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## The Government: Functions and Scope

### 5.1.3 Measures of Government Deficit

When a government spends more than it collects by way of revenue, it incurs a budget deficit<sup>3</sup>. There are various measures that capture government deficit and they have their own implications for the economy.

**Revenue Deficit:** The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts

$$\text{Revenue deficit} = \text{Revenue expenditure} - \text{Revenue receipts}$$

The revenue deficit includes only such transactions that affect the current income and expenditure of the government. When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy to finance a part of its consumption expenditure. This situation means that the government will have to borrow not only to finance its investment but also its consumption requirements. This will lead to a build up of stock of debt and interest liabilities and force the government, eventually, to cut expenditure. Since a major part of revenue expenditure is committed expenditure, it cannot be reduced. Often the government reduces productive capital expenditure or welfare expenditure. This would mean lower growth and adverse welfare implications.

**Fiscal Deficit:** Fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing

$$\text{Gross fiscal deficit} = \text{Total expenditure} - (\text{Revenue receipts} + \text{Non-debt creating capital receipts})$$

Non-debt creating capital receipts are those receipts which are not borrowings and, therefore, do not give rise to debt. Examples are recovery of loans and the proceeds from the sale of PSUs. The fiscal deficit will have to be financed through borrowing. Thus, it indicates the total borrowing requirements of the government from all sources. From the financing side

$$\text{Gross fiscal deficit} = \text{Net borrowing at home} + \text{Borrowing from RBI} + \text{Borrowing from abroad}$$

Net borrowing at home includes that directly borrowed from the public through debt instruments (for example, the various small savings schemes) and indirectly from commercial banks through Statutory Liquidity Ratio (SLR). The fiscal deficit of the central government, after declining from 6.6 per cent of GDP in 1990-91 to 4.1 per cent in 1996-97 rose to 6.2 per cent

in 2001-02 (Table 5.1). Under the constraint imposed by the FRBMA, the fiscal deficit as well as the revenue deficit have fallen to 4.1 per cent and 2.5 per cent respectively in 2004-05 (provisional figures). The increasing share of the revenue deficit as a proportion of the fiscal deficit (which was 49.4 per cent in 1990-91 but has increased to 79.7 in 2003-04) indicates the rapid decline in the quality of the deficit.

**Table 5.1: Receipts and Expenditures of the Central Government**

(As per cent of GDP)	1990 -91	2000 -01	2001 -02	2002 -03	2003 -04
1. Revenue Receipts(a+b)	9.7	9.1	8.8	9.4	9.6
(a) Tax revenue(net of states' share)	7.6	6.5	5.9	6.5	6.8
(b) Non-tax revenue	2.1	2.7	3.0	3.0	2.8
2. Revenue Expenditure	12.9	13.2	13.2	13.8	13.1
(a) Interest payments	3.8	4.7	4.7	4.8	4.5
(b) Major subsidies	1.7	1.2	1.3	1.7	1.6
(c) Defence expenditure	1.9	1.8	1.7	1.7	1.6
3. Revenue Deficit(2-1)	3.3	4.0	4.4	4.4	3.6
4. Capital Receipts(a+b+c)	5.6	6.3	7.1	7.4	7.5
(a) Recovery of loans	1.0	0.6	0.7	1.4	2.4
(b) Other receipts(mainly PSU disinvestment)	0.0	0.1	0.2	0.1	0.6
(c) Borrowings and other liabilities	4.6	5.6	6.2	5.9	4.5
5. Capital Expenditure	4.4	2.3	2.7	3.0	4.0
6. Total Expenditure [(2+5=6(a)+6(b))]	17.3	15.4	15.9	16.9	17.1
(a) Plan expenditure	5.0	3.9	4.4	4.6	4.4
(b) Non-plan expenditure	12.3	11.5	11.4	12.3	12.6
7. Fiscal Deficit [6-1-4(a)-4(b)]	6.6	5.6	6.2	5.9	4.5
8. Primary Deficit [7-2(a)]	2.8	0.9	1.5	1.1	0.0

Source: *Economic Survey*, 2005-06

**Primary Deficit:** We must note that the borrowing requirement of the government includes interest obligations on accumulated debt. To obtain an estimate of borrowing on account of current expenditures exceeding revenues, we need to calculate what has been called the primary deficit. It is simply the fiscal deficit minus the interest payments

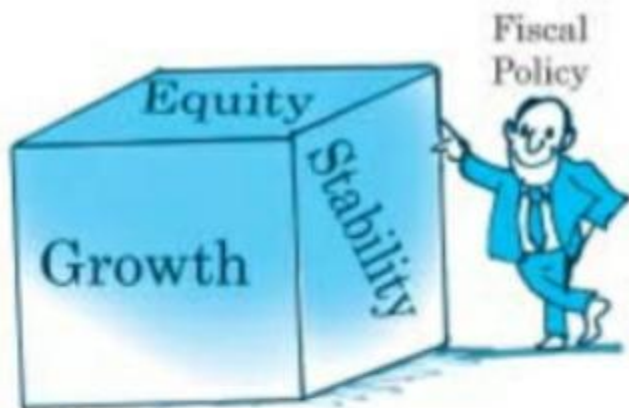
$$\text{Gross primary deficit} = \text{Gross fiscal deficit} - \text{net interest liabilities}$$

Net interest liabilities consist of interest payments minus interest receipts by the government on net domestic lending.

## 5.2 FISCAL POLICY

One of Keynes's main ideas in *The General Theory of Employment, Interest and Money* was that government fiscal policy should be used to stabilise the level of output and employment. Through changes in its expenditure and taxes, the government attempts to increase output and income and seeks to stabilise the ups and downs in the economy. In the process, fiscal policy creates a *surplus* (when total receipts exceed expenditure) or a *deficit budget* (when total





How does the Fiscal Policy try to achieve its three basic objectives?

expenditure exceed receipts) rather than a *balanced budget* (when expenditure equals receipts). In what follows, we study the effects of introducing the government sector in our earlier analysis of the determination of income.

The government directly affects the level of equilibrium income in two specific ways – government purchases of goods and services ( $G$ ) increase aggregate demand and taxes, and transfers affect the relation between

income ( $Y$ ) and disposable income ( $YD$ ) – the income available for consumption and saving with the households.

We take taxes first. We assume that the government imposes taxes that do not depend on income, called **lump-sum taxes** equal to  $T$ . We assume throughout the analysis that government makes a constant amount of transfers,  $\bar{TR}$ . The consumption function is now

$$C = \bar{C} + cYD = \bar{C} + c(Y - T + \bar{TR}) \quad (5.1)$$

where  $YD$  = disposable income.

We note that taxes lower disposable income and consumption. For instance, if one earns Rs 1 lakh and has to pay Rs 10,000 in taxes, she has the same disposable income as someone who earns Rs 90,000 but pays no taxes. The definition of aggregate demand augmented to include the government will be

$$AD = \bar{C} + c(Y - T + \bar{TR}) + I + G \quad (5.2)$$

Graphically, we find that the lump-sum tax shifts the consumption schedule downward in a parallel way and hence the aggregate demand curve shifts in a similar fashion. The income determination condition in the product market will be  $Y = AD$ , which can be written as

$$Y = \bar{C} + c(Y - T + \bar{TR}) + I + G \quad (5.3)$$

Solving for the equilibrium level of income, we get

$$Y^* = \frac{I}{1-c} (\bar{C} - cT + c\bar{TR} + I + G) \quad (5.4)$$