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Importance of Fiscal Consolidation

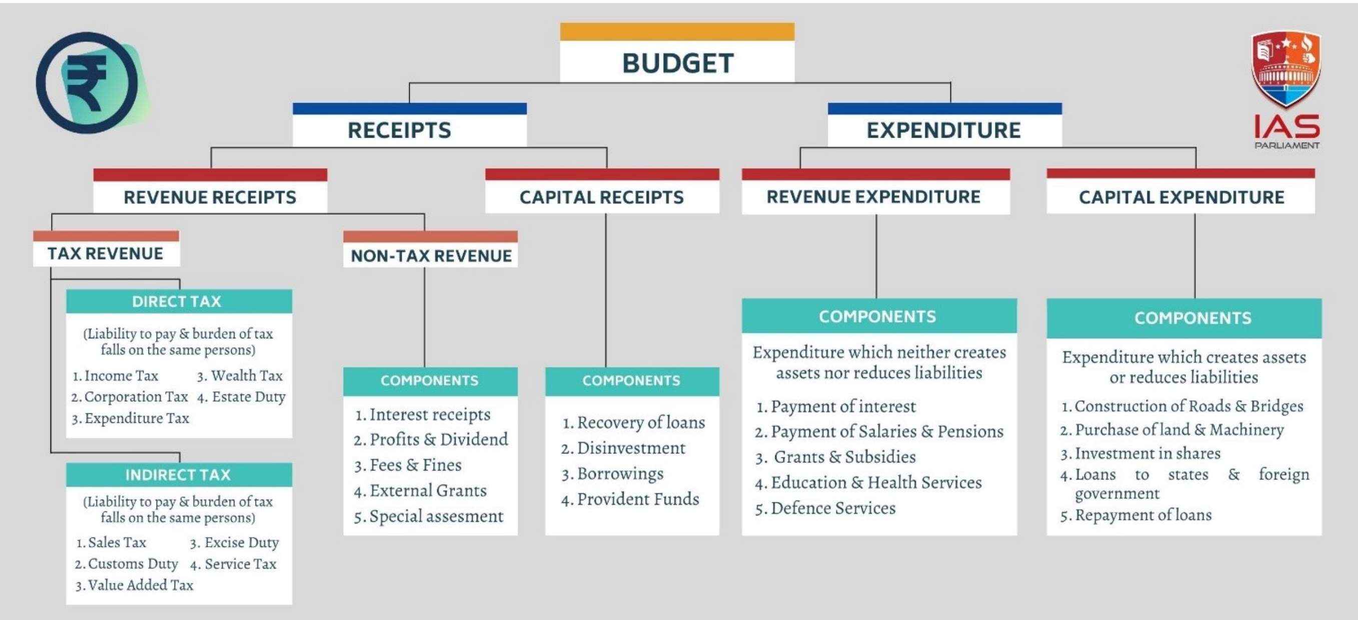
Why in news?

In the Interim Budget 2024-25 the Centre announced that it would reduce its fiscal deficit to 5.1% of gross domestic product (GDP) in 2024-25.

What is Fiscal Deficit?

> *It is the condition where the expenditure of the government exceeds its revenue in a financial year*

- When a government's expenditure exceeds its revenues, the government will have to borrow money or sell assets to fund the deficit.
- **Fiscal surplus-** It is a condition where revenues exceed expenditure, but mostly governments focus on keeping the fiscal deficit under control rather than on generating a fiscal surplus or on balancing the budget.
- **Fiscal deficit** = Total expenditure – Total receipts excluding borrowings.



- **Positive fiscal deficit**- It indicates that the government is spending more than it is earning through taxes and other sources.
    - This gap is typically financed through borrowings or by drawing down from its cash reserves.
- **Manageable fiscal deficit**- It can be used to finance essential investments in infrastructure, social welfare programs, and economic development.
- The fiscal deficit is generally expressed as a percentage of a country's GDP since it is

believed that the figure shows how easily the government will be able to pay its lenders.

For the financial year 2023-24, the Indian government targeted a fiscal deficit of 5.9% of GDP.

- **National debt**- It is different from fiscal deficit, it is the total amount of money that the government of a country owes its lenders at a particular point in time.
- The national debt is usually the amount of debt that a government has accumulated over many years of running fiscal deficits and borrowing to bridge the deficits.

Fiscal Deficit	National Debt
It focuses on the *yearly budgetary gap* between revenue and expenditure.	It encompasses the *total outstanding debt* owed by the government over time.
It is the *annual* measure.	It is the *cumulative* borrowing history of the government.
It is the amount by which the expenditure exceeds revenue.	It accumulates over many years due to persistent fiscal deficits when the government spends more than it earns and borrows to cover the gap.

To know about fiscal prudence click here

How the government fund its fiscal deficit?

- **Government borrowing-** The government borrows funds through the issuance of **government securities** called **G-secs** and **Treasury Bills**.
- This borrowing falls under **capital receipts** in the budget document, it represents the total amount of money that the central government borrows to finance its spending on public services and benefits.
- **Annual borrowing program**- It outlines how much the government plans to borrow during the fiscal year as tax and non-tax revenues fall short of financing the government's spending programs.
- **Open market operations**- The Reserve Bank of India can buy government bonds in the secondary market from private lenders who already hold these bonds.
- When the central bank purchases bond, it creates fresh money potentially lending to increased money supply and higher prices in the broader economy over time.
- **Risk free-** Government bonds are considered as risk free because governments have the ability to create fresh currency through RBI.
- **Monetary policy-** It plays a crucial role in how much it costs governments to borrow money from the market.
- The Centre's efforts to reduce its fiscal deficit may be influenced by changing borrowing conditions through the monetary policy.

Higher central bank rates makes it more expensive for the governments to borrow money from the market.

Why fiscal deficit is important?

- **Inflation-** If the government borrows too much money, it can lead to inflation as the government may be forced to print more money to pay its debts.

  Inflation is a rise in prices, which can be translated as the decline of purchasing power over time.

- **Reduced investments**- If the government is crowding out private investments by borrowing heavily, it can reduce the amount of investment in the economy, which can lead to slower economic growth.
- **Higher interest rates**- When the government borrows money to finance a deficit, it can drive up interest rates for businesses and consumers. This can maek it more expensive to borrow money, which can slow down economic growth.
- **Market perception**- The fiscal deficit serves as a signal to the market regarding the government's financial discipline.
- **Confidence in lenders**-When the government relies more on tax revenues and borrows less, it instils confidence in lenders. This will reduce borrowing costs for the governments.
- **Lower fiscal deficit**- It can enhance the credit ratings assigned to the Indian government's bonds.
- **High fiscal deficit**- It can adversely affect the government's ability to manage its overall public debt.

  International Monetary Fund warned that India's public debt could exceed 100% of GDP in the medium term due to associated risks.

- **International bond market**- India has shown interest in tapping international bond market, this can provide the government with cheaper credit opportunities.

What lies ahead?

- The Centre aims to reduce fiscal deficit in 2024-25 to 5.1% of GDP despite plans to boost the capital expenditure and other programs.
- The Centre expects tax collection to rise by 11.5% by 2024-25 which is crucial in funding government activities.
- India must adopt a balanced approach in raising tax collection as this would affect investment and consumption.

Reference

[The Hindu-Fiscal Consolidation is important]