**SEMESTER 6th (UG)**

**Subject: BUSINESS ENVIRONMENT**

**UNIT V FISCAL POLICY**

**INTRODUCTION**

Fiscal Policy refers to the policy which deals with government expenditure, taxation, borrowings and deficit financing. It is a policy under which the government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on national income, output and unemployment. Fiscal policy directly affects the monetary resources power within the hands of general public. It plays a major role in both developed and developing nations.

Fiscal policy operates through budget. That is why, it is also known as 'Budget Policy' through fiscal policy, government makes adjustment to its planned spending and imposes tax rates to influence the performance of economy. It is quite clear that public expenditure is continuously increasing and this increased expenditure is either met by deficit financing or by borrowings. Both result in to inflation in the economy. Therefore, there is need of a policy which can bring stability on one hand and can control public expenditure on the other hand.

**'Fiscal policy is the policy to achieve full employment level by altering the revenue and expenditure and\_ maintaining equilibrium between effective demand and availability of goods and services.' —G.K. Shaw**

**"Fiscal policy is defined as the discretionary action by the government to change —**

**(I) the level of government expenditure on goods and services and transfer payments and**

**(ii) the yield of taxation at any given level of output." — Prof. D.C. Rowan**

**OBJECTIVES OF FISCAL POLICY**

The main objectives of fiscal policy are :

**(1) Economic Development :** The main objective of fiscal policy formation. An underdeveloped country is generally trapped in the vicious s;circcleoof of capital due to lack of capital or investment. Through effective fiscal policy, the government tries to encourage saving and investment and accelerates the speed of economic growth.

**(2) Employment Generation :** The main aim of every government is to attain full employment level. In order to generate employment, government increases public expenditure to raise aggregate demand and reduces tax rates. When aggregate demand increases, the private sector gets incentive to spend more. Lowering taxes on corporate sector encourages additional investment and consequently generates additional employment.

**(3) Price Stability :** Another important objective of fiscal policy is to attain price stability and control inflation. When inflation exists in an economy, government, through the use of fiscal policy, reduces public expenditure and increases tax rates. Reduction in purchasing power of people results into fall in aggregate demand and prices.

**(4) Reduction in Economic Inequality :** Fiscal Policy aims at achieving social justice by reducing inequalities among different sections of the society. To remove economic inequality, progressive direct taxes like Income Tax, Property Tax are levied at a higher scale because the burden of such taxes generally fall on rich people. The income generated from these taxes is used for the welfare of the poor masses and to raise their standard of living.

**(5) Balanced Regional Development :** Another prominent objective of fiscal policy is to reduce regional disparities and achieve balanced regional development. This is done by giving tax concessions to backward areas and by increasing public expenditure in rural areas like building up dams on rivers, expenditure on roads, schools and industrial projects.

**(6) Reduction of deficit in Balance of Payment :** Through fiscal policy measures, the government aims to reduce deficit in Balance of Payment. For this government encourages exports and discourages imports.

**TYPES OF FISCAL POLICY**

Contractionary Fiscal Policy

Expansionary Fiscal Policy

• Used when inflation is growing rapidly and unemployment rote Is high.

• Involves cutting down government spending, Increasing tax rates or both.

• Results In decreasing trio purchasing power of people and aggregate demand

• Used during recession period when growth In national income Is low.

• Involves increasing government expenditure, lowering tax rates or both.

• Results In Increasing the purchasing power of people and aggregate demand.

**TOOLS/TECHNIQUES OF FISCAL POLICY OR COMPONENTS/INSTRUMENTS OF FISCAL POLICY**

Fiscal Policy is based on the theory of British economist John M. Keynes, who told that increasing or decreasing revenue (taxes) and expenditure (spending) levels influence inflation. Inspired by this belief, the government all over the world have been using fiscal policy measures to regulate their economic and business activities. Following are the tools/techniques/measures/ components or instruments of the fiscal policy.

**TOOLS OF FISCAL POLICY**

Public Expenditure I IIPolicy

Deficit Financing IV

Taxation Policy II

Public Debt Policy III

**1. Public Expenditure Policy:**  Public Expenditure means expenses incurred by the public authorities like central, state and local government. Such expenditure is incurred for the government administration, maintenance of law and order, defence, infrastructure development as well as for providing various social security benefits like pensions, health, education etc. Through public expenditure policy, the government tries to supply essential services for the satisfaction of general public which might not otherwise be provided efficiently and economically by the private sector.

**• Objectives of Public Expenditure Policy**

It mainly consists of :

1. Acceleration of rate of economic growth.
2. Maintenance of law and order.
3. Safety of country.
4. Equitable distribution of income.
5. Balanced regional development.
6. Infrastructure development.
7. Encouragement to private sector for investment.
8. Servicing of Public Debt.

**Types of Public Expediture :**

Public expenditure is required to sustain the level of effective demand in an economy. It is basically of two types.

**i. Developmental Pubic Expenditure:** it is a most important for the economic growth of economy and can not be avoided. It included expenditure on power projects, dams, roads, bridges, metros projects, irrigation etc

**ii. Non- Developmental Pubic Expenditure:** Its includes expenditure incurred for administrative services defense services, debt servicing , interest payments, subsides, health, education etc. Though, such expenditures cannot be avoided but can be reduced.

Thus, public expenditure policy is an important tool used by the government to accelerate the ion of economic development. Private investors are incapable of making such massive investments on various infrastructure projects. With the help of public spending, government tries to sustain the .level of effective demand in an economy. Greater the public expenditure. higher is the level of economic development.

• During recession an increase in public expenditure increases the aggregate demand for goods and services and leads to large increase in income via the multiplier process.

• During inflation, a reduction If public expenditure reduces aggregate demand and prices.

**2. Taxation Policy Taxes** : are compulsory financial charge levied on taxpayer (may be an individual or legal entity) by the government in order to raise funds for public expenditures. Taxes are the powerful instrument within the hands of government that have direct impact on consumption and investment.

**Objectives of Taxation Policy:**

1. To mobilise resources for public expenditures.
2. To encourage saving and investment.
3. To accelerate the pace of capital formation.
4. To ensure equitable distribution of income and wealth.
5. To reduce regional disparities.
6. To reduce deficit of balance of payment.
7. To encourage exports by providing tax incentives.

**Types of Taxes:**

1. **Direct Taxes:** These are those taxes the burden of which is borne by the same person on whom they are levied. For example Income Tax , Property Tax. Direct Taxes are progressive nature as their burden fall more on rich people.
2. **Indirect Taxes :** The taxes which are levied onone person but their burden is borne by another person. For example Goods and service tax. Custom duty, excise duty etc. . Direct Taxes are not progressive nature as their burden fall more on rich people.

Through Taxation Policy, the government raises funds for economic development. The government invest a significant portion of tax revenues in the implementation of social security schemes and poverty alleviation programmes.

• A reduction in taxes has the effect of raising disposable income, thereby increasing consumption and investment expenditure of people.

• An increase in taxes tends to reduce disposable income and thereby reduces consumption and investment expenditure.

**3. Public Debt Policy** : Public debt refers to the total borrowings by the government. The government generally borrows to meet budget deficit and to finance developmental activities. Government needs funds for developmental activities. However revenues generated from taxes are not sufficient to fulfill the need. Thus the government has to mobilise funds by resorting to public debt.

**Objectives of Public Debt Policy**

* To meet the financial needs of the government at the lowest possible long term borrowings costs.
* To keep the total debt within sustainable limits.
* To create fiscal space for developmental expenditures.
* To reduce the debt servicing.
* To have more reliance on domestic borrowings than external debt.

**Types/Sources of Public Debt**

**(i) Internal Debt :** Internal debt indicates the amount of loan raised from within the country. Internal debt consists of marketable debt and non-marketable debt. Government dated securities and treasury bills consists of marketable debt. Securities issued to National Small Savings Funds, financial institutions are part of non-marketable debt. Internal debt constituted 93.8 percent of total public debt at end March 2018.

**(ii) External Debt :** External debt represents loan from international financial institutions and foreign governments. Most of the external debt is sourced from multilateral agencies like International Development Agency (IDA), Asian Development Bank (ADB), International Bank for Reconstruction and Development (IBRD) etc. India's external debt constituted 6.2 percent of total public debt at end March 2018.

• There is direct relationship between public debt and budget deficit. With the increase in budget deficit, the amount of public debt also increases and vice-versa.

**4. Deficit Financing**: When the government takes loan from RBI to cover its budget deficit, this is called deficit financing. RBI gives money to government by printing new currency. This increase in currency results into increase in purchasing power and aggregate demand and as a result prices increases. In a developing country like India, due to poor taxable capacity of the people, government has to make use of deficit financing for generating additional resources. Deficit financing has desirable effect during recession as it results in to increase in money supply and ultimately increase in aggregate demand. But its excessive use at the time of inflation or boom is risky.

Thus , due to deficit financing the funds are available for economic growth but at the same time inflation increases. Therefore, it should be used with in safe limits.

**FISCAL POLICY V/S MONETARY POLICY**

The basic objectives of fiscal policy and monetary policy are same. Both are the government economic policies used to maintain stable and positive economic growth, achieve full employment rate and control cyclical fluctuations. However, both policies have different tools to achieve the objectives.

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| **FISCAL POLICY** | **MONETARY POLICY** |
| * Fiscal Policy deals with taxation and government disbursement. | * Monetary Policy deals with the money supply, lending rates and interest rates. |
| * Fiscal Policy is determined by the Central Government. | * Monetary Policy is administered by the Central Bank. |
| * Fiscal Policy affects the aggregate demand through change in government spending and taxation. | * Monetary Policy affects the demand and Supply of money through the use of interest rates. |
| * Fiscal Policy has impact on government budget and borrowings. | * Monetary Policy has impact on exchange rates, money lending rates and investment. |
| * Change in Fiscal Policy requires strong political decision | * RBI makes change in monetary policy independent of political Intervention. |

**ADVANTAGES OF FISCAL POLICY OF INDIA**

A fiscal policy is the measures that a government takes so as to stabilize its economy. It involves changing the allocations and levels of government expenditures and taxes. During sluggish economic times, the government cuts taxes and this leaves taxpayers with additional cash for spending, which Increases consumption levels. In contrast, increasing taxes and reducing government spending causes contraction of the economy.

Following are some important merits or contributions of fiscal policy of Government of India :

**(1) Controls inflation :** Fiscal policy helps in fighting the rates of inflation in a country. Inflation means the increase in price of services of goods without an improvement in money. As such, consumers require paying more money for the regular services and products with less accessible cash. A popular way of combating inflation is by releasing more resources into the economy. The government achieves this by buying government securities such as bonds, thus increasing cash flow.

**(2) Stimulates the economy :** A government uses its fiscal policy for boosting the aggregate demand in the economy. Aggregate demand refers to the overall demand for services and goods across the country. This demand can be increased in various ways such as cutting the indirect taxes so as to promote lower prices or cutting personal tax so as to create disposable income.

**(3) Capital Formation :** Fiscal Policy has played a very important role in the rate of capital formation in country, in private as well as public sector. A major pan of budgetary resources has been invested in Public Sector enterprises which has resulted in increase in gross domestic capital formation as percent of GDP from 10. 2 percent in 1950-51 to in 23. 7 percent in 2001-02 and 32.4 percent in 2018-19.

**(4) Employment Generation :** The government uses tools of fiscal policy to increase employment opportunities in the country. Various rural development programmes have been undertaken by the government of India to reduce unemployment rate like Prime Minister Rozgar Yojna, Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), startup schemes for young entrepreneurs etc. In the budget 2019-20, the government has allocated Rs. 60,000 crore for MGNREGA.

**(5) Reduction in Economic Inequalities :** Fiscal Policy of the country has been making constant endeavour to reduce inequality of income and wealth. Resources have been mobilised from rich class to poor by way of progressive taxes, corporation tax and capital gains tax etc. and this money has been utilised for the welfare of poor people.

**(6)Export Promotion :** Exports have been encouraged by way of providing concessions, tax exemptions, cash subsidies etc. Exports have shown a rise from 4. 5 percent in 1960-61 to 21.2 percent in 2018-2019. Import duty on raw material and capital goods used for production of goods meant for export has also been reduced with a view to encourage exports. Subsidies and tax concessions have also been given to encourage import substitution.

**(7)Balanced Regional Development :** Government has successfully used taxation policy, one tool of fiscal policy, to reduce regional disparities. Under Section 80113, 8010 and 801D, the government has provided tax concessions for 10 to 15 years for entrepreneurs making investment in backward and hilly regions.

**(8) Reduce Deficit to Balance of Payment :** Through fiscal policy, the government has taken various measures to reduce deficit in Balance of Payment. Various special Economic Zones, Export oriented units have been set up to encourage export capacity. Under Section 10 AA, tax incentives have been provided to exporters. Similarly the government has made efforts to preserve foreign exchange reserves by providing tax incentives and subsidies to import substituting industries and by levying custom duties on imports. India's foreign exchange reserves increased to USD 448.24 billion in 2019 from USD 290.48 billion in 1998.

**(9) Social Welfare :** Through fiscal policy, the government has incurred huge public expenditure to uplift the poor sections of society. From last five years (2014 to 2019), nearly 34 crore Jan Dhan Bank Accounts have been opened to ensure that poor and middle class receive the benefits of government schemes directly in their bank accounts. The government has allocated Rs. 6,400 crore in 2019-20 budget for Pradhan Mantri Jan Arogya Yojna (popularly known as Ayushman Bharat). This scheme promises an annual health cover of Rs. 5 lakh each to cover 100 million poor families in India.

**(10) Combat Economic Recession :** Fiscal Policy is a significant tool used by the government to combat economic recession. By providing tax concessions, subsidies and by increasing public expenditure, fiscal policy enhances the monetary power of general public which in turn results in increase in aggregate demand. For example To control recent recession and to give boost to economy, the government has taken several fiscal measures like reduction in corporate tax rates from 30% to 22% for existing companies and from 25% to 15% for new manufacturing companies, merger of 10 public sector banks in to 4 banks, removal of angel tax on start ups, allocation of 70,000 crore for recapitalization of public sector banks in budget 2019-20.

**LIMITATIONS/SHORTCOMING/DRAWBACKS OF FISCAL POLICY**

No doubt, fiscal policy acts as an important tool for price control, control over Government expenditure but the fiscal policy, adopted by the government of India has not proved satisfactory. Dispite serious efforts taken by the government, tax collections have not increased as anticipated. Public sector has been failed miserably in generating resources. The government could not exercise effective control over budget deficit.

Following are the limitations of Fiscal Policy.

**(1) Lack of Elasticity :** In countries like India, tax system is not that elastic as it is supposed to be. Moreover in these economies because of huge tax evasion, it is difficult to earn revenue from taxes. The spread of tax is very low.

**(2) Inadequate Statistics :** Success of fiscal measures depends on the accurate predictions of various economic parameters. Because of non-availability of reliable and accurate data, the areas of fiscal policy are not judged properly.

**(3) Increase Inflation :** Government needs fund for financing its developmental expenditure. But due to poor taxable capacity of people, the government has to take recourse to deficit financing. Excessive use of deficit financing leads to rise in prices. Thus, fiscal policy instead of being a cure of inflation has become the cause of inflation.

**(4) Huge Investment with Negative Return in Public Sector :** Huge investment in public sector have become sunk money now because of failure of public sector. Investment of Rs. 2,04,054 crore was made in public sector enterprises in 1998, Rs. 3,03,400 crore in 2001 and Rs. 21,46,735 crore in 2017-18. Return on this investment has been very low. Huge amount has to be spent to keep such undertakings going thus making the resource of country scarce.

**(5) Failed to Control Growing Inequality :** Fiscal policy of the country has failed to control the growing inequality in the distribution of income and wealth. Burden of direct taxes falls more on salaried person whereas big businessmen hardly pay taxes Spite of huge profits, taking benefits of loopholes of taxation laws. Growing trend of tax evasion has made the taxation policy ineffective.

**(6) Debt Trap :** The excessive use of fiscal instruments during recession often results in the problem of debt trap. Because of lack of resources, public debt is used for financing budget deficit. if the process of recovery from recession is long, then oversized budget deficit year after year creates a huge problem of debt repayment and management.

**(7) Bad Impact of Higher Debt on Economy :** Large public expenditure programmes financed by borrowings have negative impact on long term growth and economic well being. Higher debt ratio to GDP is treated as bad indicator of economy by foreign investors and it may result into flow of capital out of country.

**(8) Undesirable Aid and Subsidies :** The government of India provides economic assistance to large number of areas of Indian Economy. For Example, Subsidies to farmers, industrialist, Subsidy on LPG etc. Subsidies have long impact on economy. Increased spending on subsidies is compensated by government by increased taxes and lowering expenditure in other developmental projects. Subsidies which are ineffective just increase fiscal deficit.

**SUGGESTIONS FOR REFORMS IN FISCAL POLICY**

**(1) Simple and Progressive Taxation System :** The government should implement simple taxation system which curb black money and check tax evasion. The tax structure should be made more progressive so that the burden of taxes may fall more on rich than poor. More taxes should be imposed on luxury goods.

**(2) Reduction of Non-Developmental Expenditure :** The fiscal policy of the country should try to reduce the non-developmental expenditure of the country. This would reduce the volume of unproductive expenditure and its inflationary impact.

**(3) Reduction in Public Debt :** The government should reduce its dependence on public debt. The government should try to increase its tax collections. For this, the tax structure should be simplified to as to encourage tax compliance among the people. Honest tax payers should be rewarded by giving them priorities in government services.

**(4) Agricultural Taxation :** Agricultural income is fully tax free. But rich agriculturists can be brought under tax net to increase revenue in the hands of government. With the increase in revenue of government, there will be no need to resort to deficit financing or depend on public debt for generation of revenues.

**(5) Privatization of PSUs :** Loss making Public Sector Understakings should be privatized. It will reduce the burden of government.

**(6) Checking Black Money :** The fiscal policy of the country should try to curb black money through various measures like voluntary disclosure schemes, strict punishment for tax evadors etc. System of quota, permit and licenses should also be abolished.

**(7) Control Over Subsidies :** Subsidies, if not in the public interest, should be discontinued.

**(8) Public Sector Performance to be Improved :** To increase the return on huge investments made in public sector enterprises, the efficiency of public sector should be properly supervised and improved. Public Sector undertakings should be managed on commercial lines with least interference of government.