PAPER : INDIAN ECONOMY-II

UNIT-1

Topic: Fiscal policy

Meaning: Fiscal policy is one of the key tools through which government attempts to regulate and influence the economy and achieve the macroeconomic goals. It is the policy of the government related to taxes, government expenditure and government borrowing for attaining stability and desired level of growth in the economy over time. Fiscal policy refers to the budgetary policy of the government, which involves the government controlling its level of spending and taxation within the economy

Objectives of fiscal policy:

The objectives of fiscal policy are

a. **Full employment**: The first and foremost objective of fiscal policy in a developing economy is to achieve and maintain full employment in an economy. Therefore, to reduce unemployment and under-employment, the state should spend sufficiently on social and economic overheads. These expenditures would help to create more employment opportunities and increase the productive efficiency of the economy.

b. **Economic growth:** fiscal policy in a developing economy aims at achieving an accelerated rate of economic growth. Therefore, fiscal measures such as taxation, public borrowing and deficit financing etc. are used in a way so that production, consumption and distribution may not adversely affect. It promotes the economy as a whole to raise national income and per capita income.

c. **Optimum allocation of resources.** Fiscal measures like taxation and public expenditure can greatly affect the allocation of resources in various occupations and sectors. Thus optimum allocation of resources as well as mobilization of adequate resources for developmental programs is one of the important objectives of the fiscal policy.

d. **Price Stability**: To control inflationary pressures and maintain price stability in the economy is another important objective of the fiscal policy. Because the general public is adversely affected by increasing prices. Through various fiscal measures it aims to maintain stability in the economy.

e. **Development of Private sectors:** To develop the private sector the fiscal policy offers incentives to the private sector to boost their production and help them in developing their industries.

f. **Equitable distribution of income and wealth**: To ensure equitable distribution of income and wealth it aims to reduce the inequalities in the economy. Through fiscal measures like progressive taxation and public expenditure, it aims in realizing the objective.

g. **Capital Formation:** The fiscal policy also aims at increasing the rate of investment in the private and public sector. The rate of capital formation in developing countries is very low due to unemployment and low per capita income. The vicious circle of poverty is main the problem of these countries. Therefore, fiscal policy is adopted in such a way that it reduces consumption and encourages savings in the economy.

h. **Regional Balance**: To reduce regional disparities is yet another objective of the fiscal policy. It ensures to maintain a balanced development throughout the country by emphasizing more on the backward areas of the country.

Types of Fiscal Policy

a) Discretionary fiscal policy: it means deliberate change in govt taxation and expenditure to influence the level of national output and prices.

b) Non- discretionary fiscal policy: they are automatic stabilisers that automatically influence the aggregate demand and supply according to the situation (inflation/ recession) without deliberate intervention of the govt.

Discretionary fiscal policy is of two types;

a) Expansionary fiscal policy: It is adopted to cure recession in the economy.
During recession when the AD decreases, there are two fiscal methods that are followed to get the economy out of recession.
   i) Increase in Govt expenditure
   ii) Reduction in Taxes to increase the disposable income.

b) Contractionary fiscal policy: It is adopted to cure inflation in the economy.
During inflation a rise in AD and deficit due to excess govt spending create excess demand in the economy. The two methods that can be adopted are:
   i) Reduce the Govt expenditure
   ii) Increase the taxes

Techniques / tools/ instruments of Fiscal policy:

There are four tools of fiscal policy they are-

1. **Taxation:** Tax is one of the important sources of government revenue. Tax is a compulsory payment to the government. It is of two types; direct taxes and indirect taxes.

2. **Public expenditure**: : Public Expenditure can be classified into revenue and capital expenditures. Capital Expenditures of the government include acquisition of long-term assets, such as facilities or manufacturing equipment etc, which will generate business or additional profits to government. Revenue Expenditures are those expenditures which don't create any productive assets such as interest paid by the Government of India on all the internal and external loans or pension and salaries of government employees.

3. **Public debt/ borrowing**: If the government received more than it spends, it is called surplus. If government spends more than income, then it is called deficit. To fund the deficit, the government has to borrow from domestic or foreign sources.
   Debt-GDP ratio is the ratio of a country's public debt to its GDP.

4. **Deficit financing:** Deficit financing refers to means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowings. The term is also generally used to refer to the financing of a planned deficit whether operated by a government in its domestic affairs or with reference to balance of payment deficit. It is a practice adopted for financing the excess expenditure with outside resources. The expenditure-revenue gap is financed by either printing of currency or through borrowing..

Role of Fiscal policy in a developing country

In a developing economy, the budgetary policy (i.e. fiscal policy) has to perform an important role. Broadly, they are expected to achieve the following objectives:

i) Promote the growth of the economy by making productive investment both in the public and the private sectors;

ii) Mobilize maximum resources for investment keeping in view of the returns on those investments so as to ensure the growth of marginal and average rates of savings in the economy;

iii) Promote a measure of economic stability needed to realise the maximum growth of the economy; and

iv) Redistribute the national output to ensure balanced regional development.

Limitations of Budgetary/ Fiscal Policy

A number of factors can be identified which limit the effectiveness of realising the budgetary policy objectives in a developing economy. Among these, the more important are:

a) the rigidity and narrowness of the base of the tax structure posing difficulties for the establishment of a well-structured and integrated tax policy framework;

b) the lack of a sound and reliable data base on income, expenditure, savings, investment, employment, etc. making it difficult for public authorities to formulate a rational and effective budgetary policy; and

c) a lack of administrative machinery required to collect the revenue and ensure its effective spending

Components of Union Budget

The budget of the Central or Union Government is divided into two parts: (i) revenue budget (or account), and (ii) capital budget (account).

Revenue budget covers those items which are of a recurring nature. **Capital budget** covers those items which are concerned with acquiring and disposal of capital assets. Each account has a receipts side and an expenditure side. Receipts in the revenue budget consist of those items that carry no repayment liability (e.g. tax revenue, revenue surpluses etc.). Receipts in the capital budget consist largely of internal and external borrowings net of repayment; they also include recovery of loans and advances and some other receipts such as by sale of assets.

On the expenditure side, revenue expenditure is divided into two categories: development expenditure (or plan expenditure) and non-development expenditure (or non-plan expenditure).

Development expenditure consists of expenditure on social and community services such as education and health, and on economic services, such as agriculture, industry, power, transportation and communication.

Non-development expenditure consists of expenditure on administration and defense, and also payment of interest on public debt.

Revenue expenditure is expenditure on maintenance of existing levels of services.

Capital expenditure, on the other hand, is concerned with acquiring of capital assets i.e. for the expansion of the level of services.

Concept of Deficit

There are three types of deficits in any budget viz. (i) Revenue deficit, (ii) Budgetary deficit, and (iii) Fiscal deficit.

- Revenue deficit is the difference between the revenue receipts and the revenue expenditure. Revenue deficit = Total Revenue expenditure – Total Revenue receipts
- Budgetary deficit is total expenditure as reduced by total receipts
  Budgetary deficit = Total Expenditure – Total Receipts
- Fiscal deficit indicates the total borrowing requirements of Government from other sources to meet the total estimated expenditures of the government.
  Fiscal deficit = Total expenditures – Total receipts excluding borrowings
  Fiscal deficit is further split (or decomposed) into primary deficit and interest payments by Government.
  Fiscal Responsibility and Budgetary Management (FRBM) Act was enacted in 2003 with a view to reduce its deficit
- Primary deficit primary deficit is the requirement of borrowing without the interest payment. Primary deficit = Fiscal deficit - Interest payment.

Features of the Indian tax structure

1. The first feature of the Indian tax structure is the **multiplicity of tax structure**- the main feature of the Indian tax structure is the existence of a multiplicity of taxes. Union government taxes and state government taxes, both exist, and the tax structure includes both direct and indirect taxes.

2. The second feature of the Indian tax structure is that the indirect taxes hold a large share in our Indian tax structure. **Indirect taxes dominate over direct taxes**. According to research, because of the undeveloped economy and major inequality in income, the percentage of direct taxes is limited.

3. The third feature is the **insufficient tax revenue**. Although there is a rise in trend in tax revenue still the total tax revenue is still small compared to the developed countries. The GDP ratio is 8 to 9 per cent in India whereas in developed countries like the UK, and the USA the share has a range between 30 to 40 percent.

4. The fourth feature is the **incidence of taxation**. In the Indian tax structure, the incidence of taxation is much higher in urban areas than compared in rural areas because of the predominance of agriculture as an occupation in rural areas and less income in rural households.

5. The fifth feature of the Indian tax structure is its **progressiveness of the tax structure**. The Indian tax structure is framed to make sure that all indices of ability to pay are taxed. Depending on the type of commodity and consumer class excise duties are levied and collected discriminately.

6. The sixth feature is that the **tax base is very narrow** in India in both direct and indirect tax systems. The research shows that only one per cent of the working population of India comes under the preview of direct tax.

7. The seventh feature of the Indian tax structure is the **complexity of Indian laws**. With the intention of a broad-based tax system, a lot of changes have been introduced to the tax structure. There are many loopholes in the direction as well as indirect tax structure which provide a lot of loopholes to people to avoid tax.

Major defects in the tax structure/ tax sytem of India.

1. High Rate and Low Yield of Direct Taxes:

In India, as in other LDCs, the rate of direct tax is very high but the contribution to the total tax revenue is very low. In the 1950s, the rate of income tax in India was one of the highest in the world but the revenue was very insignificant. This is because high tax rates encouraged tax evasion and avoidance on a large scale.

2. Low Contribution of Income Tax:

Although the rate of income tax is the highest in India, the contribution from such is very low. Tax evasion seems to be the primary reason. Another reason is the high exemption limit in a country where per capita income is very low. In India, the exemption limit has been raised from time to time, but the levels of national and per capita incomes have failed to increase proportionately.

3. Absence of Agricultural Income Tax:

Another feature of India’s tax system is that there is no tax on agricultural income. Agriculture is the dominant sector of the Indian economy. Planned investment on agriculture has also increased over the years. But agriculture has failed to make any contribution to the introduction of the Government’s tax revenue.

4. Importance of Indirect Taxes:

In India, importance of indirect taxes has increased over the years which imply that the importance of direct taxes has diminished. In absolute terms (i.e., in terms of rupee) the contribution of direct taxes has increased but the percentage contribution of such taxes in total tax revenue has declined

5. Progressive Taxes on Income:

The Government has made the system of direct tax progressive and progressiveness is considered desirable in the interest of equity and for reducing the disparities in the distribution of income and wealth. But progressive taxes encouraged tax evasion and avoidance and have failed to reduce inequalities of income and wealth.

6. Regressive Nature:

Moreover, indirect taxes have become more and more regressive over the years. Such taxes are usually imposed on consumption goods. In general, poor people have a high propensity to consume than the rich people. In fact, the marginal propensity to consume gradually decreases with an increase in income. Thus poor people, who spend the major portion of their small income on consumption goods, pay the maximum amount of indirect taxes.

7. A parallel black money economy

Tax evasion is one of the major challenges for the taxation system in India. The amount of money evaded generates an illegal hoard which is called black money. The prevention and control of black money is a priority for transitioning towards a fair and transparent economy.