

Chapter 4

DEFICITS: MANAGEMENT OF FISCAL IMBALANCES

Three key fiscal parameters - revenue, fiscal and primary deficits - indicate the extent of overall fiscal imbalances in the Finances of the Union or State Government during a specified period. The revenue deficit of the Union Government which exhibited a declining trend during the first three years of the X Plan (2002-07) has increased by 39.39 per cent during 2005-06 over the previous year. In relation to GDP, revenue deficit increased from the level of 2.53 per cent in 2004-05 to 3.11 per cent during the year. Similarly, the fiscal deficit also increased by 58.89 per cent over the previous year and reached the level of Rs 164,927 crore (4.67 per cent of GDP) during the current year. Revenue deficit continued to be the dominant component of fiscal deficit, accounting for 61.47 per cent of it during 1985-2006. The proportion of revenue deficit in overall fiscal deficit increased from an average of 46.26 per cent during the VIII Plan (1992-1997) to an average 87 per cent during the first four years of X Plan (2002-07) reaching the peak level during 2003-04. Increasing share of revenue deficit in fiscal deficit over the period 1985-2006 pushed down the average share of net capital expenditure resulting in a negative shift rate of 2.24 per cent.

Primary deficit, which represents the current imbalances net of interest payments, averaged Rs. 18,285 crore during VIII Plan (1992-97) increased to Rs. 28,573 crore during IX Plan (1997-2002). The primary account of the Union Government had shown large fluctuations during the four years of X Plan indicating a peak level surplus of Rs. 47,177 crore in 2003-04. The peak level surplus however witnessed a decelerating trend in the next year and culminated once again into a deficit of Rs. 23552 crore in the current year. In relation to GDP, primary deficit declined from an average of 1.77 per cent during the VIII Plan (1992-1997) to 0.41 per cent in 2002-03. It later turned positive in 2003-04 and 2004-05 but in the current year trend is reversed again and primary deficit relative to GDP increased to 0.67 per cent. Improvement in primary deficit was largely due to increase in recovery of loans with the prepayment of high cost loans under the debt swap scheme in 2003-04 and 2004-05. As a result, contraction in non-debt receipts along with an increase in government expenditure led to the deterioration in fiscal deficit which in turn also worsened the primary deficit situation in 2005-06.

The increase in revenue and fiscal deficits during 2005-06 reflects a slippage in meeting the targets prescribed under FRBM Rules. High levels of fiscal deficits relative to GDP normally tend to cause sharp increases in debt-GDP ratio. Adhering to the FRBM targets in respect of revenue and fiscal deficits is therefore considered to be critical for macroeconomic, financial, external sector and budgetary sustainability.

4.1 Three key fiscal parameters - revenue, fiscal and primary deficits - indicate the extent of overall fiscal imbalances in the Finances of the Union or State Government during a specified period. The Union Budget also presents every year the trends – actual estimates of the previous year, revised estimates of the current year and the budget estimates of the ensuing year – for these fiscal parameters. This chapter presents trends, nature, magnitude and the manner of financing these deficits. Deficits arise because of imbalances in revenue and expenditure. These imbalances could be transient or structural. In the Indian context, fiscal imbalances have both been large and persistent. Besides the size and regularity, its composition, in particular that of the revenue deficit that finances current consumption has also been a cause of

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concern. Formulation of fiscal rules in the context of macroeconomic activity essentially involves setting of rules regarding the size of deficit that could be incurred to finance expenditure. This Chapter also presents the assessment of actual levels of revenue and fiscal deficits vis-à-vis targets set under FRBM Act and Rules for the financial year 2005-06.

Revenue Deficit

4.2 Revenue deficit is the excess of revenue expenditure of the Government over its revenue receipts. It represents net dis-saving of the Government and its shift to present consumption. Revenue deficit leads to increase in borrowings without corresponding capital/asset formation. Borrowings resorted to meet revenue deficit, therefore, do not have any asset back up and create an asset liability mismatch. Because of these properties, revenue deficit is considered generally less desirable. Trends in revenue deficit and some of its key parameters are indicated in Table 4.1.

Table 4.1: Revenue Deficit and its parameters

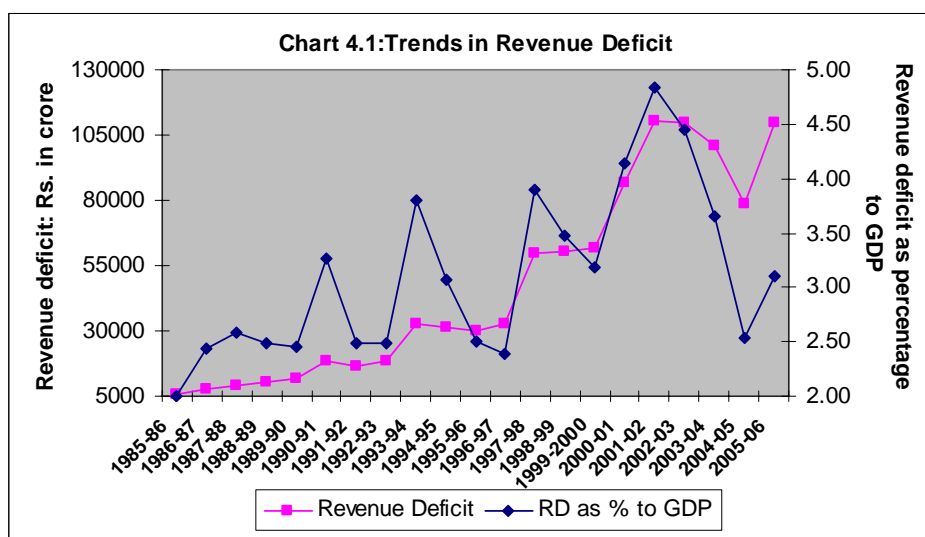
(Rupees in crore)

Period	Revenue Receipt	Revenue Expenditure	Revenue Deficit	Revenue Deficit as per cent of		
				GDP	Revenue Receipt	Revenue Expenditure
1985-2006	176760	224472	47712	3.37	26.99	21.25
VIII Plan (1992-1997)	131601	160541	28941	2.80	21.99	18.03
IX Plan (1997-2002)	237397	313109	75711	3.95	31.89	24.18
X Plan (2002-07)						
2002-03	299826	409591	109765	4.44	36.61	26.80
2003-04	339100	440086	100986	3.66	29.78	22.95
2004-05	376871	455571	78700	2.53	20.88	17.28
2005-06	430940	540637	109697	3.11	25.46	20.29
Average Annual Rate of Growth (Per cent)						
1985-2006	12.95	13.52	16.51	2.45	3.27	2.64
VIII Plan (1992-1997)	15.61	14.64	10.88	Average Annual Rate of Shift in Relative Share		
IX Plan (1997-2002)	8.12	10.40	17.29			
X Plan (2002-07)						
2002-03	13.02	9.06	-0.49			
2003-04	13.10	7.45	-8.00			
2004-05	11.14	3.52	-22.07			
2005-06	14.35	18.67	39.39			

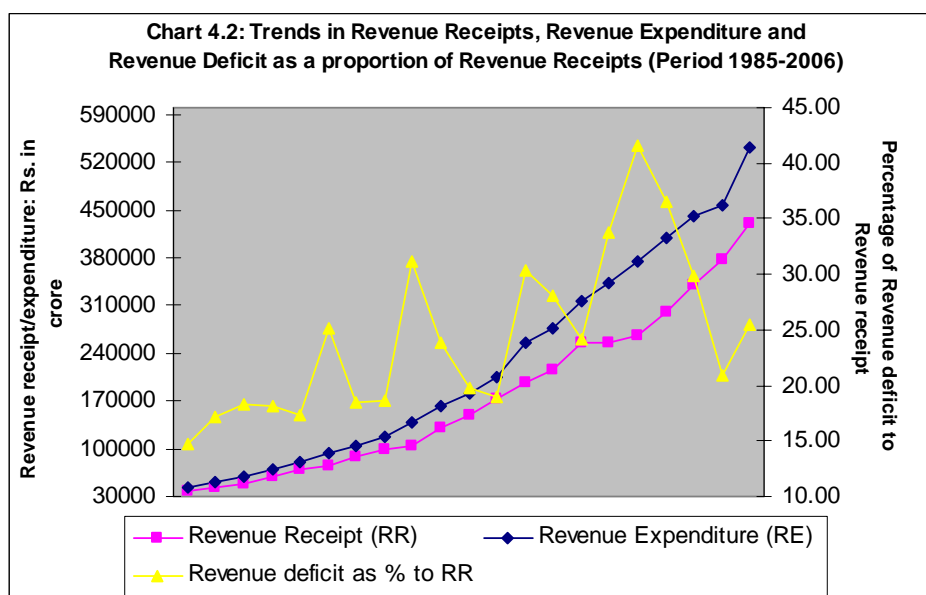
4.3 Overall revenue deficit of the Union Government increased from an average of Rs. 28,941 crore during the VIII Plan (1992-1997) to Rs. 75,711 during the IX Plan (2002-07). The revenue deficit at Rs. 110,303 crore in 2001-02, last year of the IX Plan, exhibited a declining trend during the subsequent three years and reduced to the level of Rs. 78,700 crore in 2004-05. During the current year, revenue deficit however increased by 39.39 per cent over the previous year and reached almost to the level of 2002-03. The average annual rate of growth of revenue deficit during the period 1985-2006 was 16.51 per cent. A negative spread between the trend growth of revenue

receipts and revenue expenditure contributed to the surge in revenue deficit. The rate of growth of revenue expenditure was lower than that of revenue receipt during the first three years of X Plan (2002-07) leading to a negative growth of revenue deficit. These three years witnessed a positive spread of four to seven *per cent* between revenue receipt and revenue expenditure due to relatively buoyant revenue receipt and moderately growing revenue expenditure. As a result, the revenue deficit indicated a declining trend since 2002-03 but the decline was substantial and remarkable of the order of 22.07 *per cent* in the year 2004-05. The rate of growth in revenue expenditure however exceeded again to that of revenue receipts by 4.32 percentage points resulting in an upsurge of Rs. 30997 crore in revenue deficit during the current year which seems to have put a pause to its declining trend exhibited during the preceding three years.

4.4 In relation to GDP, revenue deficit increased from an average of 2.8 *per cent* of GDP during the VIII Plan (1992-1997) to a peak of 4.80 *per cent* in 2001-02 before decelerating to the level of 2.53 *per cent* in 2004-05. The ratio however indicated accelerating trend during the course of the year 2005-06 as reflected in the Mid-Year Review by the Union Government and reached the level of 3.11 *per cent* during the year (Chart 4.1). The average annual rate of shift in the share of revenue deficit to GDP was 2.45 *per cent*.



4.5 The ratio of revenue deficit to revenue receipts was more or less in tandem with its ratio with GDP during the period 1985-2006 (Chart 4.2). As a proportion of revenue receipt, the level of revenue deficit in 2005-06 exceeded the lowest ever level attained during 2004-05 by 4.58 percentage points and was close to long term average of the period 1985-2006 indicating that on an average, revenue receipts fell short of revenue expenditure by around a quarter. As a proportion of revenue expenditure, revenue deficit was 20.29 per cent during the current year which was also close to the long term average and indicates the proportion of revenue expenditure that was debt financed (Table 4.1).



Fiscal Deficit

4.6 Fiscal deficit is the excess of total expenditure of the Government over its non-debt receipts (revenue receipts, miscellaneous capital receipts and recovery of loans and advances). Fiscal deficit normally represents the net incremental liabilities of the Government or its additional borrowings. The shortfall could be met either by additional public debt (internal or external) or by the use of surplus from public account. Fiscal deficit trends along with the trends of the deficit relative to key fiscal parameters are indicated in Table 4.2.

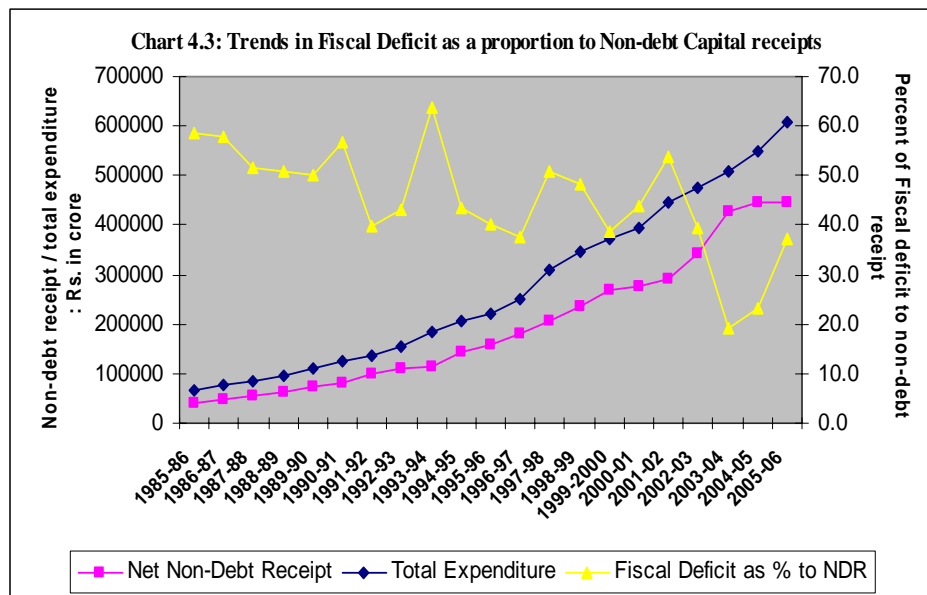
Table 4.2: Fiscal Deficit and its Parameters

(Rupees in crore)

Period	Non-Debt Receipts	Total Expenditure	Fiscal Deficit	Fiscal Deficit as per cent to		
				GDP	Non-Debt Receipts	Total Exp.
1985-2006	195105	272721	77616	5.49	39.78	28.46
VIII Plan (1992-1997)	140973	203539	62565	6.04	44.38	30.74
IX Plan (1997-2002)	254827	374502	119675	6.25	46.96	31.96
X Plan (2002-07)						
2002-03	341722	476310	134588	5.45	39.39	28.26
2003-04	425880	506817	80937	2.93	19.00	15.97
2004-05	445535	549333	103798	3.34	23.30	18.90
2005-06	444322	609249	164927	4.67	37.12	27.07
Average Annual Rate of Growth						
1985-2006	12.98	12.02	9.55	-3.67	-3.03	-2.20
VIII Plan (1992-1997)	14.51	11.87	6.42	Average Annual Rate of Shift in Proportions		
IX Plan (1997-2002)	8.74	8.86	9.00			
X Plan (2002-07)						
2002-03	17.97	6.92	-13.63			
2003-04	24.63	6.40	-39.86			
2004-05	4.62	8.39	28.25			
2005-06	-0.27	10.91	58.89			

4.7 Overall fiscal deficit increased from an average of Rs. 62565 crore during the VIII Plan (1992-97) to Rs. 119675 crore during the IX Plan (1997-2002) and further to an average of Rs. 121,063 crore during the first four years of the X Plan (2002-07). The fiscal deficit reached the peak level of Rs. 164,927 crore during the current year after surpassing the previous peak of Rs. 155,833 crore during 2000-01. The trend rate of growth of fiscal deficit was 9.55 *per cent* during 1985-2006. The substantial decline in fiscal deficit during the first two years of X Plan was surpassed by the steep increases during the subsequent two years as a result of which an average rate of growth during the first four years of X plan (2002-07) at 8.41 *per cent* remained almost close to the trend growth rate as well as the average rate of growth of IX Plan period. A steep hike in fiscal deficit during the current year was mainly on account of a contraction in non-debt receipts by Rs. 1213 crore from level of previous year due to a decline in the receipts under recovery of loans and an increase of Rs. 59916 crore in the total expenditure on account of enhanced spending especially on social and economic services and grants in aid to State and UT Governments.

4.8 Relative to GDP, fiscal deficit increased from 6.04 *per cent* during the VIII Plan (1992-97) to 6.25 *per cent* during the IX Plan with large inter year variations ranging from 6.90 in 1997-98 to 5.79 *per cent* in 2000-01. The first two years of X Plan (2002-07) witnessed a decline in ratio of fiscal deficit to GDP but during the last two years it has exhibited an increasing trend. The average annual rate of shift in its share was (-) 3.67 *per cent* during 1985-2006. As a proportion to non-debt receipts, fiscal deficit witnessed large gyrations varying from 63.6 *per cent* in 1993-94 to 19 *per cent* during 2003-04 (Chart 4.3) with negative shift rate of 3.03 *per cent* during 1985-2006. The shift rate of fiscal deficit to total expenditure was also negative but relatively at slow pace during the period.

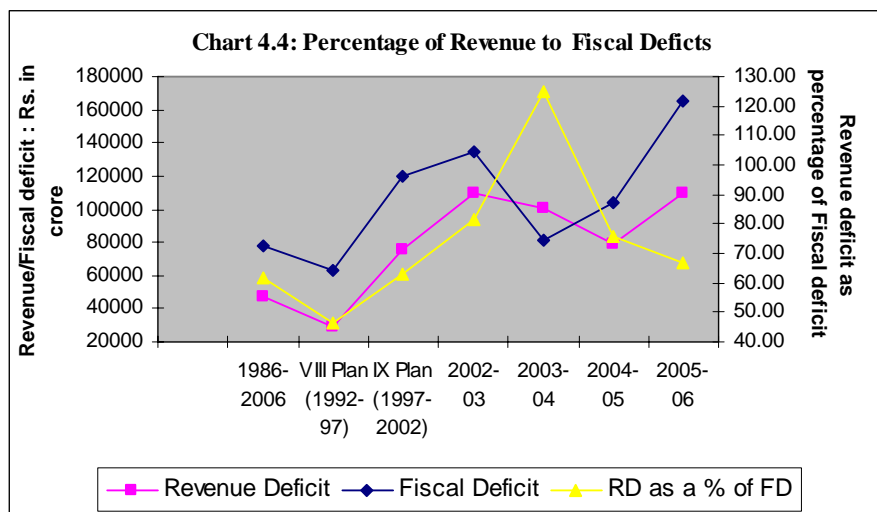


4.9 It is not uncommon for governments to run fiscal deficit and borrow funds for capital/asset formation or for creation of economic and social infrastructure. The assets created through such borrowings could pay for themselves by generating an income stream. Capital formation may also increase the overall income generating capacity of the economy, directly or indirectly and may enlarge the tax base. Further, in a situation where infrastructure becomes a binding constraint for growth, such capital formation by the government could make acceleration of growth more feasible. It may, therefore, be necessary to analyse various components of the fiscal deficit. If bulk of fiscal deficit is for sustaining capital expenditure or for providing financial accommodation to entities for capital formation, such deficits may be considered desirable upto a point. Table 4.3 below provides the movement of components of fiscal deficit over the VIII and IX Plan periods including for the first four years of the X Plan (2002-07).

Table 4.3: Components of Fiscal Deficit

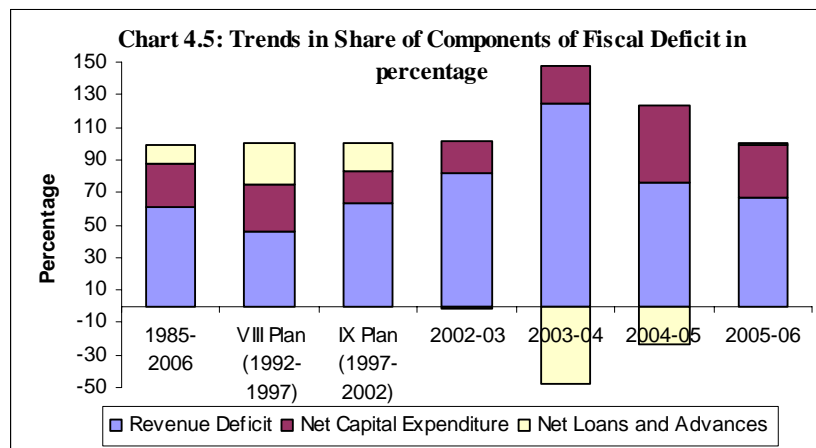
Period	Revenue Deficit	Net Capital Expenditure	Net Loans and Advances
1985-2006	61.47	26.28	11.89
VIII Plan (1992-1997)	46.26	28.25	25.49
IX Plan (1997-2002)	63.26	19.53	17.21
X Plan (2002-07)			
2002-03	81.56	20.32	-1.88
2003-04	124.77	22.79	-47.56
2004-05	75.82	47.43	-23.25
2005-06	66.51	33.07	0.42
Average Annual Rate of Change			
1985-2006	6.35	-2.24	

4.10 Revenue deficit continued to be the dominant component of fiscal deficit, accounting for 61.47 *per cent* of it during 1985-2006. The proportion of revenue deficit in overall fiscal deficit increased from an average of 46.26 *per cent* during the VIII Plan (1992-1997) to 63.26 *per cent* during IX Plan (1997-2002) and further to an average 87 *per cent* during the first four years of X Plan (2002-07) reaching the peak level during 2003-04 (Chart 4.4). The ratio of revenue deficit to fiscal deficit had a large positive shift rate of 6.35 *per cent* during 1985-2006. The increase in fiscal deficit being around 20 *per cent* more than the increase recorded in revenue deficit during the current year resulted in a decline in the ratio of revenue deficit to fiscal deficit over the previous year.



4.11 Net capital expenditure (capital expenditure- capital receipts) accounted for little over a quarter of fiscal deficit during 1985-2006. Increasing share of revenue deficit in fiscal deficit over the period 1985-2006 pushed down the average share of net capital expenditure resulting in its negative shift rate of

2.24 *per cent*. The trends reveal that as interest payments (along with the other components of committed expenditure) increases relative to current revenues of the government, a process of adjustment start in government expenditure which is normally unfavorable to capital expenditure of the Government. Trends in the co-movements of interest payments, capital expenditure and revenue receipts indicated that while increase in interest payments affected negatively the government capital expenditure, the increase in revenue receipts had a positive impact. Fiscal deficit financed around 12 *per cent* of net loans and advances. During the X Plan so far, the recovery of loans and advances almost exceeded the issue of fresh loans and the surplus actually financed part of the fiscal deficit (Chart 4.5). Continuous use of borrowed funds for meeting current expenditure not only indicated erosion in asset back up, it made capital expenditure (inclusive of loans and advances) as variable of adjustment.



4.12 The fiscal policy has a significant role in maintaining the macroeconomic stability. The efficacy and effectiveness of the fiscal tools, however, depends upon the structure of fiscal deficit. The fiscal deficit to GDP ratio has three components: primary structural deficit, structural interest payments relative to GDP, and cyclical fiscal deficit. Trends reveal that structural interest payments account for a large part of actual fiscal deficit during most of the years since the beginning of VIII Plan (1992-97). The impact of structural interest payments has been larger in the nineties and also more persistent. Defining the structural ‘primary gap’ as the difference between actual structural primary deficit and the debt-stabilizing primary deficit, data shows that the primary deficit has been higher than the ‘debt-stabilizing’ primary deficit, in most of the years in the decade of nineties and thereafter. There are long stretches towards the end of the eighties and the latter part of the nineties that the structural primary deficit has been much higher than the debt-stabilizing primary deficit. Together, structural primary deficit and structural interest payments have caused structural fiscal deficits to be large. In view of the large structural fiscal deficit, the role that cyclical

deficit can play has become extremely limited during the periods of fluctuations.

4.13 The large fiscal deficit having major component of structural nature also has implications for growth performance of an economy. Trends in the rates of growth of GDP and fiscal deficits indicated an inverse correlation between the fiscal deficit and the growth performance of the Indian economy during the periods encompassing VIII Plan (1992-97), IX Plan (1997-2002) as well as the recent years of the X Plan (2002-07). Strong growth of 6.7 *per cent* was exhibited in the Eighth Plan (1992-97) when the deficit was shrinking; some deceleration was noted in the Ninth Plan (1997-2002) when the deficit was widening; and resurgent growth in the X Plan (2002-07) with the fiscal deficit again reducing.

Primary Deficit

4.14 While fiscal deficit represents the need for additional resources in general, a part of such resources may be needed to finance interest payments. Interest payments represent the expenditure of past obligations and are independent of current allocative priorities. To look at the imbalances of the current nature, these payments need to be separated and deducted from the total imbalances. Primary deficit, which represents the current imbalances net of interest payments, averaged Rs. 18,285 crore during VIII Plan (1992-97) increased to Rs. 28,573 crore during IX Plan (1997-2002). It however exhibited an average annual surplus of Rs. 10193 crore during the first four years of X Plan (2002-07). The primary account of the Union Government had shown large fluctuations during the four years of X Plan indicating a peak level surplus of Rs. 47,177 crore in 2003-04 as interest payments exceeded the fiscal deficit during the year which was the lowest level of fiscal deficit since 1997-98. The peak level surplus however witnessed a decelerating trend in the next year and culminated once again into a deficit of Rs. 23552 crore in the current year. In fact incremental fiscal deficit of Rs. 61129 crore net of increments in interest payments provides the deficit of Rs. 50712 crore in primary account during the current year. However, due to the opening balance of primary surplus of Rs. 27160 crore resulted in a relatively lower primary deficit during the current year.

Table 4.4: Primary Deficit and its Parameters

(Rupees in crore)

Period	Revenue Deficit	Fiscal Deficit	Interest Payments	Primary Deficit*	Primary Deficit as <i>per cent</i> of GDP
1985-2006	47712	77616	62384	15232	1.08
VIII Plan (1992-1997)	28941	62565	44280	18285	1.77
IX Plan (1997-2002)	75711	119675	91102	28573	1.49
X Plan (2002-07)					
2002-03	109765	134588	124573	10015	0.41
2003-04	100986	80937	128114	-47177	-1.70

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(Rupees in crore)

Period	Revenue Deficit	Fiscal Deficit	Interest Payments	Primary Deficit*	Primary Deficit as per cent of GDP
2004-05	78700	103798	130958	-27160	-0.87
2005-06	109697	164927	141375	23552	0.67
Average annual trend rate of growth (per cent)					
1985-2006	16.51	9.55	16.89	Average Annual Rate of Change.	
VIII Plan (1992-1997)	10.88	6.42	17.44		
IX Plan (1997-2002)	17.29	9.00	14.90		
X Plan (2002-07)					
2002-03	-0.49	-13.63	9.11		
2003-04	-8.00	-39.86	2.84		
2004-05	-22.07	28.25	2.22		
2005-06	39.39	58.89	7.95		

* A negative figure indicates existence of primary surplus

4.15 In relation to GDP, primary deficit declined from an average of 1.77 per cent during the VIII Plan (1992-1997) to 0.41 per cent in 2002-03. It later turned positive in 2003-04 and 2004-05 but in the current year trend is reversed again and primary deficit relative to GDP increased to 0.67 per cent. Improvement in primary deficit from an average of 1.77 per cent of GDP to (-) 0.87 per cent of GDP in 2004-05 clearly indicates that in 2003-04 and 2004-05 non-debt receipts were adequate to meet the expenditure incurred in that year, including the capital expenditure and loans and advances net of interest payments. However, that was largely due to increase in recovery of loans with the prepayment of high cost loans by States as well as by some public sector undertakings under the debt swap scheme in 2003-04 and 2004-05 to take advantage of the soft-interest regime. As a result, contraction in non-debt receipts along with an increase in government expenditure at relatively higher pace led to the deterioration in fiscal deficit which in turn also worsened the primary deficit situation in 2005-06. Recovery of loans or accruals of miscellaneous capital receipts however indicate a decline in assets base of the government and at best could be viewed as a limited and a temporary option.

Actual Deficits vis-à-vis Targets/Requirements of FRBM Act/Rules

4.16 The FRBM Act 2003 came into effect from July 2004 following the issue of Government notification and formulation of FRBM Rules 2004. Section 4(1) of Fiscal Responsibility and Budget Management (FRBM) Act 2003, as amended, provides that the Union Government shall take appropriate measures to reduce fiscal deficit and revenue deficit so as to eliminate revenue deficit by 31 March 2009. The Act and the Rules, as these presently stand, have provided for the elimination of the revenue deficit by 2008-09, with 0.5 percentage point of GDP as the minimum annual reduction target, and fiscal deficit to be brought to the level of 3 percent of GDP, with 0.3 percentage point of GDP, as the minimum annual reduction target. The FRBM Act has some built-in flexibility in achieving revenue and fiscal deficit reduction targets as there is a provision that the specified limits may be exceeded 'due to

ground or grounds of national security or national calamity or such other exceptional grounds as the Central Government may specify'. The targets/requirements prescribed under FRBM Act/Rules are to ensure, *inter alia*, inter-generational equity in fiscal management and long term macroeconomic stability.

4.17 Along with the Budget, and as required under the FRBM Act, the Central government has been laying from 2004-05, *inter alia* the Medium-term Fiscal Policy Statement (MTFPS), specifying 3-year rolling targets for revenue and fiscal deficits as well as for tax revenue and total outstanding liabilities of the Central Government as percentages of GDP. These have been derived on the basis of assumptions on growth and the policy stance of the government. The targets for revenue and fiscal deficits set for 2005-06 in MTFP Statement for 2004-05, budget estimates for 2005-06 along with their actual levels as brought out in Union Government's Finance accounts for the year are given in Table 4.5

Table 4.5: Outcome vis-à-vis Targets under FRBM Rules (As per cent of GDP)

Fiscal Indicator	Targets set in MTFPS 2004-05	Budget Estimate 2005-06	Revised Estimates 2005-06	Actual Levels (As deduced from Finance Accounts 2005-06)	Deviation with BE
Revenue Deficit	1.8	2.7	2.6	3.11	0.41
Fiscal deficit	4.0	4.28	4.1	4.67	0.39

4.18 The budget estimates of revenue and fiscal deficits presented in Union Budget 2005-06 show a substantial variation over the projections of 2005-06 carried out in MTFPS laid along with the Budget 2004-05. The rolling indicators set in the 2004-05 Budget had targeted the revenue deficit to fall to 1.8 *per cent* of GDP by 2005-06, but the 2005-06 Budget has a more realistic revenue deficit target of 2.7 *per cent*. Similarly, the fiscal deficit for 2005-06 has been targeted at 4.28 *per cent* of GDP in the 2005-06 Budget whereas the target was much lower at 4 *per cent* in the MTFPS presented along with the budget in the preceding year. Budget 2005-06 however clarified that two significant changes in the budgetary practice had taken place from the current year having a bearing on computation of fiscal indicators. First, no credit had been taken in BE 2005-06 for the sale proceeds of Government equity in Public Sector Enterprises (PSEs) because these were no longer to be reckoned as a resource for financing the Fiscal Deficit. Instead, these receipts were to be credited into National 'Investment Fund', the income from which was to be used to finance expenditure of Social Infrastructure and to provide capital to viable PSEs. Second, no provision was made in Budget 2005-06 for Loans to States and the Union Territories with Legislature who were to raise required loans directly from the market without budgetary intermediation of the Central Government. It also mentioned that a provision of Rs. 5000 crore as compensation to States on account of shortfall in revenue that might arise due to implementation of Value Added Tax with effect from 1 April 2005 had also been included in Budget 2005-06; otherwise the budget estimate for revenue

deficit would have been 2.6 instead of 2.7 *per cent*. As this amount was likely to be spent during the year, the revised estimates presented along with Budget 2006-07 for revenue and fiscal deficits indicated downward revisions. The actual levels of revenue and fiscal deficits as per Union Finance Accounts for 2005-06 were significantly higher than their budget estimates respectively by 0.41 and 0.39 percentage points. The increase in revenue and fiscal deficits during 2005-06 from their budgeted levels instead of indicating a decline at least by a minimum annual rate of reduction reflects a slippage in meeting the targets prescribed under FRBM Rules.

4.19 High levels of fiscal deficits relative to GDP normally tend to cause sharp increases in debt-GDP ratio and might adversely affect the savings and investment, consequently growth. Adhering to the FRBM targets in respect to revenue and fiscal deficits is therefore considered to be critical for macroeconomic, financial, external sector and budgetary sustainability. Furthermore, as use of borrowed funds for meeting the current expenditure requirements has resulted in widening of asset-liability mismatches over the years, it is essential to eliminate the revenue deficit and generate sufficient revenue surplus which may be utilized for asset creation without creating liabilities. Any slippage in achieving the FRBM targets now could erode the gains already achieved.