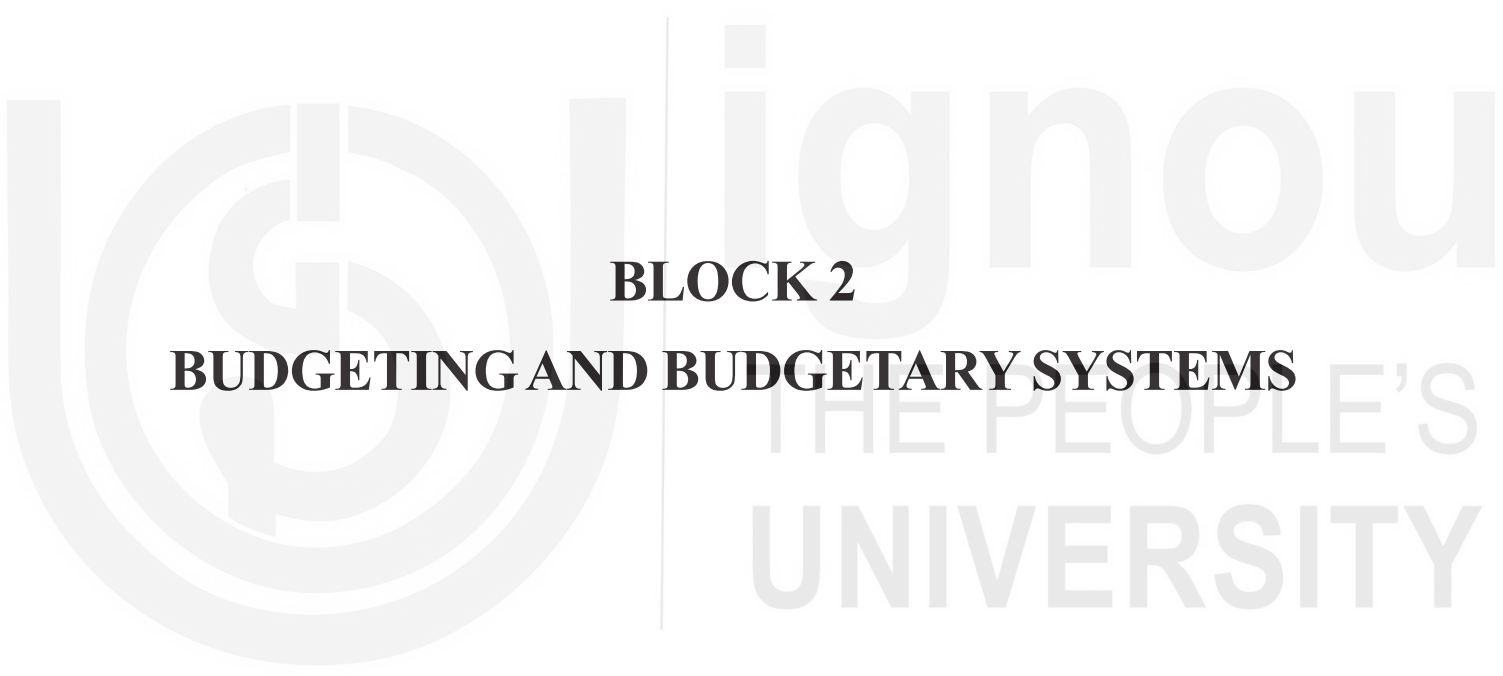




BLOCK 2

BUDGETING AND BUDGETARY SYSTEMS

UNIT4 PUBLIC EXPENDITURE: MEANING AND CLASSIFICATION*

Structure

- 4.0 Objectives
- 4.1 Introduction
- 4.2 Public Expenditure Management: Meaning
- 4.3 Public Expenditure: Objectives
- 4.4 Public Expenditure: Principles
- 4.5 Public Expenditure and Governance
- 4.6 Classification of Public Expenditure
- 4.7. Conclusion
- 4.8 Glossary
- 4.9 References
- 4.10 Answers to Check Your Progress Exercises

4.0 OBJECTIVES

After going through this unit, you should be able to:

- Explain the meaning of public expenditure and management ;
- Examine the objectives and principles of public expenditure ;
- Bring out the relationship between public expenditure and governance; and
- Describe the classification of public expenditure.

4.1 INTRODUCTION

In simple terms, public expenditure implies the money that a government spends on various activities that signify the collective needs and wants such as education, health, housing, pension etc.. In earlier times, before the nineteenth century, scholars of public finance did not pay adequate attention to public spending because their activities were quite limited. With the increase in the size of the government, it became essential that public expenditure is to be guided by proper guidelines, rules, laws, and principles. All activities in government need funds for their execution. So, public expenditure refers to the expenses which the government incurs for its own maintenance as well as for the economy. Over the last few decades, globally, there has been a significant increase in public expenditure.. The policies formulated for public expenditure are envisaged to accelerate economic growth, promote opportunities for employment and orchestrate reduction in poverty.

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This unit orients you with the meaning, objectives and principles of public expenditure and its management. The relationship between governance and public expenditure is analysed. There is discussion on the classification of public expenditure.

4.2 PUBLIC EXPENDITURE MANAGEMENT: MEANING

Public expenditure indicates the money spent by government of a country on realising the collective wants of the people. It is incurred to provide social goods, increase production, promote price stability and balanced growth, reduce income inequalities and so on. John Maynard Keynes made a case for important role of public expenditure in determining the levels of income and distribution in the economy.

The study of public expenditure and its operationalisation has come to be known as public expenditure management which relies on the role of institutional arrangements in influencing budget outcomes. It covers areas such as fiscal discipline, resource allocation and operational efficiency. Public expenditure management has become an important subject of study because during the eighties, many governments faced financial crisis of different nature creating a wide disparity between the expenditure and revenue. This has led to a rise in fiscal deficit and inflation. Monetary imbalances impacted the exchange rates resulting in macroeconomic uncertainty and low investment. Public expenditure management is related to reducing debt, stimulating the growth rate of wages to achieve lower rates of inflation, and increasing investment from internal as well as foreign sources and ultimately leading to higher economic growth.

The essential components are:

- focus on performance;
- linkages between policymaking, planning and budget;
- well-functioning accounting and financial management systems; and
- expedient and favourable links between budgeting and other systems of the government.

4.3 PUBLIC EXPENDITURE: OBJECTIVES

A budget is a financial mirror of a society's economic and social choices. The objective of public expenditure is to perform the roles assigned by the State to:

1. collect resources from the economy, in an appropriate manner; and
2. allocate the funds responsively, efficiently, and effectively.

An important principle of public expenditure is that it must be planned according to the needs of the country. The plans for public expenditure must be made as per the supporting institutional framework and human capacity that is required to implement them. Given below are three main objectives of public expenditure management:

1. **Fiscal discipline** – expenditure control;
2. **Allocation of Resources** –it must be consistent with policy priorities with focus on strategic allocation; and

3. **Operational Management** – it must be good and efficient which must lead to minimising cost per unit of output. It will also improve effectiveness by achieving the desired outcomes.

There is need for proper norms and due processes to achieve effective public expenditure management.

Objectives of Public Expenditure

After the Second World War, nations began the gigantic task of re-building their war-torn countries and economies. This increased the number of government activities and public spending. Private expenditure took a back seat as the private sector was unable and unwilling to participate in the rebuilding task. All over the world, there was an increase in public expenditure. Keynesian economics became a revolution and made the scholars devise objectives of public expenditure. They are:

1. **Resource Allocation:** One of the main objectives of public expenditure is the resource allocation comprising two components –

- i. **Current Consumption vs. Current Investment:** There are two scenarios of resource allocation for-

- the distribution of investment; and
- fulfilment of collective wants.

High levels of consumption in developed countries are an advantage in developed countries but in developing economies, it is always better to control the levels of consumption to encourage savings. However, public investments involve employment, growth, etc., which impact public policy. Maintaining a balance between current consumption and current investment is an ideal situation, but it at times is not feasible in developing countries.

- ii. **Fulfilment of Collective Wants:** Social welfare of citizens in a democracy is an essentiality for resource allocation. The goods and services for example, provision of free education, health, and hygiene, etc., cannot be done by the private sector and the government has to allocate resources for it. Public expenditure is resorted to even where there is no productive efficiency and government sector has to compete with the private sector in several areas of operation.

2. **Distribution of Income:** A government has the responsibility to strive for an equal distribution of income as much as possible to move towards inclusive development. It promotes individual freedom and social welfare. Optimal distribution of welfare expenditure is a grey area with undefined solutions. However, taxation can help to resolve this issue by using progressive income tax, corporate tax and inheritance tax etc. Contrary to this view, some scholars have also suggested a lump sum tax to balance savings and consumption. Secondly, subsidies also help in income redistribution by favouring some specific sectors. If the government deems it fit to introduce a progressive personal income tax, it must be supported by corresponding public expenditure to augment the income of the lower groups.

3. **Stability of a Nation:** It is important that the public money spent on various

sectors stabilise the state of affairs in the country. Economic stability can be achieved by adjusting the monetary and fiscal policies. Investment can be increased to improve the employment avenues in matured economies but in underdeveloped and developing economies, this becomes a difficult task. Price levels must be kept at bay to maintain balance of payments and to avoid transfer of wealth from persons with net monetary resources to those with net debts. In developing countries, public expenditure might have to compromise on price stability to foster development.

4. **Economic Development:** Public expenditure is necessary for economic development in a country. Saving and investment are important elements in public expenditure to accelerate the rate of economic development. The optimal rate of saving and investment may not be achieved if it is guided by the market mechanisms with no government control. The State has to assume the responsibility for economic development through public expenditure. In developing countries like India, it is important to control consumption and increase the rate of savings to attain higher levels of investment.

4.4 PUBLIC EXPENDITURE : PRINCIPLES

The principles of public finance govern the fiscal policy and the way public expenditure is designed to maximise social and economic benefits to people. Given below are the main principles that guide public expenditure:

1. **Principle of maximisation of social benefit:** The money spent must give maximum satisfaction to the people. This implies that the government should spend its restricted income on the sectors that would provide maximum satisfaction to all concerned.
2. **Principle of distribution of public income under different heads:** The second principle deals with equal distribution of public income to be spent under different heads. The amount of money when divided under each expenditure head is expected to give the same return of satisfaction. Marginal benefits and losses arising out of expenditure are influenced by various political and social factors.
3. **Principle of economy:** Public expenditure must be governed by the principle of economy resulting in higher productivity and efficiency. Government spending must be incurred on extremely essential items of common benefit. The developing countries have a lot of issues that hamper development and impact prudent use of resources such as, ineffective planning, lack of commitment and accountability amongst those executing the activities. In India, the Committees on Public Sector Undertakings, Estimates and Public Accounts ensure legislative control over the public expenditure. We shall be discussing about these committees in subsequent units of this Course.
4. **Principle of sanction:** No expenditure can be made without the proper appropriation of funds by the legislature. The allocated funds must be spent on only those items that they were meant for. This principle ensures economy also with the help of internal as well as external auditing at the end of a fiscal year. The audit report is tabled in the legislature to decide what action has to be taken and an Action Taken Report is also filed in the House.

5. **Principle of Surplus:** The principle of surplus implies that the government should keep its spending proportional to its income to avoid deficit budgets. An individual always tries to save some money for exigencies after keeping the income for meeting various kinds of expenditure. This is called a balanced budget, but many economists hold that this can be possible only for economies that have reached a state of full employment and stability in prices. In developing countries, contrary to this principle, governments resort to the instruments of deficit financing and deficit budgets to generate capital and to expand the public sector.
6. **Principle of Elasticity:** The policy related to government spending must be flexible so that money can be released for changing situations in the economy or environment. There could be an urgent need for a push of money in a particular sector for its sustenance or handling disaster situations such as floods or earthquakes that require large amounts of money to rebuild the area and help the people with essentials. The government must have the capacity to divert funds from one head to the other to meet the unforeseen situations.
7. **Principle of Equitable Distribution:** Public expenditure policy must follow the principle of equitable distribution to ensure balanced development of all regions in the country. This can be done by directing more funds to give benefits towards the upliftment of poor and marginalised and for the development of remote areas. There are many government schemes in India that are in place now to foster economic and social development of the marginalised sections.
8. **Principle of Productivity:** Public expenditure's main aim must be to increase productivity of the economy by raising the levels of employment, output, and income.
9. **Principle of Neutrality:** The adverse effects in an economy can be offset by the government through the principle of neutrality. Public expenditure must strive to raise the levels of aggregate consumption and improve income distribution.

The above-mentioned principles help in formulating effective public expenditure policies.

4.5 PUBLIC EXPENDITURE AND GOVERNANCE

Public expenditure management and public governance are closely linked as it is obvious that a government cannot govern well unless there are funds to spend. Good governance has three main components that every government needs to pursue. They are:

1. **Rule of Law:** According to the World Bank's Good Governance Indicators, rule of law is one of the main requisites to maintain to work towards inclusive growth. Public spending for rule of law is essential to create an environment for societal progress. It implies the existence and operation of a system based on rules, approved by appropriate authority and generally justifiable in a court of law. The laws that govern public expenditure is known to all the stakeholders and there are mechanisms in the system to resolve any kind of conflict. Such laws are usually codified in a Constitution as in India, in a written form or are established in practice, as in the UK.

However, a codified set of laws do not ensure good governance. The government's activities are dynamic, and the rules need to be flexible to accommodate the changing environments. The laws must not hinder the execution of the plans. Hence, there is need to focus on a pragmatic approach towards expenditure management in a lawful manner.

2. Transparency: The second important component of good governance is to ascertain transparency in government's expenditure on various activities. Transparency means the accessibility of information to the citizens regarding government's:

- Decisions;
- Activities; and
- Expenditure.

Information is made available to the public by the governments through the budget documents put on the public domain. The issue here is that there is abundant information but they are in a form that a citizen finds it tedious to break it down in simple terms. The citizens have the power to monitor and assess the government's activities by voting for or against the government in elections, but the true picture is generally veiled due to the technical and financial nature of the budget documents and accounts. The voters ultimately exercise their franchise based on popular perception instead of assessing the performance of the government. Transparency is also closely linked to corruption, especially, in India where its ranking on the Corruption perception Index is extremely low and seems worsening every year. The citizens have a right to access information to government's spending to comprehend the governance in the country.

3. Accountability: The expectations of the people depend on activities that the government carries out through public expenditure. This can be ensured by maintaining accountability of the government's actions so that the decision-makers can be held responsible for performance by those affected by such decisions. Accountability must be concerned with the:

- criteria that govern the public expenditure choices;
- appropriate procedures to facilitate these choices; and
- information required to support the choices.

A sound institutional framework helps in attaining the accountability of public expenditure but it is not always successful. The effectiveness of accountability rests upon the public's drive to make use of the available information through instruments that facilitate:

- the appropriateness and adequacy of the hierarchical controls; and
- transparency.

Hence, these three main components of good governance can be achieved through a sound public expenditure management system.

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

1) What are the objectives of public expenditure?

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2) List the principles of public finance.

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4.6 CLASSIFICATION OF PUBLIC EXPENDITURE

Public expenditure is the component of public finance that examines the spending, deficits, and taxation policies of the government. The classification of public expenditure is pertinent for policymaking and assessing the resource allocation for various sectors. It also helps in making sure that the expenditure is being incurred according to the legislative appropriations. On the other hand, it paves the way for policy review and measurement of performance, while taking care of governance. The public expenditure that deals with programmes, is called the 'Functional Expenditure' whereas that which is concerned with the types of inputs, is called, 'Economic Expenditure'. The economic classification of government expenditure helps in analysing the budget and framing micro – economic fiscal policy depending on the type of accounting a country selects to follow – cash accounting or accrual accounting. It distinguishes between:

- Interest payments (expense transactions) from the loan repayments (financing transactions); and
- Current expenditures from capital expenditures.

Given below is the public expenditure classification according to various international agencies:

1. International Monetary Fund: According to the International Monetary Fund (IMF)'s Government Finance Statistics (GFS) Manual, public expenditure can be classified based on the needs of policy making, reporting and budget management into different categories given below:

- Function – for policy analysis.
- Organisation – to ensure accountability and the administration of the budget;
- Funds – for administering the budget;
- Economic Categories – for statistical reporting and aggregate fiscal control;
- Object or Line Item – for compliance controls and internal management; and

- Programme – for policy formulation and performance accountability.

2. **United Nations:** The United Nations gave the ‘Classification of the Functions of Government’ (COFOG) as functional classification which organises government activities according to their purposes and analyses the allocation of resources. This classification helps in making international comparisons of the national accounts and their agendas. COFOG is beneficial to countries which do not have their classification, or they can modify it to fit their own specific needs.
3. **World Bank:** The classification of public expenditure helps in establishing a relationship between costs to government and benefits to individuals. The World Bank has given the following classification of public expenditure:

I. Specific Expenditure

- Transfer Payments –to persons, for example, pensions, etc. or to businesses.
- Purchases of goods and services – education, health, etc.

II. General Expenditure

- Purchase of goods and services – General administration, national defence, protection of persons and property, etc.

III. Interest on the Public Debt

Public Expenditure Classification in India

The Government of India spends on various activities at three levels – the Centre, State and Local. It is incurred on its development and non-development programmes or its plan and non-plan programmes during a fiscal year which is divided into two categories:

1. **Revenue Expenditure:** The *revenue expenditure* is the amount that is spent on normal running of government departments and various services.. These are those items that do not create any assets nor reduce the government’s liability. Examples of revenue expenditure are salaries, pensions, repairs, and maintenance, etc.
2. **Capital Expenditure:** It is the amount that is spent on creating long-term assets in a fiscal year such as infrastructural developmental projects to build dams, highways, plants, equipment, etc. The capital expenditure helps in reducing the liability of the government.

The above-mentioned basic classification is also called as transferrable and non-transferrable expenditure or productive and non-productive expenditure.

Plan and Non-Plan Expenditure: Since 1947, India has been following the pattern of the classification of expenditure into plan and non-plan.

Plan Expenditure is that public expenditure which represents current development and investment outlays (expenditure) that arise due to proposals in the current plan. Such expenditure is incurred on financing the central plan relating to different sectors of the economy for example, electricity generation, irrigation, science, and technology, etc. Any financial assistance given to the states also falls under plan expenditure which may be divided into revenue and capital expenditure.

Non-Plan Expenditure is the estimated expenditure in the budget for day-to-day functioning of the administration and the government for example, police, judiciary, armed forces, etc.

The only distinction that is currently applicable in India for public expenditure is revenue and capital. The distinction between plan and non-plan expenditure was abolished with the merger of both. It was done after the dismantling of the Planning Commission to ease out issues in resource allocation as it led to a fragmented view in determining the cost-of-service delivery by linking outlays to outcomes. In 2011, the Expert Committee headed by Sh. Rangarajan also proposed abolition of distinction between plan and non-plan expenditure. Now, the government expenditure incurred by the government is under the account heads of revenue, capital, and loans. Revenue expenditure can be classified into: a) Developmental and b) Non-developmental.

The expenditure that is incurred under the schemes run by the government and the number of Centrally Sponsored Schemes have been absorbed in Direct Benefit Transfer Schemes (DBTS). The primary objective of this is to ensure transparency and eliminate pilferage from the distribution of funds sponsored by the Government of India. Under this the benefit or subsidy is directly transferred to citizens living below the poverty line. This has enhanced the performance of the government schemes in case of granting subsidies and welfare payments.

The DBTS, linked with Aadhar (Unique Identification Number) to target the genuine beneficiaries, has managed to maximise outcomes from the money spent by the government by effective monitoring and targeting. The motive is not to reduce public spending but to increase its rationalisation by carrying out economic reforms which will lead to a lower fiscal deficit. This is considered a good move that will facilitate more benefits from this restructuring of the Schemes.

Check Your Progress 2

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

- 1) Distinguish between revenue and capital expenditure.

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- 2) What are the various heads of classification of public expenditure laid down by IMF?

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4.7 CONCLUSION

Public expenditure helps in achieving equitable distribution of income to develop a nation's economy and promote growth and welfare. In the present day, democracies are facing extreme poverty despite the rise in public expenditure. Market mechanisms have not fared successfully as it became evident with the 2008 economic crisis which impacted the global economy. The State has had to intervene to keep the economy in

balance to avoid the adverse effects. The more economically stable an economy is, the more it will be politically strong leading to inclusive development.

4.8. GLOSSARY

Accrual basis of accounting: It is the concept of recording revenues when earned and expenses are incurred. This method focuses on anticipated revenue of cash and expenditure.

Cash basis of accounting: This is a method where revenues are recorded when cash is received and expenses are recorded when cash is paid.

Deficit Financing: It is the practice in which a government spends more money than it receives as revenue. The gap/deficit is covered by borrowing or printing new money.

4.9. REFERENCES

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4.10. ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) **Your answer should include the following points:**

The objectives of public expenditure are:

- Resource allocation
- Distribution of income
- Stability of a Nation
- Economic Development

2) **Your answer should include the following points:**

The principles of public expenditure include:

- Maximisation of social benefit
- Distribution of public income under different heads
- Economy
- Sanction
- Surplus
- Elasticity
- Equitable Distribution

- Productivity
- Neutrality

Check Your Progress Exercise 2

1) Your answer should include the following points:

- Revenue expenditure is the amount spent on normal functioning of government departments and various services. Examples of revenue expenditure are payment of salaries, pensions, repairs and maintenance of roads etc.
- It is incurred on such items that do not create any assets nor reduce government liability.
- Capital expenditure includes the amount spent on creating long-term assets such as infrastructure development projects to build dams, highways, plants etc. This type of expenditure helps in reducing the liability of government.

2) Your answer should include the following points:

The classification of public expenditure as per International Monetary Fund's Government Finance Statistics Manual is as follows:

- Function
- Organisation
- Funds
- Economic Categories
- Object or line item
- Programme

UNIT 5 FISCAL POLICY AND MONETARY POLICY: MEANING, OBJECTIVES AND INSTRUMENTS (ROLE OF RESERVE BANK OF INDIA, WORLD BANK AND INTERNATIONAL MONETARY FUND)*

Structure

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Fiscal Policy: Meaning and Objectives
- 5.3 Monetary Policy: Meaning and Objectives
- 5.4 Instruments of Monetary Policy
- 5.5 The Monetary Policy Process and Framework
- 5.6 Role of Reserve Bank of India
- 5.7 Role of World Bank
- 5.8 Role of International Monetary Fund
- 5.9 Conclusion
- 5.10 Glossary
- 5.11 References
- 5.12 Answers to Check Your Progress Exercises

5.0 OBJECTIVES

After going through this unit, you should be able to:

- Explain the meaning and objectives of fiscal policy;
- Describe the meaning, objectives, and instruments of monetary policy; and
- Discuss the role of RBI, World Bank, and International Monetary Fund in public finance management.

5.1 INTRODUCTION

The fiscal and monetary policies laid down by governments have an impact on economic environment. They have effect on the supply of money in the economy, credit, changing rates of interest and other related aspects. The government policies are generally coordinated with monetary and fiscal policies for ensuring the welfare of economies. The Central bank of the country has the responsibility to manage the

* Contributed by Dr. Anupama Puri Mahajan, Former Post-Doctoral Research Fellow (Public Administration), Himachal Pradesh University, Shimla.

liquidity comprising cash, credit, rates of interest to promote economic growth in the country. In India, the Reserve Bank of India (RBI) is the Central Bank which controls inflation in the country through monetary and fiscal policies. The IMF and World Bank have the objective of providing guidance, technical expertise in operationalising of monetary and fiscal policies.

This unit introduces to the learners the concepts of fiscal and monetary policies, their objectives, instruments of monetary policy, role of Reserve Bank of India, International Monetary Fund and World Bank.

5.2 FISCAL POLICY: MEANING AND OBJECTIVES

The word *fiscal* is derived from a Greek word *Fisc* which means the basket that symbolised treasury of government. A fiscal policy is the part of economic policy that is concerned with the State's income and expenditure to achieve and sustain rapid economic growth in an economy. It includes public borrowing and deficit financing. Fiscal policy determines the tax revenue, public expenditure, loans, transfers, debt management, public borrowings, budgetary deficit, etc. Fiscal policy can be defined as the policy that is concerned with the various aspects of the government expenditure and the tax structure. Fiscal policy helps in the fulfilment of the objectives of the monetary policy also. It uses taxes, public expenditure, and public debt as balancing factors in economic development.

Fiscal policy includes tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. While fiscal policy encompasses the taxation and expenditure decisions of the government, monetary policy deals with the supply of money in the economy and rate of interest. It works along with the monetary policy to influence the country's money supply.

Objectives of Fiscal Policy

- **Economic Development:** The fiscal policy ensures economic development through mobilising resources through taxation, savings etc.
- **Efficient Allocation of Resources:** This is facilitated through directing allocation of funds to specified areas that foster social and economic development.
- **Reduction of Inequalities of Income:** This is attempted by fiscal policy through appropriate taxation policies.
- **Price Stability and Control of Inflation:** Fiscal policy lays down methods to control inflation and stabilise prices.
- **Employment Generation:** The expansion of infrastructure and other schemes and programmes are given a boost by the fiscal policy that promote job opportunities and employment generation.
- **Balanced Regional Development:** The fiscal policy through tax exemptions, cash subsidies lead to balanced regional development.
- **Infrastructure Development:** The development of infrastructure in the form of highways, ports, railways, airports etc., is possible through generation of more resources through taxation, public bonds and so on.

- **Capital Formation:** Fiscal policy facilitates increase in capital that leads to development of other sectors of the economy.
- **Foreign Exchange Earnings:** The increase in foreign exchange earnings is made possible by the abolition of taxes on export earnings, sales tax etc.

India's fiscal system since the early 1900s, especially in taxation has undergone changes. The initial years of India's planned development strategy had a conservative fiscal policy to keep the deficits under control. The tax system's objective was the resource transfer from the private sector to the public sector to increase the speed of industrialisation and social welfare. However, the growth did not pick up till the 1991 economic reforms. In India, the fiscal deficit was controlled by 2007-08 and it survived the economic recession with the help of tax cuts and increase in public spending.

Instruments of Fiscal Policy

The tools of fiscal policy are:

- **Taxation:** This is an important source of revenue in all countries. There are direct taxes paid by an individual such as income tax, corporate tax, taxes on property and wealth. While indirect taxes are levied on consumption. It includes sales tax, excise duty, and customs duty.
- **Expenditure:** Expenditure to be incurred on various areas is another instrument of fiscal policy.
- **Public Debt:** Borrowings from internal and external sources is another tool of fiscal policy.
- **Deficit Financing:** The filling of gap between the revenue and spending of government is deficit financing. This is done either through internal sources of finance such as issuing of bonds and securities or external borrowings from international institutions such as World Bank, IMF etc.

Fiscal Policy in India The Constitution of India provides the framework for fiscal policy of India. The federal structure of India has divided the powers of taxation and spending between the centre and states as per the Constitutional provisions and related laws. The states have lesser resources as compared to their expenditure than the Centre. The centre transfers funds to the States through the Finance Commission and other means. The Indian Constitution also provides for the Union Government to present its annual financial statement, the taxation, and the expenditure that it will be incurring in the next fiscal year, in the form of budget which is also prepared by the states.

In 2003, the Parliament passed, at the Central level, the Fiscal Responsibility and Budget Management Act (FRMB) to institute a new fiscal discipline framework. It aims to introduce transparency in India's fiscal management system. Its long-term objective is to achieve fiscal stability and to give RBI the flexibility to deal with inflation. It was enacted to introduce more equitable distribution of India's debt over years. The act has been amended several times.

On 1st July 2017, the Goods and Services Tax was introduced and passed as an Act. It is a Value added Tax (VAT) which is a comprehensive indirect tax levy and the

collection of tax on inter-state supply of goods and services is by the central government. We shall be discussing in detail about this in Unit 9 of this Course.

5.3 MONETARY POLICY: MEANING AND OBJECTIVES

Monetary policy deals with money supply, interest rates and availability of credit. It is the policy laid down by the central bank of the country or any other competent monetary authority in an economy. Through monetary policy, the central bank increases or decreases the amount of currency and credit in circulation. Monetary policy shapes the country's economic growth, and controls inflation by adjusting the money supply and controlling the rate of interest. It channelises funds into the necessary areas to attain broader economic goals. Through monetary policy, the government, or the monetary authority of the country controls the:

- Supply of money;
- Availability of money; and
- Rate of interest to attain laid down objectives aimed at economic growth and stability.

The objectives of monetary policy are:

1. **Economic growth:** Through regulating prices and income in the economy, investment is made possible that increases economic growth.
2. **Price stability:** The monetary policy attempts to achieve price stability by regulating the value of money. In times of recession, to boost the economy the interest rates are reduced to avail loans. In certain situations, loans are given at higher interest rates to decrease money supply.
3. **Exchange rate stability:** Maintenance of exchange rate stability is important for creation of international confidence on trade. Instability in exchange rates might lead to undesirable effects such as weakening of the value of currency, speculation, and flight of capital abroad.
4. **Balance of Payments (BoP) Equilibrium:** BoP is a statement of all transactions made between entities in one country and the rest of the world over a defined period. The Reserve Bank of India through monetary policy maintains the equilibrium.
5. **Financial stability:** The monetary policy attempts to ensure financial stability in the economy and to reduce sudden volatile fluctuations in the financial market and economy.
6. **Inflation target:** This is also indicated by the monetary policy. In India the RBI Act provides that once in every five years, the Government of India in consultation with the RBI sets an inflation target. The RBI has projected the Consumer Price Index inflation at 5.7 per cent during 2021-22. India has become an emerging market economy which makes sound monetary policy formulation more important. In India, the monetary policy is formulated by the RBI which is mandated under the Reserve Bank of India Act 1934. It was amended in 2016 to provide a statutory basis for implementation bring accountability and transparency.

The fiscal policy affects the ways a government controls its taxation and expenditures while the monetary policy controls the money supply in the economy.

5.4 INSTRUMENTS OF MONETARY POLICY

In order to comprehend better the monetary policy framework, it is important to discuss the instruments of monetary policy in India. They are:

1. **Bank Repo Rate:** The rate at which the Central Bank of a country gives loans to commercial banks in case of a shortage of funds is called repo rate or repurchase rate. The repo rate is used to control inflation. The banks or financial institutions approach the RBI when they face a financial crisis for a loan and the RBI advances the money at a rate of interest which is 'repo rate'. The banks or financial institutions sell government securities with a legal agreement stating that they will be repurchasing them after a fixed period.
2. **Reverse Repo Rate:** This is the rate at which RBI borrows money from the commercial banks. It also does this to reduce the excess money supply in the banking system. So, the rate at which RBI borrows money from the commercial banks within the country is called the reverse repo rate. It is used as a monetary policy instrument by increasing or decreasing the rate. The simple implication of altering the reverse repo rate is that an increase in the rate will decrease the money in the banking system and thus the money supply of a country and vice versa, other variables remaining constant.
3. **Cash Reserve Ratio:** All commercial banks must keep a minimum amount of money in proportion to their deposits with the RBI in cash, called, currency chests. This minimum ratio of cash to be kept with RBI is called the Cash Reserve Ratio (CRR). This acts as another instrument of monetary policy as a higher CRR will leave a lower amount with the commercial banks to be able to use it for loans and investment. The RBI can control the amounts that the banks can give as loans by increasing the CRR. The RBI uses CRR also to control liquidity in the economy.
4. **Statutory Liquidity Ratio:** It is relevant here to understand two terms before defining Statutory Liquidity Ratio (SLR). They are:
 - **Net Demand Liabilities:** The bank accounts from which one can withdraw sums of money like a savings/current account are called net demand liabilities.
 - **Time Liabilities:** These are those liabilities or sums of money that the banks are liable to pay to the customers after an agreed period. These include fixed, recurring deposits, cash certificates and so on.

The SLR is the ratio of liquid assets to demand and time liabilities which can be increased by 40 % by the RBI. It controls the supply of money into the economy by commercial banks

5. **Marginal Standing Facility (MSF):** The MSF is a facility which allows the commercial banks to borrow additional overnight money from the RBI by drawing from the SLR at a penal rate of interest. This makes the banks respond to unexpected liquidity shocks.

6. **Lending Rate:** These are the rates fixed by the RBI based on which money is lent to the customers. Higher the lending rate, more costly shall be the credit given to the customer. In case rates are lower, the customers can take more credit from the bank.

5.5 THE MONETARY POLICY PROCESS AND FRAMEWORK

The Monetary Policy Process: Under Section 45ZB of the amended RBI Act, 1934, the Monetary Policy Committee (MPC) was constituted by the Union Government in 2016 which comprises six members. Its main function is to keep the inflation within limits set by the government in consultation with RBI determines the interest rate that is needed to achieve the inflation target. The MPC is supported by the RBI's Monetary Policy Department in considering the viewpoints of all stakeholders and players in the economy to determine the policy repo rate or repurchase rate.

Composition of MPC: The MPC has the following six members:

- Governor of the RBI – Chairperson, *ex-officio*;
- Deputy Governor of the RBI, in-charge of the monetary policy – Member, *ex-officio*;
- One officer of the RBI to be nominated by the Central Board – Member, *ex-officio*;
- The other three members are to be experts in the field of economics, or banking or finance or monetary policy. They have a term of four years unless it is extended.

The MPC determines the policy interest rate to achieve the inflation target.

The Monetary Policy Framework

The framework regarding the monetary policy in India has the objective to set the policy repo rate by:

- evaluating the current and evolving macro – economic situation; and
- controlling the conditions of liquidity to stabilise market rates of money at or around the repo rate.

Any change in the repo rate has an effect throughout the money market and pervades the entire financial system. This impacts the aggregate demand which determines inflation and growth.

Check Your Progress 1

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

- 1) Explain the meaning and goals of fiscal policy.

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- 2) What is monetary policy? State its goals.

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- 3) What are the instruments of monetary policy?

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5.6 ROLE OF RESERVE BANK OF INDIA

The Reserve Bank of India (RBI) is the apex body, the Central Bank of the country that controls the monetary policy and monitors the banking system. It regulates the entire banking system, the liquidity conditions, financial inclusion, lending of cash to banks, selling government securities, issuing currency, managing foreign exchange, etc. It has a multi-faceted role covering the above-mentioned functions as well as credit control measures. It does not indulge itself in micro or macro banking and acts as a banker's banker. Its monetary policy aims at stabilising the economy and making the environment conducive for economic growth.

The RBI's Preamble states that, "It has the function to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". The Reserve Bank of India ensures the stability of interest rates and exchange rates and provides liquidity for productive sectors. It monitors the flow of credit to different sectors of the economy and ensures development of financial institutions. The RBI as issuer and regulator of currency notes ensures monetary stability.

5.7 ROLE OF WORLD BANK

The World Bank formally known as International Bank for Reconstruction and Development (IBRD) came into existence in 1944. It works with its member countries, of which India is a member, on the full spectrum of such issues from the revenue and expenditure planning to the effective implementation of policies relating to public expenditures. The World Bank has its offices stationed in India and other member countries. Its main function is to finance economic development through provision of low-interest loans, interest free credits and grants to developing countries. The World Bank for example recommends certain measures which are indicated below:

Public Debt – The following are the areas on which the World Bank recommends and keeps a watchful eye on:

- balancing the financial requirements for development needs against the macroeconomic stability and sustainability concerns;
- the limit of public debt;
- the extent of benchmarks useful in the policy dialogue;
- identification of vulnerabilities in design and implementation in debt management system; and

- linkages with other debt-related policies used by the Central Bank of the member countries.

Methodologies of the World Bank to improve Public Finance

The World Bank uses various methodologies to evaluate the public finance systems and suggests ways to improve them. Some of them are:

1. **Public Expenditure Reviews (PERs):** Nations like India have limited resources and the World Bank sees through PERs if optimal appropriations of the resources have been made to maximise economic growth and poverty reduction.
2. **Policy Notes:** The World Bank analyses the specific policies being followed in India to evaluate if they are enabled to meet the challenges in the country.
3. **BOOST:** The BOOST was launched in 2010 which is an Open Budgets Portal initiative to present a One Stop Shop for budget data worldwide. It helps the rest of the countries to see how the other governments are facing their fiscal challenges.
4. **Fiscal and Debt Sustainability Analysis:** The World Bank's framework assesses the sustainability of the current and expected policies. It works on the determination of policy adjustments required to manage solvency and liquidity risks.
5. **Public Expenditure and Financial Accountability (PEFA):** This tool assesses the status of public financial management. It consists of seven international partners which are the IMF, World Bank, the European Commission, French Ministry of Foreign Affairs, Norwegian Ministry of Foreign Affairs, Slovak Foreign Ministry, Swiss Secretariat for Economic Affairs, and the UK's Department for International Development. The PEFA Secretariat offers support to all the users of the PEFA framework. It provides a framework for assessing and reporting on the strengths and weaknesses of public financial management using quantitative performance indicators.

5.8 ROLE OF INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF) is an organisation of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. It was created in 1945 and is governed by and accountable to the 189 member countries. Its main objective is to ensure the system of exchange rates and international payments that enables the countries and their citizens to conduct transactions and business with each other. India is an original member of the IMF and has received support from it from time to time. It helped India in its 1991 economic crisis on the condition of India carrying out major structural reforms.

IMF brings stability in exchange rates in helping the exports of member countries thereby ensuring stability in exchange rates. It has been instrumental in the growth of international trade. The multi-lateral assistance helps members in solving their problems in trade. It acts as a reservoir of all currencies of all the member countries. A country can borrow the currency of another country out of this reservoir. Also, it

extends loans in foreign exchange to the member countries for current transactions.

The IMF provides:

- Financial assistance to member countries in handling BOP deficit;
- Concessional financial assistance for promotion of exports;
- Assistance in formulation of development oriented monetary, fiscal, exchange and trade policies;
- Special Drawing Rights (SDRs) to resolve the problem of international liquidity;
- Technical guidance and imparts training to member countries to devise and strengthen policies; and
- Suggestions for overcoming constraints in development process.

Check Your Progress 2

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

- 1) Discuss the role of Reserve Bank of India.

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- 2) What methodologies are adopted by World bank to improve public finance?

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- 3) Discuss the role of IMF in the Indian monetary and fiscal policy.

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5.9 CONCLUSION

The monetary and fiscal policies are extremely crucial in keeping the economy secure. Since the early twentieth century, the economic growth has constantly been increasing gradually relieving the world from the dreadful memories of the Great Depression. The governments in the world along with the international agencies like the IMF and the World Bank keep a check on economic and financial situation of member countries to prevent any volatilities. Now, the information that the agencies share with each other and make the best practices to implement monetary and fiscal policies are making the global economy to grow.

5.10 GLOSSARY

Consumer Price Index: It is a measure that examines the weighted average of prices of a basket of consumer goods and services such as transportation, food and medical care.

Deficit Financing: It is a practice in which a government spends more money than

it receives as revenue. The gap is met by borrowings from internal or external sources or by printing money.

Financial Inclusion: It is a method of offering banking and financial services to individuals. It is an effort to make every day financial services accessible to all in society at a reasonable/affordable cost. It focuses on providing financial solutions to the economically underprivileged.

Special Drawing Rights: These refer to an international type of monetary reserve ratio created by IMF in 1969 that offer as a supplement to the existing money reserves of the member countries.

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5.12 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:

Fiscal policy is the part of economic policy that is concerned with the State's income and expenditure. It deals with tax revenue, public expenditure, public borrowings, loans, public debt etc. Fiscal policy includes tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management.

The objectives of fiscal policy are:

- Economic Development
- Efficient allocation of resources
- Reduction of income inequalities
- Price stability and control of inflation

- Employment generation
- Balanced regional development
- Infrastructure development
- Capital formation
- Foreign exchange earnings

2. Your answer should include the following points:

Monetary policy deals with money supply, interest rates and availability of credit. It is laid down by the central bank of the country. It shapes the country's economic growth, and controls inflation by adjusting the money supply and controlling the rate of interest.

The objectives of monetary policy are:

- Economic growth
- Price stability
- Exchange rate stability
- Balance of payments equilibrium
- Financial stability

3. Your answer should include the following points:

The instruments of monetary policy in India are:

- Bank Repo Rate
- Reverse Repo Rate
- Cash Reserve Ratio
- Statutory Liquidity Ratio
- Marginal Standing Facility
- Lending Rate

Check Your Progress 2

1) Your answer should include the following points:

- The RBI is the apex body, the Central Bank of the country that controls the monetary policy and the monitors the banking system.
- It regulates the entire banking system, the liquidity conditions, financial inclusion, lending of cash to banks, selling government securities, issuing currency, managing foreign exchange, credit control etc.
- It monitors the flow of credit to different sectors of the economy and ensures development of financial institutions.
- Its monetary policy aims at stabilising the economy and making the environment conducive for economic growth

2) Your answer should include the following points:

The World Bank adopts the following methodologies to improve public finance:

- Public Expenditure Reviews
- Policy Notes
- BOOST
- Fiscal and debt sustainability analyses
- Public expenditure and financial accountability

3) Your answer should include the following points:

The IMF has an important role in providing:

- International monetary cooperation
- Financial assistance to member countries in handling Balance of Payments deficit
- Concessional financial assistance for promotion of exports
- Exchange stability
- Assistance in formulation of development oriented monetary, fiscal, exchange rate and trade policies;
- Special Drawing Rights to resolve the problem of international liquidity
- Technical guidance and training to devise and strengthen policies; and
- Suggestions for overcoming constraints in development process.

