MANAGERIAL ECONOMICS

Fiscal Policy

Topic 8

ITM BUSINESS SCHOOL
PGDM 2021 - 2023 SEM I
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Fiscal Policy and Objectives

The word fisc means 'state treasury' and fiscal policy refers to policy concerning the use of 'state treasury' or government finances to achieve the macroeconomics goals.

Government's programme of taxation, expenditure and other financial operations to achieve certain national goals

Fiscal Policy: Receipts and Expenditures of the Government

- Fiscal policy is all about **government expenditure, its composition and its financing.** There are several ways through which a government can raise money.
- It **imposes various taxes.**
- It also has **access to non-tax revenues**.
- It can also raise **non-debt receipts through public sector disinvestments**. Besides, the **government also borrows.**
- The **total government expenditure reflects what it collects from these different sources**.
- **Fiscal policy influences aggregate demand** for goods and services in an economy in several ways. **Government expenditure (G), we know, is a component of aggregate demand.** Any **change in government expenditure will, therefore, directly impact demand.**

Fiscal Policy: Receipts and Expenditures of the Government

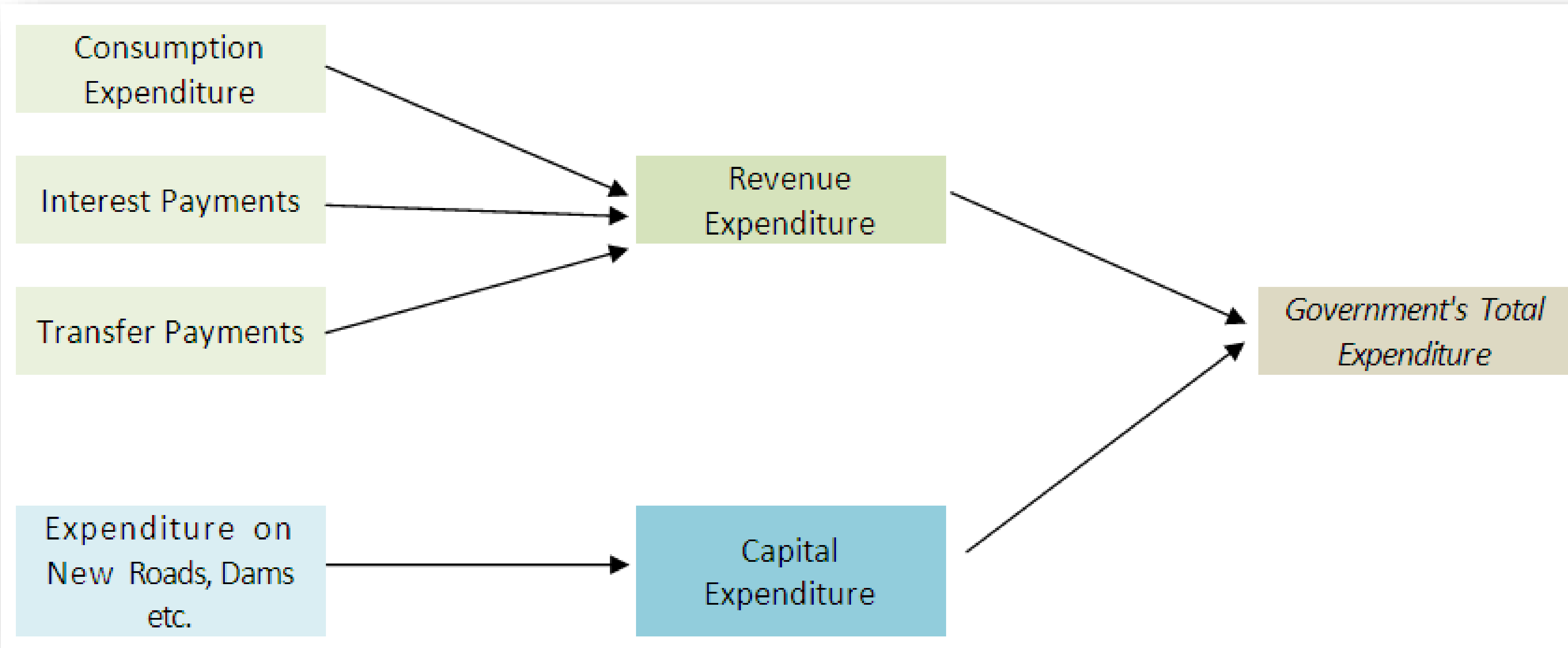
- However, when **government expenditure is financed through borrowings, it adds to government debt.** Debt-financed government expenditure has much wider implication for business, **as it impacts not only government spending but also overall private sector spending on goods and services, both at present and in the future.**
- This, in fact, is the most **important component of fiscal policy that needs to be monitored by managers**.
- Finally, a **change in the tax rates can change the disposable income with individuals and companies.** This can influence **total spending on consumption and investment goods and services in the economy.**

Expenditures of the Government

Government expenditure is divided into two parts:

a) Revenue expenditure (current expenditure), and

b) Capital expenditure.



Expenditures of the Government

Revenue expenditure can be classified under three broad categories:

1) Government Spending on Consumption Goods and Services

- The first category of revenue expenditure refers to government spending on consumption goods and services. This includes payments for the purchase of goals by the government, which are in the nature of consumables and are used up in the process of providing a good or service, for example, stationary, medicines for the hospitals run by the government, uniforms, furniture etc.
- Consumption expenditure, besides goods, also includes payments for consumption of seniors provided by the government servants belonging to police, defense, and other government ministries and so on.
- In other words, this category of revenue expenditure can he equated with Government consumption in our GDP.

Expenditures of the Government

Revenue expenditure can be classified under three broad categories:

2) Transfer Payments

- Another category of revenue expenditure consists of what are known as "transfer payments." These expenditures are so called because they are not payments in lieu of any current production of goods or service by the receiver (and, therefore, do not add to GDP). They are just transferred from one section of the society (tax-payers) to another section (which needs it) without adding to production of any goods and services in the economy. Examples will be payments towards food and fertilizer subsidy, unemployment benefit, pension etc. These are not paid against any exchange of goods and services.

3) Interest on National Debt

- A third category of revenue expenditure is interest on national debt. This is also a transfer payment but is treated as a separate category. Interest payments on national debt are transfer payments in the sense that they are payments for money borrowed over a period of time for various reasons, including war or slowdowns, and are not payments for any current goods or services produced. They deserve a special category as the size of the interest outgo reflects the size of the national debt.

Expenditures of the Government

Government expenditure, as reported, is classified in different ways:

Development and Non-developmental

- By departments; i.e., development and non-developmental expenditure under various departments of the government. Thus, components of revenue and capital expenditure will find a place in both development and non-development expenditure;

Plan and Non-plan Expenditure

- By plan and non-plan expenditure representing new and existing works under India's five-year plans. Here also, both plan and non-plan expenditure will have elements of revenue and capital expenditures; and,

Revenue and Capital Expenditure

- By revenue and capital expenditure, irrespective of development/non-development or plan/non-plan. In the discussion of India's fiscal policy in this chapter, we will follow the classification given in above, i.e., revenue and capital expenditure'.

Expenditures of the Government

- Capital expenditure is government's spending on new roads, new buildings and structures, new machines and equipments and other such durable assets, which result in further production of goods and services over an extended period of time.
- Capital expenditure adds to growth while revenue expenditure, once incurred, is gone and, at best, can have a short-term impact on the economy.

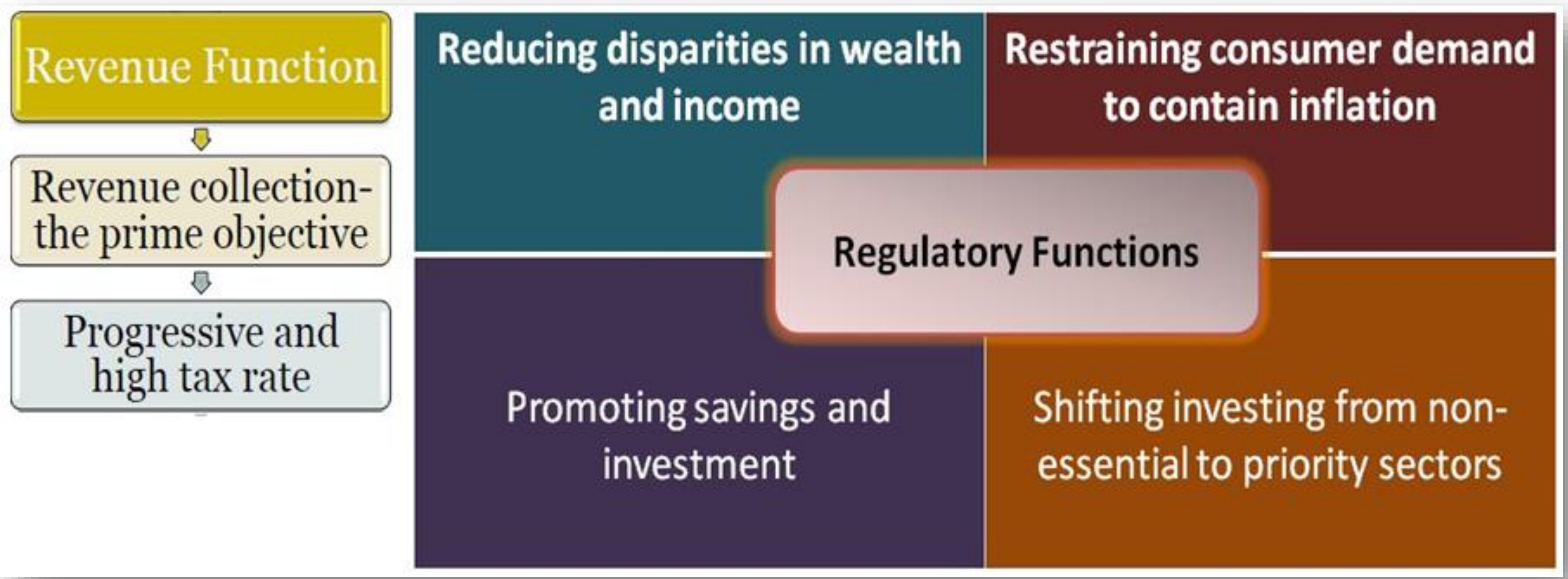
- It should be noted, however, that certain items of expenditure like spending on education, which Is essentially spending on human capital, is treated as revenue expenditure, excluding the school building which is considered as capital expenditure. Similarly, expenditure on R&D is treated as revenue expenditure rather than capital expenditure.

- Revenue expenditure may, therefore, be somewhat overstated and capital expenditure understated.

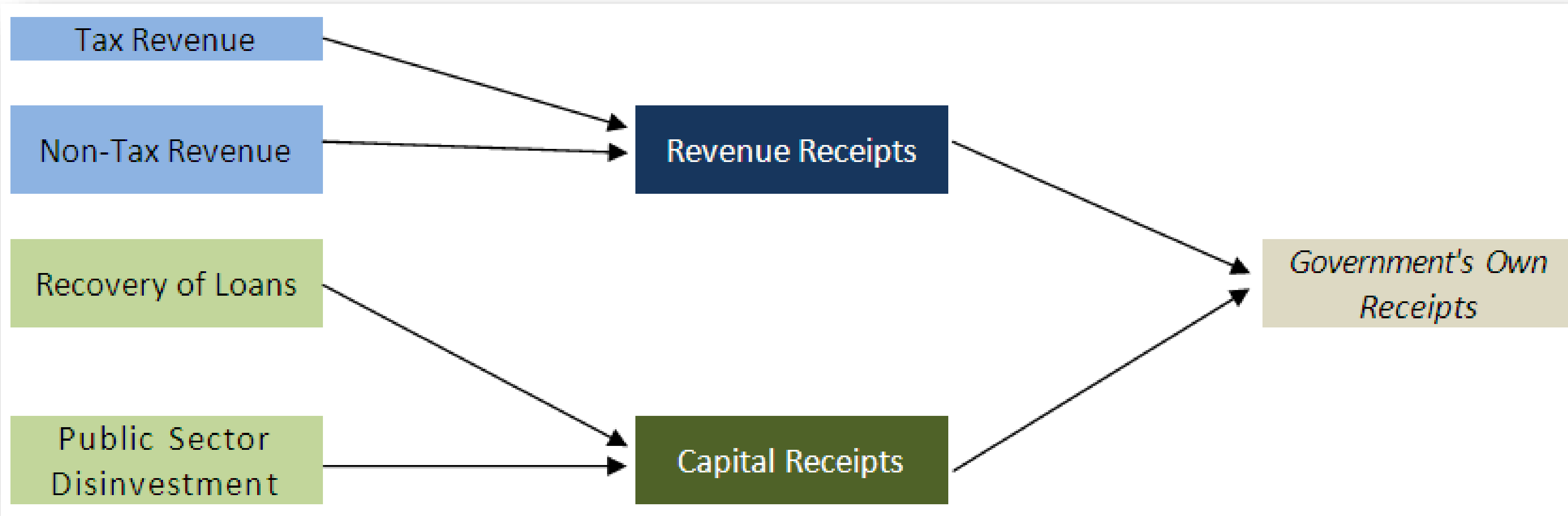
India’s Taxation Policy-Functions

India’s taxation policy has been designed to perform two basic functions;

1. Revenue Function
2. Regulatory Functions



India's Taxation Policy-Functions

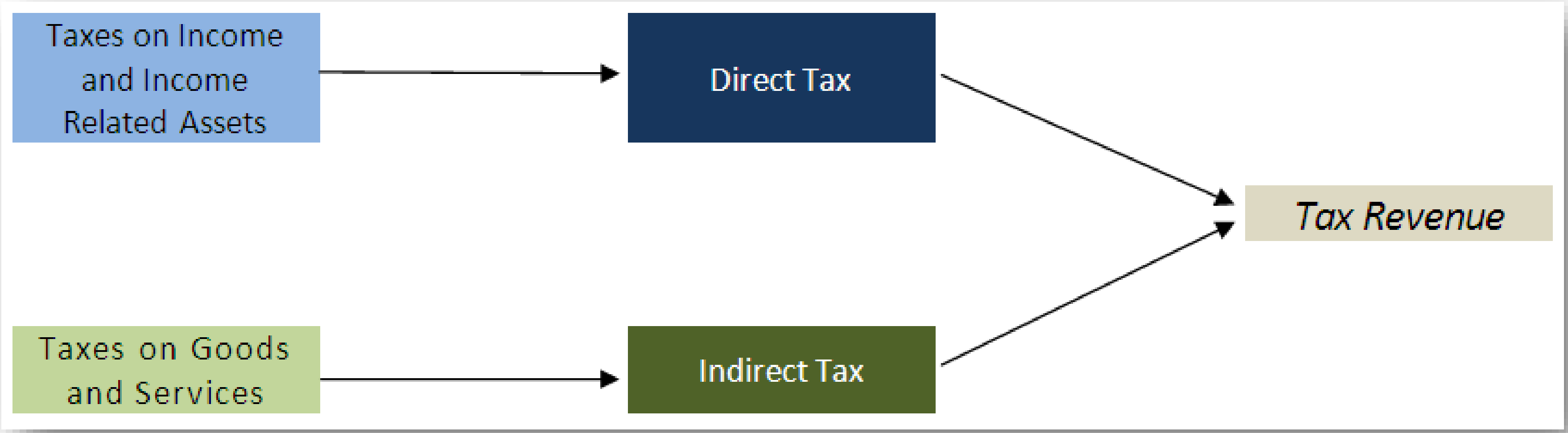


- Taxes are an important source of revenue for the government. In addition to taxes, government collects what are known as non-tax revenues.
- For the central government, these reflect interest and dividend received from its various investments, primarily, in public sector undertakings, fees etc.

India’s Taxation Policy-Functions

- For the state governments, besides the above, a major part of non-tax revenue comes from lotteries and user charges.
- Tax revenue plus non-tax revenue constitute the revenue receipts or the current income of the government.
- In both central government and state government's own' total revenue receipts, non-tax revenue accounts for roughly one-fourth of the revenues. Additionally, governments receive money through recovery of loans and public sector disinvestments. These are part of capital receipts.
- Thus, tax revenue, non-tax revenue (revenue receipts) plus recovery of loans and receipts from public sector disinvestments (capital receipts), constitute the government's own money.
- The balance of receipts is what the government borrows.

India's Taxation Policy-Functions



Taxes are of two types: direct and indirect.

- Direct taxes are levied on income or income-related assets. Thus, personal income tax, corporate income tax, wealth tax, capital gains tax etc., are all examples of direct tax. In India, most of the direct tax collection originates at the central government level. States have very little of their own direct tax revenues; however, they receive a share of centre's direct tax revenue. One characteristic of direct taxes is that they are progressive in nature, in the sense that as we move from one income bracket to the next, the incidence of tax on our income increases.

Receipts of the Government

Rupees Crore)

CENTRAL GOVERNMENT RECEIPTS - MAJOR COMPONENTS

Year	Tax revenue	Direct tax	Personal income tax	Corporation tax	Indirect tax	Excise duties	Customs duties	Non-tax revenue	Interest receipts	Revenue receipts	Capital receipts	Total receipts
2019-20	1649582	848574	358253	490313	801008	255877	97660	313179	13711	1962761	848450	2735290
2018-19	1484406	762886	333324	429555	721520	221882	82774	245276	12047	1729682	763518	2416034
2017-18	1242488	606216	258461	347712	636272	211393	78601	192745	13574	1435233		2137883
2016-17	1101372	521287	225214	295960	580085	286088	135372	272831	16229	1374203	609886	1984089
2015-16	943765	449296	172748	275917	494469	220473	128829	251260	25378	1195025	582579	1777604
2014-15	903615	500531	188336	311453	403085	153709	127994	197766	23734	1101381	484448	1585829
2013-14	815854	455829	169408	285742	360025	137975	121059	198870	21868	1014724	563894	1578618
2012-13	741877	396585	140438	255570	345292	141245	115890	137354	20761	879232	582152	1461383
2011-12	629764	343310	118224	227411	286454	116226	105614	121672	20252	751437	568918	1320355
2010-11	569868	313501	102441	209115	256367	110222	97598	218602	19734	788471	402428	1190899
2009-10	456536	271623	94532	176797	184913	84383	60223	116275	21784	572811	453063	1025874
2008-09	443319	248152	86985	160797	195169	81872	69217	96940	20717	540259	299863	840122
2007-08	439547	231574	86563	144660	207972	96178	75382	102317	21060	541864	197978	739842
2006-07	351182	169738	62707	106701	181444	92651	62819	83205	22524	434387	144482	578869

Receipts of the Government

(Rupees Crore)

CENTRE'S GROSS FISCAL DEFICIT AND ITS FINANCING

Year	GFD receipts	GFD expenditure	Gross fiscal deficit	Financing of GFD - External finance	Financing of GFD - Market borrowings	Financing of GFD - Other borrowings	Financing of GFD - Draw down of cash balances	Financing of GFD - Total Internal finance
2020-21	2230926	3027263	796337	4622	544870	299849	-53003	791715
2019-20	1915100	2681948	766846	4933	473972	287941	0	761913
2018-19	1647642	2297060	649418	5519	422735	222485	-1321	643899
2017-18	1535278	2126340	591062	7931	450728	128312	4091	583131
2016-17	1421946	1957564	535618	17997	338149	188368	-8895	517622
2015-16	1237157	1769948	532791	12748	414931	91942	13170	520043
2014-15	1139209	1649935	510725	12933	457617	-37485	77752	497884
2013-14	1044092	1546950	502858	7292	475626	39111	-19171	495566
2012-13	905122	1395312	490190	7201	507445	26556	-51012	482989
2011-12	769525	1285515	515990	12448	484111	35421	-15990	503542
2010-11	811317	1184908	373591	23556	326399	17206	6430	350035
2009-10	597392	1015874	418482	11038	394371	14460	-1386	407444

Receipts of the Government

(Rupees Crore) KEY DEFICIT INDICATORS OF THE CENTRAL GOVERNMENT

Year	Gross fiscal deficit	Net fiscal deficit	Gross primary deficit	Net primary deficit	Revenue deficit	Primary revenue deficit	Financing of GFD - Draw down of cash balances	Net RBI credit
2020-21	796337	779541	88134	82380	609219	-98984	-53003	
2019-20	766846	756120	141741	142042	499544	-125561	0	190241
2018-19	649418	639249	66770	68746	454483	-128165	-1321	325987
2017-18	591062	588668	62110	73290	443600	-85352	4091	-144847
2016-17	535618	516438	54904	51953	316381	-164333	-8895	195816
2015-16	532791	527289	91132	111008	342736	-98923	13170	60472
2014-15	510725	495245	108281	116605	365519	-36925	77752	-334185
2013-14	502858	496157	128604	143771	357048	-17206	-19171	108130
2012-13	490190	484450	177020	192041	364282	51112	-51012	54840
2011-12	515990	514103	242840	261205	394348	121198	-15990	139183
2010-11	373591	361026	139569	146738	252252	18230	6430	184969
2009-10	418482	411448	205389	220139	338998	125905	-1386	150006

Receipts of the Government

(Rupees Crore)

MAJOR HEADS OF CAPITAL RECEIPTS OF THE CENTRAL GOVERNMENT

Year	Market borrowings (net)	Small savings	Provident funds	Special deposits	Recovery of loans	Disinvestment receipts	External loans (net)	Total Capital Receipts
2020-21	544870	240000	18000		14967	210000	4622	1074306
2019-20	473972	240000	18000		16604	65000	4933	848450
2018-19	422735	125000	16059		18052	94727	5519	763518
2016-17	338149	67435	17745		17630	47743	17997	609886
2015-16	414931	52465	11858		20835	42132	12748	582579
2014-15	457617	32226	11920		13738	37737	12933	484448
2013-14	475626	12357	9753		12497	29368	7292	563894
2012-13	507445	8626	10920		15060	25890	7201	582152
2011-12	484111	-10302	10804		18850	18088	12448	568918
2010-11	326399	11233	12514		12420	22846	23556	402428
2009-10	394371	13256	16056		8613	24581	11038	453063

Receipts of the Government

MAJOR HEADS OF DEVELOPMENTAL AND NON-DEVELOPMENTAL EXPENDITURE OF THE CENTRAL GOVERNMENT

(Rupees Crore)

Year	Developmental expenditure	Economic services	Social services	Non-developmental expenditure	Total Development and Non-development Expenditure
2019-20	1341300	904780	150500	1445049	**2786349**
2018-19	1188215	783026	129828	1269021	**2457236**
2017-18	998201	623730	113382	1143772	**2141973**
2016-17	899369	569910	105303	1075825	**1975194**
2015-16	835019	495234	91462	990172	**1825191**
2014-15	813813	459786	62038	881159	**1694972**
2013-14	784504	478376	134840	803070	**1587574**
2012-13	742417	458222	119346	692856	**1435273**
2011-12	705321	436943	113612	627075	**1332396**
2010-11	666069	404312	124990	551471	**1217540**
2009-10	528242	304440	102628	514101	**1042343**

Receipts of the Government

46. Combined Receipts and Disbursements of the Central and State Governments						
						Date : Oct 12, 2020
						(₹ Crore)
Item	2015-16	2016-17	2017-18	2018-19	2019-20 RE	2020-21 BE
	1	2	3	4	5	6
1 Total Disbursements	3760611	4265969	4515946	4592774	5384046	5891729
1.1 Developmental	2201287	2537905	2635110	2561817	3136568	3399617
1.1.1 Revenue	1668250	1878417	2029044	1969188	2429965	2600308
1.1.2 Capital	412069	501213	519356	536064	631770	701186
1.1.3 Loans	120968	158275	86710	56564	74832	98122
1.2 Non-Developmental	1510810	1672646	1812455	1961322	2163599	2405700
1.2.1 Revenue	1379727	1555239	1741432	1851432	2049076	2283365
1.2.1.1 Interest Payments	648091	724448	814757	857042	931418	1043241
1.2.2 Capital	127306	115775	69370	108929	113301	120954
1.2.3 Loans	3777	1632	1654	960	1222	1381
1.3 Others	48514	55417	68381	69635	83878	86413
2 Total Receipts	3778049	4288432	4528422	4575665	5286292	5953495
2.1 Revenue Receipts	2748374	3132201	3376416	3422206	3938252	4364500
2.1.1 Tax Receipts	2297101	2622145	2978134	3009930	3282501	3670364
2.1.1.1 Taxes on commodities and services	1440952	1652377	1853859	1844705	1970009	2232599
2.1.1.2 Taxes on Income and Property	852271	965622	1121189	1162411	1308313	1433265
2.1.1.3 Taxes of Union Territories (Without Legislature)	3878	4146	3086	2814	4180	4500
2.1.2 Non-Tax Receipts	451272	510056	398282	412276	655751	694136
2.1.2.1 Interest Receipts	35779	33220	34224	35055	32612	30156
2.2 Non-debt Capital Receipts	59827	69063	142433	138195	124128	230396
2.2.1 Recovery of Loans & Advances	16561	20942	42213	42587	57120	16526
2.2.2 Disinvestment proceeds	43266	48122	100219	95608	67008	213870
3 Gross Fiscal Deficit [1 - (2.1 + 2.2)]	952410	1064704	997097	1032373	1321665	1296834

Receipts of the Government

46. Combined Receipts and Disbursements of the Central and State Governments

Date : Oct 12, 2020

(₹ Crore)

Item	2015-16	2016-17	2017-18	2018-19	2019-20 RE	2020-21 BE
	1	2	3	4	5	6
3A Sources of Financing: Institution-wise						
3A.1 Domestic Financing	939662	1046708	989167	1026854	1316732	1292212
3A.1.1 Net Bank Credit to Government	231090	617123	144792	387091	518093	-----
3A.1.1.1 Net RBI Credit to Government	60472	195816	-144847	325987	190241	-----
3A.1.2 Non-Bank Credit to Government	708572	429585	844375	639763	798639	-----
3A.2 External Financing	12748	17997	7931	5519	4933	4622
3B Sources of Financing: Instrument-wise						
3B.1 Domestic Financing	939662	1046708	989167	1026854	1316732	1292212
3B.1.1 Market Borrowings (net)	673298	689821	794856	750757	904031	1016941
3B.1.2 Small Savings (net)	-78515	-105038	-163222	-198597	-311548	-286577
3B.1.3 State Provident Funds (net)	35261	45688	42351	40944	35814	37517
3B.1.4 Reserve Funds	-3322	-6436	18423	-18298	-241	2978
3B.1.5 Deposits and Advances	13470	17792	25138	66289	32949	35987
3B.1.6 Cash Balances	-17438	-22463	-12476	17108	97754	-61765
3B.1.7 Others	316908	427343	284095	368651	557975	547131
3B.2 External Financing	12748	17997	7931	5519	4933	4622
4 Total Disbursements as per cent of GDP	27.3	27.7	26.4	24.2	26.5	26.2
5 Total Receipts as per cent of GDP	27.4	27.9	26.5	24.1	26.0	26.5
6 Revenue Receipts as per cent of GDP	20.0	20.3	19.7	18.0	19.4	19.4
7 Tax Receipts as per cent of GDP	16.7	17.0	17.4	15.9	16.1	16.3
8 Gross Fiscal Deficit as per cent of GDP	6.9	6.9	5.8	5.4	6.5	5.8

…: Not available. RE: Revised Estimates; BE: Budget Estimates

Source : Budget Documents of Central and State Governments.

Note : GDP data is based on 2011-12 base. GDP data from 2019-20 pertains to the Provisional Estimates of National Income released by Central Statistics Office on 29th May 2020. GDP for 2020-21 is from Union Budget 2020-21.

Data upto 2017-18 pertains to all States and Union Territories. From 2018-19 onwards, data is provisional and pertains to 25 States only.

Total receipts and total expenditure exclude National Calamity Contingency Fund expenditure.

1 & 2: Data are net of repayments of the Central Government (including repayments to the NSSF) and State Governments.

1.3: Represents compensation and assignments by States to local bodies and Panchayati Raj institutions.

2: Data are net of variation in cash balances of the Central and State Governments and includes borrowing receipts of the Central and State Governments.

3A.1.1: Data as per RBI records.

3B.1.1: Includes borrowings through dated securities.

3B.1.2: Represent net investment in Central and State Governments' special securities by the National Small Savings Fund (NSSF).

3B.1.6: Include Ways and Means Advances by the Centre to the State Governments.

3B.1.7: Include Treasury Bills, loans from financial institutions, insurance and pension funds, remittances, cash balance investment account.

Receipts of the Government

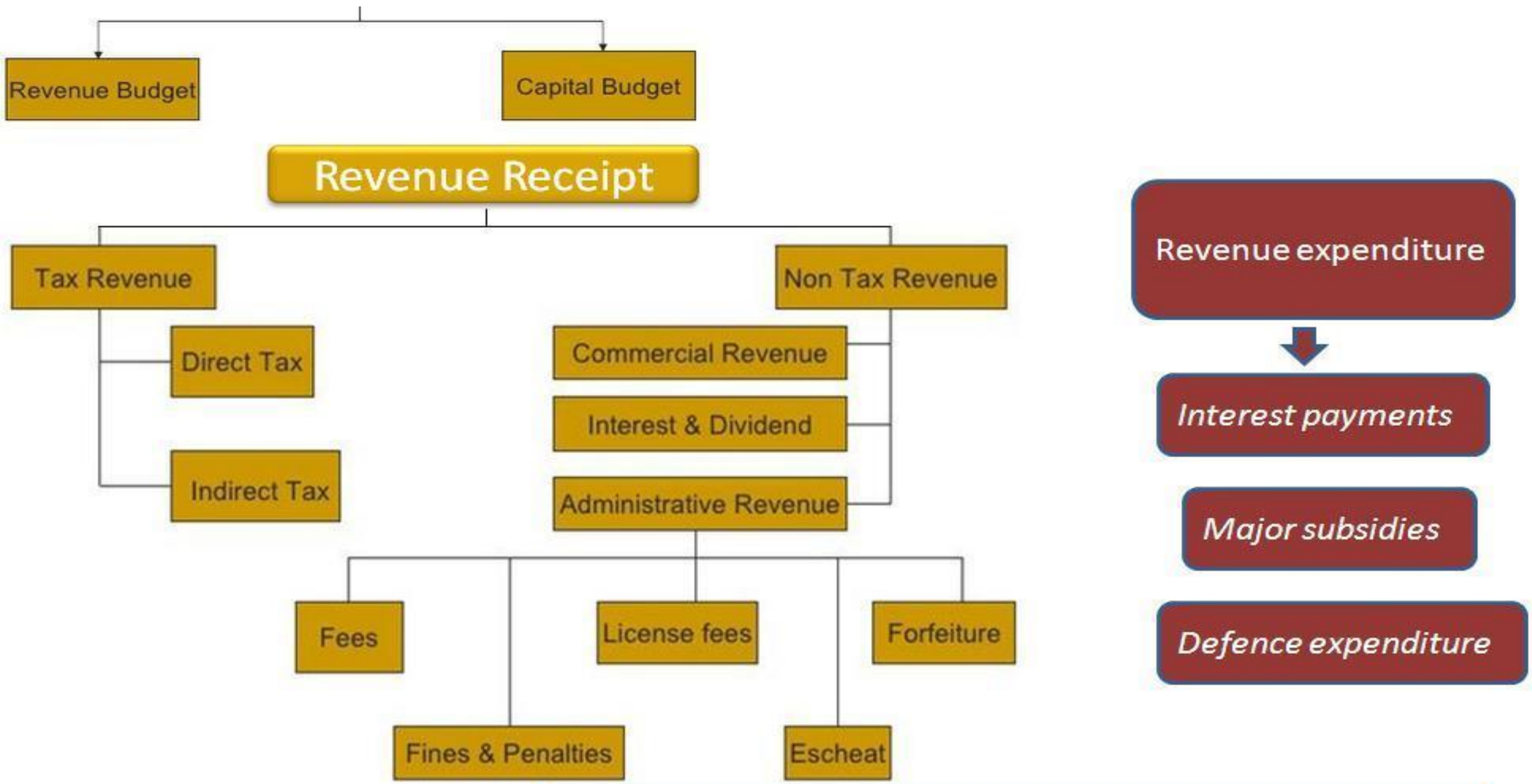
- For example, Income up to Rs 2,50,000, we pay 0% tax; Income from Rs 2,50,000 – Rs 5,00,000, we pay 5% tax; Income from Rs 5,00,000 – 10,00,000 we pay 20% tax and, above Rs 10,00,000, we pay 30% tax. In other words, as the marginal tax rate, i.e., the proportion of additional income, which must be paid in taxes, goes up from 10 to 20 to 30 per cent with each tax bracket, the average tax, i.e., the proportion of our total income, which has to be paid in the form of taxes also goes up. This implies that as GDP increases, direct taxes being progressive, their share should increase faster than the rate of growth of GDP.
- Another characteristic of direct taxes is that they affect both aggregate demand and aggregate supply. A change in the tax rates will certainly affect aggregate demand. But this will be the case only up to a point.
- If the tax rates are very high, this may lead not only to non-compliance but can also adversely affect incentive to produce and, thereby, stall aggregate supply growth.
- Most governments try to strike a balance between demand and supply sides of direct taxes.

Receipts of the Government

- Indirect taxes are levied on goods and services produced. Important items of indirect taxes for the central government are custom and excise duties.
- For the state governments, these are sales tax, state excise duties, motor vehicle tax, and stamp duty. Indirect taxes are regressive.
- As the incomes rise, the incidence of tax on income goes down. Assume a person's monthly income to be Rs. 1000. Given this income, he will probably spend the entire amount in buying goods and services. The incidence of indirect tax will thus be on 100 per cent of his income.
- Now assume his monthly Income is Rs. 1, 00,000, of which he needs Rs. 10,000 to meet his monthly purchases of goods and services. Thus the incidence of indirect tax, when his income rises to Rs. 1, 00,000, comes down to only on 10 per cent of his income. This implies that as incomes (GDP) rise, the ratio of direct to indirect taxes should move in favour of direct taxes, since direct taxes are progressive and indirect taxes are regressive.

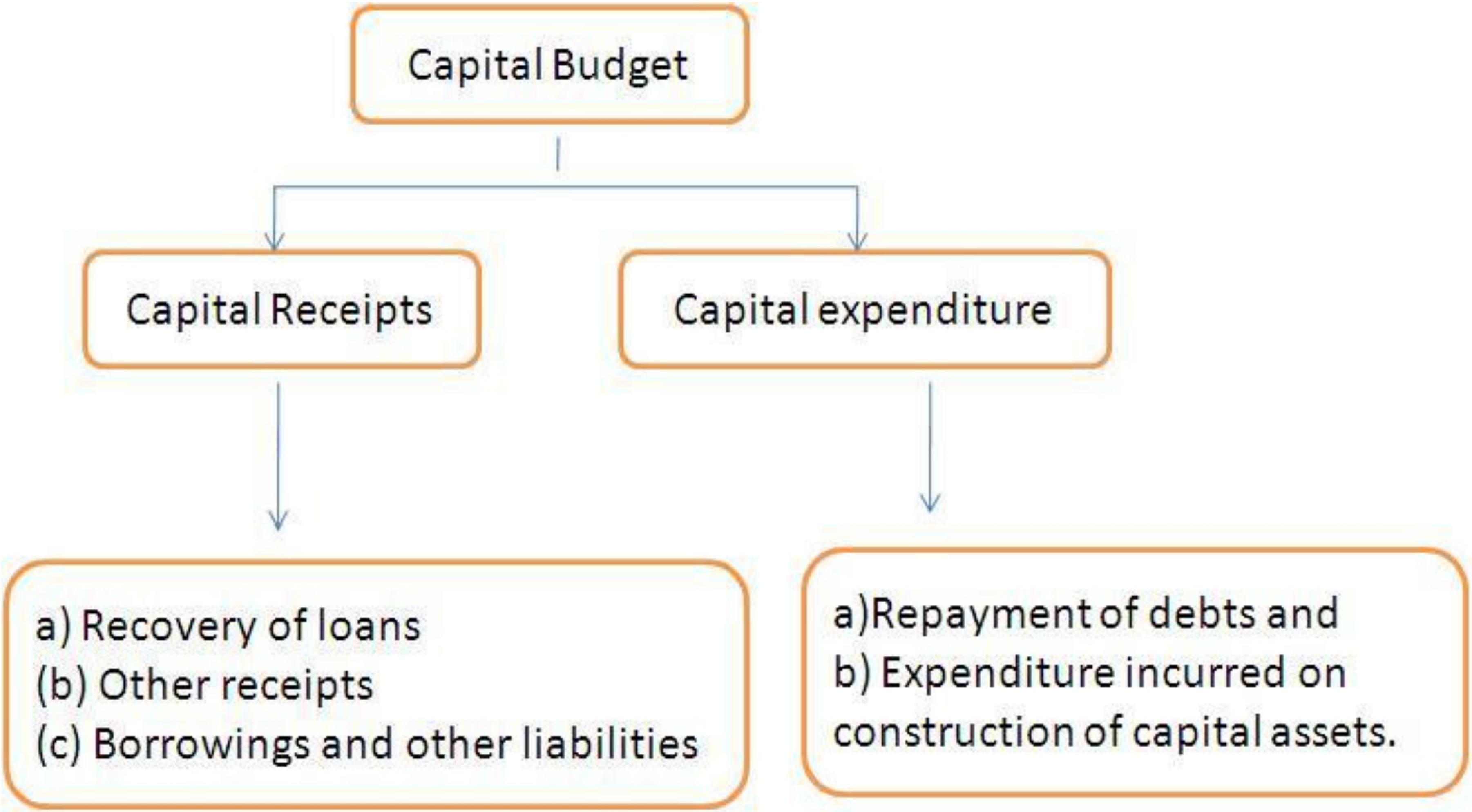
Receipts and Expenditures of the Central Government

Revenue Budget consist of revenue receipt and the expenditure met from such revenues.

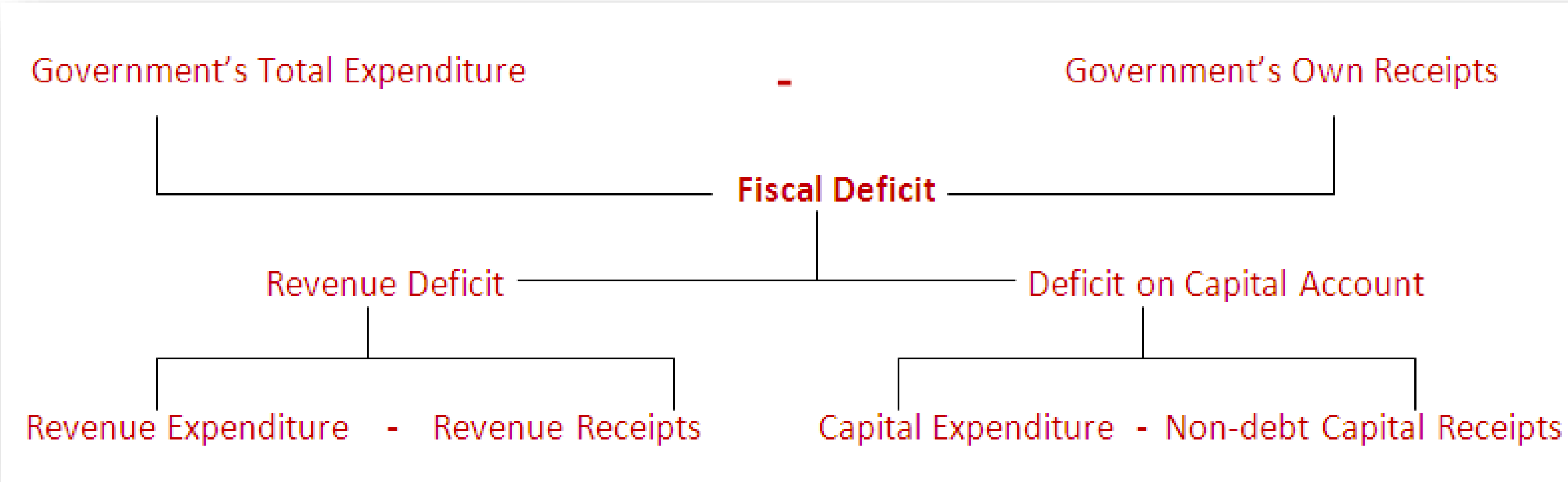


Revenue deficit = Revenue expenditure - Revenue receipts

Receipts and Expenditures of the Central Government



Government Debt



- Government deficit, henceforth called fiscal deficit, to be consistent with India's budgetary language, arises because total government expenditure exceeds government's own receipts.
- It is therefore the difference between what the government gets by way of tax and non-tax revenue, recovery of loans and receipts from the public sector disinvestments (total receipts) and what it spends annually (total expenditure). Fiscal deficit is an annual figure. This is financed through borrowing.
- Fiscal deficit can be incurred either on revenue account, called the revenue deficit or on capital account.

Government Debt

Revenue deficit arises when the revenue expenditure of the government exceeds the revenue receipts. In other words, the government is unable to meet its day-to-day expenditure (government's 'C' + transfer payments + interest payments) out of its current Income. The government is living beyond its means and is borrowing to finance the gap. Fiscal deficit on capital account, on the other hand, is due to government's ‘I’.

In other words, the government borrows money to invest for creation of assets, which lead to further production of goods and services in the economy.

Fiscal deficit is financed through two sources:

a) Domestic sources and,

b) External sources.

Government Debt

Domestic sources

- Central government's domestic sources include market borrowings (government floats a bond, for example) and other liabilities comprising of small savings, provident funds etc. State government's domestic sources include loans from the central government, market borrowings and state provident funds and small savings.

External sources

- External sources can be bilateral (from another country), multilateral (from international organizations like the World Bank or the Asian Development Bank) or foreign private banks. State government: access external sources of financing only through the central government. Both central and state governments can borrow, also, from the central bank i.e., the Reserve Bank of India (RBI), though the mode of borrowing from the central bank has undergone a change through time.

Government Debt

- When the deficit is being financed from borrowing from RBI, it is called monetized deficit, so called because it results in an increase in money supply. Monetized deficit is a part of fiscal deficit but is not reported separately because it is treated as a part of market borrowing where RBI, also, is a player.
- Today, in India, government borrowings from either external sources or RBI are insignificant. Most of the borrowing is from the domestic market (80 per cent or more) and other liabilities.
- When fiscal deficit, that is, the money borrowed to pay off the annual deficits, is accumulated over the years, we get a stock of debt that the government owes to the various entities from whom it has borrowed to finance each year's deficit. That accumulated debt is called government debt or, public debt or, national debt. Debt is a stock and deficit is a flow.

Government Debt

Primary deficit = fiscal deficit - interest payments.

- The idea is as follows: governments borrow money every year, which leads to an accumulation of debt on which interest has to be paid. If we want to find out to what extent the present government is living within its means we should not hold it responsible for the interest outgo, which is arising out of borrowings of previous governments for expenditures incurred in the past. It is not due to any current fiscal profligacy of the present government. So while fiscal deficit is the difference between government's total expenditure and its total receipts, primary deficit is the difference between the government's current expenditure (where current is defined as total expenditure minus interest payments), minus government's total receipts. Clearly, if there is still a deficit, i.e., primary deficit, and it is positive, this means that the present government is also resorting to borrowing to meet its current expenditure. This has implications for future debt build up in the economy.

Receipts and Expenditures of the Central Government

Budgetary Deficit: This is defined as the **excess of total budgetary expenditure (both on revenue and capital accounts)** over **total budgetary receipts (both on revenue and capital account).**

Gross Fiscal Deficit: This is defined as the **excess of total expenditure** including **loans net of recovery over revenue receipts (including external grants)** and **non-debt capital receipts.** This, in effect, means the **excess of government expenditure** over **government revenue and grants** and thus reflects the total resource gap. This measure has been adopted(by the IMF as the principal policy target in evaluating the performance of countries seeking assistance.

Net fiscal deficit : Gross Fiscal Deficit subtract **net lending** of the Central government

Primary Deficit: **Net fiscal deficit** less **interest payments**.

Fiscal Deficit

A: Revenue Account

1. Revenue Receipts (a + b)

(a) Tax Revenue*

(b) Non-tax Revenue

2. Revenue Expenditure (a + b + c)

(a) Interest Payment

(b) Major Subsidies

(c) Defence Expenditure

3. Revenue Deficit (2 - 1)

B: Capital Account

1. Capital Receipts (a + b + c)

(a) Recovery of Loans

(b) Other Receipts**

(c) Borrowings and other Liabilities

2. Capital Expenditure

C: Total Expenditure (A.2 + B.2)

1. Plan Expenditure

2. Non-Plan Expenditure

D: Fiscal Deficit =[C - A.l - B.l(a) - B.l(b)]

E: Primary Deficit (D - A.2(a))

Fiscal Deficit= Total Expenditure - Revenue Receipts - Recovery of Loans **-** Other Receipts**

**** Consisting mainly of PSU disinvestment**

Case

Govt to miss fiscal deficit target despite getting RBI's money: Reuters

The govt could, toward the end of 2019, be forced to raise the fiscal deficit target to 3.5% of GDP from 3.3%.

Reuters | Updated: Sep 05, 2019, 06.14 AM IST

India is likely to **miss its fiscal deficit target** for the current financial year, **despite receiving an additional dividend from the central bank**, five government officials and advisers said, as **tax collections have sunk amid a sharp slowdown**.

With **economic growth falling to a six-year low of 5% in the April-June quarter,** the sources said the **government could toward the end of 2019 be forced to raise the fiscal deficit target to 3.5% of GDP from 3.3%, amid pressure for additional stimulus measures**.

BCCL

Tax collections could fall by as much as 1 trillion rupees ($14 billion), or 4% of $344 billion annual target.

Govt to miss fiscal deficit target despite getting RBI's money: Reuters

The govt could, toward the end of 2019, be forced to raise the fiscal deficit target to 3.5% of GDP from 3.3%.

Reuters | Updated: Sep 05, 2019, 06.14 AM IST

Tax collections could fall by as much as 1 trillion rupees ($14 billion), or 4% of $344 billion annual target, two of the officials said, noting that **sharp shortfalls are expected both in goods and services tax (GST) and income tax collections.**

"Overshooting the fiscal deficit target is inevitable this year as the economic slowdown has hit government revenue," a senior adviser said, adding the deficit would rise unless the government resorts to hefty spending cuts.

Three Main Stances of Fiscal Policy

NEUTRAL STANCE: This results in large tax revenue Government. Spending is fully funded by Tax revenues and overall budget has a neutral effect on level of economic activity i.e., (G=T).

EXPANSIONARY STANCE: government expenditure is more than taxes receipts

CONTRATIONARY STANCE: Government expenditure is less than the taxes and revenues received.

Government Expenditure Financing

Instruments of Fiscal Policy

- Budgetary surplus and deficit
- Government expenditure
- Taxation- direct and indirect
- Public borrowings(debt)

Funding

The expenditure of government can be funded in different ways :

- Taxation
- Borrowing
- Consumption fiscal reserves
- Sale of fixed assets.

Instruments of Fiscal Policy

Budgetary surplus and deficit: "A budget is a detailed plan of operations for some specific future period to keep budget in balance in surplus or in deficit" An accumulated deficit over several years (or centuries) is referred to as the government debt A deficit is a flow. And a debt is a stock. Debt is essentially an accumulated flow of deficits.

- When the government keeps its total expenditure = to its revenue is means it has adopted a **Balanced-budget policy**.
- When the government decides to spend more than its expected revenue means the government pursuing a **deficit-budget policy**.
- When the government adopts a policy of keeping its expenditure substantially below its current revenue means the following a **surplus-budget policy.**

Instruments of Fiscal Policy

Government Expenditure It includes;

- Government spending on the purchase of goods & services,
- Payment of wages and salaries of government servants,
- Public investment ,
- Infrastructure development,
- Transfer payments (e.g.,pensions,subsidies,unemployment allowances, grants and aid, payments of interest, and amortization of loans)
- ***The government expenditure is an injection into the economy: it adds to the aggregate demand.***

Instruments of Fiscal Policy

Taxation: transfer of private income by means of taxes. Classified into;

1. **Direct taxes**- Corporate tax, Tax, Personal Income Tax, Banking Cash Transaction Tax ,wealth and property tax.
2. **Indirect taxes** - GST, Basic Customs Duty, Central Excise and VAT on petroleum products, State taxes on alcohol for human consumption, Electricity duties, Stamp duty, Securities Transaction Tax, Property taxes and other taxes to municipalities and Toll tax

Instruments of Fiscal Policy

Public borrowings (debt) : to finance government's budget deficits.

Internal borrowings

- Borrowings from the public by means of treasury bills and govt. bonds(it leads to a transfer of purchasing power from the public to the government **(contractionary fiscal policy)**)
- Borrowings from the central bank (it leads to monetized deficit financing **(expansionary fiscal policy)**)

External borrowings

- Foreign government
- Investments international organizations like World Bank & IMF
- Market borrowings

Target Variables

The target variables of fiscal policy,i.e., the variables which are sought to be changed through fiscal instruments are:

I. Private disposable incomes,
II. Private consumption expenditure,
III. Private savings and investment,
IV. Exports and imports, and
V. Level and structure of prices.

The interdependence of target variables--disposable income, consumption expenditure, savings, investment, imports, and price level-can be demonstrated by using the aggregate demand function. The aggregate demand *(AD) is given as:* **AD=C+I+G+X-M**

where, **C =** consumer demand, **I =** investment, **G =** public spending, **M =** imports, and **X =** exports.

In the short run, C = f(Yd), and M = f(Y)

where, Yd = Y - tY = disposable income, Y = gross income, and t = tax rate.

How Fiscal Instruments Affect Target Variables

The government can. change the aggregate demand(AD):

- by changing aggregate consumption expenditure by changing disposable income through direct taxation,

- by changing imports through tariffs,

- by changing investments through tax incentive or disincentive, and

- by changing government expenditure. The aggregate demand can be changed by changing anyone or more of these factors.

The aggregate demand can be changed by changing anyone or more of these factors.

Kinds of Fiscal Policy

1. Automatic Stabilization Fiscal Policy,
2. Compensatory Fiscal Policy, and
3. Discretionary Fiscal Policy.

Automatic Stabilization Policy:

- The automatic fiscal policy means adopting a fiscal system with built-in-flexibility of tax revenue and government spending.
- Built-in-flexibility means automatic adjustment in the government expenditure and tax revenue in response to rise and fall in GDP.
- Tax revenue increases and government expenditure decreases automatically, with an increase in GDP. Tax revenue increases because household income increases with increase in GDP.
- Tax revenue decreases and government expenditure increases automatically, with decrease in GDP and increase in unemployment.

Automatic Stabilization Policy:

Fast Growing Economy

- In a **fast growing economy,** tax collection increases with increase in incomes which constraints aggregate demand. On the other hand, unemployment decreases causing decline in government spending. The increase in tax burden and fall in public expenditure work as restraint on the effective demand-these factors reduce the growth of aggregate demand. This prevents excessive rise in the price level.

Period of Depression

- During the **period of depression**, on the other hand, this policy is supposed to result in reduced taxation due to fall in taxable incomes and increase in government expenditure on unemployment compensation, or unemployment relief payments and unemployment insurance. This kind of taxation system halts decrease in private aggregate demand by way of lower taxation, and adds to the aggregate demand by increasing government expenditure. This prevents the economy going into deep depression.

Compensatory Fiscal Policy

The compensatory fiscal policy is a deliberate budgetary action taken by the government to compensate for the deficiency in, and to reduce the excess of, aggregate demand.
The compensatory action is taken by the government in the form of *surplus budgeting* or *deficit budgeting.*

The policy of deficit budgeting is adopted to fight depression in the economy.

- The compensatory measures may be in the form of tax reduction and enhanced government spending.
- This kind of fiscal measures increases aggregate demand. Increase in aggregate demand leads first to the rise in price level.
- It adds to the producers' profit with a time lag in increase in costs.
- This increase in profits creates an optimistic environment.
- Therefore, both opportunity and incentive to invest increase.
- This is supposed to push up the level of employment and output.

The policy of *surplus budgeting* is adopted by the governments during the period of high rate of inflation, especially when inflation is caused by excessive demand.

- Surplus budgeting is a powerful tool to control the aggregate demand.
- Under this policy, the government keeps its expenditure lower than its revenue.
- If necessary, the government may resort to a higher rate of taxation and cut its expenditure further down.
- Taxation reduces disposable income.
- As a result, the aggregate demand decreases at the rate of tax multiplier.
- On the expenditure side, a cut in the government expenditure reduces the aggregate demand at the rate of expenditure multiplier.
- The two-prong attack on the aggregate demand helps reducing the demand pressure and, thereby, the inflation.

Discretionary Fiscal Policy

A discretionary fiscal policy is one in which ad hoc changes are made in the government expenditure and taxation system and tax rates at the discretion of the government as and when required.
In discretionary fiscal policy, the government makes deliberate changes in
(a) the level and pattern of taxation,
(b) the size and pattern of its expenditure, and
(c) the size and composition of public debt.

Changes in Taxation: The discretionary changes in taxation include such changes in both direct and indirect taxes as:

- increasing or decreasing the tax rates,
- imposition of new taxes or abolition of existing taxes, and
- Imposition of taxes on new tax bases.
- All these kinds of changes in taxation result in either the flow of household incomes to the government or to reduction in such flows.

Discretionary Changes in Government Expenditure:

- the size of the government expenditure,
- the pattern of government expenditure,
- the methods of financing government expenditure,
- transfer payments (e.g., subsidies, old age pensions, unemployment relief, etc.),
- overall budgetary surplus and deficit, and
- the methods of deficit financing.

Crowding-out

Crowding-out refers to the adverse effect of high deficit spending by the government on private investment.
When the government takes recourse to high deficit spending, it plans to spend more than it tax revenue. government has then to borrow from the central bank or from the market through the sale of its bonds for the purpose of financing its budgetary deficits. The two methods of borrowing force crowding-out of private investment in *two different ways*

Deficit financing: *Deficit* spending results in an increase in money incomes at the rate of expenditure multiplier without a matching increase in the production of goods and services. This sets an inflationary trend in the economy. In order to control inflation, the central bank adopts a 'tight money policy' In effect, it tightens the credit availability
and raises the interest ratel. Rise in the interest rate 'chokes off' or crowds-out the private investment.

Market borrowings: When government spending is financed through market borrowings through the sale of government bonds, bond prices go down and interest rate goes up. The rise in the interest rate causes a decline in all the interest-sensitive private investments. Besides, when households decide to invest in government bonds, their investment in real estate, like land, building and property, decreases. Therefore, it is argued that there is a fall in the private investment.

Crowding-in

Crowding-in means rise in the private investment due to deficit spending by the government.

Deficit spending leads, undoubtedly, to the rise in the interest rate which discourages private investment.

But, government deficit spending leads to rise in the aggregate demand. The incremental demand is met by increasing the production from the existing capital stock. This brings the acceleration principle in force and intensive use of existing capital results in a greater depreciation. Therefore, demand for capital increases. That is, deficit spending stimulates new investments. This argument, however, holds only when there are *unutilized resources.*

Summary

- Fiscal policy is government's programme of taxation, expenditure and other financial operations to achieve certain national goals
- Taxation policy functions include Revenue Function and Regulatory Functions
- Taxation policy anomalies include very high tax rates, cascading nature of tax system, anomalies in individual taxes and is administratively complex
- Taxation Policy Reforms brought in changes in personal income tax, company income tax, excise duties, GST and import duties