UNIT 2 FISCAL POLICY*

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2.0 OBJECTIVES

After reading this unit, you will be able to:

- state the objectives of fiscal policy;
- outline the two major types of fiscal policy along with its implications;
- review the fiscal policy followed in India since independence with an emphasis on changes introduced in it during the post-reform years;
- discuss the instruments of fiscal policy; and
- differentiate between the terms fiscal deficit, revenue deficit and primary deficit;

2.1 INTRODUCTION

Fiscal policy is a policy of the government related to taxes, government spending and borrowings of the governments for attaining stability and desired level of growth in an economy. The impact of the fiscal policy on any economy is huge. They can be gauged with the help of indicators like: (i) level of national income, employment and inflation, (ii) level of saving and investment and (iii) the position of balance of payment (BoP).

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In India, the central and state governments combined Tax-GDP ratio has increased from 6.0 percent in 1950-51 to 17.2 percent in 2015-16. Over the years 2006-07 to 2017-18, this ratio has hovered between 10-12 percent (for developed countries this ratio is higher ranging from 20 percent in Russia to 48 percent in France). Non-development expenditure of the central and state government are mainly driven by expenditure on defence, interest payment and subsidy while development expenditure is driven by railways, posts and telecommunication, social and community services, agriculture and allied activities, industries and minerals, power, irrigation and flood control, transport and communication and public works. Fiscal policy has many objectives. Specifically, it aims at: (i) mobilising resources through taxes and borrowings; (ii) maintain price stability; (iii) provide incentives for private sector growth; and (iv) reduce income and wealth inequality.

2.2 TYPES OF FISCAL POLICY

Keynes viewed fiscal policy as a tool by which government can effectively intervene to achieve the desired growth (or control) in important variables like income, employment, price, etc. in an economy. To achieve this, the fiscal policy is used in one of its two types viz. (i) expansionary fiscal policy; and (ii) contractionary fiscal policy.

Expansionary fiscal policy aims at either increasing the government expenditure or decrease the tax rates (or a combination of both) so as to boost the aggregate demand in the economy. It is particularly used at the time of economic recession. Expansionary fiscal policy however has the effect of reducing private investment because it results in higher interest rate. Contractionary fiscal policy aims at reduction in government expenditure or increase in tax or combination of both for reducing aggregate demand in an economy at the time of high inflation. This can be better understood with the help of following National Income Identity proposed by Keynes.

$$Y = C + b(Y - tY) + TR + I + G + NX \qquad (2.1)$$

where, Y = GDP, C = autonomous/subsistence consumption, b = marginal propensity to consume ($\Delta C/\Delta Y$), ($Y - tY$) is disposable income or induced consumption, TR is ‘transferred funds’ (i.e. from central to state governments on account of states’ share in central revenue, grants in aid, etc.), I is investment, G is government expenditure and NX is net export. Any change in fiscal policy has significant impact on the government’s budget through its effect on all the components reflected in Equation (2.1) above. Normally, expansionary fiscal policy results in fiscal deficit for the government. It is a situation where government income is lower than its expenditure.

2.2.1 Implications of Fiscal Policy

Tax policies impact the level of aggregate demand through changing levels of economic activities which are sensitive to changes in interest rate. While the

imposition of higher tax reduces aggregate demand it also lowers the level of economic activities through reduction in private investment. In addition, it impacts the government's social sector expenditure. There are instances where countries experience increase in government expenditure which could not be financed by tax revenues (or other sources of government income). In such situations, government is forced to borrow from the market. As a result of such borrowings, it has to devote resources in servicing the debts. Besides these economic implications, fiscal policy also has significant political implications. For instance, a change in fiscal policy could result in: (i) either increase/decrease in government expenditure or (ii) increase/decrease in tax burden to individuals/firms or both. Such changes resulting in pleasure or displeasure could show up in voters preference to the incumbent government driving them out of power at times. A good fiscal policy should therefore be prudently coordinated with monetary, debt and credit policy for effective results. It should have a clear cut road map of financing fiscal deficit and use of surplus resources.

Indian economy is a developing economy which continues to be characterised by adverse indicators (e.g. poverty, illiteracy, inequality, etc.) of economic development. It has a federal government system with its Constitution conferring the power of taxation and expenditure to both the central and the state governments. The Constitution mandates governments to submit proposals of income and expenditure for each financial year to their legislative bodies for debate and approval (known as budget). While the central government is concerned with the issues related to national interest like defence, PSUs, foreign trade, etc. the state governments are tasked to maintain law and order, address issues related to agriculture, public health, etc. Some areas like education, forest, inflation, social and economic planning fall under the concurrent list providing scope for both the central and state governments to operate. There is also a 3rd layer of government at local level (like municipal corporations, zilla parishads) with power to impose taxes for meeting the requirements of public welfare at their level.

2.3 BRIEF REVIEW OF FISCAL POLICY IN INDIA

A major policy decision in the direction of economic development in India was the establishment of the Planning Commission in 1950. Guided by socialist principles, its principal thrust during the first few decades of its establishment was to set up and strengthen the public sector base in India. The main aim of fiscal policy of that time was also therefore to transfer resources from private sector to the public sector so as to meet the consumption and investment requirements of public sector units. The other objectives of fiscal policy was to reduce income and wealth inequalities by way of taxes and 'transferred funds' to state governments so as to promote a balanced regional growth in the country.

The main source of government revenues being direct and indirect taxes, personal and corporate taxes were initially kept very high. As a matter of fact, even in 1973-74 (after 25 years of independence), the personal income taxes were in 11 tax-income slabs with rates monotonically increasing from a low of 10 percent to a high of 85 percent. The policy was similar in the case of corporate taxes where the system was one in which profit was taxed in the hands of the companies and dividend was taxed in the hands of the shareholders. The corporate tax slabs varied from a high of 45 percent to 65 percent. The Direct Taxes Enquiry Committee (1971) described the impact of the tax system in 1971 as 'confiscatory' and recommended tackling the large scale tax evasion (identified as owing to the high tax rates) by a reduction in the *marginal rate of direct taxes* to 70 percent (which was 97.5 percent before for persons with income of above rupees 2 lakhs per year including the surcharge of 15 percent levied). In 1976-77, this marginal rate of taxation was further reduced to 66 percent. A major simplification and rationalisation in this respect was achieved in 1985-86 when the number of tax slabs was reduced to 4 and the highest marginal tax rate reduced to 50 percent.

The major components of indirect taxes are excise duty, service tax and customs duties. Of all these, the central excise duty was a dominant component of indirect tax. Most of the indirect taxes were imposed on inputs of manufactured goods resulting in high price of final goods. To curtail the cascading effect, the Indirect Tax Enquiry Report of 1977 introduced a Manufacturing Value Added Tax (MANVAT). Under this, input tax credit was begun to be given to manufactures. Later, in 1986, a Modified Value Added Tax (MODVAT) was introduced. This however covered only some selected goods. Customs duty, imposed on imports with a view to promote the policy of imports substitution, which had prevailed right from the early phase of economic development in the post-independence period, continued till the 1980s. Towards the middle of 1980s, in 1985-86, the government reduced the tariffs on imported goods and also removed quantitative restriction on imports.

2.3.1 Fiscal Policy in Post-1990s

While the pre-1990s policies was aimed at import substitution, the economic policy of 1990s was pro market. Personal income tax brackets were reclassified into three parts with 20, 30 and 40 percent in 1992-93. This was further reduced to 10, 20 and 30 percent in 1997-98. Wealth tax (which was around 5 percent before) was reduced to 1 percent. Under indirect taxes, the MODVAT credit was expanded to cover most of the commodities by 1996-97. Three rates of excise duty were merged into one single rate and was renamed as Central Vat (CEVAT) in 2000-01. Customs duty on non-agricultural goods which was more than 150 percent were progressively reduced from 40 percent in 1997-98 to 15 percent in 2005-06. A service tax was introduced in 1994-95 and it has since been steadily expanded over the years.

While there were significant changes in the central taxes in the post-reform period, there were not adequate reforms in the tax policies of state governments during the 1990s. In the post-2000 years, as a part of simplification of state sales tax, a Value Added Tax (VAT) was introduced in 2005 in 21 states. Under this, VAT credit were given to tax paid on inputs. The administrative design of the VAT was such that, due to reduction in tax evasion, the revenue of the state governments increased. However, the system was not effective in the creation of a smooth nationwide market. The idea that a single Goods and Service Tax (GST) will be helpful in this direction got mooted for the first time in the year 2000.

A major change in the taxation policy was seen by a significant reforms in the structure of central government revenue. This change was evident in a structural shift from the relative shares of indirect and direct taxes. For instance, around 54 percent of total revenues of the central government came from indirect taxes in 1995-96. This was reduced to 32 percent in 2009-10. Thus, in terms of the relative shares of direct and indirect taxes in the total taxes collected (i.e. direct plus indirect), the share of direct taxes increased by 22 percent over the period 1996-2010 [i.e. from 46 percent to 68 percent]. Two major fiscal challenges that had to be faced by the end of 2010 are: (i) the World Economic Recession of 2008 (which resulted in considerable exchange rate instability and decline in growth rate consequent to decline in aggregate demand and decline in exports) on the external front; and (ii) rural farm loan waiver scheme and expansion of Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) on the domestic or internal front. There was however relatively less effect of the world economic recession on the Indian economy due to factors like: stringent financial market regulation, adequate foreign exchange reserve, big domestic market and timely fiscal policy intervention. GDP growth which was an annual average of 5.7 percent over the two decades period of 1981-2000, increased to an annual average of 7.2 percent during the period 2001-2012. A central GST Act was finally implemented all over the country in the year 2017.

Check Your Progress 1 [answer within the space given in about 50-100 words]

1) What are the objectives of fiscal policy?

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2) What is a limitation of the expansionary fiscal policy?

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3) State some of the important economic implications of a fiscal policy.

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4) In respect of direct tax (or personal income tax), how would you describe the prevailing situation in India till nearly 25 years after its independence?

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5) Between the 1970s and the 1980s, how was rationalisation in direct taxes brought about in India?

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6) What were the major changes introduced in the fiscal policies of 1990s?

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7) What would you describe as a 'structural shift' in the fiscal policy of India and in what time span was this achieved?

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8) What were the two major factors which posed fiscal challenge towards the end of 2010? What factors contributed to keeping the adverse impact due to these to a minimum for the Indian economy?

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2.4 INSTRUMENTS OF FISCAL POLICY

Since fiscal policy affects the income level by impacting the level of economic activities and level of aggregate demand in an economy, government often borrows and invest in order to maintain or accelerate the economic buoyancy in a country. From this point of view, the aim of fiscal policy can be stated as to manage the level of aggregate demand by calibrating the price and income levels in accordance with the requirements of the economy. This is achieved by adopting the three instruments of fiscal policy viz. (i) taxation, (ii) expenditure (i.e. transfer of funds to state governments and direct consumption of government), and (iii) borrowing or debts.

2.4.1 Taxation

The principal source of government revenues are taxes. They can be broadly classified as: (i) direct taxes and (ii) indirect taxes. Personal and corporate taxes are the main form of direct taxes levied by the central government. Indirect taxes are levied on goods and services and are paid by their end users. Examples of indirect taxes are: excise duty, service tax, customs duty, etc. Central excise duty is an important indirect tax levied on the manufacturing sector. Local bodies impose property tax which is a kind of direct tax.

In the period immediately after India attained its independence, the tax system in India was so structured as to transfer resources from private sector

to public sector dominated industrialisation process and to cover the cost of social welfare schemes. The share of indirect taxes in total revenue collection of India was higher than direct taxes. Such indirect taxes distort the resource allocation in the economy as their burden falls disproportionately on different groups of consumers (i.e. those who buy goods with lower elasticity of demand are also burdened with the same amount of tax as others). In other words, higher indirect taxes results in a higher burden of taxes on people with relatively low incomes. Such a policy stance, followed during the decades of 1950-80 kept the growth rate of Indian economy modest (3.5 percent average annual over the period 1950-80). The objective of taxation should be such that the proportion of direct taxes collected is more than the indirect taxes. Gross tax revenue being the sum of corporate tax, personal income tax, customs duties, excise duties and service tax, the focus on increasing the direct tax ratio should aim at expanding the base of corporate and personal income tax. Direct Tax-GDP ratio of the union government has increased from 2.3 percent in 1991-92 to 5.6 percent in 2015-16. Indirect Tax-GDP ratio has correspondingly come down from 7.4 percent in 1991-92 to 4.6 percent for 2015-16. The growth rate of the Indian economy has also increased during the years of late 1990s to the years in post-2000s (as stated above it was 5.7 percent over 1981-2000 and 7.2 percent during 2001-2012). The correlation between economic growth and revenue generation through tax collection (with an emphasis on rising share of direct taxes or lowered share of indirect taxes) is thus evident.

2.4.2 Expenditure

Central government's budgetary expenditure can be broadly divided into its own expenditure and transferred funds to state governments and the union territories. Total central government expenditure is classified into: (i) revenue expenditure and (ii) capital expenditure. Expressed as percentage of GDP, total expenditure of central government in recent years (2014-18) has been about 13 percent of which about 11 to 12 percent (i.e. more than 85 percent of total) is of revenue expenditure and the balance of 1.5 to 2 percent only (i.e. a mere 15 percent of total expenditure) is capital expenditure. Thus, revenue expenditure (which is spent on items like salaries, pensions, subsidies and interest payments) takes up the bulk of central government's expenditure. All grants given to states and union territories are treated as revenue expenditure although out of these grants some part is used for creation of capital assets. The objective of efficient government expenditure requires that over time capital expenditure should increase and revenue expenditure should come down.

2.4.3 Debt

If the total revenue of government is not enough to cover its total expenditure, then government borrows from market by issuing bonds to investors to make up for the deficit. If the size of debt is small in relation to tax revenue, government obligation in terms of debt service and repayment of

debt will be low. However, if size of debt is big and revenue collection is not sufficient to service debt, there is the possibility that government may default in the repayment of its debt. In case of high risk of default, interest rate on bond increases to cover the additional risk for investors.

Debt-GDP ratio is the ratio of a country's public debt to its GDP. Debt-GDP ratio of India was around 68.5 percent (of GDP) in 2017. Average debt-GDP ratio of India over the period 1991-2017 is 73 percent [it was highest (84.2 percent) in 2003 and lowest (66 percent) in 1996]. If a country is able to pay interest on its debt without borrowing or compromising on its economic growth, it is considered a stable scenario. Debt-GDP ratio is used as a tool to gauge the ability of a country to service its present and future debts. Empirical studies on the relationship between debt and GDP have established that if the debt-GDP is more than 90 percent, there will be a negative impact on the economic growth of that country (Reinhart-Rogoff, American Economic Review, 2010). However, there are countries, particularly developed countries, with higher debt-GDP ratio for long time (e.g. Japan above 200 percent, USA above 100 percent). But the size of the economy and their total revenue are quite adequate to service and repay their debts. Further, there are some specific features of these economies which is sustaining such a high debt-GDP ratio. For instance, most of the debt of Japan is owned by the Japanese public. Further, the Bank of Japan plays a significant role by purchasing its government bonds. Ownership of government debt in USA is also similar with two-thirds of its public debt being jointly owned by its public, banks, corporations and the federal reserve. Debt in local currency is less risky than debt in non-local currency which is affected by exchange rate fluctuations. Interest rate in both countries is also low which helps them to sustain high debt-GDP ratios.

2.5 FISCAL DEFICIT

Fiscal deficit denotes excess of government expenditure over government's income (i.e. revenue). It is commonly expressed as a percentage of GDP. Although fiscal deficit invariably varies from one year to another, unsustainable or high rates of fiscal deficit poses complications of increased demand for goods and services with a resulting high rate of inflation. In light of this, it is important to keep the level of fiscal deficit within healthy limits. This raises the question of what is an ideal limit for the fiscal deficit?

India's fiscal deficit was 5.8 percent in 1980-81. It rose to a high of 7.9 percent in 1985-86 and 8.5 percent in 1986-87. The beginning of 1990s saw higher fiscal deficit of 7.6 percent in 1990-91 but the decade ended with a lower fiscal deficit level of 5.5 percent in 2001. To set an ideal limit to be targeted by the governments (both central and state governments), a Fiscal Responsibility and Budget Management (FRBM) Act was enacted in 2003 with a view to reduce deficit, and thereby debt, to sustainable levels. The Act required the central government to contain its deficit to under 3 percent of

GDP. The set target was expected to be achieved over a medium term time frame. The measure was meant to ensure inter-generational equity in fiscal management and long term macro-economic stability. An important change of a far reaching nature in the FRBM Act was that, post-FRBM the fiscal deficit of state governments also began to get accounted. Before the FRBM Act, deficit of state government budgets were allowed to be met by overdraft from the RBI. Such overdrafts used to keep piling up and Finance Commissions used to write them off periodically. However, after the FRBM this practice has been stopped and while the states can take overdraft, if it is not cleared within a stipulated time, they are not extended certain conditional grants from the centre. This way, states have been made more accountable for their fiscal deficit post FRBM.

Following the above major step, in the post-2000 years the Indian economy has witnessed achievement of lower fiscal deficit levels in India. Except for some intermittent high levels (e.g. 2009 and 2010, 6 percent; and 2012, 5.8 percent both owing to a large measure to the package of fiscal stimulus necessitated due to the 2008 world financial crisis), for most of the remaining years the level of fiscal deficit has hovered around 4 to 5 percent with a steady decline in its trend (e.g. 2013, 4.9 percent; 2014, 4.4 percent, 2015, 4.1 percent and 2016, 3.9 percent). It is important to enhance the capacity of raising more revenue by tax collections so as to minimise the need to borrow and thereby large fiscal deficits with consequences of higher inflation rate. Since economic expansion for higher incomes need to be targeted as a goal, for which larger amount of developmental expenditure is invariably needed at an ever increasing rate, a prudent balance needs to be struck between optimal taxation policy, higher revenue generation, larger share of development/ capital expenditure [over that of non-development (or revenue) expenditure], an ideal fiscal deficit and higher share of direct taxes over that of indirect taxes. Since it is impossible to achieve a perfect balance among all these desirables, fiscal policy needs to focus on minimising the consequences of high fiscal deficit by targeting the other factors mentioned above.

Check Your Progress 2 [answer within the space given in about 50-100 words]

1) State the three instruments of fiscal policy.

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2) Illustrate the two major components of taxes viz. direct tax and indirect tax.

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3) In terms of fiscal policy pursued, what reason could be attributed for the relative low growth rate of Indian economy during the decades of 1950-80?

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4) Between capital expenditure and revenue expenditure, what has been the trend in recent years in India? What comment can you make on their relative ratios?

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5) Why is it important to keep the level of fiscal deficit low?

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6) With what objective the FRBM Act 2003 was enacted? What is a change of a far reaching measure in this Act in respect of fiscal deficit of state governments in India?

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2.6 LET US SUM UP

Fiscal policy is important to generate revenue for the government. A larger collection would mean greater ability for government expenditure. Of the two components of tax (direct and indirect), it is important to focus more on the generation of revenue by direct taxes. This is because the incidence of indirect taxes falls more heavily on people with lower incomes. Likewise, in respect of government expenditure, it is important to have a higher share of

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capital expenditure than revenue expenditure. In the Indian case, revenue expenditure have been far higher than capital expenditure. A major development of post-2000 years is the enactment of FRBM Act in 2003. The Act sets a limit of 3 percent of fiscal deficit to be attained over a medium time frame. A far reaching provision of this Act is the financial deregulation for state governments to raise capital from foreign markets. The tax-GDP ratio has increased from 6.6 percent in the year 1950-51 to about 12 percent in the post-2005 years. This is still far less than the corresponding ratio in developed countries.

2.7 KEY WORDS

Autonomous Consumption : It is a part of private final consumption expenditure which does not depend on income level of consumer. In other words, it represents that level of consumption which will be consumed by consumer even if their income is zero.

Disinvestment : It is a process under which governments sell some part of their shareholding to private investors for the purpose of either raising revenue or minimising fiscal deficit.

Economic Recession : It is a stage of an economy in which economic activities slow down resulting in decline in growth rate and higher level of unemployment.

Fiscal Deficit : (Revenue expenditure + Capital expenditure) – (Revenue receipts + Recovery of loan + other capital receipts) i.e. expenditure minus revenue from capital receipts other than loans taken. In simpler terms, it is: Total Expenditure – Total Receipts (excluding borrowings).

Gross Fiscal Deficit (GFD) : This is the amount excess of total government's current and capital expenditure including loans (net of recovery over revenue) and external grants and non-debt receipts.

Net Fiscal Deficit : Is the gross fiscal deficit minus net lending by the central government.

Gross Primary Fiscal deficit : This is: GFD – interest payment by government.

Capital Expenditure : It is expenditure by government to buy/create productive assets sustainable over long period of time.

Revenue Expenditure : Is the expenditure incurred for revenue transactions or for operational purposes like- salary and wage, rent, etc.

Primary Deficit : It is the amount of fiscal deficit after deducting interest payment on government borrowings.

Revenue Deficit : This is equal to 'Total Revenue Expenditure – Total Revenue Receipts'.

2.8 SOME USEFUL BOOKS AND REFERENCES

1) Kumar Rajiv and Alammu Soumya, (2010). "*Fiscal Policy Issues for India after the Global Financial crisis (2008-10)*". Asian Development Bank Institute, Working Paper No. 249.

2) Rao, N. Govind and R. Kavita Rao. " Trends and Issues in tax Policy and Reform in India." India Policy Forum, NCAER, www.ncaer.org/download/journal/ipf0506-paper2.pdf.

2.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Mobilising resources through taxes and borrowings, maintain price stability, provide incentives for private sector growth and reduce income and wealth inequality.

2) It keeps the interest rate high and thereby limits private investment.

3) Higher taxes reduce aggregate demand, lowers economic activity and reduces private investment. This reduces government's revenue and the resultant decline in social sector expenditure.

4) Personal income taxes varied over 11 slabs from 10 percent to 85 percent. With a surcharge of 15 percent, the marginal rate of direct taxation amounted to a whooping 97.5 percent for those with income exceeding rupees 2 lakhs per annum.

5) In the early 1970s, the marginal rate of direct taxes at the higher levels of income was brought down to 70 percent and later to 66 percent. By 1986, it was further brought down to 50 percent.

6) Slabs and rates of direct taxes were reduced to 3 (with 10, 20 and 30 percent rates) and wealth tax was reduced from 5 to 1 percent. Under indirect taxes, MODVAT which was first introduced in 1986 was extended to most of the commodities by 1997 and three rates of excise duty was merged into one rate called CEVAT in 2000-01.

7) For direct taxes, it reduced from 54 percent in 1995-96 to 32 percent in 2009-10. For indirect taxes, it increased from 20 percent to 48 percent over this period.

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8) World economic recessions on the external front and the farm loan waiving and the expansion of MGNREGA on the domestic front. Adequate foreign exchange reserve and big domestic market, among others, helped in minimising the impact on the Indian economy due to the external sector challenge.

Check Your Progress 2

1) The three instruments of fiscal policy are: (i) taxation, (ii) expenditure (transferred payment and direct consumption of government), and (iii) borrowing or debts.

2) Personal and corporate taxes are the main form of direct taxes. Excise duty, service tax and customs duty are examples of indirect tax.

3) Growth is stimulated by government expenditure which depends upon its revenue generating ability. In this, ideally, the proportion of direct taxes should be higher relative to that of the indirect taxes. This ensures greater income in the hands of the people followed by greater taxes. During the years, 1950-80, the indirect tax burden was higher. This impacted adversely on the economic growth rate keeping it low at just an average annual of 3.5 percent over this period.

4) Revenue expenditure over the years 2014-18 has been around 11 to 13 percent of GDP whereas capital expenditure is just about 1.5 to 2 percent. Ideally, the relative ratio should not be tilted towards revenue expenditure but the capital expenditure.

5) The consequences of high fiscal deficit is higher demand for goods and services and higher rates of inflation. In view of this, it is important to keep the fiscal deficit low whereby higher economic capacities generated ensures higher level of incomes and higher levels of government revenue. The spiralling effect should be upwards (higher incomes and higher taxes) and not downwards (i.e. higher inflation and lowered purchasing power and reduced demand).

6) The Act was meant to ensure inter-generational equity in fiscal management and long term macro-economic stability.