CBSE Test Paper 01

Chapter 04 Government Budget and the Economy

1. An example of a direct tax is **(1)**
   a. Entertainment tax
   b. VAT
   c. Income Tax
   d. Sales tax

2. Fiscal deficit is equal to borrowings. It is **(1)**
   a. False
   b. True
   c. Can’t say
   d. Insufficient information

3. Public expenditure can be unplanned only **(1)**
   a. Insufficient information
   b. True
   c. Can’t say
   d. False

4. What is "mps" or the 'marginal propensity to save'? **(1)**
   a. None of these
   b. the proportion of total additional planned savings to total additional income
   c. the fraction of total additional income that is used for consumption
   d. the proportion of total additional income to total additional planned savings

5. Define an indirect tax. **(1)**

6. Whether subsidies on diesel is a revenue or capital expenditure. Justify your answer. Mention any one way to reduce the consumption of diesel. **(1)**

7. What is equilibrium rate of exchange? **(1)**

8. Define Surplus Budget. **(1)**
9. Giving reasons, classify the following into direct and indirect tax. **(3)**
    i. Wealth tax
    ii. Value added tax
10. Give the meaning of revenue deficit, fiscal deficit and primary deficit. **(3)**
11. Give the relationship between revenue deficit and fiscal deficit. **(4)**
12. Discuss the issue of deficit reduction. **(4)**
13. Tax rates on higher income group have been increased. Which economic value does it reflect? Explain. **(4)**
14. How is exchange rate determined in the foreign exchange market? Explain. **(6)**
15. Distinguish **(6)**
    i. Between current account and capital account, and
    ii. Between autonomous transactions and accommodating transactions of Balance of Payments account.

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Answers

1. c. Income Tax
   Explanation: Income tax is a direct tax as tax is imposed on the person whose income is being assessed. Whatever tax is imposed on the individual is to be paid by the individual himself/herself. The tax burden cannot be shifted to anyone else.
2. b. True
   Explanation: Fiscal deficit indicates the excess of government expenditure over receipts except borrowings. For eg. if total expenditure = Rs 100 crores and total receipts = Rs. 100 crores(including borrowing of Rs. 20 crores)
   then fiscal deficit = 100 - (100 -20) = 20
   so, we see that fiscal deficit = borrowings.
3. d. False
   Explanation: Public expenditure can also be planned expenditure which refers to the expenditure which relates to the specific plans and programmes of development by the government, like construction of hospital, construction of roads, flyovers etc.
4. b. the proportion of total additional planned savings to total additional income
   Explanation: the proportion of total additional planned savings to total additional income

5. An indirect tax is one in which the burden of the tax can be shifted to another person. Indirect taxes are levied on goods and services rather than on income or profits.

6. It is a revenue expenditure as it neither creates any asset nor reduces any liability of the government.
   Way: By minimising the wastage of diesel.

7. Equilibrium exchange rate occurs when supply of and demand for foreign exchange are equal to each other.

8. Surplus budget is that budget in which estimated government receipts are more than the government expenditure

   or

   Surplus Budget = estimated Receipts > estimated Expenditure.

9. i. Wealth tax: It is a kind of direct tax as it is paid by the same person on which it is levied or imposed, i.e. burden of this tax is not possible to shift to the other person.

   ii. Value added tax: Value added tax is imposed on one person and its burden shifts to another person therefore it is an indirect tax because in case of indirect taxes burden is shifted to another person.

10. **Revenue deficit:** When the revenue receipts are less than the revenue expenditures in a government budget, this shortfall is termed as revenue deficit. Revenue Deficit = Revenue Expenditure - Revenue Receipts

    Fiscal deficit: Fiscal deficit in the budget is an important measure of deficit. IMF and World Bank generally prescribe targets for the budget deficit in terms of fiscal deficit. The Fiscal deficit is the difference between the government's total expenditure and total receipts excluding borrowings. Fiscal Deficit = Total Budget Expenditure - Total Budget Receipts (Excluding borrowings) or Fiscal Deficit = Borrowings.

    Primary deficit: The difference between fiscal deficit and interest payment is known as primary deficit. Primary Deficit = Fiscal Deficit - Interest Payments. Interest Payments on public debt are transfer payments made by the government.

11. a. Fiscal deficit is always a wider concept than revenue deficit.

    b. Revenue deficit is defined as the excess of government's revenue expenditure over revenue receipts. In terms of formula:
    Revenue Deficit = Revenue Expenditures (RE) - Revenue Receipts (RR)

    c. In short, there will be revenue deficit in a government budget when revenue expenditure exceeds revenue receipts.

    d. Fiscal deficit is defined as the excess of total budget expenditure over total receipts net of borrowings.

    e. Initially, Fiscal deficit does not take into account all types of receipts. It does not take into account borrowing. But finally they have to depend on borrowing to met

fiscal deficit.

Fiscal Deficit = Revenue Deficit + Capital Deficit (Excluding Borrowing)
= Borrowing
= Net borrowing at home + Borrowing from RBI + Borrowing from abroad

12. The deficit in a government budget can be reduced by the following step:

    i. Taxes should be increased. Government can make a plan for rising direct taxes to increase its receipts . It can also be raised by increasing rates of taxes or by imposing new taxes. Direct taxes are more productive because its cost of collection is quite lower.
    ii. Reduction in Government Expenditures: It can be done through making government activities more efficient through better planning of programmes and better administration.
    iii. Disinvestment - The government can raise its receipts through the sale of shares in PSUs (Public Sector Undertaking).
    iv. Changing the scope and role of government by withdrawing from some areas where it operated before.

13. The economic value that is reflected in the rise in the tax rate for higher income group is 'Equality and Social Welfare'.Individual welfare is availed by people themselves provided they have higher income but, welfare to all other people is not availed by individuals as they have no incentive to do that. Since the government aims at welfare rather than profit, it frames policies for economic equality and social welfare. The main objective of the budgetary policy of the government is to reduce inequalities of income and wealth in the country. Even distribution of wealth and social welfare remains the main objective of budgetary policy. Inequality arises when the income of one group is greater than the other group. The government uses progressive taxation policy to reduce the inequalities of income and wealth in the country. The government imposes high tax rates on higher income group and a low tax rate on lower income group. People with income below a certain level are not levied any direct tax altogether. All this is done so that the wealth is smoothly distributed among all classes of society.

14. Flexible exchange rate is determined by the interaction of the forces of demand and supply. The equilibrium exchange rate is determined at a level where demand for foreign exchange is equal to the supply of foreign exchange. This will be clear from Fig. (A)

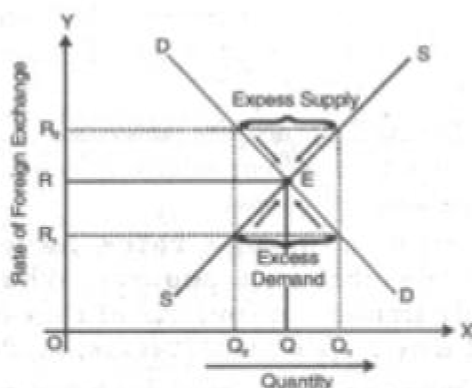

Fig. (A)

As seen in the diagram, demand and supply of foreign exchange are measured on the X-axis whereas rate of foreign exchange on the Y-axis. DD is the down ward sloping demand curve of foreign exchange and SS is the upward sloping supply curve of foreign exchange. Both the curves intersect each other at point 'E' The equilibrium exchange rate is determined at OR and equilibrium quantity is determined at OQ. Any exchange Rate (other than OR) is not the Equilibrium Exchange Rate.

i. If the exchange rate is more than equilibrium rate. If the exchange rate rises to OR_2 then demand for foreign exchange will fall toOQ_2 and supply will rise to OQ_1. It will be a situation of excess supply. As a result, exchange rate will fall till it again reaches the equilibrium level of OR.
ii. If the exchange rate is less than equilibrium rate. If exchange rate falls to OR_1 , then demand will rise to OQ_1 and supply will fall to OQ_2. It will be a case of excess demand. It will push up the exchange rate till it reaches OR.

15. The differences between Current account BOP and capital account of BOP are given below:

Basis	Current account of BOP	Capital account of BOP
	An account which records the export and import of	An account which records the trading of foreign assets

Meaning	merchandise goods and unilateral transfers are done during the year by a nation is known as Current Account. It contains the receipts and payments relating to all the transactions of visible items, invisible items and unilateral transfers.	and liabilities during the year by a country is known as Capital Account. In other words, it records all those transactions between the residents of a country and the rest of the world, which cause a change in the assets or liabilities of the residents of the country or its government.
Nature of transaction	These are the transactions which do not affect the assets or liabilities position of the country.	These are the transactions which affect assets or liabilities position of the country.
Concept	It is a flow concept.	It is a stock concept.
Balance on current account	In the current account, receipts from exports of goods, services and unilateral receipts are entered as credit items and payments for imports of goods and services are entered as negative or debit items. Surplus in current account arises when credit items are more than debit items and deficit arises when debit items are more than the credit items.	The transactions which lead to inflow of foreign exchange are recorded on the credit or positive side of the capital account whereas those transactions which lead to an outflow of foreign exchange are recorded on the debt or negative side. Surplus in capital account arises when credit items are more and deficit arises when debit items are more.
	Current Account = Exports	Capital Account = Borrowings and Lending

Formula/Components	and Imports of Visible and Invisible Items + Unilateral Transactions + Income Received and Paid to Abroad.	from and to Abroad + Investment to and from Abroad + Change in the Reserve of Foreign Exchange.

Differences between autonomous and accommodating transactions are given below:

Basis	Autonomous Transactions	Accommodating Transactions
Meaning	Autonomous transactions are the transactions between the residents of two countries which take place due to consideration of profit.	Accommodating transactions are those transactions that are undertaken to cover deficit or surplus in autonomous transactions.
Recorded	These transactions can either be recorded in current account or capital account, depending on their nature.	These transactions are recorded only in the capital account.
Effect on BOP account	These transactions are independent of the state of BOP account	These transactions are undertaken to maintain the balance in BOP account.
Alternate name	They are also called "above the line items".	These transactions are also called "below the line items".
Example	Exports and imports of goods and services, unilateral transactions etc are examples of autonomous transactions.	Borrowings from IMF, change in foreign exchange reserves etc are examples of accommodating transactions.