

## **Economic Environment and Business Strategy**

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### **Fiscal environment**

Welcome back to our course on the economic environment and business strategy. In this session, we shift our focus from monetary policy to another vital instrument of macroeconomic management: fiscal policy. Fiscal policy refers to the government's use of taxation, public expenditure, and borrowing to influence the overall direction of the economy. It plays a critical role not only in promoting economic growth and stability but also in redistributing resources and correcting market failures. In today's session, we will cover the core objectives and conceptual foundation of fiscal policy, followed by the main policy instruments: government spending, taxation, and public debt management.

And then we'll cover the structure of India's Union Budget, including the revenue and capital accounts. Then, we'll discuss the various types of budget deficits and what they reveal about the fiscal health of an economy. Finally, the political economy of fiscal policymaking draws insights from public choice theory and partisan theory. For businesses, understanding fiscal policy is essential because it shapes public investment, the tax regime, infrastructure development, and overall demand conditions.

These are all key factors that directly influence business strategies and market performance. Let us begin by unpacking the core principles and instruments of fiscal policy and examining how they shape the economic landscape in which firms operate. Let's turn to the concept and business implications of fiscal policy. Let's begin with what fiscal policy means. Fiscal policy is the use of government spending and taxation to influence the economy.

The core objectives of fiscal policy are to ensure stabilization, promote economic growth, and redistribute income from the wealthy to the poor. Fiscal policy differs from monetary policy; it can have a direct impact on aggregate demand in the economy and an immediate impact on sectoral activities within an economy. Now, let me point out and list the different types of fiscal policy. To begin with, we have expansionary fiscal policy. Expansionary fiscal policy refers to an increase in government spending and/or a decrease in taxes.

The primary objective of following an expansionary fiscal policy is to stimulate demand conditions in the economy and thereby support economic growth, particularly during economic slowdowns. In other words, if the economy is experiencing a recessionary

phase or slowdown, governments typically adopt an expansionary fiscal policy, which involves increasing government expenditure, providing more subsidies, and reducing taxes. The idea is that people have more income, and as a result, when taxes decline, they have more purchasing power. That will stimulate aggregate demand in the economy, thereby supporting economic growth. In contrast to this, there is a contractionary fiscal policy. Contractionary fiscal policy means a decline in government spending and an increase in government taxes.

This approach is primarily aimed at controlling inflation and reducing the fiscal deficit. Normally, when the economy is doing well or at a peak, and inflationary pressures are present, the government typically reduces spending or increases taxes to lower people's purchasing power, which can help control inflation and reduce the fiscal deficit. In contrast, the other approach is a neutral fiscal policy, which involves balanced spending and taxation. That means there is no expansionary policy; there is no increase in government spending over its revenue, but rather an attempt to maintain the current economic trajectory. That means not making any government interventions to alter the trajectory of the economy.

Let me now list a few key instruments of fiscal policy. The first is government expenditure, which is widely used. Government expenditure, the spending by the government, can be categorized into two types. One is capital spending, and the other is revenue spending. Government expenditure has an impact on infrastructure development and social welfare, and it can also have a multiplier effect on GDP growth.

Then comes another key instrument, taxation, and subsidy policy. There are direct and indirect taxes that are used to influence disposable income and business costs in an economy. For example, when the government reduces tax rates, people's disposable income increases. Similarly, when the government reduces taxes on goods and services, prices decrease, which in turn lowers business costs. Then there is a third component, called borrowing and public debt management.

How does the government finance the budget deficit, and how does it manage the public debt? A key aspect of fiscal policy is the government budget. A government budget is a formal financial statement that presents the government's estimated revenues and expenditures; in other words, it is a statement of the expected income and planned expenditure for a specific fiscal year. It serves as a plan for how the government will raise money, through taxes, borrowing, and other sources, and spend it on development, welfare, and administrative activities. Unlike a personal budget, a government budget starts by first estimating the expected expenditure for the next fiscal year, and then, accordingly, estimating the expected income. In the case of individuals, especially, what they do first is think and calculate their income, and in general, they then plan their expenditure.

In contrast, the government, overall, first plans its expenditure and then estimates the sources of its income or revenue. Let us now delve into the government budget in more detail. The Union Budget of the Government of India has two main components. One is called the revenue account, and the other is referred to as the capital account. We have a revenue account and capital accounts.

Each account includes receipts, which are money coming in, and the second one is expenditures, which are money going out. The revenue account includes revenue receipts, which consist of taxes, non-tax revenues, and other sources. It also has revenue expenditure, which includes salaries, subsidies, and interest payments. Then, coming to the other account, the second account, called the capital account, it again has two components, as you know: one is receipts, and the other is expenditure. Capital receipts include borrowings, loan recoveries, and asset sales, while capital expenditure includes infrastructure creation, loans, and asset acquisition.

Let's examine these concepts in detail to understand what they entail. So, let us go one by one. Begin with capital expenditures. In the union budget, capital expenditure includes spending that creates assets or reduces liabilities for the government. The key components of capital expenditures are the construction of infrastructure.

It encompasses roads, bridges, railways, airports, ports, dams, and other types of infrastructure. These are all infrastructure developments, and spending on their development is a key component of capital expenditure. The second category includes building public facilities, such as schools, colleges, and hospitals. Then come the acquisition of machinery and defense equipment, which also fall under capital expenditure. Then come investments that generate future income or dividends, and loans and advances to states, union territories, government companies, and other entities, which are also part of capital expenditure.

Let's now move on to revenue expenditure. Revenue expenditure is spending that does not result in the creation of any assets. It is used for the day-to-day functioning of government departments, mainly for salary payments, pensions, and other operational expenses. The main components, as I mentioned earlier, include the day-to-day operations of government departments, such as salaries, pensions, and operational expenses. It also includes interest payments on public debt and subsidies, such as those for food, fertilizer, and fuel.

Additionally, grants to states and union territories, even when used to create assets, are considered part of revenue expenditure. Let us now move to the other component, the capital and revenue receipt component of the government budget. As I mentioned here, it has two aspects. One is a capital receipt, and the other is a revenue receipt. Capital

receipts include non-recurring receipts of the government that either create liabilities or reduce assets.

They do not directly affect the government's revenue or fiscal balance in day-to-day operations. The key component of capital receipts is government borrowings, which include market loans from the public, borrowing from the RBI and other parties through treasury bills, as well as loans from foreign governments and international bodies. In addition, the second component is disinvestment receipts.

That is through the sale of government stakes in public sector units. You are aware of the recent sale of Air India to Tata and LIC. These are all sales of LIC shares by the government. These are all part of the government's capital receipts, which have been referred to as disinvestment receipts. Then, the third category is loan recoveries.

It includes repayments from state and union territory governments, as well as recoveries from government companies and other parties. Let's talk about revenue receipts now. Revenue receipts are recurring funds received by the government that neither create liabilities nor reduce assets. They are mainly used to finance the government's routine or operational expenditures. The key points to remember here are that it comprises tax revenue, including income tax, GST, customs duties, and other non-tax revenues, including interest received, dividends, fees, and fines.

In India, revenue receipts primarily consist of tax revenues and, to a lesser extent, non-tax revenues. They do not create liabilities, meaning no future repayment is required. However, when future repayment is required, it falls under capital receipts. Capital receipts do not reduce assets, so they are not part of the revenue receipts component. Therefore, the revenue receipts component does not involve any asset sale. I am showing you the view of the budget, the key receipts, and expenditure components.

The revenue receipts you can see are the revenue receipts. You can read about them here: tax revenue and non-tax revenue. Over time, in this table, I am showing you the figures from the 2023-24 budget to the 2025-26 budget. As you can see, the changes in the values are evident. The capital receipts you can see here are comprised of the following components: recovery of loans, other receipts, borrowing, and other liabilities.

This is the main component you can see here. In capital receipts, tax revenue is the main component, and in revenue receipts, tax revenue is also the main component. In capital receipts, borrowing and other liabilities are the main components, so the total receipt is given here. You can now turn to item number 9, where the total expenditure is given as 10 plus this plus the revenue account plus the capital account; these are the total expenditures of the government. I am also showing you, just for illustrative purposes, the allocation of government expenditure and government revenue.

You can see where the rupees come from. Of the total budget, 22% comes from income tax and corporation tax, which includes taxes on companies and corporations. The profit tax on company profits amounts to 17%, meaning that out of every 1 rupee, 17 paise is retained. The lion's share of the government's budget comes from corporation tax and borrowing, which together constitute 20 percent of the country's total expenditure; one-fourth is financed through market borrowing. The other component, of course, is the GST, which is now 18 percent. And then this is the income source; what about the spending parts, where do the rupees go? As you can see, on the revenue side, borrowing and other liabilities account for 24 percent of the total budget.

On the expenditure side, you can see that interest payments account for 20 percent of total expenditure. That means 20 percent of the total expenditure and the total government budget is spent just on interest payments. You can then see other components, including central sector schemes, defense at 8%, and the state government's share of taxes and duties at 22%. So, let's now move to a related concept in the budget, called the budget deficit. A budget deficit occurs when a government's total expenditures exceed its total revenues, excluding borrowing.

You need to exclude borrowing in a specific fiscal year. It reflects the shortfall between what the government earns and what it spends, so most governments worldwide run a deficit budget; however, some European and Scandinavian countries have a surplus budget. In a budget deficit, the government's total expenditure exceeds its total revenue. In the Indian budget, particularly in the Indian context, we employ four related concepts: four types of budget deficit.

One is called a revenue deficit. The second is called the effective revenue deficit, fiscal deficit, and primary deficit. Let's go through each of these concepts to gain a clear understanding of what they mean. Regarding the revenue deficit, it occurs when revenue expenditure exceeds revenue receipts. We have already defined what revenue expenditure is and the components of revenue receipts. Simply put, the formula is revenue expenditure minus revenue receipts.

That is a revenue deficit. Let us identify the key points here. The revenue deficit indicates that the government's earnings are insufficient to cover its routine, day-to-day operations and functions. Therefore, it encompasses transactions that affect the government's current income and expenditure. As a result, a persistent revenue deficit forces the government to borrow to meet its operational needs, such as paying the salaries of government employees and making pension payments to retired employees.

When the government's earnings are insufficient, it needs to borrow from the market. At that time, you can see that the revenue deficit occurs when revenue expenditure exceeds revenue receipts. So, normally, let us also see how the revenue deficit is met. One of the

sources is borrowing or disinvestment. That means financing the deficit through capital receipts.

That is one source. It mainly means financing the deficit through capital receipts. The second option is to reduce the revenue deficit by increasing revenue receipts, which can be achieved by increasing revenue from tax or non-tax sources, thereby increasing the total revenue. The second is the rationalization of expenditure, which involves reducing unnecessary spending. There are several implications of the revenue deficit, which is often financed through capital receipts such as borrowing or asset sales. Rising borrowing increases the interest and repayment burden, potentially worsening future revenue deficits. The second related concept is called Effective Revenue Deficit, which measures the revenue deficit after excluding grants used for the creation of capital assets.

This is the formal definition. There is one point to note. Grants for the creation of capital assets are grants-in-aid provided by the central government to states, constitutional bodies, or implementing agencies to create assets owned by those entities. Another key concept widely used when referring to a budget deficit is the fiscal deficit. The fiscal deficit indicates the government's overall borrowing requirement. In a way, the government's total borrowing requirement in a financial year equals the fiscal deficit for that year.

The formula to calculate the fiscal deficit is total expenditure minus revenue receipts plus non-debt capital receipts. You already know what total expenditure and revenue receipts are. So, when there is a gap, this deficit exists. This is because when the government spends, it has to finance that spending.

It is financed through market borrowing. In short, the fiscal deficit simply refers to the government's overall borrowing requirements. Therefore, when the government's expenditure exceeds its income, it must borrow from the markets. Normally, this difference is calculated in absolute terms. As I mentioned in one of the previous slides, 24% of the total budget is financed by government borrowing.

Another concept derived from the fiscal deficit is the government's borrowing requirements, which exclude interest payments from the fiscal deficit. So, the primary deficit is defined as the fiscal deficit minus interest payments on previous borrowing. The clear implication is that the fiscal deficit refers to borrowing. However, if you exclude interest payments, whatever is left is the borrowing available for productive purposes, not just for servicing past debt. If the primary deficit is zero, it means all borrowing is used only to pay interest, and no additional borrowing goes toward new expenditure.

I am also showing you some statistics from the Union Budget of India on the fiscal deficit; you can see the percentage of GDP: it was 5.6 percent in 2023-24 and is now 4.4 percent in 2025-26. Similarly, you can see the data and the trend for the revenue deficit,

effective revenue deficit, and primary deficit. I am also showing you some statistics on the sources of financing the fiscal deficit.

I hope this is all self-explanatory. Please go through that and always review the latest financial budget document. You will find all this data there. I am also showing you the trend in the deficit, and you can see that during COVID, there was a sharp rise, especially here.

You can see there's a sharp rise in the deficit trend. Prior to that, at one point, the fiscal deficit was 3.5. For instance, in 2020, it was 2016-17, but during COVID-19, it became 9.2, and now in 2026, it's 4.4 percent. This is another measure of debt, the debt-to-GDP ratio, which is total debt divided by gross domestic product. I am also listing some of the implications of a growing budget deficit on business conditions. First, it would adversely affect the sovereign credit rating and the government's ratings by the borrowing agency. That indicates a weak fiscal position, which in turn suggests that overall fiscal management is also considered weak.

A persistent deficit can lower a sovereign rating. When there is a deficit, the government borrows more and more from the market, which pushes up borrowing costs and interest rates. As a result, interest rates and borrowing costs rise, a phenomenon known as the crowding-out effect on private investment. When the government increases borrowing from the market, demand for loanable funds rises. That, in turn, causes bond prices to decline and bond yields to rise. Similarly, there are adverse implications for foreign direct investment. Fiscal stress and currency depreciation risks reduce investor confidence and foreign direct investment inflows.

It also adversely affects GDP growth. It may stimulate short-term economic growth, but it hinders long-term growth through debt and inflation. It also puts pressure on inflation, foreign exchange rates, and future fiscal sustainability. So let us also contextualize the fiscal policy within the Indian context. India's fiscal policy is mainly guided by the FRBM Act of 2003. This act was designed to bring greater financial discipline, transparency, and long-term sustainability to India's fiscal policy.

It sets targets for reducing the fiscal deficit and public debt while also promoting accountability through regular reporting and parliamentary oversight. We also discuss receipts and expenditures, focusing on the receipts. In the receipts, especially the revenue receipts, one of the terms we use is tax. I thought it was better to list the different types of taxes.

Broadly, there are two types of taxes. One is called a direct tax and the other is called an indirect tax. Direct taxes are levied on a person's or firm's income or wealth and are paid directly by the person or firm on whom the assessment is made. For example, income tax and corporation tax paid by corporations on their profits mean that the incidence and

burden of direct tax will be on the same person or firm. In contrast, indirect taxes are taxes on spending on goods and services; here, the person on whom it is imposed may suppose it is imposed on a different entity. For example, excess duty imposed on the production side is initially paid by firms, but they will transfer this tax burden to consumers through higher prices; thus, the burden is ultimately passed on to consumers.

These are examples of indirect tax. I have listed the advantages and disadvantages of direct and indirect taxation here. I am also introducing a concept called the Laffer curve. It shows how tax revenue rises at each possible tax rate. The idea is that when the government increases the tax rate, we assume the government's tax revenue will increase, but there is a threshold. You can see on the x-axis that when we keep increasing the tax rate, there is a threshold; afterward, if you must pay 50%, 60%, or 70% of your income as tax, it will adversely affect your motivation to work.

Then, as a result, tax revenue initially increases to a certain level, but afterward it starts declining. This relationship between the tax rate and tax revenue is often illustrated by the Laffer curve. Another related concept is Ricardian equivalence, which holds that if you receive a tax cut or subsidy, you recognize that the government will raise taxes in the future. This is often implemented to stimulate the economy, but people understand that if the government is reducing taxes or the deficit today, it will increase taxes in the future. As a result, people who save a portion of their income do so because they know they will need to pay it back to the government.

This means households internalize the debt; they anticipate future tax increases and save more now. As a result, there is no role for fiscal stimulus. In the short term, there will be a slight impact; however, it will be neutralized because people will anticipate that, if they receive spending or subsidies, they will need to pay more taxes in the future. Some government payments, if received, are understood to need to be repaid. So, let me also conclude this session by presenting two key strands in the literature on optimal fiscal policy.

One is guided by public choice theory. Proponents of public choice theory argue that policymakers act to maximize their own political welfare, not necessarily social welfare. Another theory, partisan theory, holds that political ideology shapes fiscal decisions. For instance, liberal political parties differ from conservative political parties. Liberal parties provide more subsidies and expand social security payments, whereas conservatives focus more on incentivizing the supply side of the economy through tax rebates for corporations and other productive units. The common theme is that politics strongly influences macroeconomic policymaking.

Turning to public choice theory, these are the key aspects. Voters are opaque. Voting behavior responds to short-term economic conditions, which leads to a political business

cycle. That means pre-election demand surges are followed by post-election inflation. Similarly, unemployment versus inflation.

Politicians prioritize avoiding unemployment over controlling inflation. As a result, fiscal policy has an inflationary bias compared with monetary policy. There is also a deficit bias. Politicians prefer spending on visible benefits rather than raising taxes. Consequently, there will be a persistent budget deficit, especially just before the election period.

Then, the second theorem is known as the partisan theory. It posits a party cycle. Liberal parties favor employment and redistribution benefits. They follow an expansionary policy, whereas conservative parties are known for prioritizing price stability and adopting a more restrictive policy. The implication is that changes in ruling parties lead to cyclical fiscal policies. Therefore, fiscal rules that reduce political manipulation of aggregate demand through a balanced budget are important. Overall, in this session, we discussed the various fiscal policy instruments, distinguished between different types of receipts and expenditures, and related them to the Indian budget.

Thank you for listening to my session. In the next session, we will discuss the open-economy model and its relationship to the business economic environment and strategy. Thank you.