UNIT 22 FISCAL POLICY

Structure

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22.0 OBJECTIVES

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

- State the meaning of fiscal policy and its various instruments;
- Identify the different sources of revenue and different heads of expenditure of a government; and
- Explain the objectives of fiscal policy and the limitations thereof.

22.1 INTRODUCTION

Every government seeks to control and give direction to economic activities. For this purpose it has at its disposal a number of instruments. Among these,the most important is the fiscal policy or what is also known as the budgetary policy.

The fiscal policy, or budgetary policy, operates through the financial operations of the government. Every government performs a large number of functions to carry out its responsibilities. The functions that government has to carry and perform has been continually rising. In this Unit, you will learn about the meaning and

instruments of fiscal policy, public revenue, tax, public expenditure and public debt. you will be further familiarised with government budget and its components.

22.2 MEANING AND INSTRUMENTS OF FISCAL POLICY

Fiscal policy is concerned with the finance of government,i.e., with the revenue and expenditure of government. Studied earlier, a government mobilizes financial resources through different means that include taxation and various non-tax sources. In addition, a government can and does raise financial resources by way of loan and printing of new currency.Likewise, a government undertakes various functions that involve expenditure.

By bringing out changes in structure of taxation, borrowing, etc., and by changing the size and pattern of public expenditure, government can see to bring about desired change in the economy. Thus, (i) public revenue, (ii) public expenditure and (iii) public debt form important instrument of fiscal policy.

All the instruments of fiscal policy operate simultaneously. Changes in public revenue, expenditure and debt implement each other.

Fiscal policy is defined as the policy under which a government uses the instruments of taxation, public expenditure and public borrowing to achieve various objectives of economic policy

22.3 PUBLIC REVENUE

The responsibilities of a government all over the world have been steadily increasing. Government is responsible for the national defence and also for maintenance of law and order. Besides, government is also responsible for promoting social and economic welfare of the people. All these responsibilities imply that a government has to discharge large number of functions. These require money. A government has to mobilize more and more money in order to finance its function and the money mobilized by the government is called public revenue.

The various sources of public revenue can be broadly presented as shown in fig. 22.1:

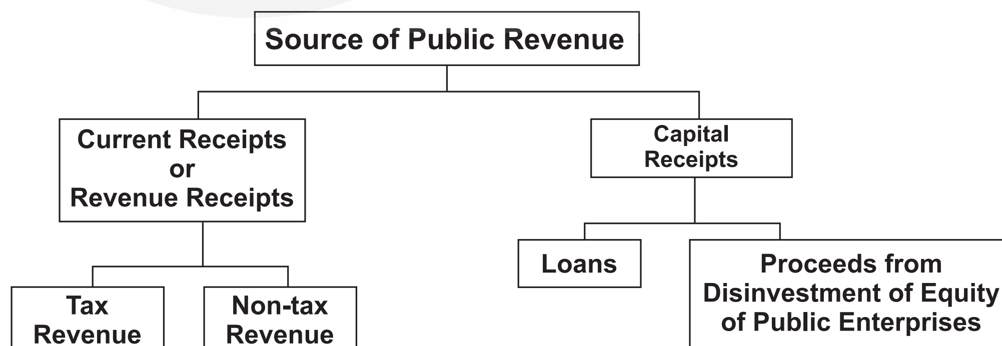

Fig. 22.1

22.3.1 Current Receipts and Capital Receipts

(i) Current receipts (also called revenue received) are those sources of inflows of money which do not create any liability of repayment on the government. For example:A government collects revenue by way of taxes. Revenue so raised is not to be ever returned to the taxpayers. Similarly, a government owns many production enterprises which are known as Public Sector Undertaking

(PSUs). The profit earned by these enterprises from part of the income of a government. These are not to be returned to PSUs.

Current receipts of government take to forms, viz., (a) tax revenue, and (b) non tax revenue.

(a) **Tax Revenue:** Every government has the power to impose a number of taxes and every government makes use of this power.

In India a number of taxes are imposed on goods,service,income and wealth etc. These include: goods and service tax (GST), income tax, wealth tax, customs duties,etc. The government mobilizes large sums of money by the way of these taxes is constituted the tax revenue of the government.

(b) **Non-tax revenue:** Revenue mobilized by the government from all sources other than taxes constitutes non tax revenue.

Of the two sources of revenue, tax revenue is generally more important than non-tax revenue.

The major source of non-tax revenue receipts can be conveniently tabulated as shown in Fig. 22.2. Let us learn them in detail.

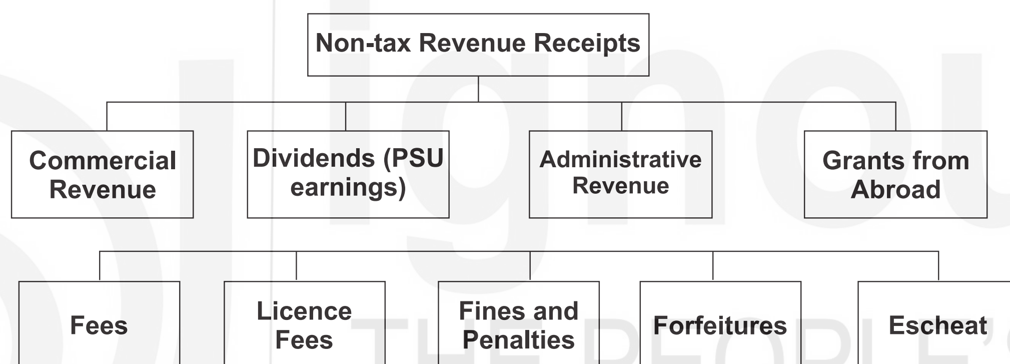

Fig. 22.2

a) *Commercial revenue:* It is the revenue received by a government in the form of prices paid for the government-supplied commodities and services. This includes payment for postage, railways, electricity, toll, interest on funds borrowed from the government, etc.

(b) *Dividends:* These are paid out by public sector enterprises out of the surplus income generated by them.

(c) *Administrative revenue:* It is the revenue that arises on account of the administrative functions of a government. Some of the different forms of administrative revenue are as follows:

– Fees: These are the charges imposed by government to defray the cost of each recurring service.

– License Fees: These are paid in those instances where are government authorities invoked simply to confer a permission or privilege. No service as such is provided by the government.

– Fines and Penalties: These are levied for infringement of law.

– Forfeitures: These are in the form of penalties imposed by courts for non-compliance with orders on non-fulfillment of contract etc.

– Escheat: It refers to the claim of the government on the property of a person who dies without having any legal Heirs or without leaving a will.

(d) Grants from abroad: Occasionally, a country receives grants and donation from governments and philanthropic organisations situated abroad.

Capital receipts, on the other hand constituted those sources of money for a government which involve either of the following two:

- A liability of prepayment is created for the government.
- An asset owned by the government is to be sold.

For example, when a government receives money by way of loans and borrowings, a liability of repayment of loans arises.

Similarly, when a government raises money by way of disinvestment of equity of government-owned enterprises, assets gets sold out to private Enterprises.

The major sources of capital receipts of a government can be conveniently presented as shown in Fig. 22.3.

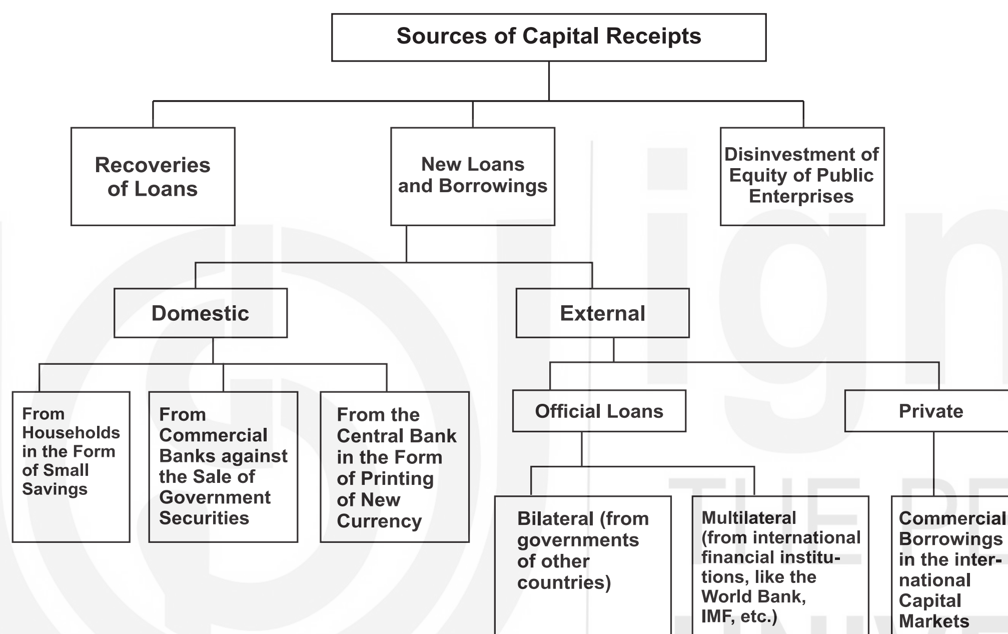

Fig. 22.3

(a) Recoveries of Loans: A government extends loan to the households, business unit and also in other countries. These loans constitute asset of the government. When these loans are paid back to the government, it gets its money back. Government's receipts increase and its assets fall. Hence, these are known as capital receipts.

(b) Loans and borrowings: A government can borrow from different sources.By way of loans a government gets money. But every loan is to be paid back. Till the loan is paid back the government carries the liability of repayment.

(c) Disinvestment: The government establishes a number of Industrial and business units which are the assets of the government.The government may sell a unit or more units in part of whole,to private sector enterprises.This sale is known as disinvestment. By this method moneyflows to the government. But in the process the role of government gets reduced.

22.3.2 Sources of Revenue of State Governments

State Government have their own independent source of revenue the different source of revenue can be classified into three parts A. Tax revenue, B. Non tax revenue, C. Central transfers.

A. Sources of tax revenue for the state government

In our Constitution, the states have been given independent tax powers. There is no work lapping of tax jurisdiction.

The underlying principle which determines this division is as follows:

- Taxes which have an interstate base are levied by the central government.

  Examples: Income Tax, Corporation tax, Custom duties, etc.

- Local taxes levied by the State Government.

  The state list contains 19 items like land revenue, tax on agricultural income, GST etc.

22.3.3 Tax Revenue

The tax revenue of the State Government can be divided into two parts, vis., (a) revenue from the taxes levied by the State Government,such as taxes on income, tax on property and taxes on commodities and services,and (b) revenue from taxes shared with the Central Government such as income tax, GST etc.

The main sources of tax revenue of states are:

(i) Taxes on income: The state government get revenue from taxes on income mainly in three ways: (a) Share of the states in the income tax imposed by the Central Government is the most important source of taxes on income. (b) Some of the states have imposed agricultural income tax (c) Professional tax, i.e., taxes is imposed on people involved in various profession.

(ii) Tax on property: The State Governments receive income from taxes on property and capital transactions.The main type of such taxes are: (a) Land revenue (b) Stamp duties and registration fee and (c)Taxes on urban immovable property.

(iii) Taxes on commodities and services: The State Governments impose taxes on commodities and services mainly in the following ways: (a) General sales tax has been the most important source of revenue for the states from the commodity taxes. It is imposed on the commodities (selected for sales tax), which are sold within the country. Sales tax has been replaced by VAT now in all states, (b) Share of states in the Union excise duties,(c) State excise duty is levied on liquid, opium and other narcotics,(d) Motor vehicle tax, (e) Entertainment tax (on cinemas,theatre performance,game etc.)including tax on betting and gambling, and (f) Electricity duties.

22.3.4 Sources of Non-Tax Revenue for the State Government

The main source of non-tax revenue for the State Governments are: (i) Fees taken in all courts except the Supreme Court. (ii) Income from undertakings owned, partly or fully, by the State Governments.(iii) Income from property owned by the State Government. (iv) Borrowings from within the country. (v) Royalty from mines, forest, treasure troves, etc. (vi) Grant-in-aid from the Central Government. (vii) Other grants from the Central Government.

C. Resource Transfer from the Central Government to the State Government

The basic principle of federal finance is that all the constituent unit should have adequate sources of revenue.

It has further been realised that the states, left to themselves, cannot raise sufficient revenues to meet their function and needs.

Moreover, wide interstate disparities exist. An important objective of development effort is to remove these regional disparities.

A consideration of these different factors points to the need of a balancing factor. Such a balancing factor is provided by the principle of transference.

Our financial system has provided for the transfer of resources from the centre of the states.

The important means of resource transfer are:

(i) Tax sharing: 42.0% of the total tax revenue collected by the Central Government is distributed among the State Governments.

(ii) Grants-in-aid:The central government extends different type of grants to state government.

These grants are made on the recommendations of the Finance Commission.

(iii) Loans:The Central Government is authorised to give loans to State Government, subject to such condition as may be laid down by or under any law made by the Parliament.

(iv) Other transfer:these include:

- Central assistance to an externally aided projects.
- loans, comprising mainly net small savings collection by the states.
- Grants and loans to the states for implementing Central schemes.
- Grants and loans for centrally-sponsored schemes.
- Grants and loans to the case of natural disasters.
- Loans to settle overdraft from the RBI.
- Special loans.

These transfers are made at the recommendations of the union Finance Ministry.

Apart from these direct transfer through sources also flow to the states through:

- The establishment / expansion of Central public undertakings, and
- The distribution of credit by the financial institution.

Check your progress 1

1) What do you mean by budgetary policy?

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2) What do you mean by public revenue?

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3) What are direct taxes?

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4) What are indirect taxes?

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22.4 TAX

A tax is a compulsory contribution levied on the wealth of an individual by the government of a country without reference to any benefit.

From this definition following important characteristics of tax can be observed:

1. A tax is a compulsory payment. All those who act as to pay tax have to make the payment. Otherwise, they are liable to fine or punishment.
2. The rate of tax is decided by the government. The taxpayer cannot bargain with the government.
3. Tax must be paid whether the individual derives any special benefit or not.
4. A tax is paid for the general or common benefits extended by the government to all the taxpayers.
5. No individual can claim any special service for himself in exchange for the tax paid to the government.

Direct Tax and Indirect Tax

(i) Direct tax is a tax which is expected to be paid out of the income or wealth of the same person on whom it has been imposed.

In other words the same person is expected to be the burden of the tax on whom the tax has been imposed.

In more technical language we say that the impact and the incidence of the tax are on the same person. By impact we mean the responsibility to pay the tax. By incidence, we mean the burden of the tax. For example: If a person earns Rs. 5 lakh a year, he is liable to pay income tax. The tax is to be paid out of his income.The tax burden cannot be shifted to any other person not given the employer.

Similarly, if a company earns Profit during a year it is liable to pay corporation tax out of its income.The company cannot shift this on anyone else.

(ii) Indirect tax is a tax whose burden can be shifted to another person. The person who is made responsible to pay the tax is expected to charge the amount of tax from another person.

In other words, the tax burden is not borne by the person on whom the tax has been imposed. Technically, we say that the impact and incidence of an indirect tax fall on different persons.

Example: Government levies GST on production of Pepsi. the company easily includes the amount of tax in the price of Pepsi and charge the same from the buyer.

Similarly, if an import duty has been imposed on an imported camera, the seller includes that duty in the price of camera. The burden (incidents) of the tax is borne by the consumer and not the seller.

Your shopkeeper charges GST from you. He is responsible to deposit the tax money with the government treasury. But he is authorised to charge the amount from you.

More generally, direct tax is levied on the income of an individual, while indirect tax is levied on expenditure.

Advantages of Direct Taxes

Direct taxes are paid out of the income or wealth of the person on whom the tax has been imposed. Direct taxes have certain merits. These can be briefly identified as:

(i) Equity: Burden of taxation is distributed on different people and institutions in just or equitable manner.The tax rates can be progressively raised as a level of income go up.

(ii) Certainty: Direct taxes satisfy the principle of certainty.The taxpayer knows well in advance in certain terms as to how much he is expected to pay.

(iii) Elasticity: With an increase in income and wealth of the people, the revenue from direct taxes also increases. Similarly, a government can raise more revenue simply by raising the tax rate.

(iv) Civic consciousness: The taxpayers are always aware of the fact that a part of their income has been transferred to the government. They begin to show more interest in the affairs of the government they work like watchdogs.

(v) Reducing inequalities: Direct taxes are generally progressive in nature. Higher incomes are taxed at higher rates.

(vi) Simplicity: Direct taxes are generally simple. They are normally understood clearly by ordinary taxpayers.

Disadvantages of Direct Taxes

(i) Arbitrary: Direct taxes tend to be arbitrary. It is indeed difficult to have objectively just on the basis of ability. The tax rates are often dictated by political compulsions of the government.

(ii) Tax evasion: Direct taxes tempt people to evade them by hiding their income and wealth.

(iii) Inconvenient: Taxpayers have to file returns of their income, these returns are scrutinised by the tax authorities. All these involved inconvenience and expenses besides time and energy.

(iv) High cost of collection: Direct taxes are often regarded as expensive to collect.

(v) Adverse effect on will to work and save: Taxpayers always do not positively react to direct taxes. Taxes work as a disincentive to work more and earn more income since a part of the additional income is to be surrendered to the government.

Advantages of Indirect Taxes

The tax burden of indirect taxes is expected to be shifted to others

The major advantages of indirect taxes can be summed up as :

(i) Convenience: Indirect taxes are convenient to pay and collect. The government finds it convenient to collect indirect taxes as they are paid in lump sum by the producer.

(ii) Difficult to evade: Indirect taxes are included in the price of the commodity. Evasion of an indirect tax will mean giving up the satisfaction of a given want.

(iii) Elasticity: As the consumption level increases, tax revenue mobilized by way of indirect taxes also increases.

(iv) Ability: Indirect taxes can serve the principle of ability. High rates of taxes may be imposed on those goods and services which are generally consumed by high income groups.

(v) Social benefit: Indirect taxes enable everyone, even the poorest citizen, to contribute something towards the expenses of the state.

(vi) Equity: Indirect taxes can be made equitable by imposing heavy taxes on luxury goods that are generally considered by the rich section of the society. Consumption of lower income group may be exempted.

(vii) Promote production and investment: Indirect taxes can be so levied that the production of goods by high-priority industries is increased and low priority Industries is discouraged.

Disadvantages of Indirect Taxes

Indirect taxes has certain disadvantages also among these the more important ones are :

(i) Unjust and inequitable: They fall alike on all the persons irrespective of their ability to pay.

(ii) Uncertain: Neither the taxpayer nor the government can be sure about the amount of tax involved.

(iii) Lack of social consciousness: Taxpayers fail to feel the pinch of tax immediately. These tax fail to evoke social consciousness among the taxpayers.

(iv) Inflationary impact: An indirect tax gets added up in the price of a product. Prices of commodities go up and this may be registered by the consumers.

Advantages of Direct Taxes	**Disadvantages of Direct Taxes**
• Equity • Certainty • Elasticity • Civil consciousness • Reducing inequalities • Simplicity	• Arbitrary • Tax evasion • Inconvenient • High cost of collection • Adverse effects on Will to Work and Save
Advantages of Indirect Taxes	**Disadvantages of Indirect Taxes**
• Convenience • Difficult to evade • Elasticity • Ability • Social benefits • Equity • Promote production and investment	• Unjust and inequitable • Uncertain • Lack of social consciousness • Inflationary impact

Check your progress 2

1) What do you mean by public expenditure?

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2) Define Regressive tax.

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3) Define Degressive tax.

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22.5 PROGRESSIVE, PROPORTIONAL, REGRESSIVE AND DEGRESSIVE TAXATION

As stated earlier, different types of taxes are imposed by a government. We have already classified the different taxes into two categories as (i) direct tax and (ii) indirect tax.

Different taxes are imposed by the government because a government has to pursue different objectives. For example, at times a government may need to encourage production and consumption of some commodities. Redistribution of income among different section of the society may be another objective of taxation. In pursuance of these objectives, a government imposes taxes at different rates on different commodities and different groups of persons. For example, a person who earns Rs. 3 lakh a year pays income tax at the rate of 10% of his taxable income. On the other hand a person who earns Rs. 10 lakh a year pays income tax at the rate of 30% of his taxable income.

On the basis of the rate of taxation the different taxes can be classified into four categories as:(A) Progressive taxation, (B) Proportional taxation, (C) Progressive taxation, and (D) Degressive taxation.

(A). Progressive taxation

In a progressive tax system the rate of tax increases as the tax base increases. That is, persons with higher income of wealth not only pay more tax, they pay tax at a higher rate.

This is illustrated below:

Suppose the tax rates at different slabs of income are as follows:

Amount of Income (₹)	Rate of Tax (₹)
0–1 lakh	10
1 lakh – 2 lakh	20
2 lakh – 3 lakh	30

From this, we calculate the tax liability of A, B and C who have annual incomes of ₹1 lakh ₹2 lakh and ₹3 lakh respectively this is shown below:

Persons	Rate of Tax (₹)	Tax liability (₹)
A	1 lakh	10,000
B	2 lakh	10,000 + 20,000 = 30,000
C	3 lakh	10,000 + 20,000 + 30,000 = 60,000

Thus, A pays a total tax of ₹10,000 on an income of ₹1 lakh, whereas C pays a tax of ₹60,000 on an income of ₹3 lakh.

B. Proportional taxation

In a proportional tax system the rate of tax remains the same at different tax bases.

Suppose, India adopt a proportional income tax system.Every individual is required to pay tax at the rate of 10% of his income. We estimate the tax liability at different levels of income as follows:

Income (₹)	Income of Tax (₹)
10	1
1,000	100
10,000	1,000
10,00,000	1,00,000

We notice the amount of tax to be paid goes on increasing but the rate at which the tax is paid remained unchanged.

C. Regressive Taxation

In a regressive tax system, the rate of tax falls as the tax base increases.

Level of income (₹)	Tax rate(%)	Tax amount (₹)
10,000	10	1,000
20,000	8	1,600
30,000	7	2,100

In this case we find that

- the amount of tax to be paid increases and,
- the rate at which tax is to be paid falls.

A regressive tax is one in which the rate of taxation decreases as the taxpayer's income increases.

D. Digressive Taxation

In a digressive tax system, the tax increases with an increase in tax base but the rate of increase of tax diminishes with every increase in the tax base.

This can be illustrated as follows:

Taxable income (₹)	Rate of tax (%)	Rate of increase in tax rate (% of point)	Amount of tax (₹)
100	5	–	5
200	10	5	20
300	14	4	42
400	17	3	68
500	19	2	95
600	20	1	120

Thus, it would be seen that with an increase in the tax base :

- Rate of tax increases.
- Amount of tax increases.
- Rate of increase in tax rate falls.

Progressive taxation is based on the principle of 'ability'-to-pay, i.e., those who earn more should pay more to the government. It helps the government in redistribution of income from rich to poor.

22.6 PUBLIC EXPENDITURE

Public expenditure refers to the expenses of the public authorities—Central Government, State Government and Local Government—either in protecting the citizens or in promoting the economic social welfare.

Public expenditure, broadly speaking, includes expenditure incurred by a government under the following heads:

- Defence expenditure: It includes expenses on equipment, payment as wages for army personnel, etc. Defence expenditure corresponds to the 'first duty of sovereign', viz., defending the society from the violence of other independent societies.
- Civil expenditure or administrative expenditure: It is incurred for the maintenance of law and Justice, viz., securing internal justice between citizens.
- Economic expenditure, (i. e., government expenditure for economic ends): It includes provision of direct services to private enterprises in the form of subsidies and provision of benefits through its own industries.
- Social expenditure: It includes expenditure on education, public health, social Insurance scheme, etc.

Each one of the above broad headings includes many subsidiary functions.

22.6.1 Revenue Expenditure and Capital Expenditure

Government expenditure can be divided into two heads:

(i) Revenue expenditure and,

(ii) Capital expenditure.

Let us learn them in detail.

(i) Revenue expenditure of a government is in the form of consumption expenditure. It does not directly create any capital asset for the economy.

Example: LPG cylinders are made available to domestic consumers at a price which is less than theper unit cost of production of a cylinder. The difference is borne by the government and is known as subsidy. Expenditure on subsidies is a part of the government expenditure it does not lead to creation of any effect.

The other characteristic of revenue expenditure is that it does not cause any reduction in the liability of the government.

Example: Expenditure incurred on the defence forces of a country does not cause any reduction in the liability of the government.

The major items on which a government increase revenue expenditure include:

(a) subsidies,

(b) interest on government loans,

(c) public administration,

(d) defence, and

(e) other economic and social services.

(ii) Capital expenditure is in the form of investment expenditure. It results in creation of assets in the economy. The more the capital expenditure, the larger the quantity of assets that are created.

Examples: Construction of roads, dams bridges, flyovers, hospitals, schools, canals, etc., involves government expenditure this expenditure creates more assets.

The other characteristic of capital expenditure is that it causes a reduction in the liabilities of the government.

Example: If the government incurs expenditure towards repayment of loans, its liabilities get reduced.

22.6.2 Main Heads of Public Expenditure

Main heads under which expenditure is incurred in India by the Central Government are as follows:

(i) Central scheme: Ours is a planned economy. For this purpose five year plans are formulated. Within each plan, development programmes are formulated and implemented as a part of each five year plan. On each of development programmes and schemes government expenditure is included. A provision for this expenditure is made each year in the budget for the year.

(ii) Central assistance to States: In our federal set-up, the State Governments receive financial assistance for the central government. The financial assistant is granted both for plan and non plan expenditure of the states. This is extended both on Revenue account and Capital account.

(iii) Interest payment: It has not been possible for the government to meet its rising expenditure from its own financial resources. it has been resorting to use borrowing both domestically and externally. Any loan, by definition, carries the application to pay interest. Same is the situation of the Government of India. With rising public debt the burden of interest payment has been rising in the economy.

(iv) Defence: Defence expenditure constitutes a big share of total expenditure on the economy. Defence expenditure is included both on maintenance of armed forces, as also on creation of Defence assets.The former constitutes revenue expenditure, whereas the latter constitute capital expenditure.

(v) Public Administration and services: The government is responsible for provision of various social,economic and administrative services in the economy. To run these services, a comprehensive government machinery has been built up at all levels. Huge sums of money are required to be spent on the maintenance and running of this machinery.

The main heads of public expenditure can be illustrated in the form of Table 22.1 which relates with a recent Union budget.

Table 22.1: Heads of Public Expenditure in Union Budget

Heads of expenditure	₹ in crore
A. Revenue expenditure of which	18,36,934
(i) Interest payment	1,90,807
(ii) Defence	57,593
(iii) Subsidies	71,431
(iv) Economic, social and other services	40,870

B. Capital expenditure	3,09,801
C. Expenditure on central schemes	9,45,078
D. Total expenditure (A + B + C)	30,91,813

Recent Change: 2017 onwards

This 12th five-year plan came to an end on March 31st 2017. With this the era of five-year plans which began with the first five year plan on April 1, 1951, has ended. The planning commission has been disbanded. in view of this distinction between plan expenditure and non plan expenditure has lost its relevance. Hence, with budget 2017-18 onwards, this distinction has been removed from the budget papers.

Two other changes in budget provisions may be noted as follows:

(i) Till the year 2016-17, the railway budget was presented to Parliament separately. From 2017-18 the Railway budget has been merged in the union budget, and it is presented as part of the union budget.

(ii) Till the 2016 17 budget the Union Budget was presented on the last working day of February every year.

From 2017-18, the practice has changed and it is now presented on the first working day of February every year.

22.6.3 Development Expenditure and Non-developmental Expenditure

Development expenditure relates to growth and development activities of the government. It includes expenditure incurred under such head as social and community service and economic services.

Non-development expenditure relates to non-development activities of the government. It is incurred under such head as defence, interest payments, subsidies, public administration, etc.

Further, it should be noted that development schemes are included in both revenue and capital budgets.

22.6.4 Importance of Public Expenditure

Public expenditure is of great significance in the context of a welfare state like India. This can be seen from the following points:

(i) Public expenditure increases economic growth:It accelerate the process of economic growth.

   (a) New industries can be set up.

   (b) Infrastructure like roads, dams, bridges, canals, flyover, etc., can be constructed.

   (c) Research and innovation are encouraged.

   (d) Rate of investment and capital formation is increased.

(ii) It increases economic welfare: This happens when public expenditure is directed towards programmes of poverty eradication, health and education of the poorer sections of the society etc.

(iii) It corrects depression and checks unemployment: Depression in an economy is the result of the fact that there is an inadequate aggregate demand for goods and services. This causes unemployment and further fall in incomes.

A government can create more employment opportunities for increasing its own expenditure. Once more employment is created, it generates more income and increase demand for goods and services.

(iv) It leads to reduction in inequalities: Public expenditure can be used to

(a) reduce inequalities in income distribution, and

(b) remove regional disparities in growth.

It is largely because of the above operations, the public expenditure has been continuously rising almost in all countries.

Is increasing Public Expenditure Necessary Good or Evil?

It is difficult to take sights on this issue. This is, however, clear that as an economy grows and the sphere of government activity expands, the size of public expenditure will keep on increasing.

It is difficult to determine any common yardstick for all the nations of the world. The proper level of Expenditure would depend upon a number of factors, among these, the more important ones are:

1. Designers and needs of the community.
2. Effects of government spending and the revenue supporting the spending.
3. Willingness of the population to be taxed.
4. Resources and population of a community.
5. Distribution of wealth and income.
6. Stage of economic development,etc.

Check your progress 3

1) Distinguish between revenue expenditure and capital expenditure.

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2) Distinguish between developmental expenditure and non-developmental expenditure.

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3) What do you mean by social expenditure?

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22.7 PUBLIC DEBT

Government borrow money from different sources to meet their budgetary needs. Governments may borrow from sources within the country of resources outside the country.

Every loan, by definition, is contracted for a fixed period of time. During this period, the borrower is under a contractual obligation to pay interest on the borrowed capital. On the maturity of the loan period, the borrower is under a contractual obligation to return the principal.

A borrower may raise a fresh loan to pay of the earlier loan.

This process may be repeated any number of times. as a result, the debt burden of the borrower goes on increasing. Public debt refers to the debt burden of a government at any point of time.

Need for Public Debt

Government normally borrowed in difficult situations as explained below:

(i) To meet budgetary deficit: Modern Government do not have any last accumulated balance to meet a budget deficit. Governments may face any of the following situations:

    (a) the revenue from taxation and other sources may not be equal to the actual expenditure, and

    (b) there may be unplanned and unexpected emergency situation like major fires, floods and famines.

    It may not be possible to mobilise fund through taxation to meet the situations. Government may Resort to borrowing.

(ii) War finance: A factor which necessitates public loans is war. Modern Warfare is so costly that the normal income through taxation falls short of the actual war expenditure. A republic loan is a better and easy method of collecting revenue than taxation.

(iii) To check recession: Public borrowing is considered very useful as a remedy for slowdown in economy. Loans enabled the government to make use of idle and unutilised points of the public in this way the government can create demand for goods and services. This will provide a much needed push to the economic activity.

(iv) To accelerate development activity: Public loans are also made for development purposes. These loans can be made to build infrastructure and capital projects.

(v) To meet contingencies: Government may be required to undertake any unexpected expenditure. This expenditure might not have been budgeted for. The government may raise loans to this type of expenditure.

(vi) Short revenue option: Taxation is a difficult choice, high taxation is generally resisted. High taxation also adversely affect the ability and willingness to work and save. Borrowing offers of a soft option to the government. It does not attract any adverse reaction. At times, people may even appreciate when a government plots new scheme of borrowing, more so, if the scheme of was any added incentives.

Methods of Redemption of Public Debt

Various methods available to a government to pay off its debts are:

(i) Repudiation of debt: It simply means that government refuses to pay the interest as well as the principal. It does not recognise its debt obligation. A government can repudiate both its internal debt and external debt. Generally, no government like to repudiate its debt as this will shake the confidence of the general public in the government.

(ii) Conversion of loans (Debt conversion): An old loan may be converted into a new loan. Conversion may be resorted to:

– when at the time of redemption of a loan the government does not have the necessary funds,or

– when the current rate of interest is lower than the rate at which the government is paying for its existing debt, so that the government can reduce its debt obligations.

(iii) Serial bond Redemption: Government may decide to repay every year a certain portion of the bonds issued previously. This enables a portion of the debt being paid off every year.

(iv) Buying up loans: A government may redeem it step to buying up loans from the market. Whenever it has surplus income, it may spend the amount of pay off government loan bonds from the market where they are bought and sold.

(v) Sinking fund: It refers to the creation and the gradual accumulation of a point which will be sufficient to pay of public debt.

(vi) Capital levy: It may be levied once in a while with the special objective of redeeming public debt.

(vii)Redemption of external debt: It can be done only through accumulating the necessary foreign exchange to pay for it.

(viii) Refunding: The simple and transparent method through which government buys back the bonds as and when they mature and stand due for payment in cash.

22.8 GOVERNMENT BUDGET: MEANING AND COMPONENTS

A budget is an annual financial statement of a government. It gives out details of total receipts and total expenditure for a year. Till now, in India, budget of the Union Government, known as the Union Budget, used to be presented on the last working day of the month of February. This practice has been changed now beginning with 2017-18 budget, it will be presented on the first day of the month of February. Similarly, each of the state government presents annual budget for the respective state. This is known as State Budget. For example, Haryana State budget, Maharashtra State budget etc.

Along with the budget for the next year, the set of figures relating to government receipts and expenditure pertaining to the preceding two years are also presented.

22.8.1 Components of Union Budget

The various components of a budget can be divided into two parts, viz., (i) revenue budget and (ii) capital budget

A revenue budget contains the details of revenue expenditure and revenue receipts of the government. These are in the nature of current expenditure and current income of the government.

A capital budget is a statement of capital receipts and capital expenditure of the government.

The sum total of the revenue budget and capital budget that contribute to the overall budget of the government. Thus, the sum of revenue receipts and capital receipts

constituted total receipts of the government. The sum of revenue expenditure and capital expenditure constitute the total expenditure of the government.

The different components can be tabulated and illustrated with the help of data from a recent Union Budget as follows:

Components of budget	(₹ in crore)
A. Revenue budget	6,02,935
A1 Revenue receipt	6,58,119
A2 Revenue expenditure	–55,184
Revenue surplus/(deficit) = (A1 – A2)	
B. Capital budget	
B1 Revenue receipt	1,47,949
B2 Revenue expenditure	92,765
Capital surplus/(deficit) = (B1 – B2)	+55,184
C. Overall budget = (A + B)	
C1 Overall receipt (A1 + B1)	7,50,884
C2 Overall expenditure (A2 + B2)	7,50,884
Overall surplus/(deficit) = (C1 – C2)	0

The state budget also follows the same pattern. However, a state government does not have the privilege of running a fiscal deficit. The state government can borrow money from the unknown government. This is in addition to the resources transferred by the union government to state governments.

22.8.2 Types of Budget

Balanced Budget, Surplus Budget, and Deficit Budget

During a year, government's overall receipts may be equal to, less than, or more than government's overall expenditure.

- If overall receipts are equal to overall expenditure, we call it a balance budget.
- If overall receipts are more than overall expenditure, we call it a surplus budget.
- If overall receipts are less than overall expenditure, we call it a deficit budget.

We know receipts and expenditure of two forms, viz., (i) Revenue receipts and (ii) Capital receipts and (i) Revenue expenditure and (ii) Capital expenditure.

We have different concept of deficits (and surplus) in government budget.

Among these concepts, more important ones are: (A) revenue deficit, (B) budget deficit, (C) fiscal deficit, (D) primary deficit.

A. Revenue Deficit

Revenue deficit obtains when the revenue expenditure of the government exceed the revenue receipt.

Revenue deficit = Revenue expenditure – Revenue receipts.

This is shown in the following tabular data from the Union Budget for a recent year:

Financial statement	**(₹ in crore)**
A. Revenue receipts	6,02,935
B. Revenue expenditure	6,58,119
Revenue deficit = (B – A)	55,184

Implications of Revenue Deficit

The golden rule laid down for any budget is that it should have a revenue surplus,i.e., the current expenditure of the government should be less than its current income. The difference on this account known as revenue surplus. The revenue surplus can be used to finance capital projects in the country. The capital project represent capital formation. These add to the production potential of the economy and thus create conditions for rapid growth.

Conversely, if a government incurs revenue deficit, it implies that its current expenditure exceeds its current revenue. To plug this difference, it will have to find additional sources of money. For example, it may borrow within the economy; it can also borrow externally. It may even decide to sell the assets owned by it.The money so realised may be used to finance the deficit. It is obvious that in this situation the economy would not be in a position to strengthen its resource-base. After all, it is bad economics to sell off family's jewel to celebrate a wedding at home. What is true for a family is true for the government also.

In short, the accepted wisdom is that a government should have a revenue surplus (and not revenue deficit); it may have an overall balanced budget or deficit budget. That is a separate question to be considered as given below.

Methods to Plug Revenue Deficit

The government may attempt to plug revenue deficit. for this purpose, it may have to:

- increase its current receipts and /or
- reduce its current expenditure

But the government comes again serious fraud block on either of these two fronts. The major source of current receipt of a government are taxes. But taxation as an instrument of resource mobilization suffers from serious limitations. Taxation beyond the limit may adversely affect people's capacity and willingness to work and save. Therefore, no government can report to raise tax rates on the taxable capacity of the people.

Similarly, a government can make serious items to cut down its current expenditure. But many items of the current expenditure are in the form of committed expenditure. These have to be incurred and cannot be cut down. If these are cut down they may adversely affect either the security of the nation on authority of the government or the welfare of the people.

Given these limitations, government may have to leave with revenue deficit, although it is presented by everyone.

B. Budgetary Deficit

Budgetary deficit will be obtained when the overall expenditure of the government, i.e., the sum total of revenue expenditure and capital expenditure exceeds the overall receipts, i.e., the sum total of revenue receipts and capital receipts. If total receipts equal total expenditure, it will be called a balanced budget. Budgetary deficit will be zero.

Budgetary deficit = Total expenditure – Total receipts.

= (Revenue expenditure + Capital expenditure) – (Revenue receipts + Capital receipts)

For example, in a recent Union Budget we have:

Financial statement	(₹ in crore)
A. Revenue receipt	6,02,935
B. Capital receipt	1,47,949
Total receipts = (A + B)	7,50,884
C. Revenue expenditure	6,58,119
D. Capital expenditure	92,765
Total expenditure = (C + D)	7,50,884

It would be seen that in the given Union Budget, overall expenditure is equal to overall receipt. It is a balanced budget in this sense.

But in case the overall expenditure were to be more than the overall receipts, the difference between the overall expenditure and the overall receipt constitutes budgetary deficit.

A budgetary deficit is always financed by printing new currency.

In a developing economy, it is always necessary to print new currency. New currency is required to meet increasing transaction in goods and services arising out of increased production of goods and services.

But if new currency is printed in a greater proportion than the proportion in which supply of goods and services has increased, there would be more money available in the economy than what is required. There would be too much money chasing too little goods. This would prove inflationary. An unchecked inflation can have serious adverse effect on the growth process in an economy. It can adversely affect both savings and investment, which are fountain head of capital formation.

Thus, no government can go for uncontrolled printing of new currency to meet its financial needs.

C. Fiscal Deficit

Fiscal deficit is calculated as follows:

Financial statement	(₹ in crore)
A. Revenue expenditure	6,58,119
B. Capital expenditure	92,765
C. Revenue receipts	602,935
D. Recoveries of loans by the government	4,497
E. Non-debt creating capital receipts	10,165
Fiscal deficit = (A + B) – (C + D + E)	1,33,287

In other words,

The fiscal deficit equals a sum of total of revenue expenditure and capital expenditure minus the sum total of the revenue receipts and the recovery of loan by government and the non-debt creating capital receipts.

Fiscal deficit = Total expenditure – Total receipts (Except borrowings)

= Total expenditure – (Revenue receipts + Non-debt creating capitalreceipts)

Gross Fiscal Deficit and Net Fiscal Deficit

Fiscal deficit as defined above is known as gross fiscal deficit. The net fiscal deficit is the difference between gross fiscal deficit and net lending by the government (net lending equals to gross loans extended by the government minus recoveries of loans).

The difference can be illustrated as :

Financial statement	(₹ in crore)
A. Gross fiscal deficit	1,33,287
B. Gross loans extended by the government	1,614
C. Recoveries of loans	4,497
Fiscal deficit = (A + B) – (C + D + E)	1,27,176

Significance of Fiscal Deficit

Fiscal deficit is the barometer of the financial health of the government.

A small amount of fiscal deficit is considered good for economic growth, especially if it is financed by printing of new currency.

Fiscal deficit implies that the injections by the government are more than the leakage from the circular flow of income. If an economy is in a position to absorb additional money, it would stimulate aggregate demand. As the result, level of employment and income will increase.

But a large amount of fiscal deficit proves counter-productive and acts as a check on growth. A large part of it is to be financed by borrowing. Some of the adverse effects may be briefly stated as follows:

(i) Rise in rate of interest and adverse effects on private investment: When government borrows large amount of money from the market, rates of interest go up in consequence private investments suffers.

(ii) Increase in public debt with increase in borrowings: The burden of public debt keep on increasing. Interest payments keep increasing at compound rates. As a result, government's ability to undertake development activities seriously suffers.

(iii) Inflationary pressures: High fiscal deficits cause inflationary pressures. Once inflation set in, non development expenditure of the government begins to grow fast.

In view of this consideration, it is important to keep fiscal deficit under check.

22.9 LET US SUM UP

Public finance is a study of the financial aspects of the government. It is similar to private finance in as much as both of these have broadly the same objectives, i.e., satisfaction of human wants. But on many points, public finance and private finance differ from each other. Public revenue consists of money receipt of the government. These receipts are general divided into two groups, viz., (i) current receipts (or revenue receipt), and (ii) capital receipts. Among the revenue receipts tax is constituted the most important sources of public revenue Non-tax revenue is collected from varied sources. Taxes are of different kind these can be classified as (i) direct and indirect tax, (ii) progressive, proportional, regressive and digressive taxes. Each kind of tax has its own merits and demerits. Public expenditure refers to the expenses incurred by government in the course of performing its various duties.Public expenditure is variously classified as (i) revenue expenditure and capital expenditure, (ii) developmental expenditure and non-development expenditure. Expenditure by the government has been regularly increasing in all the countries throughout the world. it is indicative of the fact that the governments have been assuming more and more responsibilities their sphere of activities has been expanding. The government borrow money from different sources to meet

their budgetary needs. Like a government, and individual also borrows to meet his/her financial need however there are some fundamental differences between public debt and private debt. The government can borrow from different sources both internal and external. Borrowing from domestic sources results in internal debt,while borrowing from external sources results in external debt. You will learn these of federalization in this Unit.

22.10 KEY WORDS

Fiscal policy is defined as the policy under which a government uses the instruments of taxation, public expenditure and public borrowing to achieve various objectives of economic policy

Current receipts (also called revenue received) are those sources of inflows of money which do not create any liability of repayment on the government.

Tax is a compulsory contribution levied on the wealth of an individual by the government of a country without reference to any benefit.

Direct tax is a tax which is expected to be paid out of the income or wealth of the same person on whom it has been imposed.

Indirect tax is a tax whose burden can be shifted to another person. The person who is made responsible to pay the tax is expected to charge the amount of tax from another person.

Regressive tax is one in which the rate of taxation decreases as the taxpayer's income increases.

Public expenditure refers to the expenses of the public authorities—Central Government, State Government and Local Government—either in protecting the citizens or in promoting the economic social welfare.

Revenue budget contains the details of revenue expenditure and revenue receipts of the government. These are in the nature of current expenditure and current income of the government.

Capital budget is a statement of capital receipts and capital expenditure of the government.

22.11 TERMINAL QUESTIONS

1. Discuss the important sources of revenue receipts and capital receipts of the government of India.
2. Distinguish between direct and indirect taxes.Which of these are more important in India's tax structure.
3. What do you mean by public expenditure?Describe its constituents?
4. Describe the important heads of expenditure of the Government of India.
5. Examine the reasons responsible for rapid growth of public expenditure in recent years.
6. Explain the importance of public expenditure in an economy. Is increasing public expenditure a necessary good or evil?
7. Identify the different sources of public borrowings.