Research Paper Economics

Alternative Measures of Public Sector Deficit

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ABSTRACT

Alternative measures of public sector deficit are important mainly because of its macroeconomic consequences. For finding appropriate fiscal policies to address major economic problem the correct measurement of the public sector deficit is the vital prerequisite. In this context this paper surveys the alternative public deficit measures that have been used to asses budgetary policy. Study concluded that fiscal deficit is comprehensive and better measure of deficit as compare to budgetary deficit.

KEYWORDS Fiscal policy, Public Sector Deficit

1. Introduction

The role of public sector deficit in influencing economic activity has been widely debated issue in economic literature. The choice of deficit is mainly focused on interpretation and management of fiscal policy. There is no single and correct measure of the public deficit rather a set of different deficit measurements, each applicable to specific condition. The following sections examine the alternative measurement of public sector deficit in general and in India.

2. Measurement of Public Sector Deficit

The term "budget deficit or budget balance" appears regularly in news articles, in government policy documents – usually with the warning that it is very undesirable (Eisner 1989). Although the current attention given to the budget deficit issue appears quite new, it has been analyzed for more than two centuries. Adam Smith (1723-1790) discussed the budget deficit issue in his 1776 book: 'An Inquiry into the Nature and Causes of the Wealth of Nations'. Smith mentioned that budgets need to be balanced and this balance should be the norm of government budgeting. He asserted, however, that this norm may be violated during war or emergencies.

According to economic literature and practices by institutions such as World Bank and the IMF, a couple of different ways to measure the conventional budget deficit exists. The most commonly accepted measure used by government world-wide to define the conventional budget is the resources utilized by the government in a fiscal year that need to be financed after revenues were deducted from the expenditure. According to Blejer and Cheasty (1993), the conventional deficit can therefore, usually be defined as the difference between current revenues and current expenditure of the government. It thus reflects the financing gap that needs to be closed by way of net lending, including lending from central bank.

Accroding to Esterly and Schmidt-Hebble (1994), the most accurate measure of a country's position and public sector resources transfer would be the deficit measure based on the most inclusive definition of the public sector. However, such information is not always available and is subject to accounting conventions. The World Bank defined the conventional budget deficit as the difference between expenditure items such as salaries and wages, expenditure on goods and services including capital expenditure, interest on public debt, transfer and subsidies, and revenue items including taxes, user charges, grant received and profits of non-financial public enterprises and sale of assets (Blejer and Cheasty, 1991).

The IMF stated in its 1980 Manual on Government Finance Statistics that the budget deficit equals the following fiscal deficit:

Fiscal deficit = {(revenue + grants) – (expenditure on goods and services + transfers) – (lending – repayments)}

The conventional budget balance was originally developed in an effort to provide a measure of the government's contribution to aggregate demand in the economy and the lack of equilibrium on the current account of the balance of the payments, or to measure the crowding out of the private sector in the financial sector.

Alternative indicators to measure the different interpretation of fiscal policy have increasingly been used by a large group of countries and international organizations such as the IMF, the World Bank, the OECD and the European Union (EU). Countries use different definitions of the budget deficit mainly because of convention, relationship with other levels of government and the structure of their budget.

Rutayisire (1987) has criticized the use of the conventional deficit as a measure of a country's fiscal stance and as a basis for a country's fiscal planning on the ground that it fails to isolate cyclical influences of the economy on the budget and fails to reconcile a country's fiscal policy with medium or long term objectives of economic policy. He further argued that it will incorrectly report the monetary and inflationary implication of the budget. He suggested that the budget should be manipulated based on cyclically standardized budget rather than on balancing the conventional budget.

To overcome the shortcoming of the conventional deficit measures, alternative measures of the fiscal deficit that supplement the information provided by the conventional deficit are necessary since the complications created by the changes in inflation in the interpretation of conventional deficit make an evaluation of fiscal performance over time difficult. These measures are discussed by several authors including Buiter (1983), Blejer and Cheasty (1991) and Easterly Schmidt-Hebble (1994).

To remove the effect of inflation from the interest payments, the operational or inflation-adjusted budget deficit is used. This is defined as conventional deficit less part of the debt service that compensates debt holders for actual inflation. Alternatively, it can be defined as the primary deficit plus real interest payments. If the effects of inflation are not removed, 'the deficit will be observed by the size of the amortization element included as interest payments above the line rather

than below", Blejer and Cheasty (1991). This measurement of fiscal deficit is useful for policy making when inflation is very high.

In order to remove the effects of previous deficits on the budget, Blejer and Cheasty (1991), suggest the use of the primary deficit. This refers to all government outlays except interest payments, less all revenue. Anand and Wijinberger (1989) refer to the financeable deficit which they define as the deficit that does not require more financing than is compatible with sustainable external and internal borrowing and with existing targets for inflation and output growth.

Blejer and Cheasty (1991) pronounced the structural or full employment deficit as the deficit that can be used to remove the effects of fluctuations in economic activity on the budget. This is the deficit that is adjusted for cyclical movements in the economy, as advocated earlier by Rutayisire (1987). Blejer and Cheasty (1991) point out that, in the same manner that budget deficit affects and are affected by aggregate demand, the budget deficit is also affected by the business cycle and policy implementation may have varying impact depending on the stage of business cycle at the time of implementation.

3. Definition and Measurement of Public Sector Deficit in India

The concept and measurement of deficit in Indian context has advanced over a period of time. The use of single measure of budget deficit to assess the impact of fiscal policy has been in vogue till late 1980s. the fiscal gap up to mid-1980s were measured in terms of 'budget deficit' which referred mainly to the changes in the amount of ad hoc Treasury Bills and other 91-day Treasury Bills outstanding and the changes in the central government's deposit balances with the reserve bank and its other cash balances. In fact, until the beginning of the 1990s, there was no unique concept of budget deficit relevant to all purposes and occasions. Depending on the nature of the quest, the relevant budget deficit concept could have been the government revenue deficit, the capital deficit, or overall deficit (Gill, 1991).

Chkravarty Committee emphasized the need to have a measure for the full extent of government's reliance on reserve bank so as to quantify the monetary impact of fiscal operations. Since a sizeable part of the new issues of government securities was taken up by the Reserve Bank in the absence of adequate response from the market and subscription to dated securities had as much effect on the reserve money growth as purchase of Treasury Bills, the committee recommended that the net changes in the Reserve Bank's holding of dated securities and Treasury Bills after adjusting the government deposits with the RBI, i.e., the net RBI credit to the government, may be taken to measure the extent of monetization of government deficit. The committee also recommended that the fiscal gap be measured in items of fiscal deficit which would measure the net borrowing requirement of the government.

Rangarajan, Basu and Jadhav (1989) for the first time conceptualized multiple deficit indicators. The Economic Survey of the government of India for 1989-90 brought out a measure of the fiscal gap in terms of the difference between government expenditure and net lending on the one hand and current revenue and grants on the other.

The concept of budgetary deficit has become redundant following the discontinuance of ad hoc treasury bills with effect from April 1997, which earlier served as a source for bridging the temporary mismatch between receipts and expenditure of the government. This system has been replaced by ways and means advances. Union Government has entered into an agreement with RBI in March 1997 regarding discontinuing the practice of issuing the hoc treasury bills to replenish the cash balance with effect from April 1997. RBI makes ways and means advances to Union Government, if so required (CAG report).

The budget for 1999-2000, switched over a new accounting practice from April 1, 1999 whereby loans to states against small savings collections are to be made from the especially created "National Small Savings Funds" (NSSF) under the public account. Hence, these were not included in the centre's expenditure and were, therefore, not a part of its fiscal deficit. Rangarajan et al. (2003) have recently pointed out that the official figure of fiscal deficit show discrepancies, as the non-cash transactions are not included.

Therefore, there is no single criterion to measure the resource gap in the government finances. The choice of a particular measure is purpose specific. In the context of Indian public Finance, the traditional approach while measuring the resource gap takes into consideration revenue account gap, capital account gap and overall gap. Of late, there has been a frequent mention of the concept of gross fiscal deficit (GFD) by researchers while analyzing the finances of the state governments; one variant of GFD viz., Primary deficit, which is analytically useful to examine the current operations of the Government finances, has been introduced in Indian public finance. The different measures of deficit (resource gap) in Indian context are set out below.

(a) Revenue deficit (RD) denotes the differences between revenue receipts and revenue expenditure. Current revenue expenditure of the central government is composed of plan and non-plan expenditure of the government, and is met out of current revenue receipts, which include net tax revenue and non-tax revenue.

Revenue Account Gap = Revenue Deficit (RD) = Revenue Receipts (RR) – Revenue Expenditure (RE)

(b) Capital deficit denotes the differences between capital re ceipts and capital disbursements.

Capital Account Gap = Capital Account Deficit (CDA) = Capital Receipts (CR) – Capital Disbursements (CD)

(c) Conventional Deficit or Budgetary Deficit (overall deficit) is the difference between all receipts and expenditure. Budgetary deficit define as the excess all budgeted expenditures over the all budgeted receipts. This measure takes into account, both revenue plus capital receipts and both revenue plus capital expenditure.

Overall Gap = RD + CAD = (RR – RE) + (CR – CD) = [(RR+CR) – (RE+CD)]

(d) Gross Fiscal Deficit (GFD) is the difference between aggregate disbursements net of debt repayments and recovery of loans and revenue receipts and non-debt capital receipts. Thus this concept of deficit does not take into account all types of receipts. It does not take into account borrowing. Fiscal deficit, which is equal to the difference between the total expenditure and sum of the revenue and capital, receipts (only recoveries of loan and other receipts and except borrowing and liabilities).

Gross Fiscal Deficit (GFD)

= RE + [CD-(discharge of Internal Debt (DID) + Repayments of Loan to Centre (RLC) + Recoveries of Loans & Advances (RLA)] – RR
= RE + [Capital Outlay (CO) + Loans & Advances by States (LAS) + DID+RLC – (DID + RLC + RLC)
= (RE-RR) + [CO + (LAS-RLA) + (DID-DID) + (RLC-RLC)]
= RD + CO + Net Lending (NL)

e) Net Fiscal Deficit (NFD) is the gross fiscal deficit less net lending of the State Governments.

Net Fiscal Deficit (NFD) = GFD – (LAS – RLA)

(f) Gross Primary Deficit (GPD) is defined as GFD minus in-

terest payments. Therefore, primary deficit, is the difference between fiscal deficit and interest paid (interest is paid on the money which government takes to finance the deficit in budgets).

Primary Deficit (PD) = GFD – Interest payments (IP)

(g) Net Primary Deficit (NDP) denotes net fiscal deficit (NFD) minus net interest payments.

Net Primary Deficit (NDP) = NFD – [(IP – Interest Receipts (IR)]

(h) Primary Revenue Balance denotes revenue deficit minus interest payments.

Primary Revenue Balance (PRB) = RD – IP

(i) Net Primary Revenue Balance denotes revenue deficit minus net interest payments.

Net Primary Revenue Balance (NPRB) = RD – (IP – IR)

4. Conclusion

In summary, the conventional measure of the deficit is the difference between total government outlay, including interest payments but excluding amortization payment on outstanding stock of public debt, and total receipts including grants, but excluding borrowing proceeds. This measure of the deficit is easily affected by inflation; as such an alternative measure is necessary to remove the effects of inflation from the interest payments. The operational deficit is therefore used since; if the effects of inflation are not removed the deficit would be overstated. However, the calculation of the operational deficit is rather technically difficult. The primary deficit can be used to remove the effects of previous deficits on the current deficit. There are also other forms of measuring the fiscal deficit which depend on the current problem at hand, such as the financeable or sustainable fiscal deficit, which measure the deficit that is comparable with sustainable economic targets for growth and output.

From the Indian identities it is clear that the budget deficit is the difference between the expenditure of the government and the tax revenues that government received. Similarly fiscal deficit too is termed as the difference between government's spending and earning, the difference between budget deficit and fiscal deficit is that in fiscal deficit the earning from borrowing and liabilities is not counted (Galbraith and Darity, 1995). However, fiscal deficit is comprehensive and better measure of deficit as compare to budgetary deficit. We can say so on account of two reasons. First, it is an indicator of real volume of problem of funding resources to meet expenditure needs. It indicates the expected total increase in liabilities during the year. Budgetary deficit indicates only a part of this. Second, fiscal deficit is also an indicator of increase in future liabilities in form of interest payment and loan payments. When government borrows, it has also to pay back this money with interest. In order to pay interest and repay loan government may have to either borrow more or tax people heavily in future years.

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