% of GDP.

FRBM Review Committee headed by NK Singh: Recommendations

- Government believed the **targets were too rigid**.
- In May 2016, NK Singh to review. Committee recommended, government should target a fiscal deficit of 3 % up to March 31, 2020, cut it to 2.8 % in 2020-21 and to 2.5 % by 2023.
- Committee suggested using debt as the primary target for fiscal policy. This ratio was 70% in 2017.
- **Debt to GDP ratio:** advocated for a Debt to GDP ratio of 60% to be targeted with a 40% limit for the centre and 20% limit for the states.
- **Revenue Deficit Target** – revenue deficit should be reduced to 0.8% of GDP by March 31, 2023. The minimum annual reduction target was 0.5% of GDP.
- **Fiscal Deficit Target** – fiscal deficit should be reduced to 2.5% of GDP by March 31, 2023. The minimum annual reduction target was 0.3% of GDP.
- **Escape clause**
 - Situation under which the central government can flexibly follow fiscal deficit target during special circumstances. (Terminology by NK Singh Committee on FRBM)
 - In Budget 2017, FM Arun Jaitley deferred FD target of 3% of and chose a target of 3.2%, citing NK Singh committee report.
 - But, CAG pulled up the government for deferring the targets which it said should have been done through amending the Act.
 - In 2018, FRBM Act was further amended. The clause allows govt to relax FD target for up to 50 basis points or 0.5 per cent. Under FRBM, if the escape clause is triggered to allow for a breach of FD target, RBI is then allowed to participate directly in the primary auction of government bonds, thus formalising deficit financing.



The Escape Clauses can be invoked:

- by the Government after formal consultations and advice of the Fiscal Council.
- with a clear commitment to return to the original fiscal target in the coming fiscal year.

In 2020, **FM, Nirmala Sitharaman** used escape clause provided under FRBM Act to allow relaxation of the target. FM revised FD for FY20 to 3.8 % and pegged the target for FY21 to 3.5 %.

- **Note:** The Act exempts the government from following the FRBM guidelines in case of war or calamity.

	Revised Estimates 2019-2020	Budget Estimates 2020-2021	(Projections)	
			2021-2022	2022-2023
1. Fiscal Deficit	3.8	3.5	3.3	3.1
2. Revenue Deficit	2.4	2.7	2.3	1.9
3. Primary Deficit	0.7	0.4	0.2	0.0
4. Gross Tax Revenue	10.6	10.8	10.7	10.7
5. Non-tax Revenue	1.7	1.7	1.5	1.5
6. Central Government debt	50.3	50.1	48.0	45.5
7. Of which				
Liabilities on account of EBR ¹	0.7	0.8	0.9	0.9

Table 8: Deficits (as % of GDP)

	Actuals 2019-20	Revised 2020-21	Budgeted 2021-22
Fiscal Deficit	4.6%	9.5%	6.8%
Revenue Deficit	3.3%	7.5%	5.1%

Sources: Union Budget 2021-22; PRS.

Fiscal Deficit (FD)- Fiscal deficit as per the Indian Budget 2020-21 was estimated 3.5 % of GDP.

Revenue Deficit (RD)- Revenue Deficit as per the Indian Budget 2020-21 was estimated 2.7 % of GDP.

Effective Revenue Deficit (ERD)- The effective revenue deficit as per the Indian Budget 2020-21 was estimated 1.8 % of GDP.

Tax to GDP ratio: 10.8

Debt to GDP ratio (Central Government): 50.1

Measures needed to achieve FRBM Targets

- * Completion of projects on time



Notes

- * Improving Incremental capital-output ratio (ICOR)
- * Improving performance of PSU's
- * Reducing Staff strength in government departments
- * Reducing subsidies (esp. Non merit based subsidies, improving targeted mechanism)
- * Reducing interest burden.
- * Privatising various services which impose financial burden on the government
- * Reducing interest obligations of government on small savings
- * Improving user charges
- * Adoption of ZBB, Outcome budgeting and Impact budgeting for optimal use of resources
- * Rationalising Minimum Support Price

Ways and Means Advance

- * Stated from 1st April 1997,
- * An arrangement between RBI and Government to end the age old practice of government borrowing from RBI at a mere 4.6% interest through ad.hoc treasury bills
- * Mandated under WMA, that government would borrow only at a fixed amount from RBI in a year in two 6-moths period.
- * Unless previous loans is payed, RBI will not lend
- * Also any extra amount above what is fixed will be charged interest at market price.
- * WMA, for all purpose puts a ceiling on how much government can borrow from RBI.

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