

Instruments of Fiscal Policy

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- The first tool is taxation. That includes income, capital gains from investments, property, and sales. Taxes provide the income that funds the government. The downside of taxes is that whatever or whoever is taxed has less income to spend on themselves, which is why taxes are unpopular.
- The second tool is government spending—which includes subsidies, welfare programs, public works projects, and government salaries. Whoever receives the funds has more money to spend, which increases demand and economic growth

Canons of Taxation

- By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. In fact, canons of taxation are related to the administrative part of a tax. Adam Smith first devised the principles or canons of taxation in 1776.
- Even in the 21st century, Smithian canons of taxation are applied by the modern governments while imposing and collecting taxes.

- In this sense, his canons of taxation are 'classical' in sense, four canons of taxation are:
 - (i) Canon of equality or equity (ii) Canon of certainty
 - (iii) Canon of economy (iv) Canon of convenience
- Modern economists have added more in the list of canons of taxation, these are:
 - (v) Canon of productivity (vi) Canon of elasticity
 - (vii) Canon of simplicity (viii) Canon of diversity

i. Canon of Equality:

- Canon of equality states that the burden of taxation must be distributed equally or equitably among the taxpayers. However, this sort of equality robs of justice because not all taxpayers have the same ability to pay taxes. Rich people are capable of paying more taxes than poor people. Thus, justice demands that a person having greater ability to pay must pay large taxes.
- If everyone is asked to pay taxes according to his ability, then sacrifices of all taxpayers become equal. This is the essence of canon of equality (of sacrifice). To establish equality in sacrifice, taxes are to be imposed in accordance with the principle of ability to pay.

ii. Canon of Certainty:

- The tax which an individual has to pay should be certain and not arbitrary. According to A. Smith, the time of payment, the manner of payment, the quantity to be paid, i.e., tax liability, ought all to be clear and plain to the contributor and to everyone. Thus, canon of certainty embraces a lot of things. It must be certain to the taxpayer as well as to the tax-levying authority.
- Not only taxpayers should know when, where and how much taxes are to be paid. In other words, the certainty of liability must be known beforehand. Similarly, there must also be certainty of revenue that the government intends to collect over the given time period. Any amount of uncertainty in these respects may invite a lot of trouble.

iii. Canon of Economy:

- This canon implies that the cost of collecting a tax should be as minimum as possible. Any tax that involves high administrative cost and unusual delay in assessment and high collection of taxes should be avoided altogether.
- According to A. Smith, “Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State.”

iv. Canon of Convenience:

- Taxes should be levied and collected in such a manner that it provides the greatest convenience not only to the taxpayer but also to the government.
- Thus, it should be painless and trouble-free as far as practicable. “Every tax”, stresses A. Smith, “ought to be levied at time or the manner in which it is most likely to be convenient for the contributor to pay it.”

v. Canon of Productivity:

- Taxes must be productive or cost-effective. This implies that the revenue yield from any tax must be a sizable one. Further, this canon states that only those taxes should be imposed that do not hamper productive effort of the community.
- A tax is said to be a productive one only when it acts as an incentive to production.

vi. Canon of Elasticity:

- Modern economists attach great importance to the canon of elasticity. This canon implies that a tax should be flexible or elastic in yield.
- It should be levied in such a way that the rate of taxes can be changed according to exigencies of the situation. Whenever the government needs money, it must be able to extract as much income as possible without generating any harmful consequences through raising tax rates. Income tax satisfies this canon.

vii. Canon of Simplicity:

- Every tax must be simple and intelligible to the people so that the taxpayer is able to calculate it without taking the help of tax consultants. A complex as well as a complicated tax is bound to yield undesirable side-effects. It may encourage taxpayers to evade taxes if the tax system is found to be complicated.
- A complicated tax system is expensive in the sense that even the most honest educated taxpayers will have to seek advice of the tax consultants. Ultimately, such a tax system has the potentiality of breeding corruption in the society.

viii. Canon of Diversity:

- Taxation must be dynamic. This means that a country's tax structure ought to be dynamic or diverse in nature rather than having a single or two taxes. Diversification in a tax structure will demand involvement of the majority of the sectors of the population.
- If a single tax system is introduced, only a particular sector will be asked to pay to the national exchequer leaving a large number of population untouched. Obviously, incidence of such a tax system will be greatest on certain taxpayers. A dynamic or a diversified tax structure will result in the allocation of burden of taxes among the vast population resulting in a low degree of incidence of a tax in the aggregate.

Impact and Incidence of Taxation

- The impact of a tax is felt at the point where the tax first comes in the contact with the tax payers. The impact is on the person who pays it in the first instance.
- The incidence is on the one who finally bears it. Therefore, the incidence is on the final consumers.
- According to Dalton, there are two types of incidence :
 - i. Real Burden
 - ii. Money Burden
- Money burden is measured in terms of money which consists of tax amount and additional expenses involved in paying taxes.
- Real Burden relates to the sacrifice which the imposition of tax creates on the tax payers. This sacrifice is equal to the loss of economic welfare to the individual as well as to the society.

Shifting

- It is the process of passing the money burden of a tax to some other person. The purpose of shifting is to escape the burden of taxation.
- The shifting is possible only through the process of exchange of goods and services.
- Shifting is of following kinds:
 - i. Forward shifting: In this case the burden is shifted from the producer to the consumers in the form of a rise in price of the commodity either by full amount of the tax or less than the full amount. E.g. GST, excise duty.
 - ii. Backward shifting: Here the tax on a commodity is shifted back to the agents of production. E.g. a producer may force the suppliers of raw materials to accept lower price. In this case, the price of the commodity remains the same and the burden of the tax is borne by the supplier of raw materials.

iii. Combination of both

iv. Single point and Multi-point shifting:

When a tax is shifted from the manufacturer to the consumer it is single point shifting.

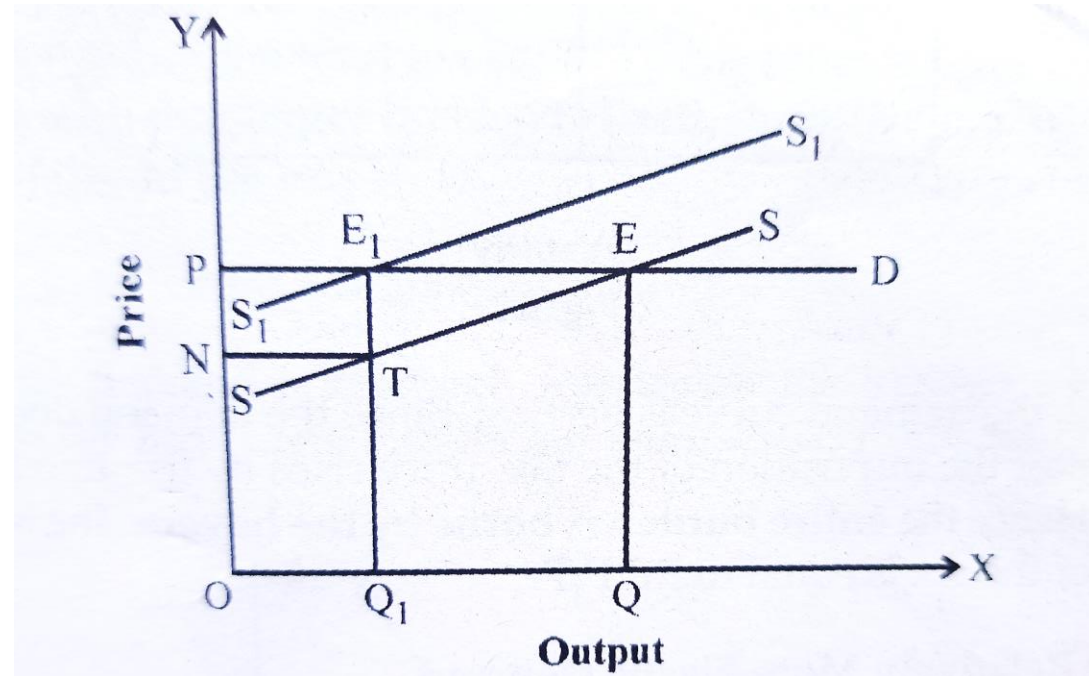
When the burden of a tax is shifted from one point to several points, it is multipoint shifting. E.g. GST on a good is shifted by the producer to a wholesaler to a retailer to a customer.

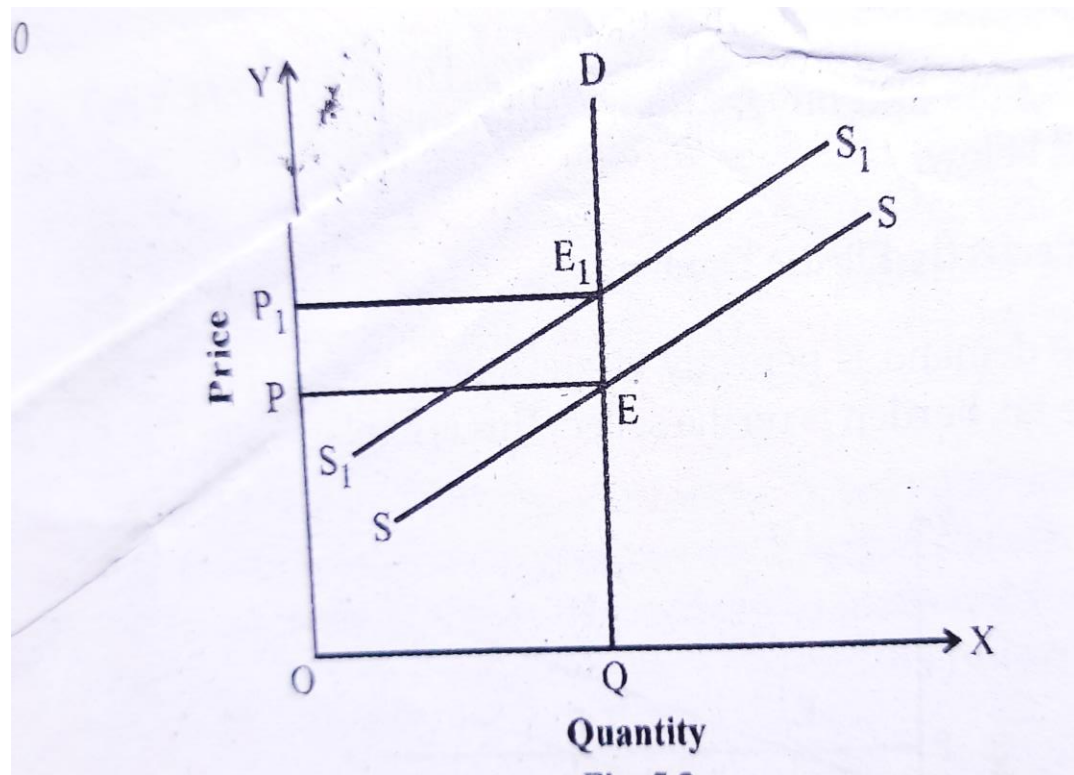
Factors Influencing Tax Incidence

1. Elasticity of demand
2. Elasticity of supply
3. Cost Conditions
4. Market Structure

Elasticity of Demand and Tax Incidence

- When the demand is perfectly elastic, the entire tax burden is on the seller.
- Tax = TE_1
- Total Tax amount paid = TE_1PN

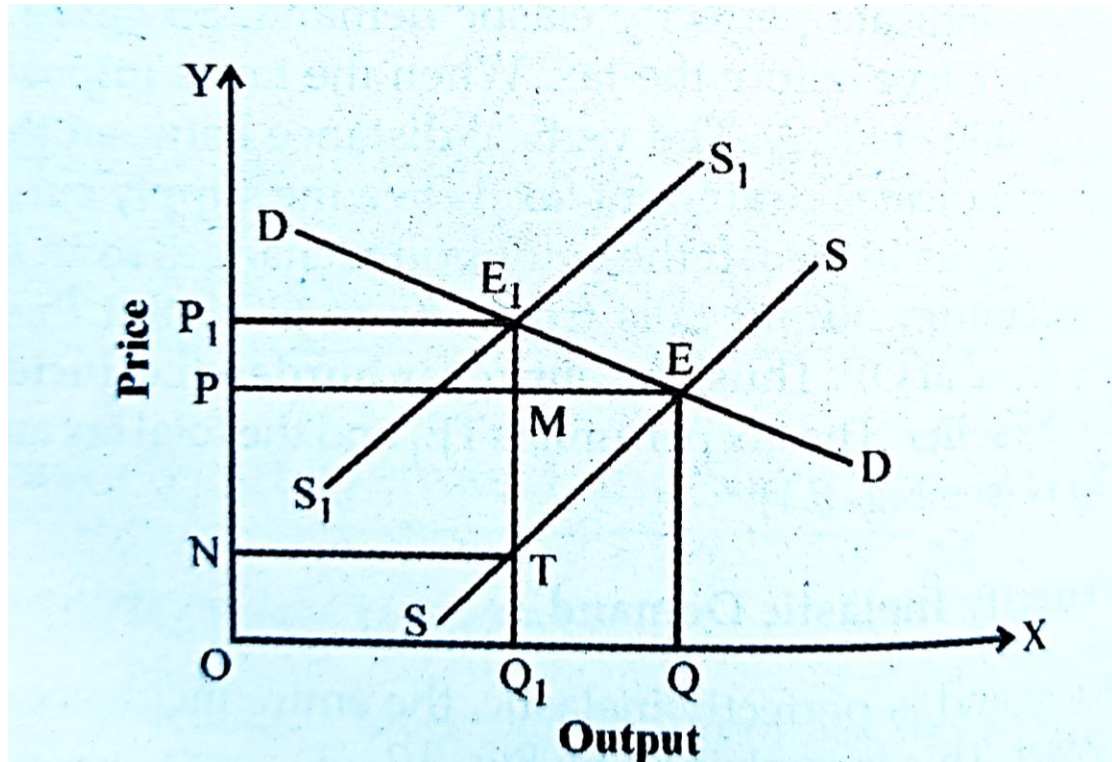




When the demand is perfectly inelastic, the burden is borne by the buyer.

Tax= EE_1

Tax amount paid= EE_1P_1P



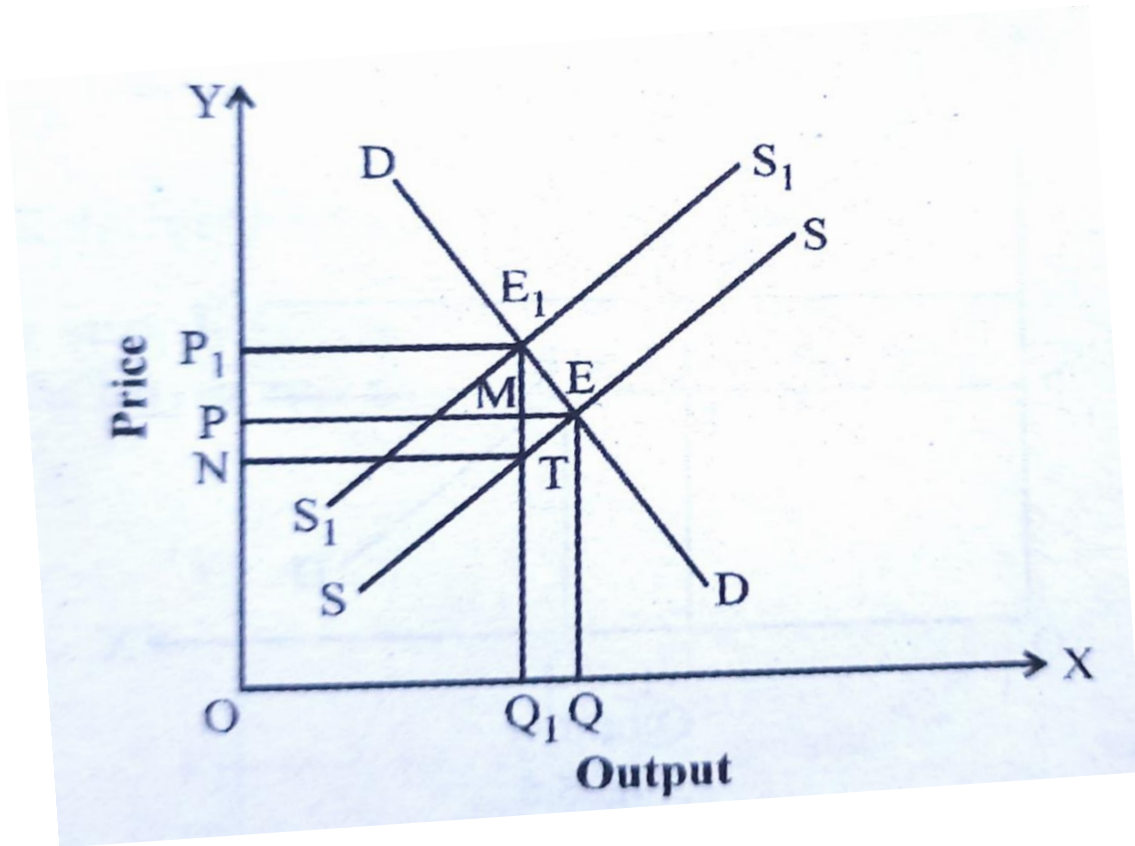
- When demand is relatively more elastic, larger burden is on seller.
- After imposition of tax resultant price rise (PP1) is lesser than the tax imposed.

Tax = TE1

Total Tax amount = NTE1P1

Tax paid by buyer = ME1P1P

Tax paid by seller = NTMP



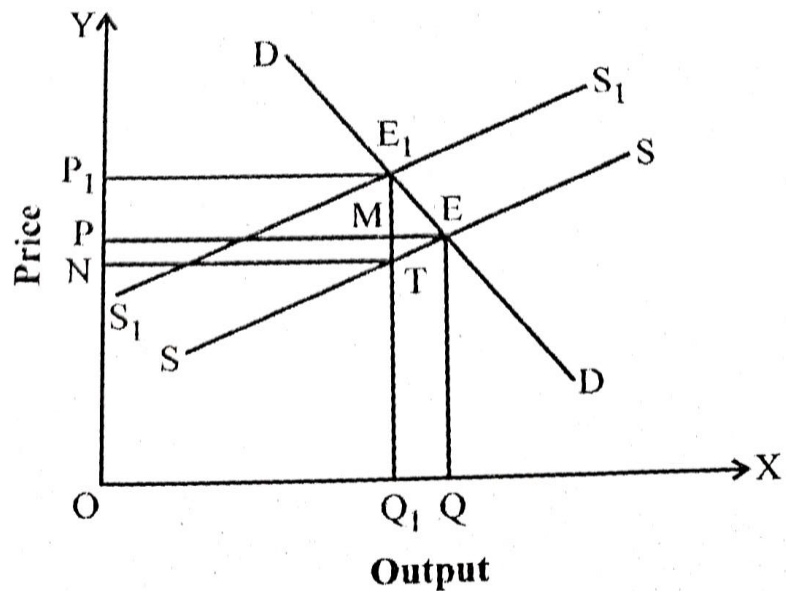
- In case of relatively less elastic demand, more burden is on buyer.
- After imposition of tax resultant price rise (PP1) is equal to the tax imposed.

Tax = TE1

Total Tax amount = NTE1P1

Tax paid by buyer = ME1P1P

Tax paid by seller = NTMP



If the supply is relatively elastic more burden is borne by the buyer and less by the seller.

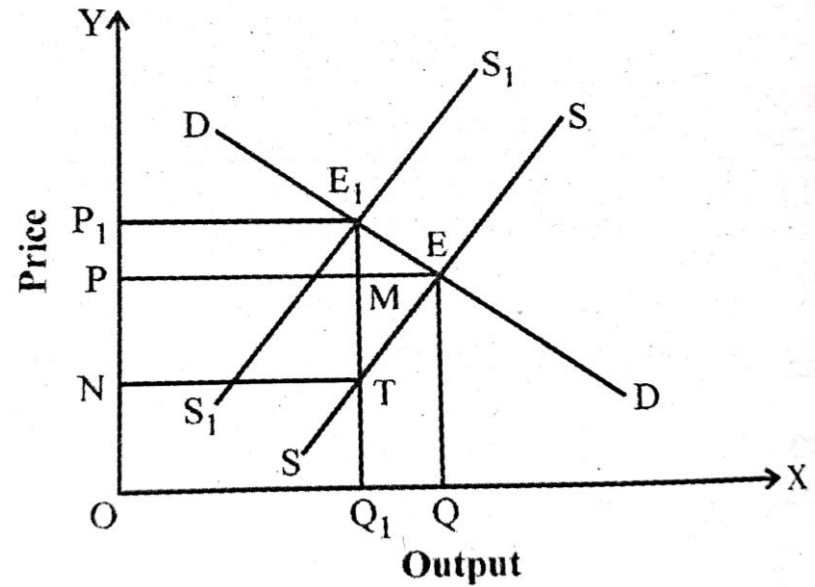
Rise in price (PP_1) is lesser than tax imposed.

Tax = TE_1

Total Tax amount = NTE_1P_1

Tax paid by buyer = ME_1P_1P

Tax paid by seller = $NTMP$



If the supply is relatively inelastic more burden is borne by the seller and less by the buyer.

Tax = TE_1

Total Tax amount = NTE_1P_1

Tax paid by buyer = ME_1P_1P

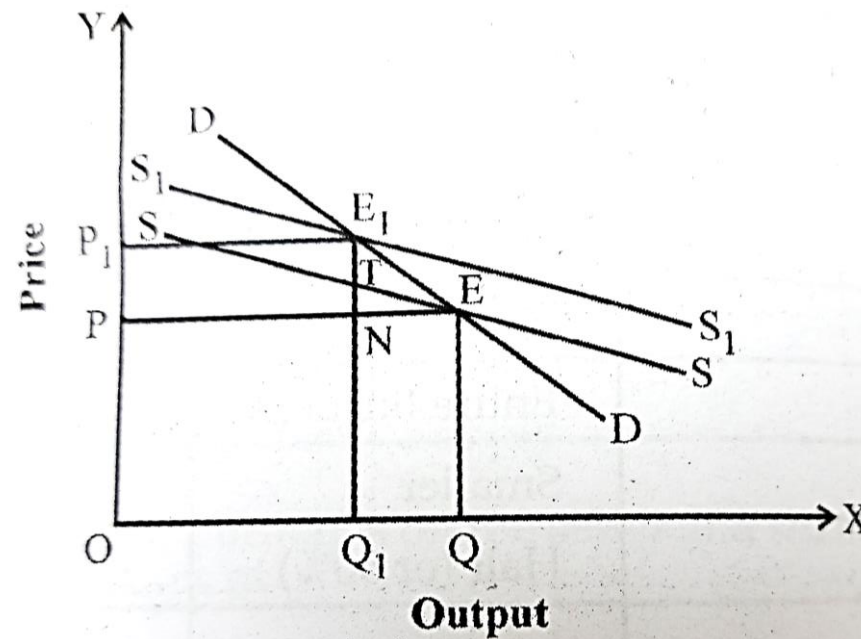
Tax paid by seller = $NTMP$

- When elasticity of demand and elasticity of supply are equal, the burden of tax is equally shared by the buyer and the seller.

Cost Conditions and Incidence of Taxation

1. Decreasing Cost Condition:

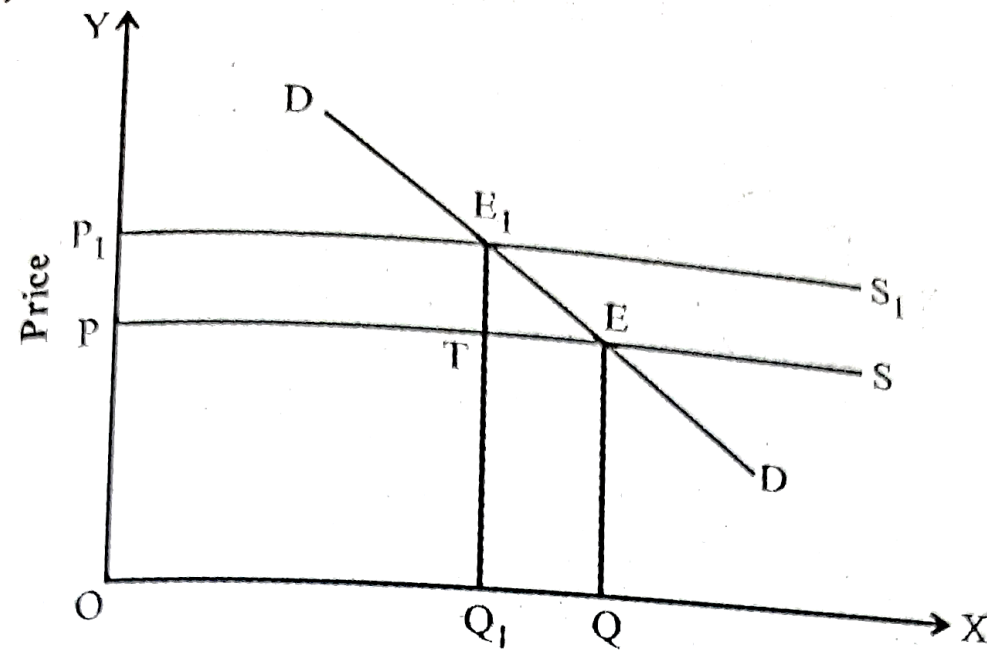
- Under increasing returns to scale, average cost per unit of output diminishes as the output increases.
- Under such a condition the tax burden on the buyers will be more than the amount of tax. The incidence of tax under decreasing cost condition is explained in the diagram.



- In the diagram SS is the supply curve. It is downward sloping because it indicates decreasing cost.
- $TE1$ is the tax imposed, due to which supply curve shifts to $S1S1$. Price rises to $OP1$.
- $OP1 > TE1$, because with the fall in output the average cost of production goes up due to decreasing cost conditions prevailing in the market.
- Thus, burden of tax amount will be more on buyers.

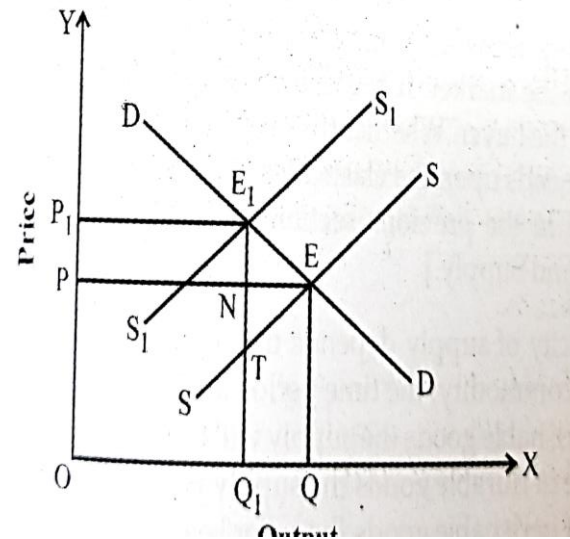
2. Constant Cost:

In this case producer shifts the entire tax burden to the consumer.



3. Increasing Cost Condition:

In this case only a part of burden is shifted to the consumer. The price rise PP_1 is lesser than the tax amount TE_1 .



Market Structure and Incidence of Taxation

- Tax Incidence under Perfect Competition:
- Under perfect competition, price is determined by the interaction between market forces. Whether burden can be shifted to buyer or not depends upon the price elasticity of demand as well as supply.

- Tax Incidence under Monopoly:

The incidence of tax under monopoly is analysed with respect to two types of taxes:

- a. Unit or specific tax
- b. Lumpsum tax

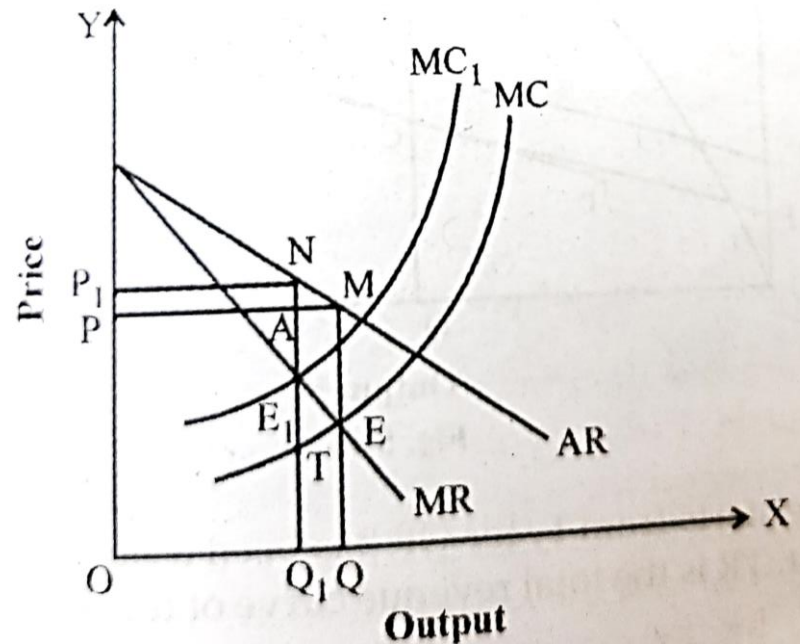
Incidence of a unit or specific tax:

- A selective tax may be imposed in the form of a unit or specific tax. It is of a fixed amount per unit of the product sold.

The monopolist will restrict the output to the point where $MR = MC$.

A unit tax will increase his cost per unit. It therefore follows that if he has still to maximize profits he will restrict output further in order to secure a higher price and shift the tax burden.

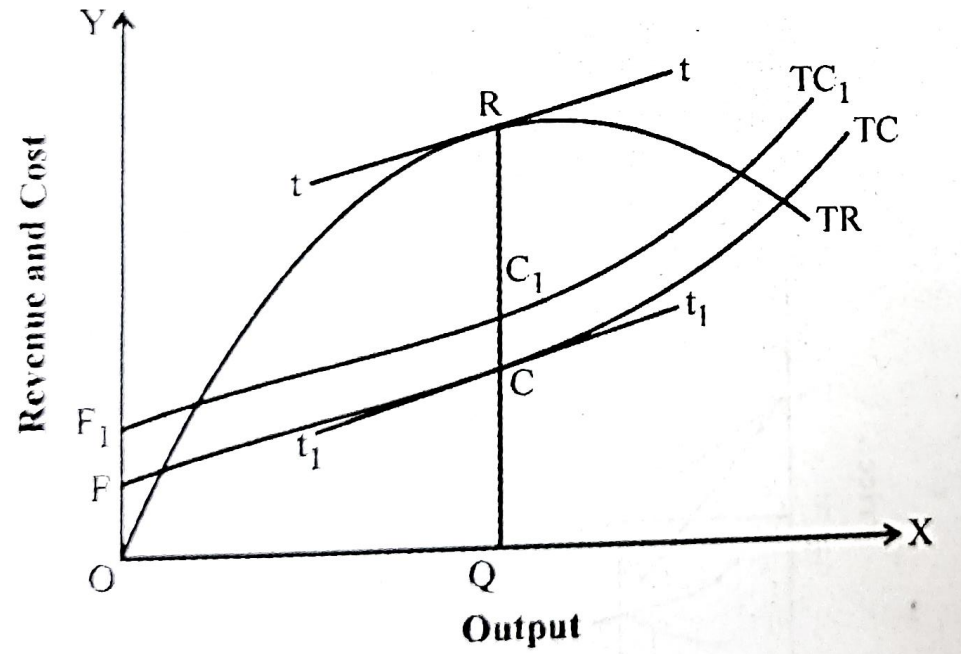
This explained in the diagram below.



- In this diagram, E is the original equilibrium where $MR = MC$. The original output is OQ and the price is OP.
- The imposition of TE1 tax on the commodity raises the cost of production and therefore the MC curve shifts to MC1.
- The new equilibrium is E1. The price has increased by PP1. The tax amount per unit is TE1 which is equal to the vertical distance between the MC curves. $PP1 < TE1$. Thus AN is the tax burden shifted to the buyer and remaining is borne by the monopolist.
- By how much price will rise and the burden will be shifted depends upon the elasticity of demand.

Incidence of Lumpsum Tax:

- Lumpsum tax is imposed generally on profit or as a licence fees.
- In this case the monopolist will not shift the burden on the buyers. The monopolist himself bears the tax burden since the lumpsum tax is independent of his supply and price. This is shown in the following diagram:



- The imposition of lumpsum tax leads to shift in the TC curve to TC1.
- Thus the profit gets reduced. Yet the optimum output remains at OQ.
- Thus, lumpsum tax doesn't affect price or quantity.

Types of Tax Rates

1. Proportional Taxation: tax rate increases in proportion to the increase in income.
2. Progressive Taxation: Tax rate increases with an increase in income.
3. Regressive Taxation: Tax rate falls as income rises. E.g. Indirect taxes
4. Digressive taxation: tax rate increases at a diminishing rate with an increase in income.

Tax base is the level of income on which a tax is charged.

Effects of Taxation

1. Effects on Income and Wealth:

A progressive taxation system reduces income inequality since the burden of such a tax falls on the rich class.

Opposite happens in case of regressive tax system.

Taxes imposed on luxury goods help in positive income distribution, whereas taxes on necessary items may have regressive effect.

2. Effect on Consumption:

- a. Income effect of taxation: The tax reduces purchasing power of the individuals. This is considered as direct burden of the tax.
- b. Substitution or Price effect of taxation: The tax creates an incentive for the tax payers to substitute less preferred but untaxed goods in place of more preferred tax goods. The loss in consumer utility from this substitution is the excess burden of the tax.
- c. Effect on consumption during inflation: A rise in tax during inflation will reduce the purchasing power of consumers, which is already low due to inflation. This helps in control of inflation.

During recession, taxation may be reduced so that people can have more disposable income in their hand. This will encourage consumption and increase economic activities in the economy.

d. Regulatory effect of taxation: Taxes imposed on certain goods can aim at reducing or discouraging their consumption, e.g. Sin goods

3. Effect on Savings, Investment and Production:

a. Effects on ability to work, save and invest:

Due to taxes on necessary goods, the consumption of such goods will reduce. This will cause a fall in ability to work. This also affects savings and investment.

b. Effects on willingness to work, save and invest:

Tax is seen as burden. If a progressive tax is levied, people will have less incentive to work hard and go to a higher slab of income because they will find it futile as they will have to pay more taxes.

Those whose demand is income elastic, will reduce the consumption and saving if a higher tax is imposed.

c. Effects on Allocation of resources: By diverting resources to desired sectors, taxation can influence size as well as pattern of production. Therefore, heavy taxes are levied on consumption of harmful goods, whereas tax concessions are given for the products whose higher production is required.

4. Redistributive effect

Taxes help in redistribution of income and wealth in more equitable manner.

Redistribution of income can also be achieved by offering incentives through tax concessions on investment to produce certain goods and services.

Also, tax holidays and tax rebates can be offered for investing in economically backward areas. Such investment may provide more employment and income to the poor, bringing down the inequality.

Tax revenue spent on various schemes meant for poor also serve to reduce inequality.

- 5. Anti-inflationary nature of taxation

Tax reduction and concessions may reduce the tax revenue, bringing down the government's expenditure which in turn would decline the money supply and aggregate demand.

Lower taxes bring down prices. This may encourage exports bringing down trade deficit.

Public Expenditure

- Expenses incurred by the public authorities—central, state and local self- governments—are called public expenditure. Such expenditures are made for the maintenance of the governments as well as for the benefit of the society as whole.
- There was a misbelief in the academic circles in the nineteenth century that public expenditures were wasteful. Public expenditures must be kept low as far as practicable. This conservative thinking died down in the twentieth century, especially after the Second World War.
- As a modern state is termed a ‘welfare state’, the horizon of activities of the government has expanded in length and breadth.

- The modern state is described as the 'welfare state'. As a result, the activities of the modern government have widened enormously. Modern governments are undertaking various social and economic activities, particularly in less developed countries (LDCs).

Importance of Public Expenditure

1. Provision of Public and Merit Goods:

Public goods: defence, law and order, justice, transportation, infrastructure, water supply.

Merit goods: health, education and housing

2. Meeting current consumption needs:

In developing countries, public expenditure is important to fulfil current consumption needs of the public and thus, maintain a high level of aggregate demand. This is done through the expenditure on pension, unemployment benefits, PDS and other types of transfer payments.

3. Capital expenditure:

A developing country must undertake various projects, like road-bridge-dam construction, power plants, transport and communications, etc. These social overhead capital or economic infrastructures are of crucial importance for accelerating the pace of economic development.

4. Fiscal Policy Instrument:

- Public expenditure is considered as an important tool of fiscal policy. Public expenditure creates and increases the scope of employment opportunities during depression. Thus, public expenditure can prevent periodic cyclical fluctuations. During depression, it is recommended that there should be more and more governmental expenditures on the ground that it creates jobs and incomes.
- On the contrary, a cut-back in government's expenditure is necessary when the economy faces the problem of inflation. That is why it is said that by manipulating public expenditure, cyclical fluctuations can be lessened greatly. In other words, variation of public expenditure is a part of the anti-cyclical fiscal policy.

5. Redistribution of Income:

- Public expenditure is used as a powerful fiscal instrument to bring about an equitable distribution of income and wealth. There are good much public expenditure that benefit poor income groups. By providing subsidies, free education and health care facilities to the poor people, government can improve the economic position of these people.

6. Balanced Regional Growth:

- Public expenditure can correct regional disparities. By diverting resources in backward regions, government can bring about all-round development there so as to compete with the advanced regions of the country.
- This is what is required to maintain integration and unity among people of all the regions. Unbalanced regional growth encourages disintegrating forces to rise. Public expenditure is an antidote for these reactionary elements.

7. Economic Development:

- Public expenditure has the expansionary effect on the growth of national income, employment opportunities, etc. Economic development also requires development of economic infrastructures.

Low Income Support and Social Security Schemes

- Among schemes, the MGNREGS has the highest allocation in 2021-22 at Rs 73,000 crore. Allocation to the scheme has seen an annual increase of 1% over 2019-20. However, in 2020-21, allocation to the scheme has been increased by Rs 50,000 crore (81%) from the budgeted stage to the revised stage, following the announcement made under the Aatmanirbhar Bharat Economic Package in May 2020.
- The PM-KISAN scheme (income support to farmers) has the second highest allocation in 2021-22 at Rs 65,000 crore, an annual increase of 16% over 2019-20. In 2020-21, allocation to the scheme has decreased by 13% from Rs 75,000 crore at the budgeted stage to Rs 65,000 crore at the revised stage.

- **Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY)**

The PMJJBY is available to people in the age group of 18 to 50 years having a bank account who give their consent to join / enable auto-debit. Aadhar is the primary KYC for the bank account.

The life cover of Rs. 2 lakh is for the one year period stretching from 1st June to 31st May and is renewable. Risk coverage under this scheme is for Rs. 2 lakh in case of death of the insured, due to any reason.

The premium is Rs. 330 per annum which is to be auto-debited in one installment from the subscriber's bank account as per the option given by him on or before 31st May of each annual coverage period under the scheme.

The scheme is being offered by the Life Insurance Corporation and all other life insurers who are willing to offer the product on similar terms with necessary approvals and tie up with banks for this purpose. As on 31st March, 2019, cumulative gross enrollment reported by banks subject to verification of eligibility, etc. is over 5.91 crore under PMJJBY. A total of 145763 claims were registered under PMJJBY of which 135212 have been disbursed.

- **Atal Pension Yojana (APY)**

- APY was launched on 9th May, 2015 by the Prime Minister. APY is open to all saving bank/post office saving bank account holders in the age group of 18 to 40 years and the contributions differ, based on pension amount chosen.
- Subscribers would receive the guaranteed minimum monthly pension of Rs. 1,000 or Rs. 2,000 or Rs. 3,000 or Rs. 4,000 or Rs. 5,000 at the age of 60 years. Under APY, the monthly pension would be available to the subscriber, and after him to his spouse and after their death, the pension corpus, as accumulated at age 60 of the subscriber, would be returned to the nominee of the subscriber.
- The minimum pension would be guaranteed by the Government, i.e., if the accumulated corpus based on contributions earns a lower than estimated return on investment and is inadequate to provide the minimum guaranteed pension, the Central Government would fund such inadequacy. Alternatively, if the returns on investment are higher, the subscribers would get enhanced pensionary benefits.

- Pradhan Mantri Mudra Yojana
- The scheme was launched on 8th April 2015. Under the scheme a loan of upto Rs. 50,000 is given under sub-scheme 'Shishu'; between Rs. 50,000 to 5.0 Lakhs under sub-scheme 'Kishore'; and between 5.0 Lakhs to 10.0 Lakhs under sub-scheme 'Tarun'. Loans taken do not require collaterals. These measures are aimed at increasing the confidence of young, educated or skilled workers who would now be able to aspire to become first generation entrepreneurs; existing small businesses, too, will be able to expand their activities. As on 31.03.2019, Rs. 3,21,722 crores sanctioned (Rs. 142,345 cr. - Shishu, Rs. 104,386 cr. Kishore and Rs. 74,991 cr. - Tarun category), in 5.99 crores accounts.

- Pradhan Mantri Vaya Vandana Yojana
- The 'Pradhan Mantri Vaya Vandana Yojana (PMVVY) has been launched by the Government to protect elderly persons aged 60 years and above against a future fall in their interest income due to uncertain market conditions, as also to provide social security during old age. The scheme is implemented through the Life Insurance Corporation of India (LIC) and open for subscription upto 31st March, 2023.
- PMVVY offers an assured rate of return 7.40% per annum for the financial year 2020-21 for policy duration of 10 years. In subsequent years, while the scheme is in operation, there will be annual reset of assured rate of return with effect from April 1st of the financial year in line with applicable rate of return of Senior Citizens Saving Scheme(SCSS) upto a ceiling of 7.75% with fresh appraisal of the scheme on breach of this threshold at any point.