Why is the fiscal deficit so important?

One of the reasons fiscal deficit is so important is that it gives us the extent of government borrowings required to meet its expenditure commitments in a financial year. It is an important indicator of macroeconomic stability. The 1991 balance of payments crisis came against the backdrop of sustained high fiscal deficit. Several countries have seen economic or debt crises due to high deficits over the years. Sustained macroeconomic imbalance could lead to recession.

What is its impact in a closed economy?

Lately, fiscal deficit hasn’t affected inflation much. However, it does have an impact on investments as it results in an increase in the cost of capital in a closed economy. When the government increases its borrowings, the savings left in the economy to finance private sector investment comes down. Therefore, the cost of capital goes up. This, in effect, dampens investments and is termed as “crowding out” of investment. This is precisely why several commentators have cautioned against increasing government borrowings at a time when investment by the private sector is low.

Do government borrowings ‘crowd out’ investments?

Evidence from India reveals that government investment actually “crowds in”
investment as these are made for the development of physical infrastructure. Investors need basic infrastructure in place before risking capital. Therefore, government investments to put in place this infrastructure are critical in crowding in private investment.

What’s the case for a fiscal expansion?

Lower demand results in unutilized capacities, which results in low investments. This leads to lower growth, thereby reducing demand. This vicious cycle should be broken by a proactive fiscal policy. **Weak demand can be addressed only by a revival of private investment, improvement of private demand, or expansion in government demand.** Only the third is in the government’s control. The Centre can increase the fiscal deficit to 3.8% of GDP. However, it should not shy away from going beyond this if needed.

What about bond yields, cost of capital?

Higher borrowings can raise cost of capital. Thus, many welcomed the move to opt for sovereign issuance, which would have led to easing of rates locally. India can undertake fiscal expansion along with monetary easing. Muted non-food inflation along with external conditions make it the right time to cut rates for lower government borrowings cost. Our fiscal deficit is 80% interest. So a reduction in cost of borrowings would create space for further expenditure.

About 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.**

Deficit financing is very useful in developing countries like India because of revenue scarcity and development expenditure needs.
Various indicators of deficit in the budget are:

1. **Budget deficit** = total expenditure – total receipts

2. **Revenue deficit** = revenue expenditure – revenue receipts

3. **Fiscal Deficit** = total expenditure – total receipts except borrowings

4. **Primary Deficit** = Fiscal deficit - interest payments

5. **Effective revenue Deficit** = Revenue Deficit – grants for the creation of capital assets

6. **Monetized Fiscal Deficit** = that part of the fiscal deficit covered by borrowing from the RBI.