6.1 Conclusions

The focus of this thesis revolved around three main objectives viz. examination of the trends and composition of central government finances, critical evaluation of the fiscal imbalance situation of the central government and examination of the impact of fiscal deficit on economic growth in India. For better understanding of the theme and construction of the thesis, the study relied upon exhaustive review of related literature and empirical research. This also included the review of the trends and composition of central government finances and fiscal sector reforms, which may have implication for the fiscal stability of India. A long-term trend in the fiscal imbalance position of the central government was examined in order to understand the root causes of rising fiscal imbalance in India. The relevant data were compiled and examined by application of econometric models and statistical tests to draw inferences and conclusions about the impact of fiscal deficit of the central government on economic growth in India. This chapter summarizes the major observations of different chapters of the thesis and proposes some economic policy options.

The literature pertinent to this study has been discussed under the two major heads. First is theoretical literature which includes (a) Alternative measurement of deficit and (b) Alternative school of thought i.e. (i) Classical School (ii) Neoclassical School (iii) Keynesian School and (iv) Ricardian Equivalence theorem. Second is empirical literature which covers (a) Concept, definition and measurement of deficit in India and other countries and (b) Impact of deficit on economic growth in India and other countries.

From the review of available theoretical and empirical literature on different measures of deficit, it clearly emerges that the choice of budget deficit is mainly focused
on interpretation and management of fiscal policy. There is no single superior measure of the deficit. However, there is a set of deficit measurements applicable to specific conditions. In the Indian context, the traditional approach for measuring the deficit takes into account the revenue deficit, capital account deficit and overall of budgetary deficit. There are also mentions of the concept of gross fiscal deficit (GFD) by some researchers who analyzed the finances of the government. One variant of GFD i.e. primary deficit, which is useful to examine the current operations of the government finances has been introduce in Indian public finance. However, fiscal deficit is the most comprehensive and better measure of deficit when compared with other measure of deficit in India.

Further an important strand of macro-fiscal theoretical literature which has received a great deal of attention from economists related to impact of fiscal deficit on economic growth. There are three views pertaining to the relationship between fiscal deficit and economic growth i.e. Neo-classical, Keynesian and Ricardian equivalence. Neoclassical economists suggest that ceteris paribus, because of high deficit a reduction in government saving cause interest rate to rise, investment to fall and economic growth to slow down. Contrary to this, the Keynesian school supports the idea that budget deficit, by the working of the multiplier has a positive effect on the macro economy and economic growth, if resources in the economy are initially underemployed. Another view that differ from the above two views is Ricardian equivalence view which argued that there is a neutral relationship between budget deficit and economic growth.

Much of empirical work examines the effect of government budget deficit on economic growth. However, there is no consensus among Indian economists on the impact of fiscal deficit on economic growth. Some researchers agreed with the Neo-classical thought in which there is negative relationship between budget deficit and economic growth while others agreed with Keynesian thought in which there is positive relationship between budget deficit and economic growth. But the empirical support in favor of the Ricardian view seems to be weak in India. As the empirical studies support
both the Neo-classical and Keynesian views for India, it was important to examine the relationship between fiscal deficit and economic growth in India and how has the persistent increase in the fiscal deficit impacted India’s economic growth over the last four decades. Major findings that emerged from this research work can be summed up as under:

The government finance i.e. expenditure and revenue pattern has changed dramatically over the last several decades and it is also responsible for the high fiscal imbalance position of the central government. In the pre-reform era, the fiscal policy was one of the important constituents of macroeconomic policy in India. It was used to achieve the objectives of economic growth, equity and social justice. In India over the years, various fiscal instruments of fiscal policy viz. taxation, public expenditure and public borrowing were employed with varying degrees of importance, to achieve higher economic growth and stability, efficient resource allocation and equitable distribution of income. However, the inadequate returns on capital expenditure and excess of consumption and expenditure over revenue resulted in a persistently large deficit, which resulted in fiscal crisis by the end of the 1990s.

Since 1991, the central government has carried out a number of fiscal sector reforms to control the fiscal imbalance position of India. The overall impact of these reforms on fiscal imbalance had been encouraging for a few years in the first half of the 1990s. However, the rising share of expenditure in GDP through the late 1990 and early 2000s, without a commensurate increase in revenue share of GDP caused the problem of fiscal imbalance in the post reform period. Thus, the fiscal development in the post-reform period presents a worrisome picture of the financial positions of the central government in India.
Trends in Central Government Finances and Fiscal Sector Reform in India

Overall Public expenditure of the central government has been growing continuously. Revenue expenditure is the main culprit of the growing imbalances in the central government finances, which increased at a higher rate in the pre-reform period when compared with the post reform period. Similarly, capital expenditure, as component of total expenditure, recorded a higher growth in the pre-reform period than in post-reform period.

In the total expenditure of the central government, revenue expenditure constituted a significant part i.e. more than 55 percent and even reached to the level of 89 indicating that the whole amount was spent on revenue account. What concerned more was that the revenue expenditure shot up only at the cost of capital expenditure. On the other hand, the share of capital expenditure in total expenditure has remained low during the post-reform period as compared to the pre-reform period. Thus, while making further fiscal reforms the target should be to improve the quality of expenditure.

Total expenditure, revenue expenditure and capital expenditure as percent of GDP reveal the true picture of the performance from expenditure front of the central government of India. Total expenditure as percent of GDP increased in the pre-reform period while declined in the post-reform period. As percent of GDP, revenue expenditure was continuously growing in the pre-reform period and has followed a stable path in the post-reform period. On the other hand, capital expenditure has declined from 5 percent of GDP in 1970-71 to 2 percent of GDP in 2010-11. It indicates that though it started growing at a higher rate in the post-reform period even then it declined its share in GDP that expresses the need to make reforms to improve the quality of expenditure.

The expenditure of the central government is categorized into developmental and non-developmental expenditure. The analysis of the available data revealed that the share
of developmental and non-developmental expenditure in total expenditure of the central government has increased significantly. The share of development expenditure in total expenditure has shown a fluctuating trend. However the share of development expenditure remained more than the non-development expenditure in the pre-reform period. But the situation has reversed in the post-reform period. This indicates that there is a need for further improvement in the quality of expenditure.

In the revenue side, it is observed that total receipts of the central government have grown at the rate of 14 percent per annum during the study period. Total receipts are classified into revenue receipts and capital receipts. The comparison of revenue receipts and capital receipts showed that with the reform measures undertaken by the central government, revenue receipts were relatively higher (14 percent per annum) as compared to the capital receipts (13 percent per annum) of the central government, which indicates that the revenue receipts have grown at a higher rate during the post-reform period. But a comparison of revenue receipts in the pre and post-reform period shows that the reforms on taxation front have not resulted into significant improvement as the growth of revenue receipts in the post-reform period has remained less than the pre-reform period.

While analyzing the share of revenue and capital receipts in total receipts of the central government, it was found that revenue receipts constituted the highest share in comparison to the capital receipts during the study period. No significant improvement in the revenue receipts as percent of GDP was observed in the post-reform period as the ratio has remained less than 8 percent for most of the years of the study period.

Total receipts measured as proportion of GDP, of the central government, comprising both revenue and capital receipts, have risen due to the implementation of reforms and various initiatives taken to raise the revenue. In spite of numerous measures initiated by the government, there was a disquieting picture of shortfall in revenue. On the one hand revenue receipts as percent of GDP did not grow significantly, while the
capital receipts as percent of GDP have shown fluctuating trend during the whole study period.

Revenue receipts are further divided into tax revenue and non-tax revenue. There has been a rapid increase in the tax revenue of the central government during the pre-reform period and the first half of the post-reform period. But after 2001-02 it started declining. This unsatisfactory performance of tax revenue should be viewed in the backdrop of the initiation of fiscal measures, which aimed at reducing the tax incidence through abolition of surcharges, reduction in customs duties and excise duties to stimulate growth. However, some important fiscal measures were under taken that led to increase in tax revenue. On the other hand, non-tax revenue grew up which largely was on account of a considerable increase in the internal sources of the central public sector undertakings.

Capital receipts of the central government, which create liabilities or reduce financial assets, constituted market borrowings, small savings, provident funds, special deposits, recovery of loans, disinvestments, and external loans. During 1970-71, external debt constituted half of the capital receipts but thereafter, its share has declined continuously and it touched 3 percent only in the year 2001-02. The share of market loan in total capital receipts remained the highest throughout the study period. Thus more reform regarding improvement in the composition of capital receipts are required to be initiated. But the central government is resorting to a high level of market borrowings, which are expensive in nature and hence may cause higher burden in future and aggravate the problem of fiscal imbalance.

Indian economy faced severe economic crisis in 1990-91. The policy makers realized the need to start the process of fiscal reforms as a part of economic reforms measures in 1991-92. Fiscal reforms process was the key component of the economic reforms with the core objective to achieve a reduction in the size of the deficit and debt in
relation to GDP. Fiscal reforms process was initiated with the main focus on taxation reforms. Important tax reforms undertaken by the central government from time to time related to the reduction in marginal tax rate and basic rate of the corporate tax. Besides, the central commodity taxes i.e., union excise duty and custom duty also underwent some changes.

Efforts were initiated to curb expenditure growth through implementation of the recommendations of the Expenditure Reforms Commission (2000). This however, took about one decade since the fiscal reform process was initiated. Numbers of policy changes were also made to implement internal debt management policy by introducing market operation in regard to absorption of government of India dated rupee security and long term Treasury Bills. Another reform related to the borrowing process was the reduction in the difference between the interest rate on market borrowing and other internal liabilities.

**Trends in Debt-Deficit, Causes of Fiscal Imbalance and FRBM Act**

There was a sharp rise in the gross fiscal deficit of the central government during 1980s that reached at the highest level in the year 1990-91. The data analysis also revealed that revenue expenditure remained higher than revenue receipts during most of the years. But the gap has shown an increasing trend up to the year 2002-03 and thereafter, it started declining. Primary deficit was much higher than revenue deficit during the whole decade of 1980-81 to 1990-91, but thereafter the revenue deficit was higher than the gross primary deficit. Curtailing this deficit was one of the key structural adjustment programmes undertaken by the central government at that time. Fiscal reforms helped to reduce the deficit during 1996-97. The process of fiscal reforms gained momentum when the government introduced the FRBM Act to control the fiscal deficit by 0.5 percent of GDP each year until it becomes zero. This however, could not be
achieved as in the post-reforms period the fiscal performance of central government has also experienced budgetary deficit for most of the years.

Conclusively, all the three indicators of the central government have shown deficits during the three decades of 1980s, 1990s and 2000s. After the reform process, the position was improved only for a few years, but it again worsened in the mid 1990s. There was some improvement since 2001-02 with the enactment of FRBM Act until the global crisis hit the Indian economy in the early 2008-09. The measures taken by the government to counter the effects of the global meltdown on the Indian economy have resulted in a shortfall in revenues and substantial increase in government expenditure, leading to deviation from the fiscal consolidation path mandated under FRBM Act.

Financing of the gross fiscal deficit of the central government can be divided into internal financing and external financing. It was observed that the internal finance of the fiscal deficit have been contributing a significant part in total financing of fiscal deficit. Further the components of internal financing of the fiscal deficit are market borrowing, other borrowing and drawn down of cash balances. It was observed that the share of other borrowing in total internal financing of the central government was much higher than the market borrowing in the pre-reform period. It was also observed that the share of other borrowings recorded a decreasing trend while the share of market borrowing in total internal financing recorded an increasing trend in the post-reform period.

Large fiscal imbalance thus has resulted into large public debt of the central government, which has been growing continuously since 1980-81. However, as a result of reform measures like absorption of government of India dated rupee securities, long term treasury bills and introduction of auctions of repurchase agreements of dated securities which aimed at reducing the central government’s fiscal deficit, the rate of growth of public debt was somewhat lower in post-reform period. But this rate of growth also falls in the range of very high category.
Further public debt in India can be divided into internal debt and external debt. Internal debt constitutes the highest share in total public debt of the central government throughout the study period and it hovered around 75 percent to 95 percent of the total public debt. On the other hand, the share of external debt in total public debt has declined from 21 percent in 1980-81 to 6 percent in 2010-11. Thus, internal liabilities as compared to the external liabilities of the central government have recorded a higher rate of growth throughout the study period. Also the internal liabilities, recorded a lower growth in the post-reform period as compared to the pre-reform period.

Public debt of the central government, as percent of GDP, has increased continuously throughout the study period. This shows that fiscal measures adopted by the central government in 1991 could not help much in curtailing the rising trend of debt-GDP ratio. Measured in percent of GDP, the internal liabilities registered a sharp increase since 1980-81. On the other hand, external debt declined continuously and reached at 3 percent of GDP in 2011-12.

While analyzing the root causes of fiscal imbalance of the central government, it was found that increase in subsidies, interest payments and defence expenditure were the principal causes for the high fiscal imbalance position of India. The analysis also stated that the subsidies as percent of GDP of the central government were not high but they were continuously growing in the pre-reform period. Immediately after the introduction of reforms in 1991, the subsidies started declining for some years but again stated growing in the latter half of 2000s. The main reason behind the growing subsides of the central government during later half of the 2000s was the global finance crisis.

Second, there has been a considerable increase in the growth of interest payments of the central government throughout the study period. In the latter half of the 1980s and first half of the 1990s interest payments as percent of GDP of the central government was
continuously growing. During post-reform period, especially after 2004-05 interest payments stared declining.

Third, there has been an enormous increase in defence expenditure in India during the planning period. Defence expenditure also constitutes a significant part of total expenditure of the central government. The Defence expenditure of the central government hovered around 2 to 3 percent of GDP during the pre-reform period. During the post-reform period defence expenditure of the central government, as percent of GDP declined and it hovered around 1 to 2 percent of GDP. Except these principal causes, there are some other factors which were also responsible for the fiscal crisis in India. They were the: poor performance of public sector, tax evasion, corruption and weak revenue mobilization.

The Fiscal responsibility and Budget Management Act-2004 is in place for around ten years now. Until 2007-08, since the introduction of FRBM Act there were significant improvements in major fiscal indicators. Between 2003-04 and 2007-08, the central government fiscal deficit declined from 4.48 percent to 2.54 percent of GDP, achieving one-year in advance the medium-term target of 3 percent. More than two-third of fiscal adjustment over this time period was due to revenue gains, with improvements in tax performance underpinned by rapid economic growth, strong corporate profits and improvements in tax administration as measured by effective tax rates. The rest of the adjustments came mostly from declining interest payments. Although, there was almost no correction on the expenditure side, the entire fiscal adjustment was driven by enhanced revenue.

Further, due to global financial crisis, the trend of declining fiscal deficit as percentage of GDP was disrupted and the fiscal consolidation as mandated in the FRBM Act was put on hold in the year 2008-09. The crisis called for increase in expenditure by the government to boost demand in the economy. As a result of fiscal stimulus, the
government moved away from the path of fiscal consolidation. In 2008-09, the central government deficit reached a historical high level which eliminated the fiscal improvements achieved since the introduction of the FRBM Act. Part of this worsening situation can be attributed to the fiscal measures undertaken since October 2008 to support economic growth in response to the global financial crisis as well as a deceleration in tax revenue due to the slowdown in economic activity.

**Impact of Fiscal Deficit on Economic Growth in India**

While examining the impact of fiscal deficit on economic growth with other variables, the study found the evidence of long run relationship between Gross Domestic Product (GDP), Gross Domestic Capital Formation (GDCF), Fiscal Deficit (FD), Inflation (INF), Money Supply (MS), Exports (EX) and Imports (IM). Further the results indicated that the gross domestic product has long run negative relationship with fiscal deficit, inflation and imports while positive relationship with gross domestic capital formation, money supply and exports was observed. However, the analysis did not find any short run relationship among the variables.

An empirical examination of the impact of fiscal deficit on economic growth provided a clear evidence of negative relationship between fiscal deficit and gross domestic product in the long run in India. Results of the study showed that a 1% increase in fiscal deficit would decrease gross domestic product by 0.11 percent. Further, the gross domestic capital formation, money supply and exports showed a positive impact on GDP i.e. 1% increase GDCF, MS and EX would increase GDP by 0.3%, 0.06%, and 0.04% respectively. On the other hand, the inflation and imports showed negative impact on GDP i.e. 1% increase in inflation and imports is expected to reduce GDP by 0.07% and 0.23% respectively.

However, based on vector error correction model, the results did not find any short run relationship between fiscal deficit and economic growth in India. This study also
employed Pare Wise Granger Causality test to find the short run relationship among the variables of the model. Estimates of Pair Wise Granger Causality test indicated that there existed unidirectional granger causality form real GDP to exports; from fiscal deficit to exports and from inflation to money supply. Moreover, results also indicated the absence of any short run causality or relationship between fiscal deficit and economic growth in India.

These findings have important policy implications and will help policy makers in determining the stance of the fiscal policy. Understanding the direction of causality between fiscal deficit and economic growth is very important in formulating effective polices. The core idea is that there must be consistency between fiscal deficit and other macroeconomic targets. When budgets persistently are overspent, it is most important to keep in view the way in which the resulting deficits are financed i.e. whether through internal or external borrowing or by monetizing in order to keep the inflation under control.

### 6.2 Policy Recommendations

Based on the reviews of available literature and the findings of this study the following policy inputs have emerged from the study.

Fiscal performance of Indian economy has started showing signs of improvement on account of decline in the growth of capital receipts and decline in the growth of the revenue expenditure during the post-reform period. But the performance has been less satisfactory on some fronts like low growth of revenue receipts in case of central government during the post-reform period. More improvements in innovative and bold decisions are needed for complete break away from the present way of functioning. Government should improve the efficiency of the public distribution system and
introduce eligibility criteria for the National Rural Employment Schemes so as to reach to the poorest.

Further, the central government has been allocating a huge share of revenue expenditure on non-development purposes. Thus Fiscal policy in India should emphasize on redirection of government expenditure for productive channels in the economy so as to increase output. The capital and investment expenditure should constitute a greater proportion of the total government expenditures than current and consumption expenditure in order to provide the needed infrastructure as a pivot for sustained growth.

As the major share of revenue receipts comes from tax source, central government should pay special attention to augment revenue receipts not only from tax sources but also from non-tax sources in order to tackle fiscal crisis. Non-tax revenue can be substantially increased by revision of user charges on public services, cutting implicit subsides on a variety of economic & social services of a non merit nature through appropriate user charges.

A major issue for the Indian economy is to reduce the growing fiscal deficits. Reduction can be achieved either by raising revenues or by decreasing expenditures. There should be appropriate policy mix to ensure that conflating macroeconomic policies does not mitigate fiscal deficit measures. The concept of government net lending (acquisition of financial assets) may be used as the key measure of reducing the fiscal deficit.

The enactment of FRBM Act, 2003 made a watershed in the process of fiscal reform. As a result, the fiscal position of India has shown a sign of improvement. But the improvement is not sustainable in the long-term. The government should target at eliminating fiscal deficit as well as revenue deficit on sustainable and long-term basis. To
achieve that the first step is on the control of fast growing subsides. The government should also ensure that the expenditure in a given year is limited to budget plans, in order to make the budget a better instrument for control of fiscal deficit.

6.3 Avenues for Further Research

There is much scope for studying the fiscal imbalance position of the state governments and consolidated budgets (i.e. central plus state governments). Moreover, the growth rate of the economy matters the most. One can examine the impact of public debt on economic growth of respective states in India. Further in the literature related to the debt trap consequences, one can examine the issue of sustainability of the public debt and its macroeconomic impact. Non-sustainability of public debt is usually referred to as a long-run problem in fiscal policy which forms a core issue in public finance.