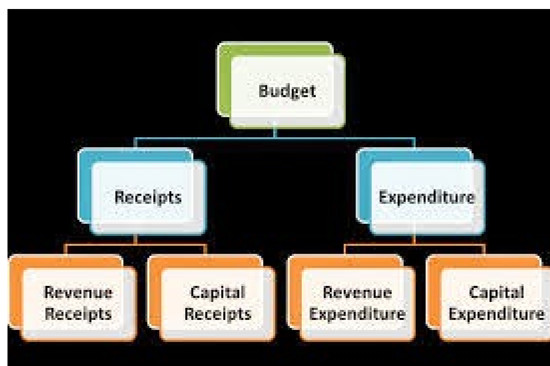
RBI & Fiscal System

Fiscal System in India

A country's fiscal system is the complete structure of government revenue and expenditures and the framework within which its agencies collect and disburse those funds. This system is governed by a nation's economic policy, which comes from decisions made by the governing body.

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply. These two policies are used in various combinations to direct a country's economic goals.



There are 3 parts of the fiscal policy

1. Public Revenue.
2. Public expenditure.
3. Public debt.

Revenues: are the source of income realized by the government and are divided into:

1. **Revenue receipts:** which consists of revenue from regular sources like Taxation revenues: eg. receipts from corporate tax, income tax, excise tax, Excise duty, custom duty, service tax etc. On tax revenue: which include interest on loans, dividends from Public sector units, Fees and stamp duties.

2. **Capital receipts:** Which refer to those inflows to government that are not in the nature of regular income, But are repayments / recoveries, or proceeds from sale of assets. Other receipts like Disinvestment (selling some shares of a PSU) comes under this head. Borrowings are simply the deficit which can be covered by taking loans from market.

Expenditure: are the expenses incurred by Govt and are divided into:

Non plan expenditure: These are ongoing expenditure not covered under the 5 - year plans. Non-plan revenue expenditure is accounted for by interest payments, subsidies (mainly on food and fertilizers), wage and salary payments to government employees, grants to States and Union Territories governments, pensions, police, economic services in various sectors, other general services such as tax collection, social services, and grants to foreign governments. Non-plan capital expenditure

mainly includes defense, loans to public enterprises, loans to States, Union Territories and foreign governments.

Plan expenditure: India has adopted economic planning as a strategy for economic development. For stepping up the rate of economic development five-year plans have been formulated. So far ten five-year plans have been completed. The expenditure incurred on the items relating to five year plans is termed as plan expenditure. Such expenditure is incurred by the Central Government.

A provision is made for such expenditure in the budget of the Central Government. Assistance given by the Central Government to the State Governments and Union Territories for plan purposes also forms part of the plan expenditure. Plan expenditure is subdivided into Revenue Expenditure and Capital Expenditure. This expenditure involves funding for programmes and projects covered by the 5 - year plans as decided by the various ministerial bodies.

Revenue expenditure - It is payments incurred for day - to - day running of government departments and various services offered to citizens. This also comprises of spending towards subsidies, interest payments. This spurs consumption in economy.

Capital expenditure: This expenditure spurs asset creation, resulting in increased investment with spending diverted towards cost associated with acquisition of assets that may include investments in shares, infrastructure as well as loans and advances given out by government.

Other Important Terms:

Public debt: The money borrowed by the government is eventually a burden on the people of India, and is, therefore, called public debt. It is split into two heads: internal debt (money borrowed within the country) and external debt (funds borrowed from non-Indian sources).

Usually the government spends more than what it earns through various sources. This shortfall, which is met with borrowed funds, is called fiscal deficit. Technically, it is the excess of government expenditure over 'non-borrowed receipts' — revenue receipts plus loan repayments received by the Govt plus miscellaneous capital receipts. Fiscal deficit for FY13 is estimated at INR.5.64 lakh crore, revenues of INR 9.18 lakh crores less expenditure of INR 14.82 lakh crores.

Fiscal deficit is measured as a percentage of GDP, hence INR 5.64 lakh crore / GDP of INR 100.74 lakh crores work out to estimated fiscal deficit of 5.6% of GDP.

Revenue Deficit: It is the excess of revenue expenditure over revenue receipts. All expenditure on revenue account should ideally be met from receipts on revenue account; the revenue deficit should be zero. In such a situation, the government borrowing will not be for consumption but for creation of assets.

Effective revenue deficit: This is an even tighter number than the revenue deficit. It is revenue deficit less grants for creation of capital assets.

Primary deficit: It is the fiscal deficit less interest payments made by the government on its earlier borrowings.

Deficit and GDP: Apart from the numbers in rupees, the budget document also mentions deficit as a percentage of GDP. This is because in absolute terms, the fiscal deficit may be large, but if it is small compared to the size of the economy, then it's not such a bad thing, especially if it is being used to create production capacities.

Types of fiscal policy

Fiscal policy has an effect on each of these categories. There are two types of fiscal policy: Expansionary and Contradictory.

Expansionary Fiscal Policy

When an economy is in a recession, expansionary fiscal policy is in order. Typically this type of fiscal policy results in increased government spending and/or lower taxes. A recession results in a recessionary gap – meaning that aggregate demand (i.e. GDP) is at a level lower than it would be in a full employment situation. In order to close this gap, a government will typically increase their spending which will directly increase the aggregate demand curve (since government spending creates demand for goods and services). At the same time, the government may choose to cut taxes, which will indirectly affect the aggregate demand curve by allowing for consumers to have more money at their disposal to consume and invest. The actions of this expansionary fiscal policy would result in a shift of the aggregate demand curve to the right, which would result closing the recessionary gap and helping an economy grow.

Contradictory Fiscal Policy

Contradictory fiscal policy is essentially the opposite of expansionary fiscal policy. When an economy is in a state where growth is at a rate that is getting out of control (causing inflation and asset bubbles), contractionary fiscal policy can be used to rein it in to a more sustainable level. If an economy is growing too fast or for example, if unemployment is too low, an inflationary gap will form. In order to eliminate this inflationary gap a government may reduce government spending and increase taxes. A decrease in spending by the government will directly decrease aggregate demand curve by reducing government demand for goods and services. Increases in tax levels will also slow growth, as consumers will have less money to consume and invest, thereby indirectly reducing the aggregate demand curve.

Conclusion on Fiscal Policy

The objectives of fiscal policy such as economic development, price stability, social justice, etc. can be achieved only if the tools of policy like Public Expenditure, Taxation, Borrowing and deficit financing are effectively used. Though there are gaps in India's fiscal policy, there is also an urgent need for making India's fiscal policy a rationalized and growth oriented one. The success of fiscal policy depends upon taking timely measures and their effective administration during implementation.

TYPES OF MONEY

- Commodity Money - Commodity money value is derived from the commodity out of which it is made. The commodity itself represents money, and the money is the commodity. For instance, commodities that have been used a Medium of exchange include gold, silver, copper, salt, peppercorns, rice, large stones, etc.
- Representative Money - is money that includes token coins, or any other physical tokens like certificates, that can be reliably exchanged for a fixed amount/quantity of a commodity like gold or silver.
- Fiat Money - Fiat money, also known as fiat currency is the money whose value is not derived from any intrinsic value or any guarantee that it can be

converted into valuable commodity (like gold). Instead, it derives value only based On government order (fiat)

- Commercial Bank Money - Commercial bank money or the demand deposits are claims against financial institutions which can be used for purchasing goods and services.

Reserve Money (M 0)

Currency in circulation + Bankers‘ ‘deposits with the RBI + ‘Other’ deposits with the RBI = Net RBI ‘credit to the Government + RBI credit to the commercial sector + RBI's claims on banks + RBI's net is foreign assets + Govemment’s currency liabilities to the public - RBI's net non-monetary liabilities.

M1

Currency with the public + Demand deposits with the banking system + 'Other' deposits with the RBI

M2

M1 + Savings deposits of office savings banks.

M3

M1+ Time deposits with the banking system

= Net bank credit to the Government + Bank credit to the Commercial sector + Net foreign assets of the banking sector + Government’s currency liabilities to the public - Net non-monetary liabilities of the banking sector.

M4

M3 +All deposits with post office savings banks (excluding National Savings Certificates)

The Indian Financial System

The term "finance" in our simple understanding it is perceived as equivalent to 'Money’. Finance exactly is not money, but it is the source of providing funds for a particular activity. The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other.