UNIT V

Fiscal policy means the use of taxation and public expenditure by the government for stabilization or growth of the economy. According to Culbarston, "By fiscal policy we refer to government actions affecting its receipts and expenditures which ordinarily as measured by the government's receipts, its surplus or deficit." The government may change undesirable variations in private consumption and investment by compensatory variations of public expenditures and taxes.

Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. This tends to influence other economic variables.

On a broad generalization, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. 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. So it can be said that the fiscal deficit can be like a double edge sword, which need to be tackled very carefully.

Main Objectives of Fiscal Policy in India

Before moving on the discussion on objectives of India's Fiscal Policies, firstly know that the general objective of Fiscal Policy.

General objectives of Fiscal Policy are given below:

1. To maintain and achieve full employment.
2. To stabilize the price level.
3. To stabilize the growth rate of the economy.
4. To maintain equilibrium in the Balance of Payments.
5. To promote the economic development of underdeveloped countries.

Fiscal policy of India always has two objectives, namely improving the growth performance of the economy and ensuring social justice to the people.

The fiscal policy is designed to achieve certain objectives as follows:-

1. Development by effective Mobilisation of Resources: The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources. The central and state governments in India have used fiscal policy to mobilise resources.

The financial resources can be mobilised by:-

a. Taxation: Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation in India is taxation.

b. Public Savings: The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.

c. Private Savings: Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issuance of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

2. Reduction in inequalities of Income and Wealth: Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

3. Price Stability and Control of Inflation: One of the main objectives of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, productive use of financial resources, etc.

4. Employment Generation: The government is making every possible effort to increase employment in the country through effective fiscal measures. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generate more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.

5. Balanced Regional Development: there are various projects like building up dams on rivers, electricity, schools, roads, industrial projects etc run by the government to mitigate the regional imbalances in the country. This is done with the help of public expenditure.

6. Reducing the Deficit in the Balance of Payment: some time government gives export incentives to the exporters to boost up the export from the country. In the same way import curbing measures are also adopted to check import. Hence the combine impact of these measures is improvement in the balance of payment of the country.

7. Increases National Income: it's the strength of the fiscal policy that is brings out the desired results in the economy. When the government want to increase the income of the country then it increases the direct and indirect taxes rates in the country. There are some other measures like: reduction in tax rate so that more peoples get motivated to deposit actual tax.

8. Development of Infrastructure: when the government of the concerned country spends money on the projects like railways, schools, dams, electricity, roads etc to increase the welfare of the citizens, it improves the infrastructure of the country. A improved infrastructure is the key to further speed up the economic growth of the country.

9. Foreign Exchange Earnings: when the central government of the country gives incentives like, exemption in custom duty, concession in excise duty while producing things in the domestic markets, it motivates the foreign investors to increase the investment in the domestic country.

The Concept of Functional Finance: laid down by Prof. A.P. Lerner

Keynesian revolution in economic thinking reconstituted the whole basis of public finance and affirmed functional finance as a fiscal norm in modern times.

Though the lead in the development of “functional finance” concept was taken by Keynes, credit goes to Prof. A.P. Lerner for coining this concept. Lerner puts that: The principle of judging fiscal measures by the way they work or function in the economy, we may call functional finance.

He contends that the fiscal operation of the government — taxing, borrowing; public spending, management of public debt, etc., deficit financing, etc. — should be designed with the objective of fulfilling certain functions which have an immediate bearing and far-reaching effects on the economic system as a whole.

In economic philosophy, the term functional finance embraces public expenditure, public revenue and debt management which were regarded as fiscal instruments effectively used to achieve objectives like attainment and maintenance of full employment with economic stability.

As Prof. Chelliah points out, the functional concept of fixed policy, thus, implies that:

(i) the fiscal operations of the government should be conducted on a functional basis and public finance should not be considered as being induced solely by the need for securing social goods meant for collective consumption

(ii) the budget need not always be balanced. As a matter of fact, the fiscal norm of functional finance is the complete antithesis of the orthodox rule of balanced budget. The functional finance norm suggests the formation of large budgets with a wider functional coverage of government spending to promote basic economic goals, e.g., (a) to obtain optimal allocation and efficient use of scarce resources at full-employment level, (b) to achieve economic stability and bring about an equitable distribution of income and wealth in the best possible manner.

Quite contrary to the classical notion, the concept of functional fiscal policy suggests that the state need not and should not assume a passive role in the economic affairs of the country.

It implies that public spending may be incurred not merely for the sake of its direct benefits, but for the sake of indirect effect it produces in raising the level of income, output and employment; and the public revenue may be raised not to meet an anticipated expenditure, but to curtail excessive demand and curb inflationary potentials in the economy. Taxation is, thus, regarded as an important and effective weapon in the hands of government to promote economic progress with stability.

Lerner suggests the following rules for government’s responsibility and activity under functional finance:

(i) The government budget should be directed towards the achievement of full employment and price stability. For this purpose, the government budget need not necessarily be balanced.

(ii) The government should incur public debt by borrowing money from the private sector only during inflation when it is, absolutely essential to mop up the excessive purchasing power from the public, thereby reducing the pressure of excess monetary demand.

(iii) During depression only, public expenditure in excess of current public revenue may be met by deficit financing, i.e., printing additional currency notes.

In short the main tenet of functional finance is the formation of unbalanced budget from time to time for perfecting the counter-cyclical goal of fiscal policy. A surplus budget is recommended during inflation and a deficit budget for recovery through excessive public spending during a deflation or depression.

Functional finance, thus, deliberately aims at unbalancing the budgets with a view to attaining and maintaining full employment level in a developed economy. In an underdeveloped economy, however, the main problem is not one of full employment but that of rapid economic growth. In a developing economy, thus, the functional aspect of fiscal policy is to be conceived in the context of a planned process of economic development.

The Concept of Federal Finance:

In usual parlance federation is defined as an association of two or more states. The federal setup is characterized by the existence of a union government (Central government) on the one hand and state government for different constituent units.

It is a form of political association in which two or more states constitute a political unity with a common government, but in which the member states retain a measures of internal autonomy. Encyclopedia Britannica defines federation **"as a form of government in which the essential principle is that there is a union of two or more States under the central body for certain permanent objectives."**

Principles of Federal Finance:

In a federation functions are distributed among different layers of government. Since each government is responsible for its own sphere of activity there should be adequate provision for source of revenue and its efficient administration for discharging the assigned functions independently and satisfactory.

Therefore the pool of total revenue source should be divided between the centre, state and local governments scientifically and reasonably. This warrants some mutually beneficial and sound principles, for the division of revenue source.

What should be the guiding principle regarding the division of functions and resources among different layers of government.

A host of economist provided an array of guiding principles in determining the resource allocation. Prof. Seligman prescribed three principles on the basis of which revenue sources i.e., taxes should be divided between the different layers of government.

These fundamental principles governing resource allocation are:

(a) Efficiency,

(b) Suitability, and

(c) Adequacy.

Efficiency norms insist that tax allocation among different layers of government should be decided by the capacity of feasibility to administer the tax effectively. There will be taxes, which can be best administered by the centre. Such taxes should be assigned to the central government. For example income tax in India.

Likewise there are some taxes which can be administered by the state government. Such taxes should be assigned to the state government. Best example is agricultural income tax. Suitability criterion insists that the nature of tax is an important aspect determining allocation.

Taxes will possess wider or narrow jurisdiction. Taxes with narrow jurisdiction should be allocated to regional or local governments rather than central government. The adequacy norms insist that revenue assigned to a particular layer of government should be sufficient to carry out the functions and responsibilities assigned to them.

The non-coordination between functions of government and revenue allocated to discharge the functions generate crucial problem in federal finance. Prof. Seligman in his Essays in Taxation observes" no matter how well intentioned a scheme may be or how completely it may harmonies with the abstract principles of Justice, if the tax does not work administratively, it is doomed to failure".

These principles are briefly explained below:

1. Independence and Responsibilities:

The success of fiscal federalism is conditioned by the two fundamental requisites- Financial independence and financial responsibility. It means that the central and state government must be financially independent within their own spheres.

Each government should possess separate and independent sources of revenue. Government at different layers should have full power to tax, to incur expenditure and to borrow to perform the assigned functions effectively.

Prof. Adarkar observes, **"Taxing autonomy and spending autonomy should go hand in hand. In the broader interest of the nation the centralization of revenue in the hands of the central government seems to be good. However too much dependence of state government on central government for resources is not a healthy practice in federal finance."**

2. Adequacy and Elasticity:

Adequacy implies that allocation of resources should be based on distribution of functions. The sources of revenue assigned to each layer of government, should be sufficient enough to discharge the functions efficiently and effectively.

For achieving this financial structure should be elastic, flexible and adaptable to the changing conditions of economy. The resources should be capable of expression in response to the rapidly growing needs and responsibilities of government otherwise the federal finance system will create rigidities during times of economic stress and strain.

As John Athan Says “if a federal system with real independence in the states is to continue, the state must have financial resources under their own control reasonably adequate to meet their responsibilities.” Justifying the principle of adequacy and elasticity.

Dr. R. N. Bhargawa observes “the scheme of resources must be set up on elastic system because no scheme, howsoever good, can be final for all times to come; under changing conditions, any argument is bound to become out of date in course of time. The scheme of division must, therefore, incorporate provisions for such changes when they become necessary in the national interest.”

3. Administrative Efficiency and Economy:

Tax resources should be assigned to different layers of government considering efficiency and economy in administration. The administrative Cost should be minimized. There should be no scope for fraud and evasion.

While allocating resources the administrative efficiency should be adhered. For example it is better and economical to allocate land tax to local bodies, excise tax on alcohol to state government and income tax to central government.

Here each layer of government is assigned such sources of revenue which it can administer efficiently. As point out by prof. Seligman, the nature of tax and character of administration determine the effectiveness of different taxes. This will ensure optimum utilization of revenue potential and help to prevent corruption and evasion in revenue mobilization and realization.

4. Other Important Principles:

1. Principle of Uniformity and Equity:

In a federation there may be regional variation in the level of economic development, owing to a number of economic and non-economic factors. Therefore contribution of each state in federal resources structure should be based according to its ability or economic condition.

Hence the principles of equality in the distribution of tax burden are another guiding principle of federal finance. Principles of uniformity insist that there should be no discrimination between citizens of different states in a federation.

Adequate provision should be there to protect the interest of backward regions and states and even weaker sections of the community, under conditions of difference in resource endowments, tax burden should be distributed on the basis of marginal sacrifice principle.

For the success of fiscal federalism there should be proper integration and co-ordinations of the financial system of different layers of government. Judicious uses of scarce resources are affected by well co-ordinated and integrated intergovernmental fiscal policy.

3. Principles of Accountability:

In a federal form of political set up federation and democracy are considered as sister institutions. So in a federation each layer of government should be accountable to its own legislature for its taxing and spending decisions.

Utmost transparency should be retained in all financial and administrative matters. Each government spending and taxing decisions should be done with regard to their effect on other governments.

4. Principle of Financial Access:
This principle implies that there should be no bar on centre and state governments in exploring new source of resources, to meet the growing financial requirements. In a sense resource should grow along with growth in responsibilities.

Moreover in order to develop healthy financial relation between different units in a federation each government unit will have to work under certain self-imposed discipline. Moreover division of resources should be subject to flexibility.

It is a reality that a number of problems arises and exist in federal finance. We should not try to overshadow these problems by putting certain rigid norms and principles.

A pragmatic approach towards finding solutions to problem is needed. Since socio-economic conditions differ from time to time and from state to state the division of resources should be subjected to flexibility and adaptability. In a federal fiscal system, there is only scope for adjustment in the light of changing circumstances

Problems of Federal Finance:
Federalism whereby two or more sovereign units of government Coexist within the same political environment, provides the primary basis for the intergovernmental fiscal problems. It is very difficult to decide which level of government will perform the specific functions as per community preference.

In addition the revenue sources necessary to finance these expenditure functions must be allocated among the various levels of government in a specified manner. A considerable divergence exist between the sources of revenue and functional expenditure obligations among the government of a federation.

Therefore some government may find it easier to than others to meet their expenditure responsibilities from their own revenue source. This situation is a form of imbalance between revenue and expenditure, that too between different levels of government.

The problems of a decentralized fiscal system in fiscal federalism, as it is called, have received much attention, in public finance literatures during the past 3 decades. This is partly due to the fact that there are different sovereign levels in the political system and because of the extension of the theory of public goods, at the national, state and local levels.

It has also been partly due to certain development in federal fiscal structure including the imbalance in the distribution of resources and needs among different levels of government. This has called forth a reconsideration of the fiscal rules to be performed by various levels of government and there relations to one another. In this context it is worth to analyses some of the important problems in federal fiscal system.

For the smooth functioning of a federation division of functions and resources is imperative. However for the last several years, there is a growing conflict between centre and state in matters regarding the distribution of financial resources, between the units in a federation, owing to political and ideological grounds.

There is multiplicity of taxing and spending activities in a federation. The allocation of functions between the centre and the state government differ from country to country. Generally the functions which are of national importance like defence, foreign affairs interstate activities etc. is usually shouldered by the central government.

Whereas matters which are of regional interest remain in the hands of regional government. Performance efficiency is the basis criteria for allocating functions among different constituent units in a federation.

As such functions like defence, foreign trade foreign affairs, post and telegraph etc. are put under the jurisdiction of central government. Subjects of regional interest like education, health service, public works, internal law and order etc. are assigned to the local government. This necessitates a proper co-ordination of the policies and activities of the centre and state governments.

Vertical Fiscal Imbalance:

In many democratic countries a large divergence exists between the revenue source and expenditure obligations among the governments of a federation. Some constituent governments in a federation many find it easier than others to manage their expenditure responsibilities from their own revenue source.

Whereas some others find it difficult to manage the revenue-expenditure programme in a balanced manner. Nowadays there is a continuous and persistent increase in the expenditure programmes of the state and local governments due to increasing welfare oriented programmes.

Expenditures on activities like education public health, social welfare, urban management, welfare schemes for weaker sections rural development activities etc. are on a continuous increase.

Whereas majority of revenue source under the control of state and local governments is inelastic in nature. This creates a situation of imbalance between growing expenditure requirements and poor yield of revenue source for state and local governments.

Contrary to this, the central government always possesses surplus revenue owing to control over more elastic sources of revenue. There occurs a situation of greater expansion of financial resources of central government, and shrinking of resources bases of state and local governments, coupled with increasing responsibilities of state and local governments due to growth of welfare activities.

This type of resource gap between the centre states is called vertical fiscal imbalance. The situation of imbalance of revenue and expenditures vertically between levels of government is referred to as the problem of non-correspondence or vertical fiscal imbalance.

Fiscal federalism tries to bridge this gap and attain a balance through vertical co-ordinations between the centre, state and local level public expenditure and resources needed to finance them.

The important methods adopted to achieve vertical fiscal equality between the centre and regional governments in a federation are:

1. Tax sharing,

2. Tax credit,

3. Tax deductibility,

4. Tax denial,

5. General grants-in-add, and

6. Selective grants-in-aid.

Under tax sharing arrangement a tax is levied and collected by single administration. But the proceeds are shared either wholly or partly with two or more units.

The allocation of the share to constituent units require some criteria which may be either within in the constitution or left to be determined by the national government or it may be determined by periodical agreement between the centre government and constituent units.

Under the tax credit, a superior government unit allows a credit against its tax to anyone who pays the same kind of tax to subordinate units. This method eliminates tax competition problem and thereby increases the capacity of the subordinate units.

Tax deductibility is another method to correct vertical imbalance. Under the method permission is granted by one government to deduct tax paid from the tax payers upon which another government levies taxes.

Under the tax denial the government may put restrictions on state and local government taxing powers. It includes denial of power to subordinate jurisdictions to levy certain taxes, putting a ceiling on the tax rule used by the lower level governmental units; Any upward change in the tax rate requires the approval of the central legislature. These methods of tax co-ordination are known as tax denial or tax restrictions.

In order to avoid overlapping of taxes and duplication of administration and to ensure uniformity of the base of taxation, the method of tax supplement must be used. The higher level government collects the tax with an additional duty imposed by the lower level governments.

Another method of collecting vertical imbalance in fiscal resources transfer is grants-in-aid. Three types of grants are used to transfer revenue to lower level of government viz. General

(Block or unconditional) grant, or selective grant (restrictive or conditional grant and matching or non-matching grants.

Horizontal Fiscal Imbalance:

Horizontal imbalance exists between units at the same level of sovereignty. When fiscal imbalance occurs between different units of government at the same level of government in a federation, it is known as problem of equalization or horizontal fiscal imbalance.

In a federation differences exist in the per capita distribution of income and wealth and the volume of trade among different states. Regional difference in resource endowment among different communities leads to variation in per capita revenue potential among communities.

Horizontal fiscal imbalance is corrected and the principle of fiscal equity is achieved through equalization of fiscal residue. Prof. J. M. Buchanan defines fiscal residue as **"net benefits from tax-expenditure programme i.e., benefit from expenditures minus disutility from tax payment."**

Due to difference in resource endowment, level of development and variation in the implementation of tax expenditure programmes among different states in a federation, the central and state taxes generate unequal fiscal residue for their citizens. Thus a gap in fiscal residue arises and the some must be equalized to achieve, what is called horizontal fiscal balance.

This gap in fiscal residue can be filled by interstate transfer of resources. That is there should be a federal arrangement for transferring resources from richer states to poor states.

This will help to reduce interpersonal fiscal inequality. Musgrave put it as realization of horizontal equality however it is unlikely that rich states within a country will voluntarily agree to transfer adequate resources to the resource deficient poor states. Foe affecting such a transfer a strong political set up at the centre is needed.

Another problem in federal set up is the tax competition, In order to attract more capital and trade from other parts of the country, one state government may reduce or abolish certain type of taxes, this policy may sometimes benefit backward states. However this type of competitive tax reduction may hinder the smooth flow of interstate trade.

It may again generate regional disparities in development, and income endowments among communities. This is a practical problem in federal fiscal system in modern period.

Source: https://www.accountingnotes.net/

Report of the 13th Finance Commission (2010-2015)

The Government must cut its fiscal deficit to 3% of the GDP by the end of fiscal year 2013-14 and eliminate its revenue deficit in 2014-15, according to the key recommendations of the 13th Finance Commission. The fiscal deficit is estimated at 5.7% in the year ending on March 2011, and will fall further to 4.8% in the year 2011-12, a 13th Finance Commission said. The report of the 13th Finance Commission, said that the fiscal deficit should drop to 4.2% in 2012-13 and to 3% in 2013-14. Finance Minister Pranab Mukherjee said that the Government has accepted all major suggestions of the 13th Finance Commission. The Centre must cap its total debt at 68% of the GDP by the end of financial year 2014-15, the report of the 13th Finance Commission stated.

Source: https://www.indiainfoline.com/article/budget-highlights/report-of-the-13th-finance-commission-2010-2015-114021219921_1.html