FISCAL CONSOLIDATION - GS III MAINS

Q. Most governments today focus on keeping the fiscal deficit under control rather than on generating a fiscal surplus or on balancing the budget. Comment on the need of fiscal consolidation in the Indian perspective. (15 marks, 250 words)

News: *Why is fiscal consolidation so important? | Explained*

What's in the news?

- Recently Union Finance Minister Nirmala Sitharaman announced during her Budget speech that the **Centre would reduce its fiscal deficit to 5.1% of gross domestic product (GDP) in 2024-25**.

Fiscal Deficit:

- Fiscal deficit refers to the shortfall in a government's revenue when compared to its expenditure.
- When a government's expenditure exceeds its revenues, the government will have to borrow money or sell assets to fund the deficit.

Fiscal Surplus:

- When a government runs a fiscal surplus, on the other hand, its revenues exceed expenditure.
- It is, however, quite rare for governments to run a surplus.
- Most governments today focus on keeping the fiscal deficit under control rather than on generating a fiscal surplus or on balancing the budget.

How does the government fund its fiscal deficit?

1. Borrowing Mechanism:

- Government borrows money from the bond market to fund its fiscal deficit.
- Lenders, including private entities and central banks, compete by purchasing government-issued bonds.

2. Central Bank's Role:

- Central banks like RBI are significant players in the credit market.
- RBI may indirectly purchase government bonds in the secondary market from private lenders, creating fresh money through open market operations.

3. Money Supply Impact:

- RBI's bond purchases can increase money supply, leading to potential inflation in the broader economy over time.

4. Risk-Free Nature:

- Government bonds are generally considered risk-free as the central bank can create fresh currency under extreme scenarios to repay lenders.
- Governments find it relatively easy to borrow money from the market.

5. Interest Rate Challenges:

- Government faces challenges not in borrowing itself but in the interest rates it offers.
- Worsening government finances lead to decreased demand for bonds, prompting the government to offer higher interest rates, increasing borrowing costs.

6. Monetary Policy Influence:

- Central bank lending rates, which were near zero pre-pandemic, have risen post-pandemic.
- Higher central bank rates make it more expensive for governments to borrow, influencing the Centre's efforts to reduce fiscal deficit.

Concerns of Higher Fiscal Deficit:

1. Inflation Impact:

- A high fiscal deficit is directly linked to inflation, as the government may resort to using freshly issued money to cover the deficit. This can contribute to higher inflation rates.

2. Pandemic Scenario:

- The fiscal deficit surged to 9.17% of GDP during the pandemic but has since improved and is expected to drop to 5.8% now.

3. Market Perception:

- The fiscal deficit serves as an indicator of the government's fiscal discipline. A lower fiscal deficit can enhance ratings for Indian government bonds, signalling responsible financial management.

4. Borrowing Confidence:

- Funding more spending through tax revenues and borrowing less builds confidence among lenders, reducing the government's borrowing costs.

5. Debt Management:

- A high fiscal deficit can impact the government's ability to manage overall public debt.
- The International Monetary Fund warned of potential risks, projecting India's public debt to exceed 100% of GDP in the medium term, though the government contested this assessment.

6. International Bond Market:

- Lowering the fiscal deficit may facilitate the government's efforts to tap into the international bond market, making it easier to sell bonds overseas and access more affordable credit.

Fiscal Consolidation:

- It refers to the policies undertaken by Governments (national and sub-national levels) to reduce their deficits and accumulation of debt stock. Thus, it 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.

Fiscal Consolidation in India:

In India, fiscal consolidation or the fiscal roadmap for the centre is expressed in terms of the budgetary targets to be realized in successive budgets. The Fiscal Responsibility and Budget Management (FRBM) Act gives the targets for fiscal consolidation in India. Following factors from the expenditure side and revenue side should be considered by the government to achieve fiscal consolidation.

- **Improved tax revenue realization** by implementing measures like increasing efficiency of tax administration by reducing tax avoidance, eliminating tax evasion, enhancing tax compliance etc. are to be made.

- **Enhancing tax-GDP ratio** by widening the tax base and minimizing tax concessions and exemptions also improves tax revenues.

- **Better targeting of government subsidies** and extending Direct Benefit Transfer schemes for more subsidies.

- The appropriate amount of fiscal consolidation for each country will depend on a number of factors, including the strength of its economy, the **public debt and interest developments**, the ease of financing debt and political decisions concerning taxes and spending.

- **Higher economic growth rate** will help the government to get higher tax revenues as well. Augmentation of tax revenue is necessary to bring fiscal consolidation as there are limitations for reducing government expenditure in India.

WAY FORWARD:

1. Fiscal Deficit Target (2024-25):

- The Centre aims to reduce the fiscal deficit to 5.1% of GDP.
- Despite plans for increased capital expenditure and program spending.

2. Revenue Source:

- Majority of funding for spending plans come from tax collections.
- Expects a significant 11.5% rise in tax collections for 2024-25.

3. Expenditure Changes:

- Planned reduction in fertiliser subsidy from ₹1.88 lakh crore (2023-24) to ₹1.64 lakh crore (2024-25).

- Projected decrease in food subsidy from ₹2.12 lakh crore (2023-24) to ₹2.05 lakh crore (2024-25).

4. Economic Growth Concerns:
- Raising tax rates to boost collections may negatively impact economic growth.
- Taxes can act as a dampener on overall economic activity.

5. Fiscal Deficit Target Challenges:
- Ambitious fiscal deficit targets may face challenges.
- Uncertainty as government projections may not align with actual outcomes.

Go back to basics:
Fiscal Responsibility and Budget Management (FRBM) Act:
- The FRBM Act, 2003, intends to bring transparency and accountability in the conduct of the fiscal and monetary actions of the government.
- The central government agreed to the following fiscal indicators and targets, subsequent to the enactment of the FRBM Act.
- Revenue deficit to be eliminated by the 31st of March 2009. **A minimum annual reduction of 0.5% of GDP.**
- Fiscal Deficit to be brought down to at least 3% of GDP by 31st of March 2008. A minimum annual reduction – 0.3% of GDP.

Mandatory Documents:
The FRBM Act made it mandatory for the government to place the following along with the Union Budget documents in Parliament annually such as
- Medium Term Fiscal Policy Statement
- Macroeconomic Framework Statement
- Fiscal Policy Strategy Statement.

Other Key Takeaways:
- The FRBM Act proposed that revenue deficit, fiscal deficit, tax revenue and the total outstanding liabilities be projected as a percentage of gross domestic product (GDP) in the medium-term fiscal policy statement.
- Several years have passed since the FRBM Act was enacted, but the Government of India has not been able to achieve targets set under it. The Act has been amended several times.
- In 2013, the government introduced a change and introduced the concept of effective revenue deficit.
- This implies that effective revenue deficit would be equal to revenue deficit minus grants to states for the creation of capital assets.
- In 2016, a **committee under N K Singh** was set up to suggest changes to the Act.