Fiscal Policy

Definition

- It refers to the policy of the government as regards taxation, public borrowing and public expenditure with specific objectives in view – to produce desirable effects on the national income, production, employment and general price level.

Importance of Fiscal Policy

- Recognized during the Great Depression of 1930s by John Maynard Keynes.
- Prior to that it was believed that government's activities should remain restricted to the maintenance of law and order and provision of certain essential services to the economy.
- During Great Depression it was realized that private sector on its own cannot initiate a process of recovery since the incentive to invest was simply not there – hence government's role was felt necessary.
- Keynes promoted the role of the government by realizing that to solve the problem of unemployment equilibrium, government must step in.
- In situations of inflation or deflation the government can step in to control the volume of expenditure in the economy.

Objectives of Fiscal Policy

- Increasing the rate of investment – to increase the rate of investment, savings has to be increased. Savings can be increased by raising the governmental income through taxation and public borrowing.
- Encouraging a socially optimum pattern of investment – direct investments in those fields that are desirable from the point of view of the society. In developing countries investments in railway tracks, telegraphs and telephone systems, power plants, electricity generations and sometimes in basic and capital goods industries may be socially optimum.
- Reducing inequalities in income – a welfare state committed to social equality and economic justice will promote income equality. In this context fiscal policy becomes effective through promotion of a progressive income tax structure, heavy indirect taxes on luxury items and light indirect taxes on mass consumption goods. Government can undertake programs on medical care of the poor, free education for poor children, free housing for poor landless laborers etc.
- Reducing unemployment – public expenditure can help to tackle the problem through construction of school buildings, hospital buildings, roads, earthen dams, irrigation canals etc. in rural areas to reduce seasonal unemployment. In India - Cash Scheme for Rural Employment, Food for Work Programme, National Rural Employment Programme, Jawahar Rozgar Yojana, National Rural Employment Guarantee Scheme etc.
- Controlling inflationary tendencies – in order to implement large scale industrialization programmes developing countries often have to resort to deficit financing. This may create inflationary situations as supply of goods may fail to increase in accordance with the increase in demand. In this context fiscal policy can step in by reducing demand through increase in taxes or encourage production through tax incentives to industries.

Sources of Public Revenue

- Taxation
- Public borrowing

Taxation: Objectives

- Transferring resources from the hands of the public to the hands of the state to make possible public investment – through taxation, requirements of development can be met. But the optimum level of taxation differs from country to country depending on preferences of citizens, administrative competence in the government etc.
- Restraining or curtailing consumption and thus transferring resources from consumption to investment – through direct taxes the government can reduce the disposable income in the hands of the people, thus restricting their capacity to buy goods. Through indirect taxes the government can raise the prices of goods, thereby restricting consumption. If funds raised through imposition of taxes are loaned either to the private sector for carrying out investment or utilized directly by government for building up public enterprises or developing social overhead capital, the process of capital formation and economic development gets a boost.
- Increasing the incentive to save and invest – to encourage the habit of savings, income tax concessions are generally granted on money saved. Similar concessions are also granted on savings of firms and other institutions. To encourage investment, tax rebates, tax holidays to business enterprises are allowed in the initial years of their operations.
- Modify the pattern of investment – encouraging investments in desirable areas through tax incentives and by restricting investments in unproductive channels (speculative activities, investment in real estates, land, property etc.) through high levels of taxation. If the government feels that investment in basic and capital goods industries is necessary for pushing up the rate of industrialization, it can set up these industries in the public sector by utilizing the resources obtained through taxation.
- Mitigating economic inequalities – redistributive government finance helps in improving productivity and real income of people through human capital formation (programmes on education and training to reduce illiteracy and increase skills leading to an increase in the quality of manpower). Redistributive finance also reduces political instability in underdeveloped countries by helping in reducing the gap between rich and poor.

Types of Taxes

- Progressive taxes - when higher income families pay not only larger income taxes, but pay a higher fraction of their incomes in the form of taxes compared to the poor.
- Proportional taxes - all taxpayers pay exactly the same proportion of income.
- Regressive income taxes - poor pay a larger fraction of their income in taxes than the rich.
- Direct taxes – the burden of the tax is borne by the individual on whom the tax is imposed.
- Indirect tax – the burden of the tax is borne by individuals other than on whom the tax is imposed.

Use of Different Taxes in Generation of Resources

Personal income tax

- It is a direct tax as the burden of the tax is borne by the person on whom the tax is imposed.
- Developing countries depend on income tax to a far lesser extent than developed nations because of the inability to pay (due to low income) and also widespread tax evasions (due to weaknesses in general administration).
- Less than 3% of the third world population pay income tax whereas 60-80% of the population of developed nation pay income taxes.
- Assessment of the incomes of a vast majority of the people living in rural areas is difficult due to non reporting of income and also non exchange of entire output in the market for money.
- However considerable scope for income tax collection from the wealthy minorities exist.
- In underdeveloped countries wealthy groups have enough political power to block tax measures that they consider threats to their position.

Corporate Income Tax

- It is direct tax imposed on the profits of corporations and companies.
- Share of corporate income tax in total revenue is much less in developing nations than in developed nations because: (1) corporate sector is only a small part of the economy; (2) in order to encourage corporate activities the governments of developing countries offer wide range of incentives to the companies e.g., depreciation allowance, tax rebates, capital investment subsidies, exemption from taxes for some initial years etc.; (3) governments generally avoid taxing corporate sector heavily as high taxes discourage the formation of new companies.
- Argument in favor of corporate taxes – it is easier to collect such taxes as the number of companies are small and they are easily identifiable, so easier to maintain their accounts and tax them.
- Multinational firms are large and earn huge profits, so they can be taxed heavily. But usually governments avoid doing that to promote foreign investments.

Property/ Wealth tax

- It is a direct tax imposed on the property of individuals depending upon the value of the property.
- Property taxes can be used to mop up resources from the rich sections of the society in developing countries where extreme inequalities in income and wealth exist.
- Favorable consequences – (1) revenue resources of the government are likely to increase considerably through heavy taxation on the very rich propertied minorities; (2) such taxes do not have any adverse effect on the incentives to invest as they are not levied on productive activities of the people; (3) inequalities in income can be brought down through such taxes.
- They do not usually contribute much to the public revenue in developing countries as their share in total tax revenue is less than 10%.
- Urban property are more heavily taxed than rural properties (land). The rich landholders can exercise an effective control over the government. Also there may be difficulty of making property assessments and keeping them up to date.

Excise Duty

- It is an indirect tax imposed on the manufacturer of a product, who recovers it from the wholesalers and retailers.
- In most developing countries its contribution is more than 40% of the total tax revenue.
- Heavy dependence on excise duty as a source of revenue is indicator of the fact that the countries have failed to make their tax structure sufficiently progressive.
- Dependence on indirect taxes only increases the regressivity of the tax system as all persons who consume the commodity must pay the tax whether they are rich or poor.
- Situation can be averted by taxing luxury goods more.
- Taxing more luxury goods than goods of mass consumption fails to produce the desired result as luxury goods are highly price elastic while goods of mass consumption are highly price inelastic.

Sales Tax

- It is an indirect tax as the liability to pay the tax is on the shopkeeper, who claims it from the customers.
- Excise duty is levied on production, sales tax is usually levied at the point of final sale of the commodity.
- Collected from all registered trading concerns who invariably shift their burden to consumers.
- In principle, sales tax can be introduced at any of the 3 stages – manufacturing stage (Colombia, Ghana, Uganda etc.), wholesale stage (Pakistan, Honduras) and retail stage (India).
- Retail stage taxation is most difficult to administer since a large number of small traders are operating in the economy and it is very difficult to maintain contacts with all of them. Many of these small traders do not have any accounting knowledge and are illiterate.
- Taxation at the wholesale stage is less difficult to administer especially if large wholesalers are covered.

Customs Duties

- Associated with foreign trade.
- It is an indirect tax imposed on the importer/ exporter of a product, which is recovered from the retailers and customers.
- 2 types – export duty (imposed on exports) and import duty (imposed on imports).
- For developing countries import duties are more important – reasons – (1) exports of these countries are very low and difficult to increase because of unfavorable conditions in the international market and consumer prejudices against goods of developing countries; (2) in order to protect domestic goods against foreign competition, imported goods have to be made expensive than domestic goods.
- Developing countries need to import large scale capital goods for development but due to poor exports, are forced to impose heavy duties on import of inessential consumer goods and luxuries.
- Import duties can be of 2 types – specific (tax per unit of the commodity sold, not price) and advalorem (tax as a percentage of the value of the commodity, hence dependent upon price). Specific duties are easier to administer but not flexible. Advalorem import duties are flexible and revenue from them increase with price. In India import duties are generally levied on an advalorem basis.
- Import duties are easier to administer as goods imported are limited in number and the ports through which they enter are also limited. The goods arrive in bulk containers and cannot escape detection.
- Similar arguments can be made about export duties also. But in developing countries the trend is export subsidies rather than export duties to make the products competitive in the international market.

Expenditure Tax

- It is a direct tax.
- Tax is imposed on the actual expenditure (personal income less savings) of an individual.
- It does not affect personal savings adversely as it is imposed on actual expenditure of an individual. Against this, income tax has more adverse effect on personal savings and progressive income tax is likely to erode the capacity to save in an economy.
- Administrative cost of expenditure tax is heavy and difficult to administer.
- India introduced expenditure tax in 1957 on the basis of N. Kaldor’s recommendation to curtail conspicuous consumption. But did not work. Therefore the government had to abandon it.

Tax on agriculture

- In developing countries, agriculture is either tax free or very lightly taxed. Reason – agriculture is the subsistence sector of the economy and is therefore not in the position to bear heavy tax burden.
- Argument is true for a large section of the rural population but not for the large landholders. Therefore failure to tax large landholders makes the tax system inequitable and unjust.
- Types of agricultural tax – land taxation, agricultural income tax, taxation of agricultural produce etc.
- Land taxation is the oldest form of agricultural tax – also known as land revenue – difficult to administer as in developing countries there is no clearly defined pattern of land ownership – most cultivators are tenants, having only rights to cultivate than own land.
- For agricultural income tax, the local authorities can form an estimate of the total income and wealth of the people living in an area, with incomes below the exemption limit of a proper income tax, by considering crops, cattle, wages etc.
- If the government can exercise effective control over the marketing system, it can impose tax on agricultural produce – it can purchase the crops from the farmers at prices net of tax and later collect the actual tax from the wholesalers or other intermediaries who purchase the crop from the government – difficult to administer.

Goods and Services Tax (GST)

- Biggest reform in India's indirect tax structure since liberalization.
- A single point tax structure with uniform rates will do away with the business of variable state taxes for most goods.
- All central- and state-level taxes and levies on all goods and services will be subsumed within an integrated tax having two components: a central GST and a state GST.
- Central taxes that GST will replace – central excise duties, excise duty on medicinal and toiletries preparations, additional duty of excise on textile and textile products, central sales tax, service tax, additional duties of customs, service tax, cess and surcharges related to supply of goods and service.
- State taxes that GST will subsume – state VAT/ sales tax, purchase tax, luxury tax, entry tax, entertainment tax, tax on advertisements, tax on lotteries and gambling, state cess and surcharges.
- Out of GST – alcoholic and petroleum products. Each state can set rates.
- Under GST there will be tax only on value addition at each stage (e.g., manufacturing, wholesale and retail trade), with producer or seller at every stage able to set off his taxes against the central or state GST paid on his purchases.
- The end consumer will only bear the GST charged by the last dealer in the supply chain, with set off benefits at all previous stages.
- It will discourage tax evasion.

Problems in Raising Resources through Taxation

- There is a large non-monetized sector in developing countries. It is difficult to evaluate the real income of farmers and other self employed people, and in including the value of home produced and consumed food in the taxable income of farmers.
- Illiterate population. Most of the farmers, wage earners, small shopkeepers, craftsmen etc., cannot even fill out the simplest income tax return forms.
- No voluntary compliance on the part of tax payers. Large number of businessmen do not maintain books properly. While fixed income groups (salaried class) pays income tax regularly, a large number of prosperous businessmen evade taxes.
- Anonymity in the ownership of wealth – makes difficult to tax income derived from capital or wealth in an effective way.
- In agricultural sector, the large landholders are let off and therefore the burden of tax falls on the small monetized or market sector.
- Inefficient and corrupt administration in developing countries.

Public Borrowing

- Second most important source of public revenue.
- Different from taxes as all borrowings must be repaid.
- Justified for construction of roads, railways, canals, irrigation, installation of power plants, building of schools, hospital buildings etc.
- Financing of such activities through government borrowing is better than through taxation as taxation will place heavy burden on the present generation while the benefits will accrue to a number of generations.
- Government can raise public debt either in the form of voluntary loan or in the form of compulsory loan.
- Voluntary loan – raising resources by issuing various types of bills and securities if public expenditure exceeds public income - difficult in developing countries with low income levels.
- Compulsory Loans – more often in developing countries – frequently imposed at the time of inflation – bonds can be issued for periods ranging from 5 to 10 years with tax free interest payment – Employees Provident Fund (EPF) or National Pension Scheme (NPS).
- External loans – gap between foreign exchange payments and receipts often filled up by foreign borrowings.
- Disadvantages of foreign loans – (1) reduce the freedom of the receiver country to purchase in the cheapest market; (2) receiver country often forced to buy several inessential goods as a part of ‘package deal’; (3) often foreign loans are project tied so no freedom to use them for any other purpose; (4) often issued in an year to year basis producing uncertainty; (5)receiver country may not follow independent policies as there is a lot of political pressure from the donor nations or organizations.

Public Expenditure

- Government can increase the level of investment through creation of various public works program.
- Projects necessary for industrialization like laying railway tracks, power generation, development communication etc. are not taken up the private sector as investment is heavy but returns are low and realized only after long intervals. Similarly for basic and capital goods industries.
- Government steps in, but it requires massive expansion in public expenditure.
- This initial expenditure by the government helps in building up of the environment conducive for the development of the private sector.
- The government also has to ensure increase in agricultural production and productivity to meet the requirement of industrial sector for raw materials.
- Increased public expenditure due provision of cheap housing facilities, cheap or free health service, education etc. – they improve the level of productivity in the long run and help in building a more egalitarian society.
- Expenditure for public distribution system – new fair price shops have to be opened, storage and warehousing facilities have to be provided.
- Expenditure for reducing regional inequalities through industrial location policy – various subsidies and incentive are provided to set up industries in backward regions.

Deficit Financing

- Importance felt during the Great Depression of 1930s.
- The act of unbalancing of budget so that government expenditure exceeding government revenue, can set the economy on the path to economic recovery.
- Deficit financing refers to the methods of financing the budgetary gap.
- In developed countries the government borrows from the banks by selling securities which leads to activation of idle deposits of individuals held by the banks. Total money supply increases as a result.
- In developing countries, the government borrows from the central bank. The central bank merely prints more money so that money supply increases.

Deficit Financing in Developed Countries

- Deficit financing in developed countries advocated during the phase of depression when there is chronic deficiency in private demand leading to a sharp fall in the level of expenditure of the economy – goods remain unsold – capital equipment and machinery remain idle – banks and general public prefer not to undertake the risk of investment and accumulate idle cash.
- In such circumstances the government can push up its expenditure through deficit spending on public works (building roads, bridges etc.), which will create employment opportunities, leading to increase in purchasing power of people.
- The increase in demand will push up productive activities in the economy (more private investments), creating more employment and income, and helping the economy to come out of depression.
- How effective the method will be, will depend upon the responsiveness of private expenditure.

Deficit Financing in Developing Countries

- In developing countries level of voluntary savings plus resources raised by the government in the form of taxes, public borrowings and external finance are much less compared to the needs of investments.
- This gap has to be filled through deficit financing, hence it helps in promoting economic development in developing countries.
- Creation of new money through deficit financing leads to inflation due to deficient resources for production (factory buildings, machineries etc.).
- Inflationary situation may not arise in developed countries as resources for production are present but demand is deficient – if the available resources are sufficient to cater to increased demand due to deficit financing, inflation will not occur.
- In developing countries increase in income through increase in money supply will result in increase in consumption of food items. Since supply of food may not increase as fast as the increase in demand, the prices will increase.
- Resources raised through deficit financing are rarely spent on consumption goods (through programs such as distribution of high yielding variety seeds, fertilizers etc. to farmers) and more on building costly capital equipment (e.g., laying railway tracks, improved communication facilities, hydro electricity generation etc.). Hence food inflation is common.

Cases for Inflationary Method of Financing

- According to some economic growth must be accompanied by inflation.

- Inflations leads to a transfer of income from wage earners to a group of profit earners. If prices rose faster than wages and propensity to save out of profits is higher than the propensity to save out of wages, savings and investment will increase leading to an increase in economic growth.

Deficit Financing or Taxation in Developing Countries?

- Deficit financing leads to inflation and many of the developing countries are currently reeling under the inflationary pressure.
- Many developing countries are not efficient enough to come out of the inflationary pressure once it sets in.
- Hence taxation more favorable.

Budget Deficit

- Budget deficit is the excess of total expenditure (including both revenue and capital) over total receipts (including both revenue and capital).
- Capital expenditure/ receipts are associated with the purchase or sale of fixed assets that are expected to be productive over a long period of time.
- Revenue expenditure/ receipts are associated with day-to-day activities, such as cost of goods sold or purchased, repairs and maintenance expenses etc.
- There can be 3 different types of deficits in the budget depending upon the types of receipts and expenditures taken into account – (1) revenue deficit; (2) fiscal deficit; (3) primary deficit.

Revenue Deficit

- Revenue Deficit = Total Revenue Expenditure – Total Revenue Receipts
- Revenue deficit is associated with the current expenditure and current receipts of the government.
- The government has to borrow to finance its expenditure.
- A higher revenue deficit implies higher repayment burden in future.
- The government should try to curtail its higher consumption expenditure.
- The government can raise taxes on rich and impose new taxes where possible to meet the deficit.

Fiscal Deficit

- Fiscal deficit = total expenditure (revenue and capital) – total receipts (revenue and capital) excluding borrowings
- It is a measure of how much the government needs to borrow from the market to meet its expenditure when its resources are inadequate.
- Fiscal deficit is zero if we add borrowings to total receipts.
- Borrowings include not only the amount of accumulated debt (i.e., the amount of the loan) but also the interest on any previous loan.
- There can be fiscal deficit without revenue deficit – (1) when revenue budget is balanced but capital budget is in deficit; (2) when revenue budget is in surplus, but deficit in the capital budget is greater than the surplus in revenue budget.
- Fiscal deficit is advantageous if it creates new capital assets to increase productive capacity of the economy. It is detrimental if used to cover revenue deficits only.
- Methods to finance fiscal deficit – (1) borrowing from the public and commercial banks by taking money from provident fund and small savings schemes; (2) borrowing from external sources like IMF, World Bank; (3) deficit financing.
- Tax base should be broadened and concessions and reductions in taxes should be ruled out to reduce fiscal deficit. A reduction in expenditure on major subsidies, bonus, LTCs etc. may also help.

Primary Deficit

- Primary deficit = fiscal deficit of current year – interest payments on previous borrowings.
- It shows how much the government is borrowing to meet expenses other than interest payments.
- Primary deficit excludes the burden of the previous debt and only shows the net increase in the government's debt that is due to the current fiscal.
- If primary deficit is zero, then fiscal deficit is equal to interest payments. It implies the government has to borrow to finance the interest payment only.
- A reduction in primary deficit means that the government is making attempts to reduce its excess expenditure.