What exactly is a government deficit?

Government finances are adequately discussed during the budget and at times of slowdown. One such indicator of interest is the deficit of the government. There are three measures of government deficits:

1. **Revenue deficit** is the difference between the total expenditure of the government and its total revenue.
2. **Fiscal deficit** is the difference between total expenditure and its total revenue except borrowings.
3. **Primary deficit** is the difference between fiscal deficit and interest payments.

Fiscal deficit is one of the most discussed of the three, as it is the money the government borrows to meet its expenditure.

So, is it bad if the fiscal deficit increases?

A natural inclination is to believe that if the expenditure is greater than the revenue, then it must be a bad thing. Unfortunately, there’s no simple answer to this question. A prolonged fiscal deficit above 4% is likely to be problematic, but there’s little difference between a deficit of 3.5% or 3.8%. More than the amount of fiscal deficit, what really matters is how the borrowed money is being utilized. If it is utilized for construction of physical infrastructure, then it is not necessarily a bad thing. But if it is used for farm loan waivers or other such subsidies, then a high fiscal deficit should be a cause of major concern.

What is the expected fiscal deficit for FY20?

The budget estimates indicated a fiscal deficit close to 3.3% of GDP that seemed unrealistic given the extent of the current economic slump. The FRBM Act allows a 0.5 percentage point relaxation in deficit in the event of a severe slowdown. This allows the government a fiscal deficit till 3.8% without violating the provisions of the FRBM Act.
How does fiscal deficit impact inflation?

Conventional wisdom has been that fiscal deficits result in undue inflationary pressures. This is based on India’s experience with high deficits in the 1980s and since 2009 onwards, when inflation and fiscal deficits were both high. But an important fact during these two periods was high international prices of global commodities and high minimum support prices for farmers. Moreover, not all deficits are inflationary: if the additional money is utilized for investments rather than subsidies, inflation is likely to be muted.

Can the govt keep on spending as it wants?

Not at all. Though fiscal deficits may not impact inflation, they do impact interest rates—the cost of government borrowings. A higher cost of borrowing constrains government borrowings. In the present situation, the government must respond with a countercyclical fiscal policy. Luckily, that has been the stance of the finance ministry; however, it must share a credible long-term, medium-term fiscal consolidation road map.

FRBM Act – Objectives, targets, Amendments

Fiscal Responsibility and Budget Management Act (FRBM Act) was introduced in Parliament as the FRBM Bill in December 2000. It seeks to foster fiscal discipline on the Central Government and achieving a balanced budget with effective revenue management. The Act was passed on August 26, 2003, therefore it is also called Fiscal Responsibility and Budget Management Act (FRBMA), 2003. FRBMA was brought into effect from July 5, 2004.

Objective:

The objective of FRBM Act was to inculcate the habit of fiscal discipline in the governance structure of the country. It sets targets and suggests means of reducing fiscal and revenue deficits.

Targets:

The targets that were set in original version of act were:

- Reduction and Elimination of revenue deficit by 2008-09
- Thereafter build up adequate revenue surplus
- Reduction of fiscal deficit to no more than 3 per cent of GDP at the end of 2008-09
- Reduce the Gross Fiscal Deficit (GFD) by March 31, 2008

Statements mandated under FRBM Act

The Central government shall lay in each financial year before both houses of Parliament the following statements of fiscal policy along with the annual financial statement and demands for grants:

1. The Medium-term Fiscal Policy Statement
2. The Fiscal Policy Strategy Statement
3. The Macro-Economic Framework Statement
Exemptions

Section 4 of the FRBM Act, 2003 states that “due to ground or grounds of national security or national calamity or such other exceptional grounds as the Central Government may specify”, the set targets for revenue and fiscal deficit can be exceeded.

Amendments in FRBM Act

More than 15 years has passed since FRBM Act was first introduced. But still the government is nowhere near the targets set under the act. The subsequent governments at Centre have amended the act to achieve fiscal prudence. Here are the amendments that have been done in the act so far:

• FRBM Rules 2004
  1. To bring down the GFD to not more than 3 per cent of GDP at end of March 31, 2008. To achieve this target of GFD the Central Government shall reduce the GFD by an amount equivalent to 0.3 percent or more of GDP at end of each financial year beginning with financial year 2004-05.
  2. To achieve target of RD by March 31, 2008, Central government shall reduce RD by an amount equivalent to 0.5 percent or more of GDP at end of each financial year, beginning with 2004-05.
  3. The Central government shall not give guarantees aggregating to an amount exceeding 0.5 percent of GDP in any financial year beginning with financial year 2004-15.

• FRBM Rules 2013: It introduced two changes:

  The concept of effective revenue deficit was introduced
  effective revenue deficit = revenue deficit – grants to states for creation of capital assets

  Medium Term Expenditure Framework Statement: medium-term framework provides for rolling targets for expenditure, imparting greater certainty, and encourages prioritization of expenditure

  To bring down the GFD to not more than 3 per cent of GDP at the end of March 31, 2017. To achieve this target of GFD, Central Government shall reduce the GFD by an amount equivalent to 0.5 percent or more of GDP at end of each financial year beginning with financial year 2013-14.
  To achieve the target of RD by March 31, 2015 Central government shall reduce RD by an amount equivalent to 0.6 percent or more of GDP at end of each financial year beginning with 2013-14.
  In order to achieve target of effective revenue deficit by March 31, 2015, Central Government shall reduce such deficit by an amount equivalent to 0.8 per cent or more of GDP at end of each financial year, beginning with financial year 2013-2014.

• FRBM Act Amendment 2015

  GFD not more than 3 per cent of GDP at end of March 31, 2018 with annual reduction by an amount equivalent to 0.4 per cent or more of GDP at end of each
financial year beginning with Financial Year 2015-16 RD of not more than 2 percent of GDP by March 31, 2018 with annual reduction by an amount equivalent to 0.4 per cent or more of GDP at the end of each financial year beginning with Financial Year 2015-16. In order to achieve target of effective revenue deficit by March 31, 2018, Central Government shall reduce such deficit by an amount equivalent to 0.5 per cent or more of GDP at end of each financial year, beginning with financial year 2015-2016.

- **Budget 2018-19**
  1. The central government shall reduce the fiscal deficit by an amount equivalent to 0.1 percent or more of the gross domestic product at the end of each financial year beginning with the financial year 2018-19, so that fiscal deficit is brought down to not more than 3 percent of the GDP by 31st day of March, 2021
  2. It proposed to bring down fiscal deficit to 3.3 percent, 3.1 percent and 3 percent of the gross domestic product by 2018-19, 2019-20 and 2020-21

**FRBM Review Committee (N.K Singh Committee)**

The government formed the committee to review the FRBM Act, 2003 to suggest changes in the act. The committee was headed by Mr. N K Singh (politician, economist and former Indian Administrative Service officer). Recommendations of the committee were:

- **Debt to GDP ratio**: The Committee suggested using debt as the primary target for fiscal policy. A debt to GDP ratio of 60% should be targeted with a 40% limit for the centre and 20% limit for the states. The targeted debt to GDP ratio should be achieved by 2023.

- **Fiscal Council**: The Committee proposed to create an autonomous Fiscal Council with a Chairperson and two members appointed by the centre. To maintain its independence, it proposed a non-renewable four-year term for the Chairperson and members. Further, these people should not be employees in the central or state governments at the time of appointment. The Committee suggested that grounds in which the government can deviate from the targets of FRBM should be clearly specified, and the government should not be allowed to notify other circumstances.

- **Borrowings from the RBI**: The draft Bill restricts the government from borrowing from the Reserve Bank of India (RBI) except when: (i) the centre has to meet a temporary shortfall in receipts, (ii) RBI subscribes to government securities to finance any deviations from the specified targets, or (iii) RBI purchases government securities from the secondary market.