3. INDIA’S FISCAL POLICY

Q.No.1. List any two statements that are intended to control potential rise in prices. (B)

a) Centre scraps import duty on wheat to ease supply and check prices.
b) Monetary Policy panel members voted unanimously for a rate cut.

Q.No.2. List any two statements that bring in welfare to the underprivileged sections of the society by ensuring equity and fairness. (B)

a) A fortified mid-day meal gets underway at Karnataka’s government schools.
b) The Government to spend Rs. 60,000 crores more on rural jobs

Q.No.3. List any two statements that meant to provide incentives to promote the production/use of resources in a socially desirable direction. (B)

a) Government looking at subsidizing Smart phones to boost digital payments
b) No service tax on credit, debit card transactions up to Rs. 2,000.

Q.No.4. Define Economic Problem. (B)

ECONOMIC PROBLEM
a) The basic economic problem of scarcity arises on account of qualitative as well as quantitative constraints
b) The resources available to any society cannot produce all economic goods and services that its members desire to have.
c) Therefore, the basic questions arises for any economy such as what, how and for whom to produce and how much resources should be set apart to ensure growth of productive capacity.

Q.No.5. Explain the role of government in an economic system in the words of Adam Smith (B)

Role of Government: By Adam Smith:
a) Adam Smith is often described as a bold advocate of free markets and minimal governmental activity.
b) According to Smith the resource allocation role of government lies in national defence, maintenance of justice and the rule of law, establishment and maintenance of highly beneficial public institutions and public works which the market may fail to produce on account of lack of sufficient profits.
Since the 1930s, as a consequence of the great depression, the state’s role in the economy has been distinctly gaining in importance and therefore, the traditional functions of the state, have been supplemented with what is referred to as economic functions (also called fiscal functions or public finance function).

While there are differences among different countries in respect to the nature and extent of government intervention in economies, all governments are still expected to play a major role. This comes out of the belief that government intervention will invariably influence the performance of the economy in a positive way.

Q.No.6. Explain the role of Government in an economic system in the words of “Richard Musgrave”. (B)

Role of Government: By Richard Musgrave:


b) Musgrave believed that, for conceptual purposes, the functions of government are to be separated into three, namely, resource allocation, (efficiency), income redistribution (fairness) and macroeconomic stabilization.

c) The allocation and distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function.

i) The allocation function aims to correct the sources of inefficiency in the economic system while

ii) The distribution role ensures that the distribution of wealth and income is fair.

iii) Monetary and fiscal policy, the problems of macroeconomic stability, maintenance of high levels of employment and price stability etc. fall under the stabilization function.

SIMILAR QUESTIONS:
1. Explain the role of government in a market economy.
A. Refer answers of 5th and 6th questions.

Q.No.7. What is meant by resource allocation? Explain Private sector resource allocation and State’s resource allocation. (A)

Resource allocation:

a) It refers to the way in which the available factors of production are allocated among the various uses to which they might be put.

b) It determines how much of the various kinds of goods and services will actually be produced in an economy.
c) One of the most important functions of an economic system is the optimal or efficient allocation of scarce resources so that the available resources are put to their best use and no wastages are there.

d) In the real world, resource allocation is both market determined and government determined.

e) Efficient allocation of resources is assumed to take place only in perfectly competitive markets. In reality, markets are never perfectly competitive.

**Private sector resource allocation:** It is characterized by market supply and demand and price mechanism as determined by consumer sovereignty and producer profit motives.

**State’s resource allocation:** It is accomplished through the revenue and expenditure activities of governmental budgeting.

**Q.No.8. Why do markets generate misallocation of resources? (B)**

**Reasons for the mis-allocation of resources during market failures:**

a) Imperfect competition and presence of monopoly power in different degrees leading to under-production and higher prices than conditions of competition. These distort the choices available to consumers and reduce their welfare.

b) Markets typically fail to provide collective goods which are consumed in common by all the people.

c) Externalities cannot influence through markets i.e. the decision about how much of the good or service should be produced e.g. pollution.

d) Factor immobility causes unemployment and inefficiency.

e) Imperfect information

f) Inequalities in distribution of income and wealth.

**Q.No.9. Enumerate the rationale of Government intervention in market failure in the words of Musgrave. (B)**

**Reasons for Government intervention in market failure: By Musgrave:**

1. According to Musgrave, the state is the instrument by which the needs and concerns of the citizens are fulfilled and therefore, public finance is connected with economic mechanisms that should ideally lead to the effective and optimal allocation of limited resources.

2. It makes necessary for the government to intervene in the market to bring about improvement in social welfare.

3. In the absence of appropriate government intervention, market failures may occur and the resources are likely to be misallocated by too much production of certain goods or too little production of certain other goods.

4. The allocation responsibility of the governments involves suitable corrective action when private markets fail to provide the right and desirable combination of goods and services.

**SIMILAR QUESTIONS:**

1. Support the sentence ‘market failures provide the rationale for government’s allocative function in the words of Musgrave.
Q.No.10. Describe why governments should perform the allocation function in an economy? (A)

1. **Role of government in Resource Allocation:**
   a) The resource allocation role of government’s fiscal policy focuses on the potential for the government to improve economic performance through its expenditure and tax policies.
   b) The allocative function in budgeting determines who and what will be taxed as well as how and on what the government revenue will be spent.
   c) It is concerned with the provision of public goods and the process by which the total resources of the economy are divided among various uses and an optimum mix of various social goods (both public goods and merit goods).
   d) The allocation function also involves the reallocation of society’s resources from private use to public use.

2. **Allocation instruments by which governments can influence resource allocation in the economy:**
   a) Government may directly produce the economic goods (for example, electricity and public transportation services).
   b) Government may influence private allocation through incentives and disincentives (for example, tax concessions and subsidies may be given for the production of goods that promote social welfare and higher taxes may be imposed on goods such as cigarettes and alcohol).
   c) Government may influence allocation through its competition policies, merger policies etc. which will affect the structure of industry and commerce (for example, the Competition Act in India promotes competition and prevents anti-competitive activities).
   d) Governments’ regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.
   e) Government sets legal and administrative frameworks.
   f) Any of a mixture of intermediate techniques may be adopted by governments.
   g) Maximizing social welfare is one of the primary and most commonly manifest reasons for government intervention in the market.

**Conclusion:** However, it is also possible that instead of eliminating market distortions, sometimes governments may contribute to generate them. The possible sources of this type of government failures are inadequate information, conflicting objectives and administrative costs involved in government intervention.

**SIMILAR QUESTIONS:**
1. What are the different instruments available to the government to improve allocation efficiency in an economy?
   A. Refer any five points of the 2nd side heading
2. What are the allocative instruments of government can influence the resource allocation in the economy?

Q.No.11. Define distributive function. What are the aims of distributive function of the government? (A)

1. **Distributive function:** The distributive function of budget is related to the basic question of for whom should an economy produce goods and services.
   a) It is concerned with the adjustment of the distribution of income and wealth so as to ensure distributive justice namely, equity and fairness.
b) It also relates to the manner in which the effective demand over the economic goods is divided among the various individual and family spending units of the society.

c) Effective demand is determined by the level of income of the households and this in turn determines the distribution of real output among the population.

2. The distribution function of the government aims at:

a) Redistribution of income to achieve an equitable distribution of societal output among households.

b) Advancing the well-being of those members of the society who suffer from deprivations of different types.

c) Providing equality in income, wealth and opportunities.

d) Providing security for people who have hardships.

e) Ensuring that everyone enjoys a minimal standard of living.

SIMILAR QUESTIONS:
1. What are the aims of distributive function?

A. Refer the 2nd point

Q.No.12. What type of redistribution measures should be accomplished with minimal efficiency costs by carefully balancing equity and efficiency objectives? (A)

There is, nevertheless, an argument that in exercising the redistributive function that there exists a conflict between efficiency and equity.

The conflict is that governments' redistribution policies which interfere with producer choices or consumer choices are likely to have efficiency costs or deadweight losses. Controversial issue on the statement ‘Greater equity can be achieved through high rates of taxes on the rich’

The sentence may not be true because

a) High rates of taxes could also act as a disincentive to work.

b) It discourages people from savings and investments and risk taking.

c) It will have negative consequences for productivity and growth of the economy.

d) The potential tax revenue may be reduced.

e) The scope for government’s welfare activities would get seriously limited.

As such, an optimal budgetary policy towards any distributional change should reconcile the conflicting goals of efficiency and equity by exercising an appropriate tradeoff between them.

SIMILAR QUESTIONS:
1. How redistributive function does balance the conflict between efficiency and equity?

A. Refer five points mentioned in the above.

Q.No.13. What is the basis for stabilization function? What is the need for Stabilization function in the market economy? (A)

1. Basis or theoretical rationale for the stabilization function of the government:

a) According to Keynesian proposition, a market economy does not automatically generate full employment and price stability and therefore the governments should pursue deliberate stabilization policies.

b) Business cycles are natural phenomena in any economy and they tend to occur periodically.
c) The stabilization function is concerned with the performance of the aggregate economy in terms of:
   i) Labour employment and capital utilization,
   ii) Overall output and income,
   iii) General price levels,
   iv) Balance of international payments, and
   v) The rate of economic growth

2. Need for Stabilization function in the market economy
   a) The market system has inherent tendencies to create business cycles.
   b) The market mechanism is limited in its capacity to prevent or to resolve the disruptions caused by the fluctuations in economic activity.
   c) In the absence of appropriate corrective intervention by the government, the instabilities like recessions, inflation etc. may be prolonged for longer periods causing enormous hardships to people especially the poorer sections of society.
   d) It is also possible that a situation of stagflation (inflation and unemployment exist side by side) may set in and make the problem more complicated
   e) The contagion effect (When stabilization issue becomes more complex as the increased international interdependence causes forces of instability to get easily transmitted from one country to other countries).

Conclusion:
   a) The stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation.
   b) Not only the economic crisis that engulfed the world in 2008 but also the more recent euro area crisis have highlighted the importance of macroeconomic stability and therefore, revived interest in countercyclical fiscal policy.

SIMILAR QUESTIONS:
1. What is the theoretical rationale for the stabilization function of the government? (or) Describe the rationale for the stabilization function of government policy.
   A. Refer point 1

2. Which situations create need for Stabilization function in the market economy?
   A. Refer point 2

3. As far as stabilization function is concerned what are the terms to be considered for the performance of the aggregate economy?
   A. Refer point 1 (C)

Q.No.14. Explain how economic stability can be achieved through fiscal policy. (A)

Generally government’s fiscal policy has a strong influence on the performance of the macro economy in terms of employment, price stability, economic growth and external balance.

1. The two major components which are important in stabilizing the economy:
   a) An overall effect generated by the balance between the resources the government puts into the economy through expenditures and the resources it takes out through taxation, charges, borrowing etc.
   b) A microeconomic effect generated by the specific policies it adopts. Government’s stabilization intervention may be through monetary policy as well as fiscal policy.
Monetary policy has a singular objective of controlling the size of money supply and interest rate in the economy which in turn would affect consumption, investment and prices.

2. **Role of fiscal policy in stabilizing the economy:** Fiscal policy for stabilization purposes attempts to direct the actions of individuals and organizations by means of its expenditure and taxation decisions.

   a) On the expenditure side, Government can choose to spend in such a way that it stimulates other economic activities. For example, government expenditure on building infrastructure may initiate a series of productive activities.

   b) Government expenditure injects more money into the economy and stimulates demand.

   c) Production decisions, investments, savings etc can be influenced by its tax policies.

   d) Taxes reduce the income of people and therefore, reduce effective demand.

   e) During recession, the government increases its expenditure or cuts down taxes or adopts a combination of both so that aggregate demand is boosted up with more money put into the hands of the people.

   f) To control high inflation the government cuts down its expenditure or raises taxes.

   g) Expansionary fiscal policy is adopted to alleviate recession and contractionary fiscal policy is resorted to for controlling high inflation.

   h) Deficit budgets are expected to stimulate economic activity, surplus budgets are thought to slow down economic activity.

**Conflict:**

There is often a conflict between the different goals and functions of budgetary policy. The challenge before any government is how to design its budgetary policy so that the pursuit of one goal does not jeopardize the other.

**SIMILAR QUESTIONS:**

1. What are the two major important components in stabilizing the economy?
   A. Refer point 1

2. Explain the role of fiscal policy in terms of macroeconomic fluctuations through stabilization function.
   A. Refer any five sub points in point 2

Q.No.15. Draw a tree diagram representing an overview of fiscal policy (A)
Q.No.16. Define Fiscal policy. What are the objectives of Fiscal policy? (A)

**Fiscal policy:** Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and level of growth of aggregate demand, output and employment. It includes any design on the part of the government to change the price level, composition or timing of government expenditure or to alter the burden, structure or frequency of tax payment. Fiscal policy is in the nature of a demand-side policy.

**Note:** An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

**OBJECTIVES OF FISCAL POLICY**

The objectives of fiscal policy are derived from the aspirations and goals of the society. Since nations differ in numerous aspects, the objectives of fiscal policy also may vary from country to country.

The most common objectives of fiscal policy are:

- Achievement and maintenance of full employment,
- Maintenance of price stability,
- Acceleration of the rate of economic development, and
- Equitable distribution of income and wealth.

The importance as well as order of priority of these objectives may vary from country to country and from time to time. For instance, while stability and equality may be the priorities of developed nations, whereas economic growth, employment and equity may get higher priority in developing countries.

**Note:** These objectives are not always compatible; for instance, the objective of achieving equitable distribution of income may conflict with the objective of economic growth and efficiency.

Q.No.17. Explain about the different instruments of fiscal policy. (B)

The Keynesian school is of the opinion that fiscal policy can have very powerful effects in altering aggregate demand, employment and output in an economy when the economy is operating at less than full employment levels and when there is need to offer stimulus to demand.

In fact, the global financial crisis about the year 2008 has caused fiscal policy to be at center of the public policy debate.

**INSTRUMENTS OF FISCAL POLICY:** The tools of fiscal policy are TAXES, GOVERNMENT EXPENDITURE, PUBLIC DEBT and the GOVERNMENT BUDGET.

Q.No.18. How does the government expenditure acts as an instrument of fiscal policy? (B)

**Government Expenditure (GE):**

Government expenditure is an important instrument of fiscal policy. It includes:

1. Current expenditures to meet the day to day running of the government (i.e. consumption),
2. Capital expenditures which are in the form of investments made by the government in capital equipment and infrastructure, and
3. Transfer payments i.e. government spending which does not contribute to GDP because income is only transferred from one group of people to another without any direct contribution from the receivers.
Role of Government Expenditure as an Instrument of Fiscal Policy:

a) Government may spend money on performance of its large and ever-growing functions and also for deliberately bringing in stabilization.

b) Direct impact of Government expenditure: GE involves employment of labour as well as purchase of multitude of goods and services. These expenditures directly generate incomes to labour and suppliers of materials and services.

c) Indirect impact of Government expenditure: The indirect effect will be in the form of working of multiplier. The incomes generated are spent on purchase of consumer goods. The extent of spending by people depends on their MPC.

d) Government expenditure in rectifying Inflation: When there is a fear of inflationary rise in prices, GE will be reduced. It reduces incomes of the people and thus the decreased public spending helps to eliminate excess aggregate demand.

e) Government expenditure in rectifying economic recession:
   i) During a recession, it may initiate a fresh wave of public works, such as construction of roads, ports, irrigation facilities, electrification of new areas etc.
   ii) Primary employment in public works programmes will induce secondary and tertiary employment, and before long the economy is put on an expansion track.
   iii) It generates surplus capacity in consumer goods industries and an increase in demand for various goods leads to expansion in production.
   iv) It will strengthen the general confidence of businessmen and their willingness to invest.

f) Government expenditure in rectifying economic depression:
   i) During depression GE may use the concepts of either ‘pump priming’ or ‘compensatory spending’.
   ii) When private spending becomes deficient, certain volumes of public spending will help to revive the economy. It is termed as Pump priming
   iii) When the government spending is carried out with the intention to compensate for the deficiency in private investment, It is termed as Compensatory spending.

SIMILAR QUESTIONS:

1. What will be the direct impact of government expenditure under fiscal policy?
   A. Refer point “b”

2. What will be the indirect impact of government expenditure under fiscal policy?
   A. Refer point “c”

3. What is the role of Government expenditure in rectifying Inflation?
   A. Refer point “d”

4. What is the role of Government expenditure in rectifying economic recession?
   A. Refer point “e”

5. What is the role of Government expenditure in rectifying economic depression?
   A. Refer point “f”

6. Define ‘pump priming’
   A. Refer point ii in “f”

7. Define Compensatory spending.
   A. Refer point iii in “f”
Q.No.19. How does the taxes levied by the government acts as an instrument of fiscal policy? (A)

Public revenue refers to the government revenue in the form of taxes, fees, sale of public goods and services, fines, donations, etc.

**Taxes:** Taxes form the most important source of revenue for governments. Taxation policies are effectively used for establishing stability in an economy.

**Role of Taxes as an Instrument of Fiscal Policy:**

a) Taxes determine the size of disposable income in the hands of the general public which in turn determines aggregate demand and possible inflationary and deflationary gaps.

b) The extent of tax reduction and/or increase in government spending required depends on the size of the recessionary gap and the magnitude of the multiplier.

c) Role of taxes during recession and depression
   i) Reduction in income taxes leaves higher disposable incomes with people inducing higher consumption.
   ii) Reduction in corporate taxes increases the prospects of profits for business and promotes further investment.

d) Role of taxes during inflation,
   i) During inflation new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes and to wipe off the surplus purchasing power.
   ii) But the excessive taxation suppresses new investments and therefore the government has to be cautious about a policy of tax increase.

**SIMILAR QUESTIONS:**

1. On what factors do the amount of tax reduction or level of increase in government spending depends upon?
   A. Refer point b

2. What should be the tax policy during recession and depression?
   A. Refer point c

3. What should be the tax policy during inflation?
   A. Refer point d

Q.No.20. How does the public debt acts as an instrument of fiscal policy? (B)

**Public Debt or public borrowings:** Public Debt is an amount borrowed by the government.

A nation’s debt is the difference between its total past deficits and its total past surpluses. If a government has borrowed money over the years to finance its deficits and has not paid it back through accumulated surpluses, then it is said to be in debt.

[Diagram showing Public Debt with branches for On the basis of Place of borrowing and on the basis of form of borrowing, with sub-branches for Internal Debt, External Debt, Market loans, and savings.]
**Internal Debt**: The government borrows from its own people in the country.

**External Debt**: The government borrows from outside sources.

**Market Loans**: In this case the government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets. For financing capital projects, long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued.

**Small Savings**: They represent public borrowings, which are not negotiable and are not bought and sold in the market. In India, for mobilizing small savings such as National Savings Certificates, National Development Certificates, etc. are introduced.

**Role of Public Debt as an Instrument of Fiscal Policy**:  
- a) A rational policy of public borrowing and debt repayment is a potent weapon to fight inflation and deflation.  
- b) Borrowing from the public through the sale of bonds and securities decreases the aggregate demand in the economy.  
- c) Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

**Q.No.21. How does budget acts as an instrument of fiscal policy? (B)**

**Budget**: It is a statement of revenues earned from taxes and other sources; and expenditures made by a nation's government in a year. A government's budget can either be balanced, surplus or deficit.

**Budget as an Instrument of Fiscal Policy**:  
- a) Government's budget is widely used as a policy tool to stimulate or contract aggregate demand as required.  
- b) **Effect of Balanced budget**: It will have no net effect on aggregate demand (since the leakages from the system in the form of taxes collected are equal to the injections in the form of expenditures made).  
- c) **Effect of Budget Surplus**:  
  - a) It has a negative net effect on aggregate demand (*since leakages exceed injections*).  
  - b) It reduces national debt and interest rates.  
  - c) It increases savings  
- d) **Effect of Budget Deficit**:  
  - a) It has a positive net effect on aggregate demand (since total injections exceed leakages from the government sector).  
  - b) It will add to the national debt.  
- e) Higher levels of domestic savings decrease international borrowings and lessen the current account deficit.  
- f) Deliberate changes in composition of revenue and expenditure components of the budget are used to change macro-economic variables such as level of economic growth, inflation, unemployment and external stability.

**SIMILAR QUESTIONS:**  
1. What is the effect of balanced budget on aggregate demand?  
2. What is the effect of Surplus budget on aggregate demand, national debt, interest rates and savings?  
3. What is the effect of Deficit budget on aggregate demand and national debt?
Q.No.22. What are the two primary types of fiscal policy used by the government to influence the economic activities in an economy? (C)

The two primary types of fiscal policy used by the government are discretionary fiscal policy and non-discretionary fiscal policy (or) automatic stabilizers.

**Discretionary Fiscal Policy:** Discretionary fiscal policy is a change in government spending or taxes. Its purpose is to expand or shrink the economy as needed. It includes Expansionary fiscal policy and Contractionary fiscal policy.

**Non-Discretionary Fiscal Policy (Or) Automatic Stabilizers:** Automatic stabilizers are part of the structure of the economy and are ‘built-in’ fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle.

Q.No.23. Explain non-discretionary fiscal policy (or) automatic stabilizers? (A)

Changes in fiscal policy do not always require explicit action by government. In most economies, changes in the level of taxation and level of government spending tend to occur automatically.

**Non-Discretionary Fiscal Policy (Or) Automatic Stabilizers:**

a) In non-discretionary fiscal policy, the tax policy and expenditure pattern are so framed that taxes and government expenditure automatically change with the change in national income.

b) Automatic stabilizers are part of the structure of the economy and are ‘built-in’ fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle without any need for discretionary policy action.

c) It involves built-in tax or expenditure mechanism that automatically increases aggregate demand (or aggregate spending) when there is recession and reduces aggregate demand (or aggregate spending) when there is inflation in the economy.

d) Any government programme that automatically tends to reduce fluctuations in GDP is called an automatic stabilizer. Automatic stabilizers have a tendency for increasing GDP when it is falling and reducing GDP when it is rising.

e) Personal income taxes, corporate income taxes and transfer payments (unemployment compensation, welfare benefits) are prominent automatic stabilizers.

f) Since automatic stabilizers affect disposable personal income directly, and because changes in disposable personal income are closely linked to changes in consumption, these stabilizers act swiftly to reduce the extent of changes in real GDP.

g) In brief, automatic stabilizers work through limiting the increase in disposable income during an expansionary phase and limiting the decrease in disposable income during the contraction phase of the business cycle.

However, automatic stabilizers alone would not be sufficient to correct instabilities. The government needs to resort to discretionary fiscal policies.

**SIMILAR QUESTIONS:**

1. Explain how automatic stabilizers bring stability in an economy.
   A. Refer above answer.

Q.No.24. What is the impact of non-discretionary fiscal policy (or) automatic stabilizers during contractionary phase of business cycle (or) recession in an economy? (A)

**Consequences during recession and the role of automatic stabilizers:**

1. Incomes are reduced
2. With progressive taxation the proportion of income that is taxed will be reduced.
3. It results in lower tax payments as well as some tax refunds.
4. Simultaneously, government expenditures increase due to increased transfer payments like unemployment benefits.
5. Thus fall in tax revenue and rise in government expenditure provide proportionately more disposable income available for consumption spending to households.
6. In brief, automatic stabilizers work through limiting the decrease in disposable income during the contraction phase of the business cycle.

In the absence of automatic responses, household spending would tend to decrease more sharply and the economy would in all probability fall into a deeper recession.

SIMILAR QUESTIONS:
1. Justify the sentence “The automatic stabilizers work through limiting the decrease in disposable income during the contraction phase of the business cycle”.

A. Refer above answer.

Q.No.25. What is the impact of non-discretionary fiscal policy (or) automatic stabilizers during expansionary phase of business cycle (or) inflation in an economy? (A)

Consequences during expansionary phase and the role of automatic stabilizers:
1. When an economy expands, employment increases.
2. with progressive system of taxes people have to pay higher taxes as their income rises
3. This leaves them with lower disposable income and thus causes a decline in their consumption and also aggregate demand.
4. Corporate profits tend to be higher attracting higher corporate tax payments.
5. With higher income taxes, firms are left with lower surplus causing a decline in their consumption and investments and thus in the aggregate demand.
6. Again, during expansion unemployment falls, therefore government expenditure by way of transfer payments falls and with lower government expenditure inflation gets controlled to a certain extent.
7. The built-in stabilisers automatically remove spending from the economy to reduce demand-pull inflationary pressures and further expansionary stimulation.
8. In brief, automatic stabilizers work through limiting the increase in disposable income during an expansionary phase of the business cycle.

SIMILAR QUESTIONS:
1. Justify the sentence “The automatic stabilizers work through limiting the increase in disposable income during an expansionary phase of the business cycle”.

A. Refer above answer.

Q.No.26. Explain the types of fiscal policies to correct business cycle instability in the economy? (B)

Fiscal policy measures to correct different problems created by business-cycle instability are of two basic types namely, expansionary and contractionary.

1. **Expansionary fiscal policy:**
   a) It is designed to stimulate the economy during the contractionary phase of business cycle or when there is an anticipation of a business cycle contraction.
   b) This is carried out by increasing aggregate expenditures and aggregate demand through an increase in all types of government spending and / or a decrease in taxes.
2. **Contractionary fiscal policy:**
   a) It is designed to restrain the levels of economic activity of the economy during an inflationary phase or when there is anticipation of a business-cycle expansion which is likely to induce inflation.
   b) This is carried out by decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/or an increase in taxes.
   c) It should ideally lead to a smaller government budget deficit or a larger budget surplus.

**SIMILAR QUESTIONS:**
1. Describe the term **expansionary fiscal policy.**
   A. Refer 1st point
2. Describe the term **contractionary fiscal policy.**
   A. Refer 2nd point

**Q.No.27. How do changes in government expenditure (G), and taxes (T) eliminate a recessionary gap? (A)**

**Recessionary Gap:**
A recessionary gap, also known as a contractionary gap, is said to exist if the existing levels of aggregate production is less than what would be produced with full employment of resources. This gap occurs during the contractionary phase of business-cycle and results in higher rates of unemployment. (or) This gap occurs when the aggregate demand is not sufficient to create conditions of full employment.

**Role of expansionary fiscal policy to eliminate a recessionary gap:**
According to Keynes when the aggregate demand falls short of aggregate supply, it results in unemployment of resources, especially labour. In that case, the government intervenes through an expansionary fiscal policy.

**Expansionary Fiscal policy for Combating Recession**

![Graph showing LAS, SAS1, SAS2, AD1, and AD2]

a) Real GDP at Y1 level lies below the natural level, Y2. This represents a situation where the economy is initially in a recession. There is less than full employment of the resources in the economy.

b) According to Classical economist with the assumption of flexibility of wages
   This would cause wages to fall resulting in reduction in costs. Consequently, suppliers would increase supply and the short run aggregate supply curve SAS1 will shift to the right SAS2 and bring the economy back to the level of full employment at Y2.
c) According to Keynes with the assumption of wages will not adjust rapidly to accommodate the unemployed i.e. wages are ‘sticky downward.’

When once recession set in, it would persist for a long time. The government responds by increasing government expenditures (adopts deficit budget) in adequate quantities as to cause a rightward shift in the aggregate demand curve from $AD_1$ to $AD_2$. Now the firms respond to growing demand by producing more output. In order to increase their output in the short-run, firms must hire more workers. This has the effect of reducing unemployment in the economy.

d) The increase in level of government expenditure depends upon the GNP gap created due to recession and also on the size of multiplier (Multiplier depends upon MPC).

e) The increase in government expenditures need not be equal to the difference between $Y_2$ and $Y_1$, it can be much less.

f) The concept of ‘fiscal multiplier,’ suggests that the government needs to incur only a lesser amount of expenditure to cause aggregate demand to increase by the amount necessary to achieve the natural level of real GDP.

g) Sources of government to raise its expenditure:

  i) If government increases taxes (i.e. self-defeating) it reduces the disposable incomes and also aggregate demand. It runs the risk of crowding out private spending.

  ii) Hence the government resorts for a deficit budget which may be financed either through borrowing or through monetization (creation of additional money to finance expenditure).

**Note:** The expansionary fiscal policy will be successful only if there is accommodative monetary policy.

**SIMILAR QUESTIONS:**

1. Explain the term ‘recessionary gap’.
   A. Refer the definition.

Q.No.28. Explain graphically the contractionary fiscal policy for combating inflation. (B)

When aggregate demand rises beyond what the economy can potentially produce by fully employing it’s given resources, it gives rise to inflationary pressures in the economy. Under such circumstances, a contractionary fiscal policy has to be used.

1. **Contractionary Fiscal Policy:**

   Contractionary fiscal policy refers to the deliberate policy of government applied to curtail aggregate demand and consequently the level of economic activity.

   It is a fiscal policy aimed at eliminating an inflationary gap. This is achieved by adopting policy measures that would result in the aggregate demand curve (AD) shift to the left so the equilibrium may be established at the full employment level of real GDP.

   This can be achieved either by:

   a) **Decrease in government spending:** With this, the total amount of money available in the economy is reduced which in turn reduces the aggregate demand.

   b) **Increase in personal income taxes:** It reduces disposable incomes leading to fall in consumption spending and aggregate demand.

   c) **Increase in business taxes:** An increase in taxes on business profits reduces the surpluses available to businesses, and as a result, firms’ investments shrink causing aggregate demand to fall. It discourages the potential entrants who will respond by holding back fresh investments.

   d) A combination of decrease in government spending and increase in personal income taxes and/or business taxes
2. Contractionary Fiscal policy for Combating Inflation

The above graph depicts the following:

a) As real GDP rises above its natural level, ‘Y’, prices rises from $P_1$ to $P_3$, prompting an increase in wages and other resource prices. This causes the SAS curve to shift to left from SAS 1 to SAS 2. But the real GDP remains the same at Y.

b) Now the government intervenes to control inflation through **contractionary** fiscal policy to reduce aggregate demand. (So that the aggregate demand curve ($AD_1$) does not shift to $AD_2$).

**SIMILAR QUESTIONS:**

1. How do changes in government expenditure (G), and taxes (T) eliminate an inflationary gap?
   A. Refer point a, b, c, d in 1st point

Q.No.29. What are the limitations involved in fiscal policy? (A)

Discretionary fiscal policy is the conscious manipulation of government spending and taxes to influence the economy.

**Significant limitations in respect of choice and implementation of fiscal policy:**

i) The following are some of the significant lags involved in discretionary fiscal-policy to counteract fluctuations:
   - **Recognition lag**: As the economy is a complex phenomenon, the government must first recognize the need for a policy change.
   - **Decision lag**: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to decide on the most appropriate policy.
   - **Implementation lag**: Even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them.
   - **Impact lag**: It occurs when the results of a policy are not visible for some time.

ii) It is practically difficult to reduce government spending on various items such as defence, social security and on huge capital projects which are already midway.

iii) Public works cannot be adjusted easily along with movements of the trade cycle because many huge projects such as highways and dams have long gestation period.

iv) Urgent public projects cannot be postponed for reasons of expenditure cut to correct fluctuations caused by business cycles.

v) **Supply-side** economists are of the opinion that certain fiscal measures will cause disincentives.
   - **Eg.: 1** An increase in profits tax may adversely affect the incentives of firms to invest.
   - **Eg.: 2** An increase in social security benefits may adversely affect incentives to work and save.
vi) Fiscal policy changes may at times be badly timed due to the various lags so that it is highly possible that an expansionary policy is initiated when the economy is already on a path of recovery and vice versa.

vii) There are difficulties in instantaneously changing governments' spending and taxation policies.

viii) Due to uncertainties, there are difficulties of forecasting and determining the accurate policy at the time of inflation or deflation.

ix) There are possible conflicts between different objectives of fiscal policy such that a policy designed to achieve one goal may adversely affect another. For example, an expansionary fiscal policy may worsen inflation in an economy.

x) Deficit financing increases the purchasing power of people. But in underdeveloped countries, simultaneously the production of goods and services may not be able to meet the increased demand. This will result in prices rise beyond control.

xi) Increase in government borrowing creates perpetual burden on even future generations as debts have to be repaid. If the economy lags behind in productive utilization of borrowed money, sufficient surpluses will not be generated for servicing debts. External debt burden has been a constant problem for India and many developing countries.

SIMILAR QUESTIONS:
1. Point out the limitations fiscal policy.
   A. Refer any five points

Q.No.30. Explain the term “Crowding Out” with suitable example. (A)

Crowding out effect: If governments compete with the private sector to borrow money for spending, the interest rates will go up, and firms' willingness to invest may be reduced. Individuals too may be reluctant to borrow and spend and the desired increase in aggregate demand may not be realized. This situation is termed as crowded out of private sector.

a) Crowding out effect is the negative effect on fiscal policy as money from the private sector is ‘crowded out’ to the public sector

   Ex: If government provides free computers to students, the demand from students for computers may not be forthcoming.

b) Crowding Effect is less during recession.

QUESTIONS FOR ACADEMIC INTEREST – FOR STUDENT SELF STUDY

Q.No.31. ‘In its allocation role, the government acts as a complement rather than as a substitute to the market system in an economy’. Support the sentence with suitable examples?

The following government interventions do not imply that markets are replaced by government action:

a) The government can provide us with goods and services that we cannot produce on our own or buy at a price from the market.

b) The government establishes property rights and makes the necessary arrangements for enforcing contracts through provision of law enforcement and courts.

c) Goods which involve externalities that are not met by the market require intervention by the government for corrective measures.

d) Merit goods which are greatly beneficial to the society also fall under the purview of provision by the government.
Q.No.32. Support the sentence “The expansionary fiscal policy will be successful only if there is accommodative monetary policy.” (C)

The expansionary fiscal policy will be successful only if there is accommodative monetary policy.

If interest rates rise as a result of increased demand for money but money supply does not rise concurrently, then private investment will be adversely affected.

If interest rates remain unchanged, private investment will not be affected badly and a rise in government expenditure will have full effect on national income and employment.

Q.No.33. What are the measures undertaken in a contractionary fiscal policy?

Measures undertaken by contractionary fiscal policy:

a) The government needs to reduce expenditures or raise taxes only by a small amount because of the multiplier effects such actions.

b) Even as expenditures are reduced, the government may attempt to enhance public revenues in order to generate a budget surplus.

c) In any economy, on account of political, social and defence considerations government spending cannot be reduced beyond a particular limit.

d) The government can change its expenditure in response to inflationary pressures.

Q.No.34. Give some examples of redistributive function performed by the government. (B)

Redistribution of income to achieve an equitable distribution of societal output among households.

Examples of the redistribution function performed by governments are:

a) Taxation policies of the government whereby progressive taxation of the rich is combined with provision of subsidy to the poor households.

b) Proceeds from progressive taxes used for financing public services, especially those that benefit low-income households (example, supply of essential food grains at highly subsidized prices to BPL households).

c) Employment reservations and preferences to protect certain segments of the population.

d) Regulation of the manufacture and sale of certain products to ensure the health and well-being of consumers.

e) Special schemes for backward regions and for the vulnerable sections of the population.

f) In most of the egalitarian welfare states provide free or subsidized education and health-care system, unemployment benefits, pensions and such other social security measures.

SIMILAR QUESTIONS:

1. List out the examples of market intervention for socio-economic reasons in an economy?
   A. Refer any 5 points in the above topic.

2. Enumerate the circumstances which necessitate redistribution by government.
   A. Refer any 5 points in the above topic.
Q.No.35. Explain the role of Discretionary fiscal policy in stabilizing the economy. (B)

**Discretionary fiscal policy for stabilization:**

It refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment and prices. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the quantity and form of borrowing.

Governments may directly as well as indirectly influence the way resources are used in an economy.

This can be explained with the fundamental equation of Gross Domestic Product (GDP), according to expenditures.

\[ \text{GDP} = C + I + G + NX. \]

Where GDP is the value of all final goods and services produced in an economy during a given period of time.

The right side of the equation shows the different sources of aggregate spending or demands namely, private consumption (C), private investment (I), government expenditure i.e. Purchases of goods and services by the government (G), and net exports, (exports minus imports) (NX).

It is evident from the equation that governments can influence economic activity (GDP) by controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfer payments and expenditure.

Q.No.36. How the fiscal policy does helps in reducing inequalities of income and wealth in an economy? (B)

**CHALLENGE:** Many developed and developing economies are facing high inequality in incomes and opportunities.

**FISCAL POLICY FOR REDUCTION IN INEQUALITIES OF INCOME AND WEALTH:**

Fiscal policy is a chief instrument available for governments to influence income distribution both directly and indirectly.

Fiscal policy plays a significant role in reducing inequality and achieving equity and social justice.

Government revenues and expenditure have traditionally been regarded as important instruments for carrying out desired redistribution of income.

**Measures as to how each of these can be manipulated to achieve desired distributional effects.**

a) A progressive direct tax system ensures that those who have greater ability to pay, contribute more and thus the tax burden is distributed fairly among the population.

b) Indirect taxes can be differential. (EX: luxuries consumed by the richer income group are taxed heavily and the necessities consumed by the lower income group are taxed light.)

c) A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society in the form of welfare measures for the disadvantaged, such as

i) Poverty alleviation programmes

ii) free or subsidized medical care, education, housing, essential commodities etc. to improve the quality of living of poor

iii) infrastructure provision on a selective basis

iv) various social security schemes under which people are entitled to old-age pensions, unemployment relief, sickness allowance etc.

v) subsidized production of products of mass consumption
vi) Public production and/or grant of subsidies to ensure sufficient supply of essential goods, and

vii) Strengthening of human capital for enhancing employability etc.

d) But progressive tax system with high marginal taxes may discourage to work, save and invest. Therefore, the tax structure has to be carefully framed to mitigate possible adverse impacts on production and efficiency.

Hence the redistributive fiscal policy and the extent of spending on redistribution should be consistent with the macroeconomic policy objectives of the nation.

SIMILAR QUESTIONS:
1. What types of fiscal policy measures is useful for redistribution of income in an economy?
2. List any two statements that meant to provide incentives to promote the production/use of resources in a socially desirable direction.
3. What is meant by “contagion effect”.
4. Elucidate the nature of economic function performed by the government in the following cases:
   a) The government initiates a massive programme for eradication of mosquito-borne diseases in coastal areas.
   b) The government fixes the prices of 377 essential medicines listed in the National List of Essential Medicine, 2015.
5. The government decides to levy up to Rs. 20,500 per flight from private airlines on major routes in order to fund an ambitious regional connectivity scheme which seeks to connect small cities by air and to make flying more affordable for the masses. Critically examine the implications of this policy on the airlines market.
6. What is the objective of government subsidy?
7. What would be the objective of a government when it declares special schemes for backward regions?
8. How does monopoly power affect efficiency of markets?
9. Explain how government can get domestic producers produce more pulses?
10. Illustrate with an example the redistribution effect of a tax and transfer policy
11. Why do private producers hesitate to produce public parks, bridges and highways?
12. What should be the public revenue and expenditure policy of the government during recession?
13. Illustrate four cases which provide justification for government intervention in markets.
14. What are the basic questions should every economic system answer?
15. What are the other terms known for Economic functions?
16. Who introduced the three branch taxonomy of the role of government in a market economy?
17. What is the three branch taxonomy as the role of government in a market economy introduced by Richard Musgrave?
18. Do the allocation and distribution functions are primarily microeconomic functions or macroeconomic functions?

CA Inter_Economics for Finance_India’s Fiscal Policy
19. Name the function of budget that is related to the basic question of for whom should an economy produce goods and services?

20. Does the market economy automatically generate full employment and price stability?

21. What are the policies involved in Government’s stabilization intervention?

22. What is the objective of monetary policy as a part of Government’s stabilization intervention?

23. What is the aim of fiscal policy as a part of Government’s stabilization intervention?

24. Describe any few interventional measures adopted by the government.

25. Why classical economists do believed that fiscal policy is unnecessary for an economy?

26. During inflation
   a) What will be the level of utilization of resources?
   b) What does fiscal policy aims at?

27. During deflation
   a) What will be the level of utilization of resources?
   b) What does fiscal policy aims at?


29. In the process of self-defeating the recession, if government resorts to increase in taxes, what will be its effect on disposable incomes and on aggregate demand.

30. What is meant by monetization?

31. As a part of fiscal multiplier, from where will the government find resources to increase its expenditure?

32. Name the term that represents the economy’s appetite for buying goods and services.

33. Name the term that represents the economy’s capacity to produce goods and services.

34. When the aggregate demand falls short of aggregate supply it results in unemployment of resources, especially labour. Through which policy the government can now intervene?

35. Summarize the reasons for the rise in aggregate demand?

36. Does the inflationary gap occur because of rise in Aggregate demand or rise in Aggregate supply?

37. What is the impact on all types of incomes during an expansionary phase?

38. What is the impact on amount of transfer payments during an expansionary phase?

39. What is the impact on disposable income available for consumption expenditure during an expansionary phase?

40. Distinguish between Automatic Stabilizers from Discretionary Fiscal Policy.

41. How do built-in stabilizers combat demand-pull inflationary pressures?

42. What are the symptoms of the beginning of a recession?

43. What should be the tax policy during recession and depression?

44. What is the consequence excessive taxation will have on business?

45. Distinguish between pump priming and the 'compensatory spending'.

46. Explain the use of fiscal policy for economic growth.
47. The government of Country X, an underdeveloped country, having a severe problem of unemployment of labour embarks on a massive development programme. It has recognized the imminent need for boosting up investments to take the country to a higher than average growth trajectory. The following steps were taken by the government:

i) Invited tenders for a huge network of highways, solar energy generation, communication systems ad computerized systems

ii) Large number of schools throughout the country

iii) Research grants for universities and private research institutes

iv) Announced a number of free health care programmes for all

v) All citizens assured of social security

vi) Increase in payments under existing social security schemes

vii) Tax exemption limit raised for individuals, instituted progressive taxes with high marginal rates - increased corporate taxes

Very soon prices started spiraling and there was general unrest among people especially the poor.

i) Analyze each of the above measures from a fiscal policy perspective.

ii) Why did overall prices increase?

iii) What policies do you suggest to solve the problem of price rise?

iv) What are the limitations?

48. In the above example, suppose that the increase in government spending has been Rs. 5 billion. Assume that the marginal propensity to consume of people is equal to 0.6.

i) what will be the government spending multiplier

ii) What impact would a Rs. 5 billion increase in government expenditure have on equilibrium GDP?

49. List any two statements that are intended to control potential rise in prices?

50. List any two statements that bring in welfare to the underprivileged sections of the society by ensuring equity and fairness?

THE END