Government Budget and The Economy

Important Concept :

1) **A government budget :** is an annual financial statement showing item-wise estimates of expected revenue and anticipated expenditure during a fiscal year.
2) **Budget receipts :** Budget receipts refer to estimated receipts of the government from various sources during a fiscal year.
3) **Revenue Receipts**: Government receipts which neither create liabilities nor reduce assets are called revenues receipts, e.g., tax and non-tax receipts.
4) **Capital Receipts**: Government receipts which either create liabilities or reduce assets are called capital receipts, e.g., loan taken, disinvestment, recovery of loans granted to states and union territories, savings in post office.
5) **Fees**: 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 prayer.
6) **Fine**: Fines are amounts levied for an infringement of a law.
7) **Forfeitures**: Penalties imposed by courts for non-compliance with orders for non- fulfilment of contract, etc.
8) **Tax:** A compulsory payment by citizens of a country to the government without any quid pro quo (something taken or equivalent).
9) **Tax revenue:** consists of proceeds of taxes and other duties by the union government.
10) **Non-tax revenue**: Income from sources other than taxes is called non-tax revenue. It arises on account of administrative function of the government, e.g. fees, fines and penalties, forfeitures. Escheat.
11) **Revenue expenditure**: An expenditure which neither creates assets nor reduces liability is called revenue expenditure, e.g., subsidies given by government Salaries paid to Govt. employees.
12) **Capital expenditure**: An expenditure which either creates assets or reduces liability is called capital expenditure, e.g. loan granted to state govt: repayment of loans.
13) **Direct tax**: It is a tax whose liability (to pay) and the burden is borne by the same person e.g., income tax, wealth tax, expenditure tax, corporate tax, etc.
14) **Indirect tax**: It is tax whose liability to pay and the burden of the tax is borne by different persons, e.g., sales tax, excise duty, custom duty, service tax, entertainment tax, etc.
15) **Balanced budget**: A government budget is said to be a balanced budget in which government estimated receipts (revenue and capital) are equal to government estimated expenditure.
16) **Unbalanced budget**: When government estimated expenditure is either more or less than government estimated receipts, the budget is said to be an unbalanced budget.
17) **Deficit budget**: When government expenditure exceeds government receipts in the budget, the budget is said to be a deficit budget.
18) **Revenue deficit:** refers to the excess of total revenue expenditure of the government over its total revenue receipts during a fiscal year.
19) **Fiscal deficit:** is defined as excess of total expenditure over total receipts excluding borrowings during a fiscal year.

20) **Primary deficit:** is defined as fiscal deficit minus interest payments on previous borrowing

21) **Deficit financing:** borrowing of money by the Government to meet its budget deficit by selling treasury bills or government securities to RBI is called deficit financing (i.e. printing new currency notes). Alternatively, deficit financing is the mode of financing budgetary deficit (when govt. budgetary expenditure is more than the estimated revenue), more generally, in the form of printing new currency.

Meaning of a Government Budget

A government budget is an annual financial statement of estimated revenue and estimated expenditure during a fiscal year." Just as your household budget is all about what you earn and spend, similarly the government budget is a statement of its income and expenditure. In the beginning of every year, government presents before the Lok Sabha an estimate of its receipts and expenditure for the coming financial year. The government plans expenditure according to its objectives and then tries to raise resources to meet the proposed expenditure. A government earns money broadly from taxes, fees and fines, interest on loans given to states and dividend by public sector enterprises.

It spends mainly on ;

(I) securing and providing goods and services to citizens.

(II) on law and order and

(iii) internal security. defence, staff salaries, etc

Main elements of the budget are as follows:

a) It is a statement of estimates of government receipts and expenditure.

b) Budget estimates pertain to a fixed period, generally a year.

c) Expenditure and sources of finance are planned in accordance with the objectives of the government.

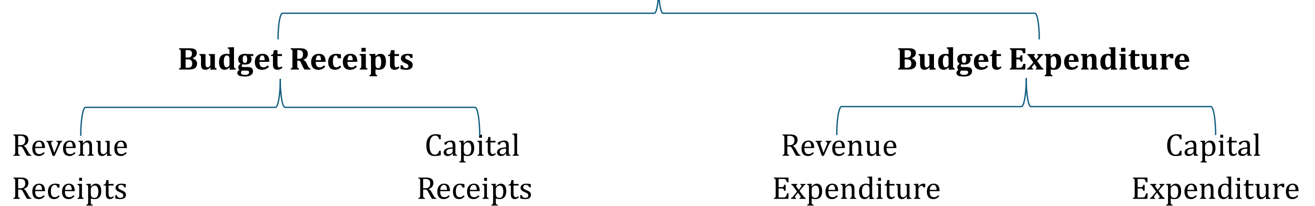
d) It requires to be approved (passed) by Parliament or Assembly or some other authority before its implementation.

Objectives of a Government Budget

It should be kept in mind that rapid and balanced economic growth with equality and social justice has been the general objective of all our policies and plans. General objectives of a government budget are as under:

- Economic growth
- Reduction of poverty and unemployment
- Reduction of inequalities/Redistribution of income
- Reallocation of resources
- Price stability/Economic stability
- financing and management of public enterprises
- Components of the budget

Structure of Government Budget

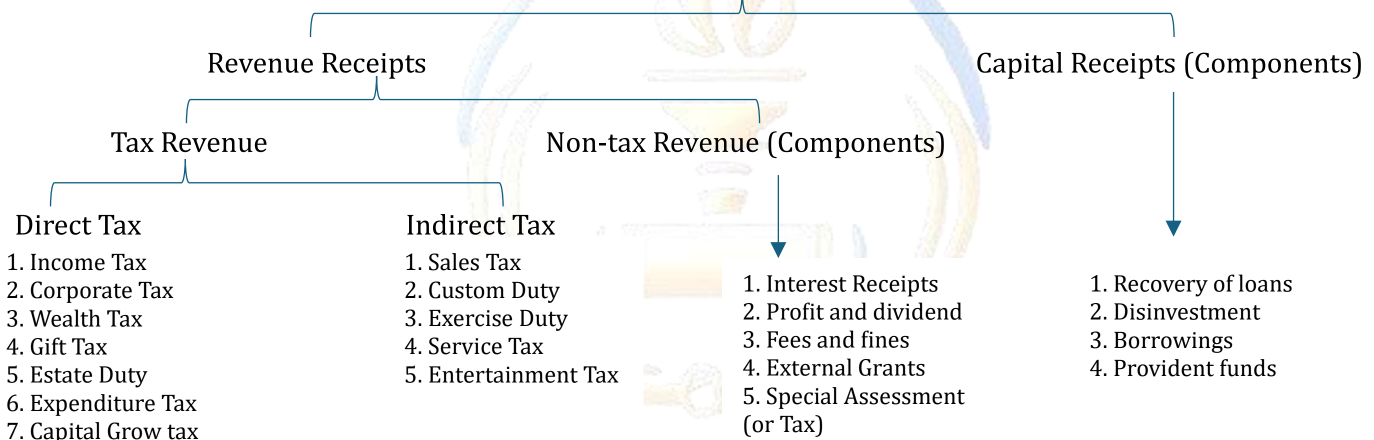


We shall first discuss all about Budget Receipts and afterwards Budget Expenditure.

Meaning of Budget Receipts

Budget receipts refer to estimated money receipts of the government from all the sources during a fiscal year. It shows the sources from where the government intends to get money to finance the expenditure (both revenue and capital expenditure). Budget receipts are of two types Revenue Receipts and Capital Receipts-as explained below. Their components are shown in the following chart.

Budget (Government) Receipts



Direct Tax
1. Income Tax
2. Corporate Tax
3. Wealth Tax
4. Gift Tax
5. Estate Duty
6. Expenditure Tax
7. Capital Grow tax

Indirect Tax
1. Sales Tax
2. Custom Duty
3. Exercise Duty
4. Service Tax
5. Entertainment Tax

Non-tax Revenue (Components)
1. Interest Receipts
2. Profit and dividend
3. Fees and fines
4. External Grants
5. Special Assessment (or Tax)

Capital Receipts (Components)
1. Recovery of loans
2. Disinvestment
3. Borrowings
4. Provident funds

Note : ↳ Direct Tax (Liability to pay and burden of tax falls on the same person) (Components)
↳ Indirect Tax (Liability to pay and burden of tax falls on different persons) (Components)

Difference between Revenue Receipts and Capital Receipts

Government receipts are divided into two groups Revenue Receipts and Capital Receipts. All government receipts which either create liability or reduce asself are treated as capital receipts whereas receipts which neither create liability nor reduce assets of government are called revenue receipts.

a) **Revenue Receipts**: Government receipts which neither (i) create liabilities nor (ii) reduce assets are called revenue receipts. These are proceeds of taxes, Interest and dividend on government investment, cess and other receipts for services rendered by the government. These are current income receipts of the government from all sources. Government revenue is the means for government expenditure in the same way as production is means for consumption. Revenue receipts are further classified into Tax Revenue and Non- tax Revenue as explained in Section 9.6.

b) **Capital Receipts**: Government receipts which either (i) create liabilities (e.g. borrowing) or (ii) reduce assets (e.g. disinvestment) are called capital receipts. Thus when gout. raises funds either by incurring a liability or by disposing off its assets, it is called a capital receipt.

- Two examples of Capital Receipts which create liability are Borrowing and Raising of funds from Public Provident Fund and Small savings deposits. How? (1) Borrowings are treated capital receipts because they create liability of returning loans. (If) Similarly, funds raised from PPF, small saving deposits in post offices and banks are treated capital receipts because they increase liability of the government to repay these amounts to PPF (Public Provident Fund) holders and small savings depositors.
- Two examples of Capital Receipts which reduce assets are Disinvestment and Recovery of Loans. How? (1) Disinvestment by government means selling (a part or whole of its shares of public sector undertakings (e.g., HMT, LIC, FCI) to private enterprises. Disinvestment is treated capital receipt because it reduces government assets. (II) Recovery of loan is also capital receipt as it reduces government assets. For instance, if UP government, which has taken loan of 100 crore from Central government, repays 20 crore, value of Central government assets of 100 crore is now reduced to 80 crore because of partial recovery of loan.

Difference between revenue and capital receipts: The main difference between revenue receipts and capital receipts is that in the case of revenue receipts, government is under no future obligation to return the amount, Le., they are non-redeemable. But in case of capital receipts which are borrowings, government is under obligation to return the amount along with interest.

Debt creating and non-debt creating capital receipts: Capital receipts may be debt creating or non-debt creating, Examples of debt creating receipts are-Net borrowing by government at home, loans received from foreign governments, borrowing from RBI Examples of non-debt capital receipts are-Recovery of loans, proceeds from sale of public enterprises (i.e. disinvestment), etc. These do not give rise to debt.

Tax revenue: Tax revenue consists of proceeds of taxes and other duties levied by the Union - government. It is the main source of government revenue. Remember, main objective of any tax system is to raise revenue to fund govt. expenditure in the budget. A tax is legally a compulsory payment imposed by the government on income and profit of persons and companies without reference to any benefit. Similarly, government levies taxes on sales of goods, manufacturing of goods, excise duty, wealth, gifts, properties, exports, Imports, etc. The money received from taxes is used by the government to meet the expenditure incurred on providing common benefits to the people. No one can refuse to pay the tax; otherwise, the defaulter is prosecuted and penalised. The taxpayer cannot demand in exchange for tax payment. For instance, a rich man cannot claim that he would not pay taxes to support schools because he has no children. The Central government collects revenue in the form of various taxes such as income tax, corporate tax, customs duty, excise duty, service tax, expenditure tax, wealth fax, interest tax, etc.

Taxes are of different kinds such as direct and indirect taxes proportional and progressive taxes, etc.

Non-tax revenue : Income from sources other than taxes is called non- tax revenue. It arises on account of administrative function of the government. These are incomes which the government gets in the form of interest, dividend, profit. fees, fines and external grants as explained below. It comprises the following items:

(i) Interest:
(ii) Profits and Dividends:
(iii) Fees and Fines:
(iv) Special Assessment:
(v) External grants-in-aid:

Components (Sources) of Capital Receipts

These are the following

a) **Recovery of loans and advances**: Loans offered by government to others are government assets because it owns money that it lends. We know that Central Government grants loans to (I) States, Union territories. (II) public sector enterprises, other parties and (Ill) foreign governments. Recovery of such loans is treated as capital receipts because it causes reduction in assets of the government.

b) **Disinvestment**: Government raises funds from disinvestment also. Disinvestment means selling whole or a part of the shares (Le., equity) of selected public sector enterprises (like Indian Oil Corporation, Steel Authority of India) held by government to private sector. As a result, government assets are reduced. Sometimes, disinvestment is also termed as privatisation because it involves transfer of ownership of public sector enterprises to private enterprises.

c) **Borrowing (domestic and external)**: Funds raised by government from borrowing are treated as capital receipts because they create liability of returning loans. These funds are borrowed from (i) open market. (i) Reserve Bank of India, (iii) foreign governments and international organisations. Government resorts to borrowing when its expenditure exceeds its revenue, i.e. when there is fiscal deficit.

d) **Small savings**: Government receipts also include small savings like Post Office deposits, Public Providend Fund deposits, National Saving Certificate deposits, Kisan Vikas Patras, etc.

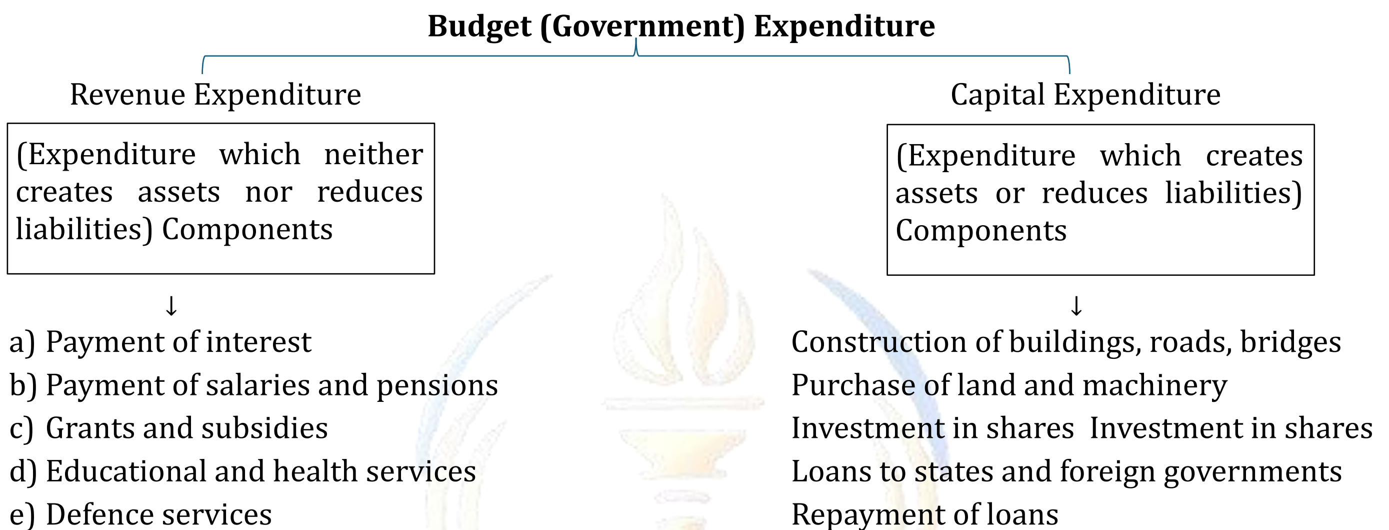
Meaning of Budget Expenditure

Budget (or Government) expenditure refers to the estimated expenditure to be incurred by the government under different heads in a year. It needs to be noted that public (government) expenditure for a welfare state has great significance because it (1) accelerates economic growth. (II) reduces inequalities and (III) checks unemployment and depression. Main objectives of government expenditure are as under. They show the importance (significance) of public expenditure.

(I) For satisfaction of collective needs of the people.
(II) For smooth functioning of government machinery.
(Ill) For economic and social welfare of the people.
(IV) For creation/addition of capital goods and infrastructure.

(V) For controlling depressionary tendencies in the economy.
(VI) For accelerating the speed of economic development.
(VII) For reducing regional disparities of growth.

Like two types of budget receipts. Le. Revenue Receipts and Capital Receipts, budget expenditure is also of two types. Le. Revenue Expenditure and Capital Expenditure as shown with components in the following chart.



Comparison between Revenue Expenditure and Capital Expenditure

Revenue Expenditure	Capital Expenditure
1. It is incurred for normal running of government departments and maintenance.	It is incurred for acquisition of capital assets
2. It does not result in creation of assets.	It results in creation of assets.
3. it is recurring in nature and incurred regularly.	It is non-recurring in nature.
4. It is support period expenditure.	It is generally a long period expenditure.
Exa. Expenditure on medicines and salaries of doctor's, subsidies, payment of interest, grant, collection of taxes	Exa. Construction of a hospital building, repayment of loan, purchase of loan, purchase of computers.

Balanced Budget, Surplus Budget and Deficit Budget

Recall, a budget is defined a defined as an annual statement of the estimated receipts and expenditure of the government over the fiscal year. Budgets are of three types: balanced, surplus and deficit budgets-depending upon whether the estimated receipts is equal to, less than or more than estimated receipts, respectively. Its three types are explained hereunder.

Balanced Budget: A government budget is said to be a balanced budget in which government estimated receipts (revenue and capital) are equal to government estimated expenditure. Let us suppose for the

sake of convenience that the only source of revenue is a lump sum tax. A balanced budget will then imply that the amount of tax is equal to the amount of expenditure. Put in symbols:

Balanced Budget

Estimated Govt. Receipts = Estimated Govt. Expenditure

Two main merits of a balanced budget are:
(i) It ensures financial stability and (ii) It avoids wasteful expenditure. Two main demerits are:
(i) Process of economic growth is hindered and (ii) Scope of undertaking welfare activities is restricted.

According to Adam Smith, public expenditure should never exceed public revenues. i.e. he advocated a balanced budget. But Keynes and modern economists do not agree with the policy of a balanced budget. They argue that in a balanced budget, total expenditure public and private) falls short of the amount necessary to maintain full employment. Therefore. government should increase its expenditure to close the gap between the expenditure essential for full employment and expenditure that actually takes place. Ideally, a balanced budget is a good policy to bring the near full employment economy to a full employment equilibrium.

Deficit Budget: When government estimated expenditure exceeds government receipts in the budget, the budget is said to be a deficit budget. In other words, in a deficit budget, government estimated revenue is less than estimated expenditure. Symbolically:

Deficit Budget = Estimated Govt. Expenditure > Estimated Gout. Receipts

These days popular democratic governments adopt mostly deficit budget to meet the growing needs of the people. It may be mentioned that Keynes had advocated a deficit budget to remedy the situation of unemployment and under-employment.

Government covers the gap either through borrowing or through withdrawals from its reserves. Thus, a deficit budget implies increase in government liability and fall in its reserves. When an economy is in an under-employment equilibrium due to deficient demand, a deficit budget is a good remedy to combat recession.

Merits and demerits of deficit budget: A deficit budget has its own merits especially for developing economy. For example:
(i) It accelerates economic growth and
(ii) It enables to undertake welfare programmes of the people.
(iii) It is a cure for deflation as it checks downward movement of prices.

At the same time, it has demerits also such as:
(i) It encourages unnecessary and wasteful expenditure by the government.
(ii) It may lead to financial and political instability,
(iii) It shakes the confidence of foreign investors.

We have read in the preceding chapter the situation of excess demand leading to inflation (continuous rise in prices) and the situation of deficient demand leading to depression (fall in prices, rise in unemployment, etc.). A surplus budget is recommended in the situation of inflationary trends in the economy whereas a deficit budget is suggested in the situation of recession.

Types of Budget Deficits

The budget deficit is the afference between 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. When there is a deficit in the bit has of the government. it implies that it spends more than what it collects through tax and non-tax revenue. This excess expenditure by government is financed by either borrowing from the market or from Reserve Bank of India, Remember, RRI has the power to create new monte Le to issue new notes. When government borrows from RBI against its own securities to finance its budget deficit, it has to pay neither the interest nor the original amount. The result is increase in the income of the people and rise in aggregate demand causing spur in price level or inflation in the economy.

There can be different types of deficit in a budget depending upon the types of receipts and expenditure we take into consideration. Accordingly, there are three concepts of deficit. namely.
(i) Revenue deficit
(il) Fiscal deficit and
(iii) Primary deficit Although budget deficit and revenue deficit are old ones but fiscal deficit and primary deficit are of recent origin.

Each of them is analysed below:

Measures of Budgetary Deficit

Revenue deficit | Fiscal deficit (Govt. borrowing) | Primary deficit

Budgetary deficit is the excess of total expenditure (both revenue and capital) over total receipts (both revenue and capital), Following are three types (measures) of deficit:

1. Revenue deficit = Total revenue expenditure - Total revenue receipts.
2. Fiscal deficit = Total expenditure - Total receipts excluding borrowings.
3. Primary deficit = Fiscal deficit - Interest payments.

Revenue Deficit

Revenue deficit is excess of total revenue expenditure of the government over its total revenue receipts. It is related to only revenue expenditure and revenue receipts of the government. Alternatively, the shortfall of total revenue receipts compared to total revenue expenditure is defined as revenue deficit. Revenue deficit signifies that government's own earning is insufficient to meet normal functioning of government departments and provision of services. Revenue deficit results in borrowing, Simply put, when government spends more than what it collects by way of revenue, it incurs revenue deficit. Mind,

revenue deficit includes only such transactions which affect current income and expenditure of the government. Put in symbols:

Revenue deficit Total Revenue expenditure - Total Revenue receipts

Remedial measures: A high revenue deficit warns the government either to curtail its expenditure or increase its tax and non-tax receipts. Thus, main remedies are:
(I) Government should raise rate of taxes especially on rich people and any new taxes where possible.
(II) Government should try to reduce its expenditure and avoid unnecessary expenditure.

Implications: Simply put, revenue deficit means spending beyond the means. This results in borrowing. Loans are paid back with interest. This increases revenue expenditure leading to greater revenue deficit. Main implications are:

I. **Reduction of assets**: Revenue deficit indicates dis-savings on government account because government has to make up the uncovered gap by drawing upon capital receipts either through borrowing or through sale of its assets (disinvestment).
II. **Inflationary situation**: Since borrowed funds from capital account are used to meet generally consumption expenditure of the government. it leads to inflationary situation in the economy with all its ills. Thus, revenue deficit may result either in increasing government liabilities or in reduction of government assets. Remember, revenue deficit implies a repayment burden in future without the benefit arising from investment.
III. **More revenue deficit**: Large borrowings to meet revenue deficit will increase debt burden due to repayment liability and interest payments. This may lead to larger and larger revenue deficits in future.
IV. **It increases burden of taxes**: It leads to repayment burden in future without Investment.

Fiscal Deficit

Meaning: Fiscal deficit is defined as excess of total budget expenditure over total budget receipts excluding borrowings during a fiscal year. In simple words, it is amount of borrowing the government has to resort to meet its expenses. A large deficit means a large amount of borrowing. Fiscal deficit is a measure of how much the government needs to borrow from the market to meet its expenditure when its resources are inadequate. In the form of an equation:

Fiscal deficit = Total expenditure - Total receipts excluding borrowings = Borrowing

If we add borrowing in total receipts, fiscal deficit is zero. Clearly, fiscal deficit gives borrowing requirements of the government. Let it be noted that safe limit of fiscal deficit is considered to be 5% of GDP. Again, borrowing includes not only accumulated debt. Le.. amount of loan but also interest on debt, Le., interest on loan. If we deduct interest payment on debt from borrowing, the balance is called primary deficit.

Fiscal deficit = Total Expenditure-Revenue receipts - Capital receipts excluding borrowing

A little reflection will show that fiscal deficit is, in fact, equal to borrowings. Thus, fiscal deficit gives the borrowing requirement of the government.

Can there be fiscal deficit without a Revenue deficit? Yes. It is possible

(i) when revenue budget is balanced but capital budget shows a deficit or

(ii) when revenue budget is in surplus but deficit in capital budget is greater than the surplus of revenue budget.

Implications

(i) Debt trap

(ii) Wasteful expenditure

(iii) Inflationary pressure

(iv) Partial Use

(V) Retards future growth

How is fiscal deficit met? (by borrowing). Since fiscal deficit is the excess of govt. total expenditure over its total receipts excluding borrowings, therefore, borrowing is the only way to finance fiscal deficit. It should be noted that safe level of fiscal deficit is considered to be 5% of GDP.

a) **Borrowing from domestic sources**: Fiscal deficit can be met by borrowing from domestic sources, e.g., public and commercial banks. It also includes tapping of money deposits in provident fund and small saving schemes. Borrowing from public to deal with deficit is considered better than deficit financing because it does not increase the money supply. which is regarded as the main cause of rising prices,

b) **Borrowing from external sources**: For instance, borrowing from World Bank, IMF and Foreign Banks.

c) **Deficit financing printing of new currency notes)**: Another measure to meet fiscal deficit is by borrowing from Reserve Bank of India. Government issues treasury bills which RBI buys in return for cash from the government. This cash is created by RBI by printing new currency notes against government securities. Thus, it is an easy way to raise funds but it carries with it adverse effects also. Its implication is that money supply increases in the economy creating inflationary trends and other ills that result from deficit financing, Therefore, deficit financing, if at all it is unavoidable, should be kept within safe limits.

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Primary Deficit

***Meaning:* Primary deficit is defined as fiscal deficit of current year minus interest payments on previous borrowings**. In other words whereas fiscal deficit indicates borrowing requirement inclusive of Interest payment, primary deficit indicates borrowing requirement exclusive of interest payment (i.e. amount of loan). We have seen that borrowing requirement of the government includes not only accumulated debt, but also interest payment on debt. If we deduct interest payment on debt from borrowing, the balance is called primary deficit. It shows how much government borrowing is going to meet expenses other than interest payments. Thus, zero primary deficit means that government has to resort to borrowing only to make interest payments. To know the amount of borrowing on account of current expenditure over revenue, we need to calculate primary deficit. Thus, primary deficit is equal to fiscal deficit less interest payments. Symbolically:

Primary deficit = Fiscal deficit - Interest payments