Update-Budget

Deficit reduction

Government deficit can be reduced by an increase in tax rates or reduction in govt expenditure. However, this fiscal tightening can cause lower economic growth – which in turn can cause a higher cyclical deficit (government get less tax revenue in a recession).

One of the best ways to reduce the deficit is to promote economic growth. If the economy grows, then tax revenue will increase, without raising taxes. High economic growth, is the least painful way to reduce the budget deficit because you don't need to raise tax rates or cut spending.

In India, the government has been trying to increase tax revenue with greater reliance on direct taxes (indirect taxes are regressive in nature – they impact all income groups equally).

Govt. is also trying to raise money through the sale of shares in PSUs. However, the major thrust has been towards reduction in government expenditure.

Deficit Financing

Budgetary deficits must be financed by either taxation, borrowing or printing money.

In the modern world, governments typically finance their deficits by issuing government bonds.

They can either be purchased:

- by the public from the existing supply of money **or**
- by central banks by increasing the monetary base, and hence the money supply and may result in inflation (called **Deficit Financing through Central Bank Borrowing**).

Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the **crowding out** of private investment

If the government finances its deficit by printing new money, then there is no crowding out of private spending. But this kind of financing is more inflationary.

CDS 2021
The increase in private investment spending induced by the increase in Government spending is known as
(a) **Crowding in** (b) Deficit financing (c) Crowding out (d) Pumping out

Prelims 2013, 2021
Which one of the following is likely to be the most inflationary in its effect?
a. Repayment of public debt b. Borrowing from the public to finance a budget deficit
c. Borrowing from banks to finance a budget deficit d. **Creating new money to finance a budget deficit**

CDS (1) 2023
The contraction of private investment spending due to deficit spending by the Government is called
(a) **crowding out** (b) crowding in (c) pump priming (d) dumping

Balanced budget

The government may spend an amount equal to the revenue it collects. This is known as a balanced budget.

If it needs to incur higher expenditure, it will have to raise the amount through taxes in order to keep the budget balanced.

When tax collection exceeds the required expenditure, the budget is said to be in surplus.

However, the most common feature is the situation when expenditure exceeds revenue. This is when the government runs a budget deficit

Fiscal Neutrality

Where government spending is covered almost exactly by tax revenue – in other words, where tax revenue is equal to government spending.

Committed expenditure

The committed expenditure of the Government on revenue account consists of interest payments; expenditure on salaries and wages; and pensions. It has first charge on Government resources. They are of committed nature which could not be avoided. Upward trend on committed expenditure leaves the Government with lesser flexibility for development sector.

Zero-based budgeting

Zero-based budgeting (ZBB) is an approach to budget formation where in a government prepares a budget from the ground, starting from zero rather than making an incremental provisioning for projects over previous year.

As opposed to traditional budgeting, no item is automatically included in the next budget. Every program and expenditure is reviewed at the beginning of each budget cycle and must justify each line item in order to receive funding.

Gender Budget

Government publishes a Gender Budget Statement (Statement 13) annually along with the Union Budget.

Gender Budget Statement was first introduced in Budget 2005-06.

This Statement indicates, in two parts, the budget provisions for schemes that are substantially meant for the benefit of women. Part A details schemes in which 100% provision is for women, Part B reflects schemes where the allocations for women constitute at least 30% of the provision.

Redistribution Function of Government Budget

Total national income of the country goes to either the private sector, that is, firms and households (known as private income) or the government (known as public income).

Out of private income, what finally reaches the households is known as personal income and the amount that can be spent is the personal disposable income. The government sector affects the personal disposable income of households by making transfers and collecting taxes.

It is through this that the government can change the distribution of income and bring about a distribution that is considered 'fair' by society. This is the redistribution function.

The redistribution objective is sought to be achieved through progressive income taxation, in which higher the income, higher is the tax rate. Firms are taxed on a proportional basis, where the tax rate is a particular proportion of profits. With respect to excise taxes, necessities of life are exempted or taxed at low rates, comforts and semi-luxuries are moderately taxed, and luxuries, tobacco and petroleum products are taxed heavily.

Stabilisation Function of Government Budget

The intervention of the government whether to expand demand or reduce it constitutes the stabilisation function.

For example, there may be times when demand exceeds available output under conditions of high employment and thus may give rise to inflation. In such situations, restrictive conditions may be needed to reduce demand.

Discretionary fiscal policy

Fiscal policy has two broad components: **discretionary policy** from explicit government actions, and **automatic stabilizers**, which refer to built-in elements in the tax-and-benefit system that tend to mitigate economic fluctuations without explicit government action.

Deliberate action by Govt to stabilise the economy against upward and downward movements is referred to as discretionary fiscal policy.

Discretionary fiscal policy is a demand-side policy that uses government spending and taxation policy to influence aggregate demand. It has two type

Contractionary fiscal policy - If the government faces a situation of high inflation characterized by excess demand in the market, it can engage in contractionary fiscal policy. For example, the government can either cut public spending or raise tax rates or both. It reduces the amount of money available for businesses and consumers to spend, which will cause consumption and investment to fall, thereby correcting the situation of excess demand.

Contractionary fiscal policy is **rarely used in democracy as politicians** campaign on the promise of government spending and lowering the tax rates in order to get elected.

Expansionary fiscal policy- It is typically used during a recession. It involves decreasing taxes, increasing government expenditures or both in order to fight **recessionary** pressures (also called **Financial motivators**). A decrease in taxes means that households have more disposal income to spend thereby correcting the situation of deficiency in demand. However, it can also lead to inflation because of the higher demand within the economy.

The drawback of expansionary fiscal policy is that it can lead to budget deficits.

Democracy tends to lead to expansionary fiscal policy.

Cyclicality of fiscal policy

Cyclicality of fiscal policy refers to the direction of change in government expenditure and taxes relative to economic/output conditions.

Fiscal policy is considered pro-cyclical, if it is expansionary during economic booms and contractionary during recessions.

If fiscal policy is expansionary during recessions and contractionary during booms, it is considered to be counter-cyclical.

Counter-cyclical fiscal measures are policy measures which counteract the effects of the economic cycle. For example, counter-cyclical fiscal policy actions when the economy is slowing would include increasing government spending or cutting taxes to help stimulate economic recovery.

Fiscal policy is said to be counter-cyclical if the government deficit increases during economic downturns.

Automatic stabiliser

Automatic stabilisers mean **expenditures** that automatically increase or **taxes** that automatically decrease when economic conditions worsen, therefore, stabilising the economy automatically. For example- Proportional taxes, unemployment benefits help to stabilise the economy against upward and downward movements.

Proportional income tax acts as an automatic stabiliser – a shock absorber because it makes disposable income, and thus consumer spending, less sensitive to fluctuations in GDP.

When GDP rises, disposable income also rises but by less than the rise in GDP because a part of it is siphoned off as taxes. This helps limit the upward fluctuation in consumption spending.

During a recession when GDP falls, disposable income falls less sharply, and consumption does not drop as much as it otherwise would have fallen had the tax liability been fixed. This reduces the fall in aggregate demand and stabilises the economy.

Welfare transfers also help to stabilise income. During boom years, when employment is high, tax receipts collected to finance such expenditure increase exerting a stabilising pressure on high consumption spending; conversely, during a slump, these welfare payments help sustain consumption.

Further, **even the private sector has built-in stabilisers**. Corporations maintain their dividends in the face of a change in income in the short run and households try to maintain their previous living standards. All these work as shock absorbers without the need for any decision-maker to take action. That is, they work automatically. The built-in stabilisers, however, reduce only part of the fluctuation in the economy, the rest must be taken care of by deliberate policy initiative.

Foreign trade influences Indian aggregate demand in two ways

First, when Indians buy foreign goods, this spending **escapes as a leakage from the circular flow of income** decreasing aggregate demand. Second, our exports to foreigners enter as an injection into the circular flow, increasing aggregate demand for goods produced within the domestic economy.

Autonomous and Accommodating Transactions

International economic transactions are called autonomous when transactions are made due to some reason other than to bridge the gap in the balance of payments, that is, when they are independent of the state of BoP. One reason could be to earn profit. These items are called 'above the line' items in the BoP. The balance of payments is said to be in surplus (deficit) if autonomous receipts are greater (less) than autonomous payments.

Accommodating transactions (termed 'below the line' items), on the other hand, are determined by the gap in the balance of payments, that is, whether there is a deficit or surplus in the balance of payments. In other words, they are determined by the net consequences of the autonomous transactions. Since the official reserve transactions are made to bridge the gap in the BoP, they are seen as the accommodating item in the BoP (all others being autonomous).

Errors and Omissions

It is difficult to record all international transactions accurately. Thus, we have a third element of BoP (apart from the current and capital accounts) called errors and omissions which reflects this.

GDP and Welfare of the people

Can the GDP of a country be taken as an index of the welfare of the people of that country?

GDP gets distributed among the people as incomes (except for retained earnings). So we may be tempted to treat higher level of GDP of a country as an index of greater well-being of the people of that country.

But there are at least three reasons why this may not be correct.

1. Distribution of GDP – how uniform is it:

If the GDP of the country is rising, the welfare of the people may not rise as a consequence. This is because the rise in GDP may be concentrated in the hands of very few individuals or firms. For the rest, the income may in fact have fallen.

2. Non-monetary exchanges: Many activities in an economy are not evaluated in monetary terms. For example, the domestic services women perform at home are not paid for. The exchanges which take place in the informal sector without the help of money are called barter exchanges. In barter exchanges, goods (or services) are directly exchanged against each other. But since money is not being used here, these exchanges are not registered as part of economic activity.

In developing countries, where many remote regions are underdeveloped, these kinds of exchanges do take place, but they are generally not counted in the GDPs of these countries. This is a case of underestimation of GDP.

Hence, GDP calculated in the standard manner may not give us a clear indication of the productive activity and well-being of a country.

3. Externalities: Externalities refer to the benefits (or harms) a firm or an individual causes to another for which they are not paid (or penalised).

For example, let us suppose there is an oil refinery which refines crude petroleum and sells it in the market. The value added of the refinery will be counted as part of the GDP of the economy. But in carrying out the production the refinery may also be polluting the nearby river. This may cause harm to the people who use the water of the river. Hence their well being will fall. Pollution may also kill fish or other organisms of the river on which fish survive. As a result, the fishermen of the river may be losing their livelihood.

Such harmful effects that the refinery is inflicting on others, for which it will not bear any cost, are called externalities. In this case, the GDP is not taking into account such negative externalities. Therefore, if we take GDP as a measure of welfare of the economy we shall be overestimating the actual welfare.

This was an example of negative externality. There can be cases of positive externalities as well. In such cases, GDP will underestimate the actual welfare of the economy.