Unit 11

I. Choose the correct answer (each question carries 1 mark)

1. The Taxes on Individual and firms are
   a) Direct Taxes
   b) Indirect Taxes
   c) Fixed Taxes
   d) Non-Tax Revenues
2. Duties Levied on goods produced with in the country
   a) Service Tax
   b) Estate Duties
   c) Excise Duties (Taxes)
   d) Customs duties
3. The Tax which acts as an automatic stabiliser
   a) Qualitative income Tax
   b) Income Tax
   c) Quantitative Tax
   d) Proportional income Tax
4. Which of the following is an example for 'Paper taxes'?
   a) Income Tax
   b) Excise Taxes
   c) Wealth Tax
   d) Customs Taxes
5. When Demand exceeds the available output under conditions of high level of employment, this may give rise to
   a) Inflation
   b) Deflation
   c) Stabilisation
   d) None of the above

II. Fill in the blanks (each question carries 1 mark)

1. Non-paying users of public goods are known as__FREE-RIDER________
2. Financial year runs from __April 1st______ to __March 31st______ in India.
3. Taxes imposed on goods imported into and exported out of India are called DUTIES_______
4. The Government may spend an amount equal to the revenue it collects. This is known as BALANCED BUDGET_________
5. Revenue deficit = Revenue expenditure - __REVENUE RECEIPTS____________

III. Answer the following questions in a sentence/word (each question carries 1 mark)

1. What are public goods?

They are goods which cannot be provided through the market mechanism, i.e. by transactions between individual consumers and producers and must be provided by the government.

2. Who are 'free-riders'?

Since non-paying users usually cannot be excluded, it becomes difficult or impossible to collect fees for the public good. This is what is called the 'free-rider' problem.

3. What do you mean by public provision?

Public provision means that they are financed through the budget and made available free of any direct payment.

4. Give the meaning of progressive Tax.

The redistribution objective is sought to be achieved through progressive income taxation, in which higher the income, higher is the tax rate.

5. What are Revenue receipts?

Revenue receipts are divided into tax and non-tax revenues. Tax revenues consist of the proceeds of taxes and other duties levied by the central government. Non-tax revenue of the central government mainly consists of interest receipts

6. Write the meaning of capital receipts.

The main items of capital receipts are loans raised by the government from the public which are called market borrowings, borrowing by the government from the Reserve Bank and commercial banks and other financial institutions through the sale of treasury bills,

7. Give the meaning of Revenue expenditure.

Revenue expenditure consists of all those expenditures of the government which do not result in creation of physical or financial assets.

8. Give the meaning of capital expenditure.

This includes expenditure on the acquisition of land, building, machinery, equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties.

9. Expand FRBMA.

Fiscal Responsibility and Budget Management Act, 2003 (FRBMA)

10. What is primary deficit?

To obtain an estimate of borrowing on account of current expenditures exceeding revenues, we need to calculate what has been called the primary deficit.

IV. Answer the following questions in 4 sentences. (each question carries 2 marks)

1. Write the difference between Public provision and Public production.

Public provision means that they are financed through the budget and made available free of any direct payment. These goods may be produced directly under government management or by the private sector.

2. Who are 'Free riders'? Why are they called so?

In case of private goods anyone who does not pay for the good can be excluded from enjoying its benefits. If you do not buy a ticket, you are excluded from watching a film at a local theatre. However, in case of public goods, there is no feasible way of excluding anyone from enjoying the benefits of the good (they are non-excludable). Since non-paying users usually cannot be excluded, it becomes difficult or impossible to collect fees for the public good. This is what is called the 'free-rider' problem.

3. Distinguish between surplus budget and deficit budget.

Through changes in its expenditure and taxes, the government attempts to increase output and income and seeks to stabilise the ups and downs in the economy. In the process, fiscal policy creates a surplus (when total receipts exceed expenditure) or a deficit budget (when total expenditure exceed receipts) rather than a balanced budget

4. Why public goods must be provided by the Government?

Certain goods, referred to as public goods (such as national defence, roads, government administration), as distinct from private goods (like clothes, cars, food items), cannot be provided through the market mechanism, i.e. by transactions between individual consumers and producers and must be provided by the government.

5. Mention the non-tax revenues of the Central Government.

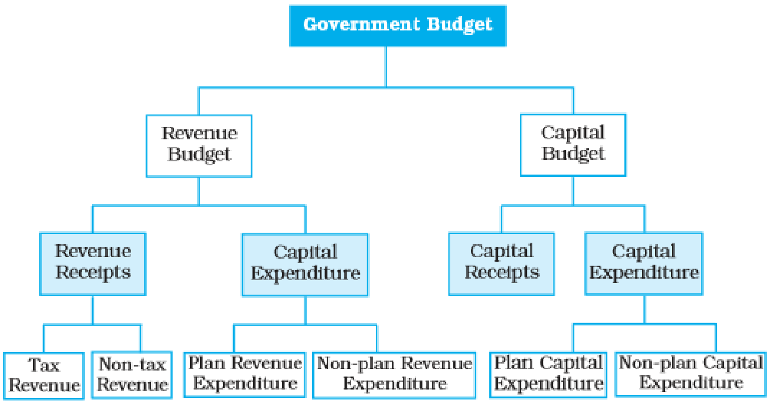
Non-tax revenue of the central government mainly consists of interest receipts (on account of loans by the central government which constitutes the single largest item of non-tax revenue), dividends and profits on investments made by the government, fees and other receipts for services rendered by the government. Cash grants-in-aid from foreign countries and international organisations are also included.

6. Why the proportional income tax acts as automatic stabiliser?

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 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.

V. Answer the following questions in 12 sentences. (each question carries 4 marks)

1. Write the chart of the Government budget.



2. Distinguish between Revenue expenditure and capital expenditure.

Broadly speaking, revenue expenditure consists of all those expenditures of the government which do not result in creation of physical or financial assets. It relates to those expenses incurred for the normal functioning of the government departments and various services, interest payments on debt incurred by the government, and grants given to state governments and other parties (even though some of the grants may be meant for creation of assets).

Capital Expenditure includes expenditure on the acquisition of land, building, machinery, equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties. Capital expenditure is also categorised as plan and non-plan in the budget documents. Plan capital expenditure, like its revenue counterpart, relates to central plan and central assistance for state and union territory plans. Non-plan capital expenditure covers various general, social and economic services provided by the government.

3. Briefly explain the revenue deficit and fiscal deficit.

The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts

Revenue deficit = Revenue expenditure – Revenue receipts

The revenue deficit includes only such transactions that affect the current income and expenditure of the government. When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy to finance a part of its consumption expenditure.

Fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing

Gross fiscal deficit = Total expenditure – (Revenue receipts + Non-debt creating capital receipts)

Non-debt creating capital receipts are those receipts which are not borrowings and, therefore, do not give rise to debt. Examples are recovery of loans and the proceeds from the sale of PSUs. The fiscal deficit will have to be financed through borrowing.

4. Does public debt impose a burden? Explain.

By borrowing, the government transfers the burden of reduced consumption on future generations. This is because it borrows by issuing bonds to the people living at present but may decide to pay off the bonds some twenty years later by raising taxes. These may be levied on the young population that have just entered the work force, whose disposable income will go down and hence consumption. Thus, national savings, it was argued, would fall. Also, government borrowing from the people reduces the savings available to the private sector. To the extent that this reduces capital formation and growth, debt acts as a 'burden' on future generations.

Traditionally, it has been argued that when a government cuts taxes and runs a budget deficit, consumers respond to their after-tax income by spending more. It is possible that these people are short-sighted and do not understand the implications of budget deficits. They may not realise that at some point in the future, the government will have to raise taxes to pay off the debt and accumulated interest. Even if they comprehend this, they may expect the future taxes to fall not on them but on future generations.

5. Write a short note on the Ricardian equivalence.

Consumers are forward-looking and will base their spending not only on their current income but also on their expected future income. They will understand that borrowing today means higher taxes in the future. Further, the consumer will be concerned about future generations because they are the children and grandchildren of the present generation and the family which is the relevant decision making unit, continues living. They would increase savings now, which will fully offset the increased government dissaving so that national savings do not change.

This view is called Ricardian equivalence after one of the greatest nineteenth century economists, David Ricardo, who first argued that in the face of high deficits, people save more. It is called 'equivalence' because it argues that taxation and borrowing are equivalent means of financing expenditure. When the government increases spending by borrowing today, which will be repaid by taxes in the future, it will have the same impact on the economy as an increase in government expenditure that is financed by a tax increase today.

VI. Answer the following questions in 20 sentences. (each question carries 6 marks)

1. Explain the classification of receipts.

Revenue receipts are divided into tax and non-tax revenues. Tax revenues consist of the proceeds of taxes and other duties levied by the central government. Tax revenues, an important component of revenue receipts, comprise of direct taxes – which fall directly on individuals (personal income tax) and firms (corporation tax), and indirect taxes like excise taxes (duties levied on goods produced within the country), customs duties (taxes imposed on goods imported into and exported out of India) and service tax.

Non-tax revenue of the central government mainly consists of interest receipts (on account of loans by the central government which constitutes the single largest item of non-tax revenue), dividends and profits on investments made by the government, fees and other receipts for services rendered by the government. Cash grants-in-aid from foreign countries and international organisations are also included.

The main items of capital receipts are loans raised by the government from the public which are called market borrowings, borrowing by the government from the Reserve Bank and commercial banks and other financial institutions through the sale of treasury bills, loans received from foreign governments and international organisations, and recoveries of loans granted by the central government. Other items include small savings (Post-Office Savings Accounts, National Savings Certificates, etc), provident funds and net receipts obtained from the sale of shares in Public Sector Undertakings (PSUs).

2. Explain the classification of expenditure.

Revenue Expenditure: Broadly speaking, revenue expenditure consists of all those expenditures of the government which do not result in creation of physical or financial assets. It relates to those expenses incurred for the normal functioning of the government departments and various services, interest payments on debt incurred by the government, and grants given to state governments and other parties (even though some of the grants may be meant for creation of assets).

Budget documents classify total revenue expenditure into plan and non-plan expenditure. Plan revenue expenditure relates to central Plans (the Five-Year Plans) and central assistance for State and Union Territory Plans. Non-plan expenditure, the more important component of revenue expenditure, covers a vast range of general, economic and social services of the government. The main items of non-plan expenditure are interest payments, defence services, subsidies, salaries and pensions.

Capital Expenditure: This includes expenditure on the acquisition of land, building, machinery, equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties. Capital expenditure is also categorised as plan and non-plan in the budget documents. Plan capital expenditure, like its revenue counterpart, relates to central plan and central assistance for state and union territory plans. Non-plan capital expenditure covers various general, social and economic services provided by the government.

3. 'The fiscal deficit gives borrowing requirements of the government'. Elucidate.

Fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing

Gross fiscal deficit = Total expenditure – (Revenue receipts + Non-debt creating capital receipts)

Non-debt creating capital receipts are those receipts which are not borrowings and, therefore, do not give rise to debt. Examples are recovery of loans and the proceeds from the sale of PSUs. The fiscal deficit will have to be financed through borrowing. Thus, it indicates the total borrowing requirements of the government from all sources. From the financing side

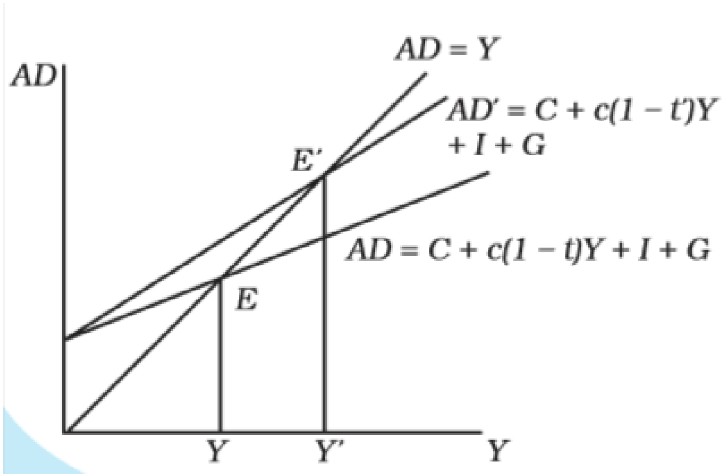
Gross fiscal deficit = Net borrowing at home + Borrowing from RBI + Borrowing from abroad Net borrowing at home includes that directly borrowed from the public through debt instruments (for example, the various small savings schemes) and indirectly from commercial banks through Statutory Liquidity Ratio (SLR).

4. Discuss the issue of deficit reduction.

Government deficit can be reduced by an increase in taxes or reduction in expenditure. 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). There has also been an attempt to raise receipts through the sale of shares in PSUs.

However, the major thrust has been towards reduction in government expenditure. This could be achieved through making government activities more efficient through better planning of programmes and better administration. A recent study4 by the Planning Commission has estimated that to transfer Re1 to the poor, government spends Rs 3.65 in the form of food subsidy, showing that cash transfers would lead to increase in welfare.

5. Explain the changes in taxes with the help a diagram.



The decrease in taxes works in effect like an increase in propensity to consume as shown. The AD curve shifts up to AD′. At the initial level of income, aggregate demand for goods exceeds output because the tax reduction causes increased consumption. The new higher level of income is Y′

The proportional income tax, thus, 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.

We note that these fiscal policy instruments can be varied to offset the effects of undesirable shifts in investment demand. That is, if investment falls from I0 to I1, government spending can be raised from G0 to G1 so that autonomous expenditure (C + I0 + G0 = C + I1 + G1) and equilibrium income remain the same. This deliberate action to stabilise the economy is often referred to as discretionary fiscal policy to distinguish it from the inherent automatic stabilising properties of the fiscal system. As discussed earlier, proportional taxes help to stabilise the economy against upward and downward movements.