Should high fiscal deficit be frowned upon?

What is the issue?

There is a debate as to whether a large fiscal stimulus would lead to high inflation amidst the deficit financing

What is deficit financing?

- "The term 'deficit financing' is used to denote the direct addition to gross national expenditures through budget deficits.
- The essence of such a policy lies in government spending in excess of the revenue it receives in the shape of taxes, earnings of State enterprises, loans from the public, deposits and funds, and other miscellaneous sources.
- The government may cover the deficit either by running down its accumulated balances or by borrowing from banks (mainly from RBI and thus 'creating' money)."

What is the current fiscal scenario?

> Fiscal deficit is the difference between total revenue and total expenditure of the government.
>
> It is an indication of the total borrowings needed by the government (so as to finance the deficit).

- Fiscal deficit for 2020-21 was at **9.3%** of the GDP.
- It is lower than 9.5% estimated by the Finance Ministry in the revised Budget estimates

What does The Fiscal Responsibility and Budget Management (FRBM) Act targets for?

- The FRBM Act, 2003 aims to

1. establish financial discipline in the economy,
2. improve the management of public funds and
3. reduce fiscal deficit

- The latest provisions of FRBM Act has set the targets to limit fiscal deficit to **3% of the GDP** by March 31, 2021
- It restricts the debt to GDP ratio of central government to 40 % of GDP and the state governments to 20% of GDP by 2024-25

What are the feared consequences of rising fiscal deficits?

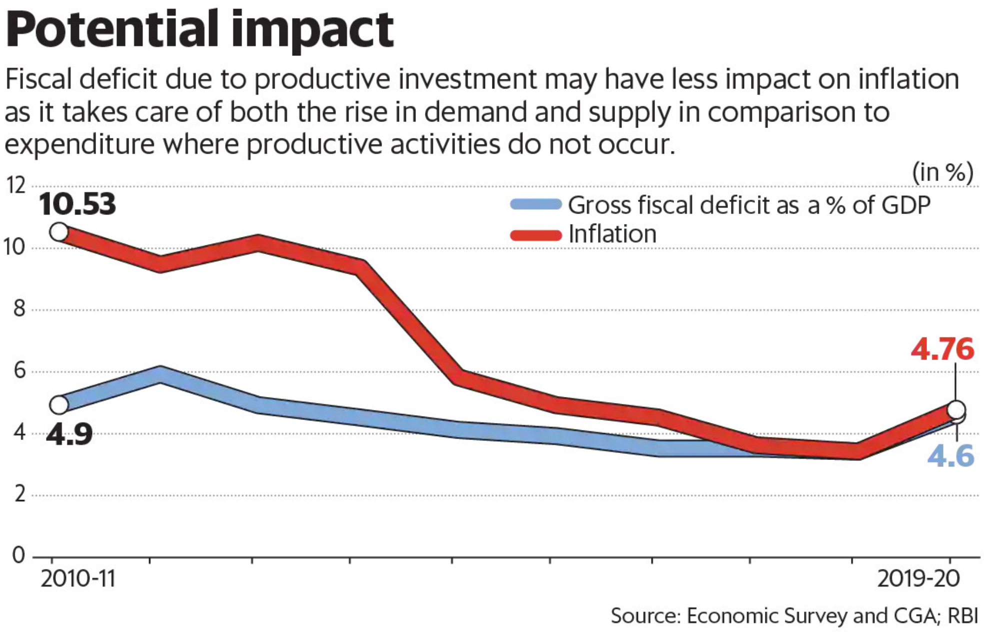
- Higher government expenditure will push up demand and generate more money in the economy which may lead to **higher inflation.**
- The government in order to repay its debt would likely to **levy more taxes** in the future
- Higher fiscal deficit also leaves little room for interest rate cuts which would affect private investments from taking off.
- Borrowing costs may remain high for consumers and industry/companies which might stall economic growth.

What is the cause for the current rise in fiscal deficit?

- Rs.4,78,196 crore has been allocated for the **defence expenditure** in 2021-22 which constitutes around 13.73%of the total central government expenditure.
- Increased spending on **pandemic-relief measures** coupled with pandemic restrictions widened the deficit
- The investment slowdown due to uncertainty also led to increased fiscal deficits

Should the government stop spending?

- Except the investment slowdown, the other two should be regarded as public goods that need to be provided whatever be the economic cost.
- A surge in overall health expenditure would help reduce illnesses and promote family welfare.



What measures need to be taken?

- Fiscal consolidation is important from the point of view of the credibility of policy-making.
- Framing a proper asset monetisation plan will help a lot in generating non-tax revenues but it carries the risk of inflation.
- Adequate structural reforms of the markets and financial sector can sustain the currently estimated potential growth of 6-7 %.
- If the recent elimination of retrospective taxation, sharp flows of foreign investments, privatisation plans, etc. materialise, the impact of large fiscal deficit may dissipate.

Source :The Hindu Businessline