
UNIT 4 BUDGETARY POLICY AND INDIAN FINANCIAL SYSTEM

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4.0 OBJECTIVES

After going through this Unit, you will be able to:

- describe the concept and objectives of the budgetary policy,
- identify the extent of integration between various segments of financial system and budgetary policy,
- evaluate the impact of budgetary policy on different sectors of the Indian financial system,
- state the role of budgetary policy in the emerging new economic environment, and
- discuss the role of Deficit Finance in financial system.

4.1 INTRODUCTION

The financial system of a State is influenced, to a great deal, by the economic policy of a country. The fiscal policy as a part of economic policy deals with taxation, public expenditure, public borrowing and debt management. The budgetary policy and the budget documents are important parts of fiscal policy. That is why, the budgetary policy and the budget documents, to a significant extent, influence the functioning of a financial system of a country. Hence, in this Unit, we shall discuss the issues relating to budgetary policy and their bearing upon the Indian financial system.

Let us begin with explaining the concepts of fiscal policy and budgetary policy in the next section.

4.2 INDIAN FISCAL POLICY

In the process of economic development, fiscal policy as an important instrument of economic policy plays an important role in the development and planning system of a country. Through fiscal policy, the Government provides public services. At the same time, it is an instrument for re-allocation of resources according to national priorities, redistribution, promotion of private savings and investments and the maintenance of stability. Fiscal policy is concerned with the aggregate impacts of various policy measures on the prescribed set of objectives. Therefore, it is in a broader framework, a measure to achieve the prescribed objectives in an economy. In other words, fiscal policy is a mean to achieve the chosen objectives like, economic growth, generation of employment opportunities, distributive justice, removal of poverty, price stability, etc.

It is clear from the above discussion that fiscal policy has a multi-dimensional role. Providing social justice to various segments is the major objective of this policy. In a developing country like India, the fiscal policy has an added importance as it is assigned an important role to achieve full employment and economic stability, and thereby achieving meaningful growth rate. Fiscal policy, on the one hand, concentrates on the resource mobilization in the economy. The system of taxes diverts funds from the private sector to the government sector. On the other side, the system of public expenditure diverts funds from government sector back to the people as they are spent for productive and welfare purposes. Public borrowings are also used for various purposes. Public debt management includes functions like floating of government loans, payment of interest and redemption of debts.

The fiscal policy is formulated to fulfil the following objectives:

- i) Mobilization of resources so as to increase the rate of investment and capital formation. This, in turn, accelerates the rate of economic growth,
- ii) Reduction of inequalities of income and wealth, or redistribution of income, in other words, an equitable distribution of income,
- iii) Increase in employment opportunities, and
- iv) Price stability.

In order to achieve these objective, the Government resorts to the following instruments:

- i) Taxation
- ii) Public Expenditure
- iii) Public Debt

These instruments affect the functioning of financial sector in the following manner :

i) Taxation

Taxation has a direct bearing on savings, investments and consumption. If the direct tax rates were high, there would be lesser savings and would also affect the consumption pattern. At the same time, if the tax rates are brought down, it would affect public investments. In such a contradictory situation, the Government has to take very precautionary step, as high corporate tax rate would affect the prices adversely. At one point of time, the corporate tax was quite high. However, with the process of liberalization it has gradually been reduced. The reduction in corporate tax creates multiple beneficial effects all round and also attracts foreign investments.

ii) Public Expenditure

Public expenditure, apart from influencing the economic growth process, has its real bearing on the activities of financial sector.

In the event of more spending through public investments, various sectors of the economy flourish, which in turn raise the demand for private investments from financial system. For example, if Government develops good infrastructure in a particular zone, more industries would come up and will demand the financial assistance from banks and financial institutes.

iii) Public Debt

The public debt comprises of internal and external debt. Internal debt includes market loans, bank temporary loans by way of treasury bills issued to RBI and commercial banks. Public debt policy affects financial sector. When Government has more borrowings, it adopts various tools such as increased level to statutory liquidity ratio to be imposed on banks, issue of treasury bills etc. All these measures reduce the credit capacity of financial institutions and these are left with less credit availability for productive purposes.

Thus, fiscal policy affects savings, investments, credit capacity, demand for credit in a financial system etc. that have direct bearing on operations of financial sector as a whole in the economy.

4.2.1 Budgetary Policy

Broadly speaking, budgetary policy is a policy through which the government uses its expenditure and revenue programmes to produce desirable results and avoid undesirable effects on national income, production and employment. Thus, budgetary policy helps in meeting the objectives set up in the fiscal policy.

The objective of budgetary policy cannot be different from the objective of fiscal policy and consequently economic development of the country. Both have to coincide.

4.2.2 Budgetary System

The document integrating the revenue and the expenditure of Government is called the '**Budget**'. A budget contains the actual estimates of revenue and expenditure of the Government of preceding year, revised estimates of the receipts and payments of the Government for the current year and the estimates for the next year. It has a role to ensure that the tax burden is reasonably imposed. On the other side, it ensures justice in allocation of expenditure among various sectors of the economy.

The budgetary policy is essentially concerned with:

- a) Raising of revenue
- b) Incurring of expenditure by the Government

The budgetary policy has been modified from time to time and made more pragmatic not only to enhance the tax resources but also to ensure that maximum people are brought within the tax net. The tax GDP ratio in India was just 6% in 1950-51, which increased nearly to 14% in 1999-2000. The Budget statement has been instrumental for providing special incentives for private savings and also encouraging investments in specified areas like housing. The budget strategies are revised every year keeping in view the overall economic growth of the country, requirements of resources, and allocation of funds according to priorities.

Strategies of the Budget (2001-2002)

The broad strategies of the Budget 2001-2002 were determined with the objective of the growth in mind and to ensure:

- i) Speeding up of agricultural sector reforms and better management of the food economy.
- ii) Intensification of infrastructure investment, continued reforms in the financial sectors and capital market and deepening of structural reforms through removal of

- remaining tiresome controls constraining economic activity.
- iii) Human development through better educational opportunities and programs of social security.
- iv) Stringent expenditure control of non-productive expenditure, rationalization of subsidies and improvement in the quality of government expenditure.
- v) Acceleration of the privatization process and restructuring of public enterprises.
- vi) Revenue enhancement through widening of tax base and administration of a fair and equitable tax regime.

Table 4.1 : Budget (2001-2002) at a Glance

	<i>(Rs in Crores)</i>
REVENUE RECEIPTS:	231745
TAX	163031
NON-TAX	68714
CAPITAL RECEIPTS:	143478
RECOVERY OF LOANS	151648
OTHER REVENUES	12000
BORROWINGS AND OTHER LIABILITIES	116314
TOTAL RECEIPTS:	375223
NON-PLAN EXPENDITURE:	275123
REVENUE ACCOUNT	250341
INTEREST PAYMENT	112300
CAPITAL ACCOUNT	24782
PLAN EXPENDITURE:	95100
REVENUE ACCOUNT	60225
CAPITAL ACCOUNT	34875
LUMP SUM PROVISION FOR ADDITIONAL PLAN	5000
REVENUE DEFICIT	78821
FISCAL DEFICIT	116314
PRIMARY DEFICIT	4014

Check Your Progress 1

1) What do you mean by fiscal policy?

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2) How public expenditure as a policy instrument can be used to enhance investment?

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3) State whether following statements are true or false:

- i) With the process of liberalization, the corporate tax has been raised. (T/F)
- ii) Human development has been one of the key strategies of union Budget 2001-02. (T/F)
- iii) The objectives of budgetary policy vary with the objectives of fiscal policy. (T/F)

4.3 INDIAN FINANCIAL SYSTEM

We are quite aware of the major components of a financial system, as these have been discussed in Unit-1. Let us discuss the various components of Indian Financial System here.

The Indian financial system consists of variety of institutions, markets and instruments that are closely related with each other. It provides the principal means by which savings are turned into investments. Given its role in the allocation of resources, the efficient functioning of the financial system is of crucial importance in a developing economy, like India.

The financial institutions/financial intermediaries, as they are called, comprise commercial banks, insurance companies, mutual funds, non-banking financial companies, development financial institutions etc. The financial markets comprise of capital market and money market, whereas financial instruments are demand deposits, short-term debt, intermediate term debt, long-term debt and equity, bonds etc.

Broadly the important functions of financial system can be described as under:

- i) It enables the pooling of funds for setting up large-scale enterprises.
- ii) It provides a way for managing uncertainty and controlling risks.
- iii) It provides a mechanism for spatial and temporal transfer of resources.
- iv) It generates information that helps in coordinating decentralized decision-making.
- v) It provides a payment system for exchange of goods and services.
- vi) It helps in dealing with information gap by handling sensitive information discreetly

4.4 IMPACT OF BUDGETARY POLICY ON FINANCIAL SYSTEM

The budgetary policy provides a leeway to integrate various financial intermediaries and make the financial system more vibrant. There are various budgetary policy measures, which set the direction of savings, credit expansion and investments. Depending on various policy measures, the extent of growth of financial system is determined.

4.4.1 Role of Budgetary Policy in the Growth of Financial Institutions

The primary role of a financial institution is to serve as an intermediary between lenders and borrowers. These institutions work under the overall supervision of the Reserve Bank of India. The funds pooled by the financial institutions are invested in diversified portfolios of financial assets. The transaction cost is lower. The financial institutions supply the ultimate lenders with liquid and less risky financial assets. Thus, financial institutions act as intermediaries between investors and savers.

The process of financial intermediation results in:

- a) Providing savers with different varieties of financial assets to invest their funds according to their preferences. It enables them to increase their savings.
- b) Borrowers are also benefited as finance is provided through the institutions as it is not easily possible to obtain directly from savers.
- c) It raises the productivity of aggregate investment, by improving its allocation. This apart, financial intermediaries also perform the important function of facilitating the normal production process and the exchange of goods and services.

The financial institutions, thus, play a vital role in the economic development of the economy. Broadly, these institutions are classified into following categories:

- a) Development financial institutions
- b) Insurance companies
- c) Other Public sector financial institutions
- d) Mutual Funds
- e) Non-Banking Finance Companies

The objective of budgetary policy is to strengthen the financial base of these institutions and to provide them operational freedom. A distinct feature of the Indian financial system is dominance of public sector institutions. Motivated by socio-

economic considerations, the system has been subject to high degree of regulations. Both entry of a new entity and its expansion have remained under the control of State. There has been a mandatory allocation of credit amongst different sectors including the government. Concessional interest rates have also been introduced.

In the recent past, the following budgetary policy measures have been initiated:

- i) The financial institutions have been given more autonomy in their operations. They have also been permitted to expand their operations in the financial sector by opening new outfits.
- ii) Prudential norms relating to capital adequacy, income recognition, classification of assets and provisioning have been made applicable to these institutions.
- iii) Insurance sector has been opened to the private sector. This will not only provide healthy conditions but also better risk cover and returns to investors. Insurance Regulatory and Development Authority has been set up to monitor the insurance institutions.
- iv) Budgetary allocation has been made to expand the capital base of NABARD, which in turn will accelerate the growth of agricultural sector and rural development.
- v) Certain tax incentives have been extended for investment in mutual funds.

4.4.1.1 Impact of Budgetary Policy on Banks

The banks mobilize surplus funds through various channels of savings. The flow of savings in the economy directly depends on budgetary policy measures. As already indicated that taxation policy, public expenditure and public debt policy affect consumption and savings, the extent of savings is much related to fiscal measures. Likewise, the expansion of credit also depends on investment policy being pursued by the Government to encourage private investments. If there are more fiscal incentives for industrial expansion, it will attract more demand for credit. Even Government's demand to meet current expenditure would limit the availability of loanable funds from the banking system.

The commercial banks transfer funds from surplus units to deficit units at the minimum operating cost. Today, we have vast network of bank branches operating all over the country. The nationalization of commercial bank in 1969 was a turning point in the history of banking in India. There have been significant achievements and pitfalls during this period. The budgetary policy has initiated a series of measures to make the banks more responsive to economic growth.

Some of the recent measures are as under:

- i) The banks are required to be more vibrant and their capital base has been strengthened. To meet the capital adequacy norm of 8%, a budgetary support of over Rs. 20,000 crore is provided to weak banks.
- ii) To make the bank credit cost effective, tax on loan interest has been withdrawn.
- iii) In the budget document, through rigorous exercises, attempts have been made to bring down the deficit, which in fact has helped banks to control flow of credit to government on concessional rate of interest.
- iv) To boost the export business, the government has set up Export Import Bank of India. The initial capital was contributed through budgetary resources.
- v) Banks have been facing serious problem with regard to recovery of their loans particularly the non-performing assets. The government has set up Debt Recovery Tribunals to expedite the cases of banks and accelerate recovery process.
- vi) The budgetary policy provided specific provisions and incentives for increasing the credit to high-tech agriculture projects.
- vii) The banking sector has been provided greater autonomy in their functions. The entry of private and foreign sector banks has been permitted to bring more competitiveness and efficiency in the working of banks.
- viii) For greater credit expansion and wider acceptability of banks in rural areas, the Regional Rural Banks (RRBs) have been set up.
- ix) The development of housing sector received prime attention in the budgetary policy. National Housing Bank has been set up. Tax concessions have been provided to the borrowers.
- x) The budgetary policy has initiated several other policy measures for the benefit of specified sectors like poor people, agriculturist, educational loans, etc.
- xi) The Statutory Liquidity Requirement (SLR) and the Cash Reserve Requirement (CRR) of banks have been reduced significantly to release more loanable funds to the banks.
- xii) To reduce its stake in the ownership of nationalized banks, the Government has decided to reduce its equity to 33% in case of such banks.

Thus, the budgetary policy has provided greater flexibility in banking operations and has made them more stronger to play a vital role in the financial system.

4.4.2 Budgetary Policy and Financial Markets

In the Indian financial system, there are two broad segments of the financial market:

- i) money market, and
- ii) capital market.

i) Money Market

The money market deals with short-term debt. The principal players in the money market are the commercial and other banks in addition to LIC, UTI, Mutual Funds, and non-banking financial companies. These intermediaries lend funds on a short-term basis to create an active inter bank call loan market. The Discount and Finance House of India (DFHI) provides liquidity to money market instruments by creating a secondary market.

ii) Capital Market

The capital market deals with long-term debts and stock (equity and preference). Each of these markets has a primary and secondary segment. New financial assets are issued in the primary market while existing financial assets are traded in the secondary market.

The growth of capital market is influenced, to a great extent, by various budgetary policy measures. For example, the taxation policy of corporate tax, dividend tax, capital gain tax, fiscal incentives for small savings etc. have direct impact and set the direction of growth of capital market. On the other hand, various fiscal incentives for industrial expansion would cause more demand from capital market by industrial sector.

The instruments of capital market have long period for maturity. It is a source of raising capital by issuing securities. The primary capital market facilitates the formation of capital. The secondary market consists of stock exchanges recognized by the government. The National Stock Exchange and Over the Counter Exchange of India provide liquidity to the securities. The Securities and Exchange Board of India (SEBI) oversees and monitors the functioning of securities market and operations, of intermediaries like mutual funds and merchant banks. Besides, there is a market for government securities which deals with debt securities issued by central/ state governments, all India financial institutions and other autonomous institutions.

The following budgetary provisions helped widening of financial markets and their operations smoothened:

- a) With a view to encourage secondary market operations, the maximum coupon rate which was as low as 6.5 % in 1977-78 was raised to 11.5 % in 1985-86 and thereafter restriction on maximum coupon rate was removed.
- b) A number of instruments were introduced in the market such as 182-day Treasury Bill, certificate of deposits, commercial paper and inter- bank participations.
- c) The Discount and Finance House of India (DFHI) was set up in 1988 by Reserve Bank of India and other financial institutions to facilitate smoothening of short-term liquidity imbalances and bring flexibility to the money market.
- d) The interest rates have been largely deregulated.
- e) Tax incentives have been provided for capital gains investment in mutual funds and investment in infrastructure development bonds.
- f) To provide further boost to money market operations, banks and other financial institutions have been allowed to set up money market mutual funds.
- g) Foreign institutional investors have been encouraged to participate in the financial markets.
- h) The concept of tax-free bonds was introduced for mobilizing greater resources.

4.4.3 Budgetary Policy and the Financial Instruments

Financial instruments are generally defined as monetary obligation of a borrower of funds (the issuer of the instrument) to the holder of the instruments. For the issuer of the instrument, it is a liability or in other words, financial obligation, for the holder it is a financial asset.

Financial instruments may be issued by economic units (private as well as public). The major financial instruments in an economy are as under:

i) Demand Deposits

Demand deposits are the financial instrument which are payable on demand to the owner by the holder. It may or may not carry interest. These are usually held by the banks by way of current and savings deposits and by post offices by way of savings accounts.

ii) **Short-Term Debt**

This is a promise to repay a specified sum along with agreed rate of interest within a short period of one year. Treasury bills, commercial papers, certificates of deposits and few other innovative instruments have been introduced in the system.

iii) **Long-Term Debt**

These are the debt instruments repayable over a period of 5 to 7 years in case of corporate sector and over 10 years in case of government bonds. They carry a specified coupon rate. Private and public sector debentures and bonds fall in this category. The debt instruments have been made more lucrative with variety of options and reasonably better yield.

iv) **Equity Stock**

This is a popular means of raising resources as capital by the corporate sector. Being owners, the equity shareholders have residual interest in the income of the company as they receive dividend after the claims of all creditors are met.

The budgetary policy has aimed from time to time that various financial instruments depending on variety of needs are brought into the system. They perform both the functions of financial assets and financial liabilities.

In this direction, the budgetary policy has a very important role because the nature of new financial instruments and their innovativeness depend on budgetary policy decisions. Such incentives are in the form of tax incentives to attract more savings, growth of investments to meet increased money supply and growth of capital market in tune with changes in policy measures for industrial growth.

The budgetary policy has made the financial instruments as discussed above, more acceptable. Some of the other financial contracts like forward futures, swaps, options and pension funds have been introduced in the system. The following are some of budgetary policy measures, which have increased the utility of above instruments in the financial system.

- i) The ceiling coupon rate on bonds has been abolished.
- ii) Some specified bonds such as infrastructure and power development have been given tax benefit.
- iii) The volume of money market instruments has been increased.
- iv) Number of steps has been taken to make short-term debt

instruments more acceptable. The eligibility norms have been liberalized from time to time.

- v) Mutual funds investments have also been given certain rebate in tax .
- vi) Specific guidelines have been issued for operations of forward futures, swaps, options etc.

Check Your Progress 2

- 1) State three major functions of financial intermediaries.
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- 2) What major steps have been adopted in the recent years to make the banks more vibrant?
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- 3) State how the budgetary policy affects the financial markets
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4.5 THE INTEREST RATE POLICY AND THE FINANCIAL SYSTEM

The interest rate policy basically aims at:

- i) ensuring government borrowings at cheaper rates,
- ii) supporting certain activities through concessional lending rates,
- iii) mobilizing substantial savings, and
- iv) ensuring stability in the macro-economic system.

The interest rates in India had, in the past, been substantially regulated by the Reserve Bank of India which had the following features:

- i) Interest rates on deposits with commercial banks were subject to ceiling.
- ii) Interest rates on loans were subject to floors.
- iii) Interests rates payable by companies on deposits were subject to a ceiling.

- iv) Interest rates charged by development financial institutions were subject to floors.
- v) Interests rates payable on small saving schemes were fixed by the government.

The interest rate regime in India has undergone a rapid transformation during recent years. The structure of interest rates, which was extremely complex, has now been rationalized. Banks are now free to determine their own Prime Lending Rate and to prescribe the maximum spread over it. Loans upto Rs. 2 lakhs are to be granted at rates not exceeding the Prime Lending Rate of relevant maturity. The money market rates have been completely freed. So are the rates at which corporate entities can borrow funds from the capital market. Deposit rates have also been deregulated, except the interest rate on saving accounts, which is determined by the Reserve Bank of India.

The interest rate deregulation has influenced the government securities market also. The Central Government has been able to meet its requirements from the market through the auction mechanism. The rates of interest settled at the auctions have come to reflect truly the market conditions. This has been proved both in relation to dated securities and treasury bills. With abundant liquidity, the interest rates have clearly shown a downward decline. The 364-day treasury bills are increasingly being used as a benchmark for fixing other rates in the system. With the development of an active government securities market, where rates are more or less determined by the market, the emergence of the open market operations as an indirect instrument of monetary control will assume importance. Steps are being taken to bring about significant institutional changes in the government securities market.

With the reform in the interest rate structure, an emphasis has been placed on widening and deepening of various segments of the financial sectors of money market and capital market. In the budget 2002-03, Government has decided to link interest rate on small savings with the average yield on Government Securities of comparable maturity.

Role of Budgetary Policy in the emerging new economic environment:

India has been pursuing the policy of economic reforms since 1991-92. The major policy initiatives are:

- i) Macro economic stabilization through fiscal policies.
- ii) Trade policy reforms to provide stimulus to exports.
- iii) Industrial policy reforms to provide greater competitive environment to industries.

- iv) Wide spread reforms in financial sectors to achieve financial efficiency.

The monetary and fiscal policies aim at controlling aggregate demand in tune with the growth of the economy. These policies are known as stabilization policies. The budgetary policies act as a link between both, the macro economic stabilization and structural policies. Therefore, budgetary policy has a very crucial and significant role in creating an environment conducive to economic growth.

There has been a number of policy measures taken in the recent years to accelerate the process of economic reforms. These include:

- i) Wide range of financial sector reforms including banking sector, capital market operations, non-banking financial companies and other development financial institutions.
- ii) Serious attempts have been made through budgetary policy to correct fiscal imbalances.
- iii) The tax laws has been rationalized to ensure:
 - a) lower personal and corporate taxes.
 - b) broaden the tax base; and
 - c) inflation adjustment of tax rates.
- iv) The policy has been adopted for progressive expansion of MODVAT system.
- v) Continued rationalization of custom tariffs structure.
- vi) The new economic policy has lent more emphasis on large flow of direct foreign investment.

The above analysis indicates that budgetary policy has an important contribution in achieving the goals and objectives of new economic policy.

4.6 DEFICIT FINANCING AND FINANCIAL SYSTEM

According to the Planning Commission, the term "Deficit Financing" is used to denote direct addition to gross national expenditure through budget deficits whether the deficit is on revenue or on capital account. The essence of such a policy lies, therefore, in government spending in excess of the revenue it receives in the shape of taxes, earnings of state enterprises, loans from public, deposits and funds and other miscellaneous sources.

The government may cover the deficit either by:

- i) Running down its accumulated balance (withdrawing its cash balances),
- ii) Borrowing from the central bank,
- iii) Borrowing from commercial banks, or
- iv) Creating new money by resorting to the printing press.

In short, deficit financing means incurring public expenditure in excess of public receipts from all sources. The quantum of deficit financing in a given period can be measured by variations in the financial assets and the non-monetary liabilities of the RBI and of the treasury.

The deficit financing has affected the operations of financing system to a large extent as financial system especially the banks were directed to provide significant credit support for government expenditure (current and capital both).

The period since early 1970s was characterized by weakening of fiscal discipline leading to large expansion in the central government's domestic and foreign currency borrowing requirements .The ratio of the gross fiscal deficit to GDP increased from 3.5 % in 1970-71 to 8.4% in 1990-91. The obligatory cash reserve requirements of scheduled banks (held at the central bank) and the statutory liquidity ratio (to be met through holdings of government and other approved securities), reduce the resources of banks. With a view to keeping the government's borrowing costs down, the yield on both treasury bills and long-term paper were left artificially low. This limited the demand for government paper by banks (and other financial intermediaries, such as insurance companies and provident funds). Residual financing needs of the government were, therefore, met by the Reserve Bank.

Such a mix of policies had deleterious long-term effects as large fiscal deficits became chronic and continuous escalation of the above-mentioned two ratios became necessary. In the early 1970s the cash reserve ratio for the banks was as low as 3% and the statutory liquidity ratio was 25%. By 1991-92, the CRR rose to 5% and SLR was 38.5%. At the same time, the Reserve Bank's holding of Central Government debt (i.e., its monetisation of the Government deficit) ballooned. By 1991, it was clear that the burden of Government debt was becoming unsustainable and that a significant improvement in the primary deficit was needed.

Sustained fiscal adjustments must underpin further reforms. In the absence of credible fiscal control and price stability, there is some risk that interest rate deregulation could result in overshooting and disrupt the reform process. The Government of India has committed itself to continued reduction in its gross fiscal deficit from the level of 5.7%

reached in 1992-93. The fiscal deficit as a proportion of GDP was budgeted, at 4.7 per cent in 2001-02 (BE) compared with 5.5 per cent in 2000-01 on the basis of original unaudited figures. Trends in the financial year 1993-94 were somewhat worrying, with the seasonally unadjusted deficit in the first half of the year running at an annual rate roughly triple the targeted level. This reflects revenue shortfalls partly related to sluggish industrial activity and delay in sale of equity in public enterprises. There has been agreement between Reserve Bank and Government that this incremental deficit should not be monetised. Accordingly, Government has resorted to additional borrowing through treasury bills and zero-coupon bonds at market-related rates. Fortunately, this unplanned increase in the borrowing requirement has occurred at the time when the domestic market is flush with funds, but this is short-term phenomenon that cannot be relied on. Nonetheless, the use of these market instruments has meant that the monetised deficit can be kept under control.

Check Your Progress 3

- 1) List the three measures initiated in the budgetary policy to make the banks more responsive to growth.

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- 2) Name any two measures which have been taken to strengthen the capital market?

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- 3) Name two measures through which the Government cures its budget deficit.

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4.7 LET US SUM UP

Budgetary Policy as a part of economic policy deals with taxation, public expenditure, public borrowings and debt management. The budgetary and monetary policy and the budget documents influence the functioning of financial system to a great extent.

Taxation policy has a direct bearing on savings, investments and consumption. Change in the direct tax rates affect the

level of saving and the consumption patterns. Public expenditure also influences the linkage between public investment and its spill over effect on private investment. Public debt policy also affects financial sector through changes in SLR and CRR, which in turn, reduce the credit capacity of the financial institutions. Thus, budgetary policy affects savings, investments, credit capacity demand for financial system, which, in turn, have direct bearing on the financial system.

A lot of changes have been made in the Indian budgetary policy after July 1991 to boost the financial system and make it more vibrant. The Financial Institutions have been given more autonomy after the beginning of economic reforms since July, 1991. As a major policy change, the insurance sector has been opened to private sector. Budgetary Policy has also provided greater flexibility in banking operations and has made them stronger to play a vital role in the financial system. The budgetary provisions have also helped widening the financial markets. A number of financial instruments such as Treasury Bills of shorter duration, certificate of deposits, commercial papers etc. have been introduced.

The deficit financing has affected the operations of financial system to a large extent as financial system, especially the banks, provide a large amount of support through purchase and sale of government securities. Since early 1970s, the domestic and foreign currency borrowing requirements of the Government have expanded to a great deal. In order to keep the Government's borrowing cost down, the yield on the long-term debt has been kept low. Such a policy measures has deleterious long-term impact on the financial system.

4.8 KEY WORDS

Balance of Payment: A systematic and summary record of a country's receipts and payment made to the rest of the world.

CRR : Cash reserves to be kept by the Commercial Banks as certain proportion of their demand and time deposits.

Economic growth : The expansion of the per capita output of the economy. In other words, a tendency of rise in real level of net national product.

Exchange rate : The price at which one currency can be exchanged for another.

Human development : The process of widening people's choices and the level of well being

- Progressive tax** : Progressives taxes refer to increasing rate of taxes at the increasing level of income.
- Propensity to consume** : The desire to consume expressed as the proportion of income spent on goods and services.
- Pump priming** : Attempt to reflate the economy by running a small budgetary deficit.
- Redemption of debt:** The repayment of an outstanding loan by the borrower in order to cancel it.

4.9 SOME USEFUL BOOKS

Economic Survey – Government of India, 2001, 2002

Union Budget Document, 2001-02, 2002-03

I.C. Dhingra (2001)— *Macro Economics Analysis and Policy*, Sultan Chand and Sons, New Delhi

Rudra Dutt (2001) — *Indian Economy*, S. Chand and Company, New Delhi

Cooper, S.K. and Fraser, D.R. (1990): *The Financial Market Place*, IIIrd edition, Westley Publishing Co., Massachuales, New York.

4.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Fiscal Policy is a policy instrument, which deals with the taxation, public expenditure and public debt to achieve the desired objectives.
- 2) By making the public expenditure in socio-economic infrastructure, which in turn, motivates the private investment.
- 3) (i) False (ii) True (iii) False

Check Your Progress 2

- 1) i) Serve as an intermediary between lenders and borrowers.
ii) Provides savers with different varieties of financial assets to invest their funds.
iii) Provides borrowers with the opportunity to obtain funds.

- 2)
 - i) Debt Recovery Tribunal has been set up to expedite the cases of banks suffering from the problem of recovery of their loans.
 - ii) Entry of private and foreign banks has been permitted to make the system more competitive and effective.
 - iii) The Statutory Liquidity Requirements (SLR) and Cash Reserve Requirements (CRR) have been reduced significantly to release more loanable funds to the banks.
- 3) Various policy measures of budgetary policy, such as taxation affect the level of saving and investment, which in turn, affects the functioning of financial markets.

Check Your Progress 3

- 1)
 - i) Withdrawal of tax on loan interest.
 - ii) Setting up Export-Import Bank of India to boost the export business.
 - iii) Reduction of CRR and SLR to release more loanable funds to the banks.
- 2)
 - i) Removal of coupon rate.
 - ii) Introduction of new instruments like Treasury Bill, Certificate of Deposits, Commercial Paper and inter-bank participation.
- 3)
 - i) Market Borrowing
 - ii) Deficit Financing