SRIRAM's IAS

FISCAL SYSTEM

Fiscal Policy Definitions

- That part of government policy which is concerned with raising revenue through taxation and with deciding on the amounts and purposes of government spending.
- The government's policy in regard to taxation and spending programs. The balance between these two areas determines the amount of money the government will withdraw from or feed into the economy, which can counter economic peaks and slumps.
- Government spending policies that influence macroeconomic conditions. These policies affect tax rates and government spending, in an effort to control the economy.
- Government policy for dealing with the budget-especially with taxation and borrowing
- The policy of a government in controlling its own expenditures and taxation, which together make up the budget
- Fiscal policy is the means by which a government adjusts its levels of revenue and spending in order to monitor and influence a nation's economy

Fiscal policy involves use of taxation and government spending to influence economy. In other words, fiscal policy relates to raising and spending money in quantitative and qualitative terms.

As far as fiscal receipts are concerned, taxes, user charges (power, water, transport charges etc.); disinvestment proceeds; borrowings from internal and external sources are the main channels. All receipts are not earned and some are borrowed. Receipts and expenditure are divided into revenue and capital accounts. Expenditure is also shown as Plan and Non-plan items.

Fiscal policy deals not only with the quantity but the quality of public finance as well. In other words, not merely how much is raised and spent but how has it been raised- is it raised by way of taxes or borrowings; are they excessive or irrational etc. Also, the way the finances so raised are used- wastefully or productively. How much is spent on plan heads and how much populistically targeted etc also is studied.

Fiscal policy can achieve important public policy goals like growth; equity; promotion of small scale industries; encouragement to agriculture; location of industries in rural areas; labour - intensive growth; export promotion; development of sound social and physical infrastructure etc.

Art.112 of the Constitution mandates that expenditure be shown in revenue and other categories.

Non-Plan expenditure is not a Constitutional term but is in use to emphasize on the point that government spends financial resources for consumption (maintenance) as well as asset creation. It includes expenditure on interest payments; defense; subsidies; and public administration.

A break up of the finances into revenue and capital streams, in general, is as follows:

- Revenue receipts are recurrent receipts. Revenue account includes the following receipts: taxes and non-tax sources. Taxes are income tax , corporation tax, excise duty, customs duty etc; non tax resources include user charges ;interest receipts; dividends; profits etc

- Revenue account expenditure is essentially the non-plan expenditure that does not create assets, that is, - interest payments, defence; subsidies and public administration. It is synonymous with maintenance and consumption expenditure as also welfare expenditure.
- Capital account receipts are recoveries of loans and advances made by the Union Government to States, UTS and PSUs; fresh borrowings from inside the country and from abroad; disinvestment proceeds etc. As is clear from above, some of them are debt and some are non-debt.
- Capital account expenditure is loans made to States, UTs and PSUs; expenditure for asset creation in infrastructure and social areas; loans repaid etc.

Definitions of Deficits

Revenue deficit is the difference between the revenue receipts on tax and non-tax sides and the revenue expenditure. Revenue expenditure is conventionally considered synonymous with consumption and non-development, in general. But in the case of India, the social sector expenditure like on education, labour welfare, health, contributions to agriculture, social security etc on government – flag ship schemes are in the revenue expenditure. When revenue deficit is zero, we can fund for consumption from government's own resources and not borrowing.

ERD

An additional fiscal indicator, namely, effective revenue deficit, was introduced in the FRBM Act by the Finance Act, 2012. Effective revenue deficit has been defined as the difference between "the revenue deficit and the grants for creation of capital assets".

Grants for creation of capital assets are defined as "the grants-in-aid given by the Central Government to the State Governments, constitutional authorities or bodies, autonomous bodies and other scheme implementing agencies for creation of capital assets". The amendment seeks to eliminate effective revenue deficit by 2015 which was later postponed to 2018 March.

The government is committed to reduce the effective revenue deficit to 0.7 per cent in 2017-18 and take it to 0.2 per cent by 2019-20

The 14th Finance Commission suggested the government scrap this concept because the Constitution has provisions only for revenue and capital expenditures."Under the Constitution, there are only two categories of expenditure — the one on the revenue account and that broadly expressed as capital expenditure. Artificially carving out revenue account deficit into effective revenue deficit... leads to an accounting problem and raises the moral hazard issue of creative budgeting," the Commission had said.

Fiscal deficit is the difference between what the government earns and its total expenditure. That is, the difference between what is received by the government on revenue account and all the non-debt creating capital receipts like recovered loans and disinvestment proceeds ; and the total expenditure. It amounts to all borrowings of the government in a given period. It is targeted at 3.2% of GDP in 2017-18 compared with 3.5% in the previous year.

FD = Total expenditure of the Government in a budget minus (Revenue receipts + non-debt creating capital receipts).

Difference between Gross FD and Net FD. The Central government makes capital disbursements as loans to the different segments of the economy. In the developing countries, a large part goes as loans to other sectors-States and local Governments, public sector enterprises and the like. Net fiscal deficit can be arrived at by deducting net domestic lending from gross fiscal deficit.

Budget deficit considers only the difference between the total budgeted receipts and the expenditure, the amount that was printed by RBI and supplied to the GOI as credit It was abolished in 1997.

Fiscal Deficit mirrors the health of government finances most accurately unlike the budget deficit concept. BD does not cover all borrowings but only that portion of the borrowings for which government relies on printing money by the RBI

Monetised deficit is the borrowings made from the RBI through printing fresh currency. It is resorted to when the government can not borrow from the market (banks and financial institutions like LIC etc.) any longer due to pressure on interest rates or for reasons like fresh money injection into the economy is necessary to push growth up. It means infusion of fresh currency into the market. It corresponds to the budget deficit that is discarded as a concept since 1997. It is discontinued from 2006 as a part of the FRBM 2003.

Primary deficit is the difference between the fiscal deficit and the interest payments. The concept helps in assessing the progress of the government in its fiscal control efforts.

Deficit Financing

Deficit Financing is the phrase used to describe the financing of gap between Government receipts and expenditure. Such gap is called budgetary deficit. It is financed by printing fresh money by the RBI. The gap can be genuine as the Government wants to spend on welfare and infrastructure for which it has no money and so borrows from the RBI; or due to bad finances of the government; or mainly for consumption and populism.

When the Government has to spend more than what it can raise through tax, non-tax and other sources, it borrows from the market. It can not borrow above a certain amount from the market as it may be inflationary; push up interest rates and thus make it even more costly for the government to service the loan which also tilts the balance away from capital expenditure; and crowd out private investment. Then Reserve Bank of India prints money and supplies credit though at a cost and not free. In other words, when the resources from taxes, user charges, public sector enterprises, public borrowings, small scale borrowings and others are not enough, RBI prints and gives to the Government. It is called deficit financing.

The money printed by the RBI is called high powered money or reserve money or monetary base.

The concept of budget deficit was dropped from 1997 budget and as a result deficit financing also was stopped in that limited sense. That is, as a concept both were discontinued as the two were two sides of the same coin- budget deficit is monetized through deficit financing. In fact, FRBM disallows RBI printing money to finance government deficit in normal conditions.

The beneficial contribution of deficit financing to India's economic planning and development is manifold. First, in the early 1950s, our domestic savings ratio was less than 9 per cent of GDP, and that constrained the investment and welfare activity of the government.

Second, the capacity to raise non-inflationary sources of financing (taxes, small savings, genuine public borrowings, etc.) was highly limited.

Third, external aid could supplement domestic funding only to a limited extent. It is better to source debt from inside than outside.

Fourthly, foreign direct investment was discouraged as a source of investment and thus scarcity of investment resulted. Therefore, government borrowing became necessary through monetization.

There are two views on the matter. There are some people who regard deficit financing as essential for the purposes of development and welfare; as a healthy means of stimulating economy. There are those who regard any deficit financing as inflationary and a serious threat to the stability of the economy.

On balance it may be said that, if deficit financing is done prudently and the borrowed money is used well, it is healthy. However, if the borrowed money is wasted for maintenance, is it against good economics as it can negatively affect money supply and inflation; and also dampen growth.

The viability and desirability of deficit financing, in short, depends on

- Extent of borrowing
- End use of the money borrowed.

How Much of Fiscal Deficit Is Right?

Fiscal deficit is bridged by market borrowings and central bank printing fresh currency (monetization), if necessary. To a limited extent, FD is important as the Government's ability to help growth and welfare increases. Government can always return the loans when its revenues improve due to tax buoyancy. However, FD becomes problematic and even destabilizing when it overshoots a rational threshold. Sovereign debt crisis in Greece and the fiscal woes of USA are the result of unsustainably high debt and borrowing.

Therefore, moderation of fiscal deficit is important. Large and persistent fiscal deficits are a cause of concern, as they pose several risks. Fiscal deficits may cause macroeconomic instability by inflating the economy as money supply rises.

Corporate sector is crowded out – they are left with inadequate funds in the markets as the government borrowing requirements increase. Added to that, interest rates will be high as there is pressure on the available money in the market. If the funding route is through RBI monetization, it means inflation and instability. Inflation may mean less savings, less investment and eventually it hurts the sustainability of high growth.

Large deficits, even if they do not spill over into macroeconomic instability in the short run, will require higher taxes in the long term to cover the heavy burden of internal debt. It means, as the FRBM Act says , inter-generational parity is hurt if debt mounts as future generations will have to pay higher taxes to help the government repay the debt.

Government liabilities- interest payments- increase and there is far less for development.

BOP pressures may mount if inflows drop due to the country being downgraded by rating agencies like Standard and Poor, Moody etc. Therefore, FDs must be moderated- they are desirable within limits but hurtful beyond the limits.

The above analysis applies to FD in normal times. But in abnormal times like since 2008-09 when the world slipped into recession impacting Indian economy negatively, FD must be allowed to be increased for the fiscal stimuli which are necessary to arrest downturn in the economy and revive growth. FRBM allows such counter-cyclical expenditure. Even then, deficit should be incurred not for populist expenditure but to stimulate the economy.

The sovereign debt crisis (SDC) of Greece is due to excessive FD. However, an SDC is by definition inability of the government to service the loans taken from offshore credit market in foreign currency. It has no relation with internal debt. Though the two are intimately related as explained here: Greece borrowed from overseas market and spent excessively. Taxes were not collected efficiently and there was large scale evasion. Government revenues fell drastically due to recession and tax leakages. The need for massive borrowing and spending increased. The stimulus package aimed at keeping up social services did not yield any returns in monetary terms which meant that the Government could not return the loans it took and so could not raise further loans that were affordable: government was not able to raise the money at normal rates of interest. It had to pay high rates of interest. That means it was debt-trapped- borrow to pay the existing debt at higher and higher rates. The banks and other financial institutions that invested in Greek government bonds panicked. Their share prices fell. Financial system was in danger of instability. Similar crisis was seen in Ireland later and Spain and Portugal too. These countries are acronymally called PIGS. The lesson from Greek crisis is that FD may be incurred only for productive reasons and ensure good returns and external loans for budgetary purposes are to be at a minimal level. Tax collections should be efficient. Accounts of government should be properly maintained and not dressed up.

Reducing FD

FD has to be reduced and the FRBM targets are to be conformed to, under normal conditions. But upto3% of GDP for FD as laid down by FRBM Act is necessary and desirable as the Government can borrow and spend for welfare and growth.

The extent of reduction and the manner of reduction matter. More resources should be raised from taxes, user charges, disinvestment etc. Expenditure control should not involve cuts on social sector expenditure as it hurts poor and demographic dividend can not be reaped.

The level of FD should be determined keeping in consideration the following

- whether the debt can be put to productive deployment
- The rate of return on the borrowed funds' use is adequate
- the impact on private sector investment by way of crowding out effect etc.

Even more important is not to cut social spending in a move to reduce deficit. In other words, while FD reduction is needed for macroeconomic stability and inter-generational parity. Introduction of GST, the DTC amendments, selective disinvestment, broadening of tax base, tax buoyancy etc. will yield enough to moderate borrowings.

Global Crisis And The FD In India

Global recession impacted India and our growth rate slipped. Tax revenues were hit. There was a massive fall in demand. Corporate sectors postponed investment. Threat to employment was real. Therefore, Government took it upon itself to spend more by borrowing. The result is that fiscal deficit reached an abnormally high level- 6.8% in the year 2009-10. The fiscal measures taken by the government to counter the negative fall -out of the global slow down on the Indian economy paid off.

Firstly, the Government responded by providing three focused fiscal stimulus packages in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets.

Secondly, the RBI took a number of monetary easing and liquidity enhancing measures to facilitate flow of funds from the financial system to meet the needs of productive sectors.

This fiscal accommodation led to an increase in fiscal deficit from 2.7 per cent in 2007-0.8 to 6.2 percent of GDP in 2008-09.These measures were effective in arresting the fall in growth rate of GDP in 2008-09 and stemmed the fall and achieved a growth of 6.7 per cent. The growth rate further improved to 8.4 % for the next two fiscal years of 2009-10 and 2010-11.

The deficit was financed by raising Internal Debt and from Public Account surplus cash. The unsustainably high fiscal deficit could not be continued for long and had to be phased back to normal levels by a calibrated rollback since 2010-11.

FRBM Act 2003

Fiscal Responsibility and Budget Management (FRBM) Act 2003 was notified in 2004 with the following salient features

- annual targets of reduction in deficits, government borrowing and debt
- Government to annually reduce the revenue deficit by 0.5 per cent and the fiscal deficit by 0.3 per cent beginning fiscal 2004-05.
- elimination of revenue deficit and reduction of fiscal deficit to 3% of GDP by March 31, 2009
- a cap on the level of guarantees and total liabilities of the Government.
- Prohibits Government to borrow from the RBI (primary borrowing) after April 1, 2006. RBI can not print money to lend to the government.
- On a quarterly basis, that Government shall place before both the Houses of Parliament an assessment of trends in receipts and expenditure.
- Annually present the macro-economic framework statement, medium term fiscal policy statement and fiscal policy strategy statement. The three statements would provide the macro-economic background and assessment relating to the achievement of FRBM goals.
- Under exceptional circumstances, Government may be compelled to breach targets. In case of deviations, the Government would not only be required to take corrective measures, but the Finance Minister shall also make a statement in both the Houses of Parliament.

Borrowing from the RBI is permitted in exceptional situations like natural calamities. FRBM was brought in for fiscal discipline; increase plan expenditure; reduce the amount of borrowings; meet consumption from government's own fiscal resources; leave the RBI with autonomy as far as money creation goes etc. Fiscal consolidation is necessary particularly in the era of globalization when the penalty for irresponsibility is high.

New Zealand was the first country to enact a Fiscal Responsibility Act in 1994, thereby setting legal standards for transparency of fiscal policy and reporting, and holding the Government formally responsible to the public for its fiscal performance. A similar legislation, the Charter of Budget Honesty, has been enacted in Australia. The UK, too, has enacted a Code for Fiscal Stability. The global recession from 2008 onwards has made the government breach the FRBM targets vastly. But fiscal consolidation since then has been on track and the target for FD in 2017-18 as mentioned above is 3.2% of GDP and to be made 3% by 2018-19.

FRBM 2.0

The 13th Finance Commission reviewed the Act in 2009 and suggested that there should be greater flexibility regarding the fiscal targets as there is uncertainty in general and also about the global economy.These include agro-climatic events of a national dimension, global recessions impacting the country's exports and shocks caused by domestic or external events like asset price bubbles or systemic crises in important sectors like the financial markets.

Following these recommendations, the Act was amended by the Finance Act 2012. One of the amendments was that, along with the Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and the Macroeconomic Framework Statement, the Central Government would also have to lay a Fourth Statement viz., the Medium Term Expenditure Framework (MTEF) Statement in both the Houses of Parliament, immediately following the Session of the Parliament in which the Budget has been presented. MTEF statement set forth a three-year rolling target for expenditure indicators.

Another significant change made in the amendment to the FRBM Act in 2012 was that, instead of targeting the revenue deficit, the FRBM Act would target a new concept, the 'effective revenue deficit'—the difference between revenue deficit and grants for creation of capital assets. In essence, this placed capital expenditure out of the purview of the revenue deficit.

Finally, the dates by which the effective revenue deficit and fiscal deficit targets were to be met were extended. The effective revenue deficit was to be eliminated and the fiscal deficit was to be below three per cent by March 2015. These targets were once again revised in the Finance Act 2015, postponing the dates of achievement to March 2018.

Fiscal Consolidation

Fiscal consolidation means strengthening government finances. Fiscal consolidation is critical as it provides macro-economic stability; cuts wasteful expenditure; can enable government to spend more on infrastructure and social sectors. Tax reforms, disinvestment, better targeting of subsidies and so on are the hallmarks of fiscal consolidation.

Enactment of FRBM Act provides an institutional framework and binds the government to adopt prudent fiscal policies. There is a need to involve states to effect overall fiscal consolidation and strengthen the growth momentum.

GST and revised DTC are an important federal effort toward fiscal reforms and consolidation. Also, without fiscal consolidation- conversion of subsidies into capital expenditure that forms assets- it is not possible to step up public investment, especially in areas such as agriculture, where gross capital formation has dropped from 1.9 per cent to 1.3 per cent of GDP since 1990-91.

Fiscal consolidation in India includes the following reforms:

- Revenue reforms include tax reforms on both direct and indirect tax front; rationalization of tax exemptions, improving efficiency of tax collection, and tax stability.
- On the expenditure side, reform areas include cutting out non-essential and unproductive activities, schemes and projects, allocation of resources to priority areas, reducing cost of services, rationalizing subsidies; reduction of time and cost overruns on projects, getting proper 'outcome' from output

The reduction in fiscal deficit should not be achieved by a reduction in plan expenditure. It should be done by way of realisation of higher revenues and rationalizing revenue non-plan expenditure.

Kelkar Committee 2012

A roadmap for fiscal consolidation was worked out by a committee headed by former Chairman of the 13th Finance Commission Vijay Kelkar to retrieve fiscal prudence after the stimulus. Kelkar committee said that the reduction in deficit could be achieved through a combination of share sale of state-owned companies, pruning petro-product subsidies through raising prices of diesel and LPG or cooking gas and implementation of the Goods and Services Tax or GST.Administrative reforms including beefing up of IT infrastructure have also been suggested.

Bimal Jalan Committee on Expenditure Management

NDA Government in 2014 set up Expenditure Management Commission, headed by formerRBI Governor Bimal Jalan, to suggest ways to reduce food, fertiliser and oil subsidies and narrow the fiscal deficit.

The panel has been set up as there is a need to review the allocative and operational efficiencies of the government expenditure to achieve maximum output. Government proposes to overhaul the subsidy regime, including food and petroleum subsidies, and make it more targeted while providing full protection to the poor. The subsidy bill on food, petroleum and fertilisers is estimated at Rs2.4 lakh crore for 2017-18 fiscal.

Austerity

When the fiscal position weaken much, the austerity measures taken can be: ban on five-star venues for government meetings; foreign locations for conferences, exhibitions and seminars; and executive class airline tickets for officials; keep the size of delegations going abroad at an "absolute minimum; banned recruitment for central government posts for one year and the purchase of new vehicles.

N.K. Singh panel to review India's Fiscal Responsibility and Budget Management (FRBM)

The N.K. Singh panel to review *India's Fiscal Responsibility and Budget Management (FRBM) Act* suggested the creation of a new Fiscal Council and a focus on public debt to GDP ratio- target of 60% debt to GDP by 2023 from the present level of about 68%.

The FRBM Committee, set up in May 2016 to review the Centre's fiscal roadmap, had submitted its four-volume report in January 2017.

The committee favours a debt-to-GDP ratio of 60% for the general government by 2022-23, 40% (38.74%) for the central government and 20% for state governments. Within the framework, the committee has recommended adopting fiscal deficit as the key operational target consistent with achieving the medium-term debt ceiling, at 3% of GDP for three years, between 2017-18 and 2019-20. Revenue deficit-to-GDP ratio has been envisaged to decline steadily by 0.25 percentage points each year from 2.3% in 2016-17 to 0.8% in 2022-23.

The committee has prescribed a so-called glide path to these targets—steady progress towards them—and also suggested that there be some flexibility in the deficit targets on both sides, downwards when growth is good and upwards when it isn't.

The panel has recommended enacting a new Debt and Fiscal Responsibility Act after repealing the existing Fiscal Responsibility and Budget Management (FRBM) Act, and creating a fiscal council.

The proposed three-member fiscal council will prepare multi-year fiscal forecasts for the central and state governments (together called the general government) and provide an independent assessment of the central government's fiscal performance and compliance with targets set under the new law.

However, to deal with unforeseen events such as war, calamities of national proportion, collapse of agricultural activity, far-reaching structural reforms, and sharp decline in real output growth of at least 3 percentage points, the committee has specified deviation in fiscal deficit target of not more than 0.5 percentage points.

The committee said that if there is a sharp increase in real output growth of at least 3 percentage points above the average for the previous four quarters, fiscal deficit must fall by at least 0.5 percentage points below the target.

For any deviations, the Centre would be expected to hold formal consultations with the three-member Fiscal Council that would also make multi-year fiscal forecasts for Central and General governments.

The committee has also called for institutional reforms in general government's fiscal management, including the Centre giving consent to State borrowings under Article 293 of the Constitution.

Major Budget Reforms 2017

- Budget presentation preponed – Union budget was traditionally presented in the last week of February and passed by mid-May. However, in 2017, budget was presented on February 1.
- There was no vote on account(Art.116) thus
- Railway Budget merged – The Railway Budget was presented separately since 1924 on the recommendation of committee led by Sir William Acworth. This was done because Railway revenue was high. But railway revenue has shrunk to 11.5 percent of general revenue. From 2017 onwards, railways will be part of the general budget. By merging the two budgets, the government can take a wholistic view.
- Plan and non-plan expenditure removed
- Shankaracharya committee on calendar for budget

Plan And Non Plan Expenditure Classification And Its Unsustainability

In the Budget, expenditure is shown both as revenue and capital and also as plan and non-plan within both. In conventional understanding, 'Plan' expenditures, as the name implies, encompass annual plan projects contributing to five-year plan; these include projects like dams, roads, power plants etc. Non-Plan expenditure relates to maintenance, consumption and welfare. Non-plan expenditure does not create assets. When a project is being built, it is a plan item of expenditure. When completed and being maintained, it is a non-plan item of expenditure.

However, in India there is plan and non-plan in both revenue and capital expensiture and revenue plan expenditure is composed of flagship programmes as seen below. At present, non-Plan expenditure constitutes approximately 70-75 percent of the budgetary expenditure at central and state levels.

'Non-plan' expenditure may be on the revenue or capital accounts and has the following items

- Interest payments
- Subsidies
- Defence
- Public Admn.
- Loans and grants to States, PSEs and UTs
- acquisition of ships, vessels andaircrafts for Coast Guard Organisation , construction of road works by Border Roads Development Board, purchase of ready-built accommodation for CBDT, construction of office buildings by CPWD, acquisition/construction of residential and non-residential buildings for Indian Missions abroad and investment in International Financial Institutions, Capital Outlay on Police
- grants to foreign governments : for Bhutan, Nepal, African Countries, Bangladesh , Sri Lanka, Myanmar, Afghanistan, Maldives, and other developing countries

Rangarajan Committee 2012

The high-level expert committee was set up in 2010 under the Chairmanship of Dr. C. Rangarajan to suggest measures for efficient management of public expenditure and was mandated to see whether the classification of expenditure into Plan and Non-Plan is rational and can be continued. The report of the Committee was presented in 2012 and the following are the salient points:

- The government should do away with the distinction between Plan and Non-Plan expenditure and redefine roles of the Planning Commission and the Finance Ministry. Plan and Non-Plan distinction in the budget is not able to provide a satisfactory classification of developmental and non-developmental dimensions of government expenditure. It has therefore become dysfunctional. The committee recommended that Plan and Non-Plan distinction in the budget should be removed.
- The report suggested a basic shift to outputs and outcomes.
- The report also called for strengthening the Central Plan Monitoring System (CPMS) and empowering the citizens to seek information on flow of resources and utilisation with a view to promoting transparency and accountability.

The distinction between plan and non-plan expenditure items has become simplistic and is artificial and untenable. The building of a new school or a primary health centre is considered a Plan investment but its running and maintenance is considered non-Plan spending. Thus, very often it had led to Government allocation being reduced for maintenance as it is classified as non-plan item and will be criticized.

In the Sarva Siksha Abhiyan, expenditure on teachers' salary constituted Plan Revenue Expenditure, and that on construction of school buildings was Plan Capital Expenditure. The government made allocations to the Rural Development Ministry for building roads under the Pradhan Mantri Gram Sadak Yojana as Plan Expenditure, but their maintenance belonged to Non-Plan budget. Similarly, funds for teachers (Kendriya Vidyalayas, Navodaya Vidyalas, other government schools) and for doctors (Health centres and Medical colleges of the government) came from Non-Plan Budget while school buildings and hospital buildings were plan expenditure. Thus there are buildings without employees.

Expensive equipments in hospitals were bought under plan spending but maintenance suffered as employees were not hired. Thus, assets are neglected. New projects are allotted money while the completed projects are neglected.

It is important to take a consolidated view of finances keeping in perspective the interdependence of Plan and non-Plan expenditures.This classification had given rise to a misleading notion that Plan expenditure was developmental and Non Plan was non-developmental. Resource allocation would be easier now by putting plan and non-plan expenditure together; this approach of looking at expenditure as a whole will also help link outlays to outcomes better.

The reasons for scrapping the distinction from 2017-18 are

- 5 Year Plans are discontinued
- Planning Commission is no longer there
- Undesirability of keeping the distinction for the reasons detailed above.

Public Debt

Public debt includes government's internal debt comprising borrowings inside the country like market loans; borrowing from the RBI through printing; and external debt comprising loans from foreign countries, international financial institutions, NRI deposits, commercial institutions etc. In the expression `public debt and "other liabilities". "Other liabilities" include outstanding against the various small saving schemes, provident funds etc. External debt means what the nation owes to foreign lenders- includes private sector borrowings too. However, public debt includes what the government owes to lenders inside and outside the country. *(More in the classroom)*

Public debt is justified as the government does not have adequate resources and taxation can not be done beyond a point. It should be for productive reasons and also welfare reasons. The spiral of deficit and debt run the risk of undermining the country's creditworthiness, devaluing the currency and destabilising the entire economy with grave social consequences. Therefore, it should be incurred judiciously.

India's debt to GDP ratio, when the total outstanding liability –internal and external, is included as of March 31, 2017, is Rs 68.5%.

Generally, Government debt as a percent of GDP is used by investors to measure a country's ability to make future payments on its debt, thus affecting the country's borrowing costs and government bond yields.

External Debt

Annual Publication 'India's External Debt: A Status Report 2016-17' prepared by the Department of Economic Affairs, Ministry of Finance, Government of India gives a detailed analysis of India's External Debt position at end-March 2017.

The salient features of the Report are:

- India's external debt stock stood at US$ 471.9 billion, decreasing from 2016.The decline in external debt was due to the decrease in long-term debt particularly NRI deposits and commercial borrowings.
- long-term external debt was US$ 383.9 billion and accounted for 81.4 per cent of total external debt
- Short-term external debt increased by 5.5 per cent to US$ 88.0 billion. This is mainly due to the increase in trade related credits, a major component of short-term debt with a share of 98.3 per cent.
- Government (sovereign) external debt was US$ 95.8 billion and constituted 20.3 per cent of the total external debt.
- India's external debt has remained within manageable limits and the external debt situation has improved as indicated by the increase in foreign exchange reserves cover to debt to 78.4 per cent and fall in the external debt-GDP ratio to20.2 per cent. External debt of the country continues to be dominated by the long-term borrowings.

A cross country comparison based on 'International Debt Statistics 2017' of the World Bank, which presents the debt data for 2015, shows that India continues to be among the less vulnerable countries with its external debt indicators comparing well with other indebted developing countries. External debt comprises of commercial borrowings, NRI deposits, short-term debt as well as multilateral and bilateral debt.

Commercial borrowings continued to be the highest with a share of 37.4 per cent of total external debt, followed by NRI deposits (24.1 per cent) and short-term debt (18.4 per cent). Multilateral debt is at 12% and bilateral debt is at about 5%. The share of US dollar denominated debt continued to be the highest in external debt, followed by the Indian rupee, SDR, Japanese yen and euro.The ratio of concessional debt to total external debt was 8.7 per cent.

The valuation effect arises because external debt is denominated in different currencies, and the US dollar value which is the international unit for debt, fluctuates over time vis-à-vis other currencies. If US dollar appreciated against Indian rupee and most other major currencies or otherwise, there is a change in the total debt stock.

External Debt Management

The prudent external debt management policy of the Government of India continues to focus on monitoring long and short-term debt, raising sovereign loans on concessional terms with longer maturities, regulating external commercial borrowings through end-use, encouraging rupee denominated bonds like Masala bonds, and rationalizing interest rates on Non-Resident Indian deposits.

Rupee Debt

Rupee denominated debt refers to that part of India's total external debt that is denominated in India's domestic currency, the Rupee.

Unlike foreign currency denominated external debt like ECBs, FCCBs etc, in case of rupee denominated debt the *currency risk* (the risk arising from appreciation or depreciation of the nominal exchange rate) is borne by the creditor and not by the borrower. Borrower returns as much as he borrowed (as many rupees) with interest as fixed irrespective of the exchange rate . Thus, if the domestic currency appreciates vis-à-vis the foreign currency, the creditor stands to gain vis-à-vis the borrower since he receives more rupees than the current rate suggests.

In India rupee denominated debt comprises the following categories;

- *Rupee Debt;* Includes the outstanding defense and civilian state credits extended to India by the erstwhile Union of Soviet Socialist Republics (USSR). The repayment is primarily through exports of goods to Russia.

- *Rupee denominated* Non-Resident Indian (NRI) Deposits.

- Foreign Institutional Investors (FII) investment in Government Treasury-Bills and dated securities and

- FII investment in corporate debt securities (with such investments ceiling set by GOI annually).

In short, external debt consists of

- long-term external debt which is the bulk part
- NRI deposits
- multilateral loans
- commercial borrowings
- bilateral loans and
- Trade credit

Internal Debt

Internal debt includes loans raised by the government in the open market through treasury bills and government securities, special securities issued to the RBI and most importantly, various bonds like the oil bonds, fertilizer bonds etc.The money sterilized from the market in by the Market Stabilisation Scheme (MSS) is also shown in the government's statement of liabilities. Introduced in 2004, MSS envisages the issue of treasury bills and/or dated securities to absorb excess liquidity arising out of the excessive foreign currency inflows. (Read ahead)

The internal debt of the government also includes others like the outstanding against small-savings schemes, provident funds, deposits under special deposit schemes etc. These debts are shown under a separate head titled 'other liabilities'.

Debt should be moderated for the reasons cited in the discussion on FD above.

Masala Bonds

Masala bond is a term used to refer to a financial instrument through which Indian entities can raise money from overseas markets in rupee, not foreign currency. By issuing bonds in rupees, an Indian entity is shielded against the risk of currency fluctuation, typically associated with borrowing in foreign currency. Besides helping diversify funding sources, the cost of borrowing is lower than domestic markets. As masala bonds are denominated in rupees, foreign investors will be taking the currency risk.

Masala is an Indian word for spices. The term was used by International Finance Corporation (IFC) to evoke the culture and cuisine of India. Dim sum bonds are bonds issued outside of China but denominated in Chinese renminbi, and not the local currency. They are named after dim sum, a popular style of cuisine in Hong Kong. Similarly, Samurai bonds for Japan.

Unlike dollar bonds, where the borrower takes the currency risk, masala bond makes the investors bear the risk. The first Masala bond was issued by International Finance Corporation in 2014 when it raised money to fund infrastructure projects in India. Later in International Financial Corporation for the first time issued green masala bonds to be used for private sector investments that address climate change in India.

In 2016 HDFC issued Masala bonds and thereby became the first Indian company to issue masala bonds and later NTPC issued first corporate green masala bonds. NHAI, Shriram Transport Finance and Indiabulls Housing Finance are the others (2017).

An investor who buys a bond issued by an Indian entity at a rate that is, say, 200 basis points above the globally accepted pricing benchmark — the London Interbank Offered Rate or Libor is optimistic about India, and hoping that currency and inflation would be stable enough to ensure good returns after factoring in exchange rate risks. With India's GDP or national income rising, and projected to grow at a reasonably fast rate over the next few years, many overseas investors like to buy such bonds to earn higher returns compared to the US and Europe where interest rates are still low.

The key for the success of these bonds will be a stable exchange rate. If the masala bonds take off it could lower India's cost of capital over a period of time. Inflows from these financial instruments could also support the rupee. It is seen as a small incremental step towards internationalisation of rupee and full rupee convertibility. Masala bonds are a step to help internationalise the Indian rupee and also deepen the Indian financial system. IFC's 5-year green Masala bond is listed on the London Stock Exchange. Similar offerings from other countries have also been after the food or culture of that country like "dim sum" label for Chinese offshore issues or "Samurai" bonds for Japanese offshore issues.

Before masala bonds, corporates have had to rely on avenues such as external commercial borrowings or ECBs. The challenge with the likes of ECBs is the entity raising money is faced with a currency risk - they have to be raised and repaid in dollar terms.

The Reserve Bank of India has issued guidelines allowing Indian companies, non-banking finance companies (HDFC, India Bulls Housing Finance are examples of such companies) and infrastructure investment trusts and real investment trusts (investment vehicles that pool money from various investors and invest in infrastructure and real estate sectors) to issue rupee-denominated bond overseas.

Zero Base Budgeting

Tenth Plan Approach Paper says that ZBB will be followed for rationalization of expenditure. The ZBB methodology was taken up first in 1987 in the Union Budget and was recommended for the Government departments and PSUs. Many state governments also applied it, for example, Government of Rajasthan and Maharashtra .The Maharashtra Government renamed it ` Development -based budget'

Under the ZBB, a close and critical examination is made of the existing government programmes, projects and other activities to ensure that funds are made available to high priority items by eliminating outdated programmes and reducing funds to the low priority items. Governmental programmes and projects are appraised every year as if they are new and funding for the existing items is not continued merely because a part of the project cost has already been incurred. Programmes are discarded if the cost-benefit ratio is below the prescribed norms.

The objective of the ZBB is to overhaul the functioning of the government departments and PSUs so that productivity can be increased and wastage can be minimised. Scarce government resources can be deployed efficiently. ZBB as a resource planning and control technique and process yielded substantial benefits in the advanced countries like New Zealand, UK, Australia and Sweden in terms of efficiency gains, better resource use, lower costs and finally surplus budgets, particularly in New Zealand. However, the use of ZBB to human development programmes and poverty alleviation and employment generation programmes is limited and the results are cumulative and can not be assessed annually.

The Economic Survey 2014 says that the expenditure on social schemes needs to be rationalised. -'What is needed is a 'zero budgeting' approach with a revamp, reorganization, and convergence of schemes.' Zero-based budgeting runs contrary to traditional budgeting where the previous year's budget is taken as a base. It re-evaluates the entire budget

WMAs

Prior to 1997, the RBI lent to central government against ad hoc Treasury bills, (since mid-50's) This provision for extending short-term financing was created to bridge temporary mismatches in receipts and payments. However, the central government slipped into the practice of rolling over this facility, resulting in automatic monetisation of the government's deficit. Automaticity refers to RBI having to print money if the Government's cash balances with the RBI went below a threshold fixed. It had no choice but to create currency and lend to the Government of India. The process of creating 91-day bills and subsequently funding them into non-marketable special securities at a very low interest rate (4.6%) emerged as a principal source of borrowing. It was thought to be irrational for the reasons that the interest rate is not market driven and was very concessional. Nor did the RBI have any voice in deterring the same. Nor was there a limit to how much could be printed in this way.

In the case of state governments, the RBI provides two types of WMAs. Normal WMAs are clean or unsecured advances extended at the bank rate(marginal standing facility), while special WMAs are extended against the government securities. The latter is exhausted first and then the former may be sought to a limited extent. If the state government borrows over and above the WMA allowed for it by the RBI, it is called overdraft and there is a limit to that too set by the RBI.

Adhoc Treasury Bills and WMA

Union Government replaced adhoc treasury bills with WMAs in 1997. WMAs given by RBI to GOI do not require any collateral. Its amount is limited and arrived at the beginning of the fiscal year through consultation between Government and the RBI. There are penal interest rates if the pre-agreed amount is violated. Ways and Means Advances are made at the Repo Rate. Overdraft is charged penally at two percent above the repo rate

Replacement of the adhoc bills with WMA represents an advance in fiscal discipline and harmonization of the fiscal and monetary policies as the RBI is consulted in Governmental short term borrowing and the `automaticity' is dropped in the creation of currency by the RBI to fund governmental expenditure.

Some Words

Fiscal Drag

A situation where inflation pushes income into higher tax brackets- bracket creep. The result is increase in income taxes but no increase in real purchasing power. This is a problem during periods of high inflation. Government gains due to higher tax collections and the economy suffers as growth is dragged down due to less demand. In high-growth and high inflation economies ('overheated'), fiscal drag acts as an automatic stabiliser, as it acts naturally to keep demand stable. *More in the Classroom*

Fiscal Neutrality

When the net effect of taxation and public spending is neutral: neither stimulating nor dampening demand.

Crowding Out

Excessive government borrowing can lead to shrinkage of the liquidity in the market; forces the interest rates to go up; private investment is crowed out for two reasons: liquidity availability is less and the rates are high. Investment suffers and growth decelerates. The Government also may not spend the borrowed resources well to generate returns. It may spend on populist schemes. However, if the government deploys the funds well, it may have a 'crowding in' effect: the infrastructure built can have a multiplier effect on investment, jobs, tax collections and growth. For example, Bharatmala that was announced in October 2017.

Pump-Priming

Deficit financing and spending by a government on public works in an attempt to revive economy during recession – countercyclical measures. It can raise the purchasing power of the people and thus stimulate and revive economic activity to the point that deficit spending will no longer be considered necessary to maintain the desired economic activity.

Small Savings

Small savings instruments are Post Office Monthly Income Schemes and Time Deposits; National Savings Scheme; Indira Vikas Patra; Kisan Vikas Patra; Public Provident Fund and so on. They are aimed at promoting safe and long-term savings by individuals. They are called small savings because the amount saved is relatively small. They are initiated by the central Government but mobilized by the State Governments; and are deposited with and managed by the central government. As a reward State Governments receive all such savings as loan.

Small savings are a sizeable portion of the financial savings of the country. They contribute to the finances of the Government- federal and State- that is, they are an important source of borrowing for the government. These schemes have a built in tax concession that enhances their attraction for the small savers. They also earn a rate of interest that is higher in comparison to what the banks offer. They are meant to be savings by low income and other groups but are open to all.

Small savings instruments in India are retailed through 1.53 lakh post offices of which about 1.29 lakh are in rural areas.

The National Small Savings Fund (NSSF), in the Public Account of India has all the small savings. Money in the Fund is invested in Central and State Government Securities. The investment pattern is as per norms decided from time to time by the Government of India.

The Fund is administered by the Government of India, Ministry of Finance (Department of Economic Affairs) under National Small Savings Fund (Custody and Investment) Rules, 2001, framed by the President under Article 283(1) of the Constitution.

2017

The government in 2017 exempted all but four States from mandatory investment norms for the National Small Savings Fund (NSSF). It means that all other states except the four are not on-lent the savings mobilized. They have other ways of raising loans, presumably at cheaper rates. But the centre needs to keep up with these schemes to promote savings and offer attractive rates to senior citizens and such other needy.

It will help the Centre lower its dependence on market borrowings through the RBI, it will also help keep the fiscal deficit in check though only in statistical terms. Public Account of India where the NSSF is placed is outside the budgetary approvals from Parliament. However, repayment of the principal and interest will be from the Union Budget. Economists said the Centre could provide other public sector units a dispensation similar to the one given to the FCI.

Public Goods, Merit Goods And Demerit Goods

Public goods are those goods whose consumption by some does not diminish them for others. That is, they are non-rivalrous. Common examples include law and order, parks, street-lighting, defence etc. They are goods meant for the entire public. Merit goods are goods like education, health care etc. that are important for the society as a whole- that is, they have positive externalities. Market may not supply them in adequate quantities. Government supplements the market. Demerit goods are those whose consumption should be discouraged. They have negative externalities. Examples include: tobacco, alcohol etc. Thirteenth Finance Commission calls them sin goods and wants them to be harshly taxed.

Giffen Goods

They include goods whose demand goes up when the price increases. They are the status markers and exclusivist in nature.

Twin Deficits

Budget deficit (fiscal deficit) and current account deficit-the former fuelling the latter as the borrowings increase are known as twin deficits. USA is a prime example. So is India!!!!
(Recent developments in the classroom)

'Fiscal Cliff'

A combination of expiring tax cuts and across-the-board government spending cuts that were scheduled to become effective Dec. 31, 2012. The idea behind the fiscal cliff was that if the federal government allowed these two events to proceed as planned, they would have a detrimental effect on an already weak economy, perhaps sending it back into an official recession as it cut government spending and investment, collected more taxes which cut down both consumption and investment, increased unemployment rates and undermined consumer and investor confidence.