GS FOUNDATION FOR CSE 2024
ECONOMY-11
FISCAL POLICY-BASICS

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2. PUBLIC FINANCE

- **Public finance** is the area of economics which deals with **resource mobilization and resource utilization to accomplish activities of the government** at all levels (Central, State and local bodies level).

- The objectives of the public finance are to manage public funds, mobilize resource for government activities, promote economic and social development, reduce inequalities, ensure price stability, manage the currency value in the international market, ensure long term sustainability (both economic and environmental) by controlling fiscal deficit and public debt.

1) GENERAL BUDGET

- Budget is the annual financial statement.
  - » **Article 112** of the Constitution of India requires central government to lay down annual financial statement in front of the Parliament.
  - » **Article 202** of the Constitution of India requires the same from state governments in front of their respective state legislatures.

- It is the **statement of account of the government**. It also reflects government's **vision** and highlights the overall government **policy**.

- **From 1921** to 2016-17, Railway Budget was presented separately from the general budget. But this practice was done away from 2017-18 general Budget, where Railway Budget was merged with general budget on the recommendations of the Bibek Debroy committee.

- **Budget contains** an account of **expected receipts and expenditure** of the government. It has three components:
  1. Actual figure for the previous year
  2. Budgeted and Revised figure for the current year
  3. **Estimates for the upcoming year**.

  - For e.g., if it is the Budget of 2023-24, it would be presented on 1st Feb 2023.
    - So, it would contain actual figures for FY 2021-22.
    - It would also contain budgeted and revised figure for FY 2022-23
    - An estimate for the FY 2023-24.

2) THE THREE FUNDS

- The estimated receipts and expenditures are made out of the three funds: Consolidated Fund of India, Public Accounts of India and Contingency Fund of India.

A) CONSOLIDATED FUND OF INDIA (ARTICLE 266(1)):

- **All revenues** received by the GoI, all **loans raised** by that government by the issue of treasury bills, loans or ways and means advances and **all moneys received by that Government in repayment of loans** shall form one consolidated fund which is entitled as "The Consolidated Fund of India".

- **All expenses incurred by the Government** including repayment of debts and loans given to state governments/ UTs is spent from this fund.

- **Note1:** Government needs Parliament's approval to withdraw money from thus fund.
- **Note2:** Each state has its own respective Consolidated Fund of State with similar provisions.
- **Note3:** The CAG audits these funds and reports the relevant legislatures on their management.

B) PUBLIC ACCOUNTS OF INDIA (ARTICLE 266(2)):

- All Public money received other than those included in Consolidated Fund of India are held in Public Accounts of India.
  - It mainly consists of money raised through small saving schemes, provident fund schemes etc.
  - The **government is just custodian of these**. It has to be repaid in future (either on maturity or when people demand it).

- This kind of debt or obligations raised by government is called **other liabilities**.
  - Please note: Public Accounts doesn't only contain other liabilities. It also has some other receipts too.

- **Note:** Expenditures from Public Account of India are not to be approved by the Indian Parliament. It is because of the returning nature of the fund.

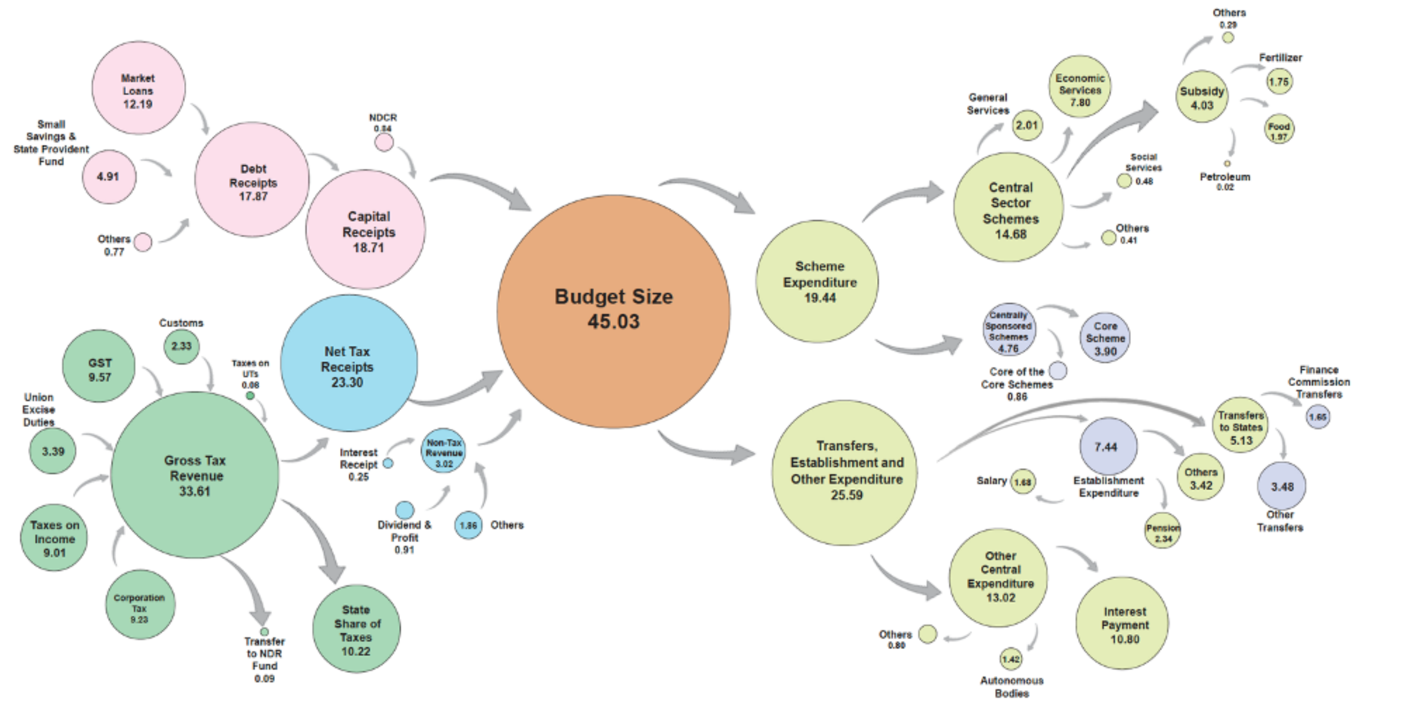
C) CONTINGENCY FUND OF INDIA (ARTICLE 267):

- It is created to meet unforeseen expenditure. It is held at the disposal of the President of India. He/she can meet the expenditure and get the approval of the Parliament later.
- **Note**: Each state can have its own Contingency Fund established under Article 267(2).
- **Note**: CAG audits all expenditure from the contingency fund of India and Public Account of India as well as contingency fund and public account of each state.

3. BUDGET PROFILE 2023-24

(In ₹ lakh crore)

बजट की रूपरेखा
BUDGET PROFILE



4. UNDERSTANDING VARIOUS COMPONENTS OF THE BUDGET: RECEIPTS AND EXPENDITURE

1) RECEIPTS

- **Receipts** can be broadly divided into **Revenue Receipts** and **Capital Receipts**

A) REVENUE RECEIPTS ARE ONE-WAY TRANSACTIONS, AND THEY DON'T NEED TO BE PAID BACK.

- They include **Net Tax Receipts** and **Non-Tax Revenue**
  - **Tax Revenue (Gross Tax Revenue)** include the revenue generated by levy and collection of taxes by the Central government.
    - **Union Excise Duty**: Duties of excise on the following goods - (a) Petroleum Crude (b) High Speed diesel (C) motor spirit (petrol) (d) natural gas (e) aviation turbine fuel (f) tobacco and tobacco products
    - **GST**
    - **Custom Duties** (tax on export and import of commodities from and to the country
    - **Corporate Tax**
    - **Income Tax (Personal Income Tax)**

- **Taxes of Union Territories** (UT (except Delhi and Puducherry) are under direct administration of the Centre. So, their tax income is lumped and taken into account in Central Budget and accounted for under this head.
- **Other Taxes and Duties**: Tax income from other taxes like wealth tax, securities transaction tax are lumped together under this category.

- **Net Tax Receipt** is obtained by taking out State's Share of Taxes and Transfer to NDRF from the Gross Tax Receipts.
  - **National Disaster Relief Fund (NDRF):** It is financed by levy of cess on certain items, chargeable to excise and customs duty, and approved annually through finance bill.
    - Currently, a National Calamity Contingent Duty (NCCD) is levied to finance the NDRF and additional budgetary support is provided as and when necessary.

- **Non-Tax Revenue** include:
  - **Interest Receipts**: From the loans given to states and other government bodies.

  - **Dividend and Profit**: Profit is the dividend income from fully government owned enterprises. Dividends are income from the shares owned by government in private or semi-government enterprises.

  - **Other Non-Tax Receipts** include receipts from:
    - » Fiscal services
      a. Currency, coinage and mint i.e., profit from circulation of coins, is accounted under this head.

Details about Minting of Coins in India

- The GoI has the sole right to mint coins and design coins in various denominations. The responsibility of coinage vests with the GoI in terms of Coinage Act, 2011 as amended from time to time.
- GoI is the sole authority for minting of coins under the Coinage Act, 2011 as amended from time to time.
  - Coins are minted at four Government of India mints at Mumbai, Alipore (Kolkata), Saifabad (Hyderabad), Cherlapally (Hyderabad) and Noida (UP).
- Currently, coins in India are being issued in denominations of Rs 1 and above. They are called Rupee Coins.
- Coins can be minted and issued up to the denomination of Rs 1000 as per the Coinage Act, 2011.

- The coins are circulated through the RBI.
- Government also issues commemorative coins.

- The difference between the intrinsic value and face value is the profit for the government.
  - Intrinsic value -> Cost of production of the coin. It is the metal and other costs.
  - Face Value -> Value mentioned in the coin.

b. **Other Fiscal Services**:
   - These receipts are mainly related to contributions by RBI towards Extended Fund Facility (EFF) charges payable to the IMF, remunerations etc., received from IMF and Penalties realized against Economic offences.

» General Services (e.g., profits from Central Police, Public Services Commission etc.)
» Economic Services (i.e., receipt from various departments like Agriculture, transport, communication etc.),
» Social Services (departments like education, health etc.),
» **Grants in Aid** (from **foreign governments, multilateral bodies** etc.),
» Non-Tax Receipts from UTs (without legislature)
  - They are related to administrative services; sale of timber and forest produce mainly in A&N Islands; receipts from Chandigarh transport undertaking; Receipts from shipping, tourism, power etc.

B) CAPITAL RECEIPTS

- **They** result in **either reduction in government assets** (sale of shares, disinvestment) or **increase in some liability** (government borrowings). It can be divided into **Debt-Capital Receipts** and **Non-Debt Capital Receipts**

- **Debt Capital Receipts** include the fresh borrowings by government, along with other liabilities.
  - **Fresh Borrowing** can be **from within the country** (Internal) or **from outside the country** (external)
    - **Internal Loans** include **Market loans** through bonds, **Treasury Bills** issued to RBI & Banks, **Ways and Means Advances** by RBI etc.
      - **Market Loans**: Government of India's borrowing through **dated government securities** is called Market Loan. They are long term (more than 1 year) debt instruments. Generally, the tenure ranges from 5 years to 40 years. These **government securities** are sold through market auction. Since 2002-03, the Central government has been announcing half-yearly Indicative market calendars based on its core borrowing

requirements. These auctions are conducted by RBI's Public Debt Office (PDO), as debt manager to central government. The dated securities are **mostly fixed coupon securities**. The government also issued **Floating Rate Bonds** (FRBs) on which the coupon rate is reset semi-annually by adding a 'spread' to the base rate, determined through auction. Interest is paid semi-annually on both fixed and floating rate bonds.

- **Treasury Bills Issued to RBI and Banks**
  - These are the securities issued by Government Treasury. They are **short term** in nature and in this regard, they are different from market loans.
  - They are **not-interest bearing** (zero interest / zero coupons). They are thus called zero coupon bonds. They are **issued at discount rate**. (i.e., securities worth Rs 1,000 would be issued at an amount lower than Rs 1,000)
  - Treasury bills can be of different maturity. Till 1991-92, Treasury bills were only of 91 days maturity. This was also called ad-hoc treasury bills. To replace it, Ways and Means advance were introduced.
  - In 1998-99, 182-day treasury bills were introduced. It was soon replaced by 364-day T Bills. Again, 182-day treasury bills were introduced and later 14 days treasury bills were introduced in 1999-2000.

- **Other Internal Debt**:
  - Debt raised to meet the budget needs apart from the above methods is called other internal debt. They include:
    - **Funded Securities**:
      - Sometimes short-term treasury bills are converted as market loans (long-term loans) to defer the repayment. These are called funded securities. These were made non-marketable (i.e., it can't be sold to third party). Sometimes, portion of this security was made marketable.

    - **Other Special Securities Issued by RBI**:
      - Bonds issued by the government, to raise funds which were outside its annual borrowing program such as the oil bonds, fertilizer bonds etc. were classified as special securities. If these bonds were subscribed by RBI, they are accounted for in this head.

    - **Cash Management Bills (CMBs)**

- Cash Management Bills (CMBs) are short term bills issued by Central Government. The purpose of the mechanism is to enable government meet its short term needs.
- The bills are issued by RBI on behalf of the government.
- Thus, CMBs are short term money market instruments that help the government to meet its temporary cash flow mismatch. Key features:
  - **Maturity less than 91 days** (this is the key difference between treasury bills and CMBs)
  - **Generic characteristics of Treasury bills** - issued at discount rate and redeemed at face value at maturity.
  - They are eligible for SLR securities.
- CMBs were issued first on 12th May 2010.

- **Ways and Means Advances:**
  - As a banker to the government, RBI gives temporary loan facility to the Central and State governments. This facility is called Ways and Means Advances (WMA).
  - It was introduced in 1997 to meet mismatches in the receipts and payments of the government.

  - **How does it work?**
    - Government can get, immediate cash from RBI, if required. But it has to be **returned in 90 days**. Interest rate is charged at the **existing repo rate**.
    - If WMA exceeds 90 days, it would be treated as overdraft (interest rate is 2% points more than the repo rate)

  - **What is the WMA limit?**
    - The limits of WMA are decided by government and RBI mutually and revised periodically.

  - There are two types of Ways and Means advances - normal and special.
    - **Special WMA** or **Special Drawing Facility** is provided against collateral of the

government securities held by the state. After the state has exhausted the limit of SDF, it gets normal WMA. The interest rate for SDF is one percentage point less than the repo rate.

- **The number of loans under WMA** is based on three-year average of actual revenue and capital expenditure of the state.
- **Note:** Both WMA and Cash Management bills are used to meet the temporary mismatch in the cash flow of government.
- **Key difference between WMA and Cash Management Bills**:
  - **CMBs** are subscribed by others through auction like Treasury bills.
  - **WMA is a loan** given by RBI.

– **Market Stabilization Scheme**:
  - » It is not a pure fiscal/budgetary exercise, but a **fiscal cum monetary instrument**. It is a facility to control liquidity due to excess foreign exchange flow into the country.
  - » When a lot of foreign exchange flows into the country, there will be a matching rupee circulation in the economy. This would contribute to inflation.
  - » Under this scheme, Government issues securities through RBI and mops up the excess liquidity/money supply.
  - » The money collected is used by government for its need till its repayment.
  - » The amount of issue and the date of issue is decided by RBI in consultation with the Ministry of Finance, GoI.

– **Special Floating and Other Loans**
  - » Special floating loans are launched to raise money and their interest is subject to revision periodically, in accordance with some predefined variables.
  - » One such scheme was launched in 2001-02.

- **Securities against Small Savings**:
  - In 1999-2000, the GoI created a fund called National Small Savings Fund in the Public Accounts of India.

  - **Barring** State Provident funds, insurance and pension funds, trusts and endowments, and some small saving funds, collections of various small savings schemes like Post Office Savings Account, National Savings Time Deposits, National Savings Recurring Deposits, National Savings Monthly Income Scheme Account, Senior Citizens Saving Scheme, National Savings Certificate, Kisan Vikas Patra and Sukanya Samriddhi Account and Public Provident Fund are **deposited in NSSF**.

  - **Net collection** is invested in central and state government securities, and are invested in various public agencies like FCI, NHAI etc. These are called **Securities against Small Savings**.
    - Note: Net collection means deposit - withdrawals during the financial years.
    - The interest amount generated from these investments are used to pay interest for the subscribers of small saving schemes.
    - **Note:** Only the amount invested in central government securities are accounted under this head.
    - **Note:** The respective states and the public sector enterprises accounted for their borrowings

- **Compensation Bonds and Others**:
  - Bonds issued by government to affected persons by its policy decisions.
  - For e.g. - government abolished Zamindari system and to compensate for the loss of zamindars, the government issued bonds. These bonds were made to be encashed in the future and are of long-term nature.

- **Non-Negotiable, Non-Interest-bearing Securities issued to international financial institutions.**
  - These securities are issued to international financial institutions like WB, ADB. They are non-negotiable i.e., they can't be sold to others by security holder

and can be redeemed only form the issuing authority.

- **External Borrowings**: It includes money borrowed from outside the country from various sources and instruments. They are classified as multilateral and Bilateral loans:
  - **Multilateral Loans**: From IMF, WB etc. These are not borrowed against securities.
  - **Bilateral Loans**: Loans raised from foreign government and foreign government bodies directly.

- **Other Liabilities** are those money which are not directly borrowed but are available for government expenditure. It includes money deposited by people in custody of government such as for Provident Fund, NSSF, Small Saving Accounts etc.
  - Further, under this government may also use reserve funds of the Railways, Posts & Telegraph.

– **Non-Debt Capital Receipts**
  » These capital receipts don't create any liabilities.
  » They include **Recovery of Loans** and **Disinvestment of Government Shares**

2) EXPENDITURE

– The public expenditure can be classified as - **Revenue Expenditure** and **Capital Expenditure**:

1. **Revenue Expenditure**: Expenditure incurred to meet day-to-day and regular needs of government. This will not yield any profit/revenue in future. It is a one-way payment. It includes:
   » **Interest Payments**: Interest paid on borrowings and other liabilities and discounts on treasury bills constitute this category.
   » **Defence, Police**: - Expenditure of revenue nature towards law and order and defence.
   » **Subsidies**: On PDS, Fertilizers, fuel etc.
   » **Grants to States/UTs**: Though these grants are spent under capital expenditure by the receiving governments they come under this head as stipulated by Article 34(C) of the Audit code.
   » **Pensions and Salaries** of central government departments and those paid out of consolidated fund as charged expenditure.
   » **Economic Services**: Noncapital expenditure towards agriculture, industry, power, transport etc.
   » **Other General Services**: Non-capital expenditure towards education, health, broadcasting, etc. is included in this category.
   » **Social Services**: Non-capital expenditure towards education health etc.
   » **Postal Deficit**: Postal department is not able to generate enough revenue and is fulfilled by expenses of central government.
   » **Expenditure on UTs without legislations**

» **Grants to Foreign Governments**: Grants to countries like Nepal Bhutan etc. towards their developmental expenses; aids given to them during disaster etc.

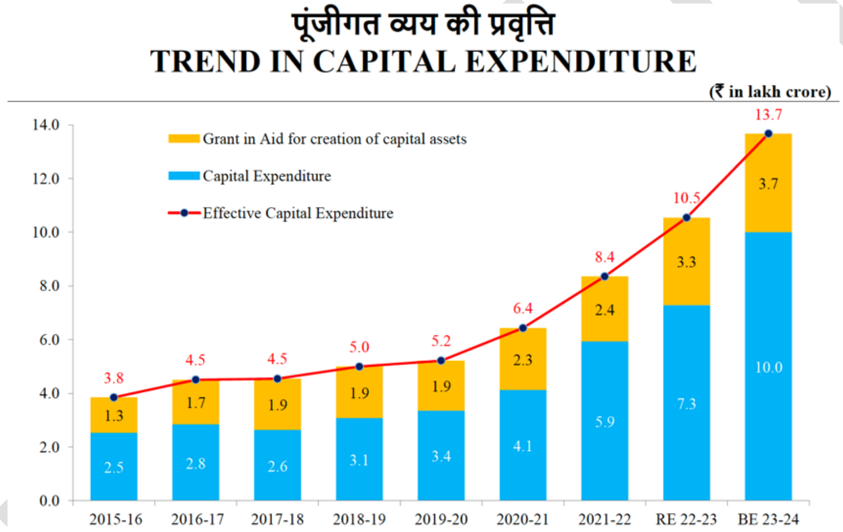
2. **Capital Expenditure**:
   » These expenses create **permanent assets or loans** which will yield periodical income. It is a two-way payment i.e., money spent can be recovered through periodical income and/or by disposal of the asset created.
   - It also **includes loans given to state governments and Uts**.

3) WHAT DOES ESI 2022-23 SAY ABOUT GOVERNMENT EXPENDITURE

Pragmatic Expenditure Policy of Reprioritization

Following the countercyclical fiscal policy, the government expenditure in FY21 rose to 17.7% of GDP higher than the previous five-year average of 12.8%. With revival of economic growth, this was brought down to 16.0% in FY22 and 15.3% in FY23 (BE).

After ensuring basic safety nets for the vulnerable, the emphasis of the government expenditure shifted to provide domestic capital expenditure. **Capital expenditure** rose in FY21. Later in FY22, FY23 and FY24 (BE), it has increased substantially.



Capex Led Growth to Bring Back Animal Spirits and Manage Debt Levels

- The government's thrust on capital expenditure, particularly in the infrastructure intensive sectors like roads and highways, railways, and housing and urban affairs, has longer term implications for growth.

- **Advantages of Higher Capital Expenditure:**
  - Strengthens aggregate demand.
  - Crowds in private spending
  - Enhances longer term supply chain productivity.

– Centre has also worked towards enhancing capex from state governments by providing long-term interest free loans and capex-linked additional borrowings.

Geopolitical Development stretched Revenue Expenditure Requirement

– **FY21** needed a lot of pandemic related support and hence revenue expenditure reached **15.6%** of the GDP. However, with winding up of pandemic related support, this was brought down to **13.5% (FY22:PA)**. This reduction was primarily due to reduction in subsidy expenditure which was brought from to **3.6% of GDP in FY21** to **1.9% in FY22**. This was further estimated to go down to **1.2% of GDP** in FY23 (BE).

– **But** the sudden outbreak of geopolitical conflict led to higher fuel, food and fertilizer prices requiring higher food and fertilizer subsidy.

- **Therefore, government** sought an **additional Rs 80,000 crore for the expenditure** towards the food subsidy and additional allocation under PMGKAY and Rs 1.09 lakh crore for fertilizer subsidy required this year.

5. KEY TERMS TO UNDERSTAND

1) FISCAL DEFICIT; PRIMARY DEFICIT ETC.

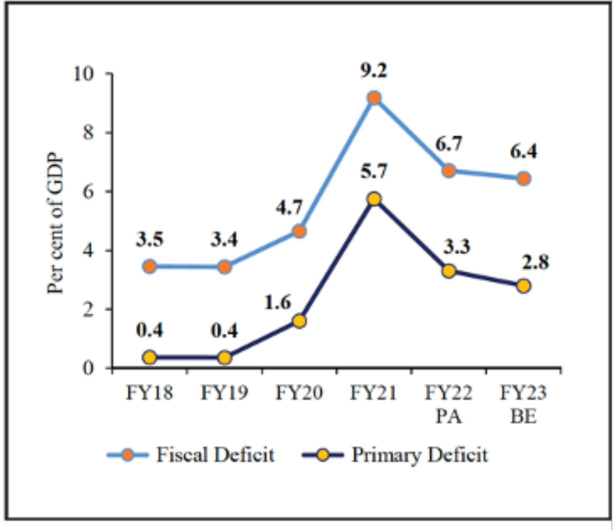
It is the difference between the Revenue Receipts plus Non-debt Capital Receipts (NDCR) and the total expenditure. It is **reflective of total borrowing requirements** of the government.

- **Fiscal Deficit**
  = Total Expenditure - Total Receipts other than borrowings
  = Revenue Expenditure + Capital Expenditure - (Revenue Receipt + Non-Debt Creating Capital Receipt)

- **Budget 2023-24: Key Fiscal Policy Targets**:
  i. **Fiscal Deficit (FY24: BE)**: 5.9
  ii. Targeted Fiscal Deficit to be below **4.5%** by 2025-26.

- **Implications of High fiscal deficit**:
  - **Inflationary Spiral**: Borrowing from RBI leads to increased money supply in economy which leads to higher inflation.
  - **Increased national debt**: This will impact future economic growth as a large part of the expenditure will go in paying interest for the debt rather than for capital investment.

Figure III.1: Trends in Union government deficits over the years- On the way to fiscal consolidation



Source: Union Budget documents, O/o CGA

- **Vicious Cycle of high Fiscal Deficit and Low GDP Growth**
- **Crowding out Effect**: This is the situation when high borrowing by the government (due to high fiscal deficit) leads to reduction in availability of funds for private investors. Accordingly overall investment in the economy reduces.
- **Erosion of government credibility**: High fiscal deficit (thus high debt of government) erodes credibility of the government in domestic as well as international money market. It may also lead to reduction in the 'Credit Rating' of the government (and the economy). Lower credit rating may lead to global investors withdrawing their investment from the domestic economy.

- **Therefore**, fiscal deficit shouldn't be allowed to go beyond manageable limits (about 3% of the GDP is considered manageable).
    - **High deficit** also signifies fiscal indiscipline. It points to a situation when GDP growth is low, and unemployment is high. The economy slips into stagnation and revival becomes difficult with FDI.

ii. **Revenue Deficit**: It refers to excess of revenue expenditure over revenue deficit.

iii. **Effective Revenue Deficit** is the difference between Revenue Deficit and Grants for Creation of Capital Assets.
- **The calculation of effective revenue deficit was introduced from 2010-11 budget.**

iv. **Primary Deficit** is measured as Fiscal Deficit less interest payments.
- **Primary Deficit** = Fiscal Deficit - Interest Payment

v. **Monetized Deficit**: It goes beyond the government's budgetary operations. It represents increase in the net RBI credit to the Union government which is the sum of increase in RBI's holding of government debt and any draw down by the government of its cash balance with RBI.

vi. **Fiscal Slippage**: If the actual fiscal deficit is more than what was expected it is called fiscal slippage.

2) BALANCED AND UNBALANCED BUDGET

i. **Balanced Budget**: A balanced budget is that budget in which government receipts are equal to government expenditure.
- **Merits:**
    - **Government is not indulging in wasteful expenditure.**
    - **It also ensures financial stability and signals fiscal discipline in the economy.**
- **Demerits:**
    - **During the 1930s Depression in the global economy, the demerits of balanced budget was understood:**

1. Balanced Budget **does not offer any solution to the problem of unemployment** especially when unemployment is due to reduction in aggregate demand.
2. Balanced budget is not conducive for growth in developing economies. For growth, more investment is needed, and some fiscal deficit should be acceptable. Moreover, developing countries have low capital output ratio, meaning investment will lead to much higher output and thus deficit should be acceptable to ensure investment which will have higher outputs in the economy.

ii. **Unbalanced Budget**:

- Here receipts and expenditure of government are not equal. It can be of two types:
  - i. **Surplus Budget:** More receipt than expenditure i.e. government is not spending all the receipts.
    - **Need of Surplus Budget:** It is desired when economy is battling inflation and thus government tries to reduce the aggregate demand by either increase in revenue collection or decrease in government expenditure.
    - **Demerit of Surplus Budget**: Since surplus budget lowers the Aggregate Demand, it is not desired at the time of economic slowdown.
  - ii. **Deficit Budget**: Here government expenditure are greater than government receipts.
    - **Keynes** and other modern economists stress significance of deficit budget, highlighting its merits.
    - **Merits**: Deficit budget contributes to economic growth when the loans are focused on increasing the capital investment in the economy. Deficit budget raises the level of Aggregate Demand in two ways:
      - i. By way of high government expenditure.
      - ii. By inducing greater expenditure (investment and consumption) by the people.
    - **Demerits**: Already discussed