

## Redefining fiscal deficit in India: A real economy perspective

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### Abstract

The concept of fiscal deficit in India has been used very narrow since 1991, the year which it is introduced. Actually this concept should be analyzed broadly considering a real economy consisting of various layers of governments and substantial share of black economy. This article tries to explain briefly the idea of redefining fiscal deficit in a real economy perspective considering practical difficulties in accounting of the same.

**Keywords:** fiscal deficit, public sector in India, black economy, national income identity, primary deficit

### Introduction

The term fiscal deficit is relatively new in the Indian public finance lexicon. The fiscal deficit found its place in the 1991-92 budget document of the government of India only after The Committee to Review the Working of the Monetary System submitted its report in April 1985. The Explanatory Note to the Budget at a Glance in 1991-92 stated: "From this year the documents show, apart from revenue deficit and overall budgetary deficit, the fiscal deficit also. Fiscal deficit is the difference between the revenue receipts on the one hand total expenditure including loans, net of repayments".

In other words, Government of India defines the fiscal deficit as the excess of total expenditures including net lending over total receipts other than borrowing. It is quite different from the IMF definition of fiscal deficit, which is the excess of expenditure over current (revenue) receipts. The disinvestment proceeds, which come under the revenue receipts in the IMF definition, are treated as non-borrowed capital receipts in India. There has also a difference in accounting with reference to net lending, which is considered as a determinant of deficit in India, is not considered according to the IMF definition. Similarly, instead of net borrowing (borrowing minus repayment), gross borrowing is taken as the way of financing the deficit in India. This has led to serious theoretical flaws in the calculation of the size of fiscal deficit in India. The part of the gross borrowings, which once transferred to the private sector will just returned back by changing hands inside the private sector. Therefore, it does not affect the overall macro situations.

In the framework of national income identity net borrowing and net lending being transfers do not have any effect on national income, unless this results in crowding out of private investment. So these elements must be excluded from the deficit.

In a regime of liberalized interest rates and financial sector flexibility, the cost of borrowing tends to rise sharply. As a result, the interest on government debt has raised sharply contributing sustainability to the fiscal deficit. To underplay

this tendency in the budget and show up the government's fiscal prudence, the Finance Ministry has opted two strategies. First, it is increasingly relying on zero-coupon bonds in its debt portfolio. Second, it is assiduously promoting a new index of fiscal strategy in the Economic Survey and the interim Budget, viz., the 'primary deficit'.

According to the Economic Survey 1996 "a better measure of success achieved in fiscal consolidation is the primary deficit which is the fiscal deficit excluding interest payments". However, in the economic literature its importance is almost ignored and most of the economists have taken primary deficit only as an indicator of the sustainability of deficit.

Interest payments, which are the excluded part of the primary deficit from the fiscal deficit, can be considered as a pure transfer because interest payments go to the profit earners. Transfers to the profit earners do not affect demand in the short period. In calculating the primary deficit only gross interest payments is deducted from the fiscal deficit, while there has some interest receipts which also come from the profit earners, should be netted from gross interest payments. A deficit indicator adjusts for net repayment on interest from net fiscal deficit ( $NFD = \text{Gross Fiscal Deficit} - \text{Net Lending}$ ), which is termed as net primary deficit, is generally considered as a better indicator of deficit.

Other than interest payments, there have transfers in the form of subsidies. Kumar (1999b) <sup>[7]</sup> pointed out two kinds of subsidies: first, subsidies to the lower income group or the non-propertied classes and second, subsidies to the profit earners. Subsidies to the wage earners have impact on the level of income as it enhances the consumption expenditures of the masses. While, the latter kind of subsidies do not have these impact. So the portion of subsidies going to the profit earners should be excluded from the deficit measure.

For the estimation of subsidies to the wage earners and the profit earners, food and non-food subsidies can be taken as proxies. Then, the Modified Primary Deficit (MPD) can be calculated as follows:

MPD = Primary Deficit – Other Transfers to Profit Earners

Modified Primary Deficit in India can be considered as a best proxy measure for the fiscal policy. While the paucity of data on the whole public sector limits its effective assessment. Data on subsidies are not readily available for all layers of governments; even if available they are based on estimates.

Kumar (1999a and 1999b) <sup>[6,7]</sup> strongly argues that besides all the above deficiencies there is paucity of white economy data because of the existence of substantial black economy in India. Its non-inclusion in analyses resulted in a partial understanding of the Indian economy and often incorrect policy pronouncements. The need to incorporate the black economy is not simply an empirical matter, but a theoretical necessity.

Kumar (1999b) <sup>[7]</sup> analyses the national income identity with a black economy component identifies a black economy part along with a white economy part in all the variables in the equation (1) except for  $T_p$ , B and I.

$$(P_p - T_p) = MPD + I_p + C_c + CAB \quad \dots(1)$$

Where

$P_p$  = Profit of the private sector

$T_p$  = Tax on profit

$I_p$  = Investment by the private sector

$C_c$  = Capitalist consumption

CAB = Current account balance

### Undeclared Profits

White profits are the ones declared for tax purposes and  $T_p$  are the taxes paid out of them. No taxes are paid out of black gross profits since they are undeclared. So  $P_p$  needs to be separated into two parts: white private gross profits  $P_{pw}$  and black private gross profit  $P_{pb}$ .

### Capitalist Consumption and Black Incomes

Consumption intensity out of black incomes is larger than out of the white incomes and also more import intensive. The goods consumed using black incomes do not necessarily originate in the black economy. Similarly white incomes may be used to purchase goods or services produced in the black economy. Hence no useful purpose is served in writing the black and white components separately.

### Black Investments

Private investment  $I_p$  needs to be split into a black and a white component,  $I_{pb}$  and  $I_{bw}$ . The black components are not necessarily come out of black incomes and the white not necessarily out of white incomes only.

### Budget Deficit and Public Sector

The impact of black economy on the budget deficits is both because expenditures are inflated and revenues are less. Its effect on the budget is that instead of showing a primary fiscal surplus there is a deficit.

### Black Economy and the External Sector

The true (X-M) term needs to be separated into its black and

white components with the latter reflecting the official data and the former the remaining part.

After incorporating the black economy components in all such variables, the national income identity, as given in equation (2),

$$P_p - T_p + I = (BD + B) + I_p + C_c + CAB \quad \dots (2)$$

Where

I = Interest payments by the government

BD = Budget Deficit

B = Borrowings by the government from the private sector can be modified as follows:

$$\begin{aligned} & (P_{pw} - T_p) + P_{pb} + I \\ & = [Budget Deficit + B] + I_{pw} + I_{pb} + C_c + \\ & (X - M)_w + (X - M)_b \end{aligned} \quad \dots (3)$$

There are several attempts by various economists to measure the size of black economy in India. Acharya and associates (1985) <sup>[1]</sup> estimated the size of black economy to be 20 per cent of the white economy for 1980-81. Gupta (1992) <sup>[5]</sup> estimated it to be 51 per cent for 1987-88. Kumar and Sen (1993) <sup>[8]</sup> estimated a figure of 30 per cent for 1990-91. Kumar (1999a) <sup>[6]</sup> estimated a size of 40 per cent for 1995. As we already mentioned, if we incorporate the black economy into calculation we get a budgetary surplus rather than a deficit with every definition. However, the data on black economy is not available for a continuous period and consistent method; we have strong limitation in incorporating black economy in the calculation of deficits.

The national income identity we discussed in equation (1) considers the national income of the whole country including all layers of the government. As we are analyzing the deficits in the accounts of public sector in India, we should include all layers of government and the public sector undertakings in to consideration. Partial consideration of the whole public sector also gives incomplete results. The problem of deficit shifting can be automatically avoided by taking the whole public sector in to analysis (Aneesh, 2016) <sup>[2]</sup>.

While the paucity of data for some layers of government and public sector enterprises make the compilation of the whole public sector difficult. Since the data for the central government and state governments/UTs are readily available from the budget documents and the RBI publications respectively, the data base for other layers are hardly available. The data for Central Public Sector Enterprises are accessible from the Public Enterprises Survey since 1985; the data for the State Public Sector Enterprises are hardly compiled and not easily available. Further, the data for the local self-governments are hard to collect and compile.

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