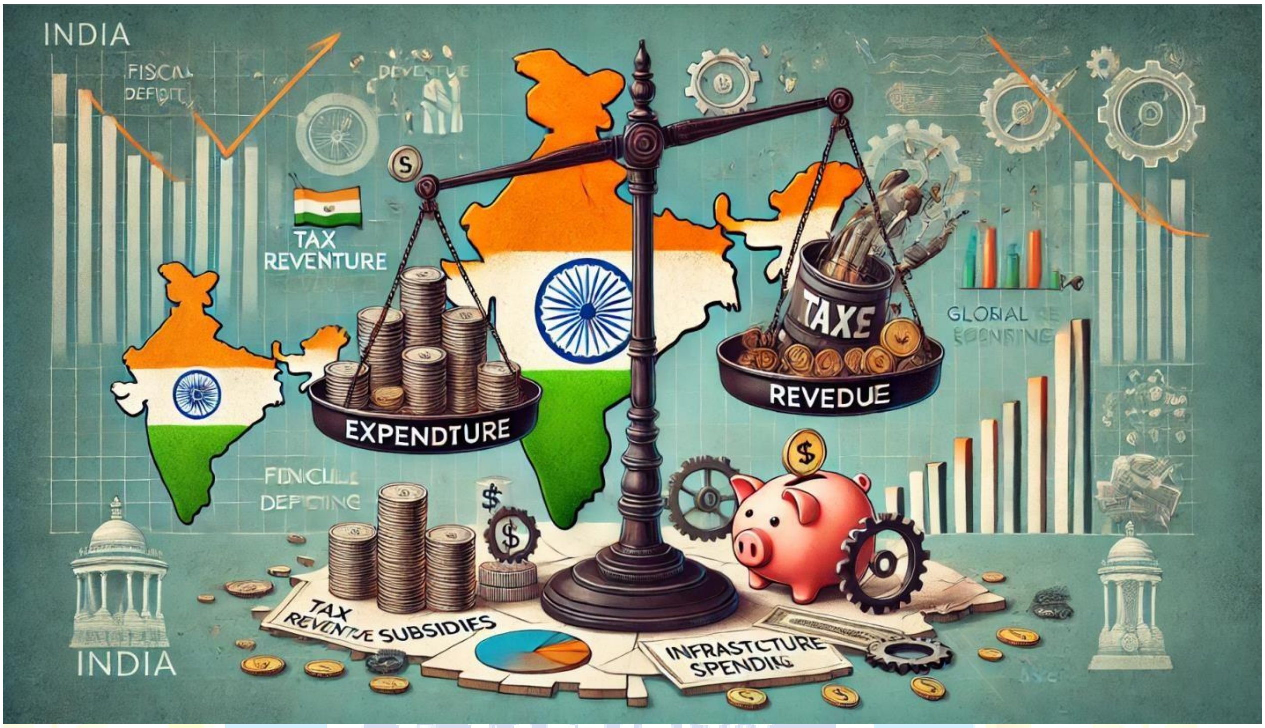
"INDIA'S FISCAL DEFICIT: BALANCING GROWTH AND STABILITY": ECONOMY: PAPER III



What is Fiscal Deficit?

Fiscal deficit occurs when a government's total expenditure exceeds its total revenue, excluding borrowings.

In simple terms, it is the gap between what the government spends and what it earns through taxes and other sources. This deficit is usually expressed as a percentage of the country's Gross Domestic Product (GDP) to provide a clearer picture of its scale relative to the size of the economy.

Governments often finance this deficit by borrowing domestically or from international markets. While a certain level of fiscal deficit is common, especially for developing economies like India, sustained high deficits can have implications for economic growth, inflation, and financial stability.

Factors Responsible for Fiscal Deficit in India

India's fiscal deficit is influenced by several factors, many of which are rooted in the unique characteristics of its economy:

1. **Revenue Challenges:**
    - **Tax Compliance and Collection:** Despite efforts to formalize the economy,

India's tax-to-GDP ratio remains relatively low compared to other economies. Tax evasion and a large informal sector contribute to limited revenue generation.
- **Subsidies and Welfare Programs:** Subsidies on food, fuel, and fertilizers to support vulnerable sections of society strain government revenues.

2. **Expenditure Demands:**
   - **Developmental Expenditures:** Investments in infrastructure, health, and education, crucial for economic growth, often exceed budgeted allocations.
   - **Interest Payments:** A significant portion of government spending goes towards servicing existing debt, limiting funds for other areas.
   - **Defense Spending:** Geopolitical challenges necessitate high expenditure on defense and security.
3. **Economic Shocks:**
   - Events like the COVID-19 pandemic forced the government to increase spending on healthcare and relief measures, widening the fiscal deficit.
4. **State Finances:**
   - States contribute significantly to the overall fiscal deficit through their borrowing and spending practices, particularly on populist schemes.

Why is Fiscal Deficit Structural in India?

In India, the fiscal deficit is not merely a short-term concern but a structural issue. This means that it is deeply embedded in the economy due to the following reasons:

1. **Dependence on Subsidies:**
   - India's socio-economic landscape necessitates extensive subsidies to support the economically weaker sections, leading to persistent expenditure pressures.
2. **Low Revenue Base:**
   - The reliance on indirect taxes (like GST) over direct taxes results in a volatile revenue stream, particularly during economic slowdowns.
3. **High Public Debt:**
   - The burden of repaying past borrowings consumes a substantial portion of government revenues, perpetuating the cycle of borrowing.
4. **Federal Structure:**
   - The division of responsibilities and revenues between the Centre and the states often leads to inefficiencies and overlapping expenditures.

Trends in Fiscal Deficit Today

India's fiscal deficit trends have seen significant shifts in recent years. In FY25, the central government set an ambitious target of **4.9% of GDP**, further reducing from the earlier interim target of 5.1%. Interestingly, the fiscal deficit in the first half of FY25 reached only 29% of the annual target, the lowest in over two decades. This was achieved due to:

- **Decline in Government Expenditure:** Expenditure fell by 0.4% year-on-year (Y-o-Y) in the first six months of FY25, driven by a 15.4% reduction in capital expenditure.
- **Robust Tax Collections:** Gross tax collections rose by 12% Y-o-Y in the same period, exceeding the budgeted growth rate of 10.8%.

While the trend suggests disciplined fiscal management, it also highlights concerns over reduced capital expenditure, which could impact economic growth in the long term.

Factors Influencing Fiscal Deficit

Several factors directly and indirectly influence India's fiscal deficit:

1. **Economic Growth:**
   - Higher growth leads to increased tax revenues, reducing the fiscal deficit. Conversely, slowdowns or recessions widen the deficit.
2. **Global Economic Conditions:**
   - Fluctuations in crude oil prices, exchange rates, and global financial markets impact India's import bill and borrowing costs.
3. **Policy Choices:**
   - Welfare schemes, subsidies, and infrastructure investments significantly affect government spending.
4. **Political Cycles:**
   - Election years often see higher expenditures on populist measures, although FY25 has bucked this trend.
5. **External Borrowings and Trade Deficits:**
   - Reliance on foreign borrowings and persistent trade deficits add to the fiscal burden.

Significance of Fiscal Deficit for India's Future

The fiscal deficit is a double-edged sword for India's economy. While some level of deficit is necessary for growth, especially in a developing economy, excessive deficits can lead to:

1. **Inflationary Pressures:**
   - Borrowings to finance the deficit can increase money supply, leading to inflation.
2. **Crowding Out of Private Investment:**
   - High government borrowings can reduce the availability of funds for private players, impacting economic activity.
3. **Sovereign Ratings and Investor Confidence:**
   - Persistently high deficits can lead to downgrades in credit ratings, making it costlier for the country to borrow internationally.
4. **Growth Potential:**
   - Judicious fiscal management allows for greater investment in productive areas,

boosting long-term growth.

In the near term, India's fiscal consolidation efforts, coupled with initiatives to boost tax revenues and control expenditures, are likely to yield positive outcomes. However, the challenge lies in balancing growth and fiscal discipline.

Conclusion

Fiscal deficit is a critical barometer of India's economic health. While the government has made commendable progress in reducing the deficit to manageable levels, structural challenges persist. Addressing these issues requires reforms in tax administration, rationalization of subsidies, and efficient public expenditure.

India's fiscal future hinges on its ability to strike a balance between spending for growth and maintaining fiscal discipline. With robust tax collections and improving economic fundamentals, the country is well-positioned to navigate these challenges. However, sustained efforts are needed to ensure that fiscal deficit management supports not just economic stability but also inclusive growth.

Main Practice Question

Discuss the structural nature of fiscal deficit in India, outlining the key factors contributing to its persistence and evaluating its implications for economic growth and fiscal stability. ***(250 words)***

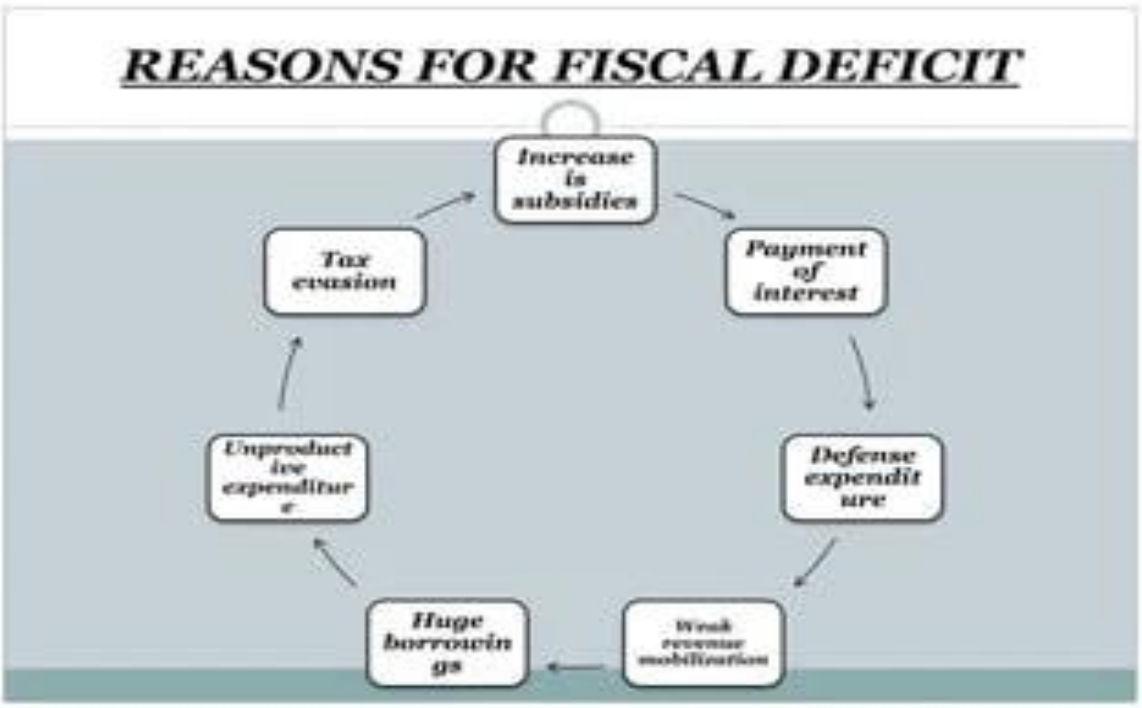
Answer Guidelines:

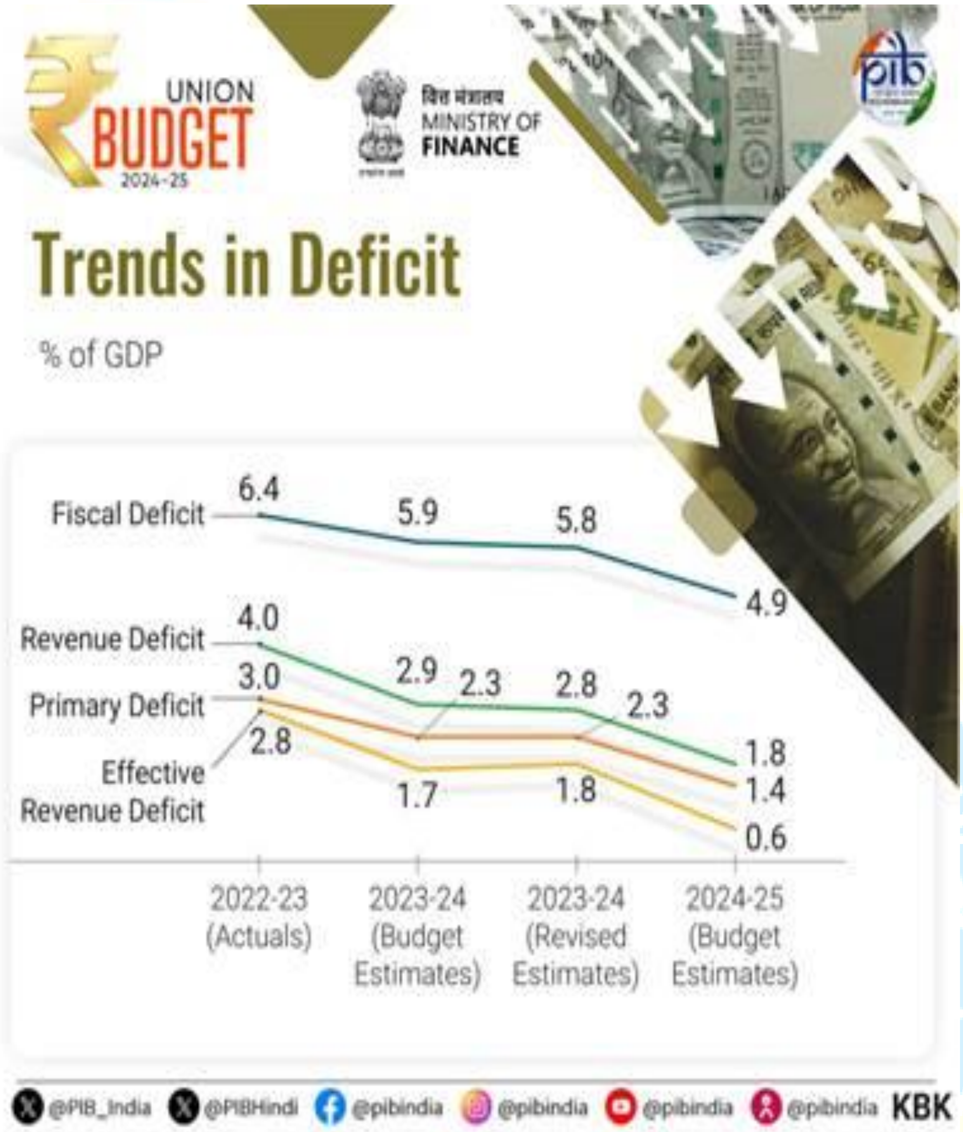
1. **Introduction (30-40 words):**
   - Define fiscal deficit and its structural nature.
   - Mention why India's fiscal deficit is considered structural, highlighting its recurrent and embedded causes.
2. **Body:**
   - **Key Factors (80-100 words):**
     - Revenue constraints:
       - Low tax-to-GDP ratio.
       - Dependence on indirect taxes and tax evasion.
     - Expenditure pressures:
       - Persistent subsidies (food, fuel, fertilizer).
       - High interest payments due to existing public debt.
       - Developmental and welfare expenditures.

    - Federal structure challenges:
        - State borrowing and overlapping expenditures.
- **Implications (80-100 words):**
    - Limits government's ability to invest in growth-oriented projects.
    - Risks inflation and crowding out of private investment.
    - Sovereign rating impacts and increased borrowing costs.
    - Challenges in achieving long-term macroeconomic stability.

3. **Conclusion (30-40 words):**
    - Emphasize the need for structural reforms, including tax administration efficiency, subsidy rationalization, and expenditure prioritization.
    - Link fiscal discipline with sustainable economic growth and resilience.

Fiscal deficit




UNION BUDGET 2024-25
MINISTRY OF FINANCE
Trends in Deficit
% of GDP
Fiscal Deficit
6.4
5.9
5.8
4.9
Revenue Deficit
4.0
2.9
2.8
1.8
Primary Deficit
3.0
2.3
2.3
1.4
Effective Revenue Deficit
2.8
1.7
1.8
0.6
2022-23 (Actuals)
2023-24 (Budget Estimates)
2023-24 (Revised Estimates)
2024-25 (Budget Estimates)
@PIB_India @PIBHindi @pibindia @pibindia @pibindia @pibindia KBK

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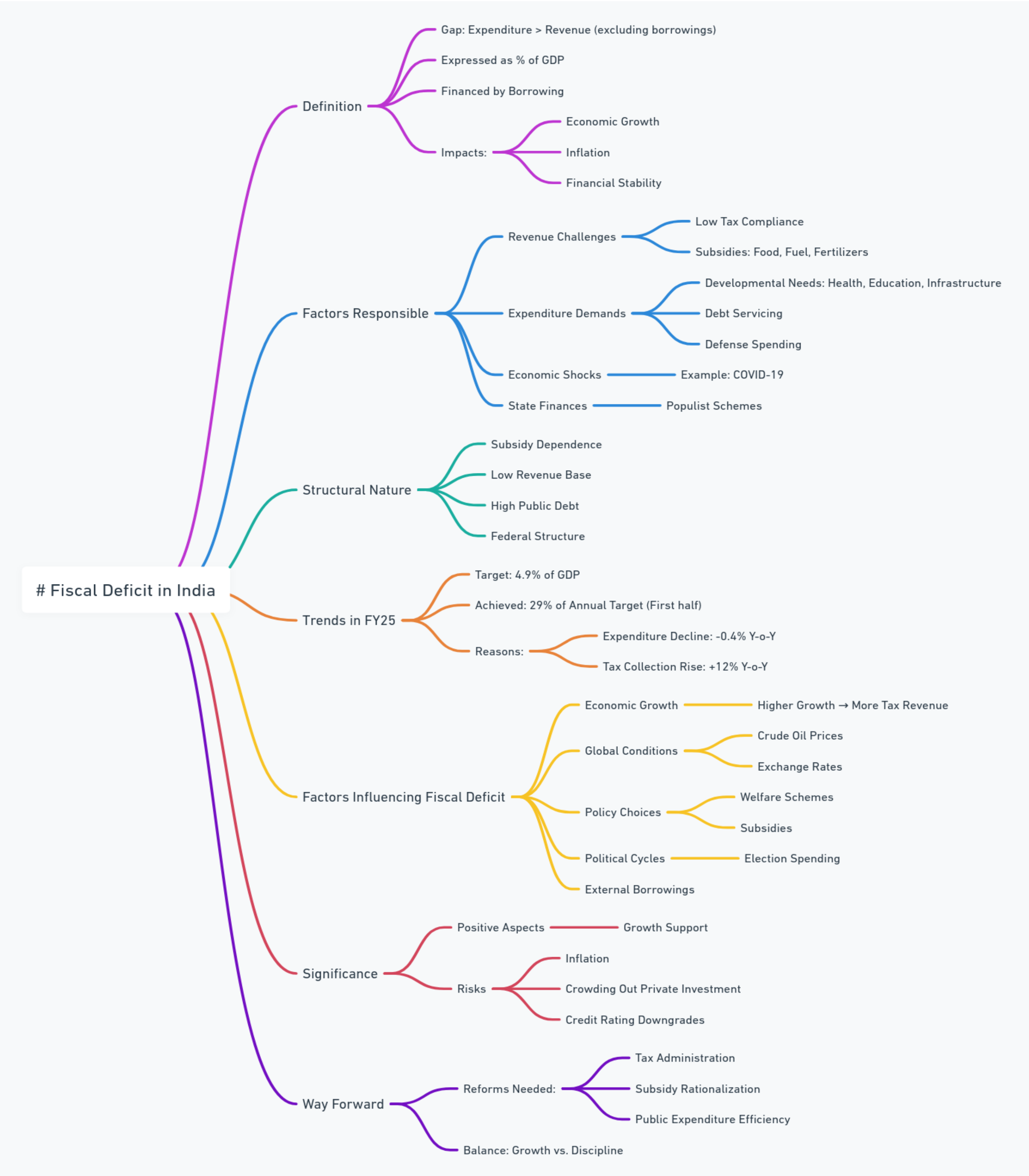
Fiscal Deficit in India
Definition
Gap: Expenditure > Revenue (excluding borrowings)
Expressed as % of GDP
Financed by Borrowing
Impacts:
Economic Growth
Inflation
Financial Stability
Factors Responsible
Revenue Challenges
Low Tax Compliance
Subsidies: Food, Fuel, Fertilizers
Expenditure Demands
Developmental Needs: Health, Education, Infrastructure
Debt Servicing
Defense Spending
Economic Shocks
Example: COVID-19
State Finances
Populist Schemes
Structural Nature
Subsidy Dependence
Low Revenue Base
High Public Debt
Federal Structure
Trends in FY25
Target: 4.9% of GDP
Achieved: 29% of Annual Target (First half)
Reasons:
Expenditure Decline: -0.4% Y-o-Y
Tax Collection Rise: +12% Y-o-Y
Factors Influencing Fiscal Deficit
Economic Growth
Higher Growth → More Tax Revenue
Global Conditions
Crude Oil Prices
Exchange Rates
Policy Choices
Welfare Schemes
Subsidies
Political Cycles
Election Spending
External Borrowings
Significance
Positive Aspects
Growth Support
Risks
Inflation
Crowding Out Private Investment
Credit Rating Downgrades
Way Forward
Reforms Needed:
Tax Administration
Subsidy Rationalization
Public Expenditure Efficiency
Balance: Growth vs. Discipline