

CUET · ECONOMICS · CLASS XII · CODE 309

# Government Budget and the Economy

CUET unit: Government Budget

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## Snapshot

- The Union Budget rests on a constitutional framework — Article 112 mandates an Annual Financial Statement for the financial year 1 April–31 March.
- The budget splits into a Revenue Budget (current-year items) and a Capital Budget (items affecting assets/liabilities), with receipts and expenditure classified under both.
- Budgeting has three objectives — allocation (public goods), redistribution (transfers + progressive taxes) and stabilisation (correcting demand fluctuations).
- The three key deficit measures — revenue deficit, fiscal deficit and primary deficit — come with formulae, an indicative table (2024–25 P.A.) and policy implications.
- Debt, Ricardian equivalence, crowding-out, deficit reduction strategies and the FRBMA, 2003 framework complete the topic. A highly formula- and table-driven topic that CUET mines for numerical and statement-based MCQs.

## Detailed Notes

### 2.1 Core concepts

- A mixed economy contains both the private sector and the government; this chapter limits government's role to functions carried on through the budget (NCERT Intro, p. 67).
- Article 112 requires the government to lay before Parliament an Annual Financial Statement of estimated receipts and expenditures for every financial year (1 April–31 March) — this constitutes the main budget document (NCERT §5.1, p. 67).
- The budget is split into two accounts: the revenue account (revenue budget) records items relating to the current financial year only; the capital account (capital budget) records items concerning the assets and liabilities of the government (NCERT §5.1, p. 67).
- Allocation function: government supplies public goods (national defence, roads, government administration) that the market cannot supply because public goods are non-rivalrous (one person's consumption does not reduce others') and non-excludable (free-riders cannot be kept out) (NCERT §5.1.1, p. 67–68).

- Public provision vs public production: public provision means goods are financed through the budget and used without direct payment; public production means goods are produced directly by the government (NCERT §5.1.1, p. 68).
- Redistribution function: government alters personal disposable income through transfers and taxes to bring about a distribution considered "fair" by society (NCERT §5.1.1, p. 68).
- Stabilisation function: when aggregate demand is insufficient for full employment, government raises demand; when demand exceeds output causing inflation, government uses restrictive measures (NCERT §5.1.1, p. 69).
- Revenue receipts are non-redeemable (do not create a claim on the government) and split into tax revenue (direct taxes — personal income tax, corporation tax; indirect taxes — excise duties, customs duties, service tax) and non-tax revenue (interest receipts, dividends/profits from government investments, fees, foreign cash grants-in-aid) (NCERT §5.1.2, p. 68–69).
- Direct taxes are progressive (higher income → higher rate) and serve redistribution; firms are taxed proportionally; necessities are exempt/lightly taxed while luxuries, tobacco and petroleum are heavily taxed (NCERT §5.1.2, p. 68).
- Capital receipts are receipts that create liability or reduce financial assets — borrowings (loans the government must return), PSU disinvestment (sale of shares which reduces government's financial assets), and recovery of loans. They are classified as debt-creating or non-debt-creating (NCERT §5.1.2, p. 69).
- Revenue expenditure is expenditure NOT incurred for creation of physical/financial assets — covers normal functioning of departments, interest payments on debt, and grants to state governments and other parties (NCERT §5.1.3, p. 69).
- Capital expenditure is expenditure that creates physical or financial assets or reduces financial liabilities — includes acquisition of land, buildings, machinery, equipment, investment in shares, and loans/advances by Centre to States/UTs/PSUs (NCERT §5.1.3, p. 70).
- Expenditure is also classified into plan vs non-plan: plan expenditure relates to Central Plans (Five-Year Plans) and central assistance to State/UT plans; non-plan expenditure covers general, economic and social services — its main items are interest payments, defence services, subsidies, salaries and pensions; interest payments are the single largest non-plan revenue expenditure component (NCERT §5.1.3, p. 69–70).
- Three FRBMA-mandated policy statements accompany the budget — Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement (NCERT §5.1.3, p. 70).
- Balanced budget: revenue = expenditure; surplus: tax collection exceeds required expenditure; deficit: expenditure exceeds revenue — the most common situation (NCERT §5.2, p. 70–71).

- Revenue deficit = Revenue expenditure – Revenue receipts; for 2024–25 (P.A.) it is 2.6 per cent of GDP — implies government is dissaving, financing consumption from other sectors' savings, forcing eventual cuts in productive capital/welfare expenditure (NCERT §5.2.1, p. 71).
- Fiscal deficit = Total expenditure – (Revenue receipts + Non-debt creating capital receipts); equivalently = Revenue Deficit + Capital Expenditure – Non-debt creating capital receipts. It indicates the total borrowing requirement of the government from all sources; for 2024–25 (P.A.) it is 5.6 per cent of GDP (NCERT §5.2.1, p. 71–72).
- From the financing side: Gross fiscal deficit = Net borrowing at home + Borrowing from RBI + Borrowing from abroad (NCERT §5.2.1, p. 72).
- Primary deficit = Gross fiscal deficit – Net interest liabilities; it isolates current fiscal imbalance by excluding interest on accumulated debt; for 2024–25 (P.A.) it is 2.0 per cent of GDP (NCERT §5.2.1, p. 72).
- Fiscal policy (Box 5.1, Keynes): government uses changes in expenditure and taxes to stabilise output and employment; government expenditure multiplier =  $1/(1-c)$ ; tax multiplier =  $-c/(1-c)$  — smaller in absolute value than the G-multiplier; balanced budget multiplier = 1 (NCERT Box 5.1, p. 73–75).
- Proportional tax ( $T = tY$ ) acts as an automatic stabiliser — disposable income, and hence consumption, becomes less sensitive to GDP fluctuations (NCERT Box 5.1, p. 76–77).
- Debt: deficits are flows that add to the stock of debt; continued borrowing accumulates debt and interest obligations; borrowing transfers consumption burden to future generations (NCERT 'Debt', p. 78–79).
- Ricardian equivalence (David Ricardo): forward-looking consumers anticipate future tax rises to repay today's borrowing, so they save more — taxation and borrowing are equivalent means of financing expenditure (NCERT p. 79).
- Crowding out: government borrowing via bonds competes with corporate/private bonds for available savings, reducing private investment — though if deficits raise output, more income → more saving and the crowding-out may be offset (NCERT 'Other Perspectives', p. 79–80).
- Deficit reduction: raise taxes (with greater reliance on direct taxes since indirect taxes are regressive), raise receipts via sale of PSU shares, or — the main thrust — cut expenditure through better planning/administration; cuts in vital areas (agriculture, education, health, poverty alleviation) would adversely affect the economy (NCERT 'Deficit Reduction', p. 80).
- FRBMA, 2003 mandates reducing fiscal deficit to  $\leq 3\%$  of GDP and eliminating revenue deficit (deadline rescheduled to 2009–10), reducing fiscal deficit by 0.3% and revenue deficit by 0.5% of GDP each year; central government cannot borrow from RBI except for temporary cash mismatches; RBI cannot subscribe to primary issues of central government securities from 2006–07 onwards (NCERT Box 5.2, p. 81–82).

- **Why a budget matters:** in a market economy, three things are uncertain — whether public goods will be provided, whether income will be distributed fairly, and whether aggregate demand will match full-employment output. The budget is the **operational instrument** through which the elected government addresses all three (NCERT §5.1, p. 67).
- **Budget calendar:** in India the Finance Minister presents the Union Budget on **1 February** each year (advanced from end-February since 2017); the financial year runs **1 April to 31 March**. Parliament must pass the Appropriation Bill and Finance Bill before the new financial year begins (NCERT §5.1, p. 67, contextual).
- **Public-good examples in detail:** national defence (one citizen's safety does not reduce another's), street lighting (non-rivalrous within the lit area), public broadcasting, basic scientific research, public health surveillance — each fails the private-market test because of the free-rider problem and would be undersupplied without budget financing (NCERT §5.1.1, p. 68).
- **Public provision ≠ public production — example:** the government may **finance** primary education (public provision) but the actual teaching may be by NGO-run schools (private production with public funding); conversely the railway system is both publicly financed and publicly produced (NCERT §5.1.1, p. 68).
- **Indian data — tax-GDP ratio:** India's gross tax-GDP ratio is about 11–12% (Centre + States about 17–18%), well below the OECD average of 33%. Raising this ratio is a long-standing fiscal goal because higher tax revenue allows higher productive expenditure without raising deficits (NCERT §5.1.2 contextual, p. 68).
- **Indian data — direct vs indirect tax composition:** direct taxes (income + corporation) now contribute about 55% of Central tax revenue; indirect taxes (GST + customs + union excise) about 45%. The direct-tax share has risen since the 1991 reforms, improving the progressivity of the tax system (NCERT §5.1.2, p. 68, contextual).
- **GST evolution:** introduced **1 July 2017**, GST subsumed central excise, service tax, additional customs duties and most state VATs/entry-taxes; it is administered jointly by the GST Council (Centre + States). NCERT references service tax — students should know it was merged into GST (NCERT §5.1.2, p. 68, contextual).
- **Indian data — deficits:** for 2024–25 (P.A.) — Revenue Deficit 2.6% of GDP, Fiscal Deficit 5.6%, Primary Deficit 2.0%. Interest payments at 3.6% of GDP are now larger than defence (1.0%) or major subsidies (1.4%) combined — illustrating the debt-trap risk (Table 5.1, NCERT p. 71).
- **Indian data — debt-GDP ratio:** Centre's debt is about 56% of GDP; States' debt about 28%; combined general-government debt about 84% of GDP — among the higher levels in emerging markets and the main reason FRBMA targets remain binding (NCERT 'Debt', p. 78, contextual).
- **Fiscal-deficit-financing options:** market borrowing (mostly G-Secs), small-savings deposits, external borrowings (multilateral and bilateral), drawing down cash

balances. Since the FRBMA, **monetisation** (RBI subscribing to primary G-Sec issues) is prohibited — preventing direct money creation to finance deficits (NCERT §5.2.1, p. 72, contextual).

- **Crowding-out arithmetic:** if total savings in the economy = ₹100 and government borrows ₹40, only ₹60 is left for private corporate borrowing — raising interest rates and reducing private investment. The size of crowding-out depends on how interest-elastic private investment is (NCERT 'Other Perspectives', p. 79).
- **Ricardian equivalence — Indian context:** David Ricardo's hypothesis assumes forward-looking, intergenerationally-altruistic consumers. In India, where many households are credit-constrained and consumption-smoothing is imperfect, Ricardian equivalence is unlikely to hold strictly — government deficits do raise aggregate demand in the short run (NCERT 'Ricardian Equivalence', p. 79).
- **FRBMA 2003 — additional features:** requires the Finance Minister to present three statements with the budget — Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement, Macroeconomic Framework Statement; mandates quarterly review by Parliament; the NK Singh Committee 2017 reviewed and recommended a debt-GDP target alongside the deficit target (NCERT Box 5.2, p. 81, contextual).
- **Balanced-budget multiplier — quick proof:** with  $MPC = c$ ,  $\Delta Y$  from  $\Delta G$  is  $\Delta G / (1-c)$ ;  $\Delta Y$  from  $\Delta T$  is  $-c \cdot \Delta T / (1-c)$ . If  $\Delta G = \Delta T$ , net  $\Delta Y = (1-c) \cdot \Delta G / (1-c) = \Delta G$  — i.e., the multiplier is **exactly 1**, regardless of  $c$ . NCERT highlights this elegant result (NCERT Box 5.1, p. 75).
- **Proportional-tax automatic-stabilising effect:** replacing lump-sum  $T$  with  $T = tY$  changes the AD slope from  $c$  to  $c(1-t)$ . Multiplier becomes  $1/[1 - c(1-t)]$  — smaller than  $1/(1-c)$ , so the same autonomous shock produces a smaller income swing. This is exactly why progressive income taxes act as **built-in stabilisers** during business cycles (NCERT Box 5.1, p. 76).

## 2.2 Definitions to memorise

Term	Definition	Page
Public good	Non-rivalrous and non-excludable good whose benefits are available to all and from which no one can be excluded	67–68
Free-rider	Non-paying consumer who enjoys the benefits of a public good	67
Public provision	Goods financed through the budget and used without direct payment	68
Public production	Goods produced directly by the government	68
Revenue receipts	Receipts that do not create a claim on the government (non-redeemable); include tax + non-tax revenue	68
Direct tax	Tax levied on individuals/firms — e.g. personal income tax, corporation tax	68

Term	Definition	Page
Indirect tax	Tax on goods/services — e.g. excise duties, customs duties, service tax (now subsumed in GST)	68
Capital receipts	Receipts that create liability or reduce financial assets — borrowings, disinvestment, recovery of loans	69
Revenue expenditure	Expenditure NOT for creation of physical/financial assets — normal departmental functioning, interest payments, grants	69
Capital expenditure	Expenditure that creates physical/financial assets or reduces financial liabilities	70
Plan expenditure	Expenditure on Central Plans and central assistance for State/UT plans	69
Non-plan expenditure	Expenditure on general, economic and social services — main items: interest, defence, subsidies, salaries, pensions	69–70
Balanced budget	Government spending equals revenue collected	70
Surplus budget	Tax collection exceeds required expenditure	71
Deficit budget	Government expenditure exceeds revenue	71
Revenue deficit	Revenue expenditure – Revenue receipts	71
Fiscal deficit	Total expenditure – (Revenue receipts + Non-debt creating capital receipts) = total borrowing requirement	72
Primary deficit	Gross fiscal deficit – Net interest liabilities	72
Automatic stabiliser	Mechanism (e.g. proportional tax, welfare transfers) that dampens income fluctuations without active policy action	77
Discretionary fiscal policy	Deliberate change in G or T to stabilise the economy	77
Ricardian equivalence	View that taxation and borrowing are equivalent means of financing expenditure because consumers anticipate future taxes and save more today	79

### 2.3 Diagrams / processes to remember

- Chart 1, p. 69: "Components of the Government Budget" — Budget splits into Revenue Budget (Revenue Receipts → Tax/Non-tax; Revenue Expenditure → Plan/Non-plan) and Capital Budget (Capital Receipts; Capital Expenditure → Plan/Non-plan).
- Table 5.1, p. 71: Receipts and Expenditures of the Central Government 2024–25 (P.A.) as % of GDP — Revenue Receipts 9.2 (tax 7.9 + non-tax 1.4); Revenue Expenditure 11.8 (interest 3.6, major subsidies 1.4, defence 1.0); Revenue Deficit 2.6; Capital Receipts 5.8 (recovery 0.1, other 0.1, borrowings 5.6); Capital Expenditure 3.2; Non-debt Receipts 9.4; Fiscal Deficit 5.6; Primary Deficit 2.0.

- Fig. 5.1, p. 74: Effect of higher government expenditure — AD shifts up to AD', equilibrium income rises from  $Y^*$  to  $Y'$ .
- Fig. 5.2, p. 74: Effect of a reduction in taxes — AD shifts upward; income rises.
- Fig. 5.3, p. 76: Government and aggregate demand with proportional taxes — AD curve becomes flatter (slope  $c(1-t)$ ).
- Figs. 5.4 & 5.5, p. 77: Effect of increase in G and reduction in proportional tax rate  $t$  — AD shifts upward; equilibrium income rises.

## 2.5 Key formulas

Formula	Meaning	NCERT page
Revenue Deficit = Revenue Expenditure – Revenue Receipts	Dissaving on the revenue account	71
Fiscal Deficit = Total Expenditure – (Revenue Receipts + Non-debt creating Capital Receipts)	Total government borrowing requirement	72
Fiscal Deficit $\equiv$ Revenue Deficit + Capital Expenditure – Non-debt creating Capital Receipts	Alternative identity	72
Primary Deficit = Fiscal Deficit – Net Interest Payments	Fiscal stance net of legacy debt servicing	72
Government expenditure multiplier = $1 \div (1 - c)$	Effect on Y of $\Delta G$ (lump-sum tax setting)	73–74
Tax multiplier = $-c \div (1 - c)$	Effect on Y of $\Delta T$ (lump-sum)	75
Balanced budget multiplier = 1	Equal $\Delta G$ and $\Delta T$ raise Y by $\Delta G$	75
Proportional tax: $T = tY$	Automatic-stabiliser tax rule	76
AD with proportional tax = $C^- + \bar{I} + G^- + c(1-t)Y$	Slope flatter than two-sector	76
Fiscal Deficit 2024-25 $\approx$ 5.6% of GDP; Revenue Deficit $\approx$ 2.6%; Primary Deficit $\approx$ 2.0%	Indicative magnitudes	71
FRBMA targets: Fiscal Deficit $\leq$ 3% of GDP; Revenue Deficit = 0	Statutory ceilings	81–82

## 2.4 Common confusions / NTA trap points

- Revenue deficit vs Fiscal deficit: revenue deficit covers only revenue account (RE – RR); fiscal deficit covers total expenditure minus non-borrowing receipts and equals the borrowing requirement.

- Fiscal deficit formula uses Revenue Receipts + NON-DEBT creating capital receipts (recovery of loans + disinvestment) — NOT total receipts and NOT total capital receipts (borrowings must be excluded).
- Primary deficit subtracts only interest payments (net interest liabilities), not the entire revenue deficit.
- Capital receipts (which include borrowings)  $\neq$  non-debt creating capital receipts (only recovery of loans + disinvestment). NTA loves this distinction.
- Disinvestment (sale of PSU shares) reduces government's financial assets and is therefore a capital receipt — but it does NOT create debt; it is a non-debt creating capital receipt.
- Interest payments and grants to states are revenue expenditure even though grants may help create assets at the recipient end.
- Loans given by Centre to States/PSUs are capital expenditure, not revenue expenditure.

## Practice MCQs

## PYQ Alignment

Government Budget is among the highest-yield chapters in CUET Economics, with 8–12 MCQs typically appearing every year. Direct factual questions on definitions of revenue/capital receipts and expenditure, statement-based questions distinguishing fiscal deficit from revenue deficit, and numerical sums asking the candidate to compute fiscal/primary/revenue deficits from a small data table are the recurring patterns; match-the-following on budget components and assertion–reason on objectives of budget are also frequent.

### CUET 2024 — Actual PYQs from this chapter

**Q.20 (CUET 2024)** Article 112 deals with:

- A) Consolidated Fund B) Public Account C) Union Budget D) Contingency Fund **Tests:** Article 112 - Annual Financial Statement **Answer:** Not in extracted key

**Q.21 (CUET 2024)** Elements creating liability and reducing assets of government are:

- A) Capital receipts B) Capital payments C) Revenue receipts D) Revenue payments **Tests:** Government liabilities and capital receipts **Answer:** Not in extracted key

**Q.40 (CUET 2024)** Match List-I with List-II List-I List-II (A) Annual Financial Statement (I) Government budget (B) Capital Receipts (II) Receipts creating liability (C) Capital Payment (III) Reduce financial assets (D) Balance of Trade (IV) Trade surplus Options:

- A) (A)-(I), (B)-(II), (C)-(III), (D)-(IV) B) (A)-(II), (B)-(III), (C)-(IV), (D)-(I) C) (A)-(I), (B)-(III), (C)-(II), (D)-(IV) D) (A)-(IV), (B)-(I), (C)-(III), (D)-(II) Tests: Budget components - Annual Financial Statement, Capital Receipts Answer: Not in extracted key

