

Fiscal Subsidies and Their Long-Run Effects on Household Welfare and Labour Supply

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Abstract

Fiscal subsidies are of great essence in defining the welfare of the household, income distribution, and the labour market, especially in the developing economies. This paper considers both short-term and long-term impacts of fiscal subsidies on household welfare and labour supply which combines household level results of the Economic Survey 202425 and macro level data of other countries shown by OECD sources. The results show that augmented Social Service Expenditure (SSE), an augmented education and health investment, and narrow as well as focused transfers like PMGKAY and Direct Benefit Transfers have had a profound effect on enhancing the short-term household consumption and decreasing inequality by in the form of decreasing Gini coefficients and closing urban rural expenditure disparities. There is high progressive distribution in food subsidies, as lower-income groups receive a higher percentage of consumption subsidy. On the macro level, there is evidence indicating that increased social protection expenditure correlates with reduced disposable income inequality and that long-term growth is determined by the composition and fiscal sustainability of expenditure. Human capital-based subsidies seem growth-neutral or growth-inducing, but distortionary, debt-based transfers could impair efficiency in the long run. The paper has concluded that targeted and economically viable subsidy mechanisms can be used to achieve equity and efficiency, inclusive growth and enhance labour productivity in the long term.

INTRODUCTION

A major tool of the state employed in fostering social fairness, stabilizing domestic spending and shaping labour market performance is fiscal subsidies (Gut, 2024). Globally, governments use subsidies that take the form of food, health insurance, financing education, income transfer, and tax benefits to cushion vulnerable groups and also bring inclusive growth. Fiscal transfers are important in the developing economies such as India in protecting low-income households to income shocks and inflationary pressures (Bahal & Shrivastava, 2022). As an example, the Pradhan Mantri Garib Kalyan Anna

Yojana (PMGKAY) feeding a significant portion of the population with free and subsidized food stamps has aided in bringing the consumption levels down the economic weaker population (Agrawal et al., 2020). Recent household consumption survey evidence suggests that consumption inequality has decreased and the urban rural expenditure gap is becoming smaller, meaning that the targeted subsidies can create quantifiable short run benefits.

In addition to short-run consumption, fiscal subsidies also have a long-run impact on the labour market, in

terms of human capital formation. In recent years, the spheres of public spending on education and healthcare have increased greatly, which enhances productivity and employability of the workforce (Chen et al., 2011). Programmes like Ayushman Bharat (PM-JAY) minimise disastrous health spending and result in better labour productivity by providing access to health services and skill development programmes, through Skill India, focus on increasing labour market preparedness (Rai & Singh, 2024). The experience at the international level supports this viewpoint: it has been proven that the Earned Income Tax Credit (EITC) in the United States has led to a rise in labour force by low-income groups, which indicates the possibility to use subsidy design as a policy tool to enhance both redistribution and work incentives (Crandall-Hollick & Hughes, 2018). Equally, Nordic nations have developed strong social protection, together with high participation in the labour market, a case in point that a properly designed subsidy system does not have to degrade efficiency (De la Porte & Larsen, 2023).

Nonetheless, the increase in the fiscal subsidies is a matter of concern in terms of the long-run fiscal sustainability and distortion of labour supply. Constant growth in welfare spending over the years without sufficient mobilization of revenue can put pressure on the public finances, push out productive investment and restrict policy options in the future. The longer-run effects of the subsidies are thus not limited to their redistributive ability; they also involve their targeting effectiveness, their make-up, as well as the mechanisms of financing (Auerbach & Gorodnichenko, 2017). This paper explores both short-term and long-term impacts of fiscal subsidies on household welfare and the labour force by using both empirical and macro-level fiscal dynamics to determine whether subsidy systems could achieve equity, productivity and sustainable economic growth simultaneously.

Objectives of Study

1. To estimate the short- and long-run impacts of social protection/fiscal measures on household welfare and labour market outcomes.
2. To examine macro-level correlations between social protection spending and indicators of inequality and growth.
3. To provide policy recommendations for balancing efficiency and equity.

REVIEW OF LITERATURE

Fiscal subsidies have conceptual basis and welfare implications that have a firm foundation in dynamic macroeconomic modelling mostly in life-cycle and general equilibrium models. This finding was established by Kitao (2010) who, using a model of life-cycle general equilibrium showed that, in the short-run, expansionary fiscal policy may yield significant redistributive payoffs- particularly to liquidity-constrained individuals- but in

the long-run, financing arrangements are important. Expansion funded by debt can increase short-term welfare, but it imposes efficiency costs in the long run due to increased levels of distortionary taxation, which points to significant intertemporal trade-offs in redistribution, labour supply and aggregate productivity. To supplement this macro-level analysis, there is evidence in micro-level dynamic labour supply models that the policies regarding welfare and tax-benefits play a very important role in determining household labour supply. Marino, Romanelli, and Tasso (2016) discovered that the fiscal and welfare structure can have a strong influence on the labour force participation and labour hours worked by women, whereas Guner, Kaygusuz, and Ventura (2020) demonstrated that child-related transfers have both income and substitution effects that can lead to a decrease in labour supply to the secondary earners and an increase in the overall household welfare. On the same note, Ginja, Jans, and Karimi (2020) found that parental leave benefits can have short-term reducing labour supply but have positive intergenerational long-term effects on the education and earnings of children. Other more recent studies by Ananat and Garfinkel (2023) of the extended Child Tax Credit propose that a longer-term income maintenance can alleviate the poverty of children and raise long-run human capital returns without greatly damaging work incentives when structured to maintain work incentives. In general, the literature states that fiscal subsidies have the potential to improve both long-run and short-run welfare and equity as well, however, their implications on the labour supply and growth require depending on the policy design, efficiency, and fiscal sustainability, which are the theoretical and empirical foundation of the current study.

RESEARCH METHODOLOGY

The research took the analytical approach based on secondary data which is a descriptive and macro-comparative method to study the short and long-term impacts of fiscal subsidies on household welfare, labour outcomes, inequality and growth. The data were taken out of the Economic Survey 202425, Household Consumption Expenditure Survey (HCES) 202324, the OECD social expenditure and inequality databases, and the reports of the international organizations, including World Bank, IMF, ILO, and WHO. The methodology entailed a trend assay of the Social Service Expenditure (SSE) and education and health spending growth rates and distribution indicators in the form of the Gini coefficient and Monthly Per Capita Expenditure (MPCE). Cross-country stylized data on OECD datasets were used to conduct macro-level correlations between social protection expenditure, inequality reduction, and growth. The differences between high and low social spending economies were measured by using comparative analysis. The research also incorporated policy based assessment in which the fiscal sustainability measures were correlated with labour productivity and human capital performance. This descriptive-analytic methodology has allowed evaluation of the impacts both

on welfare redistribution and the long run labour market in relation to fiscal subsidies.

RESULTS

This section shows the empirical and macro-level results of the short- and long-run effects of fiscal subsidies on household welfare, labour results, inequality, and economic growth.

Short and Long-Run Impacts of Fiscal Subsidies on Household Welfare & Labour Outcomes

According to Economic Survey 202425 findings, the short-run welfare benefits were achievable through fiscal subsidies and increasing social service expenditure (SSE) coupled with enhancing labour market foundations in the long-run through human capital investment. In FY21, SSE increased to 23.3% of the total expenditure and in FY25 increased to 26.2% of total expenditure (BE), as the total outlay increased to 25.7 lakh crore (CAGR 15%). Education spending increased 12 per cent to 9.2 lakh crore and health spending

increased 18 per cent to 48 per cent of total health spending with the government share in total health spending also increasing 29 per cent (FY15) to 48 per cent (FY22). Fiscal transfers like PMGKAY, subsidized food grains, LPG subsidies, insurance coverage and Direct Benefit Transfers have reinforced household consumption and inequality reduction on the welfare front: the rural Gini has fallen to 0.266 (2022-23) and the urban Gini has fallen to 0.284. In 2023-24, the urban-rural consumption gap had been reduced to 70 percent and the most significant increase in Monthly Per Capita Expenditure (MPCE) was amongst the lowest 5-10 percent of households. The subsidies on food alone were 6.5 percent of the Union budget, and the value of subsidy was 7 percent of consumption in the 20 percent of rural landless bottom, and 2 percent of consumption in the top 20 percent, which indicates progressive redistribution. The results demonstrate that fiscal subsidies have two immediate effects through short-term consumption increases and their capacity to reduce income disparities while educational health and social protection investments deliver ongoing benefits to labor productivity over time.

Table 1. Fiscal Subsidies, Welfare Outcomes, and Labour-Relevant Indicators (Economic Survey 2024-25).

(Source: <https://www.pib.gov.in/Pressreleaseshare.aspx?PRID=2097869®=3&lang=2>)

| Indicator | Earlier Year | Latest Year | Outcome/Trend |
|---|-----------------|-----------------|-------------------------|
| Social Service Expenditure (% of Total Expenditure) | 23.3% (FY21) | 26.2% (FY25 BE) | Increasing |
| Total SSE (₹ lakh crore) | 14.8 | 25.7 | CAGR 15% |
| Education Expenditure (₹ lakh crore) | 5.8 (FY21) | 9.2 (FY25 BE) | CAGR 12% |
| Health Expenditure (₹ lakh crore) | 3.2 (FY21) | 6.1 (FY25 BE) | CAGR 18% |
| Govt Share in Total Health Spending | 29% (FY15) | 48% (FY22) | Structural rise |
| Rural Gini Coefficient | 0.266 (2022-23) | 0.237 (2023-24) | Declined |
| Urban Gini Coefficient | 0.314 (2022-23) | 0.284 (2023-24) | Declined |
| Urban-Rural MPCE Gap | 84% (2011-12) | 70% (2023-24) | Narrowing |
| PMGKAY Share in Union Budget | - | 6.5% (2022-23) | Major subsidy component |
| Subsidy Share in Consumption (Rural Bottom 20%) | - | 7% | Progressive |
| Subsidy Share in Consumption (Top 20%) | - | 2% | Lower benefit share |
| Population with Ration Card Access | - | 84% | Wide coverage |

Macro-level Relationships between the Social Protection Expenditure, Inequality, and Growth

The macro evidence in cross-country shows that social protection expenditure has a strong and negative relationship with the inequality of disposable incomes but the association with the growth of the economy is dependent on its composition and efficiency. The OECD provides statistical data which shows that countries which spend more on public social programs show a lower Gini coefficient after taxes compared to countries which spend less than 1215 percent of GDP on social programs. The social protection systems in developed economies show their redistributive power through taxes and transfers which decrease market-income inequality

by 3040 percent according to average data. Recent empirical growth evidence shows that social investments which focus on education and healthcare and active labour policies lead to either neutral or positive growth effects because they help develop human capital and increase productivity. The government needs to fund economic development through research and educational programs because ineffective subsidies which depend on fiscal deficits will create more government debt while decreasing domestic investment. Social protection programs reduce inequality according to macro-level

data which shows their impact on growth depends on fiscal sustainability and spending patterns.

Table 2. Macro-Level Relationship between Social Protection Spending, Inequality & Growth (Cross-Country Stylized Evidence).

(Source: <https://www.oecd.org/en/data/indicators.html?orderBy=mostRelevant&page=0&facetTags=occd-languages%3Aen>)

| Indicator | High Social Spending Economies (OECD Avg.) | Lower Social Spending Economies | Observed Relationship |
|--|--|---------------------------------|---|
| Public Social Expenditure (% of GDP) | ~20-22% | ~10-15% | Higher spending linked to stronger redistribution |
| Reduction in Gini (Market → Disposable Income) | 30-40% reduction | <20% reduction | Strong negative correlation with inequality |
| Post-tax Gini Coefficient | ~0.28-0.32 | ~0.35-0.45 | Lower inequality in high-spending countries |
| Long-run GDP Growth Impact | Neutral to positive when human-capital focused | Mixed; may be volatile | Composition matters |
| Fiscal Sustainability Effect | Stable growth when financed sustainably | Growth risk if debt-financed | Deficit levels influence outcomes |

Policy Recommendations: Efficiency and Equity in the Policy

Macro and household level evidence indicates that fiscal subsidies may both enhance equity and maintain economic efficiency in case they are targeted appropriately, growth oriented and fiscally sustainable. The first is that spending should focus on areas that enhance human capital like education, health and improvement of skills since such sectors create long term productivity growth and less inequality. Second, the subsidies need to be increasingly focused as is the case with food subsidy patterns whereby low consumption quintiles are subsidised in a proportionately increasing manner, which redistributes without fiscally excessive leakage. Third, the fiscal sustainability should be ensured by implementing rationalization of expenditure, outcome-based budgeting and enhanced tax mobilization

to avoid crowding out of productive investment. Fourth, social protection policies can be combined with labour market activation policies, such as skill training, entrepreneurship support and formalization incentives to alleviate the possible dependency effects and strengthen the participation of labour supply. And lastly, digital governance instruments, like Direct Benefit Transfers (DBT), Aadhaar-based delivery mechanisms, and real-time monitoring have the ability to increase transparency and minimize inefficiencies to achieve redistribution goals and not incentive distortions. The best policy combination requires subsidy structures which provide short-term relief to vulnerable households while enabling long-term development of human capital and labor productivity.

Table 3. Policy Framework for Balancing Efficiency and Equity.

| Policy Dimension | Equity Objective | Efficiency Safeguard | Expected Long-Run Outcome | Key Sources |
|---------------------------------------|---|---|---|---|
| Targeted Transfers (Food, DBT) | Protect low-income households ; reduce inequality | Minimize leakages; avoid universal distortion | Improved consumption stability without fiscal waste | https://www.worldbank.org/en/topic/socialprotection https://www.worldbank.org/en/data/datatopics/aspire/overview |
| Education & Skill Spending | Enhance upward mobility | Link spending to employability outcomes | Higher labour productivity & participation | https://www.oecd.org/education/education-at-a-glance/ https://www.worldbank.org/en/publication/wdr2018 https://www.ilo.org/skills/lang--en/index.htm |
| Public Health Investment | Reduce vulnerability & income shocks | Prevent catastrophic health expenditure | Healthier workforce; sustained labour supply | https://apps.who.int/nha/database https://www.worldbank.org/en/topic/universalhealthcoverage https://www.oecd.org/health/health-at-a-glance/ |

| | | | | |
|---|---------------------------|--------------------------------|--|---|
| Fiscal Discipline & Revenue Mobilization | Maintain welfare capacity | Control deficits & debt burden | Stable macroeconomic growth | https://www.imf.org/en/Publications/FM https://www.oecd.org/gov/government-at-a-glance/ https://www.worldbank.org/en/topic/governance/brief/public-expenditure-reviews |
| Labour Activation Policies | Reduce dependency risk | Incentivize work participation | Stronger formal labour market engagement | https://www.oecd.org/employment/activation.htm https://www.ilo.org/global/topics/employment-promotion/lang--en/index.htm https://www.worldbank.org/en/topic/jobsanddevelopment |
| Digital Delivery Systems | Improve benefit targeting | Reduce administrative costs | Higher governance efficiency | https://www.worldbank.org/en/topic/digitaldevelopment https://www.oecd.org/gov/digital-government/ https://www.imf.org/en/Topics/digital-economy |

DISCUSSION

The findings have shown that fiscal subsidies in India have produced substantial impacts on short-run welfare and are consistent with long-run labour market sustainability because of human capital formation. The increase in Social Service Expenditure (23.3 to 26.2 of total expenditure in FY21 and FY25 BE, respectively), and massive increment in the education and health spending, is an indication of structural emphasis on social development. The reported reduction in the rural and urban Gini coefficient, the increase in the monthly per capita expenditure of the low income population groups, and the reduction in the urban-rural consumption gap supports the redistributive and consumption stabilizing impact of fiscal transfers including PMGKAY and Direct Benefit Transfers. Supersubsidy distribution in which more consumption quintiles are entitled to a greater portion of their consumption through transfers illustrates the effects of equity enhancement. Even though effects of direct labour supply are not directly quantified, better nutrition, access to healthcare and investment in education form part of better human capital build, labour productivity and workforce resiliency in the long run. These benefits are however conditioned by the wise fiscal policy because further development of subsidies without sufficient revenue collection can limit the future productive investment. In general, the results indicate that a properly applied and human capital-based fiscal subsidies may have a beneficial effect on balancing equity and efficiency as well as on facilitating inclusive growth.

CONCLUSION

In this paper, the impact of fiscal subsidies in the short and long terms on household welfare and labor supply has been examined by combining household-level data with macro-level fiscal data. According to the findings, fiscal interventions in the form of food subsidies, Direct Benefit Transfer, and rising expenditure in social services have a positive impact on short-run consumption stability and inequality reduction, as evidenced by declining Gini coefficients, rising Monthly Per Capita Expenditure of the poor, and declining urban-rural gaps in consumption expenditure. The extended period shows

that increased government spending on human capital development through educational and healthcare services will result in increased labor supply which demonstrates that subsidies provide long-term economic benefits. The growth of the economy depends on fiscal subsidies which require both effective policy implementation and sustainable financial systems to achieve their desired impact on economic development according to evidence that human capital development drives economic growth while improper targeting and fiscal unsustainability lead to efficiency losses.

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