Quadrant II – Notes

Paper Code : CEG 105

Module Name : Need to Control Fiscal deficits – Capital receipts and Revenue Receipts

Module No : 05

NEED TO CONTROL FISCAL DEFICITS

Concept of Fiscal Deficit

A fiscal deficit is a gap by which government's total expenditures exceed the government's total generated revenue. This, however, does not include the government borrowings. Fiscal deficit indicates the amount of money that the government will need to borrow during the financial year. A greater deficit implies more borrowing by the government and the extent of the deficit indicates the amount of expense for which the money is borrowed.

Fiscal deficit = Total expenditure – Total receipts excluding borrowings

Reasons explaining the Need to Control Fiscal Deficits

A rising fiscal deficit leads to a vicious cycle. Fiscal deficits lead to:

1. **High interest rates:** Government borrowings is in fact one of the last resorts left with the government and that results in higher interest rates in the market. Higher interest rates are resulted because markets are doubtful about repayment by the government.

2. **The Crowding Out Effect**
   The government to cover up for its deficit borrows more from the private sector in the form of bonds. By selling the bonds it takes money from the private sector. The savings of the private sector gets reduced which lessens its ability to invest which ultimately crowds out the private investment out of the market.

3. **Higher Taxes**
   Whenever the debt to GDP ratio amplifies, the government requires to increase the tax revenue which it does by increasing its tax rates.

4. **Inflation**
   A large fiscal deficit is financed by borrowing from the Reserve Bank of India, often by issuing new currency for the government. This causes greater expansion in money supply through the process of money multiplier and generates inflationary situation in the economy. Fiscal deficit can also imply an increment in the government spending's which then increases AD that results in higher price levels of services and goods.

5. **Debt Trap**:
   Fiscal deficit indicates the total borrowing requirements of the government. Borrowings not only involve repayment of principal amount, but also require payment of interest. Interest payments increase the revenue expenditure, which leads to revenue deficit. It creates a vicious circle of fiscal deficit and revenue deficit, wherein government takes more loans to repay the earlier loans. As a result, the country is caught in a debt trap.

6. **Foreign Dependence:**
   Government also borrows from rest of the world, which raises its dependence on other countries.

7. **Hampers the future growth and macroeconomic stability:**
   Borrowings increase the financial burden for future generations. It adversely affects the future growth and development prospects of the country. Fiscal deficits, spilled over, could lead to macro-economic instability particularly if the government resorts to deficit financing.

8. **Wasteful Expenditure by Government**: a rising fiscal deficit may lead to unnecessary and wasteful expenditure by the government.

9. **Balance of Payments (BoP):**
   Larger fiscal deficits have adverse effects on balance of payment (BoP) too. Aggregate excess demand representing a shortage of domestic supplies spills over as current account deficit (CAD). External loans raised to finance the CAD, ultimately leads to a BoP crisis.

Measures to Control Fiscal Deficits

- ***Measures to Reduce Expenditure***

To reduce the deficit or the gap between the expenditures and income, the government may cut back on certain expenditures and also increase revenue-generating activities.

1. Sale or closure of sick units
2. Reduce subsidy payments
3. Reduce interest payment
4. Reduce leave travelling concessions, bonus, etc.
5. Curtail and avoid unplanned expenditure

- ***Measures to Increase Revenues***

1. Prevent evasion
2. Broaden the tax base
3. Disinvestment
4. Policy of moderate taxes and simplified taxation structure
5. Inducing economic growth
6. Restructuring of public sector undertakings
7. Reducing unwanted tax concessions

REVENUE RECEIPTS AND CAPITAL RECEIPTS

A government budget is an annual financial statement showing item wise estimates of expected revenue and anticipated expenditure during a financial year.

Components of Government Budget: The government budget comprises of two main parts:

1. Budget Receipts
2. Budget Expenditures

Budget receipts are further sub-divided into Revenue receipts and Capital receipts. Budget expenditures are further sub-divided into Revenue expenditure and Capital expenditure.

Main Features of Revenue Receipts

- A receipt is a revenue receipt, if it satisfies the following conditions:

(i) The receipt must not create a liability for the government. E.g. taxes levied by the government are revenue receipts as they do not create any liability.
(ii) The receipt must not cause decrease in the assets. E.g. payment of fees and fines by the public does not decrease the assets of the government.
(iii) Revenue receipts include items which are **repetitive and recurring** in nature

Sources of Revenue Receipts

(i) Tax Revenue: A tax is a legally compulsory payment imposed by the government on income and profit of persons and companies without reference to any benefit. E.g. Income tax, Corporation tax, Excise duties, Customs duties, etc.
(ii) Non-Tax Revenue: refers to government revenue from all sources other than taxes. Revenue received in the form of interest payments, Dividends Profits of Public Sector Undertakings, Fees and Fines, etc.

Main Features of Capital Receipts

- A receipt is a capital receipt, if it satisfies the following conditions:

(i) Creates liabilities (E.g. Borrowings are treated as capital receipts because they create the liability of returning loans
(ii) Reduces assets (E.g. Disinvestment by government means selling a part or whole of its shares of public sector undertakings. This reduces the assets of the government)
(iii) Capital receipts include items which **are non-repetitive and non-routine in** nature

Sources Of Capital Receipts

(i) Borrowings are treated as capital receipts because they create the liability of returning loans. (Domestic and External): Borrowings are made to meet the financial requirement of the country. A government may borrow money: Domestically: General Public (By issuing government bonds in the open market). Reserve Bank of India. Externally: Rest of the world (foreign government and international institutions)

(ii) Raising of funds from Public Provident Fund (PPF) and Small savings deposits in post offices and banks are treated capital receipts because they increase the liability of the government to repay these amounts to PPF holders and small savings depositors.

(iii)Disinvestment by government means selling a part or whole of its shares of public sector undertakings. This reduces the assets of the government.

(iv)Recovery of loans is also capital receipt as it reduces government assets. E.g. If UP government, which has taken loan of Rs 100 crore from the Central government repays Rs 20 crore, the value of Central government assets of Rs 100 crore is now reduced to Rs 80 crore because of partial recovery of loan.