# UNIT-V

## GOVERNMENT BUDGET AND THE ECONOMY

# CHAPTER 8

# GOVERNMENT BUDGET AND THE ECONOMY

The purpose of this chapter is to understand what a government budget is and how the government budget interacts with and affects the economy. The budget is the most important information document of the government. One part of the budget is similar to a company's annual report. This part presents the overall picture of the financial performance of the government during the period since its last budget. The second part of the budget presents the government's financial plans for the period up to its next budget, in order to inform the country, and seek legislative approval. As a consequence of Keynesian economics, budgetary policies are considered significant in the stabilisation of the economy.

**Budget and its Objectives**

The budget is an annual statement of the estimated receipts and expenditures of the government over the fiscal year, which runs from April 1 to March 31. The government has several policies it wishes to implement in the overall task of performing its functions. Implementation of these policies requires expenditure by the government, and some source of funding for that expenditure. The budget, is thereby a fiscal tool for the government to implement its various policies.

The objectives that are pursued by the government through the budget are as follows:

1. *Activities to secure a reallocation of resources*: The government has to reallocate resources in line with social and economic considerations in case the market fails to do so, or does so inefficiently.
2. *Redistributive Activities*: The government redistributes income and wealth to reduce inequalities, by expenditures on social security, subsidies, public works etc.
3. *Stabilising Activities*: The government tries to prevent business fluctuations and maintain economic stability through expanding public expenditure during recession and contracting the former during inflation. (Keynesian economics).

4. *Management of Public Enterprises*: Government undertakes commercial activities that are of the nature of natural monopolies, heavy manufacturing, etc. through its public enterprises. A natural monopoly is a situation where there are economies of scale over a large range of output; then one firm can produce at a lower average cost than could more than one firm. Industries which are potential natural monopolies are railways, electricity etc. These usually come under state regulation because if left unregulated, there will be a tendency of the monopolist to curtail output in pursuit of profit maximising behaviour, thereby lowering social welfare.

There are three levels at which the budget impacts the economy. First, is aggregate fiscal discipline. This means having control over expenditures, given the quantum of revenues. This is necessary for proper macroeconomic performance. The second is the allocation of resources based on social priorities and the third is the effective and efficient provision of programmes and delivery of services. Effectiveness measures the extent to which goods and services the government provides achieves its goals, or attains its targets or achieves its mission. Efficiency refers to the cost per unit of goods or services provided.

## Components of the Budget

Governments at every level have their own constitutional processes to prepare, present and execute their budgets. We shall however, focus only on the budget of the Central Government.[1] The budget is divided into the revenue budget and the capital budget. The Revenue Budget consists of the revenue receipts of the government and the expenditure met from such revenues. The Capital Budget consists of capital receipts and payments. We will now undertake a classification of receipts and expenditure in order to understand how they are reflected in the Revenue and the Capital Budgets.

### *Budget Receipts*

Receipts may be classified as revenue receipts and capital receipts.

*Revenue Receipts*

Revenue receipts may be divided into *tax revenue* and *non-tax revenue*. Tax revenues consist of the proceeds of taxes and other duties levied by the Union Government (Central Government). The proposals of government for levy of new taxes, modification of the existing tax rates or continuance of the existing tax rates are contained the budget. Taxes are of two types – direct taxes and indirect taxes. *Direct taxes* are those taxes levied immediately on the property and income of persons, and those that are paid directly by the persons to the state. Income tax, interest tax, wealth tax, corporation tax are all examples of direct taxes. *Indirect taxes* are those that affect the income and property of persons through their consumption expenditures. Customs duties, excise duties, sales tax, service

[1] Similar to Central Government, states also prepare budgets.

tax are all examples of indirect taxes. Indirect taxes are levied on the goods and services which people consume, and are hence indirectly taxing income, at the time when the income is spent.

While direct taxes are compulsory and cannot be escaped, a person can avoid paying indirect tax by refraining from entering into the particular transaction that leads to the tax being levied e.g. a person can avoid excise duty on biscuits by merely avoiding the purchase of biscuits.

Non-tax revenue consists of all other revenue receipts. They may be of the following types. Commercial revenue is revenue received by the government in the form of prices paid for government-supplied commodities and services. This includes payments for postage, tolls, interest on funds borrowed from government credit corporations, electricity, railway services etc. Another source of revenue is interest and dividends on investments made by the government. Administrative revenue is revenue that arises on account of the administrative function of the government. The following are some examples of different sources of administrative revenue.

*Fees* are defined as 'a payment to defray the cost of each recurring service undertaken by the government, primarily in the public interest, but conferring a measurable special advantage on the fee payer', e.g. college fees in government colleges. *License fees* are paid in those instances in which the government authority is invoked simply to confer a permission or privilege rather than to perform a service of a more tangible and definite sort, e.g. registration fee for an automobile, firearm, etc. *Fines and penalties* are levied for an infringement of a law. *Forfeitures* of basic surety or bonds are penalties imposed by courts for non-compliance with orders or non-fulfilment of contract etc. *Escheat* refers to the claim of the government on the property of a person who dies without having any legal heirs or without leaving a will.

Table 8.1 shows the revenue receipts of the Government of India as per budget estimates for 2002-03.

**Table 8.1: Revenue receipts of the Union Government as per 2002-03 budget estimates**

| Item | Amount (Rs. in crores) |
|---|---|
| Tax revenue | 172965 |
| Non-tax revenue | 72140 |
| Total revenue receipts | 245105 |

*Source* : Economic Survey, 2002-03, Government of India.

### *Capital Receipts*

The main items of capital receipts are loans raised by the government from the public (these are called Market Loans), borrowings by the government from the Reserve Bank of India and other parties through the sale of treasury bills, loans received from foreign governments and bodies (e.g. World Bank, Asian Development Bank, etc.), recoveries of loans granted to state and union territory governments and other parties, small savings and deposits in the public provident fund (PPF), etc.

Table 8.2 shows the capital receipts of the Government of India as per budget estimates for 2002-03.

**Table 8.2: Capital receipts of the Union Government as per 2002-03 budget estimates**

| Item | Amount (Rs. in crores) |
|---|---|
| Recovery of loans | 17680 |
| Other receipts (mainly PSU disinvestment) | 12000 |
| Borrowings and other liabilities | 135524 |
| Total Capital receipts | 165204 |

*Source* : Economic Survey 2002-03, Government of India.

### *Expenditure*

Expenditure may be classified in the following three ways:

1. *Revenue expenditure* and *capital expenditure*

Revenue expenditure is the expenditure incurred for the normal running of government departments and provision of various services, interest charges on debt incurred by the government, subsidies etc. In general, any expenditure that does not result in the creation of assets is treated as revenue expenditure. However, all grants given to state governments are treated as revenue expenditure even though some of the grants may be for creation of assets.

Capital expenditure consists mainly of expenditure on acquisition of assets like land, buildings, machinery, equipment; investments in shares, etc., and loans and advances granted by the central government to state and union territory governments, government companies, corporations and other parties.

2. *Plan expenditure* and *Non-Plan expenditure*:

Plan expenditure is that public expenditure which represents current development and investment outlays that arise due to plan proposals. Non-plan expenditure is all other expenditure, generally of recurring nature.

Table 8.3 shows the break up of expenditure into revenue and capital, plan and non-plan, as per the budget estimates for 2002-03.

**Table 8.3: Break ups of expenditure as per budget estimates for 2002-03**

| Sl. No | Item | Amount (Rs. in crores) |
|---|---|---|
| 1 | Interest payments | 1,17,390 |
| 2 | Major subsidies | 38,923 |
| 3 | Defence expenditure | 43,589 |
| 4 | Revenue expenditure | 3,40,482 |
| 5 | Capital expenditure | 69,827 |
| 6 | Plan expenditure | 1,13,500 |
| 7 | Non-plan expenditure | 2,96,809 |
| 8 | Total Expenditure (6+7) or (4+5) | **4,10,309** |

*Source* : Economic Survey 2002-03, Government of India.

3. *Developmental and Non-developmental expenditure*

Developmental expenditure includes plan expenditure of Railways, Posts and Telecommunications and non-departmental commercial undertakings which are financed out of their internal and extra budgetary resources, including market borrowings and term loans from

**Table 8.4 : Break-ups of expenditure of Central, State and Union Territory Governments, 2001-02.**

| Sl. No | Item | Amount (Rs. in crores) |
|---|---|---|
| 1 | Developmental expenditure | 369266 |
| 2 | Defence (net) | 62000 |
| 3 | Interest payments | 144588 |
| 4 | Tax collection charges | 8533 |
| 5 | Police | 24383 |
| 6 | Others | 121045 |
| 7 | Non-developmental expenditure (2+3+4+5+6) | 360549 |
| 8 | Total expenditure (1+7) | 729815 |

*Source* : Economic Survey, 2002-03, Government of India.

financial institutions to State Government public enterprises. It also includes developmental loans given by the Central and State Governments to non-departmental undertakings, local bodies and other parties.

Non-developmental expenditures include expenditures on defence, interest payments, tax collection, police, and other expenditures. Other expenditures include that on general administration, pensions, ex-gratia payments to former rulers, famine relief, subsidies on food and controlled cloth, grants and loans to foreign countries and loans for non-development purpose to other parties etc.

Table 8.4 shows the break up of expenditure of Central, State and Union Territory Governments (including internal and extra-budgetary resources of public sector undertakings for their plans) into developmental and non-developmental expenditure, as per 2001-02 budget estimates.

## Balanced, Surplus and Deficit Budgets

We have defined the budget as an annual statement of the estimated receipts and expenditures of the government over the fiscal year. A budget may be in surplus, in deficit or balanced, subject to the following conditions:

| Relative Sizes of estimates | Type of Budget |
|---|---|
| Revenue < Expenditure | Deficit |
| Revenue = Expenditure | Balanced |
| Revenue > Expenditure | Surplus |

Let us first consider the case of a *surplus budget*. A surplus budget is one where the estimated revenues are greater than the estimated expenditures. To simplify the analysis, let us assume a situation where the only source of revenue is a lump sum tax. Now, as we saw from chapter VI, the effect of a tax is to lower the consumption and therefore, aggregate demand by an amount equal to the marginal propensity to consume (MPC) times the amount of the tax. The effect of government expenditure is to increase the aggregate demand by the amount of the expenditure. Now, if tax (and therefore revenue) is sufficiently higher than the government expenditure, then we will have MPC times tax is greater than expenditure. Then, the reduction in aggregate demand (due to the tax) is greater than

the increase in aggregate demand (due to expenditure). The net effect of this is to lower aggregate demand. Thus, a surplus budget will lower aggregate demand.

Lowering aggregate demand is a good way to combat inflation that arises out of the presence of excess demand. However, a surplus budget is a poor strategy in the case of a deflation and recession, as it will lower the already deficient demand, thus worsening the situation.

A *balanced budget* is one where the estimated revenue equals the estimated expenditure. Again, suppose that the only source of revenue is a lump sum tax. A balanced budget will then mean that the amount of tax equals the amount of expenditure. The decrease in aggregate demand (due to the tax) is equal to MPC times the tax. Since tax is equal to expenditure, the decrease in aggregate demand is also equal to MPC times the expenditure. Now, the increase in aggregate demand due to the expenditure is equal to the amount of the expenditure. Then, the increase in aggregate demand (due to expenditure) is greater than the decrease in aggregate demand (due to the tax). The net effect is to increase aggregate demand by an amount equal to the expenditure multiplied by 1– MPC. Thus, a balanced budget will slightly increase the aggregate demand. A balanced budget is therefore a policy instrument to bring the economy which is at near full-employment to a full-employment equilibrium.

A *deficit budget* is one where the estimated revenue is less than the estimated expenditure. This means that the tax is less than the expenditure. The reduction in aggregate demand (due to the tax) is equal to MPC times the tax. The increase in aggregate demand (due to expenditure) is by an amount equal to the expenditure. Now, if tax is sufficiently less than the expenditure then the reduction in aggregate demand will be less than the increase in aggregate demand. The effect of this will be to increase aggregate demand. The deficit budget is therefore a policy instrument to combat recession, where the economy is in an under-employment equilibrium due to deficient demand.

### *Types of Deficit*

There are four different concepts of budget deficit. They are *budget deficit, fiscal deficit, primary deficit* and the *revenue deficit*. We shall analyse them individually.

#### *Budget Deficit*

The *budget deficit* is the difference between the total expenditure on one hand, and current revenue and net internal and external capital receipts of the government on the other. It has to be financed by net internal and external capital receipts. The calculation of the budget deficit is shown in Table 8.6.

#### *Fiscal Deficit*

The *fiscal deficit* is the difference between the total expenditure of the government (by way of revenue expenditure, capital expenditure and loans net of repayments) on one hand,

and on the other hand, the revenue receipts plus those capital receipts which are not in the nature of borrowing, but which finally accrue to the government.

The extent of the fiscal deficit is an indication of how far the exchequer is living beyond its means. The fiscal deficit indicates the amount of borrowing the government has to do. A large fiscal deficit implies a large amount of borrowings. This creates a correspondingly large burden of interest payments in the future. In the present, a large fiscal deficit may also fuel inflationary pressures.

*Primary Deficit*

The *primary deficit* is the fiscal deficit minus interest payments. It therefore indicates, how much government borrowing is going to meet expenses other than interest payments. It reflects the extent to which current government policy is adding to future burdens stemming from past policy. It is often used as a basic measure of fiscal irresponsibility. In other words, it is a measure of how much the government is borrowing in continuance of its profligate ways. A low or zero primary deficit means that while its interest commitments on earlier loans have compelled the government to borrow, it is aware of the need to tighten its belt.

*Revenue Deficit*

The *revenue deficit* is the excess of government's revenue expenditures over revenue receipts. It gives information on what the government is borrowing for. In the analogy of the household, the revenue deficit tells the amount the householder is borrowing to pay the grocer, rather than add a roof to the house. Given the same level of fiscal deficit, a higher revenue deficit is worse than a lower one. The revenue deficit implies a repayment burden in the future, not matched by any benefits via investment.

Table 8.5 shows the various deficits as per 2002-03 Indian budget estimates.

**Table 8.5: Types of deficits as per 2002-03 budgetary estimates**

| No. | Item | | Amount (Rs. in Crores) |
|---|---|---|---|
| **1.** | **Revenue receipts** | | **245105** |
| | (i) Tax revenue | 172965 | |
| | (ii) Non-tax revenue | 72140 | |
| **2.** | **Capital receipts** | | **165204** |
| | (i) Recovery of loans | 17680 | |
| | (ii) Other receipts (mainly PSU disinvestments) | 12000 | |
| | (iii) Borrowings and other liabilities | 135564 | |
| **3.** | **Revenue expenditure** | | **340482** |
| | (i) Interest payments | 117390 | |
| | (ii) Major subsidies | 38923 | |
| | (iii) Defence expenditure | 43589 | |
| **4.** | **Capital expenditure** | | **69827** |
| **5.** | **Total expenditure** | | **410309** |
| | (i) Plan expenditure | 113500 | |
| | (ii) Non-plan expenditure | 296809 | |
| **6.** | **Fiscal deficit [5 – 1 – 2(i) – 2(ii)]** | | **135524** |
| **7.** | **Revenue deficit [3 – 1]** | | **95377** |
| **8.** | **Primary deficit [6 – 3(i)]** | | **18134** |

*Source* : Economic Survey, 2002-03, Government of India.

The overall budgetary deficit of Central, State and Union Territory Governments is estimated using the table of budgetary transactions (Table 8.6)

**Table 8.6: Overall budgetary deficit of Central, State and Union Territory Governments as per 2001-02 budgetary estimates.**

| No. | Item | | Amount (Rs. in Crores) |
|---|---|---|---|
| **1.** | **Total Outlay** | | **729815** |
| | A.Development | | 369266 |
| | B. Non-Development | | 360549 |
| | (i) Defence (net) | 62000 | |
| | (ii) Interest payments | 144588 | |
| | (iii) Tax collection charges | 8533 | |
| | (iv) Police | 24383 | |
| | (v) Others | 121045 | |
| **2.** | **Current Revenue** | | **476031** |
| | A. Tax Revenue | | 371355 |
| | (i) Income and corporation tax | 84801 | |
| | (ii) Customs | 54822 | |
| | (iii) Union excise duties | 81720 | |
| | (iv) Sales tax | 81579 | |
| | (v) Others | 68433 | |
| | B.Non-Tax Revenue | | 104676 |
| | (Internal resources of public sector undertaking for the plan) | | (45100) |
| **3.** | **Gap (1 – 2)** **Financed by:** | | **253784** |
| **4.** | **Net Capital Receipts (A+B)** | | **248124** |
| | A. Internal (net) | | 245561 |
| | (i) Net market loans | 84410 | |
| | (ii) Net small savings | 11938 | |
| | (iii) Net State and PPFs | 31525 | |
| | (iv) Special deposits on non-government PFs | 10500 | |
| | (v) Net miscellaneous capital receipts | 107188 | |
| | B. External | | 2563 |
| | (i) Net loans | 1165 | |
| | (a) Gross | 10763 | |
| | (b) Less repayments | 9598 | |
| | (ii) Grants | 698 | |
| | (iii) Revolving fund | 700 | |
| **5.** | **Overall Budgetary Deficit (3 – 4)** | | **5660** |

*Source*: Economic Survey, 2002-03, Government of India.

We have now seen the four concepts of deficits. The deficit in a budget has to be financed in one of two ways – by monetary expansion or by borrowing. Monetary expansion amounts to printing money to the extent of the deficit. The process of monetary expansion involves the government borrowing from the Central Bank through the issue of treasury bills to the Central Bank. The Central bank purchases the treasury bills in return for cash, which the government uses to fund the deficit. Alternatively, the deficit may be funded by borrowing from the public through market loans etc. The safe level of fiscal deficit is considered to be 5% of Gross Domestic Product.

**SUMMARY**

- The budget is an annual statement of the estimated receipts and expenditures of the government over the fiscal year, which runs from April 1 to March 31.
- The government implements its policies through the budget.
- The budget impacts the economy through aggregate fiscal discipline, resource allocation and provision of programmes and delivery of services.
- The budget is divided into revenue budget and capital budget.
- Revenue may be divided into revenue receipts and capital receipts.
- Expenditure may be classified in three ways – revenue vs. capital, plan vs. non-plan, and developmental vs. non-developmental.
- Budgets are of three types – surplus, balanced and deficit.
- The three concepts of deficit are – fiscal deficit, revenue deficit and primary deficit.

## EXERCISES

1. What is a budget?
2. What are the objectives of a budget?
3. What are the revenue items?
4. Define tax and non-tax revenue.
5. What is the difference between Revenue Budget and Capital Budget?
6. Classify public expenditure.
7. Differentiate between developmental and non-developmental expenditure.
8. What is non-plan expenditure?
9. Define:
   (a) Fiscal deficit
   (b) Budget deficit
   (c) Revenue deficit
   (d) Primary deficit
10. How may a deficit be financed?