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DIRECTORATE OF DISTANCE EDUCATION

B.A. ECONOMICS

136 34

FISCAL ECONOMICS

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UNIT 1 INTRODUCTION

1.1 Introduction
1.2 Meaning and Definition of Public Finance
1.3 Functions of Public Finance
1.4 Private and Public finance

1.1 Introduction

Before going into the subject as such as, a few words about the subject "Economics" would be useful to the readers. As you all know by this time, "Economics" is a unique subject. To put it simply, different interpretations for a single fact may be possible. The laws of economics are comparable to the laws of waves. Since economics is a subject that deals with the human beings and the institutions consisting of human beings, and since human beings behaviour changes frequently and the behaviour differs from place to place and from situation to situation, it is not that easy to predict the behaviours. That is the simple reason why different theories and new theories and researches and studies are coming up. To link the present subject matter under discussion namely "FISCAL ECONMICS" with the present situation we can take up one example here. Fiscal economics is categorized as normative science. That is this branch attempts at suggesting too.

Fiscal economics deals with the financial matters of the government (state). When we say government as a political institution, we need to know some politics too. If you ask the role of the sate (government), different economists would give different answers. What should the state do? You will get umpteen numbers of answers for the single question. Similarly what is not expected to be done by the state? Again there will be many answers. Similarly, one can raise many questions, and there may be many answers as well. Still there is no completely correct answer, which can be acceptable for atleast 50 percent of people. This is how the subject "Economics" differs from many other subjects.

Let us take up some more questions, for which there can be many correct and good answers. How should the state metabolize the funds required? Where from and when should the state mobilize the funds? How should the funds be distributed? To whom, where, when on what functions? If there is deficit, how should the deficit be financed? How should the loans be raised? Such as these large number of questions can be raised. Different answers are possible. There are many ways for doing all the above. Hence many answers are possible. That is why giving universally correct answer is difficult in economics. The

students, after reading this material should be able to think loudly question brilliantly discuss elaborately, deliberate sharply and keep the mind open widely.

Let us take another interesting area for discussion. In this book there will be frequent mention about the government or state. It is difficult to discuss fiscal economics without mentioning the word "government". The "government" mentioned here refers to an ideal government which aims at maximum welfare for the large majority of the citizens. You should carefully avoid thinking of any particular government in any particular point of time and space. If you keep any particular government in your mind, while going through their material, there will be a lot of confusion, for which the author of this book is not responsible. The governments formed by different political parties may have or may not have some ideologies. Therefore, whenever there is a mention if the word"government" it refers to the "ideal government" not the governments you see from time to time in different countries.

1.2Meaning and Definition of Public Finance

"Public Finance" and "Fiscal Economics" are the two terms frequently used to refer to the "study of financial aspects of the government". Different persons have used different words to define the subject "fiscal economics". The financial aspects of the government include: state revenue, expenditure and borrowing. Governments may be at national level (eg:India), state level (Eg: Tamil Nadu) or local level (Eg: Corporation, Municipality, village ***Panchayat***). The sources of revenue are taxes, fines, fees, sale of goods and services. The loans also help to meet out the expenses of the government. In the concept of "budgetary deficit" the loans were earlier included as receipts. But after 1990 in India, "fiscal deficit" is worked out, wherein the loans are not considered as revenues. Hence, fiscal deficit are always greater than budgetary deficits. The governments or state at all levels – Nationals, state and local- are sometimes referred to as "Public Authorities".

Public Finance is concerned with the operation and policies of the "fisc" – the state Treasury.By going through the definitions given in other textbooks, we can conclude that "Public Finance" is an enquiry into the facts, techniques, principles, theories, rules and polices which shape, direct, influence and govern the use of scarce resources (with alternate uses), of the government. Fiscal economics also aims at suggesting ideal economic policies.

The subject matter of public finance has been widening. As on now there are five parts:

1) Public income: This part includes the study of the methods of raising public revenues and the principles of taxation.

2) Public expenditure: This part consists of the study of the principles and the effects of the public expenditure.
3) Public Debt: This part studies the causes and the methods of public borrowing as well as public debt management.
4) Financial administration: This part includes the preparation and sanctioning of the budget, auditing etc.
5) Fiscal Policy: This part analyses the use of public finance operations to bring about economic stability and growth in the coutries.

1.3 Functions of Public Finance

Socio- Political theory of public finance as expounded by Wagner, Edgeworth and Pigou insists that the state should, through fiscal policy, transfer income from the rich to the poor with the object of maximizing social welfare of the community. Keynes and Hansen have given the "new economics". This is primarily a new concept of public finance. They emphasise compensatory action through fiscal policy to stabilize and regulate consumption on a assumption that a capitalist economy by itself cannot function and the state (Government) will have to come to the rescue of the economy. The Keynesian concept of public finance is called functional finance, by ABBA P.LERNER. According to the functional finance, the main function of taxation is not to secure funds for the state but to be a weapon to reduce the purchasing power of the people. Taxation and provision of subsidy to basic goods jointly aim at minimizing economic inequalities. The main aim of public expenditure is to influence the volume of aggregate demand to equal aggregate supply.

There is another term relating to public finance. That is called "Activating finance". According to this, the state should make such fiscal adjustments that will facilitate a flow of investment to bring about an optimal resource allocation.

1.4 Private and Public Finance

Comparison between public finance and private finance is not only necessary but also useful, for this will enable the students to understand and appreciate the nature and the problems of these two branches more correctly.

The individual is concerned with the utilization of labour and capital at her disposal in order to satisfy some of her wants. The state is concerned with the utilization of labour capital and other resources to satisfy social wants.

An individual attempts to adjust her expenditure to her income; while state adjust her expenses according to the size of her income.

Here the ways of adjustment may differ between the rich and poor, as stated by Mrs.Joan Robinson. Rich may be able to enhance her income according to her expenditure, while poor may do the otherway. State may call for an estimate of expenditure, and then set about imposing taxes and using other devices to collect the necessary funds. Some times, particularly during bad times, the state may reduce its expenditure so as to be within its income.

The individual has only limited resources at her disposal. The state can draw upon the entire wealth of the community, by using force, if necessary. The state can print currency notes; the individuals cannot do so legally. Individuals income normally comes from their current earnings, savings from the past earnings and borrowings.

While private individuals and firms can never use forces to get their revenues, Government has different degrees of force to secure its tax revenue. No tax payer can refuse to pay taxes if she is liable to pay them. However, tax avoidance and tax evasion are happening. Some monopoly firms may indirectly force the consumers to pay higher prices for their producers, by artificially creating scarcity. However, coercive power of the government is much more and far more widespread than that of private firms.

Generally the individual attempts to balance her budget, that is her expenditure and her income within a short period of time. The state normally takes a year as the period within which their budget has to be balanced. Individuals normally attempts for surplus budgeting. The public authorities normally do not go in for surplus budgeting. Deficit financing is normally welcomed in underdeveloped countries.

Profit motive is normally the main consideration of private firms nowadays. [Eg., private schools colleges hospitals etc.]. However the motives of profit and surplus do not influence government's decisions. Private business does not attempt to help the government firms. But government's business is to help the private business to grow. After 1990 in India, many private firms gulped public sector banks funds and disappeared. But governments cannot do so. When there was economic crisis in the United States of America during 2007-2008, the US Government bailed out the private banks, which became sick by adopting fraudulent methods. But so far no private firm saved the government.

Privateexpenditure is governed by customs, habits etc. A poor man, who cannot give education to his children, would spend lot of money for celebrating birth day for his son. To gain social status, people waste money, food, time, energy etc.. A good government would not do so. Public expenditure is governed and controlled by deliberate economic policy followed by the government.

Every individual attempts to maximize her satisfaction by distributing her limited income on different goods and services in such a way that the marginal utility of money spent on each good would be more or less the same. This is equi-marginal utility principle explained in microeconomics. The state spends its income in such a way that the total welfare of the society/ community is maximized. Government aims to get more funds from their own people. In some households also, the adult male members take away disproportionately larger portion of the household income for their (liquor) consumption.

The elderly people saved a greater portion of their savings for their children and grand- children. But, the youth today prefers the present since they hope to live for a short period. Private business also disappears once the original entrepreneur is dead. But the state is a permanent organization and is the custodian not only for the present but also for the future generations. For instance, an individual who owns a coal mine may exploit it to the maximum extent to get the largest amount of profit at the earliest possible. But the good sate would not do so.

An individual may not and does not like to show her financial affairs. But the state gives the greatest publicity to its budget proposals, and in factpublicity strengthens rather than weakens public credit.

Like private individuals, households, firms, the government is also an element in the economy. Cordial relationship among them alone can bring development in the economy.

MODEL QUESTIONS

1. Why is the fiscal economics categorised as normative science?
2. Explain the term “public finance”.
3. What are the functions of public finance?
4. Distinguish between “Public Financé” and “Private Finance”.
5. What are the subject matters of fiscal economics?

NOTES

UNIT 2 SOCIAL ADVANTAGE

2.1 Introduction

The state collects its resources from the people and private/ public organisations and spends all its resources for the people and firms. So it is somebody's money spent on somebody. Whereas private affairs is "own money spent on one's own". The maximum utility will be attained only when one spends her own money on her own use (Private Finance). The minimum utility will be attained when one uses somebody's money for some others (Public Finance). But the question is: can we depend on some private firm to get the services required for a larger community? Will the private firm serve the people without making profit?

Classical economists believed that the government must tax less and spend less. This idea was based on the doctrine that the state can do no right and that the private expenditure is preferable to public expenditure. These economists thought that most private expenditure was productive and all public expenditure was unproductive. You can still today find such kind of people around you. This is a fallacious motion based on afaulty interpretation of "productiveness". Unless productiveness' is understood sensibly it is difficult to say which expenditure is more productive. Where to spend more money to get moreprofit, more satisfaction, more joy, more happiness, more growth, more development and sustainable development in the long run? Different goods and services have different capacities to yiled welfare. In that sense, expenditure on education and health would produce greater welfare than, for example on luxuries. People with larger unearned income, better health and education may like to spend more money on luxuries which would give them greater utility. People with some addiction may spend more money on such goods which would give them greater joy not welfare. Where would the private investment flow? It would flow only to such sectors which would give them quicker and lager profit; where they can easily lure the buyers. State would invest more on such goods which are the basic needsof the lager section of the common people. Thus keeping down the state's financial operation to the minimum is not the best principle.

The operations of public finance have a deep influence on the economic life of the community; and, it should be possible to judge them by some criterion of social benefit. The best criterion for the purpose is proved by "Principle of Maximum Social Advantage (given by DALTON) and "Principle of Maximum Aggregate Welfare"(given by PIGOU)Most of the public finance operations involve transfer of purchasing power from some persons to others. Taxation cause transfer

of funds from certain individuals to state. And, there are transfers back from the state to other individuals by way of public expenditure. Taxes are compulsory payments without any quid pro quo effects. Asa result, changes take place in the volume and pattern of the production of wealth and its distribution. Are these changes socially advantageous? This is a big question. Objective answer is difficult. Different sections of the people may air different views. The rich and tax payers would always find fault with this system. They may say the state is inefficient, corrupt system. They may say the state may be defined as populist, favouring the idle people and punishing the hard working people. All these arguments are prevalent in every society.

According to a public finance expert, Dalton, "The best system of public finance is that which secures the maximum social advantage from the operations it conducts". This principle is far-reaching and its practical application is often difficult. How to measure the social advantage? Along list of assumptions, values, norms, judgements and subjective factors are required to assess the size of social advantage.

2.2 Maximum Social Advantage and Maximum Aggregate Welfare

Maximum Social Advantage (MSA) and Maximum Aggregate Welfare (MAW) principles denote almost the same idea. Maximum Social Benefit (MSB) is yet another term with same implication. Whenever tax is paid, sacrifice is undergone. As more and more tax is paid, the sacrifice involved for every unit of tax increases. That means Marginal Social Sacrifice(MSS) increases as tax amount increases. That is, they are positively associated.

Public expenditure creates benefit (utility) for those people on whom the amount is spent. When the volume of expenditure is small, the amount of benefit received from every rupee may be higher. As the volume of expenditure increases, the utility / benefit per rupee of expenditure decreases. Thus Marginal Social Benefit (MSB) decreases as public expenditure increases. Thus they are negatively associated.

Social advantage would be maximum, when Marginal Social Benefit (MSB) is larger and MSS is smaller.

According to Dalton , social advantage is maximum at a point where MSS is equal to MSB.

MUSGRAVE calls DALTON'S principle as " Maximum Welfare Principle of Budget Determination". MUSGRAVE puts that optimum size of the budget is determined at the point where net social benefit (nsb) of fiscal operations to the society becomes zero. NSB = MSB – MSS. Taxation is justifiedas long as MSB > MSS. If MSB< MSS, taxations is atrocious.

This new approach to maximum welfare to the community through budget policy has definite merit since the 'maximum sacrifice approach to the allocation of taxes is matched by a maximum benefit approach to the determination of public expenditure and the two are combined in a general theory of budget planning".

The aggregate satisfaction from public expenditure depends, among other factors on the way it is distributed over various heads. The total satisfaction to the community from agiven public expenditure will be maximum when the MSB from every head is the same.

Similarly the total sacrifice of the public revenue (taxation) depends on its distribution over various sources. The state gets its revenues from various tax and non-tax sources; and each source should be tapped such an extent as to cause the least possible total disutility (sacrifice) to the community.

2.3 Assumptions

1. The public revenue consists of only taxes (and not gifts, fees, fines, loans etc)
2. The state has no surplus or deficit budgets.
3. Public expenditure is subject to diminishing MSB.
4. The taxes are subject to increasing MSS

2.4 Difficulties of Measurement

The MSB and MSS are only concepts, the objective measurement of which is extremely difficult. The size of tax revenues and public expenditure are too large, the effects of small additional amounts of these on the community are difficult to measure. Therefore, the particular size of revenue and expenditure that will maximize the welfare of the community are difficult to be determined.

The conditions in an economy are not static; they will be changing. For example, in times of wars the state's revenue and expenditure must increase, and the increases are certainly to the advantage of the community. Similarly, the size of national income of an economy may also be varying. What is optimum at one level of income may not be so in another level of income. Therefore, it is difficult to determine the point of maximum social advantage. And, no definite volume of government expenditure and revenue can be considered as having secured that condition.

Government tax and expenditure policies do not promote social advantage in every respect . A measure which is good in one way may not be so in another. Equity in distribution may adversely affect production. Taxing the rich to help the poor is good for distributive justice, but may discourage saving and production. Some tax policies

may promote production but increase inequalities of income and wealth.

MODEL QUESTIONS

1. Why should the government spend money on public utilities?
2. Explain the concept “Social Advantage”.
3. Discuss the “Maximum Social Advantage Principle”
4. What are the difficulties faced while measuring the social benefits?
5. What are the motives of private spending and public spending?

UNIT 3 PUBLIC FINANCE

3.1 Introduction
3.2 Federal Finance
3.3. Financial Adjustments
3.4 Division of Tax Proceeds
3.5 Grants
3.6 Loans to states

3.1 Introduction

This unit covers the financial needs of central, state and local governments. Financial Relations between the centre and the units is an essential problem of public finance in a federal state. Many countries in the world have a federal form of government. Some such major countries are U.S.A, Canada, Australia, India and Pakistan.

A federal state is a union of states in which authority is divvied between the federal or national government and the state governments. Both the centre and the states are independent in the exercise of this authority. The constitution demarcates the state from federal jurisdiction. It is the supreme law of the land. It possesses a status superior to that of laws passed by the legislatures of the centre or the units.

Those matters which have importance for the country as a whole are entrusted to the national government. E.g.foreign relations, defence, communications etc.. Those matters which are considered to be of local significance are assigned to the units. Eg primary education, primary health, agriculture etc.. In fact, the distribution of powers on a permanently satisfactory basis may be difficult. Disputes often arise regarding the competence of state and national governments in respect of particular matters. Therefore, there is always a judicial authority such as the Supreme Court in India, to settle these disputes and interpret the constitution in this regard.

The exact distribution of functions between the centre and the units (states) differs from country to country.

In most federations there is also a concurrent field of authority. For example in education, laws may be passed both by the federal and state legislatures. Some forms of education may be controlled by the centre, and some other forms may be within the jurisdiction of the sates. However, in emergencies such as a war, the centre acquires an over- riding authority even in sate matters.

3.2 Federal Finance

From the division of power in a federal state follows the division of financial operations. The centre and the state separate powers of spending and taxing. There is a clear demarcation of the sources of revenue.

There are certain norms which have been suggested for the satisfactory working of a system of federal finance. They are:

- Fiscal autonomy
- Adequacy of means
- Equity
- Economy

Taxes and other sources with a base extending over the whole country, and which affect the economic life of the whole nation, are in the federal list. Other taxes which are based in individual states and the effects of which seldom go beyond the boundaries of a state are allocated to the states. For example, customs duties are usually a central head of revenue. Taxes on land are generally state sources of revenue.

3.3. Financial Adjustments

Complete financial autonomy has never been realized in practice even in the older federations of the USA, Canada and Australia. It is all the more difficult in India, for example, where scarcity of resources is more marked. Hence certain adjustments are absolutely necessary. These adjustments may take various forms.

(A) Division Of Tax Revenues

The proceeds of certain taxes levied and collected by the centre are shared between the centre and the states.

(B) Surcharges on Taxes

The centre may levy additional rates on state taxes and the state may do that on central taxes.

State Contributions

Where the state are financially strong but the centreis weak, contributions to central revenues by the units may be necessary. This was once done in the USA. The 1919 Constitution in India also provided for contributions by the provinces to the central Government.

Central Grants to Units

The centre makes certain grants in aid to states by such grants the centre influences the policies of the units. The states are made to conform their policies to national purposes.

Loans

Loans may be given by the centre to states

3.4 Division of Tax Proceeds

The proceeds of certain taxes are shared between the centre and the states. In India, this is done in respect of personal income tax.

Some taxes are levied and collected by the centre but the proceeds of those are wholly distributed to the states. This is done for uniformity in rates and coverage. The example of such tax is the estate duty.

Some taxes are levied by the centre but collected and appropriated by the states.

Complete justice and satisfaction to all the states is impossible under any system of distribution. There are always pulls and pushes from states for the adoption and rejection of particular criterion. It is difficult to measure the needs of the states by any objective criterion.

3.5 Grants

The Grants are given primarily on the basis of needs of the states. The requirements have to be carefully estimated in relation to the resources of the states. The needs may be measured in terms of population, plans for welfare and development, and backwardness of the states. However, in India there are also controversies with certain criterion. For example, if more grants are given to the states on the basis of backwardness, all the states may attempt to underestimate their State Domestic Product (SDP). If larger grants are given to more populous states, it is deemed to be a disincentive to the states successfully implementing family planning. In India in the year 2018, some states (Kerala and TN) requestedthe centre to consider their population size that was there in the year 1971. Since they have successfully implemented family planning, the population growth rate in those states had declined. Whereas in other states, population size has increased faster. So, which set of states should be given larger grants? This is the problem.
The grants are both conditional and non-conditional.

3.6 Loans to States

The states raise loans in the capital market. And, they also get short-term and long-term loans from the central government. The loans also may be conditional and non-conditional.

MODEL QUESTIONS

1. Name the countries which have federal form of government?
2. Define a federal state.
3. How are the functions of the national and state governments categorised?
4. What are the norms suggested for the satisfactory working of a federal finance system?
5. What are the methods of financial adjustments?
6. What are the bases on which the size of grants decided?

UNIT 4 TAXATION

4.1.Introduction
4.2. Source of Public Revenue
4.3. Taxation
4.4. Canons of Taxation
4.5.Theory of Taxation
4.6.Impact, Incidence and Shifting of Taxation
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4.14.Effect of Taxation
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4.16.Major Taxes of The States In India
4.17.Major Taxes of the Local Government in India

4.1.Introduction

The modern states (Governments) are no more police states, but welfare states. It has been witnessed that an increase regularly takes place in the activity of both central and local governments. This increase is both extensive and intensive. Governments constantly undertake new functions. Hence the state needs more and more income for the performance of the variety of functions. The state gets income from taxes, commercial revenues in the form of prices of and service supplied by public enterprises (This portion is not very large, for the public enterprises have other more important motives), administrative revenues in the form of fees and fines and other sources like gifts and grants. These all put together is known as public revenues. Public finance experts call the above sources are in the narrow sense. In the wider sense, borrowings from individuals and banks are also included as a source of revenues (receipts). However, in the recent years borrowing is added with budgetary deficit and shown as fiscal deficit.

In the narrower sense, public revenue includes that income which is not subject to repayment by the government. In the wider sense, public revenues include borrowings and the issue of new currency and the liabilities.

4.2 Source of Public Revenue

Source of public revenue is broadly classified into two namely (A) tax and (B) non-tax. Let us first look at non-tax revenues. Then, we shall discuss the taxation in detail.

4.2.1 Non- Tax Revenues

a) Commercial Revenue (Income from public property and enterprises)
b) Administrative Revenue (Fee, Fine, Special assessment)
c) Gifts and grants and
d) Others

a) Commercial Revenue

Income is earned by public enterprises by selling their goods and services. For example, payments for postage, tolls, interest on borrowed funds etc. They are also known as prices because they come in the form of prices for the goods and services provided by government.

b) Administrative Revenue

The receipts of incomes accrued on account of performing administrative functions by the government are called administrative revenue. The important items of administrative revenue are listed below

I. Fees

Fee is a payment to defray the cost of each requiring services undertaken by the government in the public interest. Fees or payments are imposed by the government. For example, court fee, license fee, passport fee etc.

II. Fines and penalties

Fines and penalties are imposed on persons as a punishment for infringement of laws. They are imposed to prevent crime. Fines and Penalties are arbitrarily determined.

c) Special Assignment

"A special Assignment is a compulsory contribution levied in proportion to the special benefit derived to defray the cost of specific improvement to property undertaken in the public interest". For example when the government constructs a highway, the prices of plots on either side of it will naturally go up. Therefore, the land owners may be required to bear a part of expenses incorrect by the government. Such charges are called special assessments.

d) Gifts and grants

In general gifts and grants are the payment made by one government to another for some specific functions, For example general grant to state government. Gifts are voluntary contribution made by the people to the government for some special purposes [say during floods].

e) Other sources of Revenue

Other sources of revenue are Forfeitures, Escheat, Issuing of currency and borrowings.

I. Forfeitures

It is penalty imposed by the court for the failure of individual to appear in the court to complete certain contract as stipulated.

II. Escheat

Properties having no legal heirs or without will, that go to government are called Escheat.

III. Issue of Currency

The printing of paper money yields income to the government. It is a mean to create extra resources. It is normally avoided because if once this method of financing is started it becomesdifficult to stop it. This further leads to inflation. It has happened in some African countries. There the price inflation rate went up by more than 1000%.

(f) Borrowings

This is another source of public revenues. That is borrowing from public in the form of deposits, bonds etc.. It also includes external borrowings. In the recent years in India, the proportion of external, commercial borrowing increases faster.

4.3 Taxation

4.3.1 Objectives of Taxation

A. Raising revenue
B. Regulation of consumption and production
C. Encouraging domestic industries
D. Stimulating private investment
E. Reducing income inequalities
F. Promoting economic growth
G. Development of backward regions
H. Achieving balanced – spatially §orally- growth
I. Ensuring price stability.

4.3.2 Classification of Taxation

Different basis adopted by economists to classify the taxes are forms, nature, aims and methods of taxation. The taxes are classified under the following major heads :

A. Direct taxes : Proportional, progressive and regressive taxation
B. Indirect Taxes : Specific, Advalorem, single Multiple
C. Other taxes : Income and property, production and capital goods, Value added tax (VAT), Modified value added tax, (MODVAT), Goods and services tax (GST)

4.3.3 Direct Taxes and Indirect Taxes

According to Dalton **'A direct tax is really paid by a person on whom it is legally imposed, while an indirect tax is imposed on one person, but paid partially or wholly by another, owing to consequential change in the terms of some contract or bargaining between them'.**

From the above we can reach a conclusion that direct taxes are those which are paid by persons on whom they are imposed and the real burden is also borne by them. The burden of such taxes cannot be transferred or shifted to some other persons.

That is, **in the case of direct taxes both impact and incidence fall upon the same persons.**

Indirect taxes are imposed on one person but are paid either partly or wholly by another. The person who pays the tax in the first instance, transfers its burden on the shoulders of another person. In other words, **in the case of indirect tax, the impact and incidence of the tax fall on different persons.**

Examples of **direct taxes are income tax, wealth tax, corporation tax, gift tax, etc. And examples of indirect tax are sales tax, excise duty, VAT etc.**

4.3.4 Merits of Direct Taxes

Following are the main merits of direct taxes.

a) Equity : Direct Taxes such as income tax, taxes on property, capital gain taxes etc are progressive in their nature. That is, higher incomes are taxed heavily and lower incomes are taxed lightly. Hence, direct taxes are based on ability to pay of the tax payer and they ensure canon of equity.

b) Economy: The administrative cost of collecting direct taxes is low. The tax payers directly pay the tax to the state. So there is not much waste of resources and time. That is, direct taxes satisfy the canon of economy.

c) Certainty : Another merit of direct tax is that it is certain. The tax payers know how much tax to be paid, on what basis tax is paid to the government etc. Thus, the tax payer is able to make adequate provision for the payment of tax in advance. The government can also plan the development activities since they can estimate the amount of revenue they receive in the form of taxes.

d) Elasticity and revenue generation: The yield from the direct taxes increases as the country economically advances. The government gets more revenue over the direct taxes automatically at higher rates.

e) Distributive justice: Since direct taxes are progressive in rates, tax rate increases as the income of individual rises. The tax burden will heavily be on the richer sections of the society. The increased revenue through taxes is allocated for providing subsidized food, clothing and housing to the poor and needy people. This will bring about distributive justice in the country.

f) Civic consciousness: Direct taxes create civic consciousness among the tax payers. The tax payers will be vigilant in the utilization of the tax revenue and will see whether the resources are efficiently used and wastage is avoided.

g) Absence of leakages: Since there is direct payment of taxes by tax payers to the government, there is no room for any wastages. The whole amount of direct taxes such as income tax, property tax , and taxes on capital gains etc, reaches the treasury without any middlemen.

4.3.5 Demerits of Direct Taxes

The important demerits of the direct taxes are explained below.

I. Unpopularity : The direct taxes are directly imposed on individuals. They have to bear the impact and incidence of these taxes. Thus they experience their pinch directly. Consequently, direct taxes are not as popular as indirect taxes.

II. Violation of the principle of equity: The burden of direct taxes falls almost exclusively on the richer sections of the society while the poor section are totally exempted from these taxes. This is unjustified and improper because the burden of state expenditure should be borne by individuals at all levels of society according to their ability to pay.

III. Large scale evasion : Direct taxes is based on honesty. The tax is not evaded only when the tax payer is honest. In fact

thepeople in the higher income group do not reveal their full income. It is remarked that "direct taxes are premium on honesty".

4.3.6 Merits of Indirect Taxes

The following are the important merits of indirect taxes:

a) Convenience: Indirect taxes are more convenient to pay. It is paid at the time of purchase of a commodity. Hence, the tax payer does not feel the burden of tax. The tax is hidden in the price of the commodity bought. It is paid in small amount. The government can also collect it conveniently.
b) Indirect tax lead to social welfare: Indirect taxes on narcotics and intoxicants would reduce the consumption of them which are harmful to health. Reduction in the consumption of such goods will indirectly increase the welfare of the people.
c) Indirect taxes are justified: Indirect taxes are justifiable and equitable. They are paid by all the individuals when they purchase goods and services.
d) Indirect taxes help production and investment: Another advantage of indirect taxes is that they perform as powerful tool in moulding the production and investment activities of the economy.
e) No Evasion: Indirect taxes are generally difficult to be evaded as they are included in the price of the commodity. A person can evade an indirect tax only when she decides not to purchase the taxed commodity.

f) Highly revenue yielding in developing countries: Direct taxes do not yield much income in developing countries, as the income of the people is very low. Since indirect taxescover a large number of essential commodities to be consumed by both rich and the poor in the country, large revenue could be collected.

4.3.7. Demerits of Indirect Taxes

a) Indirect taxes promoteinequality: Indirect taxes are generally imposed on the consumption goods. The poor people have to pay as much by way of indirect taxes on commodities as the rich people. This is unjust. They are regressive in nature which will promote economic inequality in society by imposing larger burden of taxes on the poor people.
b) Element of uncertainty: Indirect taxes are extremely uncertain. The revenue accrued to the government from indirect taxes cannot be estimated accurately. As soon as the tax is imposed, the price of the commodity is raised. This will in turn reduce the

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demand for the commodity. It cannot be estimated with certainty as to what extent the demand falls.

c) Lack of civic consciousness: Indirect taxes do not create civic Consciousness as the tax payers in most cases do not feel the burden of the tax they pay.
d) Indirect taxes promoteinflation: Another demerit of indirect taxes is that it promotes inflationary tendency in the economy, as they would increase the prices of the taxed goods.
e) Discourage savings: Indirect taxes discourage savings because they are included in the prices of commodities. Therefore, people have to spend more on the purchase of commodities. This will reduce the disposable income of the people and hence the savings.

4.3.8 Progressive, Proportional, Regressive and Degressive Taxes

A tax may be progressive, proportional, regressive or degressive according to the relationship between tax rate, structure and tax revenue.

a) Progressive Tax

A progressive tax is that in which the rate of the tax depends on change in income. That is, the rate of tax increases with the increase in the income. The higher the level of income, the higher the tax rate will be and vice- versa (Table 4.1).

Table 4.1: Progressive Tax Rates : An Example

Taxable Income in Rs.	Tax Rate %	Amount of Tax in Rs.
Lakhs	0	0 Thousands
Lakhs	0	160 Thousands
5 Lakhs	30	50 Thousands

b) Proportional Taxes

A proportional tax is one in which the rate of tax remains the same, irrespective of the level of income. Here, the same percentage of tax is levied on all income groups. The tax amount is simply calculated by multiplying the tax base with the tax rate. This is illustrated in Table 4.2.

Table 4.2 : Proportional Tax Rate : An Example

Taxable Income in Rs.	Tax Rate %	Amount of Tax in Rs.
3 Lakhs	10	30 Thousands
8 Lakhs	10	80 Thousands
15 Lakhs	10	150 Thousands

c) Regressive Tax

In regressive taxation, the higher the income of the tax payer, the smaller is the proportion of income she contributes to the government in the form of taxes. That is, in the regressive taxation, the tax rate declines as income increases. This type of taxation is against the objective of welfare state in modern time (Table4.3).

Table 4.3 : Regressive Tax Rates: An Example

Tax Base in Rs.	Tax Rate %	Amount of Tax in Rs.
3 Lakhs	30	90 Thousands
8 Lakhs	25	200 Thousands
15 Lakhs	20	3000 Thousands

d) Degressive Taxes

Under this tax system, the tax is mildly progressive up to a certain limit. After that the tax may be charged at a flat rate. In other words, degressive tax system is a mixture of proportional as well as progressive tax system. In this, the higher income group people have to make little sacrifice in comparison with lower income group.

Table 4.4 :Degressive Tax Rates: An example

Tax Base in Rs.	Tax Rate %	Amount of Tax in Rs.
3 Lakhs	10	30 Thousands
8 Lakhs	12	96 Thousands
15 Lakhs	15	125 Thousands
20 Lakhs	15	300 Thousands

4.3.9 Single and Multiple Taxation

Single tax refers to a system in which the taxes are levied only on one item or head of tax. It is only one kind of tax. It implies a tax on one thing. That is, one class of things or one class of people. This type of tax was advocated by economists from 17th to 19th century. Such a tax is collected at regular intervals, may be monthly or annually or any other shorter or longer duration. A single tax may be progressive, proportional or regressive.

First of all, the ***Physiocrats*** during 17th and 18th century strongly advocated a single tax on land, for according to them agriculture was the only productive sector yielding surplus. Issac Sherman proposed a single tax on all real estates- on land- because it was convenient in administration and payments. Henry George also advocated a single tax on land mainly because he thought that it was not possible to shift the tax.

a) Merits of Single Tax System

I. It is very simple tax as it simplifies the work of the government.
II. It is less costly as lesser amount is spent to collect the revenue

b) Demerits: It cannot bring adequate revenue to meet the needs of the modern governments.

I. Single tax system violates the principle of ability to pay.
II. The burden of taxation is not equally distributed
III. The tax system is not effective during the period of emergency or crisis
IV. Tax evasion is much possible
V. It lacks elasticity

4.3.10 Multiple Taxation

The multiple taxes imply there should be all types of taxes so that every citizen can contribute to the state revenue. Similarly, modern economy has to fulfill many objectives like those of economic growth, equitable distribution of income and wealth, economic stability, full employment and so on. Since no single tax can realize all these objectives simultaneously, a multiple tax system is preferred. But at the same time, too many taxes will yield only a small amount of revenue. The cost of collection will be very high. According to Dalton "It is better to rely on few substantial taxes for the bulk of revenue". Thus, the burden of taxation should be widely distributed. Multiple tax system is a mixture of proportional, progressive, direct and indirect taxes.

4.3.11specific and Ad valorem Taxes

According to the assessment, taxes on commodities can be divided in to two types – specific tax and Ad Valorem tax.

a) Specific Taxes

Taxes which are based on specific qualities or attributes of goods are called specific tax. This tax is imposed on commodities according to their weights, size or volume. It is a per unit tax on commodity. For example, specific excise duty may be levied on the cloth in the length units and tax on sugar is based according to the units of weight. Gold is not suitable for this purpose.

b) Ad valorem Taxes

When a tax is imposed on a commodity on the basis of its value, it is called ad valorem tax. This type of tax is levied after assessing the value of the taxable possession of a person. For example, several imported articles are taxed in terms of values and they have nothing to do with weight, length and size of the commodity. Salt is not suitable example for this.

4.4 Canons of Taxation

Canons of taxation refer to the administrative aspect of the tax. They relate to the rate, amount, and method of levy and collection of a tax. In other words, the qualities or attributes of a good tax are called canons of taxation. It was Adam Smith who gave first a detailed and comprehensive statement of the principles of taxation.

Adam Smith has given the following four Canons of taxation.

1. Canon of Equality
2. Canon of Economy
3. Canon of Certainty
4. Canon of Convenience (2 Es& 2 Cs)

4.4.1 Canon of Equality

Canon of equity is based on the principle of social justice and ability to pay. Tax burden should be distributed among the tax payers according to their ability to pay. That is, the rich people should bear a heavy burden and the poor a less burden. Hence, the tax system should be progressive, According to Adam Smith **"The subject of every stage ought to contribute towards the support of the government as nearly as possible, in proportion to their respective abilities, that is,**

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in proportional to the revenue which they respectively enjoy under the protection of the state".

4.4.2 Canon of Economy

Canon of economy explains that taxes should be collected at minimum cost. The tax laws and procedures should be simple. The administrative machinery should not be elaborate and costly.

Adam Smith argued that lack of economy would result when,

1. Tax administration is costly on account of complicated taxes.
2. Taxes are unduly heavy which would discourage investment, so that the income level reduces, hence the relatively lower tax yields.
3. Taxes are having elaborate and complicated administrative supervision.
4. Taxes are unproductive in yielding sufficient revenue.

4.4.3 Canon of Certainty

Taxation must have an element of certainty. That is, there must be certainty about the tax which an individual has to pay. Things like the time of payment, the manner of payment, and the quantity to be paid etc. should be plain and clear to the tax payer. It should not be arbitrary. According to the Adam Smith "The tax which each individual is bound to pay ought to be certain, and not arbitrary. This type of payment, the manner of payment, the quantity to be paid ought to be clear and plain to the contributor and to every other person".

4.4.4.Canon of Convenience

It explains that a tax should be levied in such a manner such a time that it is convenient for the tax payer to pay it. In the words of Adam Smith, "Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it".

4.4.5 Other Canons of Taxation

Besides the four canons put forward by Adam Smith, there are some other canons given by writers like Charles F. Bastable. They are canon of productivity, canon of elasticity or flexibility, canon of simplicity, canon of diversity, canon of co-ordination etc.

I. Canon of Productivity

Tax should bring large revenue. According to this canon it is desirable to have a few taxes yielding large revenue rather than having a large number of taxes yielding small revenue. It also implies that instead of

imposing large number of unproductive taxes, it is advisable to have a few productive taxes.

II. Canon of elasticity

It means that taxation should be flexible or elastic. That is, tax should be capable of increasing or decreasing the tax revenue depending on the need of the government. In other words, the tax revenue should increase automatically whenever an upward revision of tax rates is made. When tax rate is increased tax revenue should not decline. Laffer curve says, after certain point, increase in tax rate will reduce revenue from tax, due to tax avoidance ad tax evasion.

III. Canon of Diversity

This implies that there should be a number of different taxes in the country. This will make every citizen of a country to pay something to the national exchequer.

IV. Canon of Simplicity

This canon implies that the tax should be simple to understand even to a layman. It should be free from all ambiguities and provisions to avoid differences in interpretation and legal disputes.

V. Canon of Coordination

There should be co-ordination among different layers of governments in imposing taxes. Especially, in a federal country like India there should be co-ordination among the central, state and local governments regarding taxes, since each of these is having legal right to impose taxes.

4.5 THEORY OF TAXATION

The criteria used for constructing a good tax structure are called principles of taxation. The principles of taxation relate to the distribution of tax burden or allocation of tax burden to different categories of tax payers. Some important principles are explained below.

4.5.1 Principle of equity

This principle implies the fairness or justice in the distribution of burden of taxation. In other words, equity in taxation means all tax payers should bear an equal sacrifice in the payment of taxes. There are two types of equity – Horizontal equity and vertical equity.

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a) Horizontal Equity : It implies the treatment of like - people in a like - manner. That is, persons who are equally well-off should be treated equally. To secure horizontal equity, persons with same income should pay equal amounts of taxes.

b) Vertical Equity: This implies that unlike - people should be treated in an unlike - manner. That is the persons who are well-off should pay highest taxes than the worse – off people. The theory is very difficult to practice, through it looks to be pretty.

To establish both horizontal equity and vertical equity there are some other principles of taxation. They are the benefit principle, the ability to pay principle and the cost of service principle.

4.5.2 The Benefit or Quid Pro Quo Principle

This principle explains that tax should be paid in accordance with benefits each would receive from expenditure programmes to be financed by tax revenues by the governments. According to this principle, people receiving equal benefits should pay equal amounts of taxes and those who receive greater benefits pay higher taxes.

1. Merits of Benefit Approach

a) Justification for taxes: Taxes are imposed only when benefits are conferred on tax payers out of the tax revenue.
b) Equity principle: Individuals receiving benefits from the state expenditure should contribute in proportion with the benefits enjoyed by them
c) No discouragement to work and invest: As taxes are imposed on the basis of benefits, they do not discourage the willingness to work and invest.
d) Basis for allocation of taxes: Taxes are allocated to the extent of benefits received.
e) It combines both the income and expenditure sides of the budget process.

2. Demerits

a) Injustice to poor: Since modern governments are aiming at welfare state, more benefits should be provided for the poorer people. When taxes are imposed on the basis of benefits, tax burden will fall heavily upon the poor. J.S.Mill rejected the theory as it is regressive in nature.
b) Non-applicability of market principle: The market principle of demand and supply is not applicable to social goods like

education, defence, public health etc. They are supplied equally by governments for collective consumption.

c) Benefits are community based or group based: Benefits from social goods are enjoyed by community than by individuals. So beneficiaries cannot be individually identified.
d) Certain benefits are immeasurable: Some benefits of public expenditure cannot be qualified. For example, benefits from public parks, recreation, museums, research centres etc.
e) Violation of tax definition: The very definition of tax is violated as per the benefit principle. Tax is defined as a compulsory contribution without direct benefits.

4.5.3 Ability to Pay Principle or Sacrifice Theory

This theory states that those people who possess income or wealth should contribute to the state in proportion to the ability to pay. According to J.S.Mill "Equality in taxation means equality in sacrifice". According to Dalton "The burden of taxation should be so distributed that the direct real burden on all tax payers is equal". Seligman quoted that "The basic point of the ability to pay principle is that burden of taxation should be shared amongst the members of the society so as to conform to the principle of justice and equity…..and this equity criterion will be satisfied if the tax burden is determined according to the relative ability of the tax payers". In short, the ability to pay theory explains the fairness or justice in the distribution of tax burden. Taxes should be imposed to minimize the total sacrifice involved.

4.5.4. Indices of Ability to Pay

To measure ability to pay, two important approaches are used by economists 1) the Subjective (equal sacrifice) approach and 2) the objective (faculty) approach.

i. The Subjective Approach

This approach is based on the psychological or mental reactions of the tax payers. Each tax payer should make equal sacrifice, if tax burden is equally distributed. The equal sacrifice interpretation of ability to pay was originally put forward by J.S.Mill. According to him "Equality in taxation means equality in Sacrifice". There are three concepts of equal sacrifice principle. They are Equal Absolute Sacrifice, Equal Proportionate Sacrifice and Equal Marginal Sacrifice.

a) Equal Absolute Sacrifice

As per this principle, loss of utility should be equal to all the tax payers. It means that rich people should pay higher taxes than the poor.

b) Equal Proportionate Sacrifice

This implies that the loss of utility should be proportional to the total income of the tax payers. That is, higher income people should be taxed at a higher level than that of the poor. For each individual the ratio of utility lost to total utility should be equal.

c) Equal Marginal Sacrifice

This is otherwise known as least aggregate sacrifice. According to this principle, total sacrifice made by all the tax payers should be the lowest.

ii. Objective Approach

This approach explains three criteria to measure ability to pay viz., income, property and consumption.

a. Income

Income is considered to be the best index of ability to pay. Income from all sources – property, investment in share etc. in a given period is to be calculated.

b. Property

Formerly property or wealth was considered as the index of ability to pay. This was due to the fact that the standard of living of the people was not only influenced by income but also by the accumulated property and wealth.

c. Consumption

Many economists have suggested consumption expenditure as the basis of ability to pay. According to Kaldor, "Consumption rather than income should be the basis of taxation". The major difficulty of this measure is that person with large number of dependents have to spend more and hence to pay leger taxes. This is against the equity principle of taxation.

d. The Cost of Service theory

According to this theory, each tax payer should pay tax equal to the cost rendered by the government to provide a service. For example, if an individual received 0.3% of total service, he has to pay 0.3% of total cost involved in providing such services.

e. Limitations

It is difficult to estimate the cost of all services. For example defence. How can one calculate the benefit she received from the defence services?

It is against the welfare objective of the governments. If cost is taken as the basis of tax, the governments may not perform many functions which are very much desirable for the welfare of the society as a whole. E.g Relief works during the time of emergency, free medical and educational facilities etc.,

It is against the very definition of tax. Tax is a compulsory contribution and there is no direct quid-pro-quo.

The cost of services rendered by governments to individuals cannot be fixed arbitrarily, which is not just.

4.6 Impact, Incidence and Shifting of Taxation

In modern time, there is large number of taxes. In order to understand the various social and economic effects of taxes, it is very essential to discuss terms like impact, incidence and shifting.

When government imposes taxes, the amount should be paid by someone. In all cases the tax burden are not borne by the same persons on whom the taxes are imposed. To understand this in a better way we have to know two things. A)who pays the tax initially and b) who actually bears the tax burden. In short, a tax may be imposed on one person or transferred to others ultimately bear the burden. This is explained in the theory of incidence. In order to understand the theory f incidence, it is very much essential to distinguish between impact, shifting and incidence.

a) **Impact**

According to Seligman "Impact is the initial phenomenon, shifting is the intermediate process and incidence is the result. "Impact is otherwise called statutory tax incidence. It implies the burden of a tax borne by the person on whom it is imposed. In other words, impact refers to the immediate burden of a tax on the person who first bears the legal obligation of tax.

b) **Shifting**

The process of transferring the burden of a tax from one person to another is called shifting. The producer may shift the tax burden to the wholesaler, the wholesaler to the retailer and the retailer to the customers etc. This is done through the changes in prices. This is a case of forward shifting. Forward shifting may be multi-point or single-point The case explained above is an example of multipoint shifting. When the tax burden is shifted by a producer to customer directly, it is a case

of single point shifting. Shifting may also be backward. Backward shifting refers to shifting of tax burden to sellers by buyers. Tax capitalization is a particular case of backward shifting.

c) Incidence

The final or ultimate money burden of a tax is called incident. It is the money burden of a tax which is borne by the last person. That is the incidence of a tax is the final resting place of it. Let us take GST. GST is transferred by the seller to government. But actually the buyers pay the GST.

4.5.1 Distinction Between Impact and Incidence

A) Impact refers to the initial burden of the tax, while the incidence is the ultimate burden of the tax.
B) Impact is at the point of imposition, while incidence is the point of settlement.
C) The impact of tax falls on the person from whom the tax is collected and the incidence rests on the person who pays it eventually.
D) The impact may be shifted but the incidence cannot be shifted.

4.5.2 Effects and the Incidence of Taxation

In economic analysis, incidence and effect are used to denote different connotations. As we have already discussed, incidence is the final money burden of a tax whereas effects of tax refers to the economic consequences of a tax on production, consumption, distribution and exchange. The study of effect is broader than the study of incidence. Taxes affect production consumption, savings, investments, growth, regional balance, distribution of income and wealth and so on.

4.6 Concepts of Tax Incidence

There are different concepts of tax incidence. The three important views on the concept of tax incidence are the following,

a) Dalton's concept (Traditional Concept)
b) URSULA HICKS Concept of formal and effective incidence and c) MUSGRAVE'S Concept of incidence.

a) DALTON'S Concept of Incidence

Hugh Dalton has distinguished between the direct and indirect burden as well as the money burden and real burden of the tax. According to him, "The incidence of a tax is upon those who bear the direct money burden of the tax". The total direct real burden of tax refers to the loss

of economic welfare due to payment of tax. The indirect real burden is the reduction of consumption or a fall in savings. The direct real burden and indirect real burden together constitute the effects of taxation.
Hence, the incidence of taxation is the direct money burden of a tax. That is, the actual initial payments of tax which may either fall upon a person on whom it is initially imposed or if shifting is possible, upon some other persons by whom the tax money is finally paid.

b) URSULA HICK'S Concept of Incidence

Ursula Hicks has classified incidence of taxation in to Formal incidence and Effective Incidence. Formal incidence means the direct money burden of a tax. According to URSULLA Hicks the formal incidence is the "proportion of people's income which is collected by the persons who provide them with goods and services, but paid over to governing bodies to finance collective satisfactions".

Effective incidence refers to the difference between economic order relating to income distribution, consumption pattern, and allocation of resources before taxation and after taxation. She says, in order to discover the full economic consequences of a tax, we have to draw and compare two pictures – one economic set up (distribution of consumers' wants and incomes, and allocations of factors) as it is with the tax in question; the other of a similar economic set up, but without the tax. In short, the effective incidence is nothing but the economic effects of the tax.

c) MUSGRAVE'S Concept of Incidence

According to Musgrave "the distributional changes caused by changes in budgetary policies that involve resource transfer is incidence. The budgetary policy may either be tax policy or expenditure policy bringing about distributional changes. According to him there are 5 forms of incidence viz..

1) Specific tax incidence
2) Differential tax incidence
3) Specific expenditure incidence
4) Differential expenditure incidence
5) Balanced budget incidence .

(These are not discussed here due to paucity of the space)

4.8Theories of Tax Shifting and Incidence

There are different theories to explain the shifting and incidence of taxation. They are classified into three categories Viz. The concentration theory, the diffusion theory and The modern theory.

a) The Concentration Theory

This theory was developed by ***Physiocrats*** in the 18th century. They believed that all taxes ultimately concentrate on a particular kind of people. They regarded agriculture as the only productive activity which alone yield a surplus. They advocated a single tax on the net income of land. According to them diversity of taxes should be avoided. The major criticism against the theory is that all activities are productive and a single tax on land is not suitable for modern welfare state. Similarly the burden should not be concentrated on a single section of the society but instead there should be equal distribution of tax burden on the entire society. The major advantage of the theory is that it stresses that all taxes are paid out of surplus. If there is no surplus the burden of the tax is shifted to others.

b) The Diffusion Theory

The diffusion theory explains that a tax is shifted and re-shifted till its burden eventually gets scattered throughout the entire society in such a way that each individual tax payer bears only a small portion of the tax- a portion which ought to bear and is capable of bearing it. This theory was explained by some French writers like Mansfield and Canard. According to Mansfield, "Tax is like a stone falling into a lake and making a circle till one circle produces and gives motion to another and the whole circumference is agitated from the centre".

When a tax is imposed it gets diffused so that no one escapes from its burden. The diffusion occurs through the process of shifting. Equilibrium is reached when the tax burden is equally distributed among all the tax payers N.F.Canard compared the imposition of tax to extracting blood from one of the veins of human being; although it is taken from a single vein, the loss is spread over the whole body and the body remains in equilibrium. Canard believed that old taxes are preferable to new taxes, as new taxes would upset equilibrium till it got diffused. He quoted that "Every tax is good, every new tax is bad".

Limitations of the Diffusion Theory

The burden of all taxes does not get diffused. If it is the case, it is not needed to distinguish between direct taxes and indirect taxes.

c] The Modern Theory of Incidence (Demand & Supply Theory)

The modern theory of tax incidence was developed by Dalton and was supported by modern economists like Seligman and Edgeworth. The theory possesses all the virtues of the earlier theories. It states that tax should be imposed and therefore, it also believes that tax is a part of cost of production and therefore, it enters into price. Shifting of tax

burden is thus done through price changes. If there is no price transaction, shifting of tax burden is impossible. So shifting is common in commodity taxation. In short, shifting and incidence depend on pricing. Pricing in turn depends on the interaction of the market forces of demand and supply. The factors influencing the demand and supply are therefore having paramount importance in understanding the nature of tax shifting and factors which affect demand and supply are the elasticity of demand, the elasticity of supply, the laws of returns, and market structure [perfect competition, monopoly, monopolistic competition, and oligopoly.]

4.9 Elasticity of Demand and Elasticity of Supply

According to Dalton, "Incidence of a tax is divided between buyers and sellers in the ratio of the elasticity of supply to elasticity of demand." That is ES/ED where Es = elasticity of supply and Ed = elasticity of demand.

4.10. Incidence of Tax under Various Market Conditions

A) Perfect Competition and Tax Shifting

Shifting of tax incidence under perfect competition depends upon the time element, whether it is market period, short period or long period. During very short period or market period, shifting of the tax depends upon the durability of the good. If the good is perishable, the seller will bear the incidence because if she increases the price, her stock will remain unsold and will be damaged. But if the good is durable, tax is shifted. The extent of shifting will be determined by the elasticity of demand.

The tax is shifted partly to the buyer and partly to the seller in the short period. If the demand is relatively elastic, the larger incidence will be on the seller; if demand is relatively inelastic the larger incidence will be on the buyer. In the long run, all costs are included in the price. Thus, in the long period the tax is treated as cost of productions and the whole tax is shifted to the buyers.

b)Monopoly Market and Tax Shifting

Monopoly is a market situation where a single seller is controlling the entire supply of a commodity which has no close substitutes. The seller is a price maker and she maximizes profit where MC=MR. A tax increases the cost of production. Monopoly taxes are of two types – Lump-sum tax and ad-valorem or specific. In the former case, the monopolist would bear the whole incidence and in the latter case, the

monopolist will shift the tax burden partly to the buyer depending on the elasticity of demand for the good.

c) Monopolistic Competition and Tax Shifting

In monopolistic competition, there are many competing firms but with product differentiation. Each firm has its own demand curve, elasticity of which depends upon the extent of product differentiation. If the product is highly differentiated, the demand curve is less elastic; the firm can easily shift a large part of the tax to the buyers through an increased price. If product differentiation is not much, the demand curve will be highly elastic and therefore the large incidence will be on the sellers.

4.11 Factors Influencing the Process of Shifting of a Tax

It has already been discussed that the elasticity of demand and the elasticity of supply are the two important factors determining the shifting of tax burden. Besides these two factors, the following factors also influence the shifting of a tax

a) Form of quoting type of market
b) Rate of tax and type of the market
c) Availability of substitutes
d) Geographical coverage
e) Time allowed for tax shifting
f) General economic conditions
g) Familiarity of consumers with a particular set of prices
h) Public policy etc

4.12 Taxable Capacity

In recent time, public expenditure has increased enormously. The main reason is that the functions of governments have increased manifold. The modern states are no more police states but welfare states. For meeting this huge amount of expenditure revenue is needed. Taxation is the major source of revenue. The capacity of the people to pay taxes should be taken into account while increasing the tax rates or imposing new taxes. We can see some of the determinants of the taxable capacity.

Determinants Of Taxable Capacity

National income and wealth
Size of population
Standard of living of the people
Nature of public expenditure

Psychological attitude of the people
Stage of economic growth
Trade cycles
Political conditions
Tax structure
Fiscal, monetary and income policies of the governments
Favourable balance of trade
Inflow of foreign capital
Technological progress
Modernization of production pattern etc..

4.13 Some Concepts Related with Taxation

a) **Tax Neutrality :** Tax should be imposed in such a manner that it should not influence the market decision of either satisfaction motivated consumers or profit motivated producers
b) **Tax Rate Structure :** It describes the relationship between the tax collected during a given accounting period and the tax base.
c) **Tax Base :**It is the item or economic activity on which tax is imposed. For example, income, consumption, wealth etc..
d) **Excess Burden :** Excess burden or dead wright loss refers to the reduction in economic efficiency, below the level attainable with an optimal tax with no distorting effect.
e) **Buoyancy of Tax** : Buoyancy or administrative flexibility of tax refers to the total response of tax revenue to changes in tax base.
f) **Elasticity of Taxation :** Elasticity of taxation refers to the ratio of percentage change in tax yield to percentage change in coverage or rate of taxation
g) **Laffer Curve or Revenue Rate Curve :**Laffer curve or Revenue Rate Curve refers to the curve describing the relationship between tax revenue and tax rates. It is a graphical representation of the disincentives created by tax rate. It explains the inverse relationship between tax revenue and tax rates. It has an Inverted U-Shape.
h)

4.14 Effects of Taxation

We have already understood the meaning of incidence of taxation. It refers to the direct money burden of a tax. The ultimate influence of taxation on economic entities like production, consumption, distribution etc. is referred to as effects of taxation. In a wider perspective, taxation can serve as an instrument of fiscal policy in realizing socio-economic

goals like price stabilization, regulation of consumption and production, checking fluctuations of booms and depression, promoting economic growth etc. However, the economic effects of taxation need not be always good, they can be bad also. Therefore, while forming a tax policy, the government should take into consideration not only the revenue but also the economic consequences of taxation as well. According to **Dalton "The best system of taxation from the economic point of view is that which has the best or the least bad economic effects".** He discussed three types of economic effects of taxation. They are : 1) The effects of taxation on production 2) Effects of taxation on distribution and 3) Other effects of taxation.

4.14.1 Effects of Taxation on Production

According to Dalton the effects of taxation on production can be in the following three ways

a) Effects on ability to work, save and invest.
b) Effects on willingness to work, save and invest.
c) Effect on diversion of resources between firms and places.

a) **Effects on ability to work, save and invest**

Being transfer of purchasing power from individuals to governments, taxation leads to the reduction of purchasing power of the individuals' tax payers. This will lead to the reduction of income, consumption, saving etc., of the people. This will adversely affect the efficiency and ability to work of the tax payers. This effect is mostly felt by the poorer sections of the society, since their propensity to consume is reduced. This will in turn lower their standard of living and as a result their efficiency and ability to work also. On the Other hand, the efficiency and ability to work of the richer people is not affected by taxation, as taxation will result only in the reduction of their conspicuous and luxurious consumption. On this ground heavy taxation on the poorer people is objected by most of the economists.

The effect of taxation on ability to work depends on the nature tax. There are some taxes which will promote the ability and willingness to work of the people, like taxes on consumption such as liquor, tobacco, intoxicating drugs etc.. Such taxes will reduce the consumption of such goods, which are detrimental to health and efficiency.

Saving depends on income. So when there is a fall in disposable income as a result of taxation, saving is reduced which will affect investment. The ability to work, save and invest is affected by all types

of taxes. The beneficial effects of public expenditure should also to be taken into account while evaluating the effects of taxation on the same.

b) Effects on Willingness to Work, Save and Invest

The effects of taxation on the willingness, save and invest is partly determined by the monetary burden of tax and partly by the psychological state of the tax payer; that is nature of taxes and psychological reaction of the tax payers.

i] Nature of Taxes : Some taxes like tax on windfall gains, inheritance tax, tax on monopoly profit etc. will have no bad effects at all on the willingness to work, save and invest. Similarly, reasonable commodity taxes like excise duty, sales tax etc..will not affect willingness to work, save and invest adversely. Direct taxes like personal income tax will influence the willingness to work, save and invest adversely but indirect taxes being in the prices may not have such disincentive effects

ii] Psychology of the Tax Payer : The immediate effect on the mind of the tax payer on the announcement of a new measure of taxations is called the psychological reaction. A.C.Pigou called this as "announcement effect of taxation". It implies a change in the mental state of tax payer by the imposition of a new tax or by the withdrawal of an old tax or by variations in the existing tax. If the demand for income is inelastic, the tax payer will work more to maintain the pre – tax level of income. The incentive to work, save and invest of such tax payers will not be adversely affected but instead be accelerated. If a person has an elastic demand, her incentive to work, save and invest may be related with the imposition of taxes. Similarly, if the demand is unity, the desire to work remains constant whatever be the level of income.

d) Effects of Taxation on Diversion Of Resources

After the publication of "The General Theory" by J.M.Keynes, the taxation policy has assumed great importance in influencing the economic welfare of the people. A rational allocation of resources is essential for ensuring the economic welfare of the people. There are beneficial diversions of resources as well as harmful diversion of resources through taxation.

i) Beneficial Diversion

Taxation is s powerful instrument to achieve rational allocation of resources through beneficial diversion of resources from undesirable uses to the most desirable ones from the social welfare point of view.

For example, tax on luxuries, liquors, gold, diamond, tobacco etc. Tax on luxury items and comforts can divert resources from their production to the production of necessities. Another way of resource diversion is done through differential tax system.

ii) Harmful Diversion

Taxation on necessaries or articles of mass consumption may not be socially desirable. As a result of increase in price of such articles, the demand will be decreased which will in turn reduce the production. Similarly, taxes on industries will harm rural and backward areas. Taxes on domestic industries will bring about shifting of domestic resources to foreign countries where the burden of tax is minimal or to such industries which are exempted from taxation. In short, resources are shifted from high taxed countries to low taxed countries.

4.14.2 Effects of Taxation on Distribution

Distributive justice is one of the macroeconomic goals of the government. Distributive justice implies that growth in the economy should be shared equally by all section of the people. It also implies that inequalities of wealth and income should be greatly reduced through a proper, equitable distribution of income produced in the country. Taxation is regarded as an important means to reduce the inequality in income and wealth distribution.

As Dalton pointed out "Other thing being equal, one tax system is preferable to another if it has a stronger tendency to check inequality". Taxation is essential not only to collect surplus income from the rich but also to perform social welfare functions and to provide funds for uplifting the poorer sections of the commodity. In general all direct taxes, falling heavily on the people getting higher income and possessing large amounts of wealth, do have favourable effect on equalizing income and wealth. Progressive taxes on income and wealth are found to be of immense use in bringing justice in the distribution of income and wealth.

On the other hand if indirect taxes such as sales tax, excise duties etc. are imposed at higher rates, the lower and middle income groups will adversely be affected. However, even in the case of indirect taxes equality can be maintained by resorting to higher rates of taxation on luxuries and semi – luxuries.

While achieving favourable distributional effect through progressive taxation, care must be taken to ensure that the goose (rich people) that lays golden eggs (of savings and capital formation) does not die. In other words, taxes should not be severely progressive so that the savings and investments by the rich are reduced, because it is only the rich who save and invest. If tax on rich is very high, they will run

away with their cash to other countries, or even to some islands, which are known as "tax havens".

4.14.3 Effects of Taxation on Economic Stability

Economic stability refers to the control of economic fluctuations of inflation and deflation. It also implies stability in the economic activity, output, income and development. That is taxation can be used as anti-inflationary and anti-deflationary measure. According to A.P.Lerner, "Taxation is important only as a means of reducing the purchasing power in the hands of the people and cutting their spending".

a) Anti- inflationary Role of Taxation

During an inflationary period, prices of consumer goods keep on rising on account of a rise in money income of the people. Direct taxes on income and profits can reduce a substantial part of income of the people, particularly in the higher income groups, thereby reducing their disposable income. This will result in greatly reducing consumption expenditure and hence the demand for consumer goods. This will help in reducing or curbing the inflationary pressure in the economy.

Similarly, the purchasing power of the people of the poor people can be controlled by imposing higher indirect taxes like GST sales tax, excise duty etc. The impact of these types of indirect taxes will be a steady fall in the demand for consumer goods. Since the marginal propensity to consume is very high in the case of the poor people, the effect of a tax will be reducing the demand considerably. So we can understand that taxation is a very good measure in checking inflation.

b) Anti-deflationary Role of Taxation

During a deflationary period the purchasing power of the people has to be enhance. During deflation the demand for consumer goods will fall as result of deficiency of effective demand. In order to boost up the level of demand in the economy, taxes are to be reduced or avoided if possible. This will increase the disposable income of the people. This will raise the demand for goods and services which will eventually increase the prices and production will also be increased. Thus, stability in prices will be maintained in the economy.

4.15 Major Taxes in India

The tax of the government may be classified into three categories Taxes on income and expenditure Taxes on properties and capital and Taxes on Commodities. First two types of taxes are direct taxes and the third type of tax is indirect taxes.

4.15.1 Income Tax

Income tax has become the most important type of direct tax in India. The period of assessment of income tax is one year. Money income is taken as the basis of income tax in almost all countries of the world. In India income tax was introduced in1860 by Sir James Wilson to meet the heavy expenses incurred during the Sepoy Mutiny of 1857. Though it was introduced to meet only the temporary needs of the government, it became a permanent feature of our tax system due to its revenue yield. In 1939, the rate structure was designed on a slab system.

After Independence, the government appointed Income Tax Investigation Commission 1947, to investigate all matters relating to taxation of income so as to prevent its evasion and avoidance. The Commission recommended in its report in 1948 that all loop-holes in income tax system was to be plugged. The income tax (Amendment) Act, 1953 incorporated a number of recommendations of the Commission. The Income Tax Act, 1961, as amended from time to time through Annual Finance Acts, is the basis of Income Tax in India.

A notable feature of income taxation in India is that the whole proceeds of income tax do not go to the central Government. According to the recommendations of various Finance Commissions, a large share of the total proceeds is distributed among state governments.

4.15.2 Corporation Tax

A corporation tax is a tax on net income of business corporations or companies. In India, it was introduced after the First World War and since then it has become an integral part of Indian taxes paid by shareholders on their dividends. That is, corporation i.e, interest charges, wages and depreciation costs etc. earned by the corporation during an assessment year and the remaining is distributed among the shareholders in the form of dividends. The main feature of Corporation tax is that the entire proceeds of this form the revenue of the Union Government and no share is divided among states.

Advantages of Corporation Tax

a. Since the governments confer special benefits upon the companies and corporations like perpetual legal existence, limited liability and easy capital issue, they are liable to be taxed.
b. The income of the corporations constitutes an important source of accumation of ideal income and wealth. Thus it is appropriate to tax such income and wealth in order to ensure equity in the economy.
c. The undistributed income of the corporation is mainly used as reserves or for expansion of the company. All these will enhance the capital gains, which are to be taxed.

d. It is not only that the corporations have independent ability to pay, but also that their incomes are earned from supplying services. Hence, corporation incomes should be more heavily taxed than the personal incomes.

Disadvantages

a) It is argued that the imposition of a corporate income tax and a personal income tax will bring about a double taxation. This is because of the fact that shareholders of corporations are also subjected to personal income tax.
b) It discourages investment in risky enterprises
c) The burden of such a tax falls entirely upon the ordinary shareholders and not on the preference shareholders.
d) The ultimate burden of corporation tax is to be borne by the consumers. The corporation will deem the tax as cost of production and will include this in the prices. Hence, the final burden is rested on the consumers.

4.15.3 Expenditure Tax

Expenditure tax is a tax on expenditure. It is levied when the income is spent. In India it was first imposed in 1958 following the recommendations of Nicholas Kaldor. He had suggested the imposition of this tax to prevent the possibility of tax evasion and to discourage superfluous consumption. According to Kaldor the major advantages of expenditure tax are the following:

a. It is more easily definable than income tax
b. Expenditure is better index of taxable capacity.

The expenditure tax was abolished in 1962. It was again introduced in 1964 and was abolished in 1966. In 1987, it was again introduced under the Expenditure Tax Act, 1987.

4.15.4 Taxes on Capital Transactions and Property

The expenditure tax was abolished in 1962. It was again introduced in 1964 and was abolished in 1966. In 1987, it was again introduced under the Expenditure Tax Act, 1987. The following are the major taxes in this group:

a] Estate Duty

Article 269 of the Indian Constitution provides for the imposition and collection of the estate duty in respect of property other than agricultural land, by the centre. The whole proceeds of this duty, except those which are attributable to the Union Territories, are assigned to the states with in which this duty is levyable and distributed among them in

accordance with the law made by the Parliament, on the recommendations of the Finance Commission.

An estate duty is levied when any movable and immovable property or interest there in passes or is deemed to pass at death of its owner. The tax is payable by legal heirs on the estate of a deceased person inherited by them. It is also known as death duty or inheritance tax or succession tax. This tax came in to force with effect from October 15, 1953 and was abolished from the middle of March 1985.

b] Wealth Tax

Wealth tax is a tax which is levied on the net wealth of individual. It is also known as a tax on capital or property taxation. This tax was imposed on the recommendation of Nicholas Kaldor in 1957. He justified the imposition of an annual tax on wealth on the ground of equity, economic effect and administrative efficiency.

Not all wealth holders were taxed. Wealth below rupees 2.5 lakh was exempted. Initially the tax rate was very high (15%). Consequently it led to wide scale evasion and avoidance. Subsequently the rate was reduced to a very moderate level ranging from 0.5% to 2%. In 1992-93 the finance minister withdrew the wealth tax on productive assets such as guest houses, residential houses, jewelry etc. With effect from April 1993 wealth tax is chargeable in respect of the net wealth exceeding Rs. 15 lakh at 1% only. As a consequence, of these changes, the revenue from this tax has gone down considerably. Recently the wealth tax has been recommended to be abolished.

Gift tax

The Gift tax was introduced in April 1958 on the recommendation of Nicholas Kaldor. It covered the Gifts made by individuals, Hindu Undivided Families, Companies, firms and association of persons. Initially, it was levied on the donor and not on the donee. All gifts made by a donor during a particular year were liable for Gift tax. However, the liability of paying the tax was shifted from the donor to the donee who receives the gift under the new Gift Tax Act of 1990. Thus the gift was made donee-based. The reason for the major change in the taxation on the gifts is that the mechanism of Gifts was used to split up capital and launder black money. The Gift tax was abolished in October, 1998.

Capital Gain Tax

Capital gain implies gain arising from the sale of a capital asset. Capital gains occur if the selling price of land, buildings, capital equipment, stock exchange securities, happen to be more than the amount invested in them. One of the most important characteristics of capital gains is

that it is an irregular or unusual gain, unlike a person's normal income which is regular.

Capital gains cam be divided into two categories Short – term capital gains and Long-term capital gains. Capital gains from sale of capital assets held for not more than 36 months are called short-term capital gains. Similarly, capital gains from sale to capital assets held for more than 36 months are considered long-term capital gains.

Securities Transactions Tax (STT)

This tax was introduced in 2004-05. STT is levied on the sale and purchase of securities at the dealing/strike price in addition to service tax and stamp duties collected for registration and transfer of securities.

Banking Cash Transaction Tax

This tax was imposed for the first time in India during 2005-06. It was on withdrawals of cash from a current account in a bank in excess of a specified amount on any single day. The objective of this tax is to track the black money transactions.

4.15.5 Customs Duties

Taxes on international trade, particularly known as custom duties, are levied and collected by the Central Government and entirely owned by it as per Constitutional provision. Custom duties usually take the form of import duties and export duties. That is, custom duties are levied on goods imported to India (import duties) from foreign countries and goods exported from India (export duties) to foreign countries.

Objectives of Custom Duties

For raising revenue: Custom duties are one of the important sources of revenue. For this aim, it is better to levy on goods which are largely imported than those which are produced at home.

For protecting domestic industries: Tariffs or duties may be imposed for protecting domestic industries. Protection is justified on the basis of infant industry argument. Infant industries may not be able to compete with well- developed industries. Therefore, it is argued that infant industries are to be protected till they become strong and can stand on their own legs.

For attaining equal status: To ensure an equal status to domestic industries and foreign industries, a countervailing duty is advocated. The imposition of an excise duty on the domestic goods will raise the price of domestic goods. This will be advantageous for the foreign goods and harmful for the indigenous goods. For attaining an equal status for both goods, a countervailing duty on imported goods, which is equal to the excise duty in amount, is to be imposed.

For achieving price stability: Price stability is obtained by imposing import and export duties. A reduction in import duties may increase imports bringing about a fall in prices. Similarly, an exemption of export duties will be enlarging exports which will in turn raise prices.

4.15.6 Other Taxes

Taxation of services was introduced in 1994-95 initially by levying the tax on stock brokers, general insurance and telephone services. The number of taxable services has been increased from time to time. In 2011 – 12, the service tax rate was 10% and in 2012-13 it was 12%. The union Budget 2012 – 13 introduced a negative list with effect from July 1. 2012.

VAT is a multi – point tax levied at each stage of value addition chain with a provision to allow input tax credit on tax paid at an earlier stage. It is a general consumption tax assessed on the value added to goods. In the case of sales tax, there are problems of double taxation of commodities and multiplicity of taxes, resulting in cascading of tax burden. Under VAT, set off is given for input tax as well as tax paid on previous purchases. Multiplicity of taxes with overlapping nature like the turn over taxes, Octroi, the CST and surcharges is another feature of the present indirect tax regime. VAT was unanimously acknowledged to be a major reform in indirect taxation system.

VAT was first proposed by Germany; but was first implemented by France in 1954. The European Economic Community introduced VAT in 1967. In India ‘The Indirect Taxation Enquiry Committee’ (L.K.Jha Committee, 1976) suggested adopting VAT applied to the manufacturing stage combined with a reformed system of sales taxation. In pursuance of the proposal made in the Long Term Fiscal Policy, the government introduced a modified system of value added or MODVAT in the budget for 1986- 87. It came in to force with effect from March 1, 1986. The government introduced the new Central Value Added Tax (CENVAT) scheme by replacing the MODVAT scheme, with the effect from April 1, 2000.GST has replaced all of them since July 2017.

4.15.7 Goods and Services Tax (GST)

The Goods and Services tax (GST) is an indirect tax reform measure. It is a tax on goods and services, which is leviable at each point of sale or provision of service, in which at the time of sale of goods or providing the services, the seller or service provider can claim the input credit of tax which she had already paid while purchasing the goods or producing the service. GST is similar to VAT; the only difference is that it takes into account services also. GST is a broad based and a

single comprehensive tax levied on goods and services consumed in an economy.

The Finance Minister P.Chidambaram in his Budget speech in 2006 has said: "It is my sense that there is a large consensus that the country should move toward a National Level Goods and Service Tax (GST) that should be shared between the centre and the states. I purpose that we set April 1, 2010 as the date of introducing GST. World over, Goods and Services attract the same rate of tax. This is the foundation of GST. People must get used to the idea of a GST. We must converge progressively the service tax rate and CENVAT rate. I propose to take one step this year and increase the service tax rate from 1 per cent to12 per cent. Let me hasten to add that since service tax paid can be credited against service tax payable or exercise duty payable, the impact will be very small."

The GST can be divided into following sections to understand it better :

a) Charging Tax : The dealers registered under GST (Manufactures, Wholesalers and Retailers and Service Providers) are required to charge GST at the specified rate of tax on goods ad services that they supply to customers. The GST payable is included in the price paid by the recipient of the goods and services. The supplier must deposit this amount of GST with the government.
b) Getting Credit of GST : If the recipient of goods and services is a registered dealer (Manufactures, Wholesalers and Retailers and Service Provider) she will normally be able to claim a credit for the amount of GST she had paid, provided she holds a proper tax invoice. This "input tax credit" is set off against any GST (out put),which the dealer charges on goods and services, which she supplies to her customers.
c) Ultimate Burden of Tax on Last Customer
d) The net effect is that dealers charge GST but do not keep it, and pay GST but get a credit for it. This means that they act essentially as collecting agents for the government . The ultimate burden of the tax falls on the last and final consumer of the goods and services, as this person gets no credit for the GST paid by her to her sellers or service providers.
e) Registration : Dealers will have to register for GST. These dealers will include the suppliers, manufactures, service providers, wholesalers and retailers. If a dealer is not registered she normally cannot charge GST and cannot claim credit for the GST she pays and further cannot issue a tax invoice
f) Tax Period : The tax period will have to be decided by the respective law and normally it is monthly and / or quarterly. On a particular tax period, which is applicable to the dealer concerned, the dealer has to deposit the tax if her output credit is more than the

input credit after considering the opening balance, if any, of the input credit.

g) Refunds : If for a tax period the input credit of a dealer is more than the output credit then she is eligible for refund subject to the provisions of law applicable. The excess may be carried forward to the next period or may be refunded immediately depending upon the provision of law.
h) Exempted Goods and Services : Certain goods and services may be declared as exempted goods and services and in that case the input credit cannot be claimed on the GST paid for purchasing the raw material in this respect or GST paid on services used for providing such goods and services.
i) Zero Rated Goods andServices : Generally, export of goods and services are zero-rated and In that case the GST paid by the exporters of these goods and services is refunded. This is the basic difference between zero rated goods and services and exempted goods and services.
j) Tax Invoice : Tax invoice is the basic and important document in the GST and a dealer registered under GST can issue a tax invoice and on the basis of this invoice the credit (input) can be claimed.

Normally a tax invoice must bear the name of supplying dealer, his tax identification numbers, address and tax invoice nnmbers. Coupled with the name and address of the purchasing dealer, his tax identification numbers, address and description of goods sold or service provided.

The idea of GST was first proposed in the budget speech of 2006-07 which had set out the deadline of 2010 for its introduction in the country. To implement such a tax regime a constitutional amendment would be needed as the centre as well as states is involved in this issue. To operationalize the GST, the Constitution Bill 2011 [115th Amendment] was introduced in the Parliament. The Finance Minister expressed the hope that the two tax reforms [the GST and the Direct Tax Code] would be implemented soon. Paving the way for initiation of major taxation reforms in the country, in a historical move, the 122nd constitutional Amendment bill to introduce the GST was unanimously passed by parliament in August 2016. The GST has been in operation in India since 1 July 2017. By 1 May 2018 more than 400 notifications and orders had been issued. The highest rate of GST was 28%. However the GST was reduced on many items and on many occasions before 2019 elections. For certain items the GST rates were 0%, 5%, 12%, and 18%.

The GST exemption threshold limit was Rs.10 lakh annual turnover for north eastern and hill states and Rs. 20 lakh annual turnover for other states. During 2018-19, the contribution of GST to

the total revenue of was 21% which was equal to the corporate tax (21%).

GST paid on the procurement of goods and services can be set off against that payable on the supply of goods and services. But being the last person in the supply chain, the end consumer has to bear this tax and so in many respects, GST is like a last point retail tax. The GST will subsume most indirect taxes like Value Added Tax, Service Tax, Central Excise, Entertainment Tax, Luxury Tax, Octroi, Lottery tax etc.. India will have a dual GST system where both states and centrewould have powers to levy taxes on goods and services. In short, the GST is:

An indirect tax on final consumption of goods and services
Levied on business and recovered by them on supplies
GST is typically charged on registered businesses.
Input GST incurred in relation of taxable output of goods and services is available as on offset
Objectives of GST
To lower tax rates due to broadening of the tax base and minimizing exemptions & exclusions;
To create a common market across the country, one nation one tax and one market
To reduce transaction and compliance costs.
To facilitate business decisions on purely economic considerations

4.16 Major Taxes of The States In India

Land revenue, Agricultural income tax, Stamp duties, court fee and registration, Taxes on urban immovable property, Taxes of trade, profession and employment, Motor Vehicle taxes, Entertainment tax, Electricity duties etc..

4.17 Major Taxes if the Local Governments in India

a) Taxes on Land and Buildings
b) Octroi and terminal taxes
c) Taxes on Animals and Boats
d) Taxes on Vehicles
e) Taxes on Professions, Trades and Employments
f) Taxes on advertisement other than those published in newspapers
g) Other miscellaneous taxes like theatre or show tax, duty on transfer of property, taxes on goods, passengers carried by roads, railways or trolls etc.

MODEL QUESTIONS

1. What are the major sources of revenue of the government?
2. What are the qualities of a good tax system?
3. Explain the canons of taxation.
4. Distinguish between impact and incidence of taxation.
5. What are the main principles of taxation?
6. Explain the theories of incidence of taxation.
7. Distinguish between direct taxes and indirect taxes.
8. What are the major taxes of central government in India?
9. Explain the concept of equity in taxation.
10. Write short notes on
    a) Progressive taxes and proportional taxes
    b) Regressive taxes and degressive taxes
    c) Tax shifting and elasticity of demand and supply
    d) Subjective approach of ability to pay
    e) Value Added Tax (VAT) and Goods and Services Tax (GST).

UNIT 5 PUBLIC EXPENDITURE

5.1 Meaning and Importance
5.2 Causes for the Increase in Public Expenditure
5.3 Classification of Public Expenditure
5.4 Dalton's Classification Of Public Expenditure:
5.5. Effects of Public Expenditure

5.1 Meaning and Importance

Government spending gained momentum after the Great Depression during 1930s in the USA and The publication of "General Theory" by John Meynard Keynes. He suggested government spending to get away with the problems created by the Great Depression. Till then, the world countries were expecting the market forces to clear the market gluts; but it did not happen. After government started spending huge funds, market gluts disappeared. Since then many countries started giving greater powers for the governments. Governments started taking up more and more economic activities and thus public spending (also public borrowings) started rising continuously.

The expenses incurred by the government for its own maintenance, preservation and welfare of the economy as a whole is referred to as public expenditure. In other words, it refers to the expenses of public authorities – central, state and local governments in a federation for the satisfaction of collective needs of the citizen or for promotion of economic and social welfare. The development functions include education, public health, social security, irrigation canal, drainage, roads, buildings, etc.. The major cause of increase in the public expenditure is nothing but, these developmental functions. Hence, the study of public expenditure has become very significant in the study of public finance.

The two major reasons for the larger public expenditure and borrowing are: [a] The economic activities of the state has increased manifold and [b] nature and volume of public expenditure have greatly affected the economic life of the country in a different manner i.ethey have affected production and distribution and general level of economic activities.

In the laissez-faire era, the state was assigned a very limited role to play. The functions assigned to the state were based on the principle of least interference or 'that government is the best which spends the least'. The classical school led by Adam Smith restricted the functions of the state to 'Justice, Police and Arms'. They considered government

expenditure as wasteful and that money could be used well by private persons than by the government. Adam Smith in his magnum opus 'The Wealth of Nations' published in 1776 observed that the sovereign has three main duties to perform [a] to protect the society from violence and invasion of other independent societies [b] to protect against injustice and erecting and maintaining certain public works.

According to David Ricardo, 'If you want a peaceful government you must reduce the budget'. JB say opined that 'the very system of all plans of finance is to spend little and the best of all taxes is that which is least in amount'.

In recent time, public expenditure has been increased enormously. The main reason is that functions of governments have been increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, a German economist, presented his famous 'Law of Increase of State Activities'. He states that 'comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments'. This increase is both intensive and extensive.

RA Musgrave, the twentieth century economist, advocated public expenditure since a government is forced to do many activities such as activities to secure a reallocation of resources, redistribution activities, stabilizing activities and commercial activities.

Governments constantly undertake new functions while they perform both old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a satisfactory fashion are satisfied by the central and local governments.

5.2Causes for the Increase in Public Expenditure

One of the most important features of the present century is the phenomenal growth of public expenditure. Some of the important reasons for the growth of public expenditure are the following.

A) Welfare State : Modern states are no more police states. They have to look in to the welfare of the masses for which the state has to perform a number of functions. They have to create and undertake employment opportunities, social security measures and other welfare activities. All these require enormous expenditure.

B) DefenceExpenditure: Modern warfare is very expensive. Wars and possibilities of wars have forced the nation to be always equipped with arms. This causes great amount of public expenditure.

C) Growth OfDemocracy: The form of democratic government is highly expensive. The conduct of election, maintenance of democratic institution like legislatures etc. cause great expenditure.

D) Growth of Population: Tremendous growth of population necessitates enormous spending on the part of the modern governments. For meetings the needs of the growing population and growing consumerism, educational institutions, food materials, hospitals, roads and other amenities of life are to be provided.

E) Rise in Price Level: Rises in price have considerably enhanced public expenditure in recent years. Higher prices mean higher spending on the part of the state on items like payment of salaries, purchase of goods and services and so on.

F) Expansion public Sector: Counties aiming at socialistic pattern of society have to give more importance to public sector. Consequent development of public sector enhances public expenditure.

G) Development expenditure: For implementing developmental programmes like Five Year Plans, Modern governments are incurring huge expenditure.

H) Public Debt: Along with debt, rise the problems like payment of interest and repayment of the principle amount. This results in an increase in public expenditure.

I) Grants and Loans to state Governments and UTs: It is an important feature of public expenditure of the central government of India. The government provides assistance in the forms of grants – in-aid and loans to the states and to the UTs.

J) Poverty alleviation Programmess: As poverty ratio is high, huge amount of expenditure is required for implementing alleviation programmes.

5.3 Classification of Public Expenditure

Public expenditure has been classified into a) **Revenue Expenditure** and b) **Capital Expenditure.** Revenue expenditure is current expenditure. For example, it includes administrative expenditure, salary and maintenance expenditure. This expenditure is of a recurring type. Capital expenditure is of capital nature and is incurred once for all. It is non-recurring expenditure. For example, expenditure in building, multi-purpose projects or on setting up big factories like steel plants, money spent on land, machinery and equipment.

Revenue Budget or Revenue Account is related to current financial transactions of the government which are of recurring in nature. Revenue Budget consists of the revenue receipts of the government and the expenditure metout from this revenue. Revenue Account deals with taxes, duties, fees, fines and penalties, revenue from

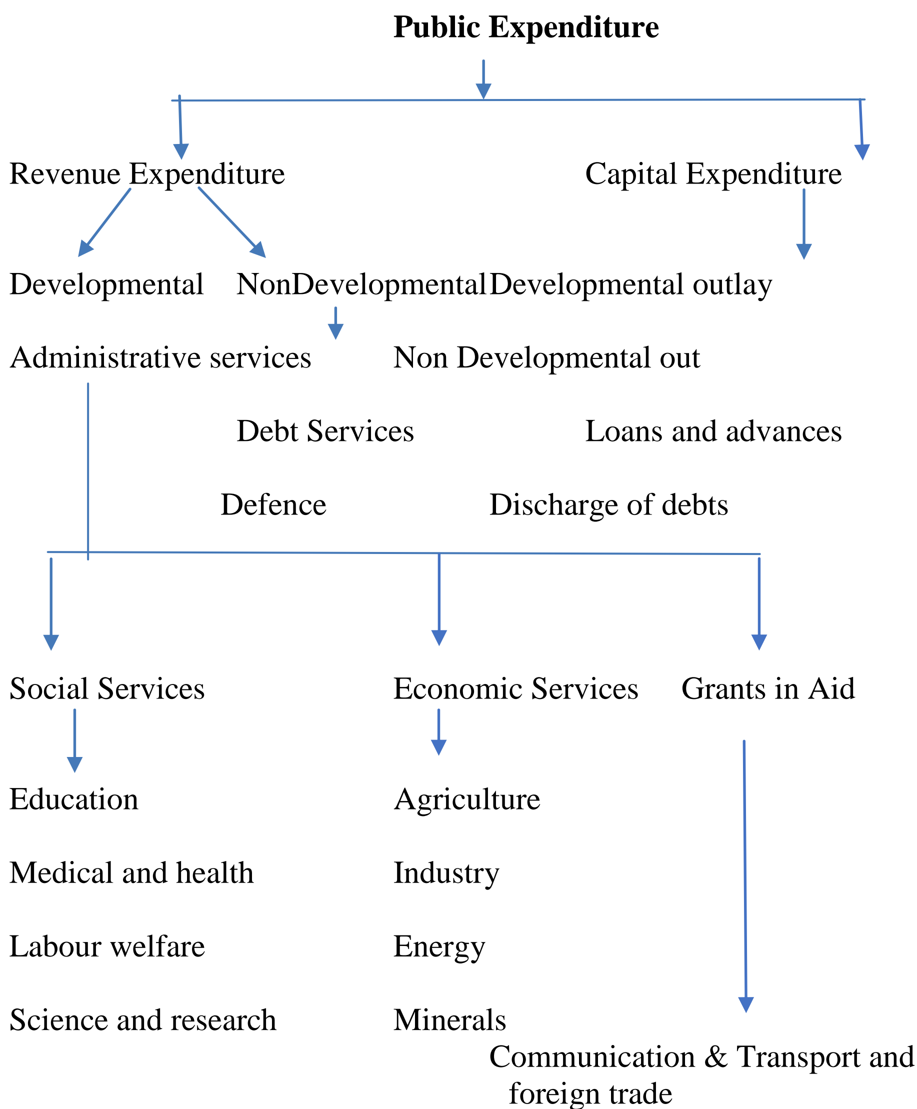
Government estates, receipts from government commercial concerns and other miscellaneous items, and the expenditure there from.

The Capital Account is related to the acquisition and disposal of capital assets. Capital budget is a statement of estimated capital receipts and payment of the government over fiscal year. It consist of capital receipts and capital expenditure. The capital account deals with expenditure usually met from borrowed funds with the object of increasing concrete assets of a material character such as construction of buildings, irrigation projects etc.

Capital Receipts include a) Borrowings b) Recovery of loans and advances c) Disinvestments and d) Small savings.

Capital Expenditure Includes

a) Development Outlay b) Non-developmental Outlay C) Loans and advances and d) Discharge of debts. This can be explained in the tree diagram given in the next page.



5.4 Dalton's Classification of Public Expenditure

Following Dalton, public expenditure may be classified as (Dalton, 1922, Principles of Public Finance, Routledge Library Editions).

A) The maintenance of the Ceremonial Head (President, Governors) of the state including diplomatic representatives abroad.
B) The maintenance of the machinery of civil government, which includes expenses of the executive and the legislative.

C) The maintenance of the army and police to protect the country from foreign aggression and to maintain law and order within the country.

D) The administration of justice.

E) The expenditure on the development of agriculture (many developed countries are paying larger agricultural subsides in various forms, but in India, this is very low, industry and commerce (few industries in India get huge subsidies), transportation and communication, ports, currency and mint, and so on.

F) Social expenditure are those on education, public health (now in India private expenditure on these fields are fast increasing) and social schemes.

G) Public debt charges including payment of interest and repayment of principle.

5.5. Effects of Public Expenditure

The traditional economists held the view that the state should least interfere in economic activities and the government is merely an agent for the people to keep political organization intact. During the time of Adam Smith the government that interfered least in the economic activities of the state was considered the best government. Till the beginning of the 20th century, state performed only limited functions – the maintenance of law and order and protection of the country from the external attack. Therefore, the state had to collect only small revenue and spend little. Recently, in almost all countries of the world there has been a phenomenal increase in the magnitude and the variety of governmental activities.

After the acceptance of the principles of welfare state, the role of the government [the necessity of maintaining full employment and

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economic development etc.] has expanded. All these show the need for an ever increasing public expenditure. In the following paragraphs we can explain the important effects of public expenditure.

5.5.1 Effects of Public Expenditure on Production

The effect of public expenditure on production can be evaluated by examining its effect on the following

a. Effect on ability to work, save and invest
b. Effect on willingness to work, save and invest.
c. Effect on diversion of economic resources

A) Ability to work, save and invest

Public expenditure may tend to influence to ability of the people to work, save and invest. This is described as efficiency effect. Public expenditure designed to increase the efficiency of the people will certainly improve the ability to work .When a person's ability to work increases, her earnings will also increase. As a consequence her ability to save also improves. For example, expenditure on education, health services and cheap housing facilities, subsidized food, free education, means of transportation, communication etc.. will increase the efficiency of the people to work. Similarly, public expenditures incurred for maintaining law and order build up the confidence in the minds of the people which will in turn encourage them to invest in production activities. Public expenditure may have adverse effects also. If public money is spent on wasteful social function or on the production of intoxicants and drugs which are detrimental to health, the ability to work, save and invest of the people may adversely be affected. Hence, public expenditure should be incurred in such a way that it is most beneficial to entire society**.**

B) Willingness to Work, Save and Invest

Public expenditure may tend to affect the willingness of the people to work, save and invest which is described as 'incentive effect. As far as the will to save and invest is concerned, it depends to a great extent on the character of the public. For example, old age pension, provident fund benefit, insurance against sickness and unemployment allowances etc..have an adverse effect on the willingness of the people to work, save and incest. This is because people will have a feeling that the government will look after them, when they are enable to earn and income. Therefore public expenditure should be incurred in such a way that it may not adversely affect the incentive to work of the people. The willingness to work can be increased by making the benefits conditional i.e,, the people may be required to contribute something in

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order to avail the benefit of social security measures. In brief, public expenditure should be incurred systematically and in a planned manner in order to provide social security measures to the maximum extent. Public expenditure should also provide opportunity under which savings and investments are properly rewarded and do not enlarge inequalities**.**

C)Directions of Resources to Different Uses and Areas

Public expenditure can significantly influence the level and pattern of production through the direction of economic resources to different uses and areas. Therefore, the government has to incur public expenditure in those areas and regions which would secure maximum national production and maximum social advantage.

For example, the public expenditure on project like roads, railways, irrigation energy etc., helps in accelerating the tempo of the economic development. Creation of such essential projects through diversion of economic resources from private use to public is very essential in developing countries. Similarly, concessions and subsides by government may help many industries and agriculture activities. According to Dalton, the role of public expenditure in the diversion of the economic resources from private use to government use and among different region is important only when the area of economic activities of the government is limited i.e in a capitalistic economic system.

The forms of public expenditure which increase the productive power and are socially very much desirable for the transfer of resources are generally of the following nature. [a] Debt redemption [b] Development project like irrigation, power and transport, roads, railways etc. [c] Promotion of education, research, invention, training etc.. [d] Provision of public health and social security etc…

Public expenditure also results in the diversion of resources among different regions. This will reduce the regional inequality which was one of the important objectives of Indian Economic Panning. In order to bring about regionally balanced growth, the government has to provide special expenditure programmes to economically backward regions. Such diversion of resources among regions is made possible by setting up a federal system of government. Grants – in -aid from central government to state governments and from state government to local governments are examples of diversion of resources.

In short, the public expenditure does have many favourable effects on production. To conclude the effect of public expenditure on production we can quote Dalton once again. "Taxation taken alone, may check production. Public expenditure, taken alone, should almost certainly increase it. The net result should be increased production of

socially desirable goods and services that maximize economic welfare of large majority of the people at the lower strata of the society".

5.5.2 Effects of Public Expenditure on Distribution

One of the important modern state polices, especially in developing countries and socialistic countries, is reduction of inequalities in the distribution of income and wealth. Public expenditure plays a vital roles in realizing this objective. According to Dalton "The system of public expenditure is the best, which has the strongest tendency to reduce inequality of income." Public expenditure which is in the form of money grants, supply of social goods and services, social security measures, subsidies etc..Certainly affects the distribution of income in a country in socially desirable way. Expenditures carried out for benefiting the poor people such as those on social services like free medical treatment, free education, unemployment benefit etc. will enhance the benefits of the poor section. This will help reducing the gulf between the rich and the poor in the distribution of income and wealth., thus bringing about justice in the economy.

5.5.3 Public Expenditureand Stability

Economic stability refers to a fairly stable level of the nation's income employment, prices savings and investment in the economy. The economy may face cyclical fluctuations on account of imperfections in the market (depression and inflation). Public expenditure can be used to check the fluctuations. According to J.M.Keynes, economic stability impliesa stable price level. ("The General Theory of Employment, Interest and Money, 1936")

During depression, the effective demand falls short of what is required. Deficiency in effective demand leads to unemployment which in turn reduces consumption and finally to fall in production. In order to solve this problem, public expenditure is enhanced to compensate the deficiency in effective demand. This increased public expenditure during the time of depression is described as compensatory public expenditure. In a period of depression , the suitable public expenditure policy will be Deficit Budgeting (i.e, current expenditure should be in excess of current revenue).

Similarly, during the time of inflation [rising prices], the public expenditure has an entirely different role to play. The government has to adopt the surplus budgeting policy. That is, the government should spend less than its revenue. After full employment, public expenditure is likely to add to inflationary pressure, for public expenditure will further increase the purchasing power of the people without any corresponding increase in production immediately.

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MODEL QUESTIONS

1. What is the importance of public expenditure?
2. Explain developmental and non- developmental expenditure?
3. How does the public expenditure affect the economy?
4. What are the causes of increasing public expenditure?
5. Distinguish between revenue expenditure and capital expenditure?

UNIT 6 GROWTH OF PUBLIC EXPENDITURE

6.2Introduction
6.2 Theories of Growth of Public Expenditure
6.3 Views on Public Expenditure
6.3Growth of Public Expenditure in Recent Times
6.5Public Expenditure of the Indian Government
6.6Control Of Public expenditure

6.1 Introduction

As mentioned earlier the expected function the state has gone increasing over the years. Police state has become entrepreneurial state and then welfare state. The capitalist system of production has a) increased the proportion of property-less people b) resulted in concentration of wealth in fewer hands c) brought large number of beggars poor people house-less people and so on. However in democratic countries, the house-less, land-less an- property less poor people fortunately have voting rights. These people were cheated by market force. For, their political power and bargaining power were negligible. For making them to live, to stand in the queue and vote for political parties, they need to be supported financially and materially. The people attached with the state spend large sums to visit various countries and they spend lavishly. For all these governments need to spend large funds. Hence the public expenditure is going on growing.

6.2 Theories of Growth of Public Expenditure

Three popular theories of growth of public expenditure are Adolph Wagner's Hypothesis,

Wiseman-Peacock hypothesis and Colin Clark's Critical Limit Hypothesis.

6.2.1 ADOLPH WAGNER'S Hypothesis

Adolph Wagner (1835-1917) believed that there was a cause and effect relation between economic growth and public expenditure. His hypothesis of "Law of increasing state activity" lays that as per capita income and output increase in industrialized countries, the public

expenditure of those countries necessarily grows, as a proportion to total economic activity.

He explained that "Comprehensive comparison of different countries and different times shows that among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments. The increase is both extensive and intensive. The central and local governments constantly undertake new functions, while they perform both old and new functions more effectively and completely."

Conclusions

A) As the national income increase in amount, the percentage of outlay of government supplied goods is greater.
B) Increased public expenditure was the natural result of economic growth and continued pressure for social progress.

6.2.2. WISEMAN – PEACOCK Hypothesis

According to Wiseman and Peacock, public expenditure does not increase in a smooth and continuous manner. The increase in public expenditure over time has occurred in a step – like manner. They studied the experience of the United Kingdom for a secular period (1890-1955). Instead of studying the trend of public expenditure, they studied the fluctuations in government expenditure over time. The general approach to the hypothesis refers to the three related concepts. They are:Displacement effect, Inspection effect and Concentration effect.

The movement from older level of expenditure and a taxation to a new and higher level is called the displacement effect.

War and other social disturbances force the people and governments to find solution to the problems, which had been neglected earlier. This is called the inspection effect. That is, new obligations imposed on state, in the form of increased depth interest and war pensions etc.

The concentration effect refers to the apparent tendency for the central government economic activities to become an increasing proportion of the total public sector economic activity, when the society is experiencing economic growth.

6.2.3 Critical Limit Hypothesis (COLIN CLARK)

The hypothesis was developed by Colin Clark immediately after the second world war. It is concerned with the tolerance level of taxation. Maximum limit of the tolerance level is 25% of GNP. When the share of government expenditure exceeds 25% in the GNP, inflation occurs.

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6.3Views on Public Expenditure

The views on public expenditure govern the public expenditure policy of the governments. The method and direction in which the public expenditureare utilizedis of paramount importance.

Alfred G.Buchler makes some guidelines for the utilization of the expenditure by the public authorities. They are as follows:

A) Public expenditure should promote the welfare of the society.
B) Careful judgement should be exercised by the public authority and the electorate to ensure that the advantages of the public expenditure should exceed the cost; and, that the fund utilised by the government will be more conducive to social welfare than the same funds would, if privately utilised.
C) Public expenditure should be utilised in the order of priority of welfare. That is, the service which will bring about maximum welfare should be undertaken first.

Findlay Shirras has explained four views on public expenditure.

6.3.1 Benefit View

The ideal of this is maximum social advantage. That is, public expenditure should be planned so as to yield maximum social advantage and social welfare of the community as a whole, not of a particular group. Public expenditure must be spent in those directions which will maximise utility. It is possible only when the marginal utility from different uses is equal. The public authority should distribute resources so as to increase production, reduce inequalities of income distribution, preserve social life of the people and improve the quality of social like etc.. "Other things being equal, expenditure should bring with its important social advantages such as increased production, the preservation against external attack and internal disorder and as far as possible reduction in the inequalities of income. In short, public funds must be spent in those directions most conducive to the public interest i.e, maximum utility is to be attained in public expenditure"… Findlay Shirras.

6.3.2 Economy View

This implies that the state should be economic in spending money. It should not spend more than the necessary amount on items of expenditure. The sole aim is to avoid extravagance and corruption. Social benefit can be maximized when resources are not wasted. While incurring public expenditure social costs are to be minimized. To satisfy this canon, project appraisal and cost benefit analyses are to be

adopted. "Economy means protecting the interest of the tax payers not merely in effecting expenditure but in developing revenue." -Shirras.

6.3.3 Sanction View

According to this view, no expenditure should be incurred without the proper approval of the sanctioning authority. It also implies that the spending authorities should spend the amount for which it has been sanctioned and see that the sanctioned amount is properly utilized. Public accounts are to be audited at the end of the financial year. This view acts as check on arbitrary, unwise and reckless spending of public funds

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6.3.4 Surplus View

This view believes in the avoidance of deficit in public expenditure. According to Findlay Shirras, "Public authorities must earn the living and pay their way like ordinary citizens. Balanced budget must, as in the private expenditure, be the order of the day. Annual expenditure must be balanced without the creation of fresh credits unrepresented by the new assets". Modern governments do not consider'balanced budget' a virtue always. In a inflationary condition, a surplus budget is desirable as it reduces purchasing power of the individuals. Similarly, in the time of depression, a deficit budget is recommended in order to enhance the purchasing power of the people. The canon of surplus is not relevant in modern public finance.

6.3.5 Other Views on Public Expenditure

a) Productivity View

Public expenditure should promote production and increase working efficiency of the people. Major part of public expenditure should be incurred on developmental activities. The aim of public expenditure should be maximum production, employment and income.

B) Elasticity View

There should be flexibility in government expenditure. That is, the government may be able to change its public expenditure policy with changing conditions. It means that public expenditure should increase during period of emergency and reduce during normalcy.

C) Equality View

This implies that public expenditure should be incurred in such a way that inequality in the distribution of income is reduced. For achieving this canon, the benefit of public expenditure should be conferred on the poorer section of the society.

D) Neutrality View

Public expenditure should improve the production – distribution – exchange – relationship and should not worsen it. Public expenditure should reduce inequality of income and wealth and increase economic activity and exchange relationship.

E) Certainty View

The public authorities should clearly know the purposes and extent of Public expenditure to be incurred. This view explains the preparations of budgets.

6.4 Growth of Public Expenditure in Recent Times

Many of the economic variables are increasing. For instance, national income, export, import, price of petroleum product and gold, SENSEX, NIFTY and so on. Size of public expenditure in many countries are also increasing due to the reasons already explained. Some details on the government spending in four major countries are given in the table. The public spending as percent of GDP was very low till the First World War. It started raising in the 1920s, there was a lull during II World War. Then, in the last 75 years from 1940, this % has continuously increased in almost all the countries, in all the years. Thus the growth in public spending is very obvious [Vide Table 6.1].

6.5. Public Expenditure of the Indian Government

The details of the plan and non-plan expenditure of the government of India have been given in the Table 6.2. Both the kinds of expenditure have been rising sharply and almost equally [Table 6.3]. Thus the rising trend of the public expenditure is found in almost all the countries in the world is clear [Table 6.1].

Table 6.1: Government Spending as a percent of GDP

Country	1880	1920	1940	1960	1980	2000	2011
Germany	11	25	12	23	50	48	47
UK	08	27	31	36	52	39	48
USA	03	08	10	30	36	36	43
Japan	01	02	04	19	36	40	41

Source: ESTABEN ORTIZ – OSPINA AND MAX ROSEV, INTERNET.

Table 6.2: Expenditure of The Indian Government (Rs. Thousand crores)

Year	Plan Expenditure	Non-Plan Expenditure	Total Expenditure
2001-1	83	243	326
2004-5	132	366	498
2005-6	141	365	505
2006-7	170	413	583
2007-8	205	507	712
2008-9	275	608	883
2009-10	303	721	1024
2010-11	379	818	1197
2011-12	412	892	1304
2012-13	413	997	1410
2013-14	453	1106	1559
2014-15 (BE)	575	1219	1794
2014-15 (RE)	468	1213	1681
2015-16 (BE)	465	1312	1777

BE = Budget Estimates, RE = Revised Estimates

We can derive the following Table 6.3 from the Table [6.2] given above.

Table 6.3: Growth Rates

Growth	Plan Expenditure	Non-Plan Expenditure	Total Expenditure
Overall Growth Rate %	462.8	440.2	445.9

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Annual Growth Rate %	30.9	29.3	29.7

6.6. Control of Public Expenditure

Expenditure control is an important element of budget execution. Through effective control system, the agencies will be able to maintain high level of fiscal discipline and to implement planned activities within the approved appropriations. Expenditure control includes elements such as administrative and financial sanctions, ascertaining availability of budgets, recording processing control including delegation and segregation, proper recording and processing, verification and certification and finally approving and distributing the payments.

Expenditures are current and capital. Current expenditure are :pay and allowance, maintenance of building and properties, office supplies, utilities etc... Capital expenditures are : acquisition of immovable properties, structures, plant and equipment, vehicles etc..

The objectives of assessment of expenditure control is to determine whether all expenditure have been approved and utilized for the intended purpose. The expenditure are classified and recorded correctly and that government agencies achieve value for the money in the use of public resources.

The auditor verifies, observes, compares and ascertains the complaints of each main indicator and sub- indicator against the specific criteria derived from laws, rules and regulations

MODEL QUESTIONS

1) Explain Wagner's hypothesis of public expenditure.

2) Explain Wiseman – Peacock Hypothesis.
3) Explain Colin Clark Limited Hypothesis.
4) What are the views of public expenditure?
5) Write a note on growth of public expenditure in recent times
6) Explain the relationship between plan and non-pan expenditure in India.
7) Write a note on “control of public expenditure”.

UNIT 7 PUBLIC DEBT

7.1Introduction

7.2Causes for Public Debt (Need for public debt)

7.3Objectives of Public Debt

7.4Important Source of Public Debt (Types of public debt)

7.5Classification of Public Debt

7.6Reduction of Public Debt

7.7Methods of Repayment of debt

7.8Government borrowing and taxation – A comparison

7.9Government borrowing and taxation – A comparison

7.10 Comparison of Private Debt with Public Debt

7.11 Role Of Public Borrowing

7.12 Role of Public Debt

7.1Introduction

Borrowing may be either internal or external. According to Philip E. Taylor, "the debt is the form of promises by the treasury to pay to the holders of the principal. Borrowing is resorted to provide funds for financing a current deficit."

7.2Causes for Public Debt (Need for public debt)

Till the beginning of the 20th Century, state performed only very limited functions – maintenance of law and order, protection of country from external attack etc.. Therefore, the state had to collect only a small revenue and a little debt. Recently in almost all countries there had been a great increase in the magnitude and variety of governmental activities. The acceptance of the principle of the welfare state has increased the role of the state's participation in many economic activities. This has necessitated the need to find out the additional sources of finance. Hence modern governments have come to rely on public borrowings.

Public borrowings is made a) to meet budget deficit b) to meet unaccepted emergency situations c) to wage war d) to remedy depression e) to use as a matching capital f) to use for development purposes.

7.3 Objectives of Public Debt

The objectives of the public debt are the following:

a) To bridge the budget deficit (deficit financing)
b) To fight against depression
c) To check inflation
d) To finance economic development
e) To meet unforeseen contingencies
f) To get an alternate source of income when taxable capacity is reached
g) To finance wars
h) To finance public enterprises
i) To carry out welfare programmes
j) To create infrastructure
k) To create productive assets
l) To create essential non- income yielding assets (provision of public goods)

7.4Important Sources of Public Debt (Types of Public debt)

Every government has got two major source of borrowing – internal and external. Internally the government borrow from individuals, financial institutions, commercial banks and from the central bank. Externally, the governments borrow from individuals and banks, international institutions like IMF, IBRD, ADB etc… and from foreign governments. They can be briefly summarized as follows:

a) Borrowings from individuals
b) Borrowing from non-banking financial institutions (Insurance companies, Investment trust, Mutual funds etc.)
c) Borrowings from commercial banks
d) Borrowings from central banks
e) Borrowings from external sources (IMF, IBRD, ADB, Foreign governance or counties)

7.5Classification of Public Debt

a. **Voluntary and Compulsory (On the basis of legal enforcement) :** Voluntary debt is the debt which is paid not by legal enforcement. Whereas compulsory is legally forced in nature. Here people have no option but to repay the debt.
b. **Funded and Unfunded Debt (Provision for repayment) :** Funded debt is long term or 'definite period' debt. A proper agreement and terms and conditions of repayment with the percentage of interest payable are declared. They are used for the creation of permanent assets.

   Unfunded debt is for a short term and for indefinite period. It is paid through the income received from other sources. These are used for meeting current needs.
c. **Internal and External Debt :** When the government raises revenue by borrowing from within the country, it is called internal debt. Whereas if the government is borrowing from the rest of the world, it is case of external debt.
d. **Productive and unproductive (Purpose of loans) :** Loans for projects, yielding income (construction of plants, railways, power scheme etc.) are called productive debt. Loans on non-income yielding projects are called unproductive. (Eg. Loans for war, famine relief etc.)
e. **Redeemable and Irredeemable Loans (Promise to repay) :** Redeemable debt refers to the loan which the governments promises to pay of at some future date (principal plus interest). Irredeemable are those principal amount which are never returned by the government but pays interest regularly.
f. **Short / Medium / Long term Loans (Time Duration) :** Short term loans are usually incurred for a period varying from three months to one year. Usually governments get such loans from central bank by using treasury bills. These loans are called 'ways and means advances'.

Medium Term Loans are those which are obtained from more than one year but less than ten years. Long term loans are thus which are obtained for more than ten years. Thee are used to finance developmental activities.

7.6Redemption of Public Debt

Redemption of public debt means repayment of a loan and it is an important responsibility of the government. All government loans should be repaid promptly. It is, therefore, necessary that the provision of repayment should be inherent in the scheme itself.

Advantages of Debt Redemption

a) It saves the government from going into bankruptcy
b) It checks extravagance on the part of the government
c) It preserves the confidence of the lenders
d) It makes easy for the government to float future loans.
e) It reduces the cost of management of public debt
f) It saves the future generation from the pressure of public debt
g) It creates favourable climate for investment
h) It acts as a useful tool to curb deflation.

7.7 Methods of Repayment of Debt

A. **Repudiation :** It means refusal to pay debt by the governments. This method was followed by the USA after the civil war and by the USSR after the 1917 revolution. This method is undesirable and has not been used recently anywhere in the world. Repudiation shakes the confidence of the people in public debt and many provoke retaliation from creditor countries.

B. **Refunding :** Refunding is the process of replacing maturing securities with new securities. In some cases the bonds may be recommended before the maturing date when the government intends to rearrange the maturity of outstanding debts or when the current rate of interest is low. Generally, short term borrowings are made in anticipation of tax collectionsfor meeting current expenditure. However, excessive burden of new expenditure does not permit the retirement of the debt by means of revenue newly raised or by means of long term borrowing. Thus, there is necessity of refunding the loans by old lenders and renewing the loans at lower rate of interest for future period. The drawback of this method is that government is tempted to postpone its obligation of debt redemption. This leads to a continuous increase in the burden of public debt in future.

C. **Conversion ofLoans** : It is a special type of refunding. Conversion of existing securities into new securities before maturity is generally resorted to reduce the burden before by converting high interest loans into low interest loans. According to Dalton, the conversion does not reduce the burden of public debt in the state; because a reduction in interest rates reduces the ability of the creditors to pay taxes which means a loss of income to the governments there by reducing its capacity to repay loans.

D. **Sinking Funds :** Sinking fund is a special fund created for the repayment of public debt. There is a theoretical justification for creating this fund because it imposes a requirement on the government to pay the old debts regularly. According to this

method, the government sets asides a certain amount out of the budget every year for this fund. The balances in the funds are also invested and the interest accruing on them is also credited in the fund.

Sinking fund is of two types : Certain sinking fund – here, the governments credit a fixed sum of money annually. In the case of uncertain sinking fund the amount is credited when governments secures a surplus in the budget. The one danger of this method is that the government may not wait till the end of the period of maturity and utilize the fund for some other purpose than the one for which the fund was created originally.

The practice of sinking fund inspires confidence among the lenders and the enhancement of the creditworthiness of governments.

E. **Capital Levy :** Capital levy is a special type of “once for all’ tax on the capital, imposed to repay war debts. All capitals are taxed above a minimum level of assets possessed by residence of the country. Capital levy refers to a very heavy tax on the property and wealth. This tax was levied immediately after the first world war. This method has been advocated by economists like David Ricardo, Pigouand Dalton. Dalton has suggested capital levy as a method of debt reduction with least burden on the society. It is useful on account of its deflationary character.
F. **Surplus Budget:** Quite often, surplus budget is used to clear public debt. But in recent times, due to the ever increasing public expenditure, surplus budget is rare phenomenon.
G. **Buying up Loans :** Governments redeem debt through buying loans from the market.

7.8Government borrowing and taxation – A comparison

Both of them – borrowing and taxes – comeform the general public. In both cases the total volume of the money in the country will remain the same. However, while tax is not paid back to any group directly, the loan amount is paid back to the lenders viz., those who hold government bonds. A tax is paid out of current income and hence will affect the consumption inthe first instance and saving later. On the other hand, a loan is made out of saving or capital, it will not affect consumption but will affect the saving. Through loan, governments help the rich who get interest income and taxes poor.

7.9 Comparison of Private Debt with Public Debt

Both public and private borrowing imply diversion of funds from one use to another. In both cases borrowings are used to acquire certain resources.

Individual spends the borrowed funds on herself. But the government spends the borrowed funds on the community as a hold. Similarly with the repayment also.

In the private debt, the lender sacrifices money, the borrow enjoys the money. In the case of public debt, the lender, the general public, also gets benefit (from government spending). When the government pays interest it is also (tax) lenders' money going as interest to some other lenders.

The rate of interest for public loan is normally lower than that for the private loan.

7.10 Role of Public Borrowing

Economists argue that the governments use taxation to finance current expenditure and use the borrowing to finance capital expenditure. In case of developing nations both borrowing and taxation are used to finance development projects.

In times of war, substantial pressure may be applied to induce individuals to curtail consumption and to subscribe to governments loans.

Government borrowing from commercial bank and the central bank of the country may create additional purchasing power.

If interest rates are higher, and, the advantages attached to the government bonds are greater, the demand for the private company shares will decline and consequently, the prices of stocks and shares will come down. This is called as 'crowding out effect' in the credit market.

Government expenditure financed by borrowing will result in additional demand for goods and services. If the economy is working below full employment level, it will stimulate greater investment.

Loan finance implies that all those benefiting from government expenditure will have higher real income.

When government expenditure is meant to provide more economic welfare to a lower income groups, then the result will be a narrowing down of inequalities and a more equal distribution of income between people.

Interest represents a transfer of real income from the tax payer to the bond holders. The government has to tax the common people to pay interest to the bond holders (who are relatively richer). Thus the

poor people who pay taxes suffer and the relatively rich who lend loans to government get benefits through interest. If the tax payers and bond - holders are of same economic class, then there is no problem; but this is not the case normally.

Foreign loans are meant to finance the import of goods without paying for them immediately through exports. If foreign imports are consumer goods, they tend to reduce inflationary pressure, if any. If the imports consist of machinery, raw materials, technical know – how etc., they will have favourable effect of speeding up industrialization in the country .If foreign loans are meant for financing a war or modernizing an army, then the effects are known to you.

7.11 R Role of Public Debt

Borrowing refers to the methods of securing funds. Debt is the accumulated borrowing. The effects of borrowing refers to those of a programme of government expenditure financed by borrowing (as contrasted with the effects of a similar program financed by taxation). The effects of public debt refer to theeconomy which are caused by the existence of a public debt, after it has been incurred.

The existence of a public debt has an important effect on consumption. The government bonds are like wealth to those who own the bonds. This wealth would not have been there if the government had chosen to finance its expenditure through taxation.

The possession of government bonds would induce the bond – holders to spend more in excess of their current income. Thus public debt increases the private spending on consumption.

Those who have government bonds have highly negotiable and highly liquid form of assets. Bonds can easily be converted into cash. Thus, the public debt is responsible for the existence of highly liquid form of assets.

Public fund involves the use of funds and those expenditure which are considered essential and more useful than those on which the funds would have been used otherwise. If ideal funds are channelled into the development of railways, irrigation and power projects etc., the diversion is really justified.

Externally held debt may mean a certain impoverishment of the economy. The paying of interest and debt redemption to foreign countries means a corresponding reduction of national income. If the foreign debt is incurred to meet war expenditure, it would be a dead-weight debt.

External debt can be a source of trouble to a debtor countries. Creation of export surplus to repay the external debt, means an ‘exhaustion of the countries future capacities to import”. If the external debt is used productively to feed the people, then there is no trouble.

MODEL QUESTIONS

1. Distinguish between “private debt and public debt” .
2. Distinguish between “Borrowing” and Debt”.
3. What are the causes for public debt?
4. What are the objectives of public debt?
5. What are the sources of public debt?
6. Explain different kinds of public debt.
7. Explain the methods of repayment of debt.
8. How does borrowing differ from taxation.

UNIT 8 PUBLIC DEBT IN INDIA

8.1 Introduction
8.2 India's Public Debt before Independence
8.3India's Public Debt Since Independence
8.4Borrowing Programmes Till 2019 – 2020
8.5Components Of India's Public Debt
8.6Debt Position of the States
8.7 Patterns of Public Debt Growth

8.1Introduction

Public debt is of recent growth and was not heard of prior to the 18th century. In modern times, borrowing by the state has become a normal method of government finance along with other sources such as taxes, fees etc. The government may borrow from banks, business houses, other organizations and individuals. The government loan is generally in the form of bonds (or treasury bills if the loan is required for the short periods) which are promises of the government to pay the holders of these promises the principal sum along with the interest at the agreed rate.

There is some expenditure of the government which is of a capital nature, which therefore is generally met by the government by borrowing. In times of war also, government may have to borrow. Thus public debt may be partly internal and partly external.

The government of India, like all governments, has borrowed in the past and does so now. The constitution empowers the union government to borrow upon the security of the consolidated fund of India. Similarly a state may borrow with in such limits as may be fixed by its legislature. A state, however, cannot raise a loan without the sanction of the government of India.

8.2 India's Public Debt Before Independence

In the early British days, Government borrowings where mainly for war purposes. India was saddled with the expenses of all the foreign wars and expeditions in Afghanistan, Burma, China, Persia, Egypt and Abyssinia. Some other expenses in London where also charged to India. During the first World War, India made a gift of 100 Million UK Pounds to the British government which added to the unproductive debt of this country.

A large part of the early Indian public debt was raised for financing railway construction, irrigation works, etc.. Most of these loans were raised in England at high rate of interest. In 1939, the total Indian public debt stood at rupees 1,206 crores. In March 1946, total rupee debt rose to 1940 crores.

8.3India's Public Debt Since Independence

Public borrowing has increased in the post- Independence period largely because of the needs of planned development. Borrowing in foreign countries also had to be resorted to particularly because of the foreign exchange requirement of the plan. Among the internal interest bearing obligations of the government of India, the loans, treasury bills, and small savings figure prominently. And item which is an entirely post – Independence peculiarity is the U.S. Government counterpart funds, which have been available through Public Law 480 (PL 480) loans from the USA.

8.4Borrowing Programmes Till 2019 – 2020

After independence, the response to governments borrowing programmes was not very encouraging. Therefore, only a modest target was laid in the first 5 year plan. A total of rupees 520 crore was to be raised from internal sources – Rs. 115 crores from loans RS. 270 crores from small savings and deposits, and Rs. 135 crores from miscellaneous sources. Target for second five year plan was Rs. 1200 crores,. For third five year plan was Rs.1400 crores., for fourth five year plan was Rs.4,307 crores.

Borrowings and other liabilities government of India are Rs.5.32 lakh crores in 2015 -2016, Rs. 535 crores in 2016-2017., Rs.5.91 lakhcrores in 2017-18, Rs.6.24 errors in 2018-19 (Budget estimate), Rs.6.34 lakhs croresin 2018-19 (Revised estimate), and, Rs.7.04 lakh croresin 2019-20 (Budget Estimate).

8.5Components Of India's Public Debt

The public debt of government of India is composed of internal debt and external debt. Internal debt comprises a) market loans b) Compenstion bonds c) price bonds and d) 15 year annuity certificates. It also includes borrowing of a temporary nature viz., Treasury bills issued to the RBI, commercial banks etc., and also non – negotiable, non- interest bearing securities issued to international financial institution like the IMF, World bank and the ADB.

Initially, the central government borrowed mainly for financing development schemes. Now, it is really alarming that the central government is forced to borrow even to meet its current revenue expenditure. It means that the government has been living beyond its means.

External debt has increased from just 1.0% of the total debt in 1950-51 to about 5% in 2002-2003. The increase in the share of external debt is explained by the rapid rate at which external assistance had been obtained.

The largest share of India's external debt is provided by the USA. Dollar loans constitutes over 30% India's external debt.

In addition to public debt, the government of India has certain other liabilities such as small savings schemes, provident funds, deposits under the compulsory deposit schemes, income tax annuity deposit schemes, Reserve funds of the railways, Post and telegraphs etc.(In 2019 the Central government obtained 98% surplus of the RBI, earlier this % was very small).

The outstanding liabilities of the central government comprising internal and external liabilities as a proportion of GDP were 55 % in 1991. It started declining trend till 1998-1999 when it touched 51% since then they have started rising.

The increasing trend in the internal liabilities is a matter of serious concern. This has not only raised the interest burden, but also raised concern about sustainability of growing internal debt.

The burden of servicing public debt and other liabilities is becoming heavier with every passing year. Interest payment of the centre is now Rs. 6.65 lakh crores (2019-20 Budget estimate). It was Rs.5.28 lakh crores in 2017-18, Rs.4.80 lakh crores in 2016-17, Rs.4.41 lakh croresin 2015-16 and Rs.1.15 lakh croresin 2002-03.

8.6Debt Position of the States

Earlier, The total debt of the state was classified into public debt and unfunded debt. This classification does not exist now. In the new classification the major head of debt are :

I. Internal debt this comprises a) Current market loans and bonds issued in connection with the Zamindari abolition; b) Ways and means advances and overheads repayable within seven days from the RBI, and c) loans from banks and other institutions such as loans from the State Bank of India, and other commercial banks, national credit fund of NABARD, Employee's States Insurance Corporation etc

II. Loans and advances from the central Governments

III. Provident funds : This includes state provident funds, insurance and pension funds, trust and endowments etc..

8.7Patterns of Public Debt Growth

1. The aggregate public debt of state governments as ratio of GDP is now around 27%; it is increasing by 1% every year. The increasing trend in state debt – GDP ratio is significant since 1997.
2. A major component of internal debt is the advances from the national small saving fund.
3. The share of central loans and advance in the total debt of state governments has been steadily declining since 1961.
4. Heavy indebtedness of states to the centreis due to such diverse factors as block loans for state development plans, clearing over-drafts of states with RBI, etc.
5. State governments have been gradually shifting towards higher – cost sources. The interest burden of state has been steadily raising
6. Often state governments request the central governments to convert their over-drafts into loans.

The growing debt burden of the state has been a source of serious concern for the state and the centre.

MODEL QUESTIONS

1. Why are the public debts growing in the recent years in India?
2. Trace the public debt position in India.
3. What are the components of India's public debt?
4. Explain the debt position of Indian states.
5. Discuss the partners of public debt growth?

NOTES

UNIT 9 PUBLIC BORROWING

9.1Introduction
9.2 Sources of Public Borrowing
9.3 Development Finance in India

9.1 Introduction

Public borrowing refers to the method of securing funds, and it is one of the four alternatives available to the government. The other sources are taxation, profits from state enterprises and money creation. The effects of borrowing, therefore, refers to those of a programme of the government expenditures financed by borrowing as contrasted with the effects of a similar programme financed by taxation. So, public borrowing is the method and means of securing funds. Whereas the public debt is the total amount of loan amount raised . The government issues bonds and securities for borrowing money. Different methods of borrowing will have different effects on the society, economy and on the various classes and sections of the society.

9.2 Sources of Public Borrowing

As mentioned earlier, Government of India has got two major sources of borrowing, namely, internal sources and external sources. Internal sources include market loans, compensation bonds, prize bonds, annuity certificates, treasury bills, commercial bank etc.. Government has certain liabilities **such** as small saving schemes, provident funds, deposits under the compulsory deposit schemes, income tax annuity deposit schemes, reserve funds of the railways, post and telegraph etc.

Through issuing non-negotiable, non-interest bearing securities to international financial institution like the IMF, World Bank and the Asian Development Bank [ADB], Government of India obtains funds. The largest share of India's external debt is provided by the USA. Dollar loans constitutes over the 30% of India's external debt. The major countries that have extend loans to India are : Germany, Japan, UK, and USA. The major institutions that have lended to India are : IBRD (World Bank), IDA, ADB, and IMF.

Multilateral borrowings include government borrowing and non-government borrowing. Under both the heads, there are concessional and non-concessional loans from. IBRD,IMF. Bilateral borrowing also includes the above. Under Non-Government borrowing, public sector, financial institution and private sector are the largest loanees. Commercial borrowing include commercial bank loans,

securitized borrowings, International Financial Corporation, Washington. NRI deposits and foreign currency (Banks and others) deposits are also utilised by the government of India.

9.3 Development Finance in India

Till recently India was an exemplary instance of the use of development banking as an investment of late industrialization . That turn to and emphasis on development banking in the immediate aftermath Independence is explained by two features characterizing the Indian Economy at that point in time : One was the inadequate accumulation of own capital in the hand of indigenous industrialists; and other was the absence of a market for long term finance (such as bond or active equity markets).

The financial structure at the time of Independence reflected the underdeveloped nature of the economy with unduly low levels of domestic savings and investment. As a result, the financial structure was inadequately diversified. In terms of the share of financial assets, the RBI dominated, with 47% of the total, followed by the commercial banks as a group with 26% and the imperial bank with 8% Exchange Banks were established to finance foreign trade. But they had brought their share in assets down to 5%. Postal savings, cooperatives and insurance company accounted for 4% each and pension funds for a mere 2%

There are limits to which banks could be called upon to take on the responsibility of financing long term investment. Banks attract deposits from many small and medium (besides small large) depositors, who have relatively short savings horizons; who would prefer to avoid income and capital risk; and expect their savings to be relatively liquid, so that they can be easily drawn as cash. These deposits are not suitable to lending to industrial investors for making lumpy investments for long periods. Hence other sources for long term loans need to be found.

9.3.1 Development Finance Institutions (DFIs)

Due to the above mentioned reasons, the state created and promoted development banking infrastructure . That infrastructure was created over a relatively long period of time and was populated with multiple institutions often with vary different mandates. Funds for the development banks came from multiple sources other than the open "market", namely, government's budget, the surplus of the Reserve Bank of India (Around 90% of the surpluses of RBI was given to the government of India in the year 2018), and bonds subscribed by other financial institutions. Given the reliance on the government sources and

the implicit sovereign guarantee that the bonds issued by these institutions carried relatively lower cost, facilitating lending for long term purposes with relatively low interest rate. These Development Finance Institutions (DFIs) where very different from banks, and where modeled along the lines of the KREDITBANKEN in Germany during its industrial take off. The DFIs lent not only for working capital purpose, but also to finance long term investment as well, including capital intensive sectors. Having lent loan, they are very often willing to lent more in the future. So DFIs are closely monitoring the activities of the borrowers, resulting in a special form of "relationship banking". The DFIs are also nominating directors on the boards of borrowed companies. Thus the DFIs have insider's view of the functioning and fiancé of the companies involved. The DFIs provide technical assistance for drawing a project plans, identifying technology, implementing the project and even operating plants. This requires more than the financial expertise. Hence the DFIs build a team of technical and managerial (besides financial) experts. After doing so the DFIs do not want their borrowers to die. If the companies are closed, the DFIs would incur loss. So the DFIs continue to finance even the loss-making borrowers. Thus the DFIs lend to insolvent institutions as well. Since the DFIs would come to safeguard the insolvent companies, the company share-holders have faith in the DFIs. The DFIs provide merchant banking services to firms they lend to, taking firms to market to mobilize equity capital by under writing equity issues. Firms using these services benefit from the reputation of the DFIs and from the trust that comes from the belief of individual and small investors that the DFIs would safeguard their investment by monitoring the firms concerned on their behalf as well. Thus the DFIs lend and invest. The DFIs undertake entrepreneurial functions that can ensure that lending leads to productive investment that accelerates growth and make such lending sustainable.

9.3.2 Indian Experience

Indian's Experience with DFIs began with the establishment of the Industrial Finance Corporation of India (IFCI).In July 1948. There have been three phases in the evolution of the development banking. The first phase began with the Independence and extends to 1964 when the Industrial Development Bank of India (IDBI) was established. Gradually the scope of DFIs increased. By 1971, Life Insurance Corporation (LIC), Unit trust of India (UTI) and general insurance cooperation (GIC) had joined the group of DFIs. However their share put together was just 2.2% of gross capital formation. In the second Phase i.e, between 1964 and 1991, this share increased to 10.3%. In 1993, this was still higher that is 15.2%. Then gradually the importance

of DFIs declined. Due to labialization, many firms left the DFIs. By 2011 – 12, the assistance disbursed by the DFIs amounted to just 3.2% of Gross Capital Formation. During this period, WB, ADB, IFC (International Financial Corporation)and bilateral aid institutions were also lending to India.

There was little concern for sustainability and the environment. Large projects (such as big dams chemical plants, power projects and large scale miming) were pushed through, despite their adverse environmental effect and with little effect to mitigate those effects.

9.3.3. Transformation of Indian Finance

The pattern of financing of investment began to change in the 1980, when the availability of the foreign finance from the private financial market (as opposed to the bilateral and multilateral development aid network) opened up, largely because of changes in the international financial system. That access was seen as providing an opportunity to pursue more outward oriented development strategy. The balance of payment crisis of 1991 served as a trigger for that transition. The resultant financial liberalization provided for a growing role for private firms (domestic & foreign) in the financial sector. These private firms resented the availability of DFIs to obtain concessional finance. The government also encouraged private firms because of its commitment to liberalization reflected in the Narasimham Committee Reports of 1990s, especially 1998. Those reports triggered the process of transforming lending DFIs into commercial banks, starting with the ICCI (Industrial credit and Investment Corporation of India) in 2002 and IDBI in 2004. As a result the disbursal of assistance by DFIs collapsed and some DFIs were closed.

9.3.4 Assessment of key Institutions and Policies

Till the onset of liberalization, the DFIs were a key element of India's overall development strategy. When India won Independence from the British, it chose to adopt a development path that was unusual and perhaps unique. Despite the country's low level of per capita income, its geographical vastness, its large population and social diversity, The government decided to pursue a state-led strategy of development with a central role for development planning, but within a frame-work of mixed economy that gave the private sector an important role. All these features made the Indian development experiment and issue of interest to observers from across the world.

Since India's capitalist class was still to consolidate itself in full, the state needed to support the development process with its own investment and channel resources to support the investment of the private sector. Since development planning had to take into account the societal goals of a spatially and vertically unequal society, the state needed to guide investment in socially desired directions and regulate private capital to ensure it also delivered social benefits rather than merely serving private interest. For these two purposes mentioned above, the Planning Commission in India became a powerful body to design important policies perused by different ministries and departments. Government played not only regulatory but also promotional role. The state (government) made the effort to utilize the surplus fund in the best manner. For this a) there were physical controls such as licensing and foreign exchange allocation b) Statutory Liquidity Ratio (SLR). The SLR was 20% in 1949, 25% in 1964, 38.5% in 1990. After that, due to the influence of economic reform, it was reduced (23% in 2012).

Since 1980, much of the government's borrowing from the banking system supports its revenue or current account expenditures rather than spending on capital formation. The approved security consisted largely of government securities and public sector bonds.

The government nationalized the insurance companies and used the savings to direct the resources to priority areas of investment. Government choose to nationalize 14 commercial banks in 1969 and again 7 banks in 1980. Government provided seed money to DFIs by using a part of budgetary resources and some of the "profits" of the RBI. This is how state was able to look after the financial requirement for the development of the economy.

9.3.5 New Source of Finance

The shrinkage of DFIs after liberalization raises a question. Where did the new financing come from? One source of financing was internal funds. Internal sources such as retained profits and depreciation reserves accounted for a much higher share of corporate finance during the equity boom of the first half of 2000s. This share, according to the RBI is 30% during the second half of 1980s, 37% during the second half of 1990s and 61% during 2000 to 2005.

How did the share of interest raise? First increased corporate surplus resulting from enhanced sales and stagnant real wages. Two, sharp decline in nominal interest rates. Third, tax concessions and loop-holes. These are the ways through which corporate sector mobilized more cash in the hands.

Over a period, a set of quasi-public and large private companies are given the task of financially supporting infrastructure development

in India. However, the burden of financing has fallen on the government. According to some observes the benefits of infrastructure promotion are garnered by the private sector and the costs are borne by the government. When projects prove unviable, public sponsored entities suffer losses. But when profits are made it is the private sector that is the beneficiary.

9.3.6 Multilateral Agencies and Infrastructure Finance

The trends on the domestic financial front have been considerably strengthened by the support they have received from multilateral institutions like World Bank (WB), ADB and the International Finance Corporation (IFC). The WB has setup Global Infrastructure Facility (GIF) to finance infrastructure in developing countries.

9.3.7 Commercial Banks and Infrastructure Development

The role of commercial banks has risen sharply to touch 24% of the total in 2003 – 2004. Scheduled bank credit to large and medium industry grew at compound rate of 25% per annum. The ratio of scheduled of commercial bank (SCB) credit to GDP is also constantly raising after 2000. Among the industry, the infrastructure received larger portion of credit from the SCBs. Infrastructure has got long gestation gap also. The major sectors under this category are power, roads, ports, telecommunications and civil aviation. These sectors require lumpy and long term investments. Hence, SCBs with short term deposits should not go for long term and lumpy loans. As expected, private banks have been unwilling to commit much to this risky business. So, these sectors have turned to external commercial borrowing route, that has been energized with tax concession in the liberalized era. As a result India's external debt has risen sharply; within this external commercial borrowing was larger. The sectors mentioned aboveand some more which were called stressed sectors (and the loans given to them where called toxic loans) could not repay the loans. Hence the volume of non-performing asset (NPA) increased. That created problems for the commercial banks. They could not maintain the capital adequacy ratio as per Basel norms. In order to help those banks with larger NPAs, the government is injecting funds around Rs.80,000crores into the banking system, as per the 2019-20 Budget presented by Ms.NirmalaSitharaman, Hon'ble Finance Minister, Government of India on 5th July 2019.

Thus, the owners of private companies who claim to be very efficient, divert the funds to their personal uses and make the firms bankrupt. Finally the government has to come forward and bail out those sick firms. It has happened in the US in 2007- 08. The so-called

efficient and global rich companies incurred huge loss and the US Government bailed out. In India, many private companies have collapsed, and the owners of those companies ran away and hid themselves in foreign soil to escape from the Indian Judicial procedures. Finally, the government has to come forward and safeguard the interest of the share-holders, stack-holders, workers, customers and so on. As a result the financial burden and debt of the government increase ultimately. It is the tax payers on whose shoulder the total burdens falls.; and, the tax payers have to pay the taxes silently. There is no alternative (TINA). (NOTE : This material has been generated from the writings of C.P.Chandrasekhar, a faculty in Jawaharlal Nehru University, Delhi.)

MODEL QUESTIONS

1) What are the major source of public borrowing?
2) Explain the recent trends of government borrowing.
3) Discuss the contributions of development finance institutions in India development.
4) What are the problems faced by commercial banks while extending loans to the corporate sector?
5) How did the financial liberation affect the financial burden of the cooperate sector?
6) How did the government of India promote industrial development in India?
7) Why did the government of India inject funds into banking system?

UNIT 10 FEDERAL FINANCE

10.1 Meaning and Definition
10.2 Principles of Federal Finance
10.3 Analysis of Division of Revenue Expenditure and Powers
10.4 The Methods of Bringing Fiscal Balances in Federal System
10.5 The recent trends in fiscal federalism
10.6 Financial relations between centre and states
10.7 Financial relations in India
10.8 Division of Resources
10.9 Distribution and Allocation of Central Revenue
10.10 Recent Trends in Centre – State Relationship

10.1 Meaning and Definition

Federation maybe defined as a form of political association in which two or more states constitute a political unity with a common government, but in which the member states retain a measure of internal autonomy.

R.N.Bhargava states that federal finance refers to the finance of federal as well as of the state government and the relationship between the two.

With regard to federation, Kenneth C Wheare states that it is a form of government in which sovereignty or political power is divided between the central and local governments so that each of them, within its own sphere, is independent of the other.

According to Sir Robert Gorson, federal principle is the method of dividing the powers so that the general and regional governments are each, within its own sphere, interdependent and independent.

Wallace E. Oates defines federalism as special kind of decentralization, where the division of power ensuring safeguards of the units of federation, is constitutionally protected.

The subject matter of federal finance, in brief, indicates the principles and policies governing the distribution of functions and funds among the public authorities in a federal setup. In a federal setup there are different levels of governments, namely centre state and local.

10.2 Principles of Federal Finance

In a federation there is a division of legislative, executive and financial power between the centre and state governments. The duty of the federal governments is to fulfiltheir responsibilities towards the states while utilizing its own financial powers within its own jurisdiction. There are certain principles for the smooth functioning of a federation.

a) Principle of Independence and Responsibility

The first principle for the efficient and smooth functioning of the federal financial system is that each government should have independent financial resources and should be responsible for raising resources for meeting its obligations. Financial independence and responsibility are two fundamental requisites for the success of fiscal federalism. Full freedom of financial operations must be extended to both federal as well as state Governments in order that they may not suffer from a feeling of cramp in the discharge of their normal activities and in the achievement of their legitimate aspirations for the promotion of social and economic advancement. In other words, national and sub-national governments should be financially independent within their own sphere. Besides, each government should take the responsibilities of taxing, borrowing and raising resources in their spheres for performing their functions. The authority which has the pleasing job of spending money should also do the unpleasant job of taxing it. Thus "taxing autonomy and spending autonomy go hand in hand".

However, it is very difficult to put in to practice the financial independence. This is because of the problem like uniformity in tax rates throughout the federation, promotion of economic growth, maintenance of internal and external stability, balancing social and economic development in all regions etc. cannot be ignored. The cardinal principle to be followed in a financial statement is that, as far as practicable, the federal government and the states should be endowed with independent sources of revenue free from mutual interference and that the balancing factors should come in only marginally, so as to fill the gaps.

b) Principle of Adequacy and Elasticity

The principle of adequacy means that the resources of the federal government and local government should be adequate so that each layer of government can discharge its obligations laid upon it.

Principle of elasticity means that there must be feasibility to expand its resources in response to its requirements especially during the period of internal and external crisis.

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c) Administrative Economy and Efficiency :

The administrative cost of finances should be at minimum and there should be no tax evasion. Administrative efficiency can be achieved, if the resources are allocated properly between the centre and the state governments.

d) Principle of Uniformity and Equity

Principle of uniformity means that there should not be any discrimination among different units in a federation, while distributing resources among various states. Thus, the contribution of each state in federal taxes should be according to ability or economic considerations. Similarly, in order to achieve equity in taxation, a proper balance between direct and indirect taxes should be maintained. Therefore, there should be a proper adjustment between federal and state taxation to make the tax burden on all citizens equitable as far as possible.

e) Principle of Accountability

Freedom and democracy are interwoven in a federal system. Therefore, the government in a federation should be accountable to its own legislature for its spending and collecting revenue decisions.

f) Principle of Fiscal Access

This implies that there should not be bar on federal and state government in tapping new sources of revenue within their own prescribed areas to meet the growing financial needs. That is, resources should grow with the expansion of responsibilities.

g)Principle of Transfer of Resources

This means that there should be provisions for transferring the resources from one state to the other. The ideal allocation of resources between federation and states should be in accordance with the principle of national minimum which can be achieved through the transfer of resources from rich countries to poor regions in a federal set-up

h) Principle of Federal Supervision

There should be supervision by the federal government to ensure whether state governments follow the rules and regulations with regard to taxation and expenditure laid down by it from time to time.

i) Principle of Integration and Coordination

According to this principle, the whole financial system of a federation should be well- integrated and coordinated. Integration of financial systems of federal government and state governments is essential in contemporary federations. Similarly, coordination is essential for smooth and efficient functioning of federal financial system.

j) Social Principle of Federal Finance

The social principle of an effective system of federal finance is fiscal equity. Fiscal equity requires that individuals in similar economic circumstances should receive equal net fiscal benefits where they reside in the nation. For achieving fiscal equity in a federal country there are two ways. First, through introduction of equalizing transfers that provide additional revenue to areas with relatively low revenue capacities and / or relatively high expenditure needs. Secondly, through the imposition of basic minimum national standards with respect to certain public goods.

10.3 Analysis of Division of Revenue, Expenditure and Powers

There are two types of fiscal imbalances in a federal nation. They are: Vertical Fiscal Imbalance (VFI) and Horizontal Fiscal Imbalance (HFI).

a) Vertical Fiscal Imbalance (VFI)

The ideal situation in a federation is to have a state of vertical balance. That is, matching of expenditure responsibility and taxing powers, enabling each level of government to be financially sufficient. The imbalance in this regard is termed as vertical fiscal imbalance. The VFI refers to the difference between expenditures and revenues at different levels of governments. VFI arises when one level of government's financial resources exceeding its needs, the other lacks sufficient resources to carry out its functions. This is a common feature of all multi-level governments. A common solution to tackle this type of imbalance is a scheme of intergovernmental grants as a corollary to the allocation of taxing powers.

b) Horizontal Fiscal Imbalance (HFI)

HFI is referred to the existence of economic inequalities among the states. It refers to the mismatch between revenues and expenditures of governmental units within a level of governments. It refers to inter-state economic disparities resulting from differences in area, climate, topography, soil and mineral resources, factor endowments etc.

10.4 The Methods of Bringing Fiscal Balances in Federal System

Generally the central government has got the powers to levy those taxes which are more elastic and which can bring more revenues. Whereas the state governments are responsible to carry out such activities which require more expenditures. Hence, the centre may have revenue surplus and the states may have revenue deficits. However, in India, both the Union Government as well as state governments do have revenue deficits.

Similar to the above disparities, there are disparities among the state Governments too. Some states (Eg : Punjab, Haryana, Kerala, Tamil Nadu) are developed; while many of the North – Eastern states Bihar, Madhya Pradesh, Assam, Rajasthan and Uttar Pradesh (BIMARU, in Hindi diseased) are normally backward. This kind of disparity is a great nuisance to Finance Commission (FC). Whenever, the funds are distributed, the backward states demand more funds, citing their backwardness. But the advanced states blame the Finance Commission [FC] for encouraging the backwardness and the backward states. How long should we support the backward states? Why should the advanced states sacrifice for the development of the backward states? If the backward states are supported by the funds mobilized from the advanced states, the ruling parties in the advanced states may lose their popularity among their voters. For instance the people of Jammu and Kashmir [J & K] state get more benefits from the central government. This action is frequently questioned by the people of other states. As per the news on the day this note was prepared [i.e 5th August, 2019], the Special Status offered to the J & K was withdrawn.

It is obviously important to achieve vertical and horizontal fiscal imbalances to run the fiscal federalism successfully. But the question is as to how it can be done.

I.Devolution of Tax Revenue

The union government can levy and collect some taxes and distribute a portion of the revenue to the states. Here the question is as to how to share the sum (say Rs. 100) among the states, which have contributed differently and which will need differently. The states which have contributed less always seek more funds. For example Mumbai people's contribution is more in term of Income Tax. But Maharashtra as a state is not equal to Mumbai city. The contribution of North Eastern States and Jammu & Kashmir are always less than what they demand and also need. While distributing the fund, size of populations, extent of backwardness and size of collection are normally considered.

II.Surcharges On Tax

Surcharge means tax on a tax. For instance, if a person's income tax comes to Rs. 1,000 a surcharge of 3% is levied (Rs.30). So she has to pay the tax of Rs.1030. Rs.30 is called surcharge. A state can levy surcharge on the tax levied by the centre or vice versa. Generally, the union government levies surcharge on the tax levied by the central government. This surcharge may also lead to disparity among the states. For instance if a state levies surcharge, the richer states may get more revenue as compared to that of the poorer states.

III.Subsidies

Sometimes the union government may take over the power of levying taxes from the state government. In such cases, the states would lose some money. To compensate this loss the central government can extend subsidy to the states.

For instance GST (Goods and Service Tax). The GST proposal was in the air for long, may be more than 10 years in India. One of the issues relating to GST was loss of revenue to the manufacturing states (Eg. Tamil Nadu) and gains for consuming states (Eg.Kerala). So Kerala welcomed it, whole Tamil Nadu opposed it (GST). There were political reasons too. The state governments with different ruling parties (in Tamil Nadu) opposed levying GST by the union government (ruling by some other political party). In such cases provision of the subsidy to compensate the loss of revenue would work better ultimately the GST came into existence in July 2017 in India.

IV.Subvention

There may be inequality among the states even after receiving funds from the union Government. In such cases, extra financial assistance is provided by the union Government . It is also verified, whether the funds are used for the purposes it was given.

V.Reallocation Function

Whenever the states feel over-burdened with many functions, thecentre can take up some of the functions. It has happened in some countries. For example, in Switzerland the central government took over the social insurance from the states, to lessen the financial burden of the states. It all depends on the political relationships (not only financial) among the governments.

VI.Grants – in – Aid

The central government may extend the Grant – in - Aid to some states that are unable to meet out the expenses. In such cases, the centre may gain some political strength while the state may have to forego their strength. The grants – in – aid may be a) general or unconditional b) particular or specific or conditional. The grant under a) utilized for any purpose a per the wishes of the state . The grants under b) category need to be utilized only for the purpose for which the grant was given. There are advantages as well as disadvantages with both kinds. [***However, the space is not sufficient to discuss all those points.*** The students may spend some time for having discussion on those issues.]

The central government does not give grants, just like that. There are many stages of assessment, inspection, verification and so on.

Grants are granted for various purpose like carrying out certain development/ welfare programmes, managing the refugees, floods, droughts, maintaining the country's status and so on.

10.5 The recent trends in fiscal federalism

Changes are permanent. Hence changes in economic policies are essential. Generally, everyone wants to become more powerful. Who succeeds and who loses depends on various pull and push factors. However, a uniform growth alone would bring sustainable development. Though this is difficult,it is not impossible. Hence, every country with federal systems attempts.

Neither unilateral dependence nor total independence is good; interdependence is always preferred. However, in reality both independence and interdependence are difficult to be achieved. Ultimately unilateral dependence is the reality. In federal set up, normally the central government is more powerful. The central government is in a position to dictate the norms and conditions to the states. The central government is gradually raising its role, responsibilities, revenues, expenses and control on the states. The states

feel that they cannot survive without the central government's assistance. The taxes levied by the central government generally yield larger funds and are more elastic. However, it is just opposite in the caseof states. The state government's economic policies are also controlled and directed by the central government. No state can be identical to each other. However in a federal set up, it is natural that people of all the states want to enjoy a uniform economic, social and political status. It is true even if they are very much different in terms of natural resource endowments, personal and cultural aspects, aspirations, attitudes and aptitudes. The aim of the federal government is to achieve the horizontal and vertical balances. Still we have to go long path in this direction.

10.6 Financial relations between centre and states

In a federal system it is better to have a strong and smooth financial relations. In a large country like ours, where spatial and sectoral disparities exit, it is difficult to have just, fair and equitable financial relations.

In 1936, Sir Otto Niemeyer suggested to distribute 50 % of the revenue from income tax to the state. He also waived the loans due from Bengal, Bihar, Assam and north earthern states.

It was made compulsory to have Finance Commission (FC) once in 5 years. According to the 1950 – 51 Constitution of India it needs to be done by the President of India.

The FC is in charge of maintaining vertical and horizontal financial balance. In 1950, in the absence of FC, Deshmukh was invited to suggest the financial distribution. He considered the India- Pakistan partition and the size of population of the states while suggesting financial devolution.

After Independence, states with substantial population size were created.

10.7 Financial Relations in India

So far there are no big issues in financial relations in India.

Some taxes are levied, collected and retained by the union government.

Some taxes are levied, by the central government and collected and retained by the state governments.

Some taxes are levied and collected by the central government and shared with the state governments.

There are three lists of functions 1) List with central government 2) states list 3) concurrent list.

1) The functions of the union government include defence, armed force, foreign affairs, shipping, navigational and aviation, national highways, posts and telegraphs, telephones, wireless and other means of communication, currency and coinage, banking and insurance, foreign trade and commerce, foreign exchange and loans, inter- state – trade and commerce, fishing and fisheries beyond territorial waters, census, and audit of the accounts of the union and of the states.

2) The functions assigned to state governments include police, public order, betting and gambling, public health, sanitation, hospitals and dispensaries, relief of the disabled and unemployed, education, roads and bridges, agriculture and irrigation, forests, interstate trade and commerce.

3) The concurrent list includes criminal law, bankruptcy and insolvency, economic and social planning, labour welfare, social security and social insurance, industrial and labour disputes, price control, adulteration of foodstuffs and other goods.

The division of functions has been carefully devised taking advantage of past experience in India and in other countries with federal constitutions. But no such assignment of powers can be considered final; with changes in conditions, changes in the distribution of functions will also be necessary. It is generally commented that the union government always aims at taking up more responsibilities including in education [as per the Draft National Education Policy, 2019].

10.8 Division of Resources

The Constitution of India makes a clear division of fiscal powers between the union and state governments. The principle adopted for this classification is that taxes which have an inter-state base are levied by the union, while those with local base are levied by the states. The residuary powers belong to the union.

A) The union taxes, as laid down in List I, the, Seventh Schedule of the Constitution are :

i) Taxes on income other than agricultural income
ii) Corporation tax
iii) Customs duties
iv) Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparations
v) Estate and succession duties, other than an agricultural land
vi) Taxes on capital value of assets, except agricultural land, of individuals and companies

vii) Rates of stamp duties on financial documents
viii) Taxes other than stamp duties, on transactions in stock exchanges and future markets
ix) Taxes on sale or purchase of news papers and on advertisements there in
x) Taxes on railway freights and fares
xi) Terminal taxes on goods and passengers carried by railway, sea or air
xii) Taxes on the sale or purchase of goods in the course of inter-state trade

B) Taxes within the jurisdiction of the states, as given in List II of the Seventh Schedule are:

i) Land revenue
ii) Taxes on sale and purchase of goods, except newspapers
iii) Taxes on agricultural income
iv) Taxes on lands and buildings
v) Succession and estate duties on agricultural land
vi) Excise on alcoholic liquors and narcotics
vii) Taxes on the entry of goods into a local area.
viii) Taxes on mineral rights, subject to any limitations imposed by Parliament.
ix) Taxes on the sale and consumption of electricity.
x) Taxes on vehicles, animals and boats.
xi) Stamp duties, except those on financial documents.
xii) Taxes on goods and passengers carried by road and inland waterways.
xiii) Taxes on luxuries including entertainments, betting and gambling.
xiv) Tolls.
xv) Taxes on profession, trades, callings, and employment.
xvi) Capitation taxes.
xvii) Taxes on advertisement other than those contained in newspapers.

The union government has exclusive power to impose taxes which are not specifically mentioned in the state or concurrent list. The property of the union is exempt from the state taxation and the property and income of the state are exempt from union taxation. States may delegate part of their taxing power to the central government. Once, it happened in the case of agricultural land being included in the purview of the estate duty in many states.

10.9 Distribution and Allocation of Central Revenue

Apart from the taxes levied and collected by the states, the constitution has provided for the revenues from certain taxes on union list to be allocated, wholly or partly to the states. Those provisions fall into various categories.

Stamp duties and excise duties on medicinal preparations containing alcohol or narcotics are levied by the union but are collected and appropriated by the states.

Succession and estate duties, terminal taxes on goods and passengers , taxes on railways freights and fares taxes on transactions in stock exchanges and future markets and taxes on the sale and purchase of newspapers, advertisements therein are levied and collected by the union, but the entire proceeds are assigned to the states, in proportion determined by the Parliament.

Central taxes on income, except corporation tax, and taxes payable on central government emoluments, and certain union duties are levied and collected by the union but are shared by it with the states in a prescribed manner.

As important welfare and development functions are entrusted to the states, gaps between their revenues and expenditure have to be corrected through transfer of resources from the centre. This is done partly by arrangements for tax sharing. But, grants – in – aid by the union for specific purposes or general have come to occupy an important place in centre – state financial relations in India. The grants also serve the purpose of correcting inter – state disparities in resources.

After Mid 1960s, many changes have happened in the centre – state financial relationship, particularly in providing grants – in – aid . Earlier, only a particular political party was in power both at the centre and states. Since 1970,some states are ruled by political parties which do not have good relationship with the political party at the centre. Due to these differences, there appear to be biases in the allocation and utilization of funds, designing and implementing economic policies (Eg. GST) and so on. As a result, the Finance Commission faces more challenges.

The states are authorized to raise loans in the market. They also borrow from the union government. Hence, the union government exercises some control over borrowing and expenditure of the states. The rate of annual borrowing by the state from the union has considerably increased in recent years. The states also deposit with the union government.

10.10 Recent Trends in Centre – State Relationship

Changes are permanent, inevitable and unavoidable. Those with larger power are able to get more and more power; and those at bottom are always the losers in the market oriented profit motivated market economies. This has been explained by Thomas Piketty in his book " Capital in the Twenty – First Century. In the last four hundred years since 1700, the economic disparity has increased in all the eight countries – USA, Canada, UK, France, Italy, Germany, Japan, and Australia – studied by him. North – south political powers are getting more skewed.

The union government needs to be stronger. However, as Aringnar Anna pointed out, the states need not be independent of the Union nor totally dependent on the Union Government. Both the union and state government should be interdependent. Some states that are ruled by the political parties (Eg : West Bengal, Kerala, Tamil Nadu and Andhra Pradesh) have difference of opinion with the political party ruling at the centre. This has been the case particularly after 1970 in India.

Before 1970, most states were ruled by the political party that was in the centre too. Hence, there was no big problems in allocating funds and grants to the states. But after 1970s, the problem has become more acute.

Another reason for the differences between the centre and the states is that different states have grown differently. For instance, some states have not developed fast (Eg : North eastern states, Uttar Pradesh, Madhya Pradesh, Bihar, Rajasthan etc ..) due to various reasons. They are lagging behind. In order to achieve balanced growth, these states need to be supported. But who should bear the cost? Why should the developed states (like Tamil Nadu, Kerala, Andhra Pradesh and West Bengal) bear the cost ? Between Tamil Nadu and Kerala also, though they are physically closer, there are differences. Kerala's consumption is more than what she produces. Tamil Nadu produces more (eg : rice and manufacturing goods) than what she consumes. So, when it comes about GST, Kerala stands to gain and Tamil Nadu stands to lose. So Tamil Nadu was asking for compensation when the GST was in the air. These differences are the challenges for inter – state financial transfers. Generally there is a complaint from some states that the union is adversely biased towards them. The union government may not agree with this view. Anyhow, so far there are no big problems. Life is smooth. Hope it would continue in future too.

With regard to the population size (which has grown differently in different states) being taken as one of the indices for devolution of funds among the states, there were controversies. Population has grown rather slowly in Tamil Nadu and Kerala since 1971, as compared to

some other states. So Tamil Nadu and Kerala were requesting the 14th Finance Commission to consider the 1971 population while deriving the formula for fund transfer. But the 14th F.C was of the view to use 2011 population. This would favour the states which were not implementing the family planning programme. Whereas, the state which successfully carried out the Family Planning Programme would suffer. Is it fair?

Now 15th Finance Commission has come with the Chair Person N.K.Singh. This Commission is expected to submit its report in the month of July, 2019. When this book was under preparation, the FC was arranging meetings with the Economists in Mumbai (The Hindu May 10, 2019, p.13)

MODEL QUESTIONS

1. Explain the concept “federal finance”
2. What are the principles of federal system ?
3. What are the methods adopted to achieve financial balances?
4. What are the recent challenges in sharing the federal finance?
5. What are the problems to be tackled while mobilizing resources?

NOTES

UNIT 11 FINANCE COMMISSIONS IN INDIA

11.1 Introduction
11.2 Functions of Finance Commission
11.3 Report of the Thirteenth Finance Commission: 2010 – 2015 Background
11.4 14th Finance Commission
11.5 15th Finance Commission

11.1 Introduction

Regarding the Finance Commission, the Article 280 of the Indian Constitution reads as:

1. "The President shall, within two years from the commencement of the Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President Considers necessary, by order constitute a Finance Commission which shall consist of a Chairperson and other members to be appointed by the President".
2. Parliament may by law determine the qualifications which shall be requisite for appointment as members of the Commission and the manner in which they shall be selected.
3. It shall be the duty of the Commission to make recommendations to the President as to [a] the distribution between the union and the states of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the states of the respective shares of such proceeds..."

It is not a surprise that there are some challenges in the devolution of funds. The size of grants – in – aid is determined not only by economic factors, but also by political, social, regional… factors. This is the general complaint made by some states for a long period. Till this date 15 finance Commissions have come. So far 14 FCS have submitted their reports.

Under the provisions of the Constitution, the President is required under Article 280 (1) to constitute within two years from the commencement of the Constitution and there after the expiration of every fifth year or at such early year time as he may consider necessary. The Commission is charged with tremendous responsibilities of making requisite recommendations to the President of India. The finance

Commission consists of a Chairman and four members to be appointed by the President.

11.2 Functions of Finance Commission

There are two important functions – Suggestive functions and making recommendations – to be performed by the FC.

Suggestive Functions

A. To suggest the criteria of distribution between union and states of net periods which are to be, or may be divided between them.
B. To determine the allocation of net proceeds between different states according to their respective shares of proceeds.
C. To make any modification or continuance of the term of any agreement entered in to by the union government with the government of any state in part B of the First Schedule under clause V of Article 178 or Article 306.
D. To suggest the principle which should govern the grants – in – aid of the revenue of different states out of the Consolidates Fund of India.
E. To carry on other matter referred to the Commission by the President of India

Making Recommendations

a. The percentage of net proceeds of the taxes which may be divided between centre and stares.
b. The allocation of shares of the proceeds of such taxes in percentage between different states.
c. Determining the principle to govern the grants – in – aid of the revenue out of the Consolidated Fund of government of India between states.
d. The modification or continuances of the term of agreement regarding the levy of international customs and duties with part B states.
e. Grants – in – aids in tribal areas and
f. Special grants for any particular state.

Table 11.1: Finance Commissions in India

Year	**Chairman**	**Operational Duration**	**Year of Report Submission**
Nov.1951	K.C. Neogi	1952-57	December 1952
June 1956	K.Santhanam	1957-62	September 1957
Dec. 1960	A.K.Chanda	1962-66	December 1961
May1964	P.V.Rajamannar	1966-69	August 1965
February 1968	Mahavir Tyagi	1969-74	July 1969
June 1972	Brahmananda Reddy	1974-79	November 1973
June 1977	J.M.Shelat	1979-84	October 1978
June 1982	Y.B. Chavan	1984-89	November 1983
June 1987	N.K.P. Salve	1989-95	March 1990
June 1992	K.C.Pant	1995-2000	November 1994
July 1998	A.M.Khusro	2000-2005	June 2000
July 2002	C. Rangarajan	2005-10	November 2004
Oct 2007	Vijay Khelkar	2010-15	Dec. 2009
2012 (XIV FC)	Y.V. Reddy	2015-2020	Constituted on 2nd January, 2013
2019 (XV FC)	N.K.Singh	2020-2015	Constituted on 2nd January, 2013

NOTES

Table 11.2:Criteria and Relative Weights For Tax Devolution According To Latest Commissions

Criterion	Weight (Per Cent) 11th FC	12th FC	13th FC
Population	10	25	25
Income (Distance Method)*/Fiscal Capacity Distance	62.5	50	47.5
Area	7.5	10	10
Index of Infrastructure	7.5	-	-
Tax Effort	5.0	7.5	-
Fiscal Discipline	7.5	7.5	17.5

11.3 Report of the Thirteenth Finance Commission : 2010 – 2015 Background

The FC is constituted by the President under Article 280 of the Constitution. Its main work is to give recommendations on distribution of central tax revenues between the Union and States. The Thirteenth Finance Commission submitted its report in Parliament on February 25, 2010.

Terms of Reference

- The Commission was asked to make recommendations on the following matters:
- The distribution of taxes collected between the centre and the states.
- The principles determining the grants – in – aid to states out of the Consolidated Fund Of India and the sums to be paid to states.
- The measures needed to augment the Consolidated Fund of a state to supplement the resource of Panchayats and Municipalities.
- To review the state of the finances of the Centre and the States in light of the operation of the states' Debt Consolidation and Relief Facility that was introduced on the basis of the recommendations of the previous Finance Commission.
- To review the present arrangements regarding financing of disaster management
- To suggest a new roadmap for fiscal consolidation in the period between 2010 and 2015

11.3.1 Findings and RecommendationsSharing of Union tax Revenues

- The share of states in net proceeds of shareable central taxes shall be 32 per cent in each of the financial years from 2010- 11 to 2014-15.
- The share of each state in the proceeds of all shareable central taxes in each of the financial years from 2010 – 11 to 2014 – 15 shall be as specified

Finances of Union and States

A. Actual share in the tax revenue of the centre which is devolved to states : The Eleventh and Twelfth Commissions had recommended that the share of states be fixed at 29.5% and 30.5% respectively, of central taxes. However, the actual shares devolved to states have been lower than recommended by previous Finance Commissions. The government has explained that when cesses and surcharges are taken into account, the release to states is in keeping with the recommendations.

Recommendations: The Ministry of Finance should ensure that the accounts reflect all collections so that there are no inconsistencies in the amounts released to states.

B. **Losses in the power sector :** Subsidy for the power sector is the largest component of state government subsidies. The power sector in most states is beset with high losses, and inefficient infrastructure, resulting in huge losses.

Recommendation: Losses in the power sector expected to be a major drag on the finances of state governments, and therefore, the problems confronting this sector need to be addressed in a time- bound manner.

C. **Reduction of Centrally Sponsored Schemes:** Initiatives should be taken to reduce the number of centrally sponsored schemes and to restore the predominance of fund- transfers based on Planning Commission Recommendations.
D. **Goods and Services Tax (GST) :** The Commission has recommended the adoption of the GST and formulated a model GST. The main features of the model GST are :

- The central portion of the GST would include central excise duties, service tax, additional customs duties, all surcharges and cesses.
- The state GST would include VAT, Central sales Tax, cesses and surcharges, and others such as luxury tax, lottery tax, stamp duties etc..

- There would be special provisions for certain goods such as petroleum, and exemptions would be allowed only on the basis of a common list applicable to all states and the centre.

11.3.2 Union Finances

The central government has recently decided that proceeds from disinvestment shall be used fully as capital expenditure for social sector programmes. This policy needs to be liberalised and proceeds should also be used for augmenting critical infrastructure and environment related projects.

11.3.3 State Finance

The practice of diverting plan assistance to meet non-plan needs of special energy states should be discontinued.

11.3.4 For PSUs : All accounts and backlogs of PSU accounts should be cleared by states.

States need to draw a roadmap for closure of non-working PSUs by March 2011. Divestment and privatisation of PSUs should be considered and actively pursued.

11.3.5 Power Sector :

- Reduction of Transmission and Distribution (T & D) losses should be attempted.
- Unbundling needs to be carried out on priority basis and open access to transmission be strengthened.
- Proper systems should be put in place to avoid delays in completion of hydro projects.
- Regulatory institutions should be strengthened through capacity building, consumer education and tariff reforms.
- Regarding reforms in the area of pensions, a switch to the New Pension Scheme needs to be completed at the earliest.

11.3.6 Revised Roadmap for Fiscal Consolidation

[a] Central Government

- The revenue deficit of the centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014 – 15.
- A target of 68 percentage of GDP for the combined debt of the centre and states should be achieved by 2014-15.

- The Medium Term Fiscal Plan should be reformed and made a statement of commitment rather than a statement of intent.
- A number of disclosure including detailed break-up of grants to states, systematised statement on tax expenditure, compliance costs of major tax proposals, fiscal impact of major policy changes, should be made with the annual budget.
- The government should list all public sector enterprises that yield a lower rate of return on assets than a norm which should be decided by an expert committee.
- An independent review mechanism should be set- up by the centre to evaluate its fiscal reform process.

[b]State Government

- States should be able to get back to the path of fiscal consolidation after the disruption caused in 2008-09, and 2009-10. States with revenue deficit in 2007 – 08 should eliminate revenue deficit by 2011 – 12.
- General Category states with revenue deficits in 2007 – 08 should achieve a fiscal deficit of less than or equal to 3 percent of GDP by 2011-12. Other states should do so by 2013 – 14.
- States should amend/enact Fiscal Responsibility and Budget Management [FRBM] Act to build on the fiscal reform path worked out.
- State – specific grants recommended for a state should be released upon compliance.
- Borrowing limits for states to be worked out by Finance Ministry using the fiscal reform path, thus acting as an enforcement mechanism for fiscal correction by states.
- Loans from the central government to states must be administrated by ministries/ departments other than Ministry of Finance. Outstanding loans at the end of 2009 – 10 should be written off.

[c] Local Bodies

Local Bodies should get 2.28 % of the divisible pool of taxes (over and above the share of the states), after converting this share to grant – in – aid under Article 275.

Article 280 (3) (bb) & c of the Constitution should be amended to make the recommendations of the state Finance Commissions less binding on state governments.

Article 243 (I) of the Constitution should be amended to empower states Governments to constitute ad direct State Finance Commissions to give their report before the National Finance Commission finalizes its report.

- State Governments should strengthen their local audit departments through capacity building.
- Bodies similar to the SFC should be set up in states which are not covered by Part IX of the Constitution (Panchayats).
- Local bodies should be associated with city planning functions wherever other development authorities are mandated for this function.
- State governments will be eligible for the general performance grant and the special areasperformance grant only if they comply with the prescribed stipulations.

11.3. 7 Disaster Relief

- Assistance of Rs. 250 crore to be given to the National Disaster Response Force (NDRF) to maintain an inventory of items required for immediate relief.
- Provisions relating to the District Disaster Response Fund in the Disaster Management Act may be reviewed and setting up of these funds be left to the discretion of the individual States.
- The list of disasters to be covered under the scheme financed through FC grants should remain as it exists. However, man – made disasters of high – intensity may be considered for NDRF funding.

11.3.8 Grants – in – Aid to states

For augmenting the resources of rural local bodies, the Commission has recommended award of grant based on certain principles. The grant has two main components.

Basic Grant – For 5 years (2010 – 11 to 2014 – 15)

Performance Grant – For 4 years (2011 – 12 to 2014- 15)

A small portion of grants is allocated to special area covered by the V & VI schedules and areas exempted from the purview of part X and XI (A) of the Constitution.

This grant is called **“Special Area Basic Grant”,** and accessible for all the five years to meet some of the development needs of those areas.

Table 11.3: GRANTS RECOMMENDED BY THE 13th FINANCE COMMISSION (in crore)

	Compo - nents	2010-11	2011-12	2012-13	2013-14	2014-15	Total
1	General Basic Grant	241.29	279.78	326.99	387.43	458.71	1694.20
2	General Perfor-mance Grant	**0.00**	**95.66**	**224.41**	**264.70**	**312.23**	**897.00**
3	Special Area Grant	**19.39**					**19.39**
	Total	**260.68**	**375.44**	**551.40**	**652.13**	**770.94**	**2610.59**

The Commission has specially recommended using the above grants on the following components :

- Drinking water supply
- Sewage, Solid Waste Management (Rural Santation)
- Operational Expenses (Maintenance of Accounts, Conducting of Audits, Creation of Database etc)
- Non – Plan Revenue Deficit : Eight special category states (Arunachal Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya , Mizoram, Nagaland, Tripura) have non-plan revenue deficits. For these states grant of Rs. 51,800 crore was recommended.

11.4 14th Finance Commission

The 14th Finance Commission with the Chairperson Y.V.Reddy suggested that 42% of the central governments tax revenues should be distributed to the states. The union government agreed the suggestion. However, Tamil Nadu got Rs. 2,700 crores less than what she got in the previous Finance Commission. This FC suggested special funds for some states. Meghalaya and Mizoram states received fund, but Bihar did not get it.

11.5 15thFinance Commission

15th Finance Commission Chairperson N.K.Singh and some officials met some economist in Mumbai on 9th May 2019 . The prominent economists told the Fifteenth Finance Commission that [a] the government should not budget for a low fiscal deficit, knowing fully well that it will not be achieved; [b] the overall quality of budgeting

needs to improve; [c] the FC should take a consolidated view of public debt including off- budget transactions and the debt taken on by public sector enterprises; [d] was important to carefully examine whether the increased tax devolution by the 14th FC has led to improvements in the social spending of state governments; and, [e] there was a possible mismatch between the supply of and demand for state development loans, which could affect the cost of borrowings of state governments. There needed to be an incentive structure built into the devolution mechanism, and that the mechanism must also take into account the composition of the population, since many states are seeing a significant change in their proportion of the elderly population.

N.K.Singh, the Chairperson of the 15th F.C said, "the meetings have sharpened the commission's understanding on some of the key things that need to be kept in mind for continued macroeconomic stability (The Hindu, 10th May, 2019, p.13).

The 15 F.C will submit its report by October 2019. This F.C will commence legal studies on the cesses and surcharge levied by the central government but from which no share is devolved to the states. In the pre – GST era collections from direct taxes like income tax and indirect taxes including excise duty and service tax were divided between in the centre and the state in the ratio recommended by the FC. After the GST was rolled out from July 1, 2017 subsuming excise duty and service tax along with other central and state leives, the 15th FC will suggest what will be the states share in direct tax and GST collected by the centre. In both scenarios, cesses and surcharge levied by the centre are not included in the divisible pool, sources say.

The previous F.C (14th) had raised the share of states in centre's tax revenue to a record 42% for five year period starting from 2015 – 16 up from 32%.

MODEL QUESTIONS

1. What is the role of Finance Commission ?
2. What are the parameters considered for developing the formula for devolution of funds to the states?
3. Write a note on 14th Finance Commission.
4. What are the suggestions made by the economists to the 15th Finance Commission?

UNIT 12 LOCAL FINANCE

12.1 Introduction
12.2 Meaning of Local Governments
12.3 Functions of Local Government Of India
12.4 Finances of Local Governments
12.5 12.5 Suggestions for Improvement

12.1 Introduction

"Independence must begin at the bottom. Thus every village will be a republic or panchayat having full powers." Ganhiji

India has the distinction of being a unique federal country. Ordinarily, federalism involves a two tier system – central / union government at the first level and the state /provincial government at the second level. But the Indian Constitution provides for a three tier federal structure as below :-

Union Government at the top, State Government in the Middle and Local Government, i.e., Panchayats and Municipalities at Grass Root.

Local self government in India refers to governmental jurisdictions below the level of state. India is a federal republic with three spheres of government: central, state and local. The 73rd and 74th constitutional amendments gave recognition and protection to local governments and in addition each state has its own local government legislation. Since 1993, local government in India takes place in two very distinct forms. Urban localities, covered in the 74th amendment to the Constitution, have Nagar Palika but derive their powers from the individual state governments. The powers of rural localities have been formalized under the Panchati Raj System, under the 73rd amendment to the Constitution.

In India there are about 6,45,000 local governments. The village panchayats refer to the councils of the local government of India, that take care of the various administrative affairs of the rural regions. All the panchayats will be chosen by the state and will be provided such powers so as to enable them function on their own. These local governments of India are self – sufficient and self – enabled units that work under the state government of India

The 73rd Constitution Amendment Act 1992 and the 74th constitution Amendment Act 1992 came into force in the year 1993. In this Act, the constitutional status is attached to the city as well as village councils in India. Some of the significant steps that were taken for the local government in India include regular elections, and the review. Local government is today much more important in the daily

life of a citizen than the state or central government. The importance of local government can hardly be over emphasized when we consider the range, the character and the impact upon daily life of the citizen of the functions which local authorities carry out.

Local Government Provides Public Amenities and Services: They are necessary for the convenience, healthful living and welfare of the individual and the community. If these services were suddenly to cease, we should relapse into chaos.

The local Government institutions are based on the principle of division of labour. They are indispensable because the aggregate duties of government and local authorities can be shared.

Towns and villages are two distinct entities in India. They have different needs and oblems. The main requirements of towns are the provisions of housing, transport, communications, water supply, sanitary conditions, community centres, slum clearance and town planning. The main emphasis in the village has to be on improvement of agriculture, irrigation facilities, animal husbandry, village industries and the like. The personnel of Urban Local Government and Panchayati Raj institutions would require specialized training to cater to the specific needs of urban and rural areas respectively.

12.2 Meaning of Local Governments

It is not easy to answer the question "what is local government"? Local government may be described as government by popularly elected bodies charged with administrative and executive duties in matters concerning the inhabitants of a particular district or place and vested with powers to make bye – laws for their guidance. Local government has been defined from various angles. It has been defined as "an authority to determine and execute measures within restricted area inside and smaller than the whole state. The term Local Government literally means management of the local affairs by the people of the locality. It is based on the principle that the local problems and needs can be looked by the people of the locality better than by Central or State Governments. The administration of local affair is entrusted to the representatives elected by the people of the locality on regular intervals. Though local government institutions enjoy autonomy of operations, it does not mean that there are no legal restrictions upon them.

The Central and state governments are free to prescribe the limits within which a local government has to operate and also reserve the right to issue directions from time to time. Th e term "Local Government" or "Local Self- Government" means the government by freely elected local bodies which are endowed with power, discretion and responsibility to be exercised and discharged by them, without control over their decisions by any other higher authority. Their actions

are, however, subjected to the supremacy of the national government. It has been observed that local inhabitants representing local body possessing autonomy within its limited spheres, raising revenue through local taxation and spending its income on local services constitute the local self – government. For the better understanding the concept of local government and its meaning, scope and nature, it shall be desirable to study a few important definitions and interpretations from various sources. As per the General Clauses Act, 1897 "Local Government shall mean the person authorized by law to administer executive".

The essential characteristics of Local Government are its statutory status, its power to raise finance by taxation in the area under its jurisdiction, participation of local community in decision making in specified subjects and their administration, the freedom to act independently of central control and its general purpose in contrast to single purpose.

"The greater the power of the panchayats the better for the people .." M.K.Gandhi

12.3 Functions of Local Government of India

All the local Government of India have to perform certain responsibilities, which are divided into two categories a) obligatory functions and b) discretionary functions.

A) Some of the obligatory functions performed by the local governments are

- i) Registration of births and deaths
- ii) Supply of pure drinking water
- iii) Construction and maintenance of public streets
- iv) Lighting and watering of public streets
- v) Clearing of public streets, places and sewers
- vi) Naming streets and numbering houses
- vii) Establishment and maintenance of primary schools
- viii) Maintenance or support of public hospitals

B) Some of the discretionary functions, which are performed by the local governments of India are :

- i) Planting and maintenance of trees
- ii) Housing for low income groups
- iii) Construction and maintenance of public parks, gardens, libraries, museums, rest houses and other public buildings
- iv) Securing or removal of dangerous buildings and places.

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12.4 Finances of Local Governments

The significance of finance needs no elaboration as no organization can exist without at least a minimum of finances. That is why Kautilya the great Indian philosopher marked "all undertakings depend upon finance, hence foremost attention should be paid to the treasury" (Arthashastra, Mysore, Raghuveer Printing Prees, 1956, p. 65). In fact, finance constitutes the backbone, the life and blood of government, it provides fuel to the administrative machinery. Sound fiscal policy is of crucial importance.

The Reserve Bank of India in its bulletin has rightly stressed the importance of local government finances as : "within the increasing industrialisation and urbanisation under the impetus of development and planning, the local authorities form a growing part of the expanding public sector, with powers to raise and spend considerable amounts of public funds for development purpose. The contribution of local bodies to income in general and capital formation is of considerable significance, in view of their large number and the area and population they cover (RBI, Bombay, 1962 Chapter on Local Government Finances)

In India, the functions and finances of local governments are provided in the Acts passed by the state legislatures. Any mismatch or discrepancy between the two is likely to create condition of chaos. Ursula Hicks says in this regard "if local bodies are to play any significant role, they must clearly have access to adequate finances" (Development from Below, Oxford, Clarendon Press, 1966, p.276). Local government finances have received little attention in the past by Union and state governments. Even the social scientists and students of public finance had paid lesser attention and importance to the problems of finances of local governments.

As far back as in 1925, the Indian Taxation Enquiry Committee had noted that the finances of local bodies were inadequate for the services they were required to perform. Since Independence, this aspect has been enquired into by numerous central and state commissions and committees, but their recommendations have not been matched with adequate follow – up action towards implementation.

The Government of India Act, 1919 which came into force in 1921 contained a local list comprising the following taxes : Toll, tax on land and land values, tax on buildings, tax on vehicles and bots, tax on minerals and domestic servants, tax on animals, octroi, tax on private markets, tax imposed in return for services rendered, such as water rate, lighting rate, drainage rate, fee for uses of markets and other public conveniences.

The Government of India Act, 1935 did not include any local list of taxes. The Local Finance Enquiry Committee 1951 recommended a list of 13 taxes. They are terminal tax on goods and passengers carried by railway, sea or air, taxes on lands and buildings tax on mineral rights, tax on entry of goods into a local area for consumption, use or sale, tax on consumption or sale of electricity, tax on advertisement other than advertisement published in the newspaper, tax on goods and passengers carried by road and inland waterways, tax on vehicles,tax on animals and boats, tolls, tax on professions, trades, callings and employment,capitation tax andtax on entertainments.

The Taxation Enquiry Commission (1953 – 54) had also addressed itself to the question of what specific taxes be developed on local government. It had listed some taxes including tax on theatres, duty on transfer of property, tax on foods and those mentioned earlier.

Apart from the above, local bodies also depend upon grants and contributions, loans and some miscellaneous sources.

According to the study by the National Institute of Urban Affairs, income from taxes Constitute about two – third of the revenue accounts of the municipalities and over one – half of the total income from all the sources (R. Sheshadhri, Financing Urban Development in India, Centre for Urban Studies, Indian Institute of Public Administration, New Delhi, 1990, pp.63 -64)

12.5 Suggestions for Improvement

The sorry state of finance of local bodies in India needs to be improved substantially. In order to stabilize the basis of Indian Democracy, it is essential that the finance of the local bodies should be placed on a sound basis, so that they may function more efficiently. A number of suggestions have been made at various conferences and in committees' reports for the improvement in financial position of local bodies. Prominent committees / Commissions in this regard are :

a. Taxation Enquiry Committee, 1924 -25
b. Local Finance Enquiry Committee, 1949 – 51
c. Rural- urban Relationship Committee, 1963 – 66
d. Indian Taxation Enquiry Committee, 1964
e. Dr. Zakaria Committee on Financial Resources, 1965 and so on.

i) The prevalent reluctance of local bodies to introduce taxes has to be overcome.
ii) The local bodies should recover legally valid imposed taxes from the persons and enterprises.
iii) Grants to local bodies should be provided on a rational basis.
iv) The practice of sending grants when the financial year is running out should be avoided.

MODEL QUESTIONS

1. Define the concept "Local Government".
2. Discuss the significance of 73rd and 74th constitutional amendments.
3. What are the functions of local governments?
4. What are the sources of finances of local governments?
5. List out the suggestions for improvements of local finance.

UNIT 13 FISCAL POLICY

13.1 Introduction
13.2 Definitions of Fiscal Policy
13.3 The Classical Concept of Fiscal Policy
13.4 Modern Concept of Fiscal Policy
13. 5 Rules for Functional Finance by A.P.Lerner
13. 6 Objectives of Fiscal Policy in Developed Countries
13. 7 Objectives of Fiscal Policy in less developed centuries
13. 8 Contra Cyclical Fiscal Policy (Compensatory Fiscal Policy)
13. 9 Deficit Financing
13.10 Instruments of Fiscal Policy
13. 11 Uses of Fiscal Policy

13.1 Introduction

Fiscal policy refers to the policy of the governments with relation to taxation, public expenditure and management of public debt. According to Arthur Smithies, Fiscal Policy is "A policy under which the government uses its expenditure and revenue programmes to produce desirable effect and avoid undesirable effect on the national income, production and employment."

Fiscal Policy is budgetary policy of the government.It uses public expenditure and taxation as instruments. Its objective is to influence production and employment favourably.

13.2 Definitions of Fiscal Policy

AME / Agency	DEFINITION
American Economic Association	The policy which concerns itself with aggregate effects of government expenditure and taxation on income, production and employment
Otto Eckstien	Changes in taxes and expenditure which aim at short run goals of full employment, price level and stability

The significance of fiscal policy was first emphasized by J.M. Keynes, in mid- 1930s in his **"The General Theory of Employment, Interest and Money"** published in **1936.**

13.3 The Classical Concept of Fiscal Policy

The classicals believed in laissez – faire policy, Say's law of market, full employment equilibrium, optimum allocation of resources etc. According to them full employment is a common phenomenon and is supposed to reach automatically. There is no necessity of any governmental interference. The concept of fiscal policy held by the classicals is known as "Principle of Sound Finance". According to them "that government is the best which spends the least and impose lowest amount of taxes". A "balanced budget" was supposed to be the orthodox ideal of the traditional public finance policy or the classical concept of fiscal policy, known as "Sound Finance".

The rationale behind or justification for a balanced budget was based on the following grounds.

a. A balanced budget was considered an effective check upon any extravagance of the authorities.
b. An unbalanced budget leads to inflationary or deflationary pressures.
c. Any attempt to raise taxes would be resisted by the public.
d. A balanced budget was supposed to be neutral in effect on the working of the country. It was thought that the additional purchasing power through increased public expenditure by the government would be neutralized by the equivalent reduction in private expenditure by way of taxation.

13.4 Modern Concept of Fiscal Policy

The modern concept of fiscal policy is called "Functional Finance". This was stated by J.M Keynes and was developed by Abba P. Lerner. According to the policy of functional finance "Government has to play a positive role so as to regulate and control the economy by means of taxes and expenditure". The financial activities that are undertaken by the government to correct deflation or inflation refer to the functional finance. The various tools of functional finance according to Abba P.Lerner are taxing, spending, borrowing, lending, buying and selling.

13. 5 Rules for Functional Finance by A.P.Lerner

a. The financial responsibility of the government or state is to regulate spending in sucha way that the supply of goods and services may be absorbed at the current prices.
b. The purpose of borrowing is not to raise money but to make the public hold more bonds and less money.
c. The purpose of taxation is never to raise money but to leave less money in the hands of the tax payer. Taxation is governed entirely by whether the effect on spending is desirable or not.
d. Deficit financing can be adopted when the government money outlay exceeds the current money revenue of the government especially in periods of deflation.

13. 6 Objectives of Fiscal Policy in Developed Countries

a. Full employment
b. Price stability and
c. High and stable rate of growth of the economy with equity

13. 7 Objectives of Fiscal Policy in less developed centuries [LDCs]

The following are the important objectives of fiscal policy in developing countries :

a. Full employment
b. Price stability
c. Accelerated rate of economic development
d. Optimum allocation of resources
e. Equitable distribution of income and wealth
f. Economic stability and
g. Capital formation and growth

13. 8 Contra Cyclical Fiscal Policy and Compensatory Fiscal Policy

The policy taken by the government to check business fluctuations or trade cycles – or to curb the effects of booms and depressions are known as contra (counter) cyclical fiscal policy. A contra cyclical fiscal policy is adopted for achieving economic stability. At the time of boom or economic prosperity, inflation is resulted. Inflation is the result of the excessive aggregate demand. The remedial measure in this juncture is to reduce aggregate demand. For this the government has to reduce the purchasing power with the people. The government can adopt the fiscal tools in fighting against inflation and bring about economic stability.

a. **Public Borrowing :** During the time of inflation, the government has to increase its borrowing. This will in turn reduce the purchasing power with the people. This may be done in many ways like provision of higher rate of interest on savings, introducing new compulsory savings scheme, making consumers to purchase saving certificates etc.
b. **Government Spending :** During the time of inflation the government has to adopt surplus budget by reducing its expenditure than its revenue.
c. **Taxation :** taxation is a very good instrument in the hands of the government to fight against inflation. The government can impose new taxes and increase the existing tax rates as well.

The policy taken by the governments during deflation will be just the reverse of what they do during inflation.

J.M.Keynes has suggested compensatory fiscal policy to counter recession. During recession, private expenditure in the form of consumption and investment may decline due to the operation of some adverse factors. This decline in aggregate demand will reduce consumption, investment, employment etc. leading to down turn and recession in the economy. In this juncture, efforts by the government through additional expenditure (and reduced taxes) will fill the gap in demand, consumption and investment. The main thrust of compensatory fiscal policy is that the government should inject extra purchasing power through increased public expenditure to enhance demand in the economy. In effect, the government expenditure is able to compensate the reduced private expenditure. This fiscal policy is called compensatory fiscal policy.

Compensatory fiscal policy has three versions:

A) Built – in – flexibility B) Formula flexibility and C) Discretionary action

A) Built – in – flexibility : It is a system having automatic adjustment of expenditure and taxes which are made in relation to cyclical upswings and downswings without any deliberate action by the governments. For example, unemployment insurance, relief payments, old age insurance, social security scheme, corporate tax, income tax, excise duty etc.

B) Formula flexibility : Formula Flexibility is said to be a stand by authority of the government to change tax rates as soon as fluctuations in employment and price levels are observed. It is done in order to avoid the ineffectiveness of other flexibilities.

C) Discretionary Action : It refers to deliberate changes in the budget by such action as changing tax rates or government expenditure or both. It has three forms 1) changing taxes with

expenditure constant 2) changing expenditure with taxes constant and 3) changing both simultaneously.

13. 9 Deficit Financing

Mc. Graw Hill Dictionary of Modern Economic defines deficit **financing "as a practice by government of spending more than what it receives as revenue".**

According to the Planning Commission of India "Deficit financing is used to denote the direct addition to Gross National Expenditure through budget deficit whether the deficits are on the revenue account or capital account. The government may cover the deficit either by running down its accumulated balances by borrowing from the banking system"

In Indian context, deficit financing takes place, when a budgetary deficit is financed by using any one of the following methods

a. The government may withdraw its cash balances from the central bank.
b. Government may borrow fund from the central bank.
c. Government may resort to printing of additional currency.

13. 9. 1 Advantage of Deficit Financing

a. Resources are best used
b. It is helpful to developing countries where it is difficult to create resources through taxation.
c. Additional purchasing power is created

13.9.2 Limitations

1. Rise in prices
2. Increase in money supply
3. Speculative activities
4. Adverse effect on savings
5. Low investment
6. Unequal distribution of income and wealth

13.10 Instruments of Fiscal Policy

There are two basic instruments of fiscal policy : Government spending and taxation. Fiscal policy varies in response to changing economic indicators. In general, an expansionary approach is used when the economy slows down or enters a recession and unemployment rises. Under these conditions, policy makers try to stimulate economic activity by increasing spending, cutting taxes or by doing both. These strategies put more money into the hands of consumers and businessmen. If these policies are left uncontrolled, the economy can become over-heated also. When there is high employment and strong

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consumer demand, prices tend to rise and the rate of inflation can jump. When this happens, the policy makers may reverse expansionary fiscal policy and curtail spending or raise taxes. The goal is to achieve a balance that fosters sustainable economic growth and a strong job market without excessive inflation or large deficits.

The fiscal policy that is designed to stimulate the economy is spending. This is often accomplished through public funding of useful projects such as improvement in infrastructure, as it is done in India. More construction activities will be encouraged. This would increase the wage income to workers and boost the rate of inflation. The government may borrow to spend. This will increase the public debt.

Tax is another instrument. Politicians love to promise tax cuts (to win in the elections). In India corporate tax has been cut down to get more election funds from corporate sector. When the government cuts taxes, people will have more money in their pockets, but the government will get less revenue. This can lead to deficit, borrowings and increased public debt.

13. 11 Uses of Fiscal Policy

The ultimate aim of Fiscal Policy is to achieve sustainable development. This is required for reduction of poverty and inequality on the one hand and also to achieve growth on the other hand. To achieve both is abig challenge. In the US, tax cuts were introduced by Kennedy, Reagan and George W .Bush. Increase in government purchases was proposed by President Clinton in 1993 Barack Obama included both tax rebates and spending increases.

Any government programme that tends to reduce fluctuations in GDP automatically uses an automatic stabilizer. Automatic stabilizers tend to increase GDP when it is falling and reduce GDP when it is raising.

Expansionary fiscal policy consists of an increase in government expenditure, government purchases, transfer payments, reduction in taxes etc..

Contractionary fiscal policy involves a reduction in government purchases and transfer payments, an increase in taxes, etc..

13.12 Limitations to Fiscal Policy

Though the fiscal policy has an important place in economic development, it has the following limitations :

A. Size of fiscal measures

When the budget forms a small part of the national income, fiscal policy cannot have the desired impact on the economic development.

For example in India, in 2019, the GDP was around Rs.140 lakh crores; the size of Union Budget was Rs.27 lakh crores; size of population was 128 crores; and the size of income tax paying population was only about 4 crores.

Direct taxation at times becomes an instrument of limited applicability, as the vast majority of the people are not covered by it. It is true in India. Only about 3% of Indians pay income tax. Also, the share of income tax revenue to total government revenue is also small. Hence the effectiveness of fiscal policy will be lower.

B. Fiscal policy as an ineffective anti – cyclical measure

If the different sectors of the economy are not closely integrated with one another, fiscal measures – both loosening fiscal policy and tightening fiscal policy – will not stimulate speedy economic growth, of a county. If the sectors are not closely integrated, one sector may have recession other sectors may experience revival. Under such circumstances designing a proper fiscal policy will be a challenge.

C. Administrative Delay

If there are administrative bottlenecks, fiscal measures may introduce delay, uncertainties and arbitrariness.

D. Other Limitations

Large scale unemployment, lack of coordination from the public, tax evasion, low tax base are the other limitations of fiscal policy.

MODEL QUESTIONS

1. Explain the term fiscal policy?
2. Distinguish between "sound Finance" and "Functional Finance"?
3. What are the instruments of fiscal policy?
4. Explain the limitations to fiscal policy?

UNIT 14 FISCAL POLICY IN INDIA

14.1 Introduction
14.2 Budget
14.3 Budgetary Procedure in India
14.4 The State Budget

14.1Introduction

TheIndian Constitution gives a balanced fiscal policy framework for the country. With the report of the Finance Commission, formed every five years as per the provisions of the Constitution, the taxes coming under the centre are delegated to the state governments. The Constitution also says that for every financial year, the government shall prepare its proposal of taxation and spending execution and place them before the legislature for legislative debate and approval. This is known as the "BUDGET". The Central and state government have their own budgets. The various objectives of Indian fiscal policy are as follows :

i) **Development by an effective allocation of resources :** Both the central and the state governments in India have been empowered to mobilize financial resources in order to bring effective financial planning and its uses. In India financial resources are mobilized by following three means : a) Taxation b) Public Savings c) Private Savings

ii) **Expenditure of Financial Resources :** The financial resources are utilized mainly to increase the production of necessary goods. The developmental activities include Railways and Infrastructure. Non- developmental activities include interest payments, defence, subsites etc…

iii) **Reduction of Income and Wealth Inequalities :** The direct taxes play a crucial role in reducing income inequalities. Indirect taxes are more in the case of semi-luxury and luxury items. By generating resources, government implements Poverty Alleviation Programmes.

iv) Price Stability and Control of Inflation : If inflation increases at a high rate in any country then it can finally lead to an overall collapse of the social, political and economic systems of the country.

v) Employment Generation : Small Scale Industrial Units generate more employment per unit of investment. Large scale industrial units use more of resources of the country, get loans, employ cheap labour and create environmental imbalances also. But they help the politicians and get huge unmentioned

subsidies. Self-employment schemes are introduced frequently to generate employment for degree – holding youth. But they are always looking for white – collar jobs.

vi) **Balanced Regional Development :** Indiais a huge countrywith hugenatural imbalances. Hence it is difficult to take growth benefits to all the states. Governments provide various incentives such as finance at economical interest rates, cash subsidy, concession in taxes and duties etc ..for setting up projects in backward areas.

vii) **Reducing Deficit in the Balance of Payments :**Fiscal policy aims to encourage more exports by means of exemption of central excise duties and customs, exemption of income tax on export earnings, exemption of GST etc… Adverse balance of payment is rectified by applying duties on imports and by providing subsidies to export.

viii) **Capital Formation :**Fiscal policy aims at increasing savings and decreasing spending. But as on now in India just opposite is taking place. People are forced to spend more. As a result gross domestic savings as a proportion of GDP is falling since 2015. To fill the gap FDI is invited. The pros and cons of the FDI need elaborate discussion.

ix) **Increasing National Income :**Since 1990, the governments talk more about GDP growth. In order to do that, the accounting practices have been changed. A lot of non- monetized transactions have been converted into monetized transactions. Various agencies give various figures about the national income and its growth rates. The extent of black activities and black income does not seem to have come down. Smuggling (particularly) gold and diamond is a regular process in many of the airports, including Chennai and Tiruchirapalli. Since the parallel economy is very active, the national income figures are highly unreliable.

x) **Development of Infrastructure :**In 1950s and 1960s irrigation dams, tanks, Canals etc were given greater priority. Since 1990 road and rail projects are given larger emphasis. However, the infrastructure required for rural mass and farmers has not received due attention. It should be possible through fiscal policy. But India is ruled by urban elite, as written by Michael Lipton in his book “Why Poor People Stay Poor”. Though AdulKalam kept on saying PURA (Providing Urban Amenities to Rural Area), nothing has worked out. Rural – Urban disparities and rural – to urban migration continue. Urban slums and roads are congested, whereas villages are vacated.

14.2 BUDGET

14.2.1 Introduction

The term budget has been derived from a French word "bougette" which means a leather bag or purse. The term "budget" is commonly understood as a document presented by a government containing an estimated or proposed expenditure for a given period and proposed means of financing them for the approval of legislature. As per Article 112 of Indian Constitution the Government has to present in the Parliament an annual financial statement showing estimates of revenue and expenditure. This is called the Annual Financial Statement or Budget. Hence, government budget is a schedule of all revenues and expenditures that the Government expects to receive and plan to spend during the following year. A budget includes a) Financial actions of the previous year b) budget and revised estimates of the current year and c) the budget estimates for the following year. For example, in the budget 2019-20 there will be actual estimates of 2017 – 18 the budget estimates and revised estimates for the year 2018 – 19 and the budget estimates for the year 2019 – 20 .

The budget is presented in the Parliament by the union Finance Minister. Similarly, the state Governments have also to present the budget in the state Legislatures as per Article 202 of the Indian Constitution

14. 2. 2 Definitions of Budget

Many have defined the term 'budget'. Only two of them are given here. "It is a document containing a preliminary approved plan of public revenue and expenditure".

"A Budget is a pre- determined statement of management policy during a given period which provides a standard for comparison with the results actually achieved".

14. 2. 3 Government Accounts

A) Consolidated Fund: All sums of money, all revenues of the governments, the loans raised by it, receipts by way of repayment of loans constitute the Consolidated Fund. All expenditures are also incurred out of this fund. No amount can be withdrawn from this fund without the sanction of the Parliament (Article 266 (1).

B) The Contingency Fund: The fund is placed at disposal of the President to enable the government to meet the unforeseen

emergencies. Prior sanction of the parliament is not required to spend from the fund (Article 267).

C) Public Account: Certain transactions are not included in the contingency fund. They include transactions relating to provident funds, small savings collections, other deposits etc. The money thus received is kept in public account. This money does not belong to the government. It has to be paid back to the persons and authorities who have deposited it. Hence, parliamentary approval is not required for payments (Article 266 (2).

14.2.4 Features of Budget

A. It is a statement of expected revenue and proposed expenditure.
B. It is sanctioned by some authority.
C. Its periodicity is generally annual.
D. It prescribes the manner in which revenue is collected and expenditure is incurred.
E. Budget is prepared on cash basis.
F. Role of Lapse – All unutilized funds within the year 'lapse' at the end of the financial year.
G. Realistic Estimation.
H. Budget is on Gross / Net basis.
I. Form of Estimate is to Correspond to Accounts.
J. Estimates to be on Departmental Basis.

14.2.5 Objectives of A Budget

Budget is an important tool of financial administration and an effective means of enforcing fiscal policies. The main objectives of a budget are the following:

A. Re – allocation of resources.
B. Re – distribution of resources.
C. Stabilization of resources
D. Sources of information to the public of the past, present and future activities, plans as programmes of the relevant governments.
E. Tool of government policy
F. Estimation on income and expenditure
G. An instrument of fiscal policy
H. Basis of public welfare
I. Ensuring financial and legal accountability
J. Serving as a tool of management for controlling administrative efficiency.

14.2.6 Components of a Budget

The government budget is divided into Revenue Budget and Capital Budget

Revenue Budget or Revenue Account is related to current financial transactions of the government which are of recurring in nature. Revenue Budget consists of the revenue receipts of the government and the expenditure is met from this revenue. Revenue accounts deal with taxes, duties, fees, fines and penalties, revenue from Government estates, receipts from Government commercial concerns and other miscellaneous items, and other expenditure there from.

Revenue Receipts include receipts from taxation, profits of enterprise, other non-tax receipts like administrative revenue (fees, fines, special assessment etc), gifts, grants etc.. Revenue expenditure includes interest – payments ,salaries, defence expenditures major subsidies, pensions etc.

The Capital Account is related to the acquisition and disposal of capital assets. Capital budget is a statement of estimated capital receipts and payments of the government over fiscal year. It consists of capital expenditures. The capital accounts deals with expenditure usually met from borrowed funds with the object of increasing concrete assets of a material character or of reducing recurring liabilities such as construction of buildings, irrigation projects etc..

Capital Receipts include a) Borrowings b) Recovery of loans and advances c) Disinvestments and d) Small savings.

Capital Expenditure includes a) Development Outlay b) Non – developmental Outlay C) Loans and advances and d) Discharge of debts.

14.2.7 Types of Budgets

Based on the balancing of revenue and expenditure, budgets are divided into Balanced Budget and Unbalanced Budget.

a) Balanced Budget : A balanced budget is that over a period of time, revenue does not fall short of expenditure i.e., revenue is equal to expenditure (Revenue = Expenditure)
b) Unbalanced Budget : The budget imbalance may be due to an excess of expenditure over income or an excess of income over expenditure. In other words, budget may either be surplus or deficit. A budget is said to be surplus when public revenue exceeds public outlay (R > E).

A deficit budget means a budget when expenditure exceeds revenue

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14.2.8 Different Concepts of Deficits

There are different types of deficits depending on the types of receipts and expenditure. The commonly referred types of deficit are 1) Budgetary deficit 2) Revenue deficit 3) Fiscal deficit 4) Primary deficit and 5) Monetized deficit.

A. BUDGETARY DEFICIT

The budgetary deficit shows the gap between total receipts and total expenditures of the government. The budgetary gap is financed by issuing 91 days treasury bills and running down on the government's cash balances with treasuries and Reserve Bank of India.

B. REVENUE DEFICIT

Revenue deficit is the excess of revenue expenditure over revenue receipts.

Revenue Deficit = Revenue Receipts – Revenue Expenditure.

C. EFFECTIVE REVENUE DEFICIT

It is the difference between revenue deficit and grants for the creation of capital asset. This was first introduced in India in the Union Budget 2009 – 10.

Effective Revenue Deficit = Revenue Deficit – Grants for creation of capital asset.

D. FISCAL DEFICIT

Fiscal Deficit is the excess of total budget expenditures over the total budget revenue excluding borrowings. In other words, fiscal deficit is budgetary deficit plus borrowings and other liabilities. The gross fiscal deficit is the excess of total expenditure over revenue receipts and non – debt capital receipts.

Fiscal Deficit = Total expenditure – (revenue receipts + non – debt capital receipts)

Net Fiscal Deficit = Gross Fiscal Deficit – Net loans and advances.

The significance of fiscal deficit is that it is a measure of total borrowing requirements of the government. It shows the extent of dependence of the government on borrowings to meet its budget expenditure.

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E. PRIMARY DEFICIT

Primary deficit is the excess of fiscal deficit over interest payments.

Primary Deficit = Fiscal Deficit – Interest Payments

Primary Deficit explains how much government borrowing is going to meet expenses other than interest payments. It reveals the extent of burdens in future resulting from current government policy. It is a basic measure of fiscal irresponsibility. A low or zero primary deficits is a pointer to financial discipline of a government.

F. MONETIZED DEFICIT

It refers to the sum of net increase in holdings of treasury bills of the Reserve Bank of India and its contributions to the market borrowings of the government. It creates equivalent increase in high powered money or reserve money in the economy. In other words, it denotes government borrowing from the Reserve Bank of India.

Table 14.1: Types of Deficits

Types of Deficits	Concept / Meaning
Budgetary Deficit	Total Revenue [including borrowing] – Total Expenditure
Revenue Deficit	Revenue Receipts – Revenue Expenditure
Effective Revenue Deficit	Total Expenditure – (revenue receipts – non debt capital receipts)
Fiscal Deficit	Budgetary deficit + borrowings
Primary Deficit	Fiscal deficit – Interest payments
Monetized Deficit	Government Borrowing from the Reserve Bank of India

14.3 Budgetary Procedure in India

14.3.1 Introduction

The Constitution of every country lays down a budget procedure and thus the budget of every country is framed; passed and executed in accordance with that specific procedure. In almost all democratic countries including India follow the following budgetary procedures:

1. Preparation of the Budget

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2. Presentation and enactment of the budget and
3. Execution of the budget

14.3.2 BUDGET PREPARATION

The Budget Cycle normally starts towards the end of September of the current year and lasts till May of the next financial yearon the presumption that Budget shall be presented at 11:00 hours on the 28th/29th of February of a year (Last working day of February), the budget Division prepares a comprehensive schedule for carrying out the budget preparation activities. In the year in which General Elections to the Lok Sabha are held, the interim Budget is presented to Parliament on any given day convenient to Government. After the General Elections are over and assumption of office by the new Government, the Regular Budget is presented to Parliament on any date convenient to Government or as decided by the new government. The budget schedule is constantly reviewed by the senior officers to watch the progress since budget span leaves no scope for slippages.

The Schedule clearly indicates the Division/ Organization/Ministry/ Department responsible for various tasks/ activities along with the time-frame there in. Budget for a year is prepared by the Budget Division in the Ministry of Finance broadly on the basis of detailed estimates and receipts received from various Departments/ Ministers of Government of India and its own subordinate estimating authorities. The General Financial Rules also prescribe the broad guidelines, procedures and forms for the preparation of budget estimates of receipts and expenditure by the Ministers. The estimates of expenditure are prepared separately for Capital and Revenue as a Constitutional requirement and plan and non-plan in keeping with the existing classification system. The estimates of plan expenditure are made on the basis of the approved plan allocations intimated by the Planning Commission, now **NITI Aayog**. The detailed estimates of expenditure are prepared by the estimating authorities according to their assessments of requirements for the ensuring year, keeping in view the actual requirements in the past, current year's trends of expenditure, the decisions taken by the Government which will have a bearing on the funding requirements etc..

Administrative Ministers and heads of the respective Departments are supplied with skeleton forms on which they are asked to prepare the estimates. The prescribed form has four different columns:

a. Actuals of the previous year
b. Sanctioned estimates for the current year
c. The revised estimates for the current year and
d. The budget estimates for the next year. For example, the

Budget for 2019 – 20 contains the following:

1. The actuals of 2017 – 18
2. The budget estimates for 2018 – 19
3. The revised estimates for 2018 – 19 and
4. The budget estimates for 2019 – 20

These estimates are prepared on the prescribed form and in the prescribed manner. These estimates are then consolidated by the head of each department. Further, these estimates are then consolidated by the ministers concerned and passed on to the Finance Ministry for scrutiny. Finally, the Finance Ministry consolidates all these estimates and prepares the budget for presenting before the parliament.

14. 3.3 Presentation and Enactment of the Budget

As soon as the budget is ready, it is placed before the LokSabha and RajyaSabha for necessary approval in the case of Central Government and before the respective assemblies of the states in the case of state budgets. According to the Indian Constitution, all money bills must be initiated in the lower house, so they are first introduced in the LokSabha at the Centre. The central Government budget undergoes the following stages:

a) **Presentation of Budget in Parliament :**The budget is presented in the Parliament by the government in the case of Central Government and before the respective assemblies of the states in the case of state budgets. The budget is presented by the Finance Minister in the LokSabha and by a Junior Minister in the RajyaSabha. The finance Minister makes a detailed budget speech at the time of presenting the budget before the LokSabha.
b) General Discussion : Ageneral discussion takes place in both houses of the Parliament after the presentation of the budget. During the general discussion, the members of the Parliament have a right to criticize the various proposals and estimates as shown in the budget. As soon as the general discussion are over, the Finance Minister replies to all the criticisms, objections, doubts etc..raisedagainst the budget. The general discussion is over after the reply of the Finance Minister.
c) Voting : As soonas the general discussion on the budget is over along with the reply of the Finance Minister, the question arises of voting on the budget. The LokSabha starts examining the estimates or the demands for grants Ministry-wise. After the discussion, the demands of each Ministry are voted.
d) **Passing of the Appropriation Bill :**In the Constitution of India, it has been laid down that no money can be appropriated out of the Consolidated Fund, except in accordance with the

law. Hence, appropriation bill has to be passed by the Parliament.

e) **Passing of the Finance Bill :** The finance bill is represented before the Parliament after passing the money bill. The finance bill when passed becomes the Act which authorizes the government to collect the required money through taxation as per the provisions that have been made in the budget.

The budget is said to be passed when Appropriation Bill and Finance Bill are passed by the LokSabha. After the budget is passed in the LokSabha, it goes to the RajyaSabha. The RajaSabha does not enjoy the power of amending or rejecting the budget. The RajaSabha can make only recommendations to the LokSabha but within 14days only. The LokSabha may either accept or reject the recommendations of the RajyaSabha. After passing the budget in both houses, it goes to President for assent. Generally, the President gives his assent on account of his limited powers.

f) Execution of the Budget

After passing the budget, the question of its execution arises. The responsibility to execute the budget lies with the respective governments. That is, Central Government and state governments. The execution of the budget has three aspects:

1. Collection of Revenue
2. Proper custody of collected funds and
3. Distribution of Grants to different administrative ministers or departments

Each administrative minister or department is required to submit periodical returns to the Finance Ministry so as to enable them to exercise full control over it through the whole financial year

14.3.4 Glossary

Annual Financial Statement: Also referred to as Budget. Budget means the statement of estimated receipts and expenditure of the Central Government for each financial year, laid before the Parliament.
Budget: It is the statement of estimated receipts and expenditure of the Central Government as per its policy for each financial year and placed before the Parliament.

Budget Division : It means Budget Division in the Development of Economic Affairs of the Ministry of Finance in the Central Government.

Accounts or Actual of a Year : These are the amounts of receipts and disbursements for the financial year beginning on April 1st and ending on March 13st following as finally recorded in the Accounting authority's books (as audited by C&AG). Provisional Accounts refer to the unaudited accounts complied by CGA (Controller General of Accounts)

Appropriation: It means the amount authorized by the Parliament for expenditure under different primary unit of appropriation or part there of placed at the disposal of a disbursing officer.

Appropriation Accounts: These are the accounts prepared by the Controller General of Accounts for each grant or appropriation. It means the amount of the grant/appropriation and the amount spent under the grant/appropriation as a whole. Important variations in the expenditure and allotments, whether voted or charged, are briefly explained with the comments of audit.

Appropriation Charged: It means sums required to meet charged expenditure as specified in the Constitution during the financial year concerned, on the services and purposes covered by charged

Appropriation : It does not include provisions for voted expenditures

Charged Expenditure or Charged on the Consolidated Fund of India: It means such expenditure as is not to be submitted to the vote of the parliament under the provisions of the constitution

Consolidated Fund of India : Under Article 266 (1) of the Constitution all revenues of the Union Government, loans raised by it and all moneys received in repayment of loans form one consolidated fund called the Consolidated Fund of India. No moneys out of this Fund can be appropriated except in accordance with the law and for the purpose and in the manner provided in the Constitution.

Constitution : It means the Constitution of India
Contingency Fund: It means the Contingency Fund of India established under the Contingency Fund of India Act, 1950, in terms of Article 267 (1) of the constitution. Contingency Fund is in the nature of an imprest, the corpus of which is 500 crore at present.

The Contingency Fund is intended to provide advances to the executive/ Government to meet unforeseen expenditure arising in the course of a year, pending its authorization by the Parliament. The

amounts drawn from the Contingency Fund are recouped after the Parliament approves it through the supplementary Demands.

'Department of the Central Government': It means a Ministry or Department of the Central Government as notified from time to time and listed in the Allocation of Business Rules. It includes the Planning Commission, the Department of Parliamentary Affairs, the President's Secretariat, the Vice- President's Secretariat and the Cabinet Secretariat.

Departmental Estimate: It is an estimate of income and expenditure of a department in respect of any year submitted by the head of a department or other estimating officer to the Finance Ministry as the material on which to base its estimates.

Finance Ministry: It means the Ministry of Finance in the Union Government.

Revised Estimate: It is an estimate of the probable receipts or expenditure for a financial year, framed in the course of that year, with reference to the transactions already recorded and anticipation for the remainder of the year in the light of the orders already listed of.

Vote on Account: It means a grant made in advance by the Parliament, in respect of the estimated expenditure for a part of new financial year, pending the completion of the procedure relating to the voting of the demand for grants and the passing of the Appropriation Act.

Voted Expenditure: It means expenditure which is subject to the vote of the LokSabha. It is not distinguished from charged expenditure, which is not subject to voting, even though can be discussed in the Parliament.

Charged Expenditure or Charged on the Consolidated Fund of India : It means such expenditure as is not to be submitted to the vote of the Parliament under the provisions of the constitution.

Appropriation Bill: Money bill which includes all the grants for the year whether votable or non – votable.
Finance Bill: The bill which authorizes the government to collect the required money through taxation, or the provisions that have been made in budget.

Table 14.2: The Major Content of the Interim Budget Presented in February 2019 [Rs. inlakh crores]

	2015-16 Actuals	2016-17 Actuals	2017-18 Actuals	2018-19 BE	2018-19 RE	2019-20 BE
Revenue Receipts	11.95	13.74	14.35	17.25	17.29	19.77
Tax Revenue	9.43	11.01	12.42	14.80	14.84	17.05
Non Tax Revenue	2.52	2.73	1.93	2.45	2.45	2.72
Capital Receipt	5.95	6.00	7.06	7.16	7.27	8.06
Recoveries of Loan	0.20	0.17	0.15	0.12	0.13	0.12
Other Receipts	0.42	0.47	1.00	0.80	0.80	0.90
Borrowings & Other Liabilities	5.32	5.35	5.91	6.24	6.34	7.04
Total Receipts	17.90	19.75	21.41	24.42	24.57	27.84
Total Expenditure	17.90	19.75	21.41	24.42	24.57	27.84
On Revenue Account	15.37	16.90	18.78	21.41	21.40	24.47
Of Which, interest payments	4.41	4.80	5.28	5.75	5.87	6.65
Grants in aids for creation of assets	1.31	1.66	1.91	1.95	2.00	2.00
On Capital	2.53	2.58	2.63	3.00	3.16	3.36

Account						
Revenue Deficit	3.42	3.16	4.43	4.16	4.10	4.70
Fiscal Deficit	5.32	5.35	5.91	6.24	6.34	7.03
Primary Deficit	0.91	0.55	0.63	0.49	0.47	0.38

Note:

1. BE = Budget Estimate, RE = Revised Estimate.
2. The figures for 2019- 20 Budget Estimates are based on the interim budget presented in February 2019. The full budget was presented in the month of July 2019. This book was prepared in the month of June 2019.

14.4 The State Budget

The budget is presented in the Parliament by the union Finance Minister. Similarly, the State Governments have also to present budget in the state Legislatures as per **Article 202 of the Indian Constitution.** The Local Governments like Corporations, Municipalities and Panchayats also present their budgets.

MODEL QUESTIONS

1. What do you mean by a budget ? Explain the objectives of budget.
2. Explain different Concepts of budget deficits? What are the implications different deficits?
3. How far is deficit financing beneficial for an economy?
4. What do you mean by fiscal policy? Explain the major fiscal tools used to check depression and boom.
5. Explain the different stages of central Government budget in India.

MODEL QUESTION PAPER

Time: 3 Hours **Maximum: 75 Marks**

Part A (10x2=20 Marks)

Answer all the questions.

1. What is the importance of public expenditure?
2. Explain developmental and non- developmental expenditure?
3. How does the public expenditure affect the economy?
4. What are the causes of increasing public expenditure?
5. Distinguish between revenue expenditure and capital expenditure?
6. Explain Wagner's hypothesis of Public expenditure?
7. Explain Wiseman – Peacock Hypothesis?
8. Explain Colin Clark Limited Hypothesis?
9. What are the views of Public expenditure?
10. Write a note on growth of Public expenditure in recent times.

Part B (5x5=25 Marks)

Answer all the questions choosing either [A] or [B].

11. A. Explain the relationship between plan and non-pan expenditure in India?

[OR]

B.Write a note on "Control of Public expenditure"?

12. A. Distinguish between "private debt and public debt" ?

[OR]

B.Distinguish between "Borrowing" and Debt"?

13. A. What are the causes for public debt?

[OR]

B.What are the objectives of public debt?

14. A. What are the sources of public debt?

[**OR**]

B. Explain different kinds of public debt?

15. A. Explain the methods of repayment of debt?

[OR]

B.How does borrowing differ from taxation?

Part C (3x10=30 Marks)

Answer any three questions.

16.Why are the public debts growing in the recent years in India?

17.Trace the public debt position in India?

18.What are the components of India's public debt?

19.Explain the debt position of Indian states?

20.Discuss the partners of public debt growth?