PUBLIC FINANCE

M. A. Economics First Year

Semester – I, Paper-III

Director, I/c

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103EC21: PUBLIC FINANCE

MODULE 1 : INTRODUCTION

Nature, Meaning and scope of Public Finance – Govt. in a mixed economy; public and private sector, cooperation or competition; Govt. as an agent for economic planning and development; Govt. as a tool for operationalizing the planning process; private goods, public goods, and merit goods– Principle maximum social advantage.

MODULE 2 : PUBLIC REVENUE

Theory of incidence; Alternative concepts of incidence – Allocative and equity aspects of individual taxes; Benefit and ability to pay approaches; Theory of optimal taxation; Excess burden of taxes; Trade off between equity and efficiency; Theory of measurement of dead weight losses; The problem of double taxation.

MODULE 3 : PUBLIC EXPENDITURE

Wagner's law of increasing state activities; Wiseman-Peacock hypothesis; Pure theory of public expenditure; Structure and growth of public expenditure; Criteria for public investment; social cost-benefit analysis–Project evaluation; Estimation of costs, discount rate; programme budgeting and zero base budgeting.

MODULE 4 : PUBLIC DEBT

Classical view of public debt; Compensatory aspect of debt policy; Burden of public debt; Sources of public debt; Debt through created money; Public borrowings and price level; Crowding out of private investment and activity; principles of debt management and repayment.

MODUE 5 : INDIAN PUBLIC FINANCE

Indian tax system; Revenue of the Union, States and local bodies; Major taxes in India; base of taxes, direct and indirect taxes, taxation of agriculture, expenditure tax, reforms in direct and indirect taxes, taxes on services; Non-tax revenue of Centre, State and local bodies; Fiscal crisis and fiscal sector reforms in India; Reports of Finance Commissions in India.

READING LIST

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CONTENTS

Lesson No. 1

Role of Government in an Organised Society, Changing Perspectives-Government in a Mixed Economy.

Modules

1.0 Objectives :

After reading through this lesson you should be able to

- Describe the characteristics, merits and demerits of a market economy without government intervention
- Appreciate the role of government in a mixed economy
- Observe the circular flow in a mixed economy, and
- Trace the role of public sector in the changed perspective

1.1 Introduction

Ever since mankind opted to have a settled life, the need of an organised society was felt. Earlier to that i.e. in the Old Stone Age, people lead a nomadic life and have no concern for systematic management of natural resources and conduct of production activities in the society. They continue their living on using the collected food items from the forests. Gradually, human being understood the use of processed foods and started storing it for future uncertain days. Over the years, preference was accorded to lead a settled life in areas having potential to organize agricultural activities. Almost all stage theories of economic growth describe the initial stage of an economy as that in which emphasis is on rural agricultural activities. Orderly settlement of population resulted in creation of appropriate social and economic structures to guide and discipline the individuals. To institute a system of reward and punishment for obeying and disobeying the societal rules the need for an independent organisation was felt. The birth of the government is the outcome of such a social evolution process. Initially, the responsibility is given to the most successful leader of the group to occupy the chair of the king and administer the people. The structure of modern government surfaced after hundreds of years of evolution on the role of the government and its structure. Experts now view that effective state intervention and selective integration with the global economy have been responsible for development success in the past and it is also likely to remain the recipes for upward mobility in the global economy in the future.

1.2 Characteristics of a No-Government Market Economy

The absence of a government in an economy will lead to a situation of chaos and total confusion in the operation of production and consumption activities. The dominance of the mighty will create an environment of absence of confidence among the population. Life, business, production etc. will pass through a state of uncertainty assuming modest behaviour on the part of the individuals and business enterprises in a no-government economy. The economy may reflect a slightly better organizational efficiency. The economic organisation in such a society consists of two groups of players. They are the consumers and producers. The individuals as consumers will find it advantageous to operate through market to get variety of goods and services. The business enterprises as producers will organise their production activities to meet consumer needs. In the absences of „money" as a unit of exchange in such an economy, the economy may depend upon barter system of exchanging one good for the other or accept a particular commodity to play the role of money. In early days in our country, paddy played such a role and both producers and consumers exchanged commodities for paddy.

The sovereignty of the consumer is of paramount importance even in a no-government economy. The firms will produce goods and services on the basis of the choice and needs of the consumers. The consumer‟s sovereignty, however, is guided by his ability to purchase goods and services. This on the other hand depends on his ability to sell his productive services to firms and individuals. An individual without income is unable to influence the organisation of production in a significant manner. This means in such an economy, market signal plays an important role and production occurs for those items for which there is a market need.

1.2.1 Efficiency in a No-Market Government Economy:

Two important merits of such a no-government market economy have to be outlined. One is as the transactions in such an economy are voluntary; it does not involve compulsion or coercion. It is operational with voluntary cooperation among individuals. The organisation of production is possible due to the spontaneous activities of the individuals. A person can safely remain away from the production process if he is not interested in it and prepared to bear the consequences.

The second important advantage of such a market economy is that it incorporates a high degree of efficiency. Efficiency of an economy is required both in consumption and in production. In a market economy free play of market forces facilitates reaching the optimal situation. In production, an individual producer is at equilibrium when the isoquant is tangential to the iso-cost line. For the economy as a whole production efficiency is achieved when the production possibility curve is tangential to the ratio of the product prices. Efficiency in consumption is also similarly derived for a single consumer and for the society as a whole. The Pareto optimality is achieved when a set of conditions is fulfilled related to individual consumer, individual producer, single commodity and all commodities.

1.2.2 Equity in a No-Government Market Economy:

Pareto optimality attained through the market process may not be the ethically desirable equilibrium. Society may be interested in facilitating the weaker sections to come up and have a better standard of living. There exists widespread difference in capacities of individuals to earn income. This is likely to be aggravated further due to the favourable position enjoyed by such capable individuals‟ vis-à-vis the others. Further, capacity to earn income is dependent on the asset base of the individuals which is unevenly distributed in a historical process. Some individuals born in families with abundant wealth, enjoy high level of living even though they do not have necessary productive skills. Individuals with high capability and skill may not have the required assets to work on. The outcome of a free market is normally deprivation of many and enrichment of only a few. Some sort of collective action is necessary in such circumstances to enhance efficiency of the economy. The role of the government in such situations is to impose taxes on the rich and transfer it to the poor to enhance their ability and earn more income.

The second demerit of a no-government market economy is the emergence of monopolists in the market through different techniques preventing the entry of others. Due to spatial, technical and organisational advantages they try to garner maximum benefit from the market and exploit the ordinary consumer. Overall efficiency of the system gets reduced due to the fact that market values are not realistically based on real resource costs.

The third problem is with relation to changing taste of the individuals operating in such an economy. If the change is related to the commodity used as money, then it will have a chain effect on the growth of all other commodities. More desire to hold such money commodity(for example Paddy) inevitably means less availability of such commodity in the economy and vice versa.

Lastly, over the years, the so called simple village economy has changed significantly and became more complex and complicated. The inter-dependence of different sections of the economy has increased tremendously and there arose the need of certain activities, which is not the responsibility of any single individual in the society. Caring for such common items is very important to facilitate the growth of other items. For example, roads are not important for any single individual but are very important for the community as whole.

1.3 The Consequences of an All –Government economy:

When an economy fully depends upon the government to provide for all services, then the individual consumer has no private or independent decision making authority. The choice of different services is done in a collective manner and all individuals have to consume it in equal quantities. One cannot refuse the consumption of such goods or services. The price paid by the consumers is also identical for all.

In an all-government economy with equal access to consumption any difference in individual preference may result in trading of goods and services if he is permitted to do so. However, such trading requires technological division of goods and services for transaction purpose. This had happened in many socialist or communist countries where free supplies of some essential commodities were traded in the market. The performance of an all-government economy with regard to efficiency in production or fulfilling the individual preferences is well below the desired level. However, from equity point of view it ranks high and facilitates equal treatment of all individual in an equitable manner.

The difference between a no-government economy and all-government economy is insignificant if all persons have identical initial endowments and preferences. The endowment reflects the capacities or abilities of an individual. The preference is the choice of the commodities in which he is interested. Due to existence of differential endowments and differential preferences of the consumer, it is suggested to mix up the private and public sector participation in the economy to get the advantage of both.

1.4 Government-Meaning, Types and Functions:

1.4.1. Meaning

The situation arising out of no government and full government is discussed in the above paragraphs. It is now time to exactly spell out the meaning of government intervention in the decision-making process of an individual. Government is defined to be an organisation formed for the purpose of exercising authority over the actions of individuals living together in a society (Hyman, 1983). The formation of a government through political institutions specifies the role of the individuals in the decision-making process. The individuals in political capacitates decide what the government will do, how much it will spend and how to mobilize resources for their function at different points of time.

Experts feel that the activities of a government can be looked in two ways. One is to consider the state as a unitary entity with the existence of public interest, which is quite distinct from the interest of the individual citizens. This is called public interest. This is something, which is above self-interest of individual citizens and not supposed to be looked after by any one person in the society. The other approach is to consider government as equivalent to a corporate enterprise and behaves like a private person. In the second approach, the government tries to maximize „social utility" which is the sum total of individual utilities from public service consumption.

1.4.1 Types

It is identified that there are three ideal-typical historical patterns of how state authority is organized and used in the developing world. These are i. neopatrimonial states; ii. Cohesive-capitalist states and iii. fragmented-multiclass states. (Kohli, 2009). The characteristic of all modern states is a well-established public arena that is different from private sector and in addition it is centralized and exercises coercive control over a territory.

Over the years there exists overlapping and confusion with regard to the area demarcated for public and private service providers in many developing countries. Neopatrimonial states are those in which the states emerge through a distorted process with weakly centralized and barely legitimate authority structures, personalistic leaders unconstrained by norms or institutions, and bureaucracies of poor quality. In these states public officeholders tend to treat public resources as their personal patrimony. These are therefore not really modern, rational-legal states. Some African states belong to this category. Cohesive-capitalist and fragmented-multiclass states are two of the other ideal-typical states. The more modern rational-legal states in many developing countries take a mixed form accommodating both these requirements. The cohesive-capitalist states are also known as developmental states and it is the opposite of neopatrimonial states described above. These states are characterized by centralized and purposive authority structures that often penetrate deep into the society. For a variety of historical reasons these states have tried to achieve rapid economic growth on a priority basis. For achieving the goal of rapid growth, cohesive-capitalist states have carved out a number of identifiable links with society's major economic groups and devised efficacious political instruments. The main political instrument of these states is, of course, a competent bureaucracy. South Korea and Brazil successfully applied this model to bring state-led industrialization. Fragmented-multiclass state is a midway between the two extremes of political effectiveness defined by neopatrimonial states on the one end and cohesive-capitalist states on the other. Unlike neopatrimonial states, fragmented-multiclass states are real modern states. They command authority over a public arena and held accountable for poor public policies and performances. However, public authority in these states tends to be more fragmented and to rest on a broader class alliance - meaning that these states are not in a position to define their goals as narrowly as are cohesive-capitalist states. Leaders of fragmented-multiclass states thus need to worry more about political support than do leaders of other types of developing country states. For political reasons, they must pursue several goals simultaneously, as they seek to satisfy multiple constituencies. Industrialization and economic growth may be an important state goal, but it is only one among others: agricultural development, economic redistribution, welfare provision, and maintaining national sovereignty. All developing country democracies with fixed tenure elections constitute a special subset of fragmented-multiclass states. The cases of India and Brazil in several periods exemplify this type of state.

1.4.2 Functions of Government

Adam Smith, the father of economics in his „wealth of nations‟ outlined the duties of the state or government in a neat and detailed manner. For him, the first duty of the state is to „protect the society‟ from external aggression. This is to be done by building a suitable defence structure for the economy. The second duty of the state is to protect, as far as possible, every member of the society from the injustice or oppressive behaviour of every other member in it. The third and last duty of the state is to erect and maintain those public institutions and those public works, which may have the highest degree of advantage to build a society. The three functions of the classical era can be identified with maintenance of law and order and provision of essential public services.

The modern public finance experts are of the opinion that the most "elementary and universally observed function of government is the use of its authority to establish rights to use productive resources…." This means government has to facilitate production process in the economy by framing rules of ownership rights on land and property and ensure its uninterrupted use. The government will also regulate activities which are harmful for others and prevent their occurrence. Musgrave identified the activities of the government as allocation, distribution and stabilisation of the economy.

Buchanan and Flowers suggested that the first role of the government is to play the role of a referee in an economy. It has to establish and maintain a legal framework to protect the rights of the individuals and groups. It has also to specify the domain of its own activities.

Whoever violates the rules and regulation has to be penalized to conform to the socially and legally accepted rules and regulations. The second important role of the government is to act as means or process through which individuals provide certain goods and services for them. This theory tries to secure the commodities collectively rather than individually. Tax and subsidy instruments are used by constitutional authorities to mobilize resources and spend it in different activities to accomplish the above stated goals of a government.

Joseph Stiglitz viewed that the high growth of East-Asian countries is due to supportive government action with free play of market forces. Even is USA, growth rate would have been much lower if there is no support from the government in creating the necessary environment in economic development. He suggested six important activities for the government. These are promoting education, promoting technology, supporting financial sector, investing in infrastructure, preventing environmental degradation and creating and maintaining a social safety net.

1.5 Government in a Mixed Economy:

Most of the democracies of the world have now opted for a „mixed economy‟ which represents combining the benefits of both a centralized and a decentralized system. A mixed economy is defined as the "one in which government supplies a considerable amount of goods and services and significantly regulates private economic activity". A fully centralized economy where there is total absence of private sector is otherwise called a communist economy. On the other hand, when the role of the government sector is to provide the minimum is called a „pure market economy‟ or a capitalist economy. The mixing of the private and private sector identifies the economy as capitalistic whereas a higher share of public sector is identified as a communistic or socialistic.

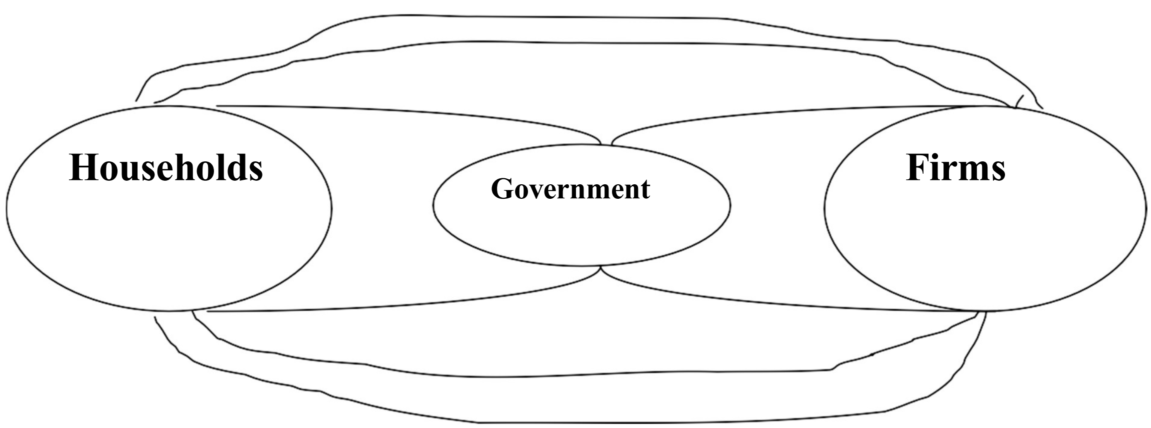
In a mixed economy the role of the market and the role of the government are becoming complementary to each other. The market economy obviously intends to exchange all goods and services through interaction of demand and supply of the tradable items. However, if it is felt by the government that the provision of a particular commodity through the market is not conducive for overall public welfare, then the government can intervene and regulate the activities of the private sector and direct it to proceed on the desired lines. If the government feels that leaving a service to the private sector is not in the national interest, then it can take exclusive control of such item into its own hands. The government provides such items through political institutions. This involves interaction among all individuals with regards to the quantum of providing the public goods and not only between the buyers and sellers as is the case in a market. The political set up in the government provides different product-mixes and the individuals together is asked to choose a particular product-mix.

The federation of the individual is, however, greatly reduced due to intervention of the government institutions. In a market economy, the consumer is supreme in the decision-making process and chooses the quantity of the product at his own discretion. He may go without consuming an item, if he is not satisfied with the quality of the product. In a controlled economy goods and services are to be consumed collectively and the individual has no option to escape from the consumption process. He has to accept the majority view even if he is not happy with quality of the service. Similarly, if he desires to consume more of a commodity he is not in a position to do so because of equal consumption condition of a public good.

1.5.1 Circular Flow in a Mixed Economy:

The role of market and the government in a mixed economy can be presented with the help of a diagram as given below:

Diagram-1: Circular Flow in a Mixed Economy.



In a pure market economy, the productive resources are owned by private individuals and they use it according to their own choice. Their action is determined by the market price of the product. The price of the product is determined by the free play of demand and supply of the individual product. The household, given the market price have the liberty of deciding as to how the resources they own are to be employed. The firms also have the discretion of choosing the inputs to be purchased and the commodities to be produced. The diagram represents two different situations. The first one relates to absence of government and free play of market. In the second the mixed economy of private and public sector is assumed. In the first model, the lower segment reflects the dependence of the producing firm on the inputs provided by the household sector in exchange for money. The firms purchase inputs from the household for carrying out production activities. The upper segment of the diagram represents commodities transactions from the firm sector to the household sector. The firms sell their manufactured commodities to the households at market-determined price.

The existence of government is included in the model which characterizes the essence of a mixed economy. The middle position of the diagram represents transaction of the government with households on the left hand side and with firms on the right hand side. The government imposes taxes, duties and fines on the individuals as well as on the firms to raise resources. The government sells its services to the public and to the firms directly or indirectly in exchange for money. The household provides inputs to the government for carrying out the production activities inside the government sector. The firms supply their outputs to the government for the same purposes. The production of different services in the government sector by using the outputs of the firms is carried out through the political institutions on the basis community preferences.

1.5.2 Nature of the Government Transactions:

The nature of government transactions in the economy can be divided into two categories. One is called exhaustive expenditure and the other is transfer payments Exhaustive expenditure represents a situation when the government withdraws productive resources or factors of production from the private sector and use it in its‟ own production. There are some other types of expenditures which need not withdraw resources from the private sector what it does is to transfer the capability of one section of the private sector to the other sector. Most of the programmes aiming to reduce poverty and employment are of this type. These are transfer payments and are not productive activities of the government in an economy. The aim of such transactions is to extract the surplus purchasing power through taxes and distribute the same among the poor as subsidies.

1.6 Summary:

The need for a government arose as a result of complex situation of economic activity growing in an economy. The extent of government intervention greatly varies among the economies of the world mixed economy is solution the difficulties of opting for either a total market-economy or a total control economy in a mixed structure both private and public sectors operate hand-to-hand with both competition and cooperation.

Model Questions:

1. Explain the characteristics of a market economy.
2. Critically examine the role of government in a mixed economy.
3. Characterise the brief feature of no-government market economy and highlight its limitations.
4. Are you in support of an all-government control of the economy? If not, why?
5. Explain the meaning of a government in modern times.
6. Described the role of government in a mixed economy.

Books for Further Reading:

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Lesson-2

PUBLIC AND PRIVATE SECTOR, COOPERATION OR COMPETITION; GOVERNMENT AS AN AGENT FOR ECONOMIC PLANNING AND DEVELOPMENT; GOVERNMENT AS A TOOL FOR OPERATIONALIZING THE PLANNING PROCESS

Modules

2.0 Objectives :

After going through this lesson, you should be able to

- Visualise the co-ordinate and competitive role of the public and private sectors
- Describe the role of the state in planning and development
- List objectives of planning for development.
- Differentiate the nature of physical and financial planning
- Evaluate consistency and incompatibility in planning

2.1 Introduction:

Planning of economic activity is commonly associated with individuals, firms and the government. It is setting goals for future and making out a strategy to achieve it with success. Households make long range plans for construction of house, education of children, marriage of daughter etc. much in advance and prepare themselves to have it. Similarly; business firms execute their modernisation and diversification plans in a strategic and planned manner. A nation also proceeds in a similar manner and plans for growth or development over a time frame.

For an economy, left to it, economic development may not take place. The classical notion of "invisible hand" failed to generate the desired economic growth. This was proved in the days of Great Depression in 1930s. Since then the interventionist role of the government has gained importance in the working of the market economy. The collective action of the market and government is to realise a whole series of internal and external economies from production process carried out in the economy. Planned realization of these economies will create income. The government provides the necessary framework to achieve these objectives. Two types of framework can be thought of here. One is a diagnostic framework. It studies the trend factors, factors causing fluctuations in the economy and problems related to backward areas. The other one is remedial framework. It analyses productivity of private and public investments, development of industries and linkage of other sectors etc. While the diagnostic framework emphasises on the output and growth of different sectors of the economy directly, the remedial framework does the same thing indirectly.

2.2 Public and Private sector

Planning is identified with governmental intervention in the market mechanism to speed up economic development. Through intervention, the government decides as how to produce, what to produce and for whom to produce. Through various policy instruments, the government regulates the activities of the private sector, to be in tune with the broad macro-economic objectives of the economy. It also carry out some of the economic activities on its" own when there is a realisation that the private sector is not interested to carry out that activity. .

2.2.1 Size of the Public Sector:

As discussed earlier, a fully controlled economy or a fully market economy is only a conceptual feasibility. It is not found in reality in any country of the world. This means that almost all the economies of the world are mixed economies in the strict sense of the term with varying proportions of the public sector participation. However, experts have agreed upon a minimum participation of public sector to the extent of 25 to 50 percent to be called as mixed economy. A situation less or more than this cut off point gives rise to either a market economy or a controlled economy. Mostly, developed capitalist countries have public sector closer to the lower limit whereas majority of the developing countries are closer to the upper limit.

2.2.2 Functions of Private Sector

The private sector in an economy is mostly guided by profit consideration. The factors of production in a private sector believe in hard working and try to maximise their earnings. The social service consideration is mostly absent in such private enterprises. The entrepreneurs here are prepared to undertake risk both in the short run and in the long run and face the consequences. They may end up with earning profit or loss in carrying out these risky activities.

2.3 Co-operation vs. Competition

The private sector is now widely acknowledged as a key partner in development through establishing new enterprises, creating jobs, providing goods and services, generating income and profits, and contributing to public revenues. In the recent years, there prevails a diverse form of engagement between the private sector with the governments, donor agencies and civil societies. These include core business activities, public private partnerships, social responsibility activities, and cross-sector or multi-stakeholder partnerships for development. The role played by governments and other public development actors is that of enabling and leveraging these private sector activities. It stresses the common objective across all partners to build on the various forms of private sector engagement, including investment, capacity building, inclusive business models, knowledge sharing and innovation and contributions to policy dialogue. Five principles were identified for achieving co-operation between private and government sectors. These principles are; inclusive dialogue for building a policy environment conducive to sustainable development; collective action; sustainability; transparency and accountability for results. There have been several experiments in executing infrastructural services through PPP mode. Many external aid institutions like World Bank, IMF etc. has made this a pre-condition for channeling aid resources. This model facilitates optimal risk allocation between public and private sectors.

2.4 Planning and Economic Development

The type of planning to be accepted in a country greatly depends on a variety of factors. The resource endowments, the political set up, the current level of development are some of these factors which determine the importance of planning mechanism. United state of America with no formal planning as yet still have sectoral guidelines which reflects indirect regulation of the private sector which is the most important feature of planned economy. Performance norm is devised in that country for each sector and it is necessary to achieve it within a definite time frame. The French type of planning gives the targets sector by sector. In that system, the government is in control of the credit system, raw materials and other infrastructure facilities. Through the ownership of all these, the government can make private enterprises move to those areas where it is interested to have more development.

The importance of planning increases manifold in case of developing economies where there exists wide difference in the economic condition between the rich and poor. Usual market forces fail to address this problem due to their inherent constraints. The investment program in such an economy has to be carefully managed; foreign inflow of capital has to be suitably maintained so that it will address both the problem of equity and efficiency in a balanced manner.

2.5 Role of the State in the Planning Process:

Planning obviously means the existence of centralised authority to draw the plan, mobilize resources and monitor the achievements. The government through the planning process may speed up economic development if attention is given to the following aspects of the functioning of the economy.

i. Identification of problems of different sectors,
ii. The production of public services like defence, justice, education etc
iii. The production of special public services such as transport, postal, telegraph etc;
iv. To carry out major public works like roads, ports, power station, etc;
v. The production of goods and services in competition with the private sector;
vi. Resource mobilization for its own activities

2.5.1 Objective of Planning

The planning process in an economy sets out a number of objectives to be achieved in the process of implementing different plans and programmes. These are;

- **Resource Allocation:** This objective of the planning process is to secure necessary adjustments in the allocation of resources by the market. Public sector intervention is necessary when market imperfection occurs and the monopoly element in the market transactions surfaces. In such a situation, the government regulates the behaviour of the monopoly firms by enacting legislation and monitoring the price and output of those firms. The second situation is where optimal output is not possible due to lumpiness in the productive factors. The firm is operating at decreasing cost segment of the average cost curve. Normally, the equilibrium output is reached when MR=MC=AR=AC. This is possible in perfect competition in the long run. But market transaction seldom satisfies this condition. In such situations, the government has to interfere and make provision for tax-subsidy offer to secure optimal output. Resource allocation also suffers when there exist external economies of production. Development of specific activity in a region results in rise in the value of other services available there. In such situation, it is possible to get a price from all beneficiaries. Then it would be possible to get the main activities at a lower price, which is not possible if it is left to the market. The government can do such a thing because it can impose tax or grant subsidy on the persons who receives these external economics or diseconomies. Similarly an activity, which may be profitable from private point of view, may be unprofitable from public point of view due to the social cost inclusion. The emergence of externality and consequential inefficiency in resource allocation give rise to a situation when some services are to be provided by the government. These are public goods and merit goods. Discussion on these will be done in the next section.

- **Resource Distribution:** The distribution objective of state policy is of recent origin. The success of allocation objective depends upon a desired or proper state of resource distribution. Efficient use of resources assumes a proper state of distribution and continuation of the same even after government intervention in the problem areas of resource allocation. The distribution of resources in an economy is determined by a number of factors. There are the law of inheritance, the distribution of talents, the availability of educational opportunities, social mobility and the structure of market. Collectively all these factors result in some degree of inequality among various groups. Complete equality is an impossibility given differences in the factors outlined above. However, the role of the government is to create favourable condition in which inequality will get discouraged and equality will be promoted. Such corrections are to be achieved in an orderly fashion without harming the rich directly. The distribution objective is normally achieved by using the instruments of tax and subsidy. Policies which can be inserted in the planning process having redistribution thrust are minimum wage legislation, administered price for farm products tariff protection, regulating monopoly trade, special packages for elimination of poverty, starting labour-intensive activities etc. the plan programmes being translated into the budget can reach any group of individuals. The economic standard of any particular group can be brought up or down through budgetary measures. In some government programmes the objective of allocation and distribution is combined. For example, provision of low cost housing to poor families has both allocation impact of resource diversion to housing sector and benefit to the poor people. While allocating budgetary resources, the government may go for either giving resources for achieving allocation objective and then for distribution or may combine both.

- **Stabilisation of price, income and employment:** The stabilization objective of planning by the government is the most recent objective included in the function of a government. Before the great depression of thirties, it was not assumed to be important. The objective of stabilization branch is to maintain high level of resource utilisation and a stable value of money. In a market economy, allowing full freedom to the market forces will inevitably lead to instability of prices and income and requires appropriate measures to bring stability. Normally, war times lead to inflationary pressure on the economy. In recent year, fiscal experts suggest the adoption of built-in-stabiliser policy to counter the evil impact of either inflation or deflation. The built-in-stabiliser policy is an automatic response to a situation of deviation from normal price and employment in an economy. Alternatively, the use of compensatory finance has to be made applicable to maintain high employment when private economic activity shows signs of instability along with excess demand in the economy. Musgrave gave three basic rules of compensatory finance. These are;

a. If involuntary unemployment prevails the effort of the government is to increase the level of demand so as to adjust aggregate expenditure upward to the value of output produced at full employment.
b. If inflation prevails, the effort is to reduce the level of demand so as to adjust aggregate expenditure downward to the value of output.
c. If full employment and price stability prevails, maintain the aggregate level of money expenditure to prevent unemployment and inflation.

The first rule states that the government has to raise the aggregate expenditure in the economy either through its own organs or through private sector or combining the two to raise the level of employment in the economy. The second rule assumes more or less full employment. In such situation, government expenditure has to be reduced, taxes to be increased and subsidies to be reduced. If full employment and price stability exist then the third rule says that the economy must provide for an expansion of demand with the growing capacity to produce.

Thus budget planning for the stabilization of income, employment and price of an economy requires to assess the level of aggregate expenditure that are automatic in character due to the effect or resource allocation and distribution in the private sector. Then demand is to be estimated to maintain full employment and stable price level. The difference between these two has to be provided through taxes and transfer payments to achieve the balance.

If necessary, the stabilisation budget can be operated independent of the allocation budget. Any interference in increasing the level of public expenditure to produce more goods and services will lead to alteration in the allocation of resources and vice-versa. Stabilisation budget can achieve its objectives only by using the instruments, of taxes and transfer payments to expand and contract the quantum of demand in the economy.

2.5.2 Consistency in planning:

Planning obviously means some amount of compulsion for the public to abide by the overall objectives spelt out by the central authority. Sometimes, this may lead to use of coercive methods, if voluntary compliance is not forthcoming. Successful planning involves as J.R. Hicks states; „as to what extent a state economy activity is effectively organised into a specific system that is theoretically consistent in the context of human behaviour of trade and market". Consistency is to be achieved and maintained continuously and the first stage to achieve is to have compatibility, which is to adjust the economic variables with one another.

In the French type of indicative planning, consistency is achieved through its three main characteristics. These are;

1. It builds up of medium and long-term trends, which complements the short-term trends as derived and defined from the market.
2. It sets out growth and development targets and indicates ways and means of achieving these.
3. With the data available on future requirements there exists a very narrow margin of incompatibilities as a result of economic interaction.

In the French model, the market mechanisms are not entirely eliminated rather allowed to shape the short-term objectives leaving the long-term goals to the government. The government has to proceed in such a manner that the activities of itself, the business sector and the household sector are consistent with one another.

2.6 Integration of Physical and Financial Planning:

The consistency of a plan is not only confined to the sectoral allocation but also between the physical targets and financial allocation. The plan which includes the basic decision on various policy matters has two dimensions. There are some activities which the government does by its own agencies and budgetary allocation is to be provided to them. In addition to this, there are various interventions of government in shaping the private sector activities and thus have financial implications. Tax relief for housing, subsidies on tractors are few examples in second category. Hence, these services can be made cheaper or costlier by putting a subsidy or tax on the items. The pattern of accounting framework through which both these objectives are to be accomplished may be different in different countries in India, the budget contains information on three years. For the first year it gives actual, for the second year it gives the revised estimates and for the current year (year for which budget is prepared) it gives the budget estimates.

Integration of physical and financial planning requires co-ordination between the agencies preparing the plan and the Ministry giving monetary allocations. In India, the Planning Commission which is responsible for the physical targets prepares the plan, keeping in view the targeted growth rate desired by the government and the Ministry of Finance allocates funds for achieving the same.

Gaps or discrepancies may, however, arise in the process of coordination. This is due to intense competition of different sectors to get more allocation from the pool. Both political and bureaucratic pressures are exerted to get higher share of the budget cake. Conflict is also possible in discharging this dual role by the government. The government acts as a producer for some commodity and also as a regulator to control the supply of some others. For example, as a producer of liquor it produces more and more and advertises on the other hand that liquor consumption is bad for health.

2.7 Incompatibility in Planning:

Total elimination of uncertainty in planning is impossible. Occurrences of war, natural calamities or major accidents disturb the plan target achievement. Sometimes irresponsible management, underestimation of cost may vitiate the plan process. Two types of effect can be noted here. One is competition effect on the budget and the other one is coercion effect on the market. The competition effect is that effect which owes its origin to the market structure influencing the operation of the public economy. For example, the government was complied to raise the salaries of the government servants in accordance with the recommendation of the Fifty Pay commission due to prevalence of high salary in the multi-nation enterprises. The most able employee is moving towards the private sector due to this. The coercion effect on the market is just the opposite. The coercion effect on the market is just the opposite. The coercion effect on the private sector is due to direct government intervention in the product market and in the capital market. In the product market, the government sells the services at a price which may be unprofitable for the private firm to operate. For example, fixing the bus fare at a particular rate, the government compels the private operators to operate at that price which may not be very much profitable. In the capital market, the government compels the financial institutions to extend concessional lending to it which deprives the private sector to get the necessary capital.

2.8 Summary

In a planned economy, the role of the government is very much complex and critical. The government has to achieve a balance between two extremes. In one extreme, it has to achieve the targets fixed in the plan and in the other extreme; it has to reduce the incompatibilities arising in the market. The heterogeneous nature of the two extremes is the real headache of the government. The compulsive measures of public economy are mostly governed by statutory rules and regulations framed for different activities. The competitive measures in the market are, however, has to operate according to their own inner logic.

Model questions:

1. Examine the mechanism of co-existence of public and private sector in an economy.
2. What do you understand by economic planning?
3. How does the government use the planning machinery to achieve the objective of Public Finance?
4. What are the different types of planning used in developing economy?
5. Distinguish between physical and financial planning. Which one is better of the two?

Books for further Reading:

1. Margolis, J & Guitton, H (Ed); (1969); Public Economics. Macmillan, St. Martin‟s press, London.

2. Musgrave: R.A & Peacock A.T; (1967), Classics in the Theory of Public Finance: Macmillan, London.
3. Due J.F and Friedlaender, A.F (1973) Government Finance: Economic of the Public Sector, Richard D.Irwin Inc; Illinois.
4. Lekhi, R.K (1988), Public Finance; Kalyani Publishers, Ludhiana.

Lesson 3

PRIVATE GOODS, PUBLIC GOODS, AND MERIT GOODS - MARKET FAILURE

Structure:

3.0 Objectives

The unit is expected to provide knowledge about the private, public, merit goods and market failure. After going through the lesson, the learner is able to

- Understand the distinction between private, public and merit goods.
- Analyse market equilibrium of a private good.
- Explain the causes for market failure and emphasize the need for political intervention.

3.1 Introduction:

Unlimited human wants are said to be both cause and consequence of uninterrupted economic activity in any economy. Hence, economic activity which centres around human wants will actively engage in the production of various goods using different resources. From the point of view of resource use, wants can be classified into private wants and public wants. The goods which are made available to the people without any charge, but through budgetary provisions by the state and satisfy the public wants are known as public goods. On the other hand, goods which are made available to the people with certain price, but financed by the market and satisfy the private wants are known as private goods. In between the public and private goods there exists other type of goods known as merit goods or semi-public goods.

3.2 Pure Private Goods:

The goods that are paid and enjoyed by individuals are known as private goods. For example, Television is said to be private good. The price of private goods are determined by the market mechanism. Thus, market mechanism which provides private goods operates on two principles viz., principle of exclusion and revealed preference. According to the principle of exclusion, those individuals who cannot pay market price for goods are excluded from the consumption of such goods. In other words private goods cannot be enjoyed by those individuals who cannot afford to pay for them. Against, this backdrop of exclusion, the markets are expected to carry out the production activity. While doing so, the producers depend on the preference pattern of consumers. Consumers in the process of purchasing goods through their actions reveal their preference. Such revealed preference pattern of consumers forms the basis for market operation. However, those individuals who are unable to reveal their preference will be excluded from consumption.

3.2.1 Equilibrium of a Pure Private Good:

Equilibrium of production relating to private good occurs at the point of intersection of demand and supply curves. Thus, the point of intersection of demand and supply curves implies the equilibrium quantity and equilibrium price. For any reason, if the equilibrium in the production is disturbed, it will be restored and re-established by the operation of market forces namely demand and supply aspects. The equilibrium process can be explained with the help of Figure 1.1

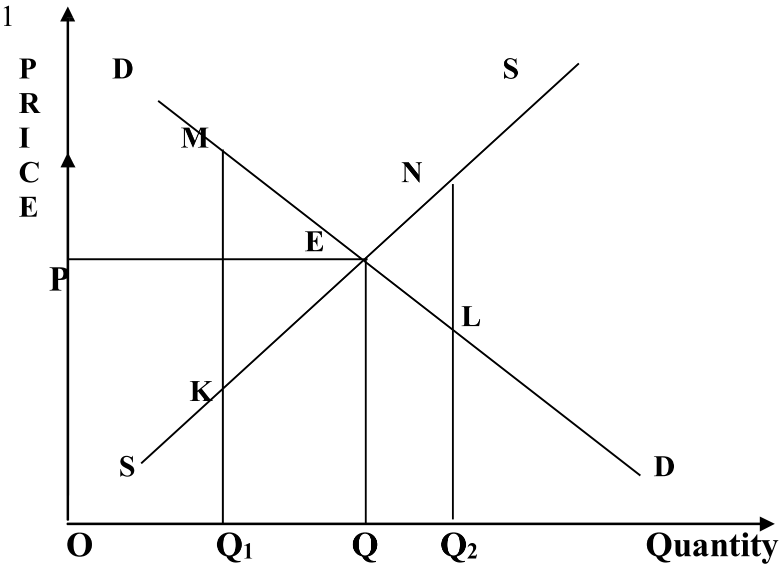

Figure 1: Equilibrium of Private Good

In the Figure, quantity is represented on X – axis, while price is represented on Y – axis. DD is the aggregate demand curve, while SS is the supply curve of a private good. The aggregate demand curve is the derived demand curve, which can be obtained by adding individual demand of each consumer at different prices. It is clear that demand and supply curves intersect at point E, so that equilibrium occurred at point „E‟. Thus, corresponding to the equilibrium point „E‟ the equilibrium quantity demanded and supplied is given by Q, while the equilibrium price is given by P. For any reason, if the equilibrium is disturbed, then either demand exceeds supply or supply exceeds demand (as shown by points M and N) and equilibrium will be restored through changes in supply of good based on price variations. Thus, equilibrium is the point where consumers as well as producers are said to be happy as the utility or benefit derived by consuming the good will be equal to the cost of production of the good. However, this sort of free market mechanism is assumed to work effectively only under the conditions of perfect competition.

3.3 State Intervention in the Market:

As pointed out, market mechanism depends on the assumption of perfect competition. However, in real world scenario conditions of perfect competition rarely presents. Complete information about price, quality of good and availability of alternative substitutes may not be available to each and every consumer. Hence, market imperfections may lead to the necessity of state intervention in regulating the markets. Government intervention in the market for provision of private goods is described as the good which is privately produced but publicly consumed. Government intervene through administered prices, quotas, licenses etc., so as to affect the demand and supply aspects.

Government intervention in the market mechanism is assumed to wipe out the market imperfections and thereby pave for perfect markets. Usually, the government agency assesses the consumption requirement of the society by taking into account of individual preference through majority preference. However, this method of information collection about individual preferences is highly expensive and cannot be taken continuously. Further, sometimes wrong assessment of market situation may also pose certain problems. Consequently, the government intervention in the market for public provision of private good may be subjected to certain inherent inefficiencies. Hence, such inefficiencies on the part of government may not be ventilated in view of confidentiality being maintained in the market operations. Public distribution of private goods through government agency may also pose certain problems. For instance, equal distribution of private goods to public may result in oversupply or under supply to an individual consumer. In case of oversupply, an individual may sell the additional goods to other individual at a higher price, so that the former will get a profit without any role in the production activity. Similarly, on account of undersupply, an individual may buy publicly supplied private goods at a higher price, which is not justified. Hence, state intervention in market mechanism may not always yield good results and efficiency.

3.4 Market Failure:

Market failure is a generally observed feature not only in case of monopoly conditions, but also even under conditions of perfect competition. The failure occurs on account of uncertainty of future, incomplete information regarding technical as well as economic aspects and deliberate attempts on the part of sellers to influence demand forces through selling techniques. Thus, market failure refers to a situation where the market mechanism fails to operate under the usual assumption applicable to a particular type of market. Such failure of the market may affect the allocation, distribution and stabilization policies of an economy.

3.4.1 Allocation of Resources:

Axiom of voluntary exchange forms the basis for economic activity in the private sector. The demand for a good is revealed through preference pattern of consumers, while the supply of good depends on the cost of production. Thus, producers will carry out the production activity, provided adequate demand is expected for the good. The assumption of perfectly competitive market conditions seldom present on account of different reasons. In some situations the consumer may be forced to go for voluntary exchange with a monopolist. For example, in Andhra Pradesh supply of electricity will be done only through Power Distribution Company Limited, the distribution wing of State Electricity Board. Thus, the electricity consumers in Andhra Pradesh State are bound to depend on state electricity board as there is no alternative to it. Of course, the alternative may be power generator, using fuel which is highly expensive. Hence, a rational consumer may not be able to afford it.

According to theory of markets, monopoly price is higher and output is lower when compared to perfectly competitive price and output. Thus, though monopoly market provides less efficient goods, yet the situation sometimes result in the survival of a single monopoly firm in the long run. It is because, in the short run new firms may enter, but very rarely survive as they cannot compete with the established monopoly firm. In such cases, the government is expected to rescue the general public against the exploitation of monopoly power of firm through regulation.

Not only in case of monopoly conditions, but also in case of perfectly competitive conditions, the failure of market will result in low quality goods. The assumption of demand based on preferences pattern of consumers and supply based on cost of production may not be satisfied in respect of certain goods. Private goods are generally purchased by any individual from the market and consumed without affecting any other individual either positively or negatively. However, in case of certain goods this condition may not be satisfied. For example television may be purchased by an individual but for having cable network; there should be minimum number of individuals possessing television sets. Similarly, cost of production in certain cases may not represent the true cost or ultimate cost of the good produced. For example, if a sugar factory releases the industrial wastes and molasses in to nearby river or air, without installing pollution control equipment, then the cost of production of sugar does not reflect the true cost involved.

3.4.2 Distribution of Income:

In a competitive economy the failure to ensure just distribution of income and wealth is said to be a market failure. Economic activity in the private sector is mainly based on profit seeking motive. Though, competitive conditions results in lower profits, yet the firms in the industry earn at least normal profits, so as to retain in the market. Generally factor rewards in a company or firm will be paid as per factor productivity. However, in certain cases factor rewards may be higher in view of their importance and role. For example, the software companies may pay higher salaries to their employees because of high value added to its product. In such cases factor rewards may not be equal to factor productivity and thus actual payment to the factor may differ with the real worth of the factor. Hence, such differences may lead to unjust distribution of income. In such a situation in order to achieve just distribution of income, the high income earning employees may be asked to donate voluntarily to the poor and needy. However, some employees may come forward to donate, while some others may not donate as the virtue of charity or donate may differ from person to person. Hence, for ensuring just distribution of income and wealth, the state intervention becomes necessary. It is because, in the absence of state intervention the situation leads to widespread inequality as efficiency and not equity is the normal outcome of a market economy.

3.4.3 Stability of Income and Employment:

In a competitive market economy where large private sector exists, often fluctuations do exist. The fluctuations occur on account of population growth, technical progress, variations in money supply, good monsoon, political atmosphere etc. Fluctuations in economic activity in economic jargon are known as business cycles. Considering phases of business cycle, „Boom‟ is a period of increasing economic activity with upswing in demand for the product. „Recession‟ on the other hand is a period of low economic activity with slackness in demand. In such situations market failure is quite possible in the stabilisation of price and employment. So, in order to ensure stabilisation of price and employment, government intervention is inevitable.

3.5 Pure Public Goods:

The goods that are manufactured by the government for the sake of its people are known as public goods or social goods. For example, roads are constructed by the government and any person can use them. The price of such goods cannot be determined by the market mechanism. Hence, the prices of public goods will be determined by the government. A public good is expected to satisfy two important characteristics viz., joint consumption and non exclusion. Joint consumption implies that the commodity is consumed by a group of people and enjoy equally in proportion without any discrimination. For example, the benefits of government hospital can be availed by all the patients living in a town. The consumption of hospital services by one patient will not reduce the hospital services to any other patient. Similarly, any number of persons can view the national doordarsan channel without preventing any other person viewing the same.

A private good has a single consumer and has to pay for it, while for a public good, the group of consumers creates the difficulty as to who will pay for it and in what proportion. Non exclusion of any one individual not interested to consume a public good is not in a position do so. It is because, irrespective of a person‟s willingness and payment, the public service is provided on the basis of majority preference. For example, immunization programme implemented in an area reduces the chance of occurrence of the disease, irrespective of whether a single individual opts for it or not. However, in respect of private good if a person is not willing to pay, then he can be excluded from using the good. But, of late it is possible to restrict the provision of certain pure public goods also to those who pay for it like a private good. It can be done through imposing user charges on the consumers consuming such public good. Thus, consumption of a public good can be restricted to the person who cannot afford to pay for it. For example, four wheeler of a person who pays toll tax on national highway will be permitted to use the national toll high ways. Thus, the extent of public use of a public good differs from good to good. For example national defence is an item in which exclusion is not possible.

It is difficult to assess the quantity of public good that is to be produced on account of two reasons. Firstly, in the absence of true preference revelation for a product makes it difficult to decide the quantity of public good to be provided. Hence, the government has to determine the individual preferences through indirect methods and thus decide the quantity of a public good to be produced. Secondly, even if the true preferences of all individuals for a product are known, the most efficient solution to the satisfaction of public good is not available.

3.6 Distinction between Public and Private Goods:

Private goods which satisfy the individual wants are produced by the private sector, while the production of public activities i.e., public goods which satisfy the public wants are carried out by the state. Distinction between public and private goods is based on the following aspects:

3.6.1 Marginal Cost:

The marginal cost of a public good is said to be either zero or it is nearest to zero. It means that, the use of a public good by one more additional member of the society does not reduce the availability of the good to others. For example, Doordarsan Television channel may be viewed by an additional household without any additional cost to the society. Similarly, one more additional vehicle may pass through a certain bridge in a town without any additional cost to the society. However, in case of private goods certainly there involves marginal cost. For example, in case of a cinema theatre, an additional member cannot view movie without purchasing ticket.

3.6.2 Externalities:

Public goods which are being produced in the public sector are subjected to have the characteristic of externalities. Externalities imply the economic benefits or losses which arise on account of production or use of public goods to the entire society. Externalities are also otherwise called as spill over effects or neighbourhood effects. For example, let us suppose that a thermal power plant is established in a village by the government. The infrastructure i.e., roads, power transmission lines, telecommunications developed for the purpose of thermal plant are also useful to the villagers is a positive externality. However, the plant which uses coal in the production of power would pollute its surroundings through emission of smoke and carbon dioxide is a negative externality. As against public goods, private goods are used to satisfy personal wants. So, the benefits or losses of private goods confine only to those individual who uses such goods. Hence, it is desirable to produce public goods only by the public sector.

3.6.3 Market Mechanism:

Market mechanism is expected to work very effectively in respect of private goods. However, according to some economists, it may fail in case of public goods. Hence, in case market mechanism fails, then the government supports the public goods.

3.6.4 Risk of loss:

Generally private individuals do not show interest in the production of certain goods, which may be subjected to risk of loss making. For example, production of goods involving huge investment and modern technology may be subjected to higher risk of loss making.

Under such conditions, despite risk of loss making, the public sector will take up production of such goods, so as to promote the welfare of the society.

3.7 Merit Goods:

A part from private goods and public goods, there exist other type of goods known as merit goods or semi public goods. In any society there are certain wants which almost all members of the society are able to satisfy. Such wants include the education and health needs of the society. Based on their importance, Musgrave calls such wants as „merit wants". Provision of such goods helps the economy in attaining not only higher level of efficiency, but also in achieving the basic objectives of the society. If provision of education is left to the private sector, then the cost of education of children is to be borne by their parents or guardians. In such a situation, on account of poverty many brilliant children may deprive of educational opportunities. Such a state of affairs not only affects the deprived children, but also the entire society resulting in low standards of efficiency. Similarly, if health services are left to the private sector, it costs not only lives of poor persons, but also the health of poor people, so that productivity at work place may be affected and ultimately leads to low standards of efficiency.

Government is expected to take up the production of such merit goods or at least supplement the availability of such goods, apart from private sector production. Thus, in addition to the production of merit goods in private sector, the government has to produce the merit goods through budget provisions. Merit goods are said to be the border line case of private and public goods. In case of merit goods, the characteristic feature of joint consumption of social goods holds good, while the characteristic feature of non exclusion holds good partially. Merit goods are nearer to public goods and thus subjected to market pricing and tax financing.

3.8 Summary:

The goods that are manufactured by the government for the sake of its people are known as public goods or social goods, while the goods that are paid and enjoyed by individuals are known as private goods. For example, roads are constructed by the government and any person can use them. But, Television is said to be a private good. The price of public goods will be determined by the government and a public good is expected to satisfy two important characteristics viz., joint consumption and non exclusion. However, prices of private goods are determined by the market mechanism and market mechanism operates on two principles viz., principle of exclusion and revealed preference. Distinction between public and private goods is based on certain aspects associated with the goods viz., marginal cost, externalities, market mechanism and risk of loss.

A part from private goods and public goods, there exist other type of goods known as merit goods or semi public goods. Provision of such goods helps the economy in attaining not only higher level of efficiency, but also in achieving the basic objectives of the society. In addition to the production of merit goods in private sector, the government has to produce the merit goods through budget provisions. Merit goods are said to be the border line case of private and public goods. In case of merit goods, the characteristic feature of joint consumption of social goods holds good, while the characteristic feature of non exclusion holds good partially.

3.9 Glossary

- Private Goods
- State Intervention
- Market Failure
- Public Goods
- Marginal Cost
- Externalities
- Market Mechanism
- Risk of loss
- Merit Goods

3.10 Model Questions:

1. Distinguish between pure private goods and pure public goods.
2. Examine the need for state intervention in the market.
3. What is meant by market failure? What are its effects? Explain.
4. What are merit goods?

3.11 Further Readings

- Musgrave, R.A & Musgrave, P.B. “Public Finance in Theory & Practice”, Mc.Graw-Hill Book Company, New York, 1989.

- Musgrave, R.A. “The Theory of Public Finance”, Mc.Graw-Hill Book Company, New York, 1961.
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Lesson 4

The Principle of Maximum Social Advantage

Structure:

4.0 Objectives

The unit is expected to provide knowledge about the Principle of Maximum Social Advantage. After going through the lesson, the learner is able to

- Understand the Principle of Maximum Social Advantage.
- Analyse the Principle through Tabular and Diagrammatic forms of explanation.
- Describe Musgrave's views on the Principle.
- Explain the tests of Social Advantage.
- Point out the limitations of the Principle.

4.1 Introduction:

The 'Principle of Maximum Social Advantage' is advocated by Prof. Dalton as the criterion to be followed by the government, so as to carry out its economic activities. The principle of maximum social advantage is said to be the principle of public finance, which is a fundamental rule and determines the financial policy of the state. However, Prof. Pigou calls the criterion as 'Principle of Maximum Aggregate Welfare'. The classical economists like Adam Smith, David Ricardo and J.B. Say believed that functions of the government should be restricted to only defence, maintenance of law and order. They were also of the opinion that the government should not interfere in economic aspects. Adam Smith and his followers considered that private expenditure is productive, while public expenditure is unproductive. Thus, according to these economists 'every tax is an evil' and 'every public expenditure is unproductive'. They were of the opinion that expenditure of the state was wasteful and it should be as possible as least. According to J.B. say, "The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount". However, modern economists strongly objected the classical view of unproductive nature of public expenditure. According to Prof. Dalton "It is not true that every tax is an evil" and all forms of public expenditure is not unproductive. For example, taxes on alcohol, cigarettes and other intoxicants which reduce the consumption of such commodities may positively good to the society. Similarly, public expenditure on education and health is considered to promote public welfare and helps in the promotion of human capital. Thus, according to modern economists, the best system of public finance is that which secures the maximum social advantage against various operations of public finance.

4.2 The Principle:

The two prominent economists namely Prof. Pigou and Prof. Dalton formulated the fundamental principle of public finance. According to the principle of maximum social advantage, the state should collect revenue and spend money so as to maximise the economic welfare of the people. When a tax is imposed, it results in disutility or dissatisfaction in the society, as it reduces the additional purchasing power of individuals. However, when the state spends the money for public purpose, it results in utility gain to the society. Hence, the state should adjust the revenue and expenditure, so as to maximise the utility and minimise the disutility.

One should understand that it is not possible to maximise the individual welfare of all people in a society. Sometimes, it may be quite possible that, the welfare of some individuals may even decrease. Hence, efforts should be made so as to maximise the welfare of a large section of the society. Thus, the principle states that the income and expenditure of the state should be so managed to maximise the net advantage to the society.

Prof. Dalton also suggested the pattern of public expenditure to be spent and the ways and means of public revenue to be collected. With every additional unit of tax raised by the state, there will be increased burden of the sacrifice and results in decreased benefit to the society. However, with every additional unit of money spent by the state, there will be increased benefit to the society. Thus, there arises a point, where the benefit derived from a unit of money spent by the state will be equal to the sacrifice imposed in raising that unit of revenue. This is the point, where the marginal social sacrifice of a community from taxation and marginal social benefit from public expenditure intersect each other.

4.3 Tabular Explanation of the Principle:

The principle can be explained with the help of the Table 4.1 as shown below:

Table 4.1

Unit of Taxation & Public Expenditure	Marginal Amount of Sacrifice due to Taxation	Marginal Amount of Utility Gained due to Public Expenditure
1	5	85
2	15	70
3	25	60
4	35	50
5	45	45
6	55	30
7	65	20
8	75	10

From the above table, it is clear that when one unit of tax is imposed, then it results in a marginal sacrifice of 5 utils, while one unit of public expenditure results in a marginal utility gain of 85 utils. Thus, the net benefit is more to the society. Further, it is clear that with the increase in the doses of taxation, the marginal sacrifice of the community is increasing. However, with the increase in the doses of public expenditure, the marginal utility gained by community is decreasing. Thus, up to the 4th dose of taxation and public expenditure, there will be net benefit to the society. However, with the 5th dose of taxation and public expenditure, the marginal sacrifice involved is equal to the marginal utility gain. Hence, the state should not impose any tax beyond the 5th dose, as it results in net decrease in the benefit to the society.

4.4 Diagrammatic Explanation of the Principle:

The principle of maximum social advantage can be explained with the help of the Figure 4.1 as shown.

Consider the amount of revenue collected and public expenditure spent by the state on X – axis. Also consider the amount of sacrifice involved (disutility) due to taxation and the amount of benefit (utility gain) due to public expenditure spent on Y – axis. The upward slopping curve from left to right (MS) represents the marginal sacrifice of taxation, while the down ward sloping curve from left to right (MB) represents the marginal utility gain of public expenditure. Thus, based on the slope of MS curve it implies that with the increased taxation, disutility i.e., marginal sacrifice of the community is increasing. Similarly, the slope of MB curve implies that with increased public expenditure, utility gain i.e., marginal benefit is decreasing. The point corresponding to the point of intersections of these two curves i.e., 'M' is said to be the optimum limit of public finance, where the welfare of the society in terms of net benefit is maximum. Hence, 'OM' is said to be the ideal or optimum level of financial operation. Any financial operation below 'OM' level (in the figure shown at M_1) implies that marginal benefit is greater than marginal sacrifice. Hence, the financial operations will continue up to the level 'OM'. However, financial operation above 'OM' level (in the figure shown at M_2) implies that marginal sacrifice is greater than marginal benefit, so such operation is not economical. Thus, following the principle of maximum social advantage, the financial operations should be continued up to the point where marginal utility of public expenditure is equal to the marginal disutility of public revenue.

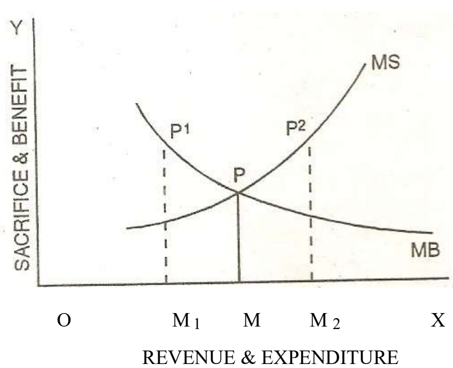

Figure 4.1

4.5 Musgrave's Views on the Principle of Maximum Social Advantage:

According to Prof. Pigou, resources should be distributed among different public uses so that marginal return or benefit for each type of outlay should be equal. According to

Prof. Dalton, following the principle of maximum social advantage, the financial operations should be continued up to the point where marginal utility of public expenditure is equal to the marginal disutility of public revenue. Musgrave supported the views of both Pigou and Dalton. However, Musgrave's explanation is based on valuation of individual preferences. The explanation is based on the Figure 4.2.

Consider amount of public revenue collected and public expenditure spent by the state in dollars on X – axis. Also consider the marginal social sacrifice involved due to taxation and marginal social benefit derived on account of public expenditure on Y – axis. The curve 'aa' indicates the marginal utility of successive dollars of public expenditures that are allocated optimally between public uses. The marginal disutility of taxes imposed so as to result in least total sacrifice is represented by the curve 'bb'. Both these schedules fall from left to right, as marginal utilities corresponding to increased doses of tax and public expenditure declines. The line 'GG' is obtained by deducting 'bb' from 'aa'. It measures the net benefits derived by successive additions to tax and expenditure operations. Thus, the optimum size of public finance i.e., budget is determined as 'OS' where marginal net benefits are zero.

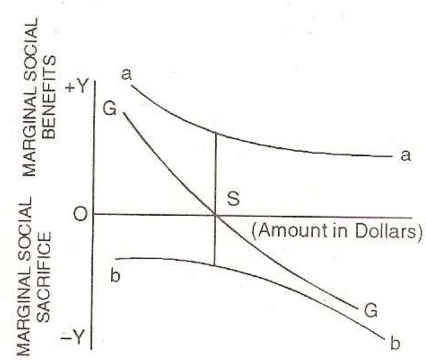

Figure 4.2

Thus minimum sacrifice approach to the allocation of taxes is matched by a maximum benefit approach to the determination of public expenditure and the two approaches are combined in a general theory of budget planning. It should be noted that no fiscal authority wants to extend its operations beyond S as the net benefit would be negative. Therefore, the minimum sacrifice approach to the allocation of taxes is matched by the maximum benefit approach in order to determine the public expenditure.

Thus, the objective of maximum social advantage can be achieved through ensuring the following three fundamental principles of financial operations:

1. Public expenditure should be carried up to the point where the benefit derived from the last unit of money spent by the state is just equal to the sacrifice involved in raising that unit of revenue i.e., db/de = ds/dt where'd' is derivative i.e., rate of change, 'b' is the social benefit, 's' is the social sacrifice and 't' is the taxation.
2. The resources of the state should be distributed among different public uses so that marginal return or benefit for each type of outlay should be equal i.e., $db_1/de_1 = db_2/de_2 = db_3/de_3$ ----- $= db_n/de_n$ where 1,2,3 n stands for items of public expenditure.
3. The taxes should be distributed such that the marginal utility of the money paid in taxation is equal to all tax payers i.e., $ds_1/dt_1 = ds_2/dt_2 = ds_3/dt_3$ ----- $= ds_n/dt_n$ where 1,2,3 n stands for different tax payers.

4.6 Tests of Social Advantage:

It is difficult to measure the principle of maximum social advantage in quantity terms. Hence, certain tests of social advantage are suggested by Prof. Dalton. Following the tests, it is possible to assess to what extent the governments are following the principle of maximum social advantage in their operations of public finance.

4.6.1 Preservation of Community:

The important duty of every government should be to preserve the community against internal disorder and external attack. Internal peace and external security creates confidence among citizens and helps promote the socioeconomic life of community. In order to maintain peace and security, the government should maintain the necessary defence, police and judiciary etc. Hence, based on the public expenditure spent on defence, law and order, the government can preserve the community.

4.6.2 Improvement in Production:

One of important objectives of the operations of the public finance is to achieve improvement in production so as to promote the economic welfare of the community. Improvement in production implies (a) increased productivity (b) improvements in the organisation of production so as to reduce wastage of economic resources (c) promotion of labour productivity. Thus, operations of public finance should concentrate on these objectives, so as to achieve improvement in production and economic welfare of the community.

4.6.3 Improvement in Distribution:

Still other important objective of the state is to ensure equitable distribution of income among various sections of the society. Such distribution of income ensures social justice. Hence, operations of public finance are expected to reduce income and wealth inequalities so as to promote the economic welfare of the community.

4.6.4 Provision for Future:

Usually, individuals give more importance to the present needs when compared to future needs. However, as against this, the responsibility of the state is to satisfy not only the needs of present generation, but also that of future generation. Thus, to ensure the maximum social advantage, the policy of the state should be to look after the needs of future generation, apart from present generation needs. Hence, the importance and consideration of future generation needs by the state is said to be yet other important objective.

4.6.5 Stability and Full Employment:

Economic instability due to trade cycles is a characteristic feature of capitalistic economic systems. In order to ensure maximum social advantage, stability and full employment is to be achieved by the state through eliminating fluctuations. Hence, operations of public finance should aim at achieving economic stability with high level of employment. During the periods of depression, public expenditure may be increased, so as to increase the effective demand and thereby promote the level of employment. Similarly, during the periods of inflation, public borrowings and heavy taxation may help in reduction of price level.

4.7 Limitations of Maximum Social Advantage Principle:

The principle of maximum social advantage can be regarded as the fundamental principle of public finance. Financial activities of any government are expected to follow the principle. However, practical application of the principle has the following limitations:

1. It is not possible to measure the utility gain of the public expenditure and disutility due to taxation. Utility or disutility cannot be quantified as it is merely physiological perceptions of individuals.
2. It is not possible to say exactly that every tax imposed by the state is burdensome to the society. For example, taxes on alcohol, cigarettes and other intoxicants which reduce the consumption of such commodities may positively good to the society. Such taxes are not at all burden to the society. Similarly, all public expenditure may not give utility gain to the society. If the public expenditure

incurred by the state on some overheads is unproductive, then it will not result in utility gain.

3. Public expenditure incurred by the government on large industry may result in utility gain only in the long run. Thus, certain public expenditure by the state may not contribute for utility gain in the short run.
4. The principle of maximum social advantage takes into account the income due to taxation only. However, the state secures income through different non tax sources such as fees, special levies, profits of public enterprises, deficit finance etc.
5. If government resorts to deficit budget so to acquire the necessary resources without taxation, then the people may not sacrifice directly or the question of disutility does not arise. However, deficit budget leads to inflation and it affects the welfare of the people. In such a case indirectly people may face the taxation situation.
6. The size of public expenditure is generally large and is not possible to divide it into small components which are used for different purposes. Hence, it is difficult to calculate marginal utility of public expenditure.

Though there are certain limitations in the application of the principle of maximum social advantage, yet they are not considered to be serious. Hence, the principle is said to be the fundamental principle of financial operations of government. Thus, in the present day scenario of economic affairs also, principle of maximum social advantage is said to be the basis for governments while formulating their economic policies.

4.8 Summary:

The principle of maximum social advantage is said to be the principle of public finance, which is a fundamental rule and determines the financial policy of the state. The two prominent economists namely Prof. Pigou and Prof. Dalton formulated the fundamental principle of public finance. According to the principle of maximum social advantage, the state should collect revenue and spend money, so as to maximise the economic welfare of the people. In other words, state should adjust the revenue and expenditure, so as to maximise the utility and minimise the disutility. One should understand that it is not possible to maximise the individual welfare of all people in a society. Sometimes, it may be quite possible that, the welfare of some individuals may even decrease. Hence, efforts should be made so as to maximise the welfare of a large section of the society. Thus, the principle states that the income and expenditure of the state should be so managed to maximise the net advantage to the society. The objective of maximum social advantage can be achieved through ensuring the following three fundamental principles of financial operations:

1. Public expenditure should be carried up to the point where the benefit derived from the last unit of money spent by the state is just equal to the sacrifice involved in raising that unit of revenue.
2. The resources of the state should be distributed among different public uses so that marginal return or benefit for each type of outlay should be equal.
3. The taxes should be distributed such that the marginal utility of the money paid in taxation is equal to all tax payers.

However, practical application of the principle has certain limitations owing to problem in the measurement of utility gain of the public expenditure and disutility due to taxation. It is not possible to say exactly that every tax imposed by the state is burdensome to the society. Further, public expenditure incurred by the government on large industry may result in utility gain only in the long run. Moreover, the principle of maximum social advantage takes into account the income due to taxation only.

4.9 Glossary

- Principle of Maximum Social Advantage
- Marginal Benefit
- Marginal Sacrifice
- Disutility

4.10 Model Questions:

1. Discuss the Principle of Maximum Social Advantage.
2. Explain the Musgrave's views on Principle of Maximum Social Advantage.
3. Examine the objective tests of Maximum Social Advantage.
4. Point out the limitations of Principle of Maximum Social Advantage.

4.11 Further Readings:

- Musgrave, R.A. "The Theory of Public Finance", Mc.Graw-Hill Book Company, New York, 1961.
- Lekhi, R.K. "Public Finance", Kalyani Publishers, New Delhi.
- B.P.Tyagi, "Public Finance", Jai Prakash Nath & Co, Meerut.

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lesson - 5

THEORY OF INCIDENCE

Structure:

1.0 Objectives

The unit is expected to provide knowledge about the Theory of Incidence. After going through the lesson, the learner is able to

- Understand the meaning of term Incidence.
- Analyse the Theory of Incidence and Shifting.
- Describe the Nature of Cost and Incidence of Taxation.
- Explain the Incidence of Taxation under different Market Conditions
- Point out the Allocative and Equity Aspects of Taxes.

1.1 Introduction:

Theory of Incidence is very important to understand the economic and social impact of any particular tax. Taxation may give rise to three different situations which can be explained with the help of three different concepts namely Impact of Tax, Tax Shifting and Tax Incidence. Initially a tax may be imposed on a particular person and he pays at the first instance. But, subsequently the tax may be transferred by the person to second person. Now, finally, the tax burden may be borne by the second person or some others who actually pay it. The first person on whom the tax imposed and paid, but does not bear the ultimate burden bears the impact of tax. The process of transferring the tax is known as shifting of the tax. The settlement of the ultimate burden on the second person or some other who actually bears is known as incidence of the tax. Thus, the incidence of tax is the result of shifting. For example, the tax levied on the production of motor vehicles will be paid by the company owner at the first instance. But, later the tax shifts from the company owner to the wholesale dealer, then from wholesale dealer to the retail dealer and thereafter from the retail dealer to ultimately the consumer. Thus, tax burden is shifted from company to the consumer ultimately. Hence, consumer is the effective tax payer as he borne the burden of tax.

1.2 Meaning of Incidence:

The Incidence of a tax refers to the money burden of a tax on the person who ultimately bears it. Thus, the incidence of a tax lies on that person, who ultimately bears it without any shifting. According to Prof Dalton "The problem of incidence is commonly conceived as the problem of who pays it. More precisely we may say that the incidence is upon those who bear the direct money burden of the tax". Further, the incidence of a tax can be classified as money burden and real burden. Further, money burden may be regarded as direct and indirect money burden. According to Prof Dalton, direct money burden is the burden of taxation in terms of money which lies on a person when a tax is levied. Thus, the person who pays the tax also bears the burden without shifting the tax. However, on the other hand, if the tax is shifted and ultimately some other else bears the burden then it is known as indirect money burden.

The real burden of incidence of a tax can also be considered as direct and indirect real burden. Prof. Dalton felt that direct real burden is the sacrifice of economic welfare which has to be made by the tax payer as a result of the payment of tax. Indirect real burden is the reduction in the consumption of goods by the tax payer due to imposition of tax.

According to Prof. Shirras, “The problems of incidence is the analysis is to determine who pays the tax i.e., on whom the money burden of the tax falls or rests”. Prof. Mehta observes, “Sometimes incidence is defined as the direct money burden of a tax”.

1.3 Types of Incidence:

Prof. Musgrave classified the incidence of taxation as three different types’ namely (a) Absolute incidence, (b) Distributional incidence and (c) Budget incidence. Such a classification of incidence deals with the changes in distributional of income due to taxation.

(a) Absolute incidence: It studies the distributional effects of a tax, when public expenditure is kept constant.

(b) Distributional incidence: It refers to distributional change of income occurred in the economy as a result of substituting a tax for another, when both public revenue and expenditure are kept constant.

(c) Budget incidence: It refers to distributional change of income occurred in the economy, when public expenditure increased through increased taxes.

Mrs. Hicks classified the incidence of taxation into two types (a) Formal incidence and (b) Effective incidence. Such a classification of incidence is based on the burden and effects of taxation.

(a) Formal incidence: It is the money burden of a tax or its money incidence. Formal incidence according to Mrs. Hicks refers to “the proportion of people’s incomes which goes not to provide the incomes of those who furnish them with goods and services, but is paid over to governing bodies to finance collective satisfaction”.

(b) Effective incidence: It refers to the effects of taxation. It will include all the advantages as well as disadvantages of a tax system. It is very difficult to correctly measure the effects of a tax system i.e., effective incidence. In order to study the effective incidence, we have to compare the existing situation with a hypothetical situation such as comparing the tax situation with a situation where there is no taxation and vice versa. Thus, in either case, one of the situations to be compared is hypothetical and so there arises the difficulty of measuring the effects properly.

1.4 Theories of Tax incidence and Shifting:

As incidence is the result of shifting, theories of incidence can be regarded as theories of shifting. There are three different theories namely (1) The Concentration Theory, (2) The Diffusion theory and (3) The Modern Theory. Let us discuss about those theories.

1.4.1 The Concentration Theory:

The theory was proposed by physiocrats. According to physiocrats, only agriculture sector is the productive sector and all others are unproductive. Hence, it is the only agricultural sector that can generate surplus. Based on the argument, according to physiocrats, land owners can pay taxes out of the surplus generated, while other persons cannot pay taxes as they cannot generate surplus. Thus, taxes levied on non agriculturalists should be shifted to agriculturalists, while taxes on agriculturalists could not be shifted. Hence, physiocrats suggested levying a single tax on agricultural land and land owners should pay the tax. Thus, any tax has the tendency to concentrate on one particular class of tax payers namely land owners. Hence, the theory is called as concentration theory of incidence of tax.

The theory is criticised by Adam Smith and even other modern economists. According to these economists

(1) Apart from agricultural sector, all economic activities are productive.
(2) Imposition of tax only on agriculturalists and agricultural land is not adequate to meet the financial requirements of governments. Hence, a single tax on land is not ideal.

1.4.2 The Diffusion Theory:

The theory was propounded by the French economist Prof. Canard. Unlike the concentration theory, the diffusion theory states that all taxes are diffused among the members of the community. Thus, taxes will not concentrate on any one particular class, but have the tendency to spread on to all individuals. It is also believed that all taxes were equitably diffused all over the society. Thus, the individuals from whom the tax is collected do not ultimately bear the whole burden, but shift it on to the other classes of the society, so that tax is diffused all over the society. Canard compared the imposition of a tax with extracting blood from one of the veins of human body. Thus, although, blood is extracted from a single vein, the loss is spread all over the whole body and the body remains in equilibrium. Prof. Mansfield also supported the argument of Canard and compared the imposition of tax like a stone falling into a lake which creates number of circles spreading throughout the lake.

The diffusion theory is subjected to the following criticism:

(1) The theory is based on the assumption that no tax is just or unjust since the burden of any tax can be diffused all over the society.

(2) The theory fails to determine the final point and the proportionate amount of incidence of tax.

1.4.3 Modern Theory:

According to modern economists, the analysis of demand and supply can be extended to study the tax incidence. In fact, the theory was propounded by Prof. Dalton, while it was also supported by modern economists like Seligman and Edge worth. If tax is imposed on a commodity, the cost of production of the commodity raises as tax forms a part of cost of production. Consequently, seller will raise the price of the commodity. Thus, incidence of tax can be shifted through change in price. Further, the seller tries to shift the tax through reducing the supply of the commodity. Thus, shifting and incidence of taxes depends on prices. However, prices are determined by the market forces namely demand and supply. But, the demand and supply are in turn affected by elasticity of demand, supply and the laws of returns. Hence, we can discuss the shifting of tax incidence based on the nature of elasticity of demand and supply conditions as follows:

(a) Elastic Demand – Shifting of Tax Incidence

(b) Inelastic Demand – Shifting of Tax Incidence

(c) Elastic Supply – Shifting of Tax Incidence

(d) Inelastic Supply – Shifting of Tax Incidence

(a) Elastic Demand – Shifting of Tax Incidence:

If tax imposed on a commodity for which the demand is perfectly elastic and supply is inelastic, the entire burden of tax will be borne by the seller. In Figure 1.1, quantity supplied and demanded is measured on X – axis, while price is considered along Y – axis. DD is the demand curve, which is a horizontal straight line parallel to X – axis implying that demand is perfectly elastic. SS and S^1S^1 are the supply curves before and after the imposition of tax respectively. Before the imposition of tax, at equilibrium price OP, the equilibrium quantity demanded and supplied is OM. Now, if a tax equal to PT is imposed, the price remains constant, but the supply reduced to S^1S^1. As tax imposed on a commodity can be regarded as an element of cost of production, the cost of production increases. Hence, the supply decreases to OM^1 due to increase in cost, but price remains unaffected. In such a case, the tax burden i.e., PT is entirely borne by the seller, as the demand is perfectly elastic. It is because, any attempt to increase the price by the seller results in zero demand. Therefore, the seller has no option except to bear the tax burden himself from his profit.

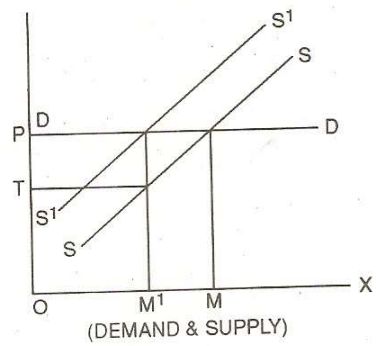


Figure 1.1 Elastic Demand – Shifting of Tax Incidence

(b) Inelastic Demand – Shifting of Tax Incidence:

If tax imposed on a commodity for which the demand is perfectly inelastic and supply is elastic, the entire burden of tax will be borne by the buyer. In Figure 1.2, DD is the demand curve, which is a vertical straight line parallel to Y – axis implying that demand is perfectly inelastic. SS and S^1S^1 are the supply curves before and after the imposition of tax respectively. Before the imposition of tax, at equilibrium price OP, the equilibrium quantity demanded and supplied is OD. Now, let us suppose that a tax equal to PT is imposed. Consequently, the cost of production will push up by the same amount of tax, so that price will increase by PT. This increase in the price due to tax will not affect the demand, as the demand is inelastic. However, supply curve becomes S^1S^1 after taxation. Thus, the entire burden of tax will be borne by the buyers and is possible by increasing the price.

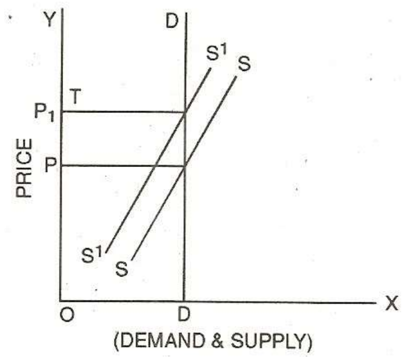


Figure 1.2 Inelastic Demand – Shifting of Tax Incidence

(c) Elastic Supply – Shifting of Tax Incidence:

If tax imposed on a commodity for which the supply is perfectly elastic and demand is inelastic, the entire burden of tax will be borne by the buyer. In Figure 1.3, SS is the supply curve which is a horizontal straight line parallel to X – axis, implying that supply is perfectly elastic. DD is the demand curve, which is relatively inelastic. Before the imposition of tax, at equilibrium price OK, the equilibrium quantity demanded and supplied is OM. Now, let us suppose that a tax equal to KT is imposed. Consequently, the cost of production will push up by the same amount of tax, so that price will increase by KT. This increase in the price due to tax will not affect the demand, as the demand is inelastic. However, supply curve becomes S^1S^1 after taxation. Thus, the entire burden of tax will be borne by the buyers.

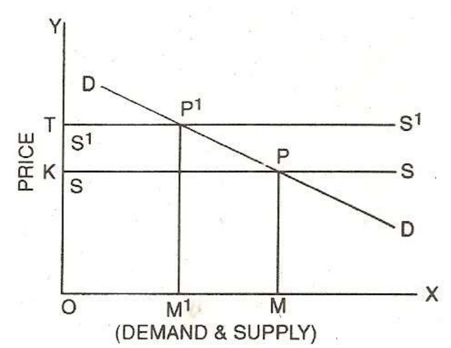


Figure 1.3 Elastic Supply – Shifting of Tax Incidence

(d) Inelastic Supply – Shifting of Tax Incidence:

If tax imposed on a commodity for which the supply is perfectly inelastic and demand is elastic, the entire burden of tax will be borne by the seller. In Figure 1.4, SS is the supply curve which is a vertical straight line parallel to Y – axis implying that supply is perfectly inelastic. DD is the demand curve, which is relatively elastic. However, demand curve becomes D^1D^1 after taxation. Before the imposition of tax, at equilibrium price OP, the equilibrium quantity demanded and supplied is OS. Now, let us suppose that a tax equal to PT is imposed. This increase in the price due to tax will affect the demand, as the demand is elastic. Hence, any attempt to increase the price by the seller results in fall in the demand. Consequently, instead of increasing price, the seller will bear the entire burden of taxation.

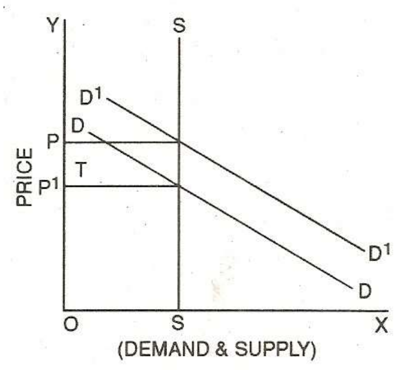


Figure 1.4 Inelastic Supply – Shifting of Tax Incidence

Generally, perfectly elastic and inelastic demand and supply cases as discussed above may not exist in real world. Hence, incidence of taxation may be examined by considering relatively elastic demand and supply situations. We can discuss the following three cases:

(a) Elasticity supply is greater than elasticity of demand ($e_s > e_d$)

(b) Elasticity supply is less than elasticity of demand ($e_s < e_d$)

(c) Elasticity supply is equal to elasticity of demand ($e_s = e_d$)

Let us understand these three cases.

(a) Elasticity supply is greater than elasticity of demand ($e_s > e_d$):

If tax imposed on a commodity for which the elasticity of supply is greater than the elasticity of demand i.e., $e_s > e_d$, the burden of tax will be borne by the buyers in high proportion than sellers. In Figure 1.5, as usual quantity demanded and supplied is measured along the X – axis, while price is measured along the Y – axis. DD is the demand curve and SS is the supply curves such that demand is relatively inelastic, while supply is elastic. Before the imposition of tax, at equilibrium price ON, the equilibrium quantity demanded and supplied is OM. Now, let us suppose that a tax equal to P^1R is imposed so that price after tax becomes ON^1. The tax amount i.e., P^1R can be written as $P^1R = P^1Q + QR$. However, it is clear that $P^1Q > QR$. Hence, the tax burden will be proportionately more on buyers than sellers and the rise in price will be equal to P^1Q.

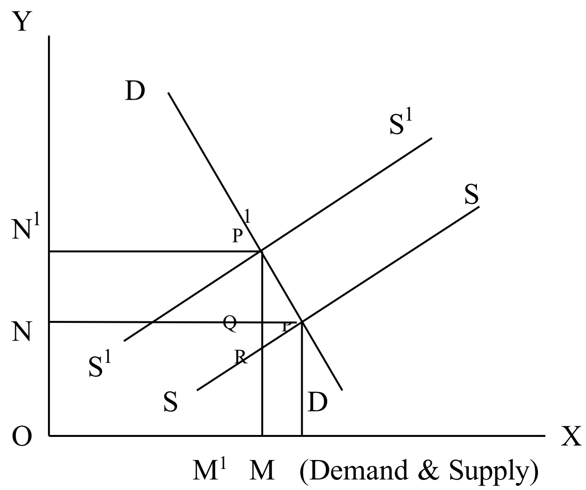


Figure 1.5 Elasticity supply is greater than elasticity of demand

(b) Elasticity supply is less than elasticity of demand ($e_s < e_d$):

If tax imposed on a commodity for which the elasticity of supply is less than the elasticity of demand i.e., $e_s < e_d$, the burden of tax will be borne by the sellers in high proportion than buyers. In Figure 1.6, DD is the demand curve and SS is the supply curves such that demand is relatively elastic, while supply is inelastic. Before the imposition of tax, at equilibrium price ON, the equilibrium quantity demanded and supplied is OM. Now, let us suppose that a tax equal to P^1R is imposed, so that price after tax becomes ON^1. The tax amount i.e., P^1R can be written as $P^1R = P^1Q + QR$. However, it is clear that $P^1Q < QR$. Hence, the tax burden will be proportionately more on sellers than buyers and the rise in price will be equal to P^1Q.

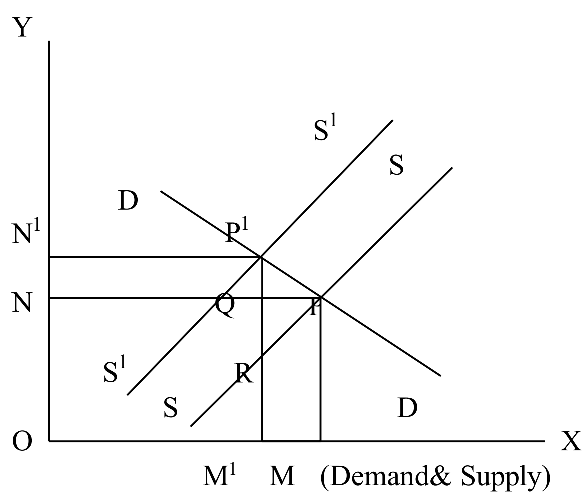
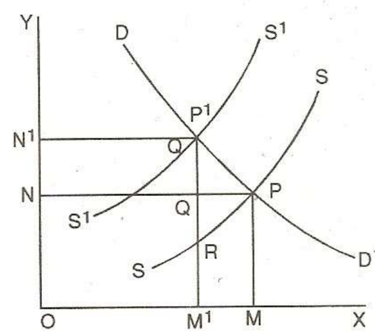


Figure 1.6 Elasticity supply is less than elasticity of demand

(c) Elasticity supply is equal to elasticity of demand ($e_s = e_d$)

If tax imposed on a commodity for which the elasticity of supply is equal to the elasticity of demand i.e., $e_s = e_d$, the burden of tax is equally distributed between the sellers and buyers. In Figure 1.7, DD is the demand curve and SS is the supply curves such that they have similar slopes. Before the imposition of tax, at equilibrium price ON, the equilibrium quantity demanded and supplied is OM. Now, let us suppose that a tax equal to P^1R is imposed, so that price after tax becomes ON^1. The tax amount i.e., P^1R can be written as $P^1R = P^1Q + QR$. However, it is clear that $P^1Q = QR$. Hence, the tax burden will be equally distributed between the sellers and buyers and the rise in price will be equal to P^1Q.



(Demand& Supply)

Figure 1.7 Elasticity supply is equal to elasticity of demand

The modern theory can be summarised in brief as follows:

Case	Nature of Demand Curve	Nature of Supply Curve	Burden on Buyers	Burden on Sellers
1	Perfectly Elastic	Inelastic	Zero	Total
2	Perfectly Inelastic	Elastic	Total	Zero
3	Inelastic	Perfectly Elastic	Total	Zero
4	Elastic	Perfectly Inelastic	Zero	Total
5	Elasticity of Supply > Elasticity of Demand		More	Less
6	Elasticity of Supply < Elasticity of Demand		Less	More
7	Elasticity of Supply = Elasticity of Demand		Equal	Equal

1.5 Nature of Cost and Incidence of Taxation:

Incidence of taxation not only depends on demand for and supply of commodities, but also on nature of cost i.e., cost of production. The nature of cost may be described by the laws of returns. Thus, we can discuss the incidence of taxation in three different cost situations as follows:

(a) Law of Constant Returns (Constant Costs)

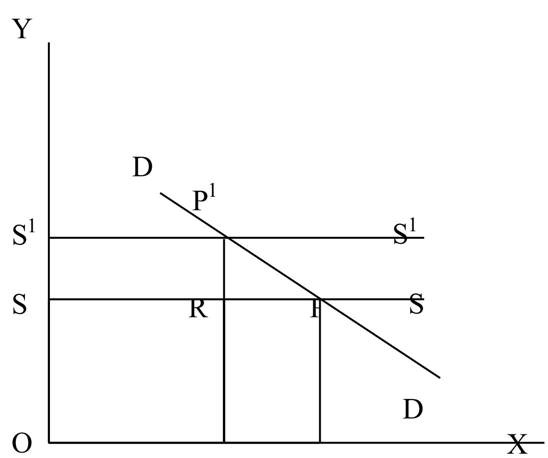
(b) Law of Increasing Returns (Decreasing Costs)

(c) Law of Decreasing Returns (Increasing Costs)

Let us understand the incidence of taxation from the point of view of cost situation.

(a) Law of Constant Returns (Constant Costs):

In case of constant returns to scale, the firm operates under constant cost conditions. Hence, the supply curve will be a horizontal straight line parallel to the X – axis, implying perfectly elastic nature of supply. The price can be increased by an amount equal to the tax. The producer will adjust the demand and supply by increasing the price and the entire burden will be borne by the buyers. In Figure 1.8, as usual, we plot the demand and supply along the X – axis and price along the Y – axis. Before imposition of tax, DD is the demand curve and SS is the supply curve, so that equilibrium price and quantity will be OS and OM respectively. After imposition of the tax P^1R, SS^1 is new supply curve, so that equilibrium price and quantity becomes OS^1 and OM^1 respectively. Thus, increase in price will be equal to the amount of tax.



M^1 M (Demand & Supply)

Figure 1.8 Incidence of Taxation - Law of Constant Returns (Constant Costs)

(b) Law of Increasing Returns (Decreasing Costs):

In case of increasing returns i.e., decreasing costs, the average cost of production declines with the increase in production. In such a case, the entire tax burden will be borne by the buyers. In this case, a tax imposed on the commodity will raise its price by an amount greater than the tax. It is because, imposition of tax results in fall in the demand for the commodity. Consequently supply will be reduced, so that average cost increases and thus, price will rise by an amount greater than the tax amount. In Figure 1.9, DD is the demand curve, while SS is the supply curve before imposition of the tax. Thus, PM is the equilibrium price and OM is the corresponding equilibrium quantity. After imposition of tax, SS^1 is the supply curve, while P^1M^1 is the price. The amount of tax imposed is P^1R, while the rise in price is equal to P^1Q. However, $P^1Q > P^1R$ and implies that rise in price is greater than the amount of tax. Thus, tax imposed on commodities produced under decreasing cost conditions or increasing returns, tend to increase price by more than the amount of tax. Hence, imposition of tax on industries subjected to increasing returns to scale is opposed by Dalton.

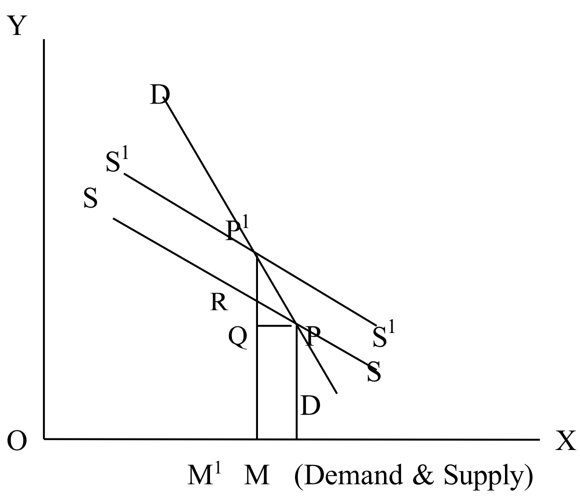


Figure 1.9 Incidence of Taxation - Law of Increasing Returns (Decreasing Costs)

(c) Law of Diminishing Returns (Increasing Costs):

In case of diminishing returns i.e., increasing costs, the average cost of production increases with the increase in production. In such a case, a part of the tax burden will be borne by the buyers. In this case, a tax imposed on the commodity will raise its price by an amount smaller than the tax. It is because, imposition of tax results in fall in the demand for the commodity. Consequently supply will be reduced, so that average cost decreases and thus, price will rise by an amount smaller than the tax amount. In Figure 1.10, DD is the demand curve, while SS is the supply curve before imposition of the tax. Thus, PM is the equilibrium price and OM is the corresponding equilibrium quantity. After imposition of tax, SS^1 is the supply curve, while P^1M^1 is the price. The amount of tax imposed is P^1R, while the rise in price is equal to P^1Q. However, $P^1Q < P^1R$ and implies that rise in price is smaller than the amount of tax. Hence, the burden of tax on buyers will be P^1Q and the same on sellers is QR. Thus, the tax imposed on commodities produced under increasing cost conditions or diminishing returns, tend to increase the price by less than the amount of tax.

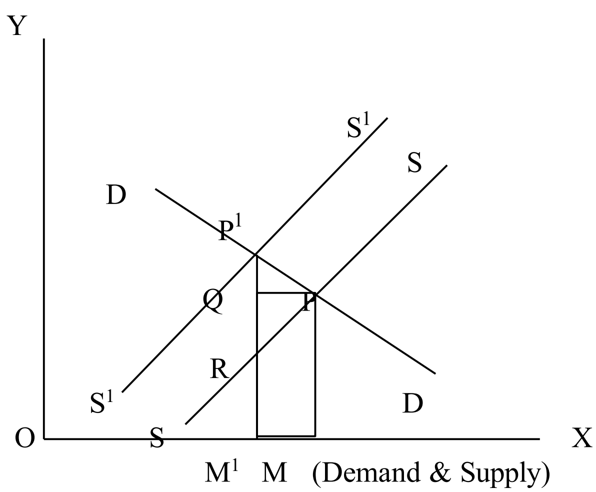


Figure 1.10 Incidence of Taxation - Law of Diminishing Returns (Increasing Costs)

1.6 Incidence of Taxation – Different Market Conditions:

The elasticity of supply depends upon market conditions such as perfect competition, monopoly etc., so that possibilities of shifting also affected. Hence, let us discuss the incidence of taxation under different market conditions.

1.6.1 Perfect Competition - Incidence of Taxation:

Perfectively competitive market has the following characteristics:

1. There exists large number of buyers and sellers.
2. The buyers and sellers have perfect knowledge about the market.
3. All firms produce identical products.
4. Free entry and free exit conditions prevail in the market.

The price in a perfectly competitive market is determined by the interaction of aggregate demand and aggregate supply. The demand curve of each firm is perfectly elastic. If any firm increases the price of its product, it may lose all of its consumers. Thus, tax burden cannot be shifted through rising prices. Similarly, a firm cannot shift the tax backward by paying less to the factors of production as the demand for factors production arising from a firm is negligibly small when compared to total demand arising from the industry. But, taxes can be shifted by reducing the supply and thereby increasing the price of the commodity. However, supply can only be curtailed in the long run. Hence, the incidence of taxation depends on the relative competitive strength of buyers and sellers, which can be measured by the elasticity of demand for and supply of the commodity.

The incidence of taxation in a perfectly competitive market can be studied by (a) market period, (b) short run and (c) long run.

(a) Market Period: It is a very short period during which the supply of the product is fixed. Thus, no adjustment is possible on supply as supply is perfectly inelastic. The incidence of a tax depends on nature of the commodity. If the commodity is perishable, the firm has no option except to sell the entire stock at any price. Thus, if a tax is imposed on a perishable commodity, then the firm cannot increase the price and shift the burden on to the buyers. However, if the commodity is non perishable, then the firm may withheld the stock for a certain period and thus can shift a part of the tax on to the buyers.

(b) Short run: In the short run under perfectly competitive market, firms will produce the commodity, if the price of commodity is able to cover the minimum average cost. Usually, firms operate to produce output at a point where marginal cost equals marginal revenue. The Figure 1.11 explains the incidence of a tax in the short run. Before imposition of a tax on the commodity, the firm is at equilibrium by producing output OQ at price OP, while the industry is in equilibrium at output ON against price OP. However, if a tax is imposed on the commodity, the marginal and average cost curves (MC^1 and AC^1) will shift upward by the equal amount of the tax. From the Figure it is clear that, new equilibrium occurred at point F implying lesser output OQ1 at the same price OP (no change in price). As a result of fall in the output of individual firms, there will be a fall in the total supply of the whole industry shown by S^1S^1. If the new final price in the short run is fixed at OP^1 then the firm produces output OQ, while the industry produces output ON^1. The rise in the price AG is less than the commodity tax imposed AC. Thus, the entire burden of tax cannot be shifted in the short run.

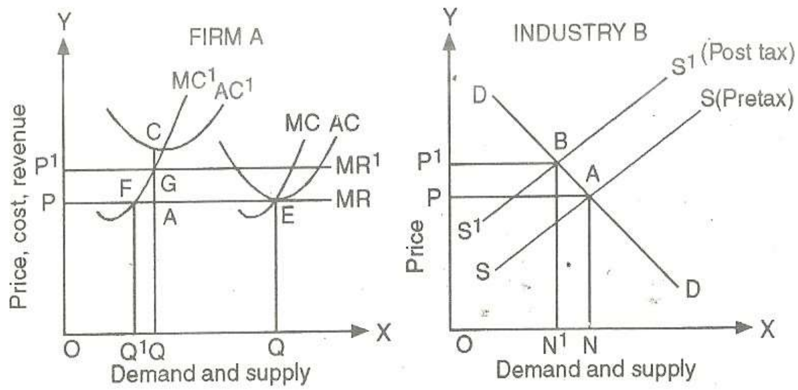


FIGURE 1.11

(c) Long Run:

In the long run as the time period is sufficient enough for any change, firms may enter or leave the industry. Hence, supply is more elastic in the long run compared to short run. Moreover, since all factors of production are mobile in the long run, the long run supply curve of industry under perfectly competitive market will be perfectly elastic. The Figure 1.12 explains the incidence of a tax in the long run when cost is constant. Before imposition of a tax on the commodity, the firm is at equilibrium by producing output OQ at price OP which equals average cost, while the industry is in equilibrium at output ON against price OP. However, if a tax is imposed on the commodity, the marginal and average cost curves (MC^1 and AC^1) will shift upward. From the Figure it is clear that, new equilibrium occurred at point F implying lesser output OQ^1 at the higher price OP^1 and is equal to average cost. Thus, the commodity tax is completely shifted to the buyers as price rises by full amount of tax. If the industry is subjected to increasing cost conditions, the increase in long period price will be less than the amount of tax. However, if the industry is subjected to decreasing cost conditions, the increase in long period price will be more than the amount of tax.

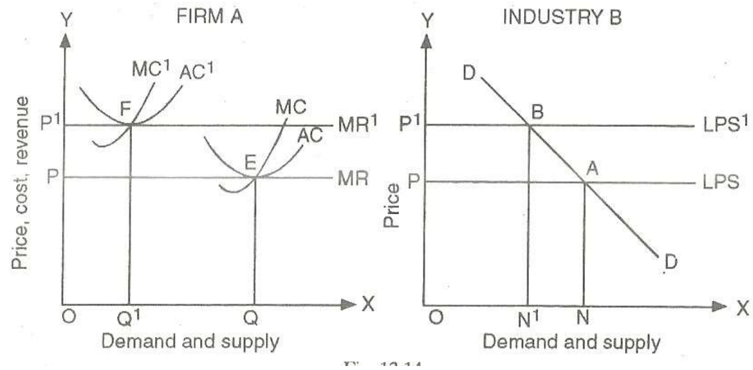


FIGURE 1.12

1.6.2 Monopoly Market – Incidence of Taxation:

Monopoly is a market situation in which there exists only one firm so that it can be regarded as an industry also and produces a product for which there are no close substitutes. The monopolist has full control over the price and supply of output. The monopolist fixes the price at the point where MR = MC, so that he can maximise his profit. Thus, monopolist fixes the price of its commodity at the point where its total net profit is the highest. From the Figure 1.13, net profit is maximised when MR curve intersects the MC curve at point E. Corresponding to the point, the OQ is the output and OP will be the market price for the commodity. When there is no tax, the profit of the monopolist is shown by the shaded area PABC.

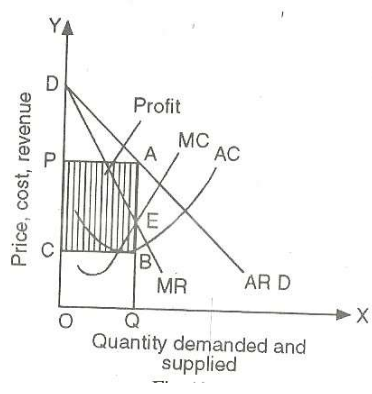


FIGURE 1.13

Under conditions of monopoly, the shifting tax burden depends on nature taxation. If tax is imposed in fixed amount or on profits the monopolist will borne the tax. However, if tax is imposed on the basis of production, the monopolist may try to shift the burden of tax on to the buyers by including the tax into price. In such a case, the extent of shifting depends on the elasticity of demand for and supply of commodities.

1.6.3 Monopolistic Competition – Incidence of Taxation:

Monopolistic competition is a market situation where there are a number of firms producing heterogeneous products (i.e. product differentiation) with wide variation in their prices. Each firm will be in a position to affect the output and pricing decisions of other firms and at the same time the firm may also be affected by other firms in a similar manner. Under the monopolistic competition, when a tax is imposed, the burden cannot be shifted by raising the price of the product, as the firm may lose its customers. However, if the tax erodes a sizable portion of the profit of a firm, then it can be shifted to the buyers depending upon the elasticity of demand of the buyers for the taxed commodity. If the demand is inelastic, then it is possible to pass on the burden. However, on the other hand if the demand is elastic, then the tax burden will be borne by the firm. After imposition of the tax, big firms will be able to shift the burden on to the buyers, while small firms will not be in a position to shift the burden. Hence, small firms may be compelled to withdraw from competition and shut down their operations.

1.6.4 Oligopoly Market – Incidence of Taxation:

Oligopoly is a market situation in which there are a few firms or sellers of a product. One of firm or seller acts as a leader in the market and determines the price and output, so that all other firms or sellers follow the price and output decisions of the leader. If a tax is imposed on the leader firm, it may shift the burden on to the buyers by raising the prices of the product, when demand for the product is inelastic. However, small firms may not be in a position to shift the burden of tax as they cannot influence the price of the product. If the amount of tax is so small such that it cannot take away a large portion of the firms, then the entire burden will be borne by the firm. But, if the tax is such that it takes away a major portion of profit, then the leader firm shifts the burden on to the buyers in the long run by making compulsory withdrawal of marginal firms.

1.7 Allocative and Equity Aspects of Taxes:

According to the principle of equity, taxation should ensure fairness or justice in the distribution of tax burden. The principle emphasizes for a distribution of tax burden, so as to ensure horizontal and vertical equity. Thus, the concept of equity implies two different aspects namely treatment of people in like circumstances and unlike circumstances. The like circumstances imply that people equally well – off from the economic point of view, should pay equal amount as taxes and is called as horizontal equity. Thus, a tax is said to be horizontally equitable, if the tax paid by two or more entities in the same economic circumstances (income, consumption, or wealth, depending on the tax) pay identical tax amounts. The unlike circumstances imply that people who are not equally well – off from the economic point of view, should pay correspondingly different amounts as taxes and is known as vertical equity. Vertical equity looks at the other dimension of fairness-how tax burdens compare across people with different amounts of tax base i.e., income. A tax is said to be progressive, regressive, or proportional if the tax burden as a percentage of income rises, falls, or remains constant, respectively, as income rises. However, whether taxes should be progressive, regressive, or proportional requires a value judgement. The capacity to pay tax depends on the following assumptions:

1. The ability to pay depends on the size of income.
2. Income utility can be measured numerically.
3. Principle of diminishing marginal utility applies to income and wealth.
4. Sacrifice involved in the tax payment by individuals should be equal.
5. Diminishing marginal utility schedule is similar to all individuals.

1.8 Summary:

The Incidence of a tax refers to the money burden of a tax on the person who ultimately bears it. Thus, the incidence of a tax lies on that person, who ultimately bears it without any shifting. The burden can be classified as direct and indirect money burden as well as real burden. Direct money burden is the burden of taxation in terms of money which lies on a person when a tax is levied. Thus, the person who pays the tax also bears the burden without shifting the tax. However, on the other hand, if the tax is shifted and ultimately some other else bears the burden then it is known as indirect money burden. Direct real burden is the sacrifice of economic welfare which has to be made by the tax payer as a result of the payment of tax. Indirect real burden is the reduction in the consumption of goods by the tax payer due to imposition of tax. The incidence can be discussed in different types. Absolute incidence is the distributional effects of a tax, when public expenditure is kept constant.

Distributional incidence refers to distributional change of income occurred in the economy as a result of substituting a tax for another, when both public revenue and expenditure are kept constant. Budget incidence is the distributional change of income occurred in the economy, when public expenditure increased through increased taxes.

According Concentration Theory of Incidence any tax which has the tendency to concentrate on one particular class of tax payers namely land owners. The diffusion theory states that all taxes are diffused among the members of the community. Thus, taxes will not concentrate on any one particular class, but have the tendency to spread on to all individuals. Modern Theory discusses the incidence under different elastic conditions of demand and supply curves. Incidence of taxation can also be discussed according to law of returns i.e., cost conditions. Further, incidence of taxation can also be discussed under different market structures such as perfect competition, monopoly, monopolistic competition and oligopoly.

1.9 Glossary:

- Incidence of Taxation
- Direct and Indirect money burden
- Direct and Indirect real burden
- Absolute incidence
- Distributional incidence
- Budget incidence
- Formal incidence
- Effective incidence

1.10 Model Questions:

1. Explain the term incidence and discuss different types of incidence.
2. Discuss the Modern Theory of Incidence.
3. Examine the incidence of taxation under different cost conditions.
4. Explain the incidence of taxation under perfectly competitive market structure.

1.11 Further Readings:

- Lekhi, R.K. "Public Finance", Kalyani Publishers, New Delhi.
- B.P.Tyagi, "Public Finance", Jai Prakash Nath & Co, Meerut.

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lesson - 6

Benefit and Ability to Pay Approaches

Structure:

2.0 Objectives

The unit is expected to provide knowledge about the Benefit and Ability approaches and Optimal taxation. After going through the lesson, the learner is able to

- Understand the Benefit Theory of Taxation.
- Analyse the Ability to Pay Approach.
- describe the Ability to Pay – Objective Indices
- Explain the concept of Optimal Taxation.

2.1 Introduction:

Distribution of tax burden is expected to be equitable and just. Based on such criterion, economists proposed benefit and ability to pay approaches. According to benefit theory, the taxes that are to be paid to the government shall depend on the benefit derived by the people from the government and also on the financial capacity of the people. Thus, tax burden shall be in proportion to the utility or benefits derived from the government expenditure.

According ability to pay theory, the money burden of taxation should be distributed in such a manner, so that every tax payer has to incur equal sacrifice. The equal sacrifice principle is explained through three alternative approaches namely equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice. But, sacrifice being the psychological perception of tax payers, it cannot be measured. Hence, the ability to pay can be assessed through objective indices such as property, consumption expenditure and income which can be measured. Optimal taxation is the study of how best to design a tax to minimize distortion and inefficiency subject to raising revenues through taxation. A neutral tax is a theoretical tax which avoids distortion and inefficiency completely.

2.2 Benefit Theory of Taxation:

During the 17th Century, the principle is developed by some economists. Writers like Aobbes, Lack, Hume, Ruses and Physiocrats are also supported the principle. According to benefit theory, the taxes that are to be paid to the government shall depend on the benefit derived by the people from the government and also on the financial capacity of the people. The government provides various goods and services to its people. People derive utility through consumption of those goods and services. Hence, according to the benefit theory, tax burden shall be in proportion to the utility or benefits derived from the government expenditure. In other words, the individuals deriving equal benefits from the government shall pay equal amount as taxes. Thus, the individuals who derived greater benefits shall pay more amount as taxes when compared to those deriving less benefit. It is in this context government acts just like a businessman. People pay businessmen according to the quantity of goods purchased; similarly, taxes should be paid according to the benefits received from the government. The benefit theory has certain merits and demerits.

2.2.1 Merits of Benefit Theory:

The following are merits of the theory.

1. Tax levied on the basis of benefits received by the people from the government ensures justice.
2. The benefit theory integrates the taxation with public expenditure, so that both can be paid attention simultaneously.
3. Scarce resources in an economy can be efficiently allocated, if tax payment is proportion to the benefit received from government services.

4. If beneficiaries of the government services are clearly identified, then taxes can be imposed on the basis the benefit theory.

2.2.2 Demerits of Benefit Theory:

The following are certain demerits of the theory.

1. There arise practical problems, as it is not possible to measure the benefits received from the government services by the individuals. For example, it is difficult to measure the social benefit received from services like national defence, law and order etc.
2. Benefit derived from goods or services is merely psychological perception and it cannot be measured. Hence, it is not possible to impose tax according to benefit.
3. The theory does not give importance to the reduction of economic inequalities and economic stability. However, in recent times, the theory plays important role in framing the objectives of development plans.
4. In the modern welfare state, a substantial portion of public revenue is being spent for the benefit of poor. Hence, according to the benefit theory, poor has to pay more taxes, as they receive greater benefits is not reasonable.
5. Benefit theory is practically useful, if government services are just like business services. However, in a welfare state, the government services may not be profit motive and on business lines.
6. It is not possible to pay taxes in proportion to benefits received. For example, people receive greater benefits from services such as education, health, housing, subsidies etc. Hence, payment of tax proportion to benefit received from such services is difficult.

From the above demerits, it is understood that the benefit theory is not practically useful, as it is not possible to measure the benefits received from the government services.

2.3 Ability to Pay Theory of Taxation:

As pointed out earlier, both the benefit theory is subjected to practical difficulties. As early as during 16^{th} Century itself, John Bowden was the first economist to argue that taxation should be based on individual's ability to pay tax. Economists like Adam Smith, Pigou, Edgeworth etc., supported the argument. The basis of the ability to pay theory is to share the tax burden by all people so as to ensure equity and justice among people. Thus, the theory implies that taxation should be based on ability to pay principle. The ability to pay theory is almost similar to that of Adam Smith's canon of equity. The cannon of equity imply that "The subjects of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities."

2.3.1 Measurement of Ability to pay – Equal Sacrifice Principle:

According to J.S. Mill, equity in taxation means equality in sacrifice. The money burden of taxation should be distributed in such a manner, so that every tax payer has to incur equal sacrifice. Thus, for equality in taxation, all persons in a like position should be treated equally and all persons in unlike position should be treated accordingly with different amounts of tax. In other words, the equal sacrifice principle calls for realisation of horizontal and vertical equity. As sacrifice involved in the payment of tax is based on the psychological perception of taxpayers, the equal sacrifice principle is said to be the subjective approach of the ability to pay theory. Three alternative approaches namely (a) Equal Absolute Sacrifice (b) Equal Proportional Sacrifice and (c) Equal Marginal Sacrifice are proposed to measure the equal sacrifice.

(a) Equal Absolute Sacrifice:

According to the principle, the loss of utility in parting with income on account of tax should be equal to all tax payers. Thus, equal absolute sacrifice requires that, persons with higher income should pay more taxes and persons with lower income should pay less tax, so that that the sacrifice is same for all persons. In fact, this principle received a lot of support initially for some time. However, the principle is rejected by many economists on the basis that such taxation represents regressive nature of taxation. In fact, rate of taxation depends on the rate at which the marginal utility of money declines with the increase in income. The tax distribution is said to be progressive, proportional and regressive if elasticity of the marginal income is greater than, equal to or less than utility. However, it is difficult to measure exactly the rate of decline in the utility of money as the income increase. According to Prof. Pigou, progressive taxation is to be adopted in case of higher incomes. Thus, absolute amount of utility lost due to tax payment should be equal to every person. In other words, the difference between utility of income before tax and utility of income after tax should be same for every tax payer. For the sake of simplicity, let us suppose that a community consists of only two persons P and Q. Let U(y) denotes the utility of income before tax and U (y – T) denotes utility of income after payment of tax, so that the principle of equal absolute sacrifice can be written as $[U(y) - U(y - T)]_P = [U(y) - U(y - T)]_Q$

(b) Equal Proportional Sacrifice:

According to the principle, the loss of utility on account of tax payment should be proportional to the total income of the tax payers. In this case also, persons with higher income should pay more taxes and persons with lower income should pay less tax. However, the ratio of sacrifice to the income should be same for all tax payers. Thus, the tax burden on two persons P and Q, according to the principle should the expressed as

Sacrifice made by P/Income of P = Sacrifice made by Q/Income of Q

(c) Equal Marginal Sacrifice:

According to the principle, taxation should be such that the marginal sacrifice involved in the tax payment of different individuals is equal. Thus, the marginal utility of income, after tax payment of all tax payers should be equal. For example, if there are two individuals P and Q, then according to the principle, Marginal utility of Money for P after payment of tax = Marginal utility of Money for Q after payment of tax. Equal marginal sacrifice principle is also known as least aggregate sacrifice.

Dalton explained the above three concepts as follows. According to principle of absolute sacrifice, the direct money burden of tax should be distributed so that the real burden of tax payers is equal. Proportional sacrifice requires that direct real burden of every tax payer should be proportional to the welfare derived from his income. According to the marginal sacrifice principle, the aggregate real burden of all tax payers should be as possible as least. Among the three principles of equal sacrifice, the equal marginal sacrifice principle is accepted by many economists. However, as sacrifice is subjective aspect, it is difficult to measure the marginal utility schedule. Hence, ability to pay is to be measured through objective method.

2.4 Ability to Pay – Objective Indices:

According to the subjective approach, taxation should be based on the sacrifice involved by individuals on account of taxes. But sacrifice being the psychological perception of tax payers, it cannot be measured. Hence, the ability to pay can be assessed through objective indices which can be measured. The objective indices are (a) Property, (b) Consumption Expenditure and (c) Income. Let us understand these indices.

(a) Property:

Ability to pay tax of an individual can be assessed on the basis of his property. However, there are certain defects in this approach and are due to problems arising in the assessment of property value. The price of same property situated in different places may be different. Moreover, in some cases, certain property may not yield incomes. Further, there may be some individuals with incomes but without having any property. In such a case, though the individual is earning income, he may not come under the purview of tax, as he does not possess property.

(b) Consumption Expenditure:

According to Nicholas Kaldor, Consumption expenditure can be regarded as an index of taxation. If taxation is based on income, then there may be scope for tax evasion. Hence, Kaldor suggested that taxation should be based on consumption expenditure. However, if taxation is based on consumption expenditure, then tax burden will be more on the poor than the rich. It is due to the fact that consumption pattern of poor is generally more compared to rich. Moreover, based on the size of the family and circumstances, an individual may incur more consumption expenditure compared to his income. Hence, in such a case, based on consumption expenditure, his ability to pay tax cannot be considered as more.

(c) Income:

Income can be regarded as an index of ability to pay tax. Henry Simon suggested for levying of only income tax by abolishing all other taxes. If income is considered as an index of ability to pay tax, then all sources of income such as salary, shares, debentures etc., should be considered as income. Many economists supported progressive taxation as tax burden may be more on rich. However, if ability to pay tax is based on income, then the following aspects should be paid attention.

(i) Distinction between earned income and unearned income should be clear. Higher tax rate should be applied on income from property compared to income from employment.

(ii) Taxation should be based on family circumstances. Income tax should be more on families with small size compared to families with large size.

(iii) Taxation should not be on the gross income. Based on the standard of living, certain income should be exempted from the purview of taxation.

(iv) Progressive taxation may be unreasonable to some extent.

Having considered all these aspects into account, income can be regarded as an appropriate index of ability to pay tax.

2.5 Optimal Taxation:

Optimal taxation is the study of how best to design a tax to minimize distortion and inefficiency subject to raising revenues through taxation. A neutral tax is a theoretical tax which avoids distortion and inefficiency completely. Other things being equal, let us suppose that a tax-payer has to choose between two mutually exclusive investment projects A and B that face the same pre-tax risk and returns, then a rational tax payer will choose that project with the lower tax or with a tax break. Based on this criterion, economists argue that generally taxes distort behaviour.

The criteria of optimal taxation can be explained as follows:

1. The first criterion of optimal taxation is to minimise the resource cost. A tax system results in not only cost of collection to the taxation authorities, but also resource cost to the tax payers. However, the cost incurred by the tax payers is usually ignored by the tax authorities, while announcing different taxes. Even if cost incurred by tax payers is considered, it may be only in terms of money and other resources, ignoring the cost in terms of time and effort.
2. The second criterion of optimal taxation is to consider a measure of justice or equity in taxation. It means that principles of taxation such as ability to pay, benefits received, cost of service should be taken into account while announcing taxes. However, economists lack a general agreement relating to principles taxation.
3. The third criterion of optimal taxation is to consider some measure of economic efficiency in taxation. However, such a criterion depends upon the way in which the concept of efficiency is defined. For example, we may confine to minimise the distortions in resource allocation, then the idea of tax system is to result in minimum possible dead weight of system as a whole.

Whatever criterion we may follow, it involves the decision making at three levels such as:

(a) The aggregate amount of taxation and its division between direct and indirect taxation.

(b) The composition and rate schedule of direct taxes.

(c) The composition and rate schedule of indirect taxation.

The above decisions at three levels are interdependent and may result in complication. The complication arises due to the fact that a modern government has non – tax means of producing budgetary resources such as market borrowings, resorting to the printing of currency and income from public sector undertakings.

For example, the incidence of sales taxes on commodities also leads to distortion. For instance, let us suppose that food prepared in restaurants is taxed, but supermarket bought food prepared at home is not taxed at purchase. If the taxpayer needs to buy food at fast food restaurants because the taxpayer may not wealthy enough to purchase extra leisure time (by working less) the taxpayer pays the tax although a more prosperous person who enjoys playing at being a home chef is more lightly taxed. This differential taxation of commodities may cause inefficiency.

The standard theory of optimal taxation implies that a tax system should be chosen to maximize a social welfare function subject to a set of constraints. The social welfare function is based on the utilities of individuals in the society. It is assumed that the social welfare function is a nonlinear function. Nonlinearity social function implies more equal distributions of utility. However, some studies assume that the social welfare function is linear one as social planner cares solely about average utility.

The goal of a social planner is to choose the tax system that maximizes the representative consumer's welfare, knowing that the consumer will respond to whatever incentives the tax system provides. In some studies of taxation, assuming a representative consumer may be a useful simplification. Once, an objective function is determined, the next step is to specify the constraints that the social planner faces in setting up a tax system. Ramsey showed that taxes should be imposed in inverse proportion to the representative consumer's elasticity of demand for the good, so that commodities which experience inelastic demand are taxed more heavily. Ramsey's efforts have had a profound impact on tax theory as well as other fields such as public goods pricing and regulation.

If the social planner is allowed to be unconstrained in choosing a tax system, then the problem of optimal taxation becomes too easy and the optimal tax is simply a lump-sum tax. If the economy is described by a representative consumer, that consumer is going to pay the entire tax bill of the government in one form or another. A lump-sum tax accomplishes exactly what the social planner wants but, in practice lump-sum taxes are rarely used. It is because; as lump-sum tax falls equally on the rich and poor, its burden is relatively more on the poor.

2.6 Summary:

The benefit and ability to pay approaches explain how taxes are to be distributed, so as to ensure equality and just. According to benefit theory, tax burden shall be in proportion to the utility or benefits derived from the government expenditure. In other words, the individuals deriving equal benefits from the government shall pay equal amount as taxes.

According ability to pay theory, the money burden of taxation should be distributed in such a manner, so that every tax payer has to incur equal sacrifice. But, sacrifice being the psychological perception of tax payers, it cannot be measured. Hence, the ability to pay can be assessed through objective indices such as property, consumption expenditure and income which can be measured. Optimal taxation is the study of how best to design a tax to minimize distortion and inefficiency subject to raising revenues through taxation.

2.7 Glossary:

- Benefit Theory.
- Ability to Pay Approach.
- Equal sacrifice principle
- Equal absolute sacrifice
- Equal proportional sacrifice
- Equal marginal sacrifice.
- Ability to Pay – Objective Indices
- Optimal Taxation.

2.8 Model Questions:

1. Explain the Benefit Theory of Taxation and discuss it merits and demerits.
2. How Ability to pay theory ensure equitable distribution of tax burden? Explain.
3. Discuss how sacrifice can be measured using ability to pay objective indices?
4. Examine the concept of optimal taxation.

2.9 Further Readings:

- H. Dalton, Principles of public finance.
- Musgrave, R.A. "The Theory of Public Finance", Mc.Graw-Hill Book Company, New York, 1961.
- Lekhi, R.K. "Public Finance", Kalyani Publishers, New Delhi.
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Lesson - 7

The Problem of Double Taxation

R.Sudarsana Rao

Contents:

Glossary

Model Questions for Self-preparation

Books for study

8.0 Objective: The objective of this Unit is to analyse the meaning of double taxation, the types of double taxation, various possibilities of double taxation and to discuss various measures to avoid double taxation with a special reference to India.

8.1 Meaning of Double Taxation: The term double taxation has a limited use in the literature of Public Finance. The concept is generally used when the same object or same is subjected to taxation more than once. According to J K Mehta „double taxation means taxing of a person twice by two authorities in the same way, that is, on the same thing or the taxing of the same base twice by the same authority. More or less a similar definition is given by Wikipedia " Double taxation is the levying of a tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes). This double liability is often mitigated by tax treaties between countries.The term 'double taxation' is additionally used, particularly in the USA, to refer to the fact that corporate profits are taxed and the shareholders of the corporation are (usually) subject to personal taxation when they receive dividends or distributions of those profits.

8.2 **Different Types of Double Taxation**

The property may be taxed on the basis of income yielded by it and again on the basis of its capital value. In this case, the same property is subject to taxation on the basis of two different criteria. The income may be taxed when it is received and also when it is spent. In this case, the tax base is income which is taxed at two different stages. A tax may be imposed on the corporate profits and again on the dividends received by the shareholders. In this case, the tax base is profits and the shareholders are subjected to taxes on two different stages – pre-distribution and post-distribution of dividends. A tax may be imposed on rental incomes or interest received and then it may be imposed upon those who make these payments. So taxation of rental or interest income in a way amounts to double taxation as the same object is taxed already at a different stage. Therefore, it is necessary to know as to what taxation of the same object twice does mean.

In this connection, J.K.Mehta observes, "In one way, taxes are always paid out of income unless they are very heavy in which case they have to be paid out of capital. Normally, all taxes are paid out of income. In abnormal times again it may be necessary to pay some taxes out of our savings. But in normal times all taxes are in general paid out of income. But that does not constitute a case of double or multiple taxation in the sense in which we are using the word here. Almost all taxes fall on income. But that does not make any two of them a case of double taxation. What is required is that they should be levied on the same thing and not paid out of the same thing."

Another important thing one has to keep in mind is that the two taxes should have reference to the same period of time. Again in the words of J.K. Mehta, "The government of a country taxes your income this year and again the next year. That does not constitute double taxation for it is not really the same income that is being taxed twice. It is sufficient, therefore, to say that double taxation involves taxation of the same thing twice either by the same authority or by different authorities."

Double taxation has the following disadvantages in any economy. Firstly, it imposed an excessively high tax burden upon those individuals and groups on whom it falls. Secondly, it is likely to have an adverse effect on the people"s incentives to work, save and invest. Thirdly, it does not ensure equity between different tax payers and, therefore, violates the basic canon of justice. Where there is a single taxing authority, the avoidance of double taxation and inequity can be possible through appropriate amendments in the tax structure of the country. However, if in an attempt of making the tax system more equitable, certain amount of double taxation is involved, it should not be objected; rather it should be regarded as socially desirable.

A more important source of double taxation is the plurality of tax authorities. In federal countries, the Central and State governments may impose taxes on the same base or the tax policies of different independent countries may create such a situation. For instance, if the government imposes a wealth tax which includes a tax on property on the basis of its capital value and at the same time, the local administration in a town or city also imposes a tax on buildings on the basis of their rental values, this is a situation involving double taxation. Similarly, double taxation may arise between different countries when their governments impose tax on the incomes not only of their own citizens but also on the foreigners who earn the whole or a part of their income within the taxing country. When these foreigners remit their incomes to their home countries, these may again be taxed. This constitutes double taxation of such incomes which imposes much higher burden on them.

Double taxation has an adverse effect on Foreign Direct Investment.(FDI) Since double taxation tends to penalize foreign enterprises, the free flow of capital and other resources like the services of technical and managerial specialists among different countries is hindered. Findlay Shirras opines that double taxation "tends to keep capital within national frontiers and prevents it from flows freely over such frontiers". Such a situation hampers the maximum or optimum utilization of the global resources and does not permit the countries to maximize social welfare. Double taxation by different independent countries works to the detriment of the underdeveloped countries particularly because they have to draw heavily upon foreign capital and technical assistance in quite a substantial measure in the earlier stages of their development. A C Pigou, however, does not believe that double taxation lowers the level of world welfare. He believes that "Insofar as aggregate government expenses are really higher in respect of a man who resides in one country and earn or invests in another than in respect of one whose all activities are confined to the same country, such a barrier corresponds to a true cost, and is prima facie desirable from the standpoint of world welfare". Pigou‟s assumption that the burden of double taxation corresponds to the true cost can be true only in rare circumstances. However, there is a reason to suppose that the governments impose taxes on foreigners to the extent of the true cost.

8.3 Avoidance of Double Taxation:

8.3.1 Avoidance at Inter-country Level

There are several disadvantages of double taxation. So double taxation needs to be avoided in all the countries. The disadvantages associated with double taxation are discussed below briefly. Double taxation imposes excessive tax burden which has very serious effects on the economic activity . The need for avoiding double taxation was actually felt first during the First World War, when many governments started exploiting excessively the progressive direct taxes of Income Tax , Inheritance and Wealth Tax . Besides, the emergence of big business and the expansion of activities such as shipping, air transport, banking and insurance companies, the solution of the problem of international double taxation assumed added significance. Consequently, the International Finance Conference held at Brussels in 1920 recommended that the problem should be tackled by the League of nations and urged "an international understanding which, while ensuring the due payment by every one of his full share of taxation, would avoid the imposition of double taxation which is at present an obstacle to the placing of investments abroad."

The avoidance of double taxation arising from the plurality of tax authorities can be achieved in different ways. But in this connection, it is important to see whether the tax authorities belong to the same (federal) country or belong to different countries.

8.3.2 Double Taxation in a Federation

In a federal country the tax powers are distributed between the federal and states. However scientifically they are distributed, there is every scope for the existence of overlapping of taxes. The centre as well as the states may impose taxes on subjects or jurisdiction of the other leading to double taxation causing different types of distortions. Double Taxation leads to impediments to the rational and profitable allocation of resources and hinders the economic development of the country. The main reason for double taxation is distribution of same tax powers to both the federal and state governments. If double taxation arises on account of taxes imposed by different States in a federation or by the Centre and the State governments, the following measures/methods may be suggested for overcoming the problem of double taxation.

8.4 Measures to Overcome Double Taxation

8.4.1 Centralisation of Finance

The inter-state double taxation can be avoided through the centralization of finances in a federal country. For instance, the USSR has successfully avoided such an overlapping by the Centre controlling the finances of the regional governments. In Switzerland, the Supreme Court has been authorized to determine the criteria for the imposition of taxes such that the possibility of double taxation is avoided. In the arrangement of centralization of finances, all taxes may be imposed by the Union (Central) government and the tax proceeds allocated between the Union government and the States keeping in view their population, resources, economic performance and certain other special problems. Although such a system is convenient for the taxpayer as well as to the Government and involves less cost of collection, some of the States may oppose such an arrangement on the grounds of equity and autonomy.

8.4.2 **Evolution of Uniform Tax Criteria**:

The Central and State governments may evolve through mutual negotiations a uniform set of criteria and a model legislation may be prepared for adoption by all the concerned governments. This can go a long way in removing this problem and infuse greater understanding and cooperation among various governments. If any State suffers loss due to such an arrangement, the Central government should make efforts to compensate it.

8.4.3 Reciprocal Tax Agreements:

If collective agreements among different States cannot be evolved, double taxation may be avoided through reciprocal tax agreements among them. The Canadian States could tackle, with some measure of success, the problem of double taxation in case of inheritance and company taxes. Similarly, a number of States in America have entered into reciprocal agreements in respect of income tax and death duty.

8.4.4 Exclusive Assignments of Tax Jurisdiction:

Another technique to avoid double taxation in federal countries is through specifying the exclusive tax jurisdiction of the Union and State governments. In this way, both of them levy taxes without transgressing their tax jurisdiction and the possibility of double taxation is avoided. The Indian Constitution makes this type of provision. While the union government has an exclusive right to levy taxes on income and capital, it has no authority to tax agricultural income and property. In the matter of commodity taxation the Union government has the exclusive authority to tax commodities while they are in the process of manufacture, export or import. The taxes on the sale and purchase of goods fall in the domain of the State governments. No doubt, this arrangement avoids double taxation in the technical sense, but it leads to competitive taxation resulting in excessive tax burden on the people. This method is, however, not applicable to inter-state double taxation which can be best avoided through the evolution of uniform tax criteria and reciprocal tax agreements.

8.5 Double Taxation in India

The Indian constitutional makers successfully avoided tax overlapping in the Indian federation by assigning exclusive tax powers to the centre and states. For instance, excise duties on production and customs are given to the Centre while taxes on sale, purchase and movement of goods are given to the states. Taxes on entry of goods are delegated by the states to the local governments. Similarly in the sphere of direct taxes also tax overlapping is avoided by giving exclusive tax jurisdiction to different tiers of the federation. Though there is no explicit tax overlapping in India, there exists the problem of double taxation mainly because of sharing of the same tax base. For instance, the excise duties imposed by the Centre and sales tax levied(StateVAT) by the states overlap as both of them fall on the same tax base. Similarly. the octroi and/or entry taxes wherever imposed by the local bodies overlap with the excise duties and sales taxes imposed by the Centre and states on agricultural and industrial products. Such overlapping is nothing but double taxation in the Indian context. Over the years, the coverage of excise duties as well as the sales tax in whichever form they are, have been exploited by both the Centre and States extensively and the the problem of double taxation has emerged. One way of avoiding this kind of problem is the union government imposing a common tax on the goods and sharing of proceeds with the States. The impending Goods and Services Tax(GST)would largely solve the problem of double taxation in the Indian federation. In fact The Jha Committee

8.6 Avoidance of International Double Taxation

It is not difficult to avoid double taxation by the same authority or by different authorities in the federal countries. In case the taxing authorities are two or more national governments, the avoidance of double taxation, is however, somewhat difficult. The International Finance Conference held at

Brussels in 1920 opined that the League of Nations should try to provide solution to double taxation at International Level. The Financial Committee of the League of Nations felt that double taxation arises because the taxing authorities levy taxes on more than one criterion like political allegiance, nature of residence, location or origin of wealth or income place of spending. The following methods may be adopted for the avoidance of international double taxation.

8.6.1 **Stipulation of the Basis of Taxation**:

Generally there are two bases of taxation- source of income and residence. If a person works in country A and earns his income there, the government of country A is entitled to tax him. Now if that person is the citizen of country B, the government in country B is also entitled to impose tax upon him. When both the governments have the right to impose tax upon his income, the problem of double taxation arises. The avoidance of double taxation in such cases requires the stipulation of the basis of taxation either according to residence or according to the place of origin of income or according to the location of property.

If the policy of taxing according to residence is followed, a peculiar situation may arise. Suppose many citizens of country A have property in country B but no citizen of country B has property in country A. Now the government of country A would be taxing all those persons who are citizens of country A, but work and earn their incomes in country B. At the same time, the government of country B cannot tax those of her citizens living in country A because these people do not have any property there (B). The loss to country B under this tax arrangement cannot be neutralized. This is, however, a theoretical possibility because the citizens of both the countries will normally have some property abroad.Sometimes double taxation is sought to be avoided through the adoption of a mixed basis that is, both on the basis of residence and of location. For instance, the immovable property may be taxed on the basis of residence. The rental income may be taxed by one government, while non-rental income by the other government.

The important and fundamental principle for the arrangement for the avoidance of double taxation is that of economic allegiance. If a person owes allegiance to two governments, naturally he should be taxed by both the governments. The double taxation can be avoided through some arrangement by which he may be taxed only once on his whole income and the proceeds be divided between the two governments in proportion to the economic allegiance he owes to them. But in this arrangement a practical problem does arise of determining the extent of economic allegiance that a person owes to each level of government.

Several measures have been suggested from time to time for the avoidance of international double taxation. A committee of technical experts on double taxation and tax evasion was appointed by the League of Nations in 1927 which subsequently met at Geneva in 1928. The Geneva Convention made several important recommendations to tackle the problem of double taxation. It proposed separate treatment of personal and impersonal income taxes such that the immovable property and mortgages thereon should be taxed in the same way. Similarly, incomes from bonds, incomes from industries, commerce and agriculture should be taxed by the country of origin. Wages should be taxed in the state of residence while pensions should be taxed in the state of origin. The principle of residence has been recognized by the International Chamber of Commerce as the best method for avoidance of double taxation. It suggested that countries should enter into bilateral agreements and make mutually beneficial arrangements for the avoidance of double taxation problem.

8.6.2 Provision of Bilateral Reliefs:

According to this method, the two countries can impose tax both on their respective subjects and foreigners earning their incomes within their respective frontiers. Accordingly, they enter into an agreement for the provision of relief to the people taxed in the other country. Under such an arrangement, in certain circumstances the accrual of tax liability of an economic unit may be lower than that envisaged under full avoidance of double taxation. Suppose, the tax rates in country X are much higher than that of the tax rates in country Y. Further, the tax relief in country X may be higher than that in country Y. Now an economic unit earning its income in country X would be subject to a higher rate of tax. In case, the economic unit earns income in country Y is subjected there to a lower tax rate but at the same time secures relief in country X at a higher rate, both the countries would be having low tax bills. The net tax liability on an economic unit would thus turn out to be smaller than in case of full avoidance of double taxation. Recently, SAARC (South Asian Association for Regional Cooperation) countries comprising India, Pakistan, Sri Lanka, Nepal, Bangladesh, Bhutan and Maldives at 13th Summit held at Dhaka in November 2005, signed a limited multilateral agreement on avoidance of double taxation in respect of custom duties. India has comprehensive Double Taxation Avoidance Agreements (DTAA) with 88(signed 88 DTAAs out of which 85 have entered into force) countries. This means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayer.

A large number of foreign institutional investors who trade on the Indian stock markets operate from Singapore and the second being Mauritius. According to the tax treaty between India and Mauritius, capital gains arising from the sale of shares are taxable in the country of residence of the shareholder and not in the country of residence of the company whose shares have been sold. Therefore, a company resident in Mauritius selling shares of an Indian company will not pay tax in India. Since there is no capital gains tax in Mauritius, the gain will escape tax altogether.The Indian and Cypriot tax treaty is the only other such Indian treaty to provide for the same beneficial treatment of capital gains.

8.7 Summary : The concept of double taxation is used when the same object is subjected to taxation more than once. In other words double taxation means taxing of a person twice by two authorities in the same way, that is, on the same thing or the taxing of the same base twice by the same authority Double taxation has several disadvantages like having adverse effect on FD and hindering the the free flow of capital and other resources like the services of technical and managerial specialists among different countries etc. so there is a need to avoid double taxation both in federal countries as well as at international level. At the intra-country level measures like centralization of finances, evolution of uniform tax criteria ,reciprocal tax agreements and exclusive tax jurisdiction will help in overcoming double taxation. At the international level stipulation of tax base and bilateral agreements do help in avoiding the double taxation. Agreements at regional level like that of tax agreements at SAARC would be more useful.

Glossary:

Bileteral Agreements: Agreements made in between two countries to avoid double taxation

Double Taxation : double taxation means taxing of a person twice by two authorities in the same way, that is, on the same thing or the taxing of the same base twice by the same authority.

Federation: The structure of a country wherein there exits more than one level of governments. This system of government is totally distinctive from a unitary type of government.

FDI : Foreign Direct Investment

GST: Goods and Services Tax

Property Tax: Tax on the capital value ofproperty

Wealth Tax: Ataximposed on the total value of wealth of a person as defined by the government

Model Questions for Self-preparation:

1 Explain the meaning of double taxation ?

2 State the important possibilities of double taxation

3 Explain how double taxation can be avoided at the national level

4.Explain how double taxation can be avoided at international level.

Books for Study:

R N Bhargava : The Theory and Working of Union Finance in India

J K Mehta: Public Finance

B P Tyagi: Public Finance

Wikipedia web site

Lesson No: 8

Wagner's law of increasing State activities; wise man –peacock hypothesis; pure theory of public expenditure; structure and growth of public expenditure:

Structure of the lesson

9.7. Summary

Technical terms

Self-Assessment questions

Reference books

9.0. Objectives:

After reading the lesson you should able to know the following:

- Wagner‟s and Peacock-Wiseman hypothesis on increasing public expenditure
- Pure theory of public expenditure and
- Structure and Growth of Public Expenditure theory and practice

9.1. Introduction

In the public finance, the concept of public expenditure occupied vital role. In the nineteenth century, until entry of Wagner, the classical economists paid very little attention to the public expenditure. They did not analyze in depth the effects of public expenditure. The Governments followed laissez faire economic policies and their functions were only confined to defend the country from foreign aggression and to maintain law and order within their territories. It is clearly found from the earlier writings of Adam Smith and David Ricardo who was devoted much space to the theory of taxation in their writings. Adam Smith has written in the Wealth of Nations that the governments should restrict their activities to: (i) defence against foreign aggression, (ii) maintenance of internal peace and order, and (iii) such public development works which no individual entrepreneur would like to undertake for want of adequate return on investment. In the last category, building of highways was specifically mentioned. All other functions besides these were considered beyond the scope of the State and expenditure on them was treated as unjust and wasteful. Thus, traditional thinking and philosophy did not favour of public expenditure as rated market mechanism as a better guide for the working of the economy and allocation of its resources. While an each private economic unit was guided by its own economic interests, the public sector should not take decisions on behalf of others. However, the free market mechanism suffered from several deficiencies like great depression (1929-31) was speeded over the world and generated several harmful socio economic effects. It necessitated the state intervention in the form of public expenditure. Thanks to the macroeconomic theory advanced by J.M. Keynes, the role of public expenditure in the determination of level of income and its distribution is now well recognized. Keynesian macroeconomics provides a theoretical basis for recent developments in public expenditure programmes in the developed countries.

Since the late 1990s with the growing importance of public expenditure, economists have shown greater interest in its analysis. There are two important theories of increasing State activities and growing public expenditure. The first one is associated with the name of Adolph Wagner and the second one with those of Allan T. Peacock and Jack Wiseman.

9.2. Wagner's law: Increasing State Activities and the Public Expenditure

In public finance literature Adolph Wagner"s law forms a corner-stone of any discussion of public sector growth. He was a nineteenth -century Economist who analysed data on public sector expenditure for several European countries, Japan and the United States.

During the last one hundred years there has been a spectacular expansion in the functions of the State and this has resulted in a phenomenal increase in public expenditure. Wagner was the first to buttress such remark with an extensive theoretical background. While expounding his theory in the late nineteenth century about the rise in public expenditure, Adolph Wagner had stated:

"*Comprehensive comparisons of different countries and different times show that among progressive peoples, with which alone we are concerned, an increase regularly takes place in the activity of both the central and local governments. This increase is both extensive and intensive; the central and local governments constantly undertake new functions, while they perform both old and new functions more efficiently and more completely. In this way economic needs of the people, to an increasing extent and in a more satisfactory fashion, are satisfied by the central and local governments*".

9.2.1. Wagner's Statement Indicates Following Points

1. In Progressive societies, the activities of the central and local government increase on a regular basis.
2. The increase in government activities is both extensive and intensive.
3. The governments undertake new functions in the interest of the society.
4. The old and the new functions are performed more efficiently and completely than before.
5. The purpose of the government activities is to meet the economic needs of the people.

6. The expansion & intensification of government function & activities lead to increase in public expenditure. According to the Wager, the elasticity of public expenditure is more than one that of income elasticity. In fact from a high elasticity it can be inferred that public sector expenditure does rise as a proportion of income. He viewed that public expenditure increases and more than increase in incomes of the public.

Wagner"s law states that "as the economy develops over time, the activities and functions of the government increase". Wagner thus stressed a functional relationship between the growth of an economy and the growth of government activities and contended that the government sector grows faster than the economy. He believed that a functional cause and effect relationship existed between the growth of an economy and the relative growth of its public sector. His „Law of increasing State Activities" predicts that the relationship would continue.

9.2.2. Growth of government sector and industrialized economies

According to Wagner, the relative growth of the government sector was an inherent characteristic of industrialized economies. He referred not only to Great Britain, which essentially had completed her industrial revolution before Wagner"s time, but to nations such as the United States of America, France, Germany (in the west) and Japan (in the east) whose industrial revolutions were contemporary to Wagner"s life.

According to the Wagner, the relation between elasticity of public goods which produce by the government may less than one (<1) while compared with increase in real per capita income during pre-industrialisation and post industrialisation. Elasticity of public goods changes with changes in real incomes. Need of public goods increases after the public reaches minimum needs. As a part of development, government should provide basic infrastructure like education and transport facilities. Wagner"s hypothesis of the increasing state activity holds that as the per capita income and output increase in the industrialized nations, the public sector of the these nations necessarily grows as a proportion to total economic activity.

The following figure 1 explains Wagner"s hypothesis of increasing governmental activities at pre and post industrialisation and phase of industrialising.

9.2.3. Growth of government sector and social progress

Wagner believed that social progress was the basic cause of the relative growth of government in the industrialized economies. The chain reaction circumstances described by Wagner are that social progress leads to a growth in government functions which, in turn, leads to the absolute and relative growth of governmental economic activity. He argued that there is a persistent tendency both towards an "extensive" and an "intensive" increase in the functions of the state. New functions are continuously being undertaken by the state while old functions are being performed more efficiently and on a larger scale.

In his attempt to validate the hypothesis, Wagner distinguished certain types of governmental activities or functions. According to Wagner, the most essential function of any government worth its name is that of providing the effective law and order machinery essential for the "environmental condition" within which a market functions. Second, he described government participation in the material production of economic goods including the provision of certain "Social products" like communications, education, monetary and banking arrangements in the face of „market failure‟.

Health and medical services are most essential, and yet an average man shows callousness in privately availing them. Most people fail to arrange proper residential accommodation for them. In the absence of social security against old age and unemployment many people will be exposed to all kinds of sufferings. Hence a modern State is expected to play an active role in providing these services.

It is argued that the need for the first type of public sector activity provision of adequate and effective law and order increases along with the economic growth and accompanying growth in the centralized administration results in a personalisation and automation of many social and economic institutions. Moreover, he believed that government corporations must produce certain economic goods requiring large fixed investment because private corporations cannot undertake such investment on a profitable basis since these industries involve heavy fixed costs. All these state activities caused to increase in public expenditure.

9.2.4. Diagrammatical Illustration of Wagner's Hypothesis

Wagner‟s hypothesis of increasing governmental activity can be followed with the help of Figure 1 where X-axis records the real per capita income while Y-axis shows the real per capita output of public goods. Time is the third dimension implicit in the diagram because growth both in the real per capita income and in the real per capita output of public goods is assumed to take place over a long period of time. Line PG_1 is linear which suggests that rate per capita output of public goods remains a constant proportion of real per capita income overtime. This implies that the production in the government sector grows overtime in a fixed proportion of the total output growth. The constant proportions line PG, is used as a reference point to the graphical presentation of Wagner"s law as depicted by curve PG_2. PG_2 shows that the proportion of real per capita output of public goods to real per capita income increases over time. That is to say,

$$\frac{(PCPG)t_2}{(PCI)t_2} > \frac{(PCPG)t_1}{(PCI)t_1}$$

where,

PCPG = real per capita output of public goods

PCI = real per capita income

t_1= initial point of time (pre-industrialisation)

t_2= later point of time (post industrialisation)

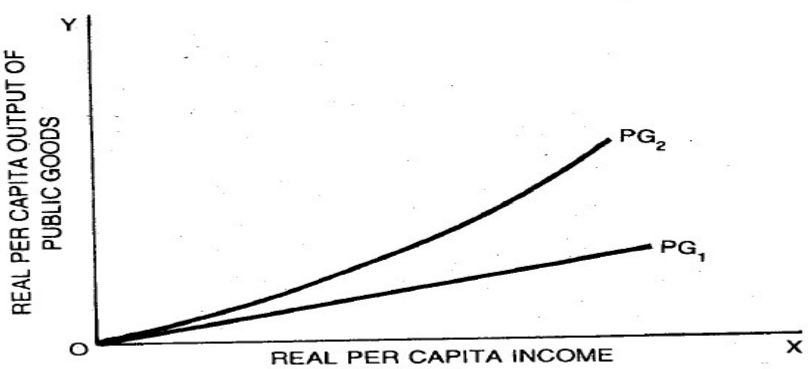


Figure.1: Wagner"s Hypothesis

9.2.5. Validity of Wagner's Law

It is quite natural that the public expenditure increases, as the government undertakes new activities. During the last one hundred years the governmental functions have increased both intensively and extensively. It appears that even in future the activities of the government will continually increase and with it the significance of public expenditure as an instrument of economic policy and otherwise will also increase. This all is consistent with Wagner"s law. For long the governments have undertaken four functions, viz., defence against foreign aggressions, maintenance of internal law and order, construction of highways and provision of education. However, since the beginning of the twentieth century these functions have undergone so much change that one wonders if they are not altogether new functions. The rising expenditure on them over the years is particularly due to their considerable expansion.

After the World War II, many underdeveloped countries won freedom. These countries are economically backward. In order to overcome their underdevelopment, they have initiated the process of growth in a planned manner. Although these countries have not opted for the socialist economic system, nonetheless they have given much attention to development of the public sector. As the infrastructure is undeveloped, the governments in these countries are making massive investments in social overhead capital. In other words, attempts are being made to develop roads and other means of transport, build a network of canals for irrigation purposes and increase production of energy. In some countries, basic industries such as iron and steel, engineering, heavy chemicals, etc., have been established in the public sector. Since market forces offer adequate incentive for making investment in consumer goods industries, their development has been completely left to private enterprise. The role of the State in agricultural development is rather indirect. The governments besides carrying out land reforms have ensured supply of biochemical fertilisers and high yielding variety of seeds at subsidised prices. In some countries, support prices have also been guaranteed to farmers by the State with the objective of ensuring stability in their income. All these development activities of the governments in the underdeveloped countries have resulted in rapid increase in their public expenditure but the ratio of the public expenditure to their gross national product is still much lower than the corresponding ratio in developed countries.

9.2.6. Criticism

Allan T. Peacock and Jack Wiseman have criticized Wagner"s law of increasing e activities on the following grounds:

1. Public expenditure deals with inter-disciplinary phenomenon but basically it lacks essentially inter-disciplinary in its analytical framework. Other sciences like political science, economics and sociology must be evolved in any theory of public expenditure. Such types of theories must consider cultural characteristics of a society. Therefore, it deals with the casual conditions described by Wagner which constitutes all the primary determinants of a relatively expanding public sector during the course of industrialization and economic growth.

2. Further, although Wagner‟s law possesses the attribute of accumulating and partially explaining the important historical facts, its lack of a comprehensive analytical framework causes it to fall short in these explanations.

3. Wagner‟s version is based on an organic self-determining theory of the state which is not, however, at least accepted in most Western countries.

4. Wagner‟s law ignores the influence of war on government‟s spending actively.

5. Wagner stresses a long-term trend of public economic activity which tends to overlook the significant „time pattern‟ or „processes of public expenditure growth.

9.3. Peacock-Wiseman hypothesis

Allan J. Peacock and Jack Wiseman have theorised growth in public expenditure on the basis of their well-known study of public expenditure growth in the United Kingdom during the period 1890-1955. This study suggests that although public expenditure tends to increase overtime, there is no smooth and continuous trend .The increase in public expenditure occurs in step like fashion. Peacock-Wiseman hypothesis of increasing public expenditure is inclusive of three concepts, which though interrelated, are separate from each other. These concepts are as follows:

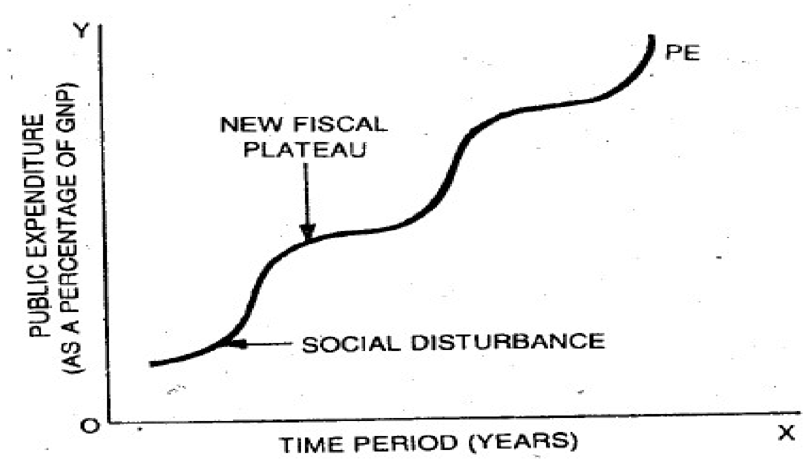
1. Displacement effect
2. Inspection effect
3. Concentration effect

9.5.7. **Displacement effect:**

According to Peacock and Wiseman, the movement from the older and lower level of public expenditure and taxation to the now and higher level of expenditure and taxation is the displacement effect. On analysing public expenditure data of the United Kingdom for the sixty five year period, Peacock and Wiseman have found that growth in government activities and its expenditure has not been continuous. Since the government‟s fiscal activities had risen step by step to successive new plateaus, the public expenditure also followed a discrete step like pattern.

Peacock and Wiseman noted that public expenditure did not rise unless there was major social disturbance or war. In peace time the government did not feel pressure to increase its expenditure. In contrast, during the periods of some social or other disturbances, a need to increase expenditure on defence or law and order was felt which could be met only by raising larger tax revenue. The government in these periods did not feel constrained on account of any resistance from the taxpayers. People usually do not oppose any increase in tax revenue during the periods of national crisis.

Figurelg.2 depicts displacement effect. In this figure time period in years is shown on the x-axis while government's expenditure as per centage of GNP has been shown on the Y-axis. The figure proves that as some social disturbance occurs, expansion in public expenditure takes place. The displacement effect occurring explains the time pattern by which governmental activity and the public expenditure expands and a new fiscal plateau is reached. As explained above, the new higher expenditure plateau may not continue with the same expenditure pattern that was created by the social disturbance.



9.5.8. **Inspection effect**

By the time social disturbance or war is over, people generally get used to new tax burden. In fact, they acquire a new tax-tolerance level and they neither expect the government to withdraw new taxes nor ask for any reduction in rates of taxes. In the absence of such compulsions the movements generally retain the new taxes. Moreover, this situation provides an opportunity to both the government and the people to review the revenue position. In this exercise they discover the inadequacy of the revenue as compared with the required expenditure. This is what Peacock and Wiseman call inspection effect.

9.5.9. **Concentration effect**

Since expenditure on defence or law and order falls in post disturbance periods without any reduction in revenue collections, a surplus emerges in government budgets. Under these circumstances, the government not only increases their expenditures under older heads but also undertake new welfare and developmental activities involving new expenditures. Therefore, in the post-disturbance period when peace is restored the public expenditure fails to come down to the pre-disturbance level. In this manner public expenditure and revenue get stabilized at a new level till another disturbance occurs and causes a new displacement effect. Peacock and Wiseman are of the opinion that each major disturbance leads to the Central government assuming a larger proportion of the national economic activity. In other words, the Central government economic activity shows a tendency of growing faster than that of the State and Local level governments. Peacock and Wiseman call this trend concentration effect.

9.6. Pure theory of public expenditure

In 1954 Paul Samuelson published his landmark paper *The Pure Theory of Public Expenditure*, which formalized the concept of public goods that are non-rival and non-excludable. He highlighted the market failure of free-riding when he wrote: "it is in the selfish interest of each person to give false signals, to pretend to have less interest in a given collective consumption activity than he really has".

The theory of public expenditure discuss in the context of the range of public expenditure and/or in terms of the division, of a given amount of public expenditure into different items. The former of the two parts may also be conceived in terms of allocation of the economy‟s resources between providing public goods on the one hand and private goods on the other.

Budget allocation takes place in the context of the principle of maximum social advantage and partly through a theory of supply of individual state services (such as, the discussion of Lindahi‟S solution). Public expenditure should reach the wants to achieve for the members of the society. This obviously involves steps for identifying the restricting conditions (or constraints) upon the achievement of this objective function, the use of cost-benefit analysis, the use of important determining variables like the interest rates, and the treatment of risk and uncertainty associated with any project. The starting point of the theory of public expenditure is the failure of the market mechanism to respond fully to the true needs of the society. Or to put is differently, market mechanism is not able to bridge the gap between private and social costs on the one hand and private and social benefits on the other.

An essential but hitherto unsolved problem of public expenditure theory is the specification or discovery of true needs and preferences of the society so that public expenditure may be allocated between them. It can be argued that willingness to pay a tax for financing a service would conceal true needs and preferences of the society. This is because a capacity to pay for a service is not the same thing as the need to have it. For example, poor people do need health care even when they cannot pay for it. Ability and willingness to pay for a service can be equated with its need only when the distribution of income and wealth is ideal and not otherwise.

There are some additional difficulties as well. Preferences of the community are generally subject to rapid and indeterminable variations, so that supply decisions cannot remain in complete conformity with them. Similarly, it is generally admitted that many members of the society themselves are not sure of their preferences. Moreover, preferences of a typical individual are influenced by what other members of society are expected to prefer. Again, a typical individual is a risk averter. He would prefer to settle for something which is somewhat less valuable but more certain. In a society no individual is certain about what the others would vote for and all of them collectively opt for a position of lower preference. In other words, the voting pattern may not reveal what the society really wants.

9.6.1. **Arrow's classic illustration**

Arrow provides a classic illustration of an inconclusive result. Supposing there are three individuals and there are three alternatives A, B and C to be arranged in descending order of preference. Assume that the three individuals have the following voting pattern:

Individual 1: A preferred to B; and B preferred to C

Individual 2: B preferred to C; and C preferred to A

Individual 3: C preferred to A; and A preferred to B

We find that A is preferred to B by a majority vote, and B is preferred to C by a majority vote from which it follows that A is preferred to C by a majority vote. But the voting pattern also shows that C is preferred to A by a majority vote. The signal regarding the community‟s preference is therefore inconclusive.

Similarly, suppose that people choose not to have any public goods at all. Should it mean that the State should cease to exist? Actually we know that there is a critical minimum of public services which any State must provide such as defence, law and justice. Also, there are many contractual payments and other traditional expenses which the State is under thligation to incur such as debt servicing, payment of pensions, salaries etc. Moreover, with the passage of time, there is an inherent tendency for public expenditure to increase.

The range of State activities is widening and is no longer confined to any pure public good. Moreover, as is now recognized, the State activities are increasingly covering distributional, welfare, planning, growth and other areas. They are also keen on expanding the supply of merit goods and forcing their consumption upon the members of the society. A whole set of questions relating to public utilities and other public enterprises have cropped up. Same is the case with public debt, an instrument through which public expenditure can be financed and which can also be used as a policy tool in many fields.

In a way, therefore, it is very difficult to handle the theory of public expenditure in its pure form, when it comes to the practical aspects of the problem. In other words, the conventional theory of public expenditure formulated within the framework of some collective objective function of the society is no longer valid. Instead, the theory should accommodate the nurturing of various vested interests and pressure groups resulting in part wastage of public expenditure.

9.7. Structure and Growth of Public Expenditure

The best way to look at the structure of government expenditure is to examine the division of total expenditure between revenue expenditure and capital expenditure. In almost all the developing countries, Public expenditure assumes great importance as a fiscal tool because of the „cherished objectives of rapid economic development and reduction of disparities of income and wealth and increasing state activities. In India also public expenditure has grown substantially because of the rapid rate of growth of population, the process of planned economic development, defence needs, welfare activities etc.

9.7.1. **Structure of public expenditure**

The total public expenditure can be classified broadly as Revenue expenditure and Capital expenditure.

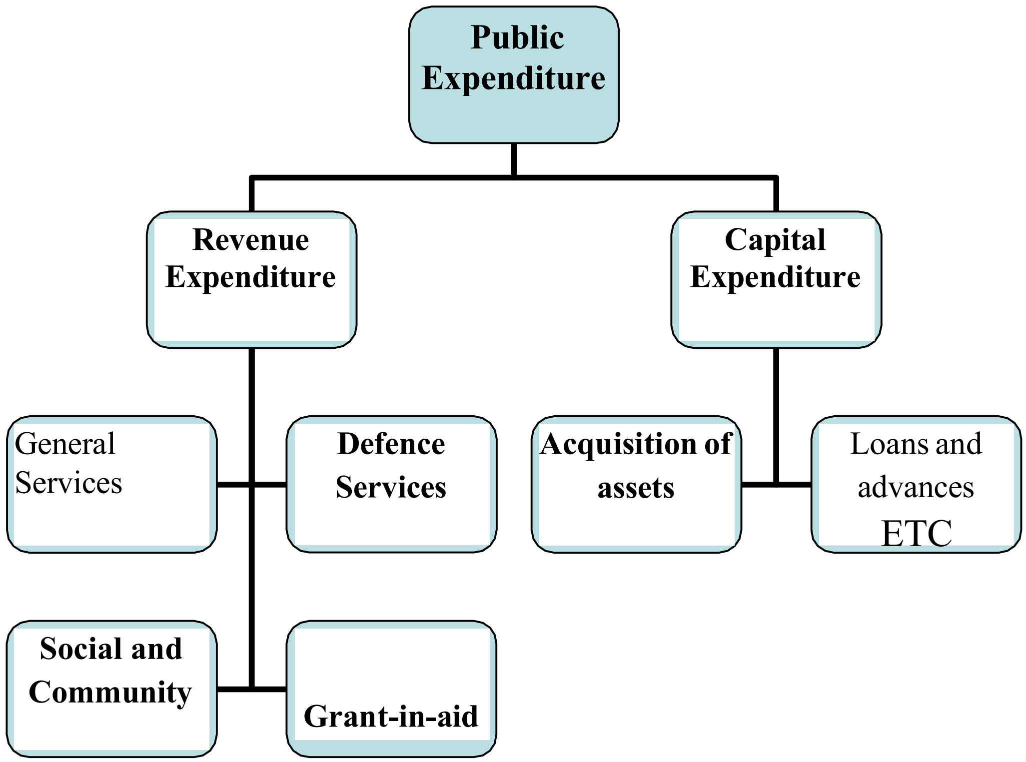


Figure 3. Structure of Public Expenditure

9.5.1.1. Revenue expenditure

Revenue expenditure is that expenditure of the government (Central/State) which does not create any assets. It is financed out of the receipts of taxes and other revenues such as receipts from the Railways. Posts and Telegraphs and civil works etc.,

The Revenue expenditure of the Central Government includes expenditure on

1. General Services

2. Defence Services

3. Social and Community Services

4. Grant-in-aid to States.

The general services includes expenditure on Parliament, administration of justice, expenditure on elections and expenditure on the office of the Controller and Auditor General of India etc., which is known as organs of the state. Besides, it includes expenditure on fiscal services, payments of interest charges, administrative services and pensions and other retirement benefits.

Expenditure on account of salaries, dearness and other allowances, pensions and retirement benefits of the defence, different Ministries such as education, social welfare, health and family welfare etc., is included. Expenditure on the Secretariat and the attached offices of the Ministries of Commerce, Agriculture, Irrigation Energy, Power, Petroleum, Industry, Shipping and Transport etc., is included under the head, Economic Services. The expenditure that arises due to the award of grants-in aid to states is also included in the revenue expenditure.

9.5.1.2. Capital Expenditure

The capital expenditure consists of expenditure for the creation/acquisition of asserts like land, building, equipment etc., and also loans and advances given by the Central Government to State governments Government enterprises and others for the development purposes. This expenditure is financed in India, by receipts such as market borrowings from, Reserve Bank of India, foreign loans and recoveries of loans financed from the state Governments and other institutions.

Capital expenditure consists of expenditure on currency, coinage and Mint and expenditure on fiscal services and on non-residential building which comes under the head General Services. The capital expenditure also includes expenditure of capital nature under the heads of Defence Services, social and community services and Economic Services. All types of developmental expenditure other than the revenue expenditure can be termed as capital expenditure under these heads. The expenditure that arises due to the loans and advances provided by the Central Government to the State Governments and Union Territories in India for undertaking developmental projects is also capital expenditure.

To be brief, it may be said that all expenditure under all the heads can be categorised as either revenue expenditure or capital expenditure. If revenue expenditure is incurred for the maintenance of the service or assets, capital expenditure is incurred for creation and / or acquisition of assets.

9.5.2. Developmental and Non-Developmental Expenditure

Revenue expenditure can further be classified as developmental expenditure and non-development expenditure. The developmental expenditure on Revenue Account includes all expenditure under the heads of Social and Community services, Economic Services and also grants-in-Aid given to States and Union Territories for plan Schemes. This expenditure is treated as Development expenditure because it helps the economy to develop further i different ways.

The non-developmental expenditure Includes expenditure on the organs of State, collection of taxes and duties, currency and coinage and mint, interest payments, subsidies, defence, police, public works, external affairs, pensions etc., It also includes expenditure required to award grants- In aid to State and union Territories for financial expenditure of non-developmental nature.

9.5.3. Development expenditure and non-development capital expenditure:

The capital expenditure can further be classified as developmental expenditure and non-development expenditure. The development expenditure on capital account includes the expenditure on (1) social and Community Services and (2) Economic Services.

Loans and Advances to State and Union Territories for financing developmental projects and loans and Advances to finance public enterprises. It is needless to elaborate the different items of expenditure under each of these heads. The capital expenditure under the above mentioned heads creates assets and capital formation. Under the non-development capital expenditure, the prominent item of expenditure is defence expenditure. Also, expenditure committed on currency, Mint and Coinage, State Trading schemes etc. is considered as non-developmental capital expenditure. So far we have discussed the structure of the public expenditure of the Central Government in India.

9.5.4. Capital expenditure and capital receipts

Capital expenditure of the Central Government consists of plan expenditure and non-plan expenditure financed out of capital receipts. The capital expenditure of the Central Government consists of loans to states and Union territories for financing Plain projects and loans to foreign governments; Capital expenditure on social and community development; capital expenditure on economic development; capital expenditure on defence; and capital expenditure on general services.

The capital receipts of the Central Government are composed of net recoveries of loans and advances to State Government and Union Territories and public sector enterprises; net market borrowings (i.e. gross borrowings less repayments) net small savings collections (gross small savings less States share) and other capital receipts which include provident funds, special deposits, etc.

Public expenditure in a developing economy has certain notable trends, and Indian Public Expenditure has shown those trends in a marked way. Government expenditure in India has been growing very rapidly particularly during the period of the plans. Before the Second World War there was no planning in India and no effort on the part of Government to establish a welfare state. Public expenditure was, therefore, comparatively small. During the war, government expenditure increased because of the war effort. In the post war period it was increased rapidly due to introduction of planning and the provision by the government of welfare services in a big way both at the Centre and in the States.

9.5.5. Trends in growth of expenditure of the Central Government:

The first major trend in public expenditures which we observe in India is the growing Revenue Expenditures of the government from Rs.144.10 billion in 1980-81 to Rs. 11619.40 billion in 2011-12 which is an 80 fold increase. Increased defence commitments, expansion of administration, the government"s international commitments, increase in government"s participation in nation building activities like education and public health, rise in prices, etc. are responsible for the increased Revenue Expenditures of the Central Government. Capital Expenditures during the same period increased about 20 times, from Rs. 83.58 billion in 1980-81 to Rs. 1567.80 billion in 2011-12 (Table 1).

Table. 1: Revenue and Capital Expenditures of the Central Government
(Rs. Billion)

Year	Revenue Expenditures (Rs. Billion)	Capital Expenditures (Rs. Billion)	Total Expenditures (Rs. Billion)
1980-81	144.10(63.29)	83.58(36.71)	227.68
1981-82	154.08(60.99)	98.57(39.01)	252.65
1982-83	187.42(60.87)	120.49(39.13)	307.91
1983-84	222.51(62.62)	132.83(37.38)	355.34
1984-85	276.91(63.46)	159.41(36.54)	436.32
1985-86	339.24(64.41)	187.42(35.59)	526.66
1986-87	408.60(64.94)	220.56(35.06)	629.16
1987-88	461.74(67.64)	220.87(32.36)	682.61

1988-89	541.06(68.39)	250.05(31.61)	791.11
1989-90	642.10(69.11)	286.98(30.89)	929.08
1990-91	735.16(69.82)	317.82(30.18)	1052.98
1991-92	822.92(73.86)	291.22(26.14)	1114.14
1992-93	927.02(75.50)	299.16(24.40)	1226.18
1993-94	1081.69(76.25)	336.84(23.75)	1418.53
1994-95	1221.12(75.97)	386.27(24.03)	1607.39
1995-96	1398.61(78.45)	384.14(21.55)	1782.75
1996-97	1589.33(79.07)	420.74(20.93)	2010.07
1997-98	1803.35(77.71)	517.18(22.29)	2320.53
1998-99	2164.61(77.49)	628.78(22.51)	2793.40
1999-00	2490.78(83.57)	489.75(16.43)	2980.53
2000-01	2778.39(85.33)	477.53(14.67)	3255.92
2001-02	3014.68(83.21)	608.42(16.79)	3623.10
2002-03	3387.13(81.96)	745.35(18.04)	4132.48
2003-04	3620.74(76.84)	1091.29(23.16)	4712.03
2004-05	3843.29(77.14)	1139.23(22.86)	4982.52
2005-06	4393.76(86.88)	663.62(13.12)	5057.38
2006-07	5146.09(88.21)	687.78(11.79)	5833.87
2007-08	5944.33(83.41)	1182.38(16.59)	7126.71
2008-09	7937.98(89.80)	901.58(10.20)	8839.56
2009-10	9118.09(89.00)	1126.78(11.00)	10244.87
2010-11	10407.23(86.92)	1566.05(13.08)	11973.28
2011-12	4266.04(32.35)	8921.16(67.65)	13187.20

Figures for 2011-12 are revised estimates.
Source: Government of India, ministry of finance, Indian public finance statistics, 2013-14

Within Revenue Expenditures, in 1980-81, defence expenditures had the highest share of 22.75 percent; interest component was 18.07 percent while subsidies were 14.07 percent. However, by 1990-91, the largest component was the interest share of 29.24 percent with subsidies constituting 16.54 percent and defence only 14.79 percent . the share of defense was 10.97, interest payments 30.19 per cent and subsidies were 10.82 per cent in in 2011-12 Table 2). Therefore, we observe that besides the burden of servicing the public debt, the subsidy burden was also quite great.

Table. 2: % of Components of Revenue Expenditures

Year	Defence Expenditures	Interest payments	Subsidies
1980-81	Defence Expenditures	Interest payments	Subsidies
1981-82	22.75	18.07	14.07
1982-83	24.95	20.74	12.60
1983-84	23.98	21.01	12.07
1984-85	23.32	21.55	13.04

1985-86	22.84	21.57	14.58
1986-87	20.70	22.14	14.14
1987-88	22.46	22.63	13.34
1988-89	19.19	24.37	12.95
1989-90	17.67	26.39	14.29
1990-91	15.88	27.65	16.31
1991-92	14.79	29.24	16.54
1992-93	13.90	32.32	14.89
1993-94	13.06	33.52	11.68
1994-95	13.85	33.97	10.73
1995-96	13.45	36.08	9.71
1996-97	13.47	35.78	9.06
1997-98	13.21	37.42	9.75
1998-99	14.51	36.40	10.28
1999-00	13.80	35.98	10.90
2000-01	14.14	36.23	9.83
2001-02	13.40	35.75	9.66
2002-03	12.62	35.65	10.35
2003-04	12.02	34.78	12.85
2004-05	11.93	34.27	12.24
2005-06	11.41	33.03	11.96
2006-07	10.97	30.19	10.82
2007-08	10.04	29.20	11.10
2008-09	9.12	28.77	11.93
2009-10	9.23	24.21	16.34
2010-11	9.94	23.37	15.50
2011-12	8.85	22.49	16.66

Figures for 2011-12 are revised estimates.
Source: Government of India, ministry of finance, Indian public finance statistics, 2013-14

9.5.6. Growth of Plan and non-Plan Expenditures

Table 3 shows that the Plan Expenditures share in the Total Expenditures declined in 1980s and through 1990s. It was 39.50 per cent in 1980-8 1 and declined to 26.94 per cent in 1989-90. It then started rising and peaked of 30.78 per cent in 1993-94. Thereafter the trend reversed again and the Plan Expenditures in 2000-01was 25.39 per cent of the Total Expenditures. Though the share of Plan Expenditures improved to 29.29 per cent in 2007-08, it continued to be low in relation to the previous decades. Post the global financial crisis and the adoption of expansionary fiscal policy by the government to deal with the crisis, the ratio started rising again and went up to 32.35 per cent. In the year 2011-12 the Plan Expenditures have increased to Rs 4266.04 billion from Rs 89.94 billion in 1980-8 1, showing an absolute increase of about 45 times. The Non-Plan Expenditures increased by about 65 times from 137.74 billion to Rs 8921.16 billion during the same period. As percentage of Total Expenditures the share of Non-Plan Expenditures increased from 60.50 per cent in 1980-81 to 74.61 per cent in 2000-01. It then remained stable for some time and came down to 68.86 per cent in 2008-09, subsequently increasing to 70.39 per cent in 2009-10 and was at 67.65 per cent in 2011-12. Interest payments, defense expenditures, subsidies and general services, together form more than 90 per cent of the Non plan Expenditures which are difficult to control with the ever-growing public debt and other liabilities.

Table 3: Plan and Non Plan Expenditures of the Central Government

Year	Plan Expenditures (Rs. Billion)	Non Plan Expenditures (Rs. Billion)	Total Expenditures (Rs. Billion)
1980-81	89.94(39.50)	137.74(60.50)	227.68
1981-82	198.54(37.70)	328.12(62.30)	526.66
1982-83	229.96(36.55)	399.20(63.45)	629.16
1983-84	242.09(35.47)	440.52(64.53)	682.61
1984-85	259.51(32.80)	531.60(67.20)	791.11
1985-86	275.20(29.62)	653.88(70.38)	929.08
1986-87	283.65(26.94)	769.33(73.06)	1052.98
1987-88	309.61(27.79)	804.53(72.21)	1114.14
1988-89	366.61(29.90)	859.57(70.10)	1226.18
1989-90	436.62(30.78)	981.91(69.22)	1418.53
1990-91	473.78(29.48)	1133.61(70.52)	1607.39
1991-92	463.74(26.01)	1319.01(73.99)	1782.75
1992-93	535.34(26.63)	1474.73(73.37)	2010.07
1993-94	590.77(25.46)	1729.76(74.54)	2320.53
1994-95	668.18(23.92)	2125.22(76.08)	2793.40
1995-96	761.82(25.56)	2218.71(74.44)	2980.53
1996-97	826.69(25.39)	2429.23(74.61)	3255.92
1997-98	1011.94(27.93)	2611.16(72.07)	3623.10
1998-99	1114.70(26.97)	3017.78(73.03)	4132.48
1999-00	1222.80(25.95)	3489.23(74.05)	4712.03
2000-01	1322.92(26.55)	3659.60(73.45)	4982.52
2001-02	1406.38(27.81)	3651.00(72.12)	5057.38
2002-03	1698.60(29.12)	4135.27(70.88)	5833.87
2003-04	2102.83(29.29)	5075.89(70.71)	7178.72
2004-05	2752.35(31.14)	6087.21(68.86)	8839.56
2005-06	3033.91(29.61)	7210.96(70.39)	10244.87
2006-07	3790.39(31.66)	8182.89(68.34)	11973.28
2007-08	4266.04(32.35)	8921.16(67.65)	13187.20
2008-09	89.94(39.50)	137.74(60.50)	227.68
2009-10	198.54(37.70)	328.12(62.30)	526.66
2010-11	229.96(36.55)	399.20(63.45)	629.16
2011-12	242.09(35.47)	440.52(64.53)	682.61

Figures for 2011-12 are revised estimates.
Source: Government of India, ministry of finance, Indian public finance statistics, 2013-14

Unless the rapid rise in the non-plan expenditure of the Central Government is checked, the government will be forced to borrow internally and externally and ultimately may get into the worst of a debt trap. It may be noted that a large part of our resources have been allocated for the defence purpose, in view of the hostilities with the neighbouring countries, which would have otherwise been spent for achieving a more rapid rate of economic growth.

9.5.7. Growth of Development and non-development expenditures

Levels of Development Expenditures followed a trend similar to that of the total public expenditures. The share of Development Expenditures in the GDP rose after 1981-82 and reached its peak values in the mid 1 980s. In the 1990s and 2000s, the share of Development Expenditures in GDP fell sharply. Thus, while there was a rise in the share of public expenditures and development expenditures in the GDP until the mid-eighties, the trend had reversed significantly in the nineties and continued in 2000s. An important factor that has been constraining the growth of Development Expenditures is the rising share of Non Development Expenditures. Non-Development Expenditures continues to be a large proportion of the Total Expenditures. Defense, debt services and administrative expenses are so large and so significant that they are responsible for keeping non-Development Expenditures at a high level. The share of non-developmental expenditures in Total Expenditures of the Centre grew from 42.54 per cent in 1980-81 to 45.70 per cent in 1990-91 and 58.62 per cent in 2000-01. Then in 2000s, post FRBMA the trend reversed and it fell to 47.21 per cent in 2011-12 (Table 4).

Table 4: Development and Non Development Expenditures of the Central Government (Rs billion)

Year	Development Expenditure	Economic services	Social services	Non-Development Expenditure
1980-81	133.27(57.46)	56.44(24.33)	10.08(4.35)	98.67(42.54)
1981-82	137.91(52.17)	67.37(25.49)	12.44(4.71)	126.44(47.83)
1982-83	163.33(50.68)	76.53(23.74)	15.09(4.68)	158.97(49.32)
1983-84	194.07(51.38)	90.43(23.94)	16.89(4.47)	183.64(48.62)
1984-85	273.75(59.64)	120.21(26.19)	21.46(4.68)	185.25(40.36)
1985-86	329.09(61.16)	140.14(26.04)	14.96(2.78)	208.99(38.84)
1986-87	354.98(54.80)	162.75(25.12)	21.61(3.34)	260.60(40.23)
1987-88	365.73(51.91)	157.22(22.31)	23.69(3.36)	302.61(42.95)
1988-89	415.36(50.95)	180.22(22.11)	27.69(3.40)	355.19(43.97)
1989-90	542.04(56.92)	256.02(26.89)	30.61(3.21)	410.20(43.08)
1990-91	586.45(54.30)	245.88(22.77)	32.74(3.03)	493.49(45.70)
1991-92	593.13(51.81)	236.81(20.69)	35.69(3.12)	551.70(48.19)
1992-93	654.79(51.94)	262.48(20.82)	40.09(3.18)	605.84(48.06)
1993-94	724.64(49.62)	275.71(18.88)	48.30(3.31)	735.86(50.38)

1994-95	828.03(50.12)	338.97(20.52)	58.73(3.55)	824.02(49.88)
1995-96	844.27(46.12)	350.29(19.14)	76.55(4.18)	986.32(53.88)
1996-97	941.97(45.63)	372.53(18.05)	96.72(4.69)	1122.17(54.37)
1997-98	1109.94(46.48)	442.46(18.53)	118.45(4.96)	1278.20(53.52)
1998-99	1372.57(47.73)	543.75(18.91)	146.56(5.10)	1502.98(52.27)
1999-00	1291.51(42.06)	609.56(19.85)	172.21(5.61)	1779.28(57.94)
2000-01	1393.86(41.38)	717.31(21.29)	176.79(5.25)	1974.70(58.62)
2001-02	1593.64(42.52)	808.68(21.58)	151.30(4.04)	2154.56(57.48)
2002-03	1841.97(43.14)	1038.20(24.32)	220.07(5.15)	2427.49(56.86)
2003-04	1954.28(44.54)	1080.71(24.63)	238.59(5.44)	2432.98(55.46)
2004-05	2149.55(44.98)	1150.30(24.07)	299.06(6.26)	2629.04(55.02)
2005-06	2290.60(44.07)	1330.53(25.60)	382.64(7.36)	2906.77(55.93)
2006-07	2557.18(42.83)	1427.72(23.92)	437.62(7.33)	3412.78(57.17)
2007-08	3256.70(44.83)	1729.55(23.81)	616.48(8.49)	4007.28(55.17)
2008-09	4713.99(52.40)	2732.22(30.37)	897.97(9.98)	4281.45(47.60)
2009-10	5282.42(50.68)	3044.40(29.21)	1026.28(9.85)	5141.01(49.32)
2010-11	133.27(57.46)	56.44(24.33)	10.08(4.35)	98.67(42.54)
2011-12	7112.76(52.79)	4504.12(33.43)	1077.56(8.00)	6361.94(47.21)

Figures for 2011-12 are revised estimates.
Source: Government of India, Ministry of finance, Indian public finance statistics, 2013-14

Under development expenditure, the Central Government Included: expenditure on social and community services, on economic services and economic services and grants-in-aid to teh States and Union territories for development purposes. Defence expenditure of the Central Government was on armed forces and it included pensions given to the retired armed personnel. Other expenditure of the Central Government consists of collection of taxes and duties, administrative services, interest payments, pension and other retirement benefits, other grants to the States, etc. If we add defence expenditure together, we could refer to them as non-development expenditure..

9.6. Control of Public Expenditure

Public expenditure has grown consistently both in the Centre and the States during recent years. It is necessary to keep watch over public expenditure with a view to ensure economy and avoid waste.

The control of public expenditure is done through different agencies and different methods in accordance with the constitution of the country. In India Public expenditure is controlled through the following methods.

1. The Parliamentary Control

2. Executive and exchequer control

3. Finance Department control and

4. Audit Control

9.7. Summary

This lesson covers four major concepts of Wagner‟s law of increasing state activities; wise man –peacock hypothesis; pure theory of public expenditure and structure and growth of public expenditure. Adolph Wagner hypothesis of „Law of Increasing State Activity‟ „lays that as a per capita income and output increase in industrialized counties, the public expenditure of those counties necessarily grows as a proportion to total economic activity. He explained the trend of public expenditure. It concludes as the national income increases in amount, the percentage of outlay for government supplied goods is greater. Increased public expenditure was the natural result of economic growth and continued pressure for social progress. However, his hypothesis was criticised by Allan J. Peacock and Jack Wiseman. Peacock-Wiseman approach to public expenditure trend is much more modest in what it claims to explain as compared to Wagner‟s law. It is in fact not an economic principle to interpret increases in public expenditure. At best, it refers to some important factors which lead to growth in public expenditure in certain historical situations. In contrast, Wagner‟s approach is far more general and thus explains growth in public expenditure in bot developed and developing countries far more correctly.

In 1954 Paul Samuelson published his landmark paper *The Pure Theory of Public Expenditure*, which formalized the concept of public goods that are non-rival and non-excludable.

Public expenditure is divided into two classes i.e., expenditure on revenue account and expenditure on capital account. The expenditure on revenue and capital account is again divided into developmental and non-developmental expenditure. The expenditure on revenue account is financed out of the receipts of taxes and the contribution of railways, post and telegraphs and civil works etc. receipts of taxes nd the contribution of railways, post and telegraphs and civil works etc. The development expenditure is made up of expenditure is that on administrative services, debt services, defence, grants to States and Union territories for non-development purposes. The expenditure on capital account is financed out of loans and similar sources.

9.10. Technical terms

1. **Public expenditure** is spending made by the government of a country on collective needs and wants such as pension, provision, infrastructure, etc. Until the 19th century, public expenditure was limited as laissez faire philosophies believed that money left in private hands could bring better returns.

2. **Social progress** is the idea that societies can or do improve in terms of their **social**, political, and economic structures. This may happen as a result of direct human action, as in **social** enterprise or through **social** activism, or as a natural part of sociocultural evolution

3. **Social products** includes communications, education, monetary and banking arrangements

4. Per capita income, also known as income per person, is the mean income of the people in an economic unit such as a country or city. It is calculated by taking a measure of all sources of income in the aggregate (such as GDP or Gross national income) and dividing it by the total population

5. **Displacement effect:** The movement from the older and lower level of public expenditure and taxation

9.11. Self-Assessment questions

1. State the Wagner"s" hypothesis on causes for increasing public expenditure and explain diagrammatically
2. Why is Peacock-Wiseman approach considered to be far more modest as compared to Wagner"s law to explain public expenditure growth?
3. Analyse the pure theory of public expenditure and explain with help of arrow" theory
4. Discuss the structure and the growth of public expenditure

9.12. Reference books

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Lesson 9

Criteria for public investment

Structure of the lesson:

10.0. Objectives

The main objective of the lesson is to elucidate the public investment criteria. It also gives an idea about the various theories on public investment criteria

10.1. Introduction

Governments undertake a variety of activities and responsible for setting macroeconomic policy; they seek to promote equity by aiding the poor and the disadvantaged and provide a variety of services, such as education, health, defence, infrastructure, and police and postal services. Public investment is aimed in accordance with the economic (profit maximisation) and social (public welfare) priorities of the country, to reduce such inequalities of income and wealth of the economy. Many of these activities involve large investments. Public investment confined to economic stability and provides goods and services at reasonable cost. There have been some controversies over what the correct discount rate ought to be between the private and public sectors of an economy. These controversies have focused on the relationships among the correct discount rate, the market rates of return, and the so-called social rate of time preference. A large amount of investment is necessary for economic infrastructure like transport and communication, water supply, sanitation power generation, etc. thus, public investment criteria Thus, the investment criteria of the government significantly differed in case of profit earnings. The profit maximization of private sector is not the rule for public investment and there are a few other criteria to be adopted. The main criteria of public investment have been discussed as under:

10.2. Issues in Criteria of public investment

Different criteria for investment have been suggested for different projects.

10.5.1. Growth Maximization Criteria:

The most general of investment criteria is to maximize the rate of economic growth. But the growth has to be achieved with price level stability as far possible and with redistribution of national income in favour of the poor. However, since public investments are to be largely made on economic heads which are not quick-yielding projects, the rise in the growth rate cannot be expected early. Another problem is that the gap period between project investment and return flows being considerably long in most cases, during which investment expenditure raises factor incomes, a general rise in the price level is bound to occur.

10.2.2. Capital-Output Ratio Criterion:

Capital-output ratio criterion of public investment is another economic literature makes special mention regarding investment criteria. The incremental capital - out put ratio is generally measured on the analysis of past experience of the economy with due allowance made for price changes.

Symbolically, $$C_r = \frac{I_1 - I_0}{Q_1 - Q_0} = \frac{\Delta I}{\Delta Q}$$

where, Cr stands for incremental capital-output ratio, I_1 and I_0 respectively for investment made in period 1 and period zero, Q_1 and Q_0 for -output quantity in period 1 and period zero, and Δ_I and ΔQ respectively stand for increment in investment and increment in quality.

Unlike in the case of whole economy, sector-wise or project-wise capital co-efficient can be estimated if we confine our investment-output analysis within that sector project. This is more important since the immediate concern of the public authorities is to know the capital-output ratio for a particular project or a few projects taken in hand at a time.

However, many of the socialistic countries not recognized the profitable output from the investment. Public sector units have establishing with aim of public welfare rather than profits gain.

10.2.3. National Product Test Criteria:

J. Tinbergen was suggested national product test criteria. He wants to measure all direct and indirect consequences of a project on the basis of that are known as shadow prices. Shadow prices to be elaborately discussed1er approximates the real value of supplying the product or service. Timbergen, however distinguishes between direct indirect effects of a project. Direct effects are those to be expected in the absence of further changes in total national income, while secondary or indirect effects consist of the changes in production which is consequences of change in national income.

10.2.4. Social Marginal Productivity Criteria.

Social marginal productivity criterion was advocated by A.E. Khan and was given an empirical treatment by H.B. Chenery who attempts to qualify the priority pattern for public investment projects. According to him, efficient allocation is one which maximizes the value of national product, and the sources in such a way that social marginal productivity of capital is approximately equal in different uses.

The most efficient allocation of resources brings about equality between marginal cost and price, which is realizable only under conditions of perfect competition. The measurement of marginal productivity is of less importance in developed countries because of wide ranging perfect market. In underdeveloped countries, however, such an estimate is essential in order to provide a proper guide efficient allocation since market value and market cost in them widely differ from social value and social cost. Therefore, public investment projects have to be ranked on the base of SMP in order that the available funds are utilised to bring into operation on1y those projects which are comparatively more beneficial to society by eliminating the low-ranking projects.

According to Chenery the projects may be decided by the following formula.

$$SMP= \frac{V + V_1 - (M+L+0+D)}{\Delta_I}$$

Where, Δ_I is increment to investment, V is the value of output, V_I the value of external economy, M, L, 0, and D stand respectively for cost of materials, labour overheads and of depreciation. If V and V_1 are taken together for benefit while (M + L + 0 + D) is taken for cost, formula can be reduced to:

$$SMP = \frac{B-C}{\Delta_I}$$

Where, B stands for benefit and C for cost

10.2.5. Reinvestment Criterion:

Leibenstein thinks that the rule of social marginal productivity requires the developing countries to choose those industries that require comparatively lower capital-labour ratio, which, however, cannot secure the much needed economic growth. Maximization of national product again is not a good guide to economic development because of the high marginal productivity to consume in these countries. Since profit receivers are the large savers and since without saving, capital cannot be formed, Leibenstein preferred public investment projects with high capital-labour ratio in order that profits are maximized. He was, therefore, interested in reinvestment of capital. In this plan, the rate of reinvestment 'r' given by:

$$r = \frac{P-ew}{C}$$

Where P = output for machine,

e = number of workers per machine,

w = real wage rate, and

c = cost per machine

Hence, (P—ew) gives the net productivity per machine and, therefore, r is the net surplus per unit cost of production, meant for reinvestment.

A.K. Sen does not find this formula at all different from the profit criterion of the capitalist mode of production. If the whole of the wage income as given by (ew) is consumed and whole of the profit as given by (P—ew) is reinvested, the rate of profit becomes the rate of reinvestment. He has modified the use of this formula in terms of growth economy as given below:

$$r = \frac{P - ew}{c} = \frac{S}{a}$$

Where $a = \frac{c}{p}$ = capital coefficient

and $$s = \frac{P - ew}{c} = p\frac{(P - ew)}{pc} = p\frac{(P - ew)}{p} \cdot \frac{p}{c}$$

$$s = \frac{P - ew}{p} \div \frac{c}{p} = \frac{s}{a}$$

Thus, A. K. Sen argues that the maximization of reinvestment (r) rate will result in maximization of the rate of economic growth.

10.2.6. Employment absorption criterion:

Eckstein is, however, more inclined to maximization of employment with low capital turnover ratio and high labour-intensive technology rather than on reinvestment criterion. The need for current consumption m the underdeveloped country is more and, hence, the scope for saving and reinvestment is limited. According to Eckstein the capital-scare, labour surplus economy of this type, production should be labour intensive and the amount important to note that maximisation of employment in a country where marginal productivity of labour is close to zero will not necessarily increase output considerably. This might well lead to a perpetual low productivity. Moreover, capital-intensive investment is supposed to activate the economy in such a way that the scope of labour absorption is automatically widened much before long.

10.2.7. Balance of Payments criterion.

Foreign exchange is often a scarce factor in underdeveloped countries which suffer from balance of payments (B.O.P) problems almost without exception. On the other hand, the imports of raw material, machines and technical know-how are necessary for their economic necessary for their economic development.

Therefore, it is advocated that while choosing from alternative projects, priority should be based on economical use of foreign exchange. JJ. Polak wants that major parts of public investment should be made on export-orientation and import-substituting projects having their positive effect on balance of payments.

Thus, there are a number of criteria to guide the investment decisions of government. They are, however, not easy to be carried out in practice. The difficulty relating to measurement of present and future benefits from public investment and of the costs attached to them remains a fundamental problem. Market prices are not a guide for investment decision in developed countries where markets are yet to be developed, less levels of wages are distorted due to wide spread involuntary unemployment, interest rates are kept artificially at lower levels than what can prevail under free forces of demand and supply, foreign exchange rates do not reveal the true character of scarcity and where controls and regulations widely substitute market behavior. If investment is to be based on social product criterion, the true worth or scarcity value of inputs and output is to be found out. To overcome these problems, the use of shadow prices had been suggested.

10.6. Other issues in public investment criteria

Stephen A. Marglin mentioned public investment criteria in different ways like: Cost-benefit criteria, Time and interest, budgetary constraints, Risk and uncertainty, dynamics in the economy, Private alternatives and alternative costs, pricing policy for public enterprises. The defining characteristic of investment decisions is their concern with benefits and costs that are not coincident. Costs are generally incurred at the outset, whereas benefits may be delayed. Future benefits and costs must be discounted to the present. An important issue in public finance is therefore the determination of the appropriate discount rate or cost of capital and its comparison with that used by private-sector firms. But, as said above, public investments not consider benefits because these are providing infrastructure to the economy at cheaper cost. Thus, pricing of the public goods are non-rival and reasonable. They cannot influences on public investment. The opportunity cost to the government of investing in risk-free real assets is the reduction in interest payments that it would achieve if the cash to be invested were instead used to repurchase government debt. Since similar opportunities are open to private-sector firms, the rate of interest on government debt is the opportunity cost of capital for a risk-free investment by both the public and private sectors.

10.7. Summary

Public investment criteria, at some extent differ to private investment. Because private investment aimed to profit motive and it lead to individual satisfaction at large. On the other, public investment focuses on public welfare by providing infrastructure to all without discrimination irrespective of profit motive. They are responsible for setting macroeconomic policy; they seek to promote equity by aiding the poor and the disadvantaged and provide a variety of services, such as education, health, defence, infrastructure, and police and postal services. Public investment is aimed in accordance with the economic (profit maximisation) and social (public welfare) priorities of the country, to reduce such inequalities of income and wealth of the economy. Many of these activities involve large investments. Various theories have explained about public investment. These covers issue relating to growth maximization, capital-output ratio criterion, national product test, social marginal Productivity, reinvestment, employment absorption and balance of Payments criterion. These criteria may adopt basing on the nature of economic system.

10.8. Technical terms

Capital-Output Ratio: The ratio of capital used to produce an output over a period of time. This ratio has a tendency to be high when capital is cheap as compared to other inputs.

National Product: An economic statistic that includes GDP, plus any income earned by residents from overseas investments, minus income earned within the domestic economy by overseas residents.

Balance of Payments: A statement that summarizes an economy’s transactions with the rest of the world for a specified time period. All transactions between a country’s residents and its nonresidents involving goods, services and income; financial claims on and liabilities to the rest of the world; and transfers such as gifts.

10.9. Self-Assessment questions

1. Critically examine the issues in public investment criterion
2. Discuss the relevance of public investment criteria in socialistic countries

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Lesson No. 10

Excess Burden of Taxes and its Measurement

Structure:

11.1. Objective

11.2. Introduction

11.3. Types of Costs

11.3.1 Administrative Cost

11.3.2 Compliance Cost

11.3.3 Excess Burden (Efficiency Cost)

11.4 Excess Burden - Distortion in Individual Choices.

11.4.1 Choice Among Goods

11.4.2 Choice Between Gods and leisure

11.4.3 Choice Between Present and future Consumption ..

11.5 Tax Rate; Tax Revenue and Excess: Burden:

11.6 Excess Burden and Different Taxes.

11.6.1 Direct Taxes· and Indirect Taxes.

11.6.2 Progressive and Proportional Tax System- Excess Burden

11.7 The Size of Excess. Burden

11.8 Summary

Model Questions

Books for further Readings

11.1 Objective:

The main objective of this lesson is to know different types of costs in relation to taxation and how some type of taxes cause excess burden. An attempt is also made to explain excess burden by examining how some taxes cause distortions in the choices of individuals between different goods, present and future consumption and also between choice of goods and leisure.

11.2. Introduction:

Governments today are committed to perform multifarious functions which require lot of resources. Almost all the governments find taxation as the most important fiscal instrument to mobilise the required resources. to finance public services. Taxation while imposing an opportunity cost, also imposes certain other costs known as administrative costs, compliance costs and efficiency costs. The opportunity cost is equal to the amount of satisfaction or utility foregone by the individual due to the payment of the fax. While the opportunity cost is often referred to as the primary cost of a tax, the other above mentioned costs are referred to as the secondary costs which vary with the choice of the individuals. Therefore, it is necessary to know more about these costs and analyse the possibilities to minimise them.

11.3 Types of costs:

11.3.1 Administration Cost: Adequate importance has not been given by the economists to both administration and compliance costs inspite of these costs in the fiscal operations of a country. Administrative cost is the cost incurred by the government for making the assessment and collection etc. ·of taxes which require both personnel and equipment. Though the administrative cost is subject to large economies of scale, the cost of administration of tax revenue collection rises with the complexity and rigidity of the existing tax laws. That is the reason why administration of a payroll tax or a head tax becomes cheaper compared to an income tax and a sales tax. A tax system becomes more and more complex if a more equitable tax system is to be adopted. Moreover, the administration cost becomes larger *in* a country with federal structure compared to a centralised system.

11.3.2 Compliance Cost:

Compliance costs are those costs which the tax payers incur for keeping the records, filling and filing of tax returns etc. Compliance cost varies with the type of tax. Also this cost increases as the tax laws become more complex and rigid. The compliance cost can be reduced by simplifying the tax laws. Of course, it again leads to the trade off between equity and the minimisation of the costs.

11.4 Excess Burden:

The concept of Excess burden is also referred as efficiency cost or deadweight loss. If a tax imposed by the government interferes with economic decisions and distorts efficient choice causing a burden to the tax payer while being of no help to the treasury is called as excess burden. For example, if an individual pays Rs. 1000 as a tax the burden it imposes on him/her may well be in excess of this amount without being any use to the Treasury. Therefore, an efficient tax policy should always try to minimize their burden.

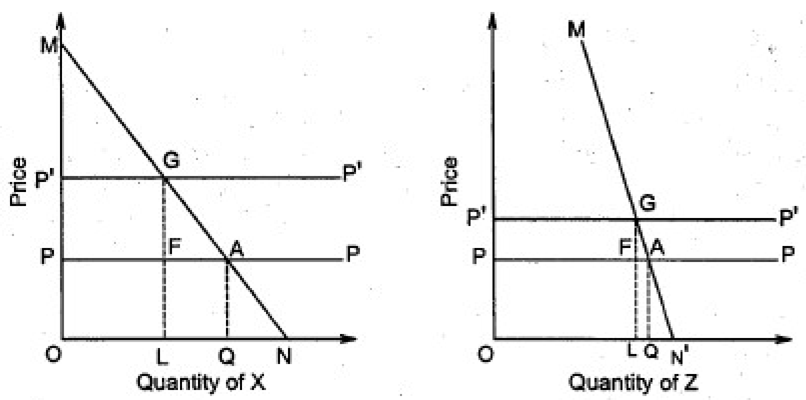
One way of avoiding such burden would be obtaining the whole amount of the tax by imposing a head tax which is insulated to economic activity. But such a tax is unacceptable on equity grounds in view of the well established fact that taxes need to be imposed on the basis of the principle of ability-to-pay basing on indices such as income, consumption, wealth etc. As equitable taxation based on economic equity is needed, it definitely interferes with the economic choices of the individuals thereby causing an excess burden or efficiency cost or. Deadweight loss. Therefore, for designing an ·efficient tax policy one has to choose that tax with less excess· burden if all the taxes are equally equitable. On the other hand, if equity is preferred to efficiency in the trade off, a less efficient tax may be chosen.

4. Excess Burden distortion in Individual choices. How a tax(es) causes distortions in the individual's choice among different products, choice between goods and leisure and the choice between work and leisure is explained below basing on the partial equilibrium analysis.

11.4.1 Choice among goods:

We can examine the excess burden effects of a tax relating to consumer good X and Z in a partial equilibrium market demand and supply. In order to analyse this aspect the concept of 'Consumers' Surplus can be used. We assume that constant cost conditions prevail in the market and also assume that the division of income between present and future consumption and time allocation between work and leisure are constant.

Excess Burden of an Excise Tax



Case - I
Elastic Demand for Product X

Case - II
Inelastic Demand for Product Z

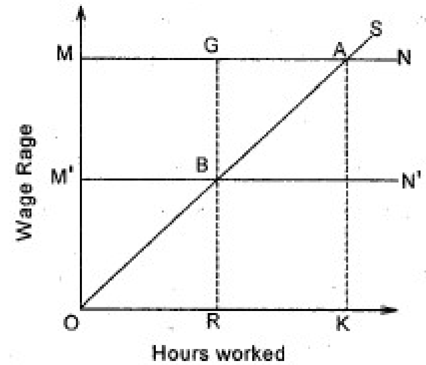
In the above diagram the demand and supply for products. X and Z are shown. The demand for X is shown by the MN line while PP is the supply schedule. It may be seen in the diagram that the pre-tax equilibrium for good X is at A, the price being OP and the quantity demanded is OQ. If a unit tax (excise duty) $t=PP^1$ is imposed by the government, under the assumption that the cost conditions are influenced only because of a tax, the supply schedule rises to PP• and the new (post-tax) equilibrium is at G. The gross price now rises to OP^1 while the quantity demanded declines to OL, and thus tax revenue equals PP^1 OF. In this context of constant cost conditions, the consumers will bear the' entire burden equivalent to PP^1 GF which is the total amount of tax revenue to the government. It is to be noted that the consumers who have earlier paid an amount of OPFL are now paying QP^1GL the difference being PP^1 GF, the tax revenue to the government.

In order to know the excess burden, it requires. further analysis with the help of consumer surplus (CS). To elaborate, the consumer paid OPAQ for an amount of OQ, but his willingness to pay is OMAN. So consumers have received a 'consumer surplus' equal to the difference between actual payment and the amount the consumer would have paid which is nothing but OMA. But in the post tax period the consumer surplus has gone down to P1MG. Consequently the consumers suffered a loss in terms of consumer surplus equivalent to PP^1GF due to the imposition of excise duty. But out of the total loss a large part equivalent to pp^1GF is gained by the government as tax revenue but the gain in terms of tax revenues is not equivalent to the entire loss sustained by the consumer. The difference between the total loss of welfare to the consumer and the gain of tax revenue to the government is the triangle area represented · by FGA: Therefore this FGA represents the extent of deadweight loss or excess burden to the economy. It may be noted that the most important factor that influences the extent of excess burden is the elasticity of demand for the product, the tax imposed cannot interfere with the choices or decision making of the individual as individuals do not try to adjust their purchases to the price. In such cases, the tax almost becomes equivalent to a lumpsum tax or head tax. Thus it exerts no excess burden.

In order to illustrate this we can make a comparison of the two situations presented in the above diagram. While ease-l presents the situation relating to the product X for which the demand is moderately inelastic, case-II represents a situation of the product Z for which the demand is highly inelastic. If an equal amount of revenue is obtained from both the goods, a unit tax FG needed to raise the revenue is comparatively less than the product Z than for X. It may be seen in the diagram that the excess burden exerted in case of Z where demand for the product is highly inelastic is smaller as represented by a smaller triangle FGA. So it follows that if the elasticity of demand is perfect inelastic, which can be obtained QY rotating the demand curve right side until it becomes vertical, the excess burden would be zero.

11.4.2 Choice between goods and Leisure:

Applying the same logical relationships, the issue of excess burden can be analysed relating to the choice between goods and leisure when a tax on wage income is imposed. For this we have to assume that there is only one consumer good (something like a combined goods of X and Z) and also there is no change in the choice between present and future consumption. The excess burden in such case is shown in figure-11.2



Case - I

Excess Burden of tax on Wage Income

Figure 11. 2

In the above diagram OS is the supply schedule of labour at the given wage rate and MN be the demand schedule. As may be seen in the diagram pre-tax equilibrium is at A while hours worked are OK and the wage rate is OM. Of course, We assume an infinitely .elastic demand for labour if a tax is imposed at t=MM 1/OM The net demand schedule shifts downward to MINI. Then it leads to a new equilibrium at B. As a result the number of hours worked will fall to OR and the net wage to OM1. Then the tax revenue equals to the rectangle area shown by M^1M GB which is entirely borne by the workers. But this explanation does not suffice to analyse the excess burden. It may be noted that the total wages paid to the workers before the tax was imposed is OMAK when they worked OK of hours at a wage rate of OM. But the workers would have worked for an amount of wages equal to OAK. Therefore, in this case, OMA is a supplier's surplus or rent, when once a tax is imposed this surplus has declined to OMIB. So the total reduction in surplus equals to M^1MAB out of which MIMGB is gained by the government as tax revenue leaving the triangle BOA as net loss or excess burden or deadweight Joss. As in the earlier case, elasticity of supply of labour will determine the extent of excess burden. For example, the excess b1rrden will be less, less elastic the supply schedule of labour is.

11.4.3 Choice Between Present and Future Consumption:

The excess burden can be explained with the same logic if a tax is imposed on interest. For this, we assume that there is no change in the choice of the individual with regard to household consumption of goods and also between goods and leisure. In order to explain the phenomenon of excess burden in this case we can use the same diagram Figure-11.2 to avoid repetition. By adopting the same figure, we now measure interest rate on the vertical axis in the place of wage rate and saving on the X-axis in the place of number of hours worked. In the absence of tax, borrower pays an interest rate of OM and thus saving equals OK. When a tax is imposed at the rate of M^1M/OM, the demand schedule slips down to M^1N^1 and consequently saving falls to OR. The tax revenue equals MIMGB, while the saver's loss of surplus equals M1MAB. So the excess burden equals BOA. Here; it may be noted that the tax rate is also important as it also causes an excess burden.

11.5 Tax Rate, Tax Revenue and Excess Burden:

It is interesting to examine the relationship between tax rate, tax yield and the excess burden or deadweight loss. An analysis of these relationships is important to examine the equity or efficiency of a tax. This can be explained with reference to a specific product tax as explained earlier.

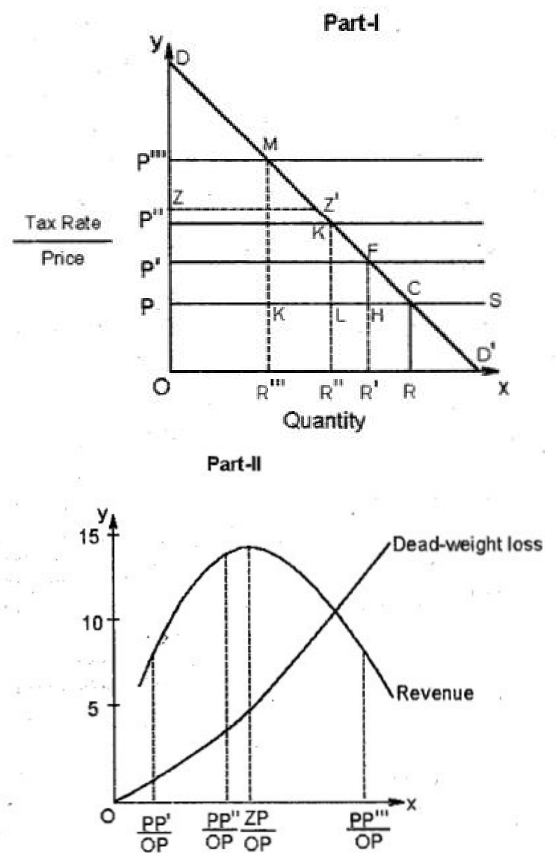


Figure 11.3
Tax Rates and Excess Burden

In the diagram Part-1 DD^1 is the demand schedule and PS is the supply schedule for the product. The equilibrium output and price of the product are OR and CR respectively. At this equilibrium PDC is the consumer surplus. But if a tax is imposed on the commodity at the rate of PP^1/OP, the supply curve takes an upward shift and as a result the consumer surplus declining to P^1DF. Actually the decline equals PP^1FC of which PP^1FH is gained in terms of tax revenue. So the excess burden is HFC. If the tax rate is raised to PP^{11}/OP output falls to. $R^{11}DK$. The loss in consumer surplus now equals to $PP^{11}KC$. The excess burden has increased further to LKC as PPHKL is gained by the government as tax revenue. If the tax rate is further increased to PP^{111}/OP output declines to OR ^{111} and revenue to PP^{111} MK resulting in a · deadweight loss of KMC.

Part II of the Figure 11.3 shows the level of revenue and excess burden to various tax rates corresponding to Part-II. It may be seen in the diagram how the tax revenue increases upto ZP/OP level. It is also evident that the deadweight loss rises at an increasing rate as the tax rate increases. In other words, the deadweight loss rises at the square of the tax rate. It implies that the increase in the tax rate becomes counterproductive once it reaches ZP/OP. It may be concluded that the quality of the tax defining in terms of the ratio of revenue to deadweight loss thus declines with a rising rate of tax. Of course, the government will have other objectives like equity besides minimizing the total excess burden.

11.6 Excess Burden and Different Taxes:

The following Table explains certain types of taxes cause or do not cause excess burden under different household choices, Taxes and Excess Burden.

Choice Fixed Between	Choice variable between	Taxes without Excess Burden	Taxes with Excess Burden
l. Laeisure (L) and Income (y), present consumption (Cp) and Future Consumption (Cf)	Product X and Product Z	Lumpsum tax Income Tax General Consumption Tax	Selective Consumption tax
2. Product X and Product Z Leisure (L) and Income (Z)	Present Consumption Tax General Consumption Tax and Selective Consumption Tax	Lumpsum tax General Consumption Tax and selective consumption tax	Income tax
3. Product X and Product Z Present consumption (Cp) and Future Consumption (Cf)	Leisure (L) and Income (Y)	Lumpsum Tax	Income Tax, Selective Consumption Tax, General Consumption Tax
None	All	Lump-sum Tax	All others

11.6.1 Direct Taxes and Indirect Taxes:

Generally it is stated that direct taxes do not cause a burden while an indirect tax causes excess burden. Therefore, all indirect taxes are considered inferior compared to direct taxes. For Instance, a head tax, an income tax and a general consumption tax imposed at the same rate do not cause any excess burden with respect to the choice of two products X and Y. But these taxes are not neutral with all other choices. For example, ·income tax causes a burden as far as the choice of leisure and income is concerned. Also it causes an excess burden with regard to the choice of present and future consumption. So it may be concluded that direct taxes though neutral yet cause excess burden under certain circumstances.

Similarly, indirect taxes, for example, a selective consumption tax when imposed on one of the two commodities will generate excess burden. Likewise, a selective consumption tax causes a burden with respect to the individual's choice between leisure and income. But the same type of tax does not cause any excess burden being neutral between present and future consumption. Similarly, an indirect tax does not generate any excess burden (rather it becomes zero) when the elasticity of demand/supply for the product subjected to tax is perfectly inelastic. So it can be concluded that indirect taxes - the non - neutral taxes - do not always cause excess burden or deadweight loss.

11.6.2 Progressive and proportional Tax system - Excess Burden :

According to R.A. Musgrave the work effort will be lower and the deadweight loss higher if an individual is asked to pay a fixed amount under a progressive tax than under a proportional tax. This is because the income effect will be the same in both cases, whereas the substitution effect will be higher under the progressive schedule. In other ·words, the substitution effect only causes an excess burden while the income effect is unlikely to cause distortions of choices. U is also pointed out that if supply effort and savings are fixed, the income tax does not cause any excess burden even if progressive rates apply." The excess burden to an individual will be greater when he is. asked to pay a given amount under a proportional rate, if the supply effort is variable. In other words, the excess burden imposed by progressive income tax exceeds that of a proportional tax, as the marginal rate of tax determining the excess burden. The optimal taxation, especially income tax always equity gains of progressive taxation against its efficiency costs.

11.6.3 Regressive Tax System and Excess Burden:·

We have already discussed how a lumpsum tax or a head tax are the only taxes which do not cause any excess burden under any of the choices -(1) choice between products, product X and product Z, choice between present consumption and future consumption, choice between ·leisure and income. Though these· taxes in general are considered neutral, they fall heavily on the poor and in effect may be considered as regressive. All taxes on goods and services are indirect taxes which are regressive in character and may exert less excess burden. But the efficiency cost needs to be weighed against the equity implications.

11.7 The Size of Excess Burden :

The size or magnitude of-excess burden assumed importance in recent years. The quantitative significance .of excess burden is important for two reasons.

(1) The excess burden inherent in several taxes needs to be considered for constructing a good tax system,

(2) It is also necessary to know the extent of excess burden in the marginal tax rupee so as to determine the optimum size of the budget. It may be noted that estimates of dead weight loss in countries like USA focussed mainly on the income tax and the consequent changes in the labour supply and the results have been subject to controversy. Moreover, the overall burden of different taxes put together cannot be determined without giving adequate subsequent allowance for distributional equity.

11.8 Summary:

Taxation has been found as the most important instrument of mobilisation of resources for financing the public expenditure. However, it causes certain costs known as administrative costs, compliance costs, and efficiency cost besides the opportunity cost. While administrative cost is the cost incurred by the government for assessment and collection of the tax, compliance cost is the cost the tax payer incurs with regard to the payment of the tax of all the costs, the efficiency cost is the most important cost which is alternatively known as excess burden and deadweight loss. If a tax imposed by the government interferes with economic decisions and distorts efficient choices causing a burden to the tax payer while being of no help to the government is called as excess burden. Excess burden is caused by a tax except the lumpsum tax or a head tax, by distorting the individual choices with regard to products, income and leisure and present consumption and future consumption excess burden is exerted differently by different taxes under different household choices. The tax rates when raised beyond a level will also expert higher levels of excess burden. The system of tax structure adopted for an individual tax also influences the excess burden. However, it has been concluded that a government need to weigh the efficiency costs with that of the equity weights while choosing a type or a

kind of tax before its imposition. This is very important because the magnitude of excess burden needs to be considered for determining the budget of the government.

Model Questions:

1. Explain the concepts of compliance and administrative costs.
2. Explain the meaning of excess burden.
3. Analyse how a specific tax like excise duty does exert excess burden
4. Explain the relationship between excess burden and tax rates under partial equilibrium.

Lesson No.11: Social Cost Benefit Analysis

Structure of the lesson

11.0. Objective:

From the lesson it can be understood the concept of process and the principles followed in choosing different projects among several alternatives. This also explains how the scarce resources can best be used in different projects by evaluating their respective costs and benefits, the importance and history of cost - benefit analysis, various aspects of cost benefit analysis including the discount rate will be the subject matter of the lesson.

11.1. Introduction:

In the evaluation of the benefits and costs which accrue from alternative public investment projects, the choice of the discount rate is crucial. A project which seems to yield substantial benefits when evaluated at a low percentage rate may well appear extremely wasteful if that rate is doubled. Cost and benefit estimation of Project evaluation is very essential to undertake further projects. Government has to allocate its scarce resources among different competing projects. This necessitates sound expenditure decisions which in turn require the costs, benefits of these alternative projects. The most popular method of project evaluation is to consider the cost benefit analysis.

11.2. Origin of Cost - Benefit Analysis:

The cost - benefit analysis has come into prominence only recently but traced back to welfare economics of 19^{th} century. It has quite a long history since 1844 with its roots in France. But this technique became prominent in this century in the United States of America with regard to evaluating expenditure decisions of the federal government. For instance, the River and Harbour Act of 1902 required the board of engineers taking into account the benefits and costs. Subsequently, in 1930s the idea of a broader social justification for selecting projects has been developed. This technique when first developed by the army natural resources engineers in the U.S.A. in 1 930s took into account not only the direct costs and benefits but also indirect costs and benefits that arise from the public resources such as land, water, transport, power, irrigation, roads etc. Since the advent of development planning in several countries in the world, this technique gained importance with further refinements and broadening the concept. Consequently this technique is used not only for evaluating industrial and commercial projects but also for evaluation of several developmental programmes in the field of health, education and social welfare programmes. Since late 1 930s evaluation was made to projects of flood control arid other water development schemes assessing not only the estimated direct costs and benefits but also indirect benefits and costs. Also, the objective of evaluation was not only to justify the project but also to help decide as to who should pay the cost of the project. Of late, especially after the Second World War, the technique‟s approach has been broadened by including indirect and secondary costs including the intangibles into the analysis. Due to the enormous growth of the public sector and the growth of large number and size of investment projects absorbing a large chunk of national resources, the importance of this technique has increased substantially in the last two decades.

11.3. Significance of Cost - Benefit Analysis (CBA):

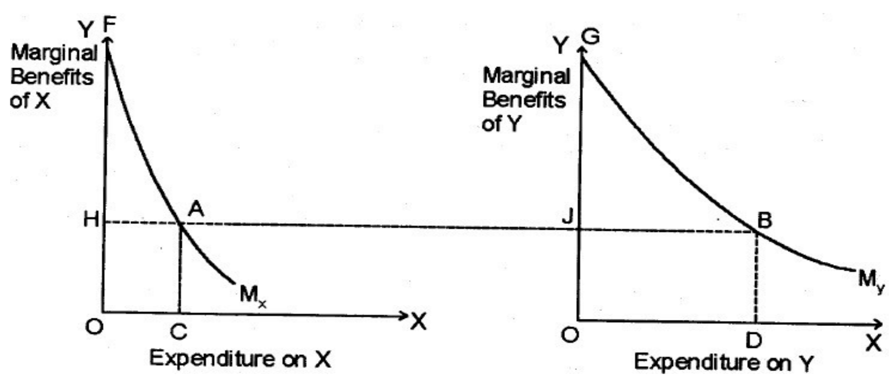
The aim of CBA is to channel resources in to projects which will yield the greatest gain in net benefit to society. Cost - benefit analysis is one of the most widely used fiscal tool for selecting projects and programmes for investment. As the resources are scarce, they need to be used in an efficient manner in accordance with the priorities of the government. Even if the resources are abundant, the government always faces the problem that how much of these resources are to be allocated to different sectors in the economy, and how much of resources are to be allocated to each department or programme within a particular sector. It is, in this context the technique of cost - benefit analysis assumes importance. In other words, the social costs and benefits should be taken into account while making decisions relating to investments in the economy. The cost benefit analysis tries to answer certain questions like whether o not a project is worth undertaken, which type of project is better among several alternative projects within a single sector or among different sectors besides the timing, method of financing etc. It not only guides the public authorities in selecting, projects within a socio - economic framework but also influences and useful in selecting projects in the private sector in a mixed economy context helping in turn to achieve national and socio - economic objectives.

11.4. Project evaluation

Project evaluation involves issues like how to determine the composition of a given size of the budget or how to allocate the total available resources in the economy among alternative projects. It is to be noted here that projects can be either of divisible or, of lumpy form. Assuming that costs and benefits are known and their identification and measurement are possible; the case of divisible project is explained below.

11.4.1. Divisible Projects:

Divisible project evaluation can be explained with reference to a budget size which is and also fixed when it is variable. It can found how the state/households allocate budget resources on two projects, X and Y. For instance, if the family budget is Rs. 10,000, the head of the household knows the costs C involved for providing each service and the benefit B to be derived from the consumption of the two items X and Y, then the outlays are to be allocated between X and Y in such a way as to derive maximum benefit from the total budget maximising the sum of net benefits or excess of total benefits over and above the costs. (benefits-Costs). In this case it is only to maximise the benefits with reference to the costs under the given size of the budget. It can be explained from the following figure.



In the above figure M_x and M_y are the schedules which show the values of marginal benefits derived froth X and Y when money is spent on both X and Y. It may be noted that the opportunity cost of spending a rupee on X is the loss of benefits due to not spending the same on Y. In other words, the total expenditure or resources (rupees) should therefore be distributed in such a way that the benefit derived from spending the last rupee on X will equate that derived from the last rupee on Y. Thus, OC is spent on X and OD spent on Y such that CA DEL and OC plus OD equals the total resources available to the household. By equating the benefits derived from the marginal rupee on X and Y, the total benefits derived both from X and Y can be maximised as shown by the areas of OHAC and OJBD respectively.

11.4.2. Budget size variable:

Determination of the budget size itself rather than the division of a given size of the budget is the real problem of budgeting. This necessitates the division of resources between the private use and public use. If it is a fixed budget, the opportunity cost of pursuing one public project consists of the benefit cost by not pursuing another government project. But in the open budget, the opportunity cost of government projects is nothing but the lost benefits from private projects forgone due to the resource transfer from private sector to public sector. Here what is required is to maximise total (B - C) of both the private and public sectors. This is possible only by equating marginal benefits from the last rupee spent on alternative projects - both private and public. This analysis can also be explained by interpreting the earlier diagram also. For example, if X is the public project, Y is the private project; the solution that has been provided will also apply. Under the assumption of perfect markets, the marginal benefit from expenditure of Re. 1 in the private sector DB equals expenditure of Re. 1 in the public sector.

11.4.3.. Lumpy projects:

Moreover, the allocation of funds between broad expenditure categories, choices are to be made among particular projects which are indivisible involving Iumpsum amounts. For instance, if a choice is to be made between a road connecting A & B and another connecting A & C, where the distance between A and B is just twice the distance between A and C, marginal adjustment is not possible. The lumpy project case can be analysed in terms of a budget size which is fixed and variable. The following Table explains the lumpy projects case.

Table -1: Project choice with Lumpy Projects and Fixed Budget

Project	Costs (C)	Benefits (B)	Net benefits (B-C)	B/C	B/C rank
Project -I	200	400	200	2	2
Project -II	145	175	30	1.2	5
Project -III	80	104	24	1.3	4
Project -IV	50	125	75	2.5	1
Project -V	300	420	120	1.4	3
Project -VI	305	330	25	1.1	6
Project -VII	125	100	-25	0.8	7

Source: Musgrave, RA & Musgrave PB 1989, Public Finance in Theory and Practice,.p.504

Let us examine a case where we have resources of Rs. 700 crores to be spent on seven alternative national highway projects as presented in Table - 1. If we follow the benefit - cost - ratio and rank the projects can choose them accordingly, projects IV, I, V and Ill. Thus, the total cost is Rs. 630 crores, benefits are Ks. 1049 crores, net benefits equal Rs. 419 crores and Rs 70 crores of the available budget is left. Alternatively, projects IV, I, V and II will be chosen by trying various combinations where the net benefits are maximised. In this case, the total cost is Rs. 695 crores, benefits are Ks. 1120 crores and net benefits equal Rs. 425 crores. Here an amount of Rs. 5 crores is unspent. On the other hand if projects are to be chosen on the condition of cost benefit ratio in excess of 1, obviously the choice is for projects I,II,IV & VI, with a cost of Rs, 700 crores, where the benefits are Rs. 1030 and net benefits are Rs.3 13. Given, the three alternatives, the first and second cases are superior to the third as both of them yield more benefits at smaller cost.

However, the choice between the first and second is more difficult. If the second case is chosen, additional benefits of Rs.7 1 crores can be had at an additional cost of Rs. 65 crores. Therefore, the net benefits rise by only Rs. 6 crores and the marginal benefit - cost ratio is only 1.09. As long as other budgets cannot offer projects with a benefit - cost ratio above 1.09, the second case will be preferred. Under the variable budget size, a public project will be undertaken as long as the benefits derived from the project exceed its costs. it may be noted that the cost of spending „n" rupees in the public sector is the loss of n rupees of benefits In the private sector. Alternatively, it may be stated that a project is undertaken as long as the net benefits are more than Zero (B - C> 0). Therefore, what is important in the selection of projects besides the costs and benefits is whether the budget is fixed or variable and also the projects are divisible or lumpy.

11.5. Distinction of Costs and Benefits:

Costs and Benefits of project may further be divided into

(1) Direct or indirect,

(2) Tangible and intangible,

(3) Final or intermediate and;

(4) Inside or outside.

The nature of costs and benefits differ from project to project. Different types of costs and benefits with reference to different projects are given in Table - 2. The costs and benefits mentioned in the table are just illustrative.

Table 2. Different types of costs and benefits of different projects

Irrigation project			
Real			
Direct	Tangible	Increased from output	Cost of pipes
	Intangible	Beautification of area	Loss of wilderness
Indirect	Tangible	Reduced soil erosion	Diversion of water
	Intangible	Preservation of rural society	Destruction of wildlife
Pecuniary	Relative improvement in position of farm equipment industry		
Moon shot project			
Real			
Direct	Tangible	As yet unknown	Cost of inputs
	Intangible	Joy of exploration	Pollution of universe
Indirect	Tangible	Technical progress generated	
	Intangible	Gain in world prestige	
Pecuniary		Relative increase in land values	
Education project			
Real			
Direct	Tangible	Increased future earnings	Loss of students" earnings, teachers" salaries, cost of buildings and books
	Intangible	Enriched life	Foregone leisure time
Indirect	Tangible	Reduced costs of crime prevention	
	Intangible	More intelligent electorate	

Pecuniary		Relative increase in teachers income	

Source: Musgrave, RA & Musgrave PB 1989, Public Finance in Theory and Practice,.p.507

11.5.1. Real and pecuniary

Real and Pecuniary type is the most important one in all the distinction of costs and benefits. Real benefits are the benefits derived by the final consumers of the public government projects. They are an addition to the community"s welfare. These benefits will be balanced against the real costs of resource withdrawal from other uses. Pecuniary benefits and costs emerge due to changes in relative prices which result in consequent upon certain adjustments in the economy with regard to the provision of public services and the changes in the pattern of resource demand. Consequently gains or losses accrued by individuals in the economy are offset and therefore do not reflect net gains or costs of entire the society.

11.5.2. Direct and Indirect:

The real benefits can be divided further as direct and indirect benefits which are otherwise known as primary and secondary. Direct benefits and costs are those which are closely related to the main objective or purpose of the project while the indirect benefits and costs are in the form of by - products, For example, a river development project may have flood control as the direct and immediate benefit but it may also have certain indirect benefits like power generation, control of soil erosion, fishery development etc. The indirect and secondary benefits need to be included in all exercises of cost - benefit analysis, though their identification and estimation is a bit difficult.

11.5.3. Tangible and Intangible:

Similarly real benefits can be termed as tangible and intangible benefits and costs. The benefits which can be valued in the market are termed as tangible while the benefits and costs which cannot be referred to as intangible. Most of the social goods and social costs may be termed as intangible. For example, the scenic beauty resulted due to the construction of an irrigation dam is an intangible benefit while the increased farm output is a tangible benefit. Though it is difficult to measure these benefits and costs, they should be included in any project evaluation.

11.5.4. Intermediate and Final:

Another distinction of real benefits and costs are intermediate and final benefits and costs. The benefits and costs which furnish benefits to consumers directly and finally are known as final benefits while certain projects which are used in the production process of other goods are known as intermediate type. There may be some projects which may provide both the types of benefits.(lly benefits and costs are divided as those which accrue ipide th risdi a rect while others which accrue oujde. This distinctioh is also referred as internal and external benefits and costs. It is very important to take into account all the spillovers of projects undertaken by states especially in a federal context to produce socially optimum levels of output of the project or product concerned.

11.6. Measurement of Benefits and Costs:

Measurement would not be a problem if all these values can be observed in terms of market prices. The question of measurement would be simple if all values could be observed in terms of market prices. But such is not the case Costs and benefits are frequently in intangible form, and even where market prices are observable these maybe in need of adjustment because markets are not perfect and distortions must be allowed for .

Valuation of Intangible items: We begin with the valuation of intangible (nonmarket) items, a problem which has to be solved for many public projects before cost-benefit analysis can be applied to them.

Social Benefits and Costs: Project benefits maybe essentially intangible as with the case of national defence, or both tangible and intangible benefits may result. Thus, education yields intangible benefits via cultural enrichment and improved functioning of the democratic process. There is a tangible benefit of increased earning power. Similarly, costs may be partly tangible and partly intangible.

But, where intangible benefits and costs are involved, measurement takes us back to the central problem of social-good evaluation. The value of such benefits and costs cannot be derived readily from market prices, and a political process is needed to determine them. Voters must decide how much they value clean air or water, or the protection afforded by an addition to national defence. Cost-benefit analysis is no substitute for this process; it is only a way to choosing among projects ***after*** the value of a benefit has been determined.

Intangible Private Benefits or Costs: Related problems arise in connection with benefits and costs which are private in nature but which do not lend themselves to market evaluation. In certain cases, indirect valuation methods of a more or less satisfactory nature may be applied to these intangible items. For instance, the personal value of time may be derived by observation of the differential prices paid for modes of transportation involving different speeds of travel.

Cost-Effectiveness: Despite the fact evaluation of benefits being difficult, analysts may be helpful in two respects. First, they can point out just what benefits or costs will result from particular projects. This shows what type of results should be valued in rupee terms. In some cases, indirect methods of evaluation may be developed. But even where benefits and costs cannot be measured indirectly, analysis may examine how the desired and costs cannot be measured indirectly, analysis may examine how the desired effect can be maximized for a given cost or how a given result may be obtained at least cost. This modest approach referred to as "cost-effectiveness" analysis, which is helpful even though the valuation of the product is difficult.

Benefits from Intermediate Goods: The task of benefit evaluation is facilitated where the public facilities are in the nature of intermediate rather than final goods. In the case of final goods such as parks, the social-good aspect must be faced. Since evaluation through toll pricing would require the inefficient device of exclusion some other approach is needed.

Cost Saving: Another situation which facilitates the task of benefit evaluation arises where provision of the public service relieves society of other costs which now become unnecessary. Thus, benefits of a programme may be measured in terms of savings in outlays on correctional institutions. The estimation of benefits in terms of costs saved provides an approximation by which to determine project selections.

11.7. Shadow Pricing

Tangible costs and benefits are recorded directly in the market if the project or product is under competitive market. But under imperfect market conditions, market prices of the outputs do not reflect true made. These adjusted values are referred to as shadow prices. The problem of shadow pricing also arises in a competitive market when a transfer of a factor to public use raises its price in private use. Here the question is how to measure the opportunity cost. Shadow pricing is used to make corrections for the presence of taxes and the cost of otherwise unemployed resources. The problem of shadow pricing assumes importance in underdeveloped ec5iiö1es where public investment and project evaluation play a predominant role in view of the scarce resources particularly the capital. Sometimes it becomes desirable to use shadow prices for labour substantially below the market price. Shadow pricing is also important in developing economies with regard to exchange rate. Besides the use of shadow prices, it is necessary to assign different weights to the benefits and costs as projects do not generate only one type of benefits and costs. The benefit mix may also differ depending upon the design of the project.

11.8. Estimates and Discount Rate:

Discounting is a technique that converts all benefits and costs into their value in the present. The benefits and costs do not accrue instantaneously in all the cases but over a period of time. While some expenditures yield benefits immediately, others yield a benefit stream over the years. It is necessary to evaluate such benefits by translating future benefits into resent value. They need to be discounted as future benefits are less valuable than present benefits. More or less, the same applies to the cost also. In other words, the opportunity cost of resources that are withdrawn from the private sector should be measured in terms of the present value of private consumption foregone. Thus, future consumption losses can discount to the present value of project. The problem can be solved by applying the social rate of discount to the benefits and costs.

Given the social rate of discount, the government can get a dis counted series of benefits and costs and some of the respective series. The most important one is the appropriate rate of discount. It is also believed that social time preference and the rate of interest are the important factors and relevant for determining the allocation of current resources between investment and consumption. Ded to give e

A.C Pigou opined that individuals are short-sighted about the future, the government intervention is needed to give enough weight to the benefit and welfare of the future generations. Individual preference for current consumption in comparison with future consumption by himself or his successors will be less if the government organises a programme by imposing some sacrifices on every individual or at last a large section of the population than if it is left to the market.

11.8.1. Illustration of discount of cost benefit:

In comparing the benefits and costs of the dam we didn‟t really consider when those benefits and costs occurred. But in many cases the timing of benefits and costs is an important aspect of the project under consideration. For this reason, dealing adequately with the timing of benefits and costs becomes a crucial part of the BCA. For example, what if the cost of constructing the dam is incurred this year, but the benefits of using the dam are not felt until next year, after the dam is completed. In this case will next year's benefits outweigh this year's costs? To deal with this kind of question, benefit-cost analysis uses a concept known as discounting.

Discounting is based on the premise that a rupee received today is worth more than a rupee received in the future. This bias toward the present arises because by placing a rupee in a safe investment today, you can increase its value to more than a rupee tomorrow. Another way of saying this is that a rupee received in the future is not worth as much as that same rupee received in the present. That is, the future value of the rupee is discounted. Discounting is the opposite of compounding. Not surprisingly, the rate at which a future value is discounted is closely related to the rate at which present values are compounded, namely the interest rate. As we know from compounding, if the interest rate is 5%, then a rupee placed in the bank today will be worth Rs1.05 a year from now. This means that if the interest rate is 5%, Rs 1.05 to be received next year is worth only Rs 1.00 today.

Whenever the benefits and costs used in a benefit-cost analysis occur in the future, it is important to discount these future values to account for their present value. If the interest rate is r, then the following formula can be used to find the present value (PV) of an amount (P_t) received at some time t in the future:

$$PV = \frac{P_t}{(1+r)^t}$$

To apply the formula, remember:

PV is the present value of the amount invested;
P_t is the rupee value of the future amount in time t;
r is the discount rate; and
t is the year in which P_t is realized.

For example, suppose that in the example of the dam construction cited above the cost of dam construction (Rs.1.1 million) is incurred at the beginning of the project (t=0), but the benefits (Rs 1.2 million) arise one year later, after the dam is finished (t=1). Suppose the interest rate is 10%.

The present value of the benefits is:

$$\text{Benefits} = \text{Rs.}\frac{12,00,000}{(1+0.10)^1} = \text{Rs.}10,90,909$$

The present value of the costs is:

$$\text{Benefits} = \text{Rs.}\frac{11,00,000}{(1+0.10)^0} = \text{Rs.}11,00,000$$

After the correction for the timing of benefits and costs (that is, on a *present value* basis), the benefits of the dam no longer exceed the costs of the dam and the dam looks like a less worthwhile investment. The reason for the change is that the discount rate now reduces the value of benefits because they occur in the future.

As another example, suppose you are given the choice of two investments. The first pays you Rs. 210 today, but nothing thereafter. The second investment pays $100 today, and Rs. 115 next year (for a total of Rs. 215). The second investment looks better, right? Maybe or maybe not. It depends on the discount rate. If the discount rate is 5%, which is the better investment? We find out by applying the present value formula:

PV of investment 1:

= Rs.210 + Rs.0
=Rs.210
$(1+05)^0$ $(1+05)^1$

PV of investment 2:

= Rs.100 + Rs.115
=Rs.209.5
$(1+05)^0$ $(1+05)^1$

Even though the second investment pays out a greater sum, after discounting the first deal looks like a better choice.

This basic formula for discounting can be applied regardless of the length of the time horizon.

There is no simple rule for choosing a discount rate. One method is to use the opportunity cost of capital as the discount rate. The opportunity cost of capital is the return that would be received if the funds being invested were invested in the private sector (say in a business or in the bond market). Often the discount rate is simply set equal to a well-publicized interest rate. For example, the cost to the union government of borrowing can be used as a discount rate. The discount rate could also be derived from what is called the social rate of time preference (SRTP). The SRTP attempts to compensate for the fact that people prefer to consume now rather than later. Because of this preference, individuals might have a bias in favor of projects that have benefits sooner rather than later. For some projects, society may want to take a longer-range perspective than individuals or businesses, and the SRTP tries to make this adjustment. For example, do you think construction of the Delhi Monument would have passed a benefit cost analysis if people had a high preference for projects with immediate benefits?

11.8.2. Social discount rate

According to Feldstein the social discount rate can be determined by taking into consideration the market preferences, preferences expressed through the ballot box, government‟s preference for the present generation and the government‟s preference for present and future generations. However, there are some problems in determining a social discount rate.

According to the social discount rate can be chosen on the basis of the rate of growth of an economy. This in turn depends on marginal capital output ratio and the rate of investment and the social rate of discount must then be equated with the marginal productivity of investment. Another problem is the varied rates of interest in both the public and private sectors. This results in considerable inefficiency in the allocation of funds. One way of solving the problem is to push down market rates of interest to the level of social discount rate of interest to the level of social discount rate so that all investment decisions whether in the private or public sector need to be taken on the same basis. The social rate of discount depends upon the perfectness or imperfectness of the capital market. If the capital market is perfect and competitive the ruling rate of interest approximates to the social rate of discount. This may not be true in the case of underdeveloped countries where the capital markets are imperfect. Moreover, it is difficult to the planners and other project decision makers to determine the social discount rate as it varies between regions and markets. Sometimes the internal rate of return is also considered as an alternative to social rate of discount. The internal rate of return is the rate of discount at which the sum of the present value of the future benefits will be equal to the sum of the present value of the costs of the projects. Its value has to be arrived at through a trial process.

11.9. Limitations:

Cost - benefit analysis occupies an important place in Public Economics and also being used in several developed and developing countries. But its relevance to large sized projects with huge investments is limited. The applicability of this technique is limited in the underdeveloped economies where the investment projects involve several structural changes.

11.10. Summary

The scarce resources are to be allocated among different competing projects. This requires sound expenditure decisions which in turn require the costs and ben- eras etc. of these alternative projects. This type of analysis using costs and benefits of projects is known as cost - benefit analysis which has become the most important branch of public finance. As projects are of divisible and lumpy type, the project evaluation can be made for divisible projects with both fixed and variable budgets. Assuming that the costs and benefits are known, and then the outlays are to be allocated among the alternative projects to derive the maximum benefits from the total budget - maximizing the sum of net benefits (NB) or the excess of total benefits over and above the costs (B-C). In the case of a project selection when the budget side is variable, the resources need to be divided between the private use and public use. In the open budget, the opportunity cost of government projects is the benefits foregone due to the resource transfer from private sector to public sector. This is possible only by equating marginal benefits for the last rupee spent on alternative projects both private and public.

11.11. Technical terms:

Social discount rate (SDR) is the **discount rate** used in computing the value of funds spent on **social** projects. Determining this **rate** is not always easy and can be the subject of discrepancies in the true net benefit to certain projects, plans and policies.

Cost Saving: An action that will result in fulfilment of the objectives of a purchase, at a cost lower than the historical cost or the projected cost.

Intermediate goods: An intermediate good is a good or service that is used in the eventual production of a final good, or finished product. These goods are sold by industries to one another for the purpose of resale or producing other goods.

Cost-effectiveness analysis (CEA) is a form of economic analysis that compares the relative **costs** and outcomes (effects) of two or more courses of action. **Cost-effectiveness** analysis is distinct from **cost**-benefit analysis, which assigns a monetary value to the measure of effect.

Intangible cost: An unquantifiable cost relating to an identifiable source. Intangible costs represent a variety of expenses such as losses in productivity, customer goodwill or drops in employee morale. While these costs do not have a firm value, managers often attempt to estimate the impact of the intangibles.

Social benefit: Social benefit is the total benefit to society from producing or consuming a good / service. Social benefit includes all the private benefits plus any external benefits of production / consumption. If a good has significant external benefits, then the social benefit will be greater than the private benefit.

11.12. Self-Assessment questions

1. Discuss the importance of discount rate in the cost - benefit analysis
2. Explain how the cost - benefit analysis is useful in the choice of projects.
3. Briefly explain the different types of social costs and benefits
4. Explain the discuss rare of cost - benefit analysis with suitable illustration
5. Explain how shadow pricing is used in the project evaluation.

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Lesson N0:12

Reforms in expenditure budgeting; Programme budgeting and Zero base budgeting.

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12.0 Objective

The main objective of planning and programme budgeting system to attain targeted goals of increase in growth and developmental activities of an economy classified into three stages.

(1) Various goals or objectives of fiscal measures and policies have to be defined. A series of programmes and schemes have also to be formulated which can help to achieve the desired results of fiscal objectives.

(2) The various projects, programmes and schemes have to be analysed in quantitative terms through the use of investment and cost benefit technique or the system analysis.

(3) The current reforms and programmes have to be related to the future costs, benefits, problems and other needed corrections. A perspective aspect of budgetary programmes makes the budget and integral part of the development planning in the economy.

The aim of Performance-based budgeting is the practice of developing budgets based on the relationship between program funding levels and expected results from granted programmes. The performance-based budgeting process is a tool that program administrators can use to manage more cost-efficient and effective budgeting outlays.

As there is a manifold increase in the public expenditure in both underdeveloped and developed countries, thus, the urgent need has been felt for augmenting the productivity of public expenditures. Therefore, most of the governments have switched over from the traditional expenditure budgeting to one or another form of rationalistic budgeting like programme budgeting, performance budgeting, planning-programming and zero base budgeting.

12.1 Reforms in Expenditure Budgeting

Introduction

During 1980's the Government budgets World over are showing very high proportion of Non – plan expenditures falling fund allocations to Planned expenditures including Health and Education. Deficit budget and trade imbalances became common trend. Then the World Bank has suggested a reform mode to the budgets of Nations World over. In that connection it has advised the Governments to reduce the Non – plan expenditure, subsidies, downsizing of the Governments, increase the funds to Health and Education and Projects with economic variability and also streamlining of the Taxation system.

A government budget is a government document presenting is proposed revenue and spending for a financial year that is:

(i) passed by the legislature

(ii) approved by the chief executive or President

(iii) presented by the Finance Minister to the nation.

The budget, which is presented by means of the Financial Bill and the Appropriation bill has to be passed by the House before it can come into effect on April 1, the start of India's financial year The Union Budget of India, referred to as the Annual Financial Statement in Article 112 of the Constitution of India, is the annual budget of the Republic of India, presented each year on the last working day of February by the Finance Minister of India in Parliament.

This document estimates the anticipated government revenues & government expenditures for the ensuing (current) financial year.

The basic elements of any budget are the receipts expenditures of Union Budget, Revenue Budget, Capital Budget, Revenue Expenditure, Revenue Receipts, Capital Expenditure, Capital Receipts (-) Revenue Deficit , (-) Capital Deficit ,(-) (borrowings and other liabilities) Fiscal Deficit and (-) (Interest payments) Primary Deficit.

These are the incomes which are received by the government from all sources in its ordinary course of governance. These receipts do not create a liability or lead to a reduction in assets. Revenue receipts are further classified as:

- **Tax Revenue:-**

Tax revenue consists of the income received from different taxes and other duties levied by the government. It is a major source of public revenue. Every citizen, by law is bound to pay them and non-payment is punishable.

Taxes are of two types, viz., Direct Taxes and Indirect Taxes.

- **Non-Tax Revenue:-**

Apart from taxes, governments also receive revenue from other non-tax sources.

1. Fees
2. Fines and penalties
3. Profits from public sector enterprises
4. Gifts and grants
5. Special assessment duty

Revenue expenditure is the expenditure incurred for the routine, usual and normal day to day running of government departments and provision of various services to citizens. It includes both development and non-development expenditure of the Central government. Usually expenditures that do not result in the creations of assets are considered revenue expenditure.

Expenses included in Revenue Expenditure: -
1. Expenditure by the government on consumption of goods and services.
2. Expenditure on agricultural and industrial development, scientific research, education, health and social services.

3. Expenditure on defence and civil administration.
4. Expenditure on exports and external affairs.
5. Grants given to State governments even if some of them may be used for creation of assets.
6. Payment of interest on loans taken in the previous year.
7. Expenditure on subsidies.

Capital Expenditure

Any projected expenditure which is incurred for creating asset with a long life is capital expenditure. Thus, expenditure on land, machines, equipment, irrigation projects, oil exploration and expenditure by way of investment in long term physical or financial assets are capital expenditure.

The main items of Capital receipts (income) are:-
1. Loans raised by the government from the public through the sale of bonds and securities. They are called market loans.
2. Borrowings by government from RBI and other financial institutions through the sale of Treasury bills.
3. Loans and aids received from foreign countries and other International Organisations like International Monetary Fund (IMF), World Bank, etc.
4. Receipts from small saving schemes like the National saving scheme, Provident fund, etc.
5. Recoveries of loans granted to state and union territory governments and other parties.

Expenditure budgeting

An expenditure budget is the portion of the country's overall budget that deals with the costs required for operations. The government prepares Expenditure Budget to calculate and record its potential spending in detail. It involves the expenses of different ministries and departments, included in different statements, in the form of net financial receipts and recoveries.
1. Revenue and Capital Expenditure
2. Planned and non-planned Expenditure
3. Developmental and non- developmental Expenditure

Expenditure budgeting is established, so that a country has an idea of the total revenue it needs- information essential to formulating effective goals and operational plans. The goal is to have stable, predictable cash flow and a high enough cash balance to deal with unforeseen events that negatively impact revenues or add to expenses.

Purpose of Expenditure budgeting

- In the Indian Context, the Department of Expenditure is the nodal Department for overseeing the public financial management system in the Central Government and matters connected with State finances.
- The principal activities of the Department include pre-sanction appraisal of major schemes/projects (both Plan and non-Plan expenditure), handling the bulk of the Central budgetary resources transferred to States,

- Implementation of the recommendations of the Finance and Central Pay Commissions, overseeing the expenditure management in the Central Ministries/Departments preparation of Central Government Accounts,
- Managing the financial aspects of personnel management in the Central Government, assisting Central Ministries/Departments in controlling the costs and prices of public services,
- The Department also coordinates matters concerning the Ministry of Finance including Parliament-related work of the Ministry

The budget 2012 highlighted two of its features that are steps in the direction of expenditure reforms. The fiscal targets for Centre under the amendments to the FRBM Act are indicated in the Budget documents.

First, the concept of Effective Revenue Deficit, introduced in the last Budget, to address the structural imbalances in the revenue account, is being brought in as a fiscal parameter. Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. Focusing on this will help in reducing the consumptive component of revenue deficit and create space for increased capital spending.

Second, a provision for Medium-term Expenditure Framework Statement is being introduced in the Act. This statement shall set forth a three-year rolling target for expenditure indicators. It would help in undertaking a de-novo exercise for allocating resources for prioritised schemes and weeding out others that have outlived their utility. This would provide greater certainty in multi-year budgeting framework. It would also encourage efficiencies in expenditure management. In implementing the Twelfth Plan, the recommendations made by the Expert Committees to streamline and reduce the number of Centrally Sponsored Schemes and to address Plan and non-Plan classification, would be kept in view. The Central Plan Scheme Monitoring System would be expanded to facilitate better tracking and utilization of funds released by the Central Government.

Finance Commissions, their Terms of Reference and Recommendations

2014 – 15 budget mainly focused on definition of Federal System, on sharing of revenues between States and Center according to C. Rangarajan XIII Finance Commission report. And with certain reforms like:

I. Abolition of Wealth Tax
II. Sanctioning of Central Educational Institutions on equal proportions according to the academic necessities of the States
III. And introduced certain Insurance Schemes to generate Services sector and Employment.

IV. Swatch Bharat Mission is a fundamental Health programme given importance in the budget.

V. Expanding the Services sector Government is involving more population as beneficiaries without incurring budgetary burden and there is a scope of Incremental benefit to the Service Tax.

VI. The main reformation is sharing of total funds under the directions of Neethi Ayog instead of Planning Commission constituted by Prime Minister and Chief Ministers of all States.

I. Major Recommendations of 14th Finance Commission headed by Prof. Y V Reddy

- The share of states in the net proceeds of the shareable Central taxes should be 42%.This is 10% higher than the recommendation of 13th Finance Commission.
- Revenue deficit to be progressively reduced and eliminated.
- Fiscal deficit to be reduced to 3% of the GDP by 2017-18.
- A target of 62% of GDP for the combined debt of centre and states.
- The Medium Term Fiscal Plan(MTFP)should be reformed and made the statement of commitment rather than a statement of intent.
- FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.
- Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act (GST).
- Initiatives to reduce the Number of Central Sponsored Schemes(CSS)and to restore the predominance of formula based plan grants.
- States need to address the problem of losses in the power sector in time bound manner.

II. Major Recommendations of 13th Finance Commission headed by Sri Vijay Kelkar.

- ✓ The share of states in the net proceeds of the shareable Central taxes should be 32%.This is 1.5% higher than the recommendation of 12th Finance Commission.
- ✓ Revenue deficit to be progressively reduced and eliminated, followed by revenue surplus by 2013-14.
- ✓ Fiscal deficit to be reduced to 3% of the GDP by 2014-15.
- ✓ A target of 68% of GDP for the combined debt of centre and states.
- ✓ The Medium Term Fiscal Plan(MTFP)should be reformed and made the statement of commitment rather than a statement of intent.
- ✓ FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.
- ✓ Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act (GST).To incentivise the states, the commission recommended a sanction of the Grant of Rs500 billion.

- ✓ Initiatives to reduce the number of Central Sponsored Schemes(CSS)and to restore the predominance of formula based plan grants.
- ✓ States need to address the problem of losses in the power sector in time bound manner.

III. The Twelfth Finance Commission of India

Introduction

The Twelfth Finance Commission was appointed on 1 November 2002 to make recommendations on the distribution of net proceeds of shareable taxes between union and states. The commission was headed by veteran economist of India, C. Rangarajan. The commission submitted its report on 30 November 2004 and covered the period from 2005 to 2010.

Major Recommendations of 12th Finance Commission

- Macro-economic stability The total Fiscal Deficit for Centre & states to be reduced to 3% of GDP and The total tax-gdp ratio of both centre& states to be increased to 17.6% of gdp in 2009-10. The revenue deficit for the centre& states combined to be reduced to 0% by 2008.
- Distribution of Union Tax The total share of states in the total shareable central taxes to be fixed at 30.5% and the share of states will come down to 29.5% if the states levy sales tax on sugar, textiles & tobacco.
- Grants to local bodies The total grant that will have to given to the states for panchayati raj institutions and local urban bodies for the period of 2005-09 will be Rs 200 billion& Rs 50 billion respectively.
- Calamity Relief Fund The calamity relief fund scheme will continue as it was in the previous plans with central & states contributing in the ratio of 75: 25. The size of fund will be Rs 213.33 billion for the period of 2005-10.
- Grant in aids to the states For the period of 2005-10, the total non-plan revenue deficit grant of Rs 568.56 billion is recommended to 15 states and the total grant of Rs 10172 is recommended for 8 educationally backward states. A grant of Rs 150 billion is recommended for building roads & bridges which is in addition to the normal expenditure of the states while the grants that is recommended to the states for maintenance of public buildings, forests, heritage conversation and specific needs of states is Rs 5 billion, Rs 1 billion, Rs 6.25 billion & Rs 71 billion.

12.2 Planning and Programme Budgeting System (P.P.B.S)

The planning and programme budgeting system (P.P.B.S) helps to integrate the long period planning the government activities and arrange to schedule the specific activities in the future. Budgetary system makes the use of analytical Quantative techniques in the evaluation of different proposals given in the budget. For a systematic estimation of cost and benefits, two techniques i.e system analysis and cost benefits are used. Programming involves the relationship of inputs and outputs to achieve the objectives.

‾**Programme budgeting is a set of procedures designed to improve the basis for policy decision and to secure a more effective and efficient allocation of scarce resources in the public sector, the output of which does not generally command market price"**

- James Cutt Writes.

Performance budgeting -

The process of fund allocation of governments in various countries has been changed from traditional expenditure budgeting to new forms of rationalistic budgeting, such as performance budgeting, programme budgeting and zero based budgeting. Under performance budgeting, various activities of the government are identified in the budget both in financial and physical terms. This is necessary to ascertain the relationship between input and output and to assess the performance in relation to cost. Performance budgeting is conceived as a system of presenting public expenditure in terms of distinguishable divisions such as government functions, programmes, activities and projects; such presentation would reflect the cost of running the government. Under this technique, funds are granted for carrying out specific amount of work identified under a particular division. A cost-benefit approach is employed which facilitates meaningful and purposeful allocation of funds. This method of budget technique promotes cost consciousness as well as cost efficiency and suggests corrections wherever required in the process of allocation of funds.

Distinction between performance and programme budgeting:

The distinction between the two systems i.e. performance and programme budgeting was analysed by Prof. J. Burkhead as: .

" In programme budgeting ,the principal emphasis is on a budget classification in which functions, programmes and their sub-divisions are established for each agency and these are related to accurate and meaningful financial data. Performance budgeting involves the development of more refined management tools, such as unit costs, works measurement and performance standards".

Advantages of planning and programme Budgeting System:

The planning and programme budgeting systems has many advantages to its credit which are highlighted below:

(a) **Assessment of performance**: the accurate planning of any project cannot yield the desired performance unless without the mere choice of a programme. Thus, PPBS provides certain criteria for the quantitative assessment of achievements. In this way, one of the prime requisites of the introduction of performance budgeting is a complete integration of budgetary and accounting classification and the progress in its application will substantially on the degree to which a parallel and well co-ordinate activities.

(b) **Reliable guide for both executive and legislature:** there is lack of automatic mechanism in conventional budgetary techniques which indicates the usefulness of a particular project. Hence, planning and programme budgeting attempts to give scientific guidance to the executive and legislature of the country/state.

(c) **Good base for decision making :** The government decision a highly complex and rigid because it requires high degree of co-ordination in decision- making agencies about the choice of projects.

(d) **Knowledge of Economic Problems**: There is no second opinion to say that economic problems always arise out of scarcity of resources in relation to requirement of the society. In such a situation ,planning and programme budgeting go a long way to solve the problem i.e. what is the root cause of the problem and simultaneously what is the alternative to get the maximum social advances?

(e) **Future programming**: Generally, government budgeting is an annual affair while the various projects and programmes are extended over a long span of period. In such a long period, assessment becomes complicated. Then planning and programme budgeting come at rescue to resolve the problem.

Limitations:

The planning and programme budgeting system is not free from limitations. President Johnson described it as a very new and very revolutionary system of the vast federal government.

The main drawbacks have been listed below:

1. The system fails to define the objectives and priorities of value judgments.
2. It does not provide sufficient scope of innovation in budgetary techniques.
3. It makes decision only based on economic efficiency and does not include the political review which is very essential for making quantitative assessment.
4. The system has a serious jeopardy of administrative structure.
5. It makes only single contribution to the rational decision-making about the expenditure of the government.
6. It does not provide accurate information of the measurement of actual cost and benefits od various projects.

Therefore, planning and programme budgeting systems has its limitations and fails to provide the correct solution for all fiscal problems. But the system has rightly recognized as the single contribution to the rational to the rational decision-making of the government expenditures.

12.3 PROGRAMME BUDGETING CLASSIFICATION

The budget would frame a programme structure to attain a particular objective and specify spending to attain it. All those expenditures allocated to the set of programmes under a particular objective as belonging to a total spending agency which is responsible for attainment of the objective. For example, the objective is eradication of poverty and Inequality in resources and Income distributions, removal of illiteracy and promoting Employment programmes by the implementation of Development and Welfare programmes and Research Projects to be taken up to

increase quality productivity of Agriculture and Industrial sectors by concentrating for promotion and provision of need basis Services and Infrastructure by the Government; these expenditures would constitute not only the poverty removal programme but also help in achieving self reliance and self sustenance in growth and development in order to attaining increase in domestic income with the expansion of markets and efficiency in promoting sales of goods and services which in turn resulting increase in revenue collections of treasury of Government.. It is important to note that since these expenditure agencies are inter -related, some programmes expenditure would draw support from a number of agencies. To explain the anatomy of programme budgeting, let us consider the table.1

TABLE .1 General Objective Eradication of Poverty.

Name of the objective	Detail of Item
Specific objective No.1	**Increase of Earning Capacity.**
Programmes	(a) Primary and secondary education programme. (b) Enrolment incentive programme. (c) Teacher's Training Programme. (d) Adult Literacy Programme. (e) Vocational education Programme. (f) Labour mobility Programme (g) Skill formation programme (h) Job placement Programme
Specific objective No.2	**Income Maintenance.**
Programmes	(a) Employment insurance Programme (b) Social security programme (c) Retirement and disablement benefits. (d) Consumption subsidy programme. (e) Public distribution programme. (f) Price support programme.
Specific Objective No.3	**Community Improvement Programme**.
Programmes	(a) Low income housing programme.

(b) Area development programme.
(c) Flood control Programme.
(d) Consumers' co-operative programme.
(e) Market improvement programme.

Specific Objective No.4 **Agricultural Improvement Programmes**

Programmes.

(a) Input supply Programme.
(b) Irrigation improvement Programme
(c) Flood control Programme
(d) Land reforms programme.
(e) Agriculture wage restructuring Programme etc.

12.4 Investment Evaluation and Cost Benefit Analysis

Introduction:

Public expenditure on a project is to pursue objectives which are different from that of the private investors. It is necessary to see what criteria the economic theory has to offer for public investment.

Capital grows out of saving. In developing countries, the scope of private savings is very limited because of low level of incomes and high marginal propensity to consume (MPC). Hence, it is the government which has to mobilize savings and take major investment decisions. A large amount of investment is necessary for economic infrastructure like transport and communication, water supply sanitation, power generation, etc. The profit maximisation of private sector is not the rule for public investment and there are a few other criteria to be adopted for the latter.

Criteria of Public Investment

The main criterion of public investment has been discussed as under:

1. Growth Maximization Criteria :

Different criteria for investment have been suggested for different projects.

2. Capital –Output Ratio Criterion:

Economic literature makes special mention of the capital -output ratio criterion of public investment. The incremental capital -output ratio is generally measured on the analysis of past experience of the economy with due allowance made for price changes.

Symbolically,

$$C_r = \frac{I_1 - I_0}{Q_1 - Q_0} = \frac{\Delta I}{\Delta Q}$$

where, C_r stands for incremental capital -output ratio, I_1 and I_0 are investment made in period I and period zero respectively Q_1 and Q_0 for out quantity in period 1 and period zero , and 1 and Q stand for increment in investment and output respectively.

3. National product test Criteria:

This criteria was suggested by J. Timbergen to measure all direct and indirect consequences of a project on the basis of what is known as shadow prices, is an accurate method to estimate the approximate of the real value of marginal cost of supplying the product or service.

Timbergen, however, distinguishes between direct and indirect effects of a project. Direct effects are those to be expected in the absence in production which is consequences of change in national income.

4. Social marginal productivity Criteria :

Social marginal productivity criterion was advocated by A. E. Khan and was given an empirical treatment by H.B. Chenery who attempted to qualify the priority pattern for public

investment projects. According to him, efficient allocation is one which maximizes the value of national product, and the rule for achieving this is to allocate resources in such a way that social marginal productivity of capital is approximately equal in different uses.

The measurement of marginal productivity is of less importance in developed countries, however, such an estimate is in order to provide a proper guide to efficient allocation since market value and market cost in them widely differ from social value and social cost. Therefore, public investment projects have to be ranked on the base of SMP in order that the available funds are utilised to bring into operation only those projects which are comparatively more beneficial to society by eliminating the low-ranking projects.

According to Chenery, the rank of the projects may be decided by the following formula for SMP.

$$SMP = \frac{V + V_1 - (M + L + O + D)}{\Delta I}$$

Where ΔI is increment to investment, V is the value of output, V_1 the value of external economy, M, L, O, and D stand respectively for cost of materials, labour over heads and of depreciation. If V and V_1 taken together for benefit while (M+L+O+D) is taken for cost, the formula can be reduced to;

$$SMP = \frac{B - C}{\Delta I}$$

Where B stands for benefit and C for cost.

5. Reinvestment Criteria:

Leibenstein thinks thank that the rule of social marginal productivity requires the developing countries to choose those industries that require comparatively lower capital -labour ratio, which, however, cannot secure the much needed economic growth. Maximisation of national product again is not a good guide to economic development because of the high marginal propensity to consume in these countries preferred public investment project with high capital-labour ratio in order that profits are maximized. He was therefore, interested in reinvestment of capital. In this plan, the rate of reinvestment (r) is given by

$$R = \frac{P - ew}{c}$$

Where p = output for machine,

e = number of workers per machine,

w = real wage rate , and

c = cost per machine

Hence (P- ew) gives the net productivity per machine and, therefore , r is the net surplus per unit cost of production meant for reinvestment.

6. **Employment Absorption Criterion**:

Eckstein is, however, more inclined to maximisation of employment with low capital turn-over ration and high labour -intensive technology rather than on reinvestment criterior, the need for current consumption in the underdeveloped country is more and hence the scope for savings and reinvestment is limited.

7. **Balance of Payments Criterion:**

Foreign exchange is often a scare factor in underdeveloped countries which suffer from balance of payment (B.O.P) problems almost without exception. On the other hand, the imports of raw materials machineries and technical know-how are necessary for their economic development. Therefore, it is advocated that while choosing from alternative projects priority should be based on economical use of foreign exchange.

Thus, there are a number of criteria to guide the investment decisions of government. They are, however not easy to be carried out in practice. The difficulty relating to measurement of present and future benefits from public investment and of the costs attached to them remains a fundamental problem. Market prices are not a good guide for investment decisions in under-developed countries where markets are yet to be developed less levels of wages are distorted due to wide- spread involuntary unemployment, interest rates are kept artificially at lower levels than what can prevail under free forces of demand and supply foreign exchange rates do not reveal the true character of scarcity and where controls and regulations widely substitute market behaviour. If investment is to be based on social product criterion. The true worth or scarcity value of inputs and outputs is to be found out. To overcome these problems the use of shadow prices had been suggested. But their calculation is also beset with many difficulties. As a result, a substantial amount of arbitrariness is bound to enter into such assessment.

12.4.1 Cost Benefit Analysis:

The most popular method of project evaluation is to consider the cost benefit analysis of different projects and then to select involving lesser cost and yielding greater benefit. It provides superior criteria for project evaluation in planned economy. It helps planning authority in making correct investment decisions to achieve optimum resource allocation by maximizing the difference between present value of benefits and costs of a project. Thus cost benefit analysis ¯ purports to describe and quantify the social advantages and disadvantages of a policy in terms of a common monetary unit‖ the objective function can be expressed as Net Social Benefit (NSB) = Benefits-Costs, where benefits and cost are measured in terms shadow or accounting prices of inputs instead of actual market prices.

Origin of Cost Benefit Analysis

The origin of cost benefit analysis can be traced back to welfare economics of 19th century. The first practical embodiment of the maximization of net benefit occurred in 1930s in the realm of water resources.

"The principle of comparing benefits to whomsoever they may accrue with the estimated costs."
Flood Control Act of 1936

In 1958 "with the simultaneous publication of works by Mckean and Krutilla and Eckstein" attempted "to formalize public investment criteria in relation to the established criteria of welfare economics. Thus benefits were related back to the consumers' surplus criteria of Dupit, Marshall and others, and ranking in terms of net social benefits was justified in terms of Pareto criteria for welfare maximization."

Welfare Aspect of Cost Benefit Analysis

The aim welfare aspect of cost benefit analysis is to channelize resources into projects which will yield the greatest gain in net benefit to society. Maximization of net benefit means the maximization of social utility. Dupit examined this problem first in 1844. Let us understand his arguments in Fig. – 1 drawn under the assumption of perfect competition.

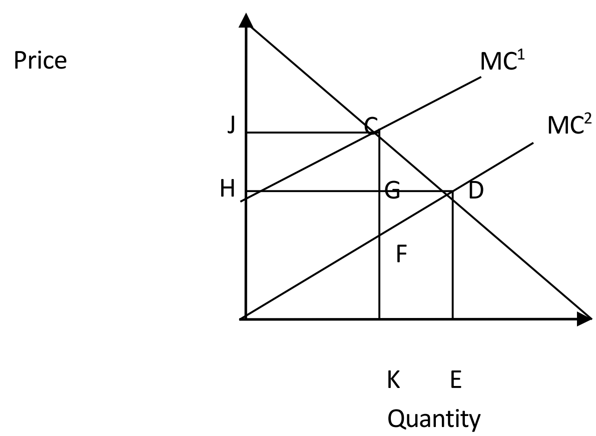


Figure - 1

In Fig – 1 it is assumed that the undertaking of the project lowers the marginal cost from MC^1 MC^2. Consequently, the market price is determined at D, the point of intersection of marginal cost with the demand curve BQ. At the new price, consumers are willing to pay OBDE for the quantity OE. The area OBDE consists of two parts-OHDE, the amount actually paid and H.BD, the extra amount they are willing to pay, called Consumer's surplus. At C, the total price which the consumers were willing to pay was OBCK. So the change in the willingness to pay as a result of lower price is KEDC. In other words, the lower price increases gross benefits by the area KEDC. The increase in benefits involves extra costs of KEDF. Hence the jet gain in benefits is the triangle FDC. This triangle consists of two parts, GCD and GFD. GCD is the gain in consumer' surplus whereas GFD is the gain in producer's surplus.

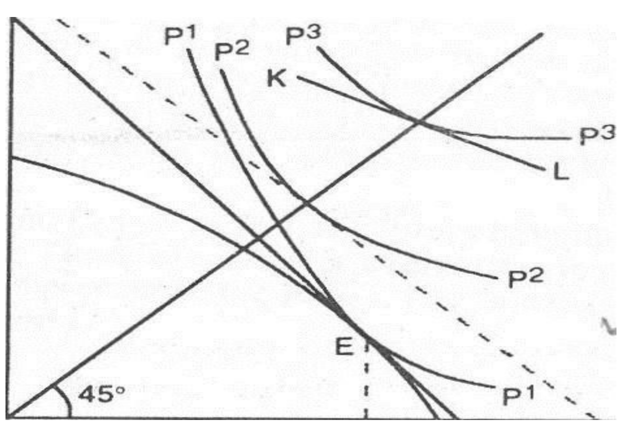
Dupit suggested that the use of combined surplus in and& to measure change in welfare arising from the imposition of a toll on a bridge crossing. But this analysis can be extended to the case of new, investment.

Marshall later adopted consumer's surplus concept to -measure the change in welfare under the Restrictive assumption of constant marginal utility of income. Other assumptions of this analysis were cardinal indicators of utility gains and losses and identical utility scales for each person. Under these assumptions there was no problem in adding up individual surpluses and losses.

Cost Benefit Analysis:

While employing capital investment for production of an output the decision is made on the expected return on investment. If such return is anticipated to be less than in other lines of production the particular product will not be able to attract capital from the investors. In the case of private sector, investment involves such a commitment to the stockholders in the form of dividends. Thus, time element is a prominent factor for investment fund, since it involves sacrifice of present consumption and waiting for future consumption an individual will sacrifice his present consumption in accordance with what is called his time preference. If he is indifferent as between one rupee worth of present consumption and one rupee ten paise worth of consumption one year preference is 0.10 or 10 per cent. This fact can be explained with the help of Fig. - 2

Future Income/
Consumption



M A C G

PRESENT INCOME/CONSUMPTION

In Fig - 2 Curve shows possibility of capital productivity or investment opportunities. The slope of the curve at different points technically called Marginal Rate of Transformation (MRT) indicates the rate at which present income can be transformed into future income. Thus, at point E the rate is given by the slope of the line DC indicating that the present income of the amount AM can be transformed into future income of the amount EM. The greater the sacrifice of present income, the larger will be the amount of transformed future income. But the rate of returns from sacrificing present income is diminishing and hence is the transformation curve concave to the point of origin.

On the other hand, marginal rate of time preference of an individual is given by the slope of his indifference curve for present consumption and future consumption. It indicates the rate at which he is ready to sacrifice present consumption against an assured amount of future consumption. If at a point of indifference surface the slope indicates larger present consumption than future consumption, the marginal rate of time preference will be negative as shown by P^3 schedule with KL slope. In the reverse case as indicated by the slope line DC at point E of indifference schedule P^I, the rate will be positive while GF slope of P^2 speaks of neutral preference or zero rates. The marginal rate of time preference and the marginal rate of transformation are equal at point E where the preference and transformation schedules are tangent to each other. At this point, the rate of interest in private economy is determined.

12.4.2 Specific Criteria's for Cost Benefit Analysis

The selection of project must be made on cost benefit analysis to formulate optimal development plans. The first step of project evaluation is to consider a list of cost and benefits of a project. It depends upon the nature of the project. The social benefits of a project include the contribution that the project would make to the attainment of national goals.

Criteria for Cost Benefit Analysis

The US Sub Committee discussed the following four benefit cost criteria's:

(i) B - C *(ii)* B - C/I

(iii) ΔB/ΔC (iv) B/C

Where B is Benefits, C is Costs, I is Direct Investment, Δ is Increment

The formula B - C / I is "for determining the total annual returns on a particular investment to the economy as a whole irrespective of to whom these accrue." If the private investment happens to be very large, then even high value of B – C /1 may be less beneficial to the economy. Thus, this criterion is not much useful to achieve satisfactory results.

The criteria of Δ B/Δ C = I is meant to determine the size of project. The adoption of the B - C criterion favours a large project and makes small and medium size projects less beneficial. Thus, this criterion helps in determining the scale of project on the basis of the maximization of the difference between B and C.

The best and most effective criterion for project evaluation is B/C. In this criterion, the evaluation of project is done on the basis of benefit-cost ratio. If B/C = I, then the project is marginal because the benefits occurring from the project just covers the costs. If B/C is less than 1, then benefits are less than costs so the project is rejected. If B/C is greater than I, the benefits are more than costs and the project is profitable and hence, it is selected. The higher the benefit cost ratio, more profitable will be the project.

In fact, the future benefits and costs based on the implementation of the above criteria's cannot be considered at par with present benefit and cost. Therefore, project evaluation requires-discounting of future benefits and costs because society prefers present to the future. For this purpose, The economists have derived a number of decision rules or criteria.

1) Net Present Value Criterion (NPV):

This is an important criterion for project evaluation. NPV = Present value of benefit present value of operating and maintaining costs — initial outlay. It is also expressed as the net present value of benefits criterion so that,

NPV of benefit = Gross present value of benefits – Gross present value of costs.

If NPV > 0 resulting that the project is socially profitable. If there are number of mutually exclusive projects, then the project will be highest net present value of benefits will be chosen.

The NPV criterion is not accurate method for project evaluation as it neglects the time horizon. Capital investments give benefits after a lapse of some time. Therefore, future benefits and costs cannot be equated with present benefits and costs. So it becomes essential to discount future benefits and costs because society prefers present to future. The discount factor is expressed as:

$D = 1 / (1+i)^t$

Where, i - is social discount rate. T is time period

Thus

$$NPV = \left(\frac{B_1}{(1+i)^1} + \frac{B_2}{(1+i)^2} + \frac{B_n}{(1+i)^n} \right) - \left(\frac{C_1}{(1+i)^1} + \frac{C_2}{(1+i)^2} + \frac{C^n}{(1+i)^n} \right)$$

B_1, B2 $\rightarrow$ Bn series of gross present benefits in years 1, 2 -----n

C_1, $C_2 \rightarrow C^n$ series of gross present cost in years 1, 2----- n

i $\rightarrow$ social rate of discount.

Only those projects should be selected in which present value of benefits exceeds the present value of costs *i.e.*

$$NPV = \frac{B_1}{(1+i)^1} + \frac{B_2}{(1+i)^2} + \cdots + \frac{B_n}{(1+i)^n} > \frac{C_1}{(1+i)^1} + \frac{C_2}{(1+i)^2} + \cdots + \frac{C^n}{(1+i)^n}$$

The ratio of present value of benefit to present value of cost should be greater than 1 for the selection of a project *i.e.*

B_1 B_2 B_n

$$\frac{\frac{}{(1+i)^1} + \frac{}{(1+i)^2} + \frac{}{} + \frac{}{(1+i)^n}}{\frac{C_1}{(1+i)^1} + \frac{C_2}{(1+i)^2} + \frac{}{} + \frac{C_n}{(1+i)^n}} .>1$$

(2) Internal Rate of Return Criterion

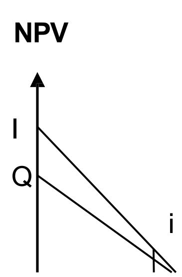
This criterion refers to the percentage rate of return implicit in the flows of benefits and costs of projects. Marglin defines the internal rate of return (IRR) as the discount rate at which present value of return minus cost is zero. The mathematical formula for the computation IRR

$$B_1 - \frac{C_1}{(1+r)^1} + B_2 - \frac{C_2}{(1+r)^2} + B_n \frac{C_n}{(1+r)^n} = 0$$

r- Internal rate of return.

In case of mutually exclusive projects, the project to be selected must have highest rate of return.

- It is not possible to change the rate of return assumed for the calculation of profitability of project.
- It is difficult to calculate rate of return on long gestation project which does not yield benefit for many years.
- This criterion is not applicable to highly capital intensive projects.
- It is difficult to calculate IRR in which the entire investment outlay cannot be made in first period.
- .The use of IRR for public investment does not lead to correct decisions because it is not possible to discount intermediate benefits and costs of public investment at internal rate of return.
- It is difficult to make choice between two alternative investments on the basis of their alternative internal rates of return..
- Layard points out the problem of capital rationing where projects cannot be selected on the basis of ranking in order of the rate of return. Such projects can only be selected on the basis of their net present value.



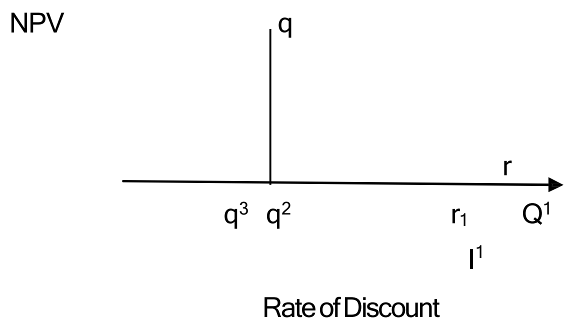


Fig. 3

n fact, IRR depends upon social rate of discount. The nice of project depends upon discount rate if Net present values of the projects are given. This can be explained with the help of a Fig. 3 given above. The rate of discount is measured along X-axis and NPV on Y-axis. The curve II^1 depicts investment of project I and QQ^1 of project Q. The IRR of project Q is higher than of project I because discount rate Or is greater than Or, at $0q^2$, the IRR of both projects are equal. But if discount rate falls below $0q^2$ projects I will be chosen because its NPV is higher by ik. The choice on the basis of changes in discount rate is called Switching and Reswitching.

Relation between NPV and IRR

The NPV at the social discount rate and the internal rate of return are two criteria which are frequently used for choosing projects. The relation between NPV and IRR is illustrated with the help of Fig. 4

As NPV falls, the discount rate increases and a situation arises when NPV becomes negative. The rate at which NPV changes from positive to negative is IRR. For the selection of project, the IRR must be higher than its discount rate *i.e. r> i.* In the Fig. 4, IRR is taken as 10 per cent be selected for development so long as NPV > 0 and *r (10* per cent) > *i* (5 per cent). For complex projects, these two criteria can give different results but mostly they are interchangeable.

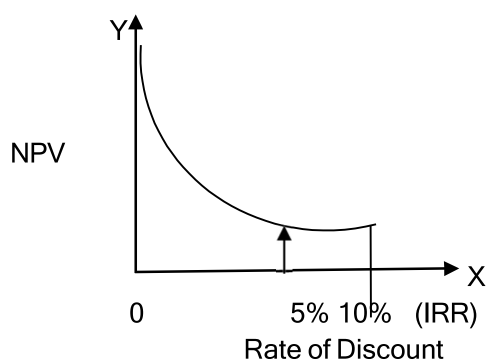
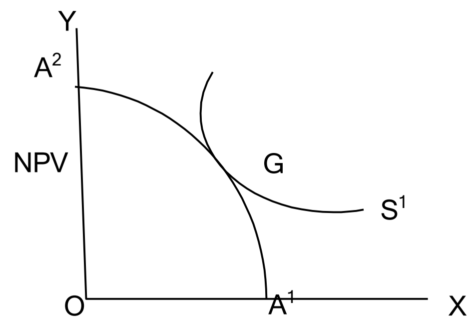


Fig. 4

NPV criterion is commonly used for project evaluation in private and public sectors. But the NPV criterion is technically superior, since IRR can give an incorrect result in special circumstances..

3. Social Rate of Discount (SRD)

Since society prefers present to future, future generations are likely to have higher levels of income, If 'the principle of diminishing marginal utility operates, then the utility gains to future generations from a given amount of benefits will be less than the utility gains to the present generations so the future gains must be discounted. The rate at which future benefits must be discounted to make them comparable with present benefit is called 'Social Rate of Discount'. In other words, it is the rate of premium which the society puts for preferring the present consumption to future consumption. This is illustrated with the help of a Fig. 5



Rate of Discount (IRR)

Fig. 5

The present consumption A^l is taken along horizontal axis *Y* and future consumptions A^2 taken along vertical axis. A^l A^2 is the transformation frontier or investment possibility curve. It A^2 consists of a series of projects arranged from right to left in order of their rate of return the cost of sacrifice of present consumption and the return is the gain of consumption in future. The society > will choose from the various investment possibilities so as to reach its highest social indifference curve S1. The society reaches an optimal position when transformation curve A^l A^2 equal its social indifference curve S^l at. point G. The slope of the transformation curves represents the rate of return on investment and the social indifference curve represents the rate of time preference. Thus, social discount rate is determined by the equality of the rate of return on investment and rate of time preference at point G.

Since the benefits and costs arc to occur in future, they are discounted in order to find their present net worth so there is a problem of choosing suitable rate at which future benefits are discounted. Generally, the market rate is used for this purpose but it fails to solve the purpose where there is multiplicity of rate of interest in market or the private and social rate of discount may not concede so there is no scientific way of choosing a suitable rate.

Pigou and Dobb regard the use of social time preference rate as *'pure myopia'.* They allege that people are victims of "defective telescopic facility" that is why they prefer present consumption to future consumption. But they reject this view on the ground that society is a continuous entity and it has collective responsibility for future generations. So they favour zero social time preference rates because the present and future should have equal weights in the estimation of the society. According to Marglin, this view is an *authoritarian rejection of individual preferences".* Sen and Eckstein pointed out that the rational fear of death is sufficient for people to have positive social time preference rate.

Hirschleifer and other use the concept of social opportunity cost to measure the social discount rate.. The social opportunity cost is a measure of the value of society of the next best alternative use to which funds employed in public project might otherwise have been put." The next best alternative use of funds is investment in private sector. If they earn a rate of 6 per cent, the public investment must also earn a rate of 6 per cent or more. Thus, social rate of discount is 6 per cent. If the

public project earns 6 per cent it should not be undertaken. Thus, the social opportunity cost method of calculating the social discount rate is not free from certain shortcomings. Hence, it is difficult to find a rate of return which may measure the social opportunity cost of funds.

Limitations of Cost Benefit Analysis:

Cost benefit analysis is a scientific technique regarding the selection and rejection of project even then it is not free from drawbacks.

Some of its limitations are:

1. **Difficulties in Benefit Assessment.** The correct estimation of benefits from a project also becomes difficult due to uncertainty regarding the future demand and supply of the products from a new project and their prices.
2. **Arbitrary Discount Rate.** The social rate of discount assumed for any project is arbitrary. there is no perfect method to find social discount rate. It remains a subjective phenomenon. But if there -is a small change in social discount rate it may change the full results of project evaluation. The arbitrarily large **discount** rate does not help in calculating the net present value of benefits of long term projects.
3. **Ignores Opportunity Cost.** It also ignores the problem of opportunity cost. Griffin and Enos state that if all prices reflect opportunity costs, all projects for which B/C 1 would be chosen.
4. **Problem of Externalities.** The side effects of a project are difficult to calculate in this analysis. There may be technological and pecuniary externalities of a river valley project, such as the effects of flood control measures or a storage dam on the productivity of land at other places in the vicinity.
5. **Difficulties in Selecting Appropriate Decision Rules. There** are three decision rules for the evaluation of project. These are NPV criterion, IRR criterion and SRD criterion. These entire criterions have their own advantages and disadvantages. Therefore, it becomes difficult to decide as to which criteria should be used. for the evaluation of the project because the wrong selection will lead to false conclusions.
6. **Difficulties in the Cost Assessment 'Cost** estimates are made on the basis of the choice of techniques, locations and prices of factor services Used. market prices of factors of pr diction are

used for this purpose provided they reflect opportunity cost. But in underdeveloped country market prices usually do not reflect the opportunity costs, because there is fundamental disequilibria which is reflected in the existence of massive under-employment at the prevailing level of wages, the deficiency of funds at prevailing interest rates and the shortage of exchange at current rates of exchange.

7. **Neglects Joint Benefits and Costs.** It ignores the problems of joint benefits and costs arising from a project. There are number of direct and indirect benefits flowing from river valley project but is is difficult to evaluate and calculate such benefits separately. Similarly, the joint costs which cannot be separated are calculated benefit wise.

8. **Adjustment for Risk and Uncertainty.** It is done in three ways, at the time of calculating the length of project life, the discount rate and by making due allowance in benefits and costs. It is advantageous to use the Government borrowing rate. The Research Programme Committee of the Indi' ***n*** Planning Commission suggests 5 per cent as productivity rate and **10** per cent as capital scarcity rate.

Evaluation of Cost Benefit Analysis

The evaluation of cost benefit analysis can be made on the following grounds

a. **Evaluation on the basis of Benefit**: refer to the addition to the flow of national output resulting from investment in particular project. Those projects are said to be profitable whose contribution to national output is greater than those with a small contribution. Benefits may be real or nominal and direct or indirect.

- **Real Benefits**: In cost benefit analysis, we are concerned with real benefits rather than nominal benefits flowing from a project. A river valley project may increase irrigational facilities to the cultivators; but if at the same time; the state levies heavy betterment levy on them, the benefit is nominal. But if the same project besides increasing irrigational facilities raises productivity of land per acre and leads to a number of other external economies whereby real income of the farmer rises, then, it is said to lead to real benefits.
- **Direct and Indirect Benefits:** Direct benefits am those-which can be obtained immediately and directly from the project and _indirect benefits are those which are more or less identical to direct benefits. The direct benefits flowing from multipurpose project arc flood control, irrigation, navigation, development of fisheries etc. But there may be also certain side effects of the project which may be categorized as indirect benefits.

"Project evaluation should take into account the effects of a project on the rate of investment, on the growth rate of population, on the acquisition of skills and managerial talents by the people."

<u>Prof. Bruton</u>

- **Tangible and Intangible Benefits**: Benefits flowing from a project may be tangible or intangible. Tangible benefits are those which can e computed and measured in terms of money while intangible benefits cannot be measured in monetary terms For example, benefits flowing from the Bhakra Nangal Project are tangible and can be compute(Intangible benefits enter into individual valuations, for which there is neither a market nor a price. They may be positive or negative.

b. **Evaluation on the Basis of Costs**: The calculation of cost of a project is very difficult because various types of costs are considered in its construction. Costs mean the value of resources used in the construction of a project.

- **Real and Nominal Costs:** Costs may be real or nominal as they involve sacrifice on the part of people. If money is borrowed from the people, it is a case of nominal cost. But if people are required to construct project themselves, they will be incurring real sacrifice and then it will be case of real cost.
- **Primary and Secondary Costs:** Primary or direct costs are those which are directly incurred On the construction of a project but the secondary costs include the cost providing benefits to the people 1%1:Acing on project such as cost of constructing houses, schools, hospitals etc. at the site of project.
- **Associated Costs:** They are the value of goods and services needed beyond these included in the cost of a project to make immediate products or services of the project available for use or sale. for example, the farmer's cost of producing irrigated crops other than any charge for water would be his associated costs of producing crops.
- **Project Costs**: These are the value of resources used in constructing, maintaining and operating the project. This includes cost of labour, capital, equipment, intermediate goods, natural resources and foreign exchange etc.

Thus, in evaluating a project, we are to compute and compare its total benefits and total direct costs. If the benefits are expected to more than costs, then only the project is profitable otherwise not. The various steps of projects evaluation are:

A. Data is collected and calculated on physical quantities of goods and services produced.
B. On physical quantities of goods and services consumed.
C. The money value of these goods and services is computed on the basis of price index in different markets giving weight to inflationary and deflationary situations.
D. Annual costs are calculated by dividing the total costs by expected life of capital assets. Similarly annual benefits are computed by the money value of direct benefits flowing from the projects and deducting from it associated costs of the project.

12.4.3 Importance of Project Evaluation

Project evaluation is a micro planning technique which is used to assess the social desirability of a project in evaluating public expenditure. It is the evaluation of the cost and benefits of each investment proposal meant for inclusion in a plan. It implies an appraisal or assessment of a project as to its operational efficiency technically, economically, financially and managerially. It also gives the effect of new project on the people of the area in which it is located, particularly on their economic and social conditions. Indian planning Commission observes that evaluation is an essential aid to policy. It may be considered as a branch of action programme. It is an integral part of development programme.

"Project evaluation refers to the procedures of fact finding about the results of planned social action which in turn moves the spiral of planning ever upward. It is the proper methodological accompaniment of rational action." – Hyman.

Prof. Little and Mirrless have given following reason:

1. In underdeveloped countries, the actual market prices are worse reflectors of the true social costs and benefits than in the case of advanced countries.

Price distortions are common feature in underdeveloped countries due to:

- Inflation in underdeveloped countries;
- Currency over valuation in underdeveloped countries;
- Imperfect capital markets in underdeveloped countries;
- Wages being not equal to marginal productivity in underdeveloped countries;
- Inelasticity of demand for exports underdeveloped countries;
- Protectionary policies of underdeveloped countries;
- Lack of market economy in underdeveloped countries;

2. All underdeveloped countries face the problem of scarcity of resources- human and material for rapid economic development, it is necessary that these scarce resources are used optimally and rationally.

3. Social cost benefit analysis of a project is more necessary in these countries.

Project Evaluation is a multi stage process and usually involves four stages:

1. Description of the technical and economic characteristics of each project.
2. Estimation of the impact of the project on the economy both during the construction phase and Operational phase.
3. Evaluation of the consequences of project which may be direct or indirect.
4. Formulation of criterion for the projects.

The purpose of Project Evaluation

Project evaluation is a base on which economic development revolves. A concrete development plan requires a sound skill and scientific knowledge about existing and potential projects. The connection between investment and the rate of growth cannot be properly estimated without proper knowledge understanding order until the savings available for investment are exhausted.

After the allocation of the investment between different sectors, the planner will have to select projects within sectors to which investment is directed. If the division of investment between different sectors of economy is to be rational, it is essential that the costs and benefits of different projects in each sector should be assessed on a comparable basis. The planning authority has to choose between this project and this choice is based on project evaluation. The selection and exclusion of project cannot be made arbitrarily. The investment allocation must be made in such a way that net benefits are maximized. Only the top few projects whose benefit cost ratio are the highest and whose aggregate capital cost add up to total size of plan are included and the rest are excluded when projects are included in plan after such a process of project evaluation the plan would turn out to be an optimal one thus, project evaluation is a technique of optimization.

12.5 Zero Based Budget

Introduction

Method for preparing Cash flow budgets and operating plans which every year start from scratch with no pre – authorized funds. Unlike the traditional (Incremental) budgeting in which past sales and expenditure trends are assumed to continue, ZBB requires each activity to be justified on the basis of Cost – Benefit Analysis, assumes that no present commitment exists, and that there is no balance to be carried forward. By forcing the activities to be ranked according to priority, ZBB provides as systematic basis of resource allocation. .

Zero-based budgeting is an approach to planning and decision-making that reverses the working process of traditional budgeting. In traditional incremental budgeting departmental managers justify only variances versus past years based on the assumption that the "baseline" is automatically approved. By contrast, in zero-based budgeting, every line item of the budget must be approved, rather than only changes.[Zero-based budgeting requires the budget request be re-evaluated thoroughly, starting from the zero-base. This process is independent of whether the total budget or specific line items are increasing or decreasing. The term is sometimes confused with "zero-sum budgeting", a personal finance technique of budgeting every unit of income received, and then adjusting some part of that budget downward for every other part that needs to be adjusted upward. Zero based budgeting also refers to the identification of a task or tasks and then funding resources to complete the task independent of current resourcing

Zero base budgeting is the latest technique of budgeting as a managerial tool. This technique was first used in America in 1962. The former President. of America, Jimmy Carter used this technique when he was the Governor of Georgia for controlling state expenditure.

As the name suggests, it is starting from a 'scratch'. The normal technique of budgeting is to use previous year's cost levels as a base for preparing this year's budget. This method carries previous year's inefficiencies to the present year because we take last year as a guide and decide *'what is to be done this year when this much was the performance of the last year'.* In zero base budgeting every year is taken as a new year and previous year is not taken as a base. The budget for this year will have to be justified according to present situation. Thus, zero is taken as a base and likely future activities are decided according to the present situations.

In zero-base budgeting a manager is to justify why he wants to spend. The preference of spending on various activities will depend upon their justification and priority for spending will be drawn. It will have to be proved that an activity is essential and the amounts asked for arc really reasonable taking into account the volume of activity.

Definition of 'Zero-Based Budgeting - ZBB'

A method of budgeting in which all expenses must be justified for each new period, Zero-based budgeting starts from a "zero base" and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the previous one.

ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped, then measured against previous results and current expectations. Because of its detail-oriented nature, zero-based budgeting may be a rolling process done over several years, with only a few functional areas reviewed at a time by managers or group leadership.

In simple words, zero base budgeting (ZBB) is a way to justify its budget requests from the bottom up, evaluating alternative programme packages and ranking programmes "as to select the best alternative and allocate resources. *Prof R.A. Musgrave* defines it as a team and suggests that the idea is to consider the budget as a whole rather than to examine incremental change only".

Importance of performance measures

Performance measures are a key component of the ZBB process. At the core, ZBB requires quality measures that can be used to analyze the impact of alternative funding scenarios on program operations and outcomes. Without quality measures ZBB simply will not work because decision packages cannot be ranked. To perform a ZBB analysis ¯alternative decision packages are prepared and ranked, thus allowing marginal utility and comparative analysis.‖

Traditionally, a ZBB analysis focused on three types of measures. ¯They (federal agency program staff) were to identify the key indicators to be used in measuring performance and results. These should be ¯measures of:

1. effectiveness,
2. efficiency, and

3. Workload for each decision unit.

Indirect or proxy indicators could be used if these systems did not exist or were under development.

Characteristics of ZBB

The following are the main characteristics of the Zero-Base Budgeting:

1. **Identification of Decision Unit**: A decision unit may be programme of a project. In each and every case decision units has an identification manager. The decision unit has the responsibility to implement a particular allocation.

2. **Decision Package**: Decision package has revolutionized the budget concept. It is a document that identifies and describes each decision unit so that the management can evaluate it and rank it. The decision package is a statement of objectives, current operations, alternatives and possible level of funding for each unit.
3. **Review and Rank**: Ranking is done by an individual manager in order of priority. While ranking a decision, three aspects are considered essential. These are what are the objectives how much resources are necessary ; how many major goals are to be achieved.
4. **Re-examination of Programme:**. ZBB requires programmes. It examines the structure, function and activities. It is never an increase or decrease over previous years.

The introduction of Zero Base Budgeting (ZBB) is not so easy as it appears. It requires a tremendous paper-work and detailed analysis. Thus, the organisation should be able to provide all information including the cost data necessary for introducing ZBB. Moreover, the successful implementation of the Zero base budgeting also depends upon the availability acceptability of the concept in letter and spirit. obviously, this acceptance would be associated with the organisation where the new system has to be 1mplemented. It is so because any apathy on the part of the people could lead to a situation in which priorities relating to the existing schemes may not be assessed accurately.

In short, it requires the following pre-conditions:

- Identification and sharpening of objectives.
- Selections of best alternative through cost benefit and cost effectiveness analysis.
- Examination of various alternative ways in order to achieve success of objectives.
- To allot priority to various objectives and programmes.
- Switching of resources from programmes with low priority to high priority.
- To identify programmes having more utility.

Process or Steps Involved In ZBB

The various steps are involved in zero base budgeting given below:

1. Objective: Unless the objective is clear, the determination of objective of budgeting is difficult so efforts should be made to achieve selected objective. Different organizations may have different objectives. One concern may try to reduce the expenditure on staff, another may try to discontinue one project in preference to another. So the first step will decide about the object and then other steps will be possible.

2. **Decision for operation:** The extent to which zero base budgeting is to be applied should be decided. Whether it should be used for all operational areas or it should be applied in some areas only should be decided beforehand.

3. **Decision Package:** The next step in ZBB is developing of 'decision packages'. A decision package is "a document that identifies a specific activity in such a manner that management can evaluate and rank it against other activities competing for limited resources, and decide whether to approve or disapprove it."

4. **Cost and Benefit:** Cost and benefit analysis should be undertaken. We should consider the cost involved and the likely benefits to accrue. Only those projects should be taken first where benefit is more as compared to the cost involved. Cost benefits analysis will help in fixing priority for various projects on the basis of their utility or ranking of decision packages.

5. **Selection and Approval:** The final step involved in zero-based budgeting is concerned with selecting and approving decision packages and finalising the budget.

Benefits or Advantages and Disadvantages of Zero-Base Budgeting

ZBB is a dynamic concept and is a modern technical management tool for planning and control of activities. It involves people at all levels in the organisation and promotes team spirit. The plans and budgets based upon ZBB are much improved than those based upon traditional budgeting. There are a number of benefits that arise from zero-base budgeting.

Advantages:

1. Efficient allocation of resources, as it is based on needs and benefits rather than history.
2. Drives managers to find cost effective ways to improve operations.
3. Detects inflated budgets
4. Increases staff motivation by providing greater initiative and responsibility in decision-making.
5. Increases communication and coordination within the organization.
6. Identifies and eliminates wasteful and obsolete operations.
7. Identifies opportunities for outsourcing.
8. Forces cost centers to identify their mission and their relationship to overall goals.
9. Facilitates more effective delegation of authority

Zero based helps in identifying areas of wasteful expenditure, and if desired, can also be used for suggesting alternative courses of action.

Disadvantages:

1. More time-consuming than incremental budgeting.

2. Justifying every line item can be problematic for departments with intangible outputs.
3. Requires specific training, due to increased complexity vs. incremental budgeting.
4. In a large organization, the amount of information backing up the budgeting process may be overwhelming.

Some of the important benefits of ZBB are mentioned below:

1. **Proper Allocation of Funds:** It enables management to allocate funds according to the jurisdiction of the programme. The priority can be fixed for various activities and their implementation will be in the same order.
2. **ZBB improves Efficiency:** Zero-base budgeting improves efficiency of the management. Every manager will have to justify the demand for resources. Only those activities will be undertaken which will have justification and will be essential for the business.
3. **Identification of Economical Areas:** Zero-base budgeting will help in identifying economical and wasteful areas. Emphasis will be given to economical activities and alternative courses of action will also be studied.
4. **Optimum use of Resources:** The management will be able to make optimum use of resources. The expenditures will be undertaken only when it will have justification. A list of priorities is prepared and cost-benefit analysis will be the guiding principle in fixing the priority.
5. **Determining of utility:** Zero-base budgeting will be appropriate for those areas whose output is not related to production. It becomes difficult to evaluate the performance of those sides which are not directly related to production but undertake other activities. This technique will be helpful in determining the utility of each and every activity of the business.
6. **Useful to attain organizational Goals:** Budgeting will be related to organisational goals. Something will not be allowed the plea that it was done in the past. Only those things will be allowed which will help in realising organisational goals.

Limitations of Zero Base Budgeting

Inspite of many advantages, there are a number of limitations arising mainly from difficulties in operation of ZBB. Some of the important limitations are as below:

- Computation of cost benefit analysis, which is essential for ZBB, is not possible in respect of non-financial matters.
- Difficulties in formulation and ranking of decision packages as every manager may not have been necessary expertise.
- The system of zero base budgeting has no scope to adjust for the changes and, thus, flexible budgeting is not possible.
- It involves a lot of time and cost of operating ZBB is also very high.

Mechanism of Zero Base Budgeting In India

The Government of India decided to switch over to performance budgeting as back as in the year of 1968-69. Performance budgeting has been implemented to the extent of performing and submitted to the Parliament by various departments as supplementary documents to the traditional budget. Therefore, the practice of incremental addition has been followed to the existing programmes without borrowing the rationale behind its continuation. Now, recently, zero base budgeting approach has been adopted by the department of Central Government from April, 1987, as one of the steps to control public expenditure. It is applied to both non-development and development expenditure.

Indian economic environment could rightly be said conducive for the implementation of Zero Base Budgeting. Executive participation, work priorities, better administration etc. are the factors which could facilitate the implementation of the system. However, there exists dire need to look into the overall impact of some of the factors like multi-level decision making, lack of proper MIS etc. As these impediments could badly affect the proper implementation of the system, therefore, efforts should be made to minimise their adverse impact.

The successful implementation of the system calls for the overall review of the various activities of the ministries or departments, if necessary, in the initial stages the services of outside experts could be requisitioned. Moreover, to enable the people associated with the implementation to understand the objectives and concept of the system in a better way, it would be essential to take necessary steps to educate them about all the important aspects of the new system. With a view to train the executives who are responsible for the smooth and effective implementation of system, services of budget analysis could be requisitioned.

Thus, from the above analysis of zero base budgeting, it can be better concluded that this system can be implemented effectively with necessary safeguards. If the system of zero base budgeting is implemented with the required preparation, it would go a long way in helping the Central and State Governments to effectively control the Un productive expenditures.

"ZBB is a helpful procedure but, clearly impracticable in detailed application. A more realistic approach would be happy the Zero-Base method to particular departments or programme on a rotating basis." - *Prof. Musgrave*

Expected Benefits

The pro-zero base budgeting claims that the system would certainly prove very effective as it brings the following benefits:

a) The budget process in a comprehensive way making clear cut analysis of priorities, objectives and needs of the economy.
b) It is a link between learning and budgeting.
c) It will help to raise cost consciousness and evaluate the cost effectiveness of its operations in detail.
d) It will provide an objective basis to eliminate programmes which have outlined their utility.
e) It will provide better management information about the working and ranking of the budget.
f) It will identify the tradeoff between and within the programmes.

g) It will help to co-ordinate, integrate and balance the effects of various departments in the light of overall objectives.
h) It will develop an atmosphere of cost consciousness and profit mindedness as projects or programmes have to stand the acid test of objectivity before they are funded.
i) It will make the budget exercise more rational and systematic and less political and arbitrary.
j) It will eliminate the programmes which have cultivated their utility and expand programmes of high priority.

In the context of Indian economic system, it is rightly claimed that these are favourable fundamentals for the introduction of zero base-budgeting as of active participation by the executive, high level of administrative scrutiny, judgment and prioritization of works.

But, on the contrary, it lacks orientation and outlook technical skill, accurate date which are the fundamental tools for them successful implementation of zero-base budgeting. There are other deficiencies like inappropriate methods of communication; creative transfer of pay affords lethargic procedure poses serious threat which creates obstacles in the smooth functioning of zero based budgeting in the country like India.

Incremental Budgeting:

In any financial year, the Govt. budget is better understood as a revision of previous budgets. Thus, it is not completely a new budget but an extension of the previous ones. When decisions to expand or reduce the expenditure for various purposes in the budget are made, a significant part of the budget remains uncontrollable, since commitments in various programmes have been in the past and they arc likely to be changed. Therefore, decisions are whether expenditure will be increased or decreased for various functions. Such an approach of budgeting is called incremental budgeting.

Thus, in contrast to incremental budgeting approach, govt. programmes are comprehensively evaluated each year in case of ZBB. In the extreme, ZBB means that each agency is assumed to start off the fiscal Year with no budget and must justify its entire request. Thus, zero base budgeting is more expertise than incremental budgeting.

There are several grounds on which zero base budget is considered to be an improvement over the traditional budgets. Some of them are mentioned below

- The traditional budgets are prepared department wise while preparing the budget, eve department gives an upgraded and inflated voucher on the ground that more employees, more project rise in price level and dearness allowances will increase the amount of the budget.
- In the traditional budget, valuations of allocation are not made. A particular department w created at a particular period. With the passage of time these activities have become obsolete.

- In a particular department, it might have been necessary to undertake some other important functions which nobody bothers to undertake. The usual allotment of budget is consumed by tradition expenditure.
- Nobody questions the continuity of the expenditure of the past year. If a fresh request is mad only justifications are called for.

TRADITIONAL BUDGETING Vs. ZERO BASE BUDGETING

Basis of Difference	Traditional Budgeting	Zero - Base Budgeting
1. Emphasis	It is more accounting oriented than decision oriented. Depends upon past data and lays emphasis on 'how much'.	It is decision oriented lays emphasis on 'why'.
2 Approach	Its approach is monitoring toward expenditures.	its approach is towards achievement of objectives.
3 Focus	Its focus is on increase or decrease in expenditure over the past.	Its focus is on cost benefit analysis.
4. Communication	In traditional budgeting communication is usually vertical.	It encourages communication, both vertically and horizontally.
5. Method	The method preparation of traditional budget is based upon extrapolation.	Its preparation is based upon selection of decision package in view of cost-benefit analysis.

Conclusion:

Zero-based budgeting requires a programme's existence to be justified in each financial year, as opposed to simply basing budgeting decisions on a previous year's allocation. It provides a systematic method of planning company financial resources. It may require an extensive amount of time and paper work. A combination of zero-based budgets with traditional budgeting spreads the workload involved in justifying new budgets and is one possible method by which zero-based budgeting can be incorporated into current budgeting techniques.

Summary

PPBS were introduced to sort out the defects of the line item budgeting system; though it was a system of budgeting and expenditure control by detailed expenditure categories. The line item budgeting system was not able to highlight the accountability of that which is produced both in terms of goods and services for the expenditure incurred. The PPBS system works on identifying the threat according to which a strategy is developed and then requirements for such a strategy are enlisted and subsequently the programmes which meet those requirements are developed. In the final stage the costs of the approved programmes are budgeted and then funds are sanctioned. The timeline for PPBS is usually one year and the three aspects of PPBS are on a near continuous basis, although not simultaneously in the same fiscal year. So, the process works on definitive program objectives based on specific budget estimates to fund the programmes. The question may be asked that how is PPBS different from the traditional budgeting process. Firstly, PPBS focuses on objectives and purposes, and the long term alternatives to achieve them.

Secondly, PPBS combines planning and budgeting by programming which thus gives a cost-effective output PPBS was aimed at improving efficiency and better allocation of resources through Establishing long-term planning objectives. Cost-benefit analysis of alternative programmes which could meet those objectives. Translating programmes into budget and legislative proposals and long term strategic projections. In fact PPBS was different from the traditional budgeting process that PPBS focused less on the existing base and annual incremental improvements to it, and more on the objectives and long term alternative means for achieving them. Because of the shift in focus, PPBS was recognized as an element of Budgetary control.

Program budgeting is an attempt to apply the economics of choice to public decision making. Its basic assumption is that explicit choice among alternative courses of action leads to better results than do other methods of decision making. At the highest governmental levels difficult choices must be made that involve the use of a portion of the nation’s resources. But the same principles apply to decision making at lower levels. The problem of allocating resources within a specific field, such as health or education, is conceptually similar to that faced in drawing up the national budget.

Program budgeting also takes account of the time dimension in many government programs. New undertakings often take time to come into operation. A typical new program may have to pass through a research and development phase and an investment or construction phase before it reaches the operating phase. Alternative programs may differ considerably in this respect. The kinds of choices made in government often involve alternatives that cannot be measured in terms of market value. For this reason governmental decisions involve much more uncertainty than do most business decisions.

A governmental program must therefore be frequently revised in the light of unfolding circumstances. Indeed, every year should be thought of as the first year of a new program. Pervasive uncertainty also requires a high degree of flexibility and a capacity for program revision. A number of options should be held open, particularly in the development phase. In most countries the usual procedure for deciding on government expenditure in a forthcoming year has been to assume that existing expenditure was appropriate and then to decide on incremental expenditure for each program. Such an approach means, however, that the change is likely to increase, rather than decrease, expenditure and that little attention is paid to what the full existing program actually accomplishes.

Technical terms: Revenue Deficit, Capital Deficit, Fiscal Deficit, Tax revenue, Non-Tax Revenue, Expenditure Budgeting. Programme budgeting, Cost Benefit, Associated Costs, Grand Bargain Recommendations, Project Evaluation, Subsidies, Zero Base Budgeting

Self Assessment Questions

1. Explain the importance of Expenditure Budgeting.
2. Analyse how the planning and programme budgeting system (P.P.B.S) helps to integrate the long period planning the government activities to schedule the specific activities in the future.
3. Explain the different Criteria's of Public Investment
4. Explain the significance of applying Cost Benefit Analysis method for Project Evaluation.
5. Write a note on recommendations of Thirteenth Finance Commission.
6. Make a critical analysis on the wasteful subsidies in India.
7. Define the concept of Zero Base Budgeting. Give its need and pre-conditions.
8. What are the various objects of Zero Base Budgeting? Have these objects been implementing in India?
9. What is Zero Base Budgeting? Briefly explain the process involved in ZBB.
10. Write a detailed note on the mechanism of Zero Base Budgeting in India. Point out its constraints, if any.
11. "Zero Base Budgeting is an effective instrument of fiscal control". Discuss fully.
12. "Zero Base Budgeting is an improvement over the traditional Budgeting." Do you agree?
13. State the expected benefits of Zero Based Budget.
14. Give the points of difference between traditional budgeting and zero-base-budgeting.

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LESSON – I3

CLASSICAL VIEW OF PUBLIC DEBT: COMPENSATORY ASPECT OF DEBT POLICY

1.0 OBJECTIVE OF THE LESSON

In this lesson, it is proposed to provide a detailed account of theory of public debt. It examines the causes, objectives and classification of Public debt. It also provides different views on public debt.

1.1 INTRODUCTION

The concept of public debt has occupied a prominent place in modern pubic finance. In the nineteenth century, the economists paid little attention to public debt as an instrument of economic development. Basically, the functions of government were restricted to justice, police and army. They were also of the confirmed belief that government debt is a burden to the society and on future generations with the passage of time, the situation has altogether changed and economic activities have forced the economists to pay greater attention to public debt. As the growth of public debt is the result of changed role of governmental functions borrowing has become a normal feature of government finance along with the other sources of public finance like taxes, fees, etc. In all the countries of the world, public debt tendency has been increasing. In fact, the burden of public debt, both external and internal has been mounting constantly year after year adding to the grave situations to the under developed and poor countries, Here, one point must be kept in view that there is a significant difference in the composition of debt of advanced countries and that of developing countries. For instance the total borrowings of poor and under developed countries consist of a large part the borrowings made from abroad while in the case of developed countries, it may compromise mainly the borrowings raised internally from the local authorities, institutions and individuals. Thus in modern times the subject of public debt and its practices has earned greater significance.

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1.2 MEANING OF PUBLIC DEBT

Public debt is the debt which a state owes to its subjects or to the nationals of other countries.Public debt arises due to the borrowings by the government. The government may barrow from banks, business organizations, business houses and individuals. The borrowings of the country may be within the country or from outside the country or both. The public debt is generally in the form of bonds (or treasury bills, if the loans are required for a short period) which carry with them the promise of the government to pay interest to the holders of these bonds at stipulated rate of interest at regular intervals, or lump sum at the end in addition to the principal, which was to be repaid at the stated time.

Generally, public debt refers to loans raised by a government within the country or outside the country. Every government has to borrow when its expenditure exceeds its revenue. But it is not a source of revenue like taxes. Of course in wider sense, the term public revenue covers all types of income. Hence, public revenue includes the money borrowed by a government. The amount borrowed by the government during any given year constitutes the income of that year. But the basic difference between the public debt and other sources of revenue is that while public debt has to be paid back by the government, the other types of income are not to be paid back. The government collects taxes from the public without any commitment or promise. But public loans or debts collected by treasury or Government from banks, institutions and individuals on the conditions given in writing that these would be repaid and interest would be paid regularly either yearly or half- yearly as per terms of loans. The terms of interest on these loans have also be selected under these conditions.

However, the concept of public debt has been defined by various economists. Prof. J.K. Mehta has rightly mentioned „public revenue, therefore consists of money that the government is not obliged to return to the individual from whom it is obtained. Public debt on the other hand, carries with the obligation on the part of government to pay money back to the individuals from whom it has obtained”.

According to Findlay Shirras "National debt is a debt which s state owes to its subjects or to the nationals of other countries". Similarly P.E. Taylor defines, "the debt is the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on that principal. Borrowings restored to in order to provide funds for financing a current deficit".

Carl S. Shoup defines public debit as "the receipts from the sale of financial instrument by the government to individuals or firms in the private sector to induce the private sector to release manpower and real resource and to finance the purchase of those resources to make welfare payments and subsidies".

1.3 CAUSES OF BORROWING

The Government may borrow because current revenue may not be enough to meet the expenditure. It also borrows because of some sudden and unforeseen expenditure, when the revenue cannot be increased to the same extent. It may also borrow to finance capital expenditure as current revenue is usually insufficient for the purpose.

In times of depression, when private demand is insufficient , the government may borrow the idle savings of the people and spend them to increase the effective demand and thereby create additional income and employment in the community. On the other hand, in an inflationary situation, when effective demand is greater than the available supply of goods and services at current prices, the government should tax more than it needs to spend in order to sterilize a part of whole of the excess purchasing power. It may use this surplus to pay debts incurred in times of depression or for meeting unforeseen needs in the future. It is thus, obvious that a sensible public debt policy can be used to check inflation or depression.

In recent years, there has been abnormal expansion in the functions of the Government and this has increased its revenue and capital expenditure. Modern Wars and growth of defence expenditure have also led to increase in public expenditure. In fact, increased public expenditure has been responsible for vast increase in public debt everywhere.

1.4. COMPARISON BETWEEN PUBLIC DEBT AND PRIVATE DEBT

There are similarities as well as dis-similarities between private borrowing and public borrowing. The government is almost in the same position as is a private borrower in case of acquiring public borrowing. Public authorities borrow funds to acquire certain resources. Similarly, private individuals make use of the borrowed funds to acquire certain resources. Both public and private debt involves diversion of funds from one type of use to other. The government may borrow either for consumption or for investment purposes like a private borrower. Both have to pay interest on their borrowings. The capacity to borrow of both depends more or less upon their capacity to repay loans. Despite these similarities, there are many dis-similarities between these kinds of debt.

The main differences between public debt and private debt are as follows:

1. The government is sovereign and it has the power of compulsion. Intimes of War or economic crisis in the country, the government can compel the people to lend money to the government. It may also refuse to pay back the debt under special conditions, though that position never occurs. But in case of private debt, no private individuals can force or compel other private individuals to lend them.
2. The government prevails for a longer time and it is possible to take loans for a longer period while a private person can borrow only for a short period of time.
3. The loan taken by the government is generally spent on productive purpose but an individual may spend the money borrowed for productive as well as for non-productive purposes.
4. The government may borrow from the sources inside the country as well as from the external sources like foreign countries. But it is very difficult to borrow from the external countries for a private individual.
5. The government generally borrows money to spend for the welfare of the society. The government utilizes the loans for the development schemes which have been started for the common welfare of the community. But the private debt is not used for the society and its main aim is profit earning. In other words, it is done to maximize profits.

6. The government repays its loans through taxing people. Additional taxes are imposed on the public to repay the borrowed money. It can also resort to printing of new money for retiring loan amounts. It may increase the price of goods and services providing by the public enterprises in order to meet the servicing of debt. It can redeem the whole of debt by imposing a capital levy. Thus the burden of public debt is shared by the public collectively. But, it is impossible for a private borrower to levy taxes. He has to pay his debt either of his personal earnings or out of the savings or by borrowing from other sources.
7. Rate of interest paid by the government is very low compared to the rate of interest paid by a private borrower. The government can reduce the rate of interest payable on public loans but for private borrower it is not possible. He has to pay the rate of interest which he has promised to pay at the time of borrowing.
8. The public debt makes its effect on the production and distribution of wealth and income in the country. But, the loan taken by a private person makes no such effect, because of being a small amount.
9. The credit of the government is very high and it is possible for it to borrow at cheaper rates. But it is not possible for the private person as the government is more trust worthy than a private individual. The government can repudiate the payment of loans taken by it from the public in some critical conditions but for a private individual it is difficult to refuse payment of loans under any circumstances. The state, normally, take this step invery rare circumstances because such an act will greatly damage the reputation of the government.
10. Finally, the government may resort to borrowing as a matter of public policy, even if it does not need funds. Borrowing may help to bring about some stability in economic life. In times of inflation, it may reduce the volume of purchasing power in the hands of people and may help to bring down prices. In times of depression, it may enable a government to incur certain expenditure, which may help to raise business activity and employment. But an individual may not borrow, when he does not need them.

1.5. ATTITUDE TOWARDS PUBLIC DEBT

Government of a country gets income from two sources, namely, public revenue and public borrowing. Public revenue consists of money that the government is under no obligation to return to the very individuals from whom it is obtained. Public borrowing, on the contrary, carries with it the obligation on the part of the government to pay the money back to the persons from whom it has been obtained.

Public borrowing is surrounded by awe, ignorance and fears and said it that "Never have so many understood so little about so much". Attitude about public debt may be summarized under three heads (i) Classical view, (ii) Keynesian view and (iii) post – Keynesian view.

(i) Classical view

The classical and writers of 19th century were generally against public borrowing. They assumed that individual consumer and business firm employ resources more efficiently. Under a fully employed economy, therefore, government can acquire resources by borrowing only at the cost of private sector where they are more fruitfully engaged. The classical writersfavoured minimum public expenditure, taxation and borrowing for the following reasons:

(a) Deficit financing means an increase in public debt. Since it is an easy method of obtaining income, government is likely to be extravagant and irresponsible. Consequently, public debt will become a definite burden on the economy.
(b) Payment of interest on Public debt and refund of the Principal will require additional taxation. It might prove to be difficult since government‟s power to tax is not unlimited.
(c) Deficit financing might produce currency deterioration and price inflation.

However, the classical economists were not against all types of public debt. They approved for productive purposes, that is, for capital projects since the fruits of such projects could be sold to buyers and refund of principal did not necessitate additional taxation. These are called self –

liquidating projects. These are expenditure projects in public enterprises that increase future income and the tax base. Such projects permit servicing (interest and amortization) of the debt incurred in their financing without requiring an increase in the future level of tax rates.

(ii) Keynesian View

Keynes made a truly significant revision in the theory of public debt. He did not accept the classical notion of a free enterprise economy which is self – equilibrating at full employment level. He advanced the concept of under employment equilibrium. Resources in the private sector may remain unemployed for relatively long periods if corrective or compensatory action is not taken by the government. In a situation when resources are unemployed on a large scale, government employment of these resources does not necessarily deprive the private sector of anything. On the other hand, increased government spending by using idle men and materials, is likely to raise the level of aggregate output and income. Hence public borrowing need not necessarily be unproductive, inflationary and burden some.

(iii) Post – Keynesian View

During World War – II and in the post war years, the size of public debt increased enormously. For instance, in united states, the volume of federal public debt increased from $ 16.3 billion in 1929 to $ 290.4 billion in 1960. The increase in size of public debt has caused some revision in economists thinking on the subject. The post-keynesian position accepts a large part of the modifications of the classical debt theory as brought out by Keynesian economics. It emphasizes, however, the transfer and management aspects as well as the interrelationships between public debt and money supply. The act of borrowing by the Government makes it unavailable to private entrepreneurs for private investment. So financing of consumption by internal borrowing will cause a curtailment of national saving and investment.On the other hand, borrowed money when used to finance public investment causes no such reduction: all that will happen is the change in the composition of capital formation. External borrowing is different from internal borrowing since it gives the borrowing country command over more goods than it is currently producing. But debt servicing may become a burden.

1.6 RECENT THINKING ON PUBLIC DEBT

Michal Posner points out that growth in the debt ratio causes alarm for two reasons. First growth in debt ratio might lead to crowding out of private investment. Second and more important is the assumption that government spending out of borrowed funds might be unproductive. The second argument is not sustainable. In fact, that part of public debt is burden somewhose servicing falls entirely or mostly on tax returns. V.M. Dandekar is of the view that a country enters in a debt trap when its capacity to take loans falls short of interest payment obligations. Hence, all public debt is not burdensome. Recent Public debt is considered for the following purposes:

(i) For smoothening out the tax rate:Capital expenditure of the non-remuneration type is lumpy. Its financing through taxation would cause considerable fluctuationsin rates. Higher rates might cause larger distortions. So debt finance would be more desirable in this situation.

(ii) For macroeconomic stabilization: A discretionary increase in public spending to cure unemployment was a Keynesian prescription.

(iii) Increased public expenditure financed by public borrowing is helpful for increasing macro economic stability.

(iv) Expenditures like health and education which do not add to physical capital formations but result in human capital formation or create favourable impact on productivity. A part of such current outlay could be met out of public borrowing.

(v) Governments of developing countries could borrow for remunerative capital in the public sector and for lending and equity investments.

(vi) Debt finance is useful for meeting the government"s non-remunerative capital formation like interest payments.

1.7 OBJECTIVES OF PUBLIC DEBT

In the past, the way of living was very simple and borrowing was not very significant. The government budgets were very small. The government also followed the policy of non-intervention in economic system. But in modern times, especially after the world depression of 1929 – 30, the public authorities started to take keen interest in the economic development of their respective countries. Public debt has become sine qua-non for the economic development of a nation. The government activity is expanding widely and without public borrowing, it is not possible to work such heavy projects. In this way, it has become part and parcel of the instrument of fiscal policy for the economic development of developed as well as the developing countries. Now-a-days, an extraordinary increase in public debt is considered good as it brings to the economy the capability of repaying the debt as it is spent on productive purposes. The crucial objectives and importance of public debt are being mentioned as below:

(1) **To cover budget Deficits:** The aim of public debt is generally to fill up the gap between the proposed public expenditure and the revenue expected during that year i.e. to cover budget deficits. The rapid expansion in states‟ functions has led to rapid expansion of public expenditure. To meet some unforeseen contingencies like floods, famines, earthquakes, epidemics etc., the government may borrow from internal as well as external sources. This is the income of the state over and above all taxes and revenue resources.

(2) **Fighting Depression:** Depression is a condition of falling prices, slackness of productive activities and no hope for profitability in the economy to eradicate the evils of depression, public debt is the most indispensable tool of financial management. The government can utilize borrowed funds for public works which would increase the effective demand of the people through the combined operations of multiplier and acceleration. This would increase income and employment. Thus, falling prices may be checked and the government may be able to lift the depressed economy to recovery and lead to prosperity.

(3) **To curb inflation:** Inflation is a condition of rising prices. Hence, the government by raising debt can withdraw a large volume of purchasing power from the hands of people, and thus, it may check prices from rising.

(4) **To Finance Development Plans:** Underdeveloped countries always face the problem of funds. Moreover, taxable capacity of such a nation is also very low. Moreover, taxation is resented if heavily imposed on the public. But to save the economy from the vicious circle of poverty, the

financing of development plans is of utmost important. Under such circumstances, public debt is the only way left with the government. The government may borrow from the persons within the country or from outside to finance development plans i.e. to bring the change in structure and creation of social overheads etc.

(5) **To meet unprecedented Expenses:** some times, the government raises loans to meet the unprecedented events like famines, floods, earthquakes, epidemics etc., the funds are also raised by the government in cases of emergencies and calamities which lead to sudden spurt in expenditure of government.

(6) **Creation of Social Overhead Capital:** Social overhead capital is a pre-requisite of any systematic development process. However, in spite of the large social gain such investment is less attractive to private investment. They should be essentially started by public sector. For this purpose, government would require resources which can be affected through public borrowing.

(7) **To Finance Public Enterprise:** The government may borrow for financing commercial enterprises run by the government. They may be established for the satisfaction of collective and merit wants such as defence, internal security, education, health and hygiene etc. For the production of some of them huge financial resources are required and taxation alone may not provide sufficient resources for the purpose. Hence, public borrowings are required.

(8) **Expansion of Education and Health Services:** Government also borrow for the creation and expansion of education and health services and likes, which improve the efficiency of people, hence the general social well – being.

(9) **To Finance War:** In this age of atomic warfare and increasing international tensions, a country needs large funds to maintain its defence services and up-to-date equipment to protect itself from foreign aggression. However modern wars are difficult to be financed by taxation alone; as heavy taxation may adversely affect production.

Hence, government may resort to public borrowing from within the country as well as from outside the country to finance war.

(10) **For better Allocation of Resources:** If the existing level of resources in the economy is not at optimum level, government may act to avoid the misallocation of resources. For instance, monopoly or monopolistic competition generally leads to misallocation of resources. Government may like to set right such allocation of resources either by taking over the monopolist firm or encouraging entry of other firms. Such firms may be provided long-term finance which government itself may obtain through borrowing.

1.8 CLASSIFICATION OF PUBLIC DEBT

Government loans differ from one another in many ways. The differences are due to the market, in which the loans are floated, the rate of interest offered, the condition of repayment or the purpose for which they are used. Different forms of Public Debt are given below:

(i) Internal and External Debt
(ii) Productive and unproductive Debt
(iii) Redeemable and Irredeemable Debt
(iv) Short – term and Long – term Debt
(v) Funded and unfunded Debt
(vi) Voluntary and compulsory Debt
(vii) Marketable and non-marketable Debt
(viii) Gross and Net Debt.

(i) Internal and External Debt

Internal Debt refers to the public loans floated within the country, while external debt refers to the obligations of a country to foreign government and international institutions. The payment of interest on foreign debt reduces the net income of the debtor country by transferring a part of its income abroad, the payment of interest on internal debt has no such effect. The country‟s national income is the same whether the income on internal debt is left with the tax payers or is taken away from them as taxes and paid out as interest on internal loan. It is a roundabout way of taking money out of one"s pocket and putting it another or the same taxpayer. Hence the payment of such interest does not affect the productive capacity of the country as a whole, but there may be indirect effects on production. However, foreign loans should not be considered as bad it they are used for productive purposes and even for war purposes.

(ii) Productive and Unproductive Debts

Productive debts are those which are used for projects which yield an income to the government i.e. railway, construction, irrigation schemes, power schemes, establishment of heavy industries like iron, steel, cement, fertilizers etc. The income derived from these projects may be enough to pay the principal and the yearly interests of the loans incurred for these projects. Besides, productive loans invested in capital goods industries will be helpful in increasing further production and not burdensome to government. On the other hand, unproductive loans are those which are incurred for financing war and forgiving relief in times of floods and droughts. The special character of unproductive debts is that they have no existing assets and they are considered as dead weight upon the government.

(iii) Redeemable and Irredeemable Debt

Redeemable debt refer to those loans which the government promises to pay off at some future date. Those loans, for which no such promise is made, are called irredeemable loans. When a loan is redeemable, the government has to make arrangement for its repayment. Money has to be arranged for this purpose. But in case of irredeemable loans the government may have to pay interest regularly.

(iv) Short – term and Long – term debt

Short – term debt is that which may mature within a period of three to nine months. They are like treasury bills and advances from the central banks. Interest on such repayable amount is generally low.On the contrary, long – term debts are repayable in a long period i.e. roughly after ten years or more. Usually such type of loans bear a higher rate of interest. Similarly, in between short-term debts and long-term debts, there is medium – term debt also.

(v) Funded and Unfunded Debt

Funded debts are long – term debts which are repayable after a year at least or are not redeemable at all. Unfunded or floating debts are those that are paid off within a year. Treasury bonds are unfunded debt because they are for three to six months and never for a longer period than a year. They are incurred for the purposes of filling the temporary gap in the budget. The rate of interest on such loans is lower than that on funded debts. Thus, government prefers to go for unfunded loans to meet the requirements of lenders. Such loans are always in anticipation of public earnings.

(vi) Voluntary and Compulsory Debt

Voluntary debt is a debt which is paid without any legal enforcement. It means, the people are willingly and voluntarily subscribe to government loans. Actually, they are subscribed to the government by the people at their own accord, ability, will and convenience. Compulsory debt, however, implies force. But they are most unpopular in modern democratic society.

(vii) Marketable and Non-marketable debt

The distinction between marketable and non-marketable debt basically depends upon the negotiability of government loans between interest bearing and non-interest bearing loans. In other words, marketable debt is one in which the securities are negotiable in the open market, while non-marketable debt is that where securities cannot be sold in the stock exchange markets. The main objective is to prevent fluctuations in their prices.

(viii) Gross and Net Debt

Gross debt consists of the total amount of debt outstanding at any time, whereas net debt is the balance amount of gross debt minus sinking funds or other assets earmarked for repayment of debt.

1.9 DANGERS OF PUBLIC DEBT

Public debt is not always a blessing. Excessive use of it creates a lot of monetary crises in the economy. It is no longer a cake eating feast but rather a careful and efficient brain to handle the management of public debt. However, the dangers of public debt are under mentioned.

1. **Extravagance:** Public debt, is generally considered as an easy money which leads to reckless borrowings. This provides incentives to the Government to implement those schemes also which require abundant expenditures. The temptation over borrowing offers dangerous results like bankruptcy or repudiation of debts.
2. **Loans for unproductive purposes:** As the government find no difficulty in borrowings and this makes the brighter chances of unproductive loans whose burden falls on the common masses of the society. Excessive expenditure on war and armaments are the good examples of such loans.
3. **It hampers economic Development**:Though loans are easily borrowed, it is excessively difficult to repay the debt.This raises unnecessary burden on tax payers. This brings instability in the economy which in turn hampers the economic development of the country.
4. **Adverse effects on Production and Distribution**: Unproductive public loans have become a permanent feature of burden on the economy which leads to unfavourable effect on production and distribution of the country.
5. **Challenge to the political freedom**:Foreign loans and assistance give the clear cut evidence of diplomatic motives behind it. The friction further challenges the political freedom. Thus it sows the seeds of hatred and national interdependence ruins.
6. **Flow of National wealth**:Foreign loans result in the drain of wealth out of the country. In other words, government should borrow only when it is a must.

1.10 CONCLUSION

So from the above discussion, we can say that public debt occupies a prominent place in modern public finance. It is an instrument of development in under developed countries. It bridges the income and expenditure gap, finances development plans and serves in emergencies like war, earthquakes, famines etc. Through effective utilization of public debt government can achieve high standard of living, planned economic development and prosperity.

1.11 GLOSSARY

- Treasury Bills
- Inflation
- Depression
- Diversion of funds
- Analogy
- Effective demand
- Consequence
- Debt servicing
- Amortisation
- Public Policy
- Famine
- Earthquake
- Epidemics
- Recovery
- Prosperity
- Aggregate Demand
- Taxable Capacity
- Overhead capital
- Hygiene
- Prerequisite
- Foreign aggression
- Disposable income
- Implication
- Redeemable
- Irredeemable
- Funded and unfunded
- Creditor
- Taxation
- Purchasing Power
- Insolvency
- Principal sum
- Bonds

1.12 REVIEW QUESTIONS

1. What is public debt? Describe various objectives of public debt?
2. Examine the classification of public debt.
3. Show the difference between public and private debt.
4. Discuss the importance and necessity of public debt.
5. Explain the classical and Keynesian views on the public debt. What is the latest attitude towards public debt?
6. What are the techniques of public debt? What are the problems of borrowing faced by developing countries?
7. Account for various dangers incurred by public debt. Whether there should be any limit?

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LESSON – I4

BURDEN OF PUBLIC DEBT: SOURCES OF PUBLIC DEBT; DEBT THROUGH CREATED MONEY

CONTENTS

MODULE 4: PUBLIC DEBT

LESSON – II

BURDEN OF PUBLIC DEBT: SOURCES OF PUBLIC DEBT; DEBT THROUGH CREATED MONEY

2.0 OBJECTIVE OF THE LESSON

The main objective of this lesson is to examine the sources of public debt, the concept of debt burden and the debt burden controversy. It also provides an overview of latest theories on burden of public debt.

2.1INTRODUCTION

There is a hot discussion on the question of public debt burden in economic literature. The burden of public debt refers to the sacrifice it will impose on society. Burden also refers to the effects on the community through an increase in taxation at the time of repayment and for paying the annual interests on the government loans. In other words, every government is bound to repay the public borrowings internally or externally with interest.

Here distinction between financial burden (Primary Burden) and real burden (Secondary Burden) is notable. In this context, David M.C. Wright observed that, "The national debt is to be measured by the effects of the interest charges and the taxes levied to meet them. The relation which the taxes imposed for interest bearing to the national money income is the question of primary importance. Therefore, when a debt is incurred by the government, the level of taxation has to be raised in order to meet interest charges and the income of the people is transferred to the government. Such a loss in income of the people can be called as financial or primary burden of public debt. The repercussions in the form of adverse effects on the capacity and willingness to work and save due to higher level of taxation are called the real burden or secondary burden. Hence, it is important to understand the concept of debt burden and the controversy related to debt repercussions for improvement of public finance.

2.2. THE CONCEPT OF BURDEN OF PUBLIC DEBT

The concept of burden of public debt is an extremely vague term. However, a distinction is made between direct money burden and indirect money burden and direct real burden and indirect real burden.

(i) Direct Money Burden

When a debt is incurred by the Government, the level of taxation in the economy has to be increased in order to meet the interest chargesso long the debt continues to exist. The consequent loss in the income of the people may be called as the direct money burden or financial burden of public debt. In the words of M.C. Wright, "The financial burden of the national debt is to be measured by the effects of the interest charges and the taxes levied to meet them. The relation with the taxes or interest bear to the national money income is the question of primary importance". Thus direct money burden is measured by the extent of money payment involved and the rise in taxation needed.

(ii) Indirect Money Burden

When loans taken by the government are to be spent on development projects it results in the creation of demand for several commodities and services. As a result of this, prices of goods and services rise and thus, impose a new burden on the society. Sometimes taxes are increased to meet repayments. Such an increase in taxation affects the level of production. This adversely affects people‟s desire to work, save and ability to work.

(iii) Direct Real Burden

Generally the government repays the principal amount along with the interest by imposing new taxes on the people. It is obvious that the taxpayers are poor people while the lenders are relatively rich. In such a case, it results in the transfer of the purchasing power from the poorer sections to the richer sections of the society.With this change in the distribution of income, more burden will fall on the poorer sections of the society. Thus, the result of repayment of public debt is that the wealth gets transferred from the active sections of the society to the passive sections of the society. This is not infavour of the national interest. Hence, it is the direct real burden of public debt.

(iv) Indirect Real Burden

For the repayment of public borrowings, the government imposes additional taxes on the common masses. Generally, most of the taxes are imposed on poor people in the form of indirect taxes which results in the rise of economic disparities and inequalities. It adversely affects the willingness to work and save. It discourages the individuals and they do not wish to work and save more because of heavy dose of taxation.

2.3 BURDEN AS COSTS TO THE SOCIETY

The burden of public debt refers to costs or disadvantages that are imposed upon the economy when public outlays are loan financed rather than tax financed. The cost of an increase in the public debt is related to the economic conditions in which it is incurred. The real cost of debt is zero if it grows during a period of large – scale unemployment. Such debt via its expansionary effect puts idle resources back to work. This increases the national output, which is nothing but a net gain to the society. Such debts do not cause any sacrifice and so no real cost is involved.

Loan financing of public outlay during a period of full employment is, of course, different. From the point of view of stabilization policy this is inappropriate. A large public debt necessitates payment of interest in substantial amount, which has to be paid out of tax revenues. Taxes may tend to dampen incentives to bear risk, to innovate, to invest and to work. In this indirect way the existence of a large debt can impair economic growth. Thus the burden of public debt is measured by the amount of strains and frictions imposed on the economy.

The concept of burden is sometimes explained in terms of the notion of abstinence or opportunity cost. When public debt is made, resources are transferred from private hands to government. This abstains people consuming current income and undergoes the pain of abstinence which may be called the burden caused by the incurring of public debt. Payment of interest and principal on public debt may increase income inequality. Bondholders belong generally to the middle and upper income groups, while tax revenue comes proportionally more from the lower income groups in poor countries. Thus the net results of debt repayment is greater income inequality. It is undesirable on equity grounds. Further, the existence of a large public debt is inflationary for the reason that government bonds are highly liquid assets making the lenders feel wealthier. This leads to greater consumption leading to inflation.

Thus, in estimating the burden of public debt, it should be taken into accent whether the debt is productive or unproductive, and whether it is internal or external besides the price level in the economy.

2.4 ESTIMATION OF PUBLIC DEBT

There are various ways of estimating the comparative burden of public debt. The most useful methods are (1) the ratio of national debt to national wealth and income and (2) the percentage of expenditure on the debt services to total ordinary expenditure. A combination of these two methods has been considered useful for estimating the relative burden of public debt.

2.5 SOURCES OF PUBLIC DEBT

There are two major resources of public borrowings viz., internal and external. Internally, the Government can borrow from individuals, commercial banks, financial institutions, charitable trusts and the central bank in a country. Externally, the government can borrow from individuals, banks international financial institutions and foreign governments. As the true effects of public borrowings will depend upon the sources of borrowed funds to a greater extent, it is necessary to understand different sources of borrowings.

(i) Internal Borrowings

(a) Borrowings from Individuals

When individuals purchase government bonds, they are diverting from the private use to the government use. They may be able to subscribe government bonds either through curtailment of current consumption or through diversion of funds meant for one‟sown business or diverting funds into government bonds from securities. To a greater extent, bonds from individuals will be absorbed out of the funds that would have been idle or would have been used to buy other securities.

(b) Borrowings from Non-Banking Financial Institutions

Borrowings from the Non-Banking financial institutions is another source of borrowing. There are insurance companies, trusts, savings banks, etc. These institutions reduce their idle cash balances when they make investment in government bonds. They prefer government bonds because security is provided by the government and they possess high negotiability and liquidity. The rate of interest paid by the government is relatively low. As a result in many cases these institutions may prefer high risk and high return securities. However, when the non-banking institutions buy government bonds, they do reduce their cash holdings.

(c) Borrowings from Commercial Banks

Individuals and non-banking financial institutions take up government bonds out of their own cash funds. But commercial banks can do by creating additional purchasing power which is popularly known as credit creation. The banking system can make additional loans upto an amount several times as great as the excess cash reserves and required reserve ratio. The credit creation is possible because the loans the bankers make, are typically added to the borrowers account and are in turn, paid to persons having accounts with other banks. Result of this process is that so long as the cash is not withdrawn from the banks, it serves as the basis for the expansion of loans.

The creation of credit by commercial banks can subscribe to the government loans. The banks need not contract their other loans and advances. The banks whenever have excess cash reserves, they are able to absorb an amount of government bonds greater than excess cash reserves. Therefore, in this process of creating additional purchasing power, if the banks place it at the disposal of the government to finance the latter‟s expenditure, pressure of inflation will be generated provided the economy is working at full employment previously.

(d) Borrowing from the Central Bank

The central bank of the country can subscribe to government loans. The central bank credits the amount of the government by purchasing government bonds. The latter pays to the creditors out of its accounts maintained with the central bank. Those who have received cheques from the government on the central bank will deposit the amount in their banks. Consequently, these banks find themselves with large cash reserves which become the basis for additional loans and advances. Thus, borrowings from the central bank are most expansionary of all the sources for not only the government secures funds for its expenditure but this banking system gets additional cash. This amount can be utilized as the basis for further credit expansion.On the contrary, the borrowings from individuals and financial institutions are merely transfer of funds from private to government use and it will not be expansionary in their effect on the economy.

(ii) External Borrowings

Government may borrow from other countries, apart from individuals and financial institutions within the country. The borrowings can be used to finance war expenditure or to buy defence equipment or to pay for the development projects or to pay off adverse balance of payments. In the past, floating of loans for the development projects like railway or dam construction was taken by the individuals, banking and other financial institutions. But in recent years, two important external sources of government borrowing are prominent as (i) international financial institutions like IMF and IBRD, the IDA and IFC. These institutions give loans to member countries for a short period covering temporary balance of payment difficulties and for long term development projects. (ii) Friendly nations give financial assistance mainly for development projects. In recent times in developing countries like India, external source of borrowing has become significant. India has also received massive assistance from the „Aid India Club".

2.6 THE DEBT BURDEN CONTROVERSY

The debt burden controversy is one of the oldest subjects of academic discussions. Whether public debt is a net economic burden has been a subject of greatdebate since the days of Mercantilists down to the present times. The repayment of debt through taxes will compel the future investment and productive activities and impose sacrifice on present generation. The debt controversy, it appears, had reached its logical end in the pronouncements of A.C.Pigou, A.P.Lerner and A.Hansen. Their views remained unchallenged for quite a long time. Thus, in order to understand the problem of debt burden different views have been detailed as under.

(i) Classical Views on the Burden of Public Debt

Academic views regarding the burden of public debt have been changing according to the changes in the general thinking. In the nineteenth century and early part of the twentieth century, public debt was condemned by the early classical economists mainly because of their lack of faith in the role of state in economic activities. Public spending was considered by them as wasteful and unproductive expenditure. There was no state intervention in the economic activities and free competition was the order of the day. Argument for laissez faire economy was that maximum private profit would lead to maximization of social welfare.

The classical view maintains that through debt financing, it is the present generation which suffers a loss of resources. The future generations will suffer if the present generation reduces its savings in order to meet the debt finance. This will reduce the productive capacity of the coming generations and they will lose. In a real sense, current financing (specially in case of war) requires resources today itself. As a matter of fact the present generation has either to curtail its consumption or saving or both. If savings are reduced the future generations has to suffer on account of reduced inheritance of capital stock. On the contrary, if present generation does not reduce its consumption, burden of public debt may pass on to the future generation.

In this regard, the views of Adam Smith, David Hume and Ricardo are identical. Adam Smith felt that once the sovereign started to borrow, his political power was increased because he was no longer dependent on tax exactions from his fellow beings. He aptly remarked that, “The ability to engage in loan finance makes for irresponsibility in sovereign”. David Hume opposed public debt saying “nations once they began to borrow, would be unable to resist until they reached the point of bankruptcy” Similarly, Ricardo characterized national debt as, “one of the most terrible scourges which was ever invented to afflict a nation”.

In this context, Dalton said “The burden of a public debt is not something which can be thrown backward and forward through time and made a fall at will, wholly on one generation or wholly on another”. However, subsequent thinkers like Mill, Malthus, Sigwick, Cairnes and others had liberal views about the impact of public debt. In the words of Malthus, “The material debt is not the evil which is generally supposed to be. Those who live on the interest from the national debt, like statesmen, soldiers and sailors contribute powerfully to distribution and demand… the debt once created is not a great evil”.

C.E. Bastable, the leading exponent of classical public debt, refuted the idea that public debt cannot be shifted on the future generation. Distinguishing between loan and tax, he mentioned, “A loan is voluntary and supplied by willingness, taxation is levied on the willing and unwilling alike.From purely a financial point of view the source of loan is really immaterial. In any case, it is an immediate relief to the taxpayer to counterbalance by greater change in future”.

(ii) Modern Theory of the Burden of Public Debt

Modern economists including J.M. Keynes, Harries, Hansen, Buchanan, Bowen, Davis, Musgrave, Modigliane and others challengedthe version of classical economists and hold the opposite opinion on the subject of burden of public debt. They submit that there is no shift of the basic burden to the future generation because the same posterity which pays the additional taxes will be benefited from the repayment of the debt. The Great world depression of thirties gave way to the development of the new theory of public debt. Moreover, classical theory of public debt also assumed full employment and unproductiveness of public expenditure as the basic pillars. Modern theory, on the other hand, is based on the assumption that public expenditure is never wasteful but it can be productive and essential means of increasing employment in the economy. Rightly A.H. Hansen, the exponent of modern fiscal theory said that “Public debt is an essential means of increasing employment and has become, an instrument of economic policy”. Thus, modern theory of public debt is concerned with macro – economic variables and not the individual utilities. It assumes the whole economy as a unit. Modern economists believe that internally held public debt involves no burden since we owe it ourselves.

According to them external debt is regarded as definite burden since repayment of principal and interest to foreign countries involve transfer of real goods and services from the debtor to the creditor country.

(a) Main Propositions of Modern Theory of Public Debt

Prof. J.M. Buchanan in his book "Public principles of public debt", declares that there are three main propositions of the modern theory of public debt.

(i) The creation of public debt does not involve any transfer of the primary real burden to future generations.

It means that, the burden of the Government borrowing and spending activity falls during the period in which it is created and it is the real sacrifice on the initial generation. According to J.M. Buchanan, "The real sacrifice of private goods and services that is real income allegedly occurs during this initial period and this sacrifice stems, not from the debt per se, but rather from the decision of the government to undertake the public expenditure by borrowing little different from financing it by taxation".

It has been observed that the public debt incurred now leaves not only an obligation to future generation but also a claim. Whatever transfer of funds takes place is only between the future members of the community. The tax payer children inherit tax liability and the bond holder children acquire an equal asset. The loss of taxpayers is offset by the gains of bond-holders and therefore, for the economy as a whole the net burden will be nil. Public borrowing may cause intergeneration transfers but not loss to the society. Thus, internal debt donot represent shifting of the burden to future generations.

(ii) The Second proposition of the modern theory of public debt is that the analogy between public debt and private debt is fallacious. In the words of Hansen, "A public debt internally is not like a private debt. It has none of the marks of a private debt. The public debt is an instrument of public policy. It is a means to control the national income and in conjunction with tax structure to regulate the distribution of income. For the individual it is important that his expenditure be kept below or at least within the limits of his income. The effect of his economic activity upon other individuals is significant for him only in so far as this, in turn affects his balance sheet. In case of public finance, the success or failure of the public policy can be determined by noting the effects of expenditure, taxes and loans on total national income and on how that national income is distributed. Hence, it can be concluded that a public debt internally held is different in nature from a private debt.

(iii) The third proposition of the modern theory of public debt is that the internal public debt and external public debt are fundamentally different in their impact. Servicing external debt results in transfer of resources from the domestic economy to the foreigners which mean a net loss to the whole economy. To the extent of the transfer or resources, the real income of future generations is reduced. Since taxes are imposed and tax rates are increased in future for servicing the debt, the burden of external public debt can be shifted to future generations.

Thus the existence of a large public debt is neither an evil nor a blessing in itself. It has both adverse as well as favourable effects on the economy. It is an instrument of public policy, but it is one which should be used with care. The problems with which the controversy is concerned are (1) the measurement of the burden (2) costs and benefits of the public debt and (3) the intergeneration distribution of the burden of public debt. The academic views about these specific aspects have been changing from time to time.

The question of shifting of debt burden has received renewed treatment in the hands of modern economists. There are at least three such theories which deserve special mention. They are explained in the following:

(a) **Capital stock theory:**This theory was advocated by David Ricardo and A.C.Pigou.According to them, whether tax finance or loan finance will shift the burden to future generation will depend upon the extent or real capital inherited by it, consequent on the construction of public investment project. This is because the welfare of future generation depends on the sacrifice of present generation without which capital cannot be formed to build up larger productive base. The curtailment of current consumption, however, depends on the reaction of present generation to the withdrawl of real resources from the private economy for the purpose of public investment projects. As compared to tax finance, it is the loan finance that would curtail current consumption less. Since, curtailment of current consumption will be less, the transfer of real capital stock of future generation will also be less. This will mean reduced future welfare. Hence, loan finance shifts burden to the future generations, while tax finance does not do so.

(b) **Welfare Attitude Theory:** Welfare attitude theory was advocated by Buchanan. He holds that loan financing of public investment does shift burden to future generations. Whether tax or loan finance will shift the burden to future generation depends on the attitude of the present generation towards their economic well-being consequent on the method of resource mobilization. Thus, if the project is financed by tax resources the tax payers feel worse off, the tax payers feel deprived of their enjoyment of income. When repayment of public debt takes place in the future period, funds are diverted from tax payers to bond holders. The tax payers by virtue of their compulsory contribution do feel worse off. The bond holders are not better off because they are just exchanging less liquid for more liquid assets in future. Since, in the future generation, the bond-holders are not better off but the tax payers are worse off, the aggregate welfare of society is reduced in the case of loan finance of public investment project. Thus public debt shifts the burden to future generation.

(c) **Inter – Generation Equity Theory:** This is the most convincing theory relating to the choice between loan finance and tax finance in providing public investment project. As advanced by R.A.Musgrave, He goes by the justification that cost of the public investment project should be borne by the users in proportion to the benefits enjoyed. He makes out a case whereby he shows that it is the loan finance and not tax finance which distributes the cost of project among beneficiary generations exactly in proportion to benefit enjoyed by them. Such inter-generation equity is possible through loan finance.

Thus, among others, are the important determinants of the limits to the growth of public debt are as follows:

2.7 BURDEN OF INTERNAL DEBT

As far as the burden of internal debt is concerned, there may be no direct money burden on the community as a whole, since the payment of interest and increased taxation to meet the burden of debt involve simply a transfer of purchasing power from one group of persons to another; to the extent the creditors (bond – holders) and tax payers are the same, there may not be any net burden at all on the community. But to the extent the creditors (bond holders) and tax payers belong to different income groups, the changes in the distribution of income among different sections of the community may take place.

However, while estimating the burden of public debt, the purpose of loan should be considered. If a loan is utilized for productive purpose, it can be paid out of the profits of the investment. But a loan to finance a war may be a dead weight and will have to be paid out by way of increased taxation. Obviously, there is no burden involved in the first case. In the second case, the burden imposed upon the tax payers will be cancelled by the benefits received by the taxpayers in the shape of interest on bonds. But it should be noted that if the rich pay in proportionately less than the proportion of public securities held by them, then there will be a direct real burden on the community. The increased taxation for the payment of interest charges and the repayment of debt may consequently affect the power as well as the willingness to work and save. Hence, it is of utmost importance that debt repayment should be managed in such a manner that it may not adversely affect production and distribution. Hence, it can be concluded that internal debt imposes burden upon the community as a whole and the belief that internal debt does not impose any burden on the community is theoretically incorrect and practically unrealistic.

2.8 BURDEN OF EXTERNAL DEBT

The nature of external debt is different from that of internal debt. The burden of external debt is greater to that of internal debt, because in case of internal debt interest charges and repayment of principal are paid within the country. It is a mere transference of wealth from one section of the community to another. The tax payer and the receiver of interest are often the same person. In the case of external debt, the payment of interest reduces the net income of the debtor country by transferring a part of its income abroad. The payment of internal debt has no such effect. Hence external debt imposes a greater burden than that of internal debt.

Again, the direct money burden of external debt is the money payments made for interest and the repayment of principle. The direct real burden is the net loss of the debtor country in economic welfare due to these payments. If the relative burden of taxation is largely upon the rich then the real burden of the community as a whole will be less than, if relative burden of taxation is largely upon the poor. The direct real burden of external debt also depends upon the purpose for which the debt is incurred. If the external debt is incurred to meet war expenditure it may be called dead weight debt, as it is unproductive in nature.

2.9 BURDEN TRANSFER AND ECONOMIC GROWTH

The traditional view of public debt does not consider the growing size of debt in relation to the growth of national income. Burden of debt is commonly expressed in terms of the per cent of national income raised through taxes to pay interest on debt. E.D. Domar has defined the burden of public debt as the ratio of the total debt to the national income. He demonstrated that “the problem of debt is essentially a problem of achieving a growing national income increase”. With a growing national income, taxation required to finance interest liabilities on public debt would not impose an unbearable burden on the economy. It is necessary to ensure that government expenditure is productive and contribute to the growth of national income. It is needed to review the existing allocations of government spending and see that maximum possible proportions of these outlays incurred in areas and in a manner that contributes optimally to the growth of national income.

Samuelson and Nordhaus, say that a large public debt creates an adverse effect on national income and economic growth. As debt accumulates overtime more and more private capital is displaced. People save by purchasing government bonds, assets like houses, shares, stocks, bonds of corporations, through savings accounts, etc. With growing public debt people accumulate government debt instead of private capital. This results in the displacement of private capital stock by public debt resulting in lower national output. Secondly, additional taxes are levied to pay interest on rising debt stock resulting in inefficiencies. This leads to further load output. Rise in external debt also lowers national income by raising the proportion of national income going in servicing the external debt. Taking all these effects together, output and consumption will grow more slowly than they would had there been no large government debt and deficit.

2.10 LOANS VERSES TAXES

Sometimes, the government faces the problem whether a certain expenditure should be met out by raising taxes or by raising loans. Heavy taxation as well as reckless borrowing may ruin the financial structure and may bring misfortunes to the economy. Let us now know what should be the general principle of raising revenue.

The general principle followed in financing public expenditure is that the normal or ordinary and recurrent expenditure should be financed out of taxes, while non-recurrent and productive expenditures should be met out of loans. This general principle has now been analysed from different angles.

The government should raise as much taxation annually as the nation can bear, to defray extraordinary or abnormal expenditure, as far as possible from this source. The great advantage of a tax, as compared with a loan, it that the former never leaves any charge behind it in the form of repayment of principle to disturb subsequent budgets. Therefore, taxation should be preferred to loan if commerce and industry are not prejudicially affected by the increased taxation. Loans on the other hand, are necessary to avoid too rapid an increase of taxation. Some system of taxation may easily be adjusted to meet the increasing expenditure than others. In an unsatisfactory tax system it is almost impossible to increase taxation. Hence, in abnormal times borrowing of the money may become important to the state, but this should be the last method to finance public expenditure.

Differences between Taxes and Loans

(1) Taxation is a burden on current income while borrowing implies the curtailment of future power of spending.
(2) Taxes come from the annual incomes and involve curtailment of present enjoyments, while a loan comes from savings and reduces the available funds from production in private sector.
(3) Tax is a compulsory contribution, while a loan is generally voluntary. The pressure of a tax is immediate, while that of a loan is imposed in future.
(4) The burden of heavy taxation may not be equitable, but the burden of loans is diffused over a long period.
(5) The taxes exercise a solitary and wholesome check on the tendency of an individual to go for extravagant expenditure, while loans give an expectation of increased income in future which may make an individual extravagant in future.

This does not mean loan finance should out rightly be rejected. In fact, taxation and loans can and should be judiciously combined. A good tax system possess considerable elasticity, and therefore, it is very much desirable that increase in revenue should be raised through taxation. But when a limit of increased taxation is reached the device of loan to finance public expenditure may be used.

The rules to finance an abnormal outlay for noneconomic purposes may be summarised as below:

(1) As far as feasible and practicable, current expenditure should be met out of the annual receipts and with the increase in expenditure, taxation should also increase.
(2) When there is non-recurring expense of a large amount, it should be financed through borrowing. This will avoid a serious disturbance of taxation.
(3) While the abnormal expenditure is expected to last for a number of years, tax structure should be adjusted to meet it.

2.11 Role of Taxes and Loans in Financing Development Plans

Most of the underdeveloped countries face the problem of improving their development plans. The problem is whether the development plans should be financed through taxation or loans.

Under – developed countries are subject to acute poverty, low per capita income and inequitable distribution of wealth. The standard of living of the people is low and the taxable capacity of the people is also low. Hence, the scope of additional taxation for financing development plans is limited. In such a situation, heavy taxation would hamper the very purpose of development as it will curb the consumption and discourage productive incentives. Hence, loans should be raised from internal as well as sources of financing heavy development projects. It is important to raise loans from external sources as the internal lending capacity of under developed countries is poor.

The financing of development projects through loans is also justified because these projects are productive and their benefits would be enjoyed by the future generation. Hence, the burden should also fall on them. The loans can be repaid when these projects start production. However, long term loans should be preferred because short term loans are nothing but postponement of taxation for a short period.

Thus development programmes should be financed both by taxes and loans. Loans have of course, an important place in the development finance, but a part of the development programmes should be financed through budgetary surpluses. It will not cause a greater real burden on the current consumption on the community than would be imposed by an equal amount of borrowing.

2.12 CONCLUSION

The burden of public debt is a controversial issue. The controversy relates mainly to the concept of the burden of public debt and to the shifting of the burden to future generation. The classical view believes that public debt imposes a burden on the society for the reason that additional taxation is needed to meet interest payments and to repay the principal. It also thinks in terms of the shifting of debt burden to future generation.

The modern approach advocated by Keynes maintains that public borrowing for the purpose of generating effective demand is no burden because it would activate idle savings in the private sector and generate income and employment. This view is followed by economists like A.P. Learner, Hansen, Buchanan, Bowen, Musgrave and Modigliani. Domar has gone a step further and integrated Keynesian view with economic growth. In his view public debt is a burden only when the rate of growth of the economy falls behind the rate of increase in interest costs.

Thus, public debt has an important role in financing development programmes of underdeveloped countries.

2.13 GLOSSARY

Financial Burden
Real Burden
Primary Burden
Adverse Effects
Controversy
Repercussion
Vague
Consequent
Principal
Purchasing Power
Passive Sections
Outlay
Inappropriate
Substantial
Strain
Friction
Abstinence
Curtailment
Diversion
Securities
Negotiability
Credit Creation
Cash Reserves
Subscribe

Absorb

Floating of loans

Intergeneration

Mainstream

Identical

Bankruptcy

Subsequent

Statesmen

Soldiers

Sailors

Liabilities

2.14 REVIEW QUESTIONS

1. What do you mean by Burden of public debt. In what way debt becomes a real burden to the community?
2. „Internal public debt imposes no burden on the community as a whole‟. Give your views.
3. Discuss the debt burden controversy.
4. Whether the burden of public debt can be shifted? If so, give arguments.
5. Critically examine the differences of classical and Keynesian views of debt burden.
6. What is public debt? Examine the major sources of public debt.
7. Discuss the differences between taxes and loans.
8. Explain the role of taxes and loans in financing the development projects in under developed countries.

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LESSON – 15

PUBLIC BORROWINGS AND PRICE LEVEL: CROWDING OUT OF PRIVATE INVESTMENT AND ACTIVITY

CONTENTS

MODULE 4: PUBLIC DEBT

LESSON – III

PUBLIC BORROWINGS AND PRICE LEVEL: CROWDING OUT OF PRIVATE INVESTMENT AND ACTIVITY

3.0 OBJECTIVE OF THE LESSON

The main objective of this lesson is to discuss about how public borrowings can be used to control price level and the limits of borrowings. It also aims to bring out the crowding out effects of private investment or activity or diversion of funds from private sector to public sector. Further, it analyses the important effects of public debt on consumption, production, distribution and levels of economic activity.

3.1INTRODUCTION

Public Debt is a two-edged sword. Used wisely and moderately, it clearly improves welfare. But, when it is used imprudently and in excess, the result can be disaster forindividual households and firms.Overborrowing leads to bankruptcy and financial ruin. For a country, too much debt impairs the government‟s ability to deliver essential services to citizens. High and rising public debt is a source of justifiable concern when debt ratios beyond certain level, financial crises become more likely and more severe.

Often, therefore, the question arises as to what extent the government should borrow without creating the adverse effects on the economy. “Crowding out” refers to the displacement of private economic activity by public economic activity. The subject has a long history in macroeconomic theory and policy debate. In recent years the dangers of public borrowing, crowding out private borrowing and public spending have been emphasized in the financial press and by administrative officials. The present chapter attempts to bring out that how public debt should be controlled for achieving price stability and crowding out of private investment and activity.

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3.2. PUBLIC DEBT AND PRICE LEVEL

Reduction of government deficits and controlling the rate of growth of the outstanding public debt has been one of the serious concerns of the developing countries today. It is shown that a certain type of fiscal instability, namely variations in the present value of current and future primary government budgets necessarily results in price level instability. In the presence of sluggish price adjustment, the fiscal shocks disturb real output and real interest rate as well.If the purpose of debt creation is the prevention of inflation, or the maintenance of stability in the absolute price level, the cost of attaining this goal is shifted to future tax payers. This sort of fiscal operation can be used to refrain from exercising purchasing power through the promise of a larger share of future incomes.

3.3. LIMITS OF PUBLIC DEBT

It has been acknowledged that there has been continuous increase in public debt in most countries of the world during last few decades. For this, there are various factors responsible for the same. In this context, an urgent question arises as to whether there is any definite limit to public borrowing. In other words, to what extent should the government borrow without creating any adverse effect on the economy? Theoretically, the opinion seems to be correct but in practice, it is not easy to mark an arbitrary limit. However, economists like Lerner and Hansen observe that there should be no such limit to public debt, rather it should be allowed to be raised till it touches natural limit at the full employment level. Therefore, in developing or underdeveloped economies, the limit to borrowing is to be determined by the capacity to raise loans and the rate of growth of income in the short-run and long-run possibilities.

Here it must be remembered that modern democratic welfare governments do not resort to borrowing aimlessly. It borrows for such consumption when it is considered absolutely requisite for economic development and in order to meet natural calamities like floods and famines etc.

In short-run period if it wants excessive borrowing, it has to raise the interest payments on its debt. The government borrowing will reduce the supply of funds available to the private sector. Therefore, a higher interest rate will emerge on account of general shortage of funds. The higher interest cost works asa deterent for the government to borrow too much unnecessarily.

In long-run period, total volume of public debt increases gradually in harmony with the growth in national income and credit structure. Thus, no limitation can be imposed on borrowings. Furthermore, the technique of refunding the debt in modern times, comes to the rescue of the public authority which results in the continuous borrowing without paying the existing debt. In other words, the authorities should not worry about the payment of old debt as it can be easily renewed and converted into new loans.

There is another view point propounded by Gurley and Shaw and the Radcliffe committee. According to Gurley and Shaw approach, the physical growth of an economy cannot be sustained without a corresponding financial growth, similarly Radcliffe committed stressed the role of public debt as a powerful tool in credit and monetary regulation of the economy.

From the above discussion, it is clear that the question whether a country can become bankrupt due to ever – increasing public debt does not have a straight answer. If bankruptcy is interpreted in the sense of inability to redeem the public debt, the country can never become bankrupt, whatever is its internal debt burden. There are many options open to the government for refunding the debt. It may impose heavy taxation, heavy capital levy or convert the existing debt into perpetual debt or make new loans to pay off the old ones or even may repudiate the debt. If the government does not like to take unpopular methods of higher taxation or repudiation of debt, it may go for printing of notes to pay off the debt. There, therefore, no question of bankruptcy in the case of internal debt.

However, in case of external debt, situation may arise when the government due to growing volume of public debt and increasing burden of interest payment and repayment may become unable to honour its obligations to the foreign country. This is the situation when the country cannot make surplus of exports over imports and is unable to build an adequate foreign exchange reserve. Under such uncomfortable circumstances, the debtor country may float new loans to pay off the old ones. This debt does not reduce the burden but only changes the credit sources.

3.4 CROWDING OUT OF PRIVATE INVESTMENT AND ACTIVITY

Crowding out means the displacement of private economic activity by public economic activity. It explains that a rapid growth of government spending leads to a transfer of scarce productive resources from the private sector to the public sector where productivity might be lower. The "Crowding out hypothesis" was popular in the 1970‟s and 1980‟s when free – market economists argued against the rising share of GDP being taken by the public sector. It illustrates that when the government chooses to run a bigger budget deficit, the government will have to sell debt to the private sector. Getting individuals and institutions to purchase the debt may require higher interest rates. A rise in interest rates may crowd-out private investment and consumption offsetting the fiscal stimulus. Eventually higher government spending needs to be funded by higher taxes and this again acts as a squeeze on spending and investment by the private sector and the economy. However Keynes believes that the probability of hundred per cent crowding out is remote especially if the economy is operating well below its capacity. If there is plentiful supply of savings is available that the government can tap into when it needs to borrow money.Well – targeted timely and temporary increases in government spending can absorb the underutilized capacity and a strong multiplier effect will generate extra tax revenue.

3.5 EFFECTS OF PUBLIC DEBT

Public debt operations like taxation and public expenditure involve the transfer of purchasing power from one section of society to another. According to Prof. Dalton, "When the government floats a loan, money is transferred from the purchasers of Government securities to government and finally to those on whom the government spends this money. When the interest on the public debt is paid, it is merely the transfer of purchasing power from those who are taxed for this purpose to the holder of securities and when the debt is repaid, there is another transfer of purchasing power". In modern times, it is generally accepted that taxation and borrowing can be utilized for either type of expenditure depending upon the circumstances.

The economic effects of the government expenditure financed by public debt are different from the effects of taxation as (a) the wealth of tax-payers is curtailed by taxation and loans do not reduce the wealth of the lenders but it merely changes its form. (b) The funds are transferred from public to the government compulsorily in case of taxation but under borrowing such a transfer of funds is voluntary. The public debt of a country affects its economy in two ways. It has its „revenue effects as well as expenditure effects". In the first place, raising of money by a specific loan makes the people change their budgets. Though, it may not affect the consumption expenditure directly as the taxation does, because people use their past or present savings to buy the public securities. But in some cases they may increase their savings and cut down their expenditure to buy the loans or securities. Obviously, public debt affects consumption expenditure. This is, therefore the first effect of public debt.

Secondly, the benefits conferred upon the peopleby the expenditure of the people raised through public loans, is another effect of public debt. These benefits may not always be different from the benefit that expenditure of tax income may confer, provided that the same use is made by borrowed money as is made of tax revenue. However, the difference is not always very radical. For instance, tax revenue may be used to pay salaries of teachers, while borrowed money may be utilized for the constructionof school building. The effects of spending of the proceeds of taxation and are of borrowing are the same. But in some cases, the difference is clear cut. The borrowed funds are used to finance expenditure of capital nature, such as for the construction of plants for generating the atomic energy. The tax proceeds on the other hand, are used to finance current revenue expenditure. The effects of former expenditure are different to that of latter. Let us now discuss the limits of public debt and effects of public debt on consumption, production, distribution and on private sector.

(i) Effects on Consumption

Consumption of the individuals has been greatly affected by the public debt. When people purchase government securities, it is not always necessary that they do it out of past savings. It can be possible that the people buy government securities by curtailing their expenditure on current consumption. Since they get an opportunity of buying government bonds of small amounts, they refrain from consuming something else and buy them. The small saving schemes started in India to finance the five year plans is of this nature. Hence, the money invested in the National Savings certificates must, to certain extent reduce the expenditure of the people in the present. Therefore, in this way the consumption is affected in the sameway as it is affected by taxes. But, when the people buy government securities out of their past savings, in has its specified effects.This does not directly affect the expenditure of the people at present. And when people buy government securities out of the idle savings, the expenditure in the present remains the same. Private investment also remains unaffected in such conditions. If however, it comes from bank deposits, it reduces the money with the bank. The banks have therefore, less money to lend to private business. Hence, private investments are affected.

(ii) Effects on Investment

Public debt may also affect adversely the incentive of investment. The commercial banks have excess cash reserves. So the sale of bonds to these banks increases the purchasing power through credit creation. Hence, it should not curtail its investment. On the other hand, the sale of these bonds to the individuals reduces the funds which they have kept for the expansion of their own business activities. There will be no adverse effect if the individual purchase these bonds out of their surplus funds. However, there is an indirect effect of the public debt. The growth of public debt may give rise to the fear of increased taxes on future. If the people feel that the public debt may result in higher taxes in future the profitability of investment in the long run will appear to be less.

(iii) Effects on Production

Public debt affects the production if it is taken in enormous forms. There is hardly any significant effect if the size of public debt is small. People purchase securities out of their surplus income and it does not affect the capital used for investments. But if the public debt is big in size, it will affect the production because its payment is made by diverting capital for the private investments. Such purchase of government securities reduces the private capital which in turn checks the economic development. The government imposes heavy taxes for the repayment of such heavy public debts. It affects the people‟s willingness to work. Besides, the existence of huge debts creates the fear of the imposition of levies or even repudiation of debt. In short this would adversely affect the people‟s desire to work and thus save production.

However, the effects of public debt must consider the effects of the expenditure of borrowed money as state is largely guided by the larger interest of the society as a whole. Therefore, when public borrowing is utilized to meet deficits or war expenditure it causes diversions which reduce production.

(iv) Effects on Distribution

Public borrowing leads to transfer of purchasing power from one section of the society to another. Generally, rich section of the society purchases government securities, but the burden of the tax falls upon the common man i.e. poor people. Thus, public debt increases the inequalities of income and affects the distribution of income. If the bond – purchasers and tax – payers are the same, the redistribution will not occur thus, increased the gap of inequalities of income. If the bond – purchasers and tax-payers are the same, the redistribution will not occur thus, increased the gap of inequalities of income. If the money borrowed is spent on the welfare schemes of poor people, it will decrease the inequality of income and it will ensure equal distribution of income among different sections of the society.On the contrary, if the public borrowings and spending create inflation, its favourable effects on distribution of income can be neutralised due to rise in prices.

(v) Effects on National Income

Public debt will have very mild effect on the economy under usual circumstances. However, government expenditure financed by borrowing is more expansionary. This carries no adverse effect of borrowings on consumption and investment. In other words, investment is reduced, it relatively reduces output of capital goods. On the contrary if government expenditure is incurred on capital goods, it provides incentives for accelerated production and it gives rise to national income. Further, if government bonds are purchased by central bank and commercial banks, the expenditure of the borrowed funds will have a considerable expansionary effect in the economy.

(vi) Effects on Resource Allocation

The public debt unlike the tax finance, has little effect on resource allocation. To a greater extent, public borrowing curtail business investment activities while decline of investment varies from one industry to another. In this way, allocation of resources are not much affected by the manner of financing these units.

(vii) Effects on Liquidity

Public debt is generally represented by bonds which are highly negotiable.Therefore, those people who hold bonds possess highly liquidity form of assets. These bonds can easily be converted into cash whenever any individual needs more funds for any purpose of transactions, precautionary and speculative motives. So, public debt is reasonable for the existence of high liquid form of assets. Furthermore another important effect of highly liquid commercial bonds can also be seen in the case of commercial central banks. In times of inflation, the central bank attempts to adopt various devices like bank rate, open market operations to restrict commercial banks to reduce their credit expansion. However, the commercial banks can increase the cash reserves through disposing of their government bonds.

Further, existence of large amounts of public debt accounts for increases in interest obligations of the government. However, increase in interest rates has a net expansionary or contractionary effect upon the economy which depends on the relative propensity to consume of the taxpayers and bondholders and the effect of tax upon investment.

(viii) Effects on Private Sector

Generally public expenditure increases the level of demand for the goods produced by the private enterprises as every unit of money spent raises the purchasing power of the people. It puts more money in circulation. However, when this type of public expenditure is financed through taxes, current consumption is reduced but on the other hand, it is financed through borrowings, current consumption is not reduced because idle savings are utilized in purchasing of bonds. Therefore, if the government uses the public borrowings in purchasing of goods and services produced by the public sector enterprises, the demand for goods in private sector may increase to the extent that government spends borrowed funds for purchasing of these goods and services. Similarly, if the borrowed funds are utilized on salaries and wages of the government officials, it may further increase their purchasing power enlarging the demand for goods and services produced by the private sector, without affecting the supply of goods and services. In this way, the effect of expenditure of borrowed funds is considered favourable.

(ix) Effects on the Working of Money Market

Public debt affects the money market when the demand for money in private sector is on a higher level and the state government fixes higher interest and vice-versa. So, there is a severe competition with the private investor if the government borrows from the public. This is because total available supply of investment funds increase in the market. On the other hand if government borrows from the bank, there are chances to give rise to currency expansion. The economic stability can be ensured through open market operations. Thus, well managed public debt can be regulated through variations in the size, composition and yield of public debt so that proper climate helps to bring stability in the economy.

(x) Effects on Cost of Production

The cost of production depends upon the prices of raw materials and other factors used in production. The state utilizes the borrowed funds to supply raw materials to the producers at reasonable rates and to provide transport and training facilities. The state may also utilize these funds in promoting industrial research or in giving subsidies to private enterprises. In all those cases the expenditure of borrowed funds reduces cost of production. Hence, the effects of borrowed funds are said to be favourable.

When borrowed funds are used, the demand for labour and capital is generated. If labour is scarce, wages may rise and the cost of production may increase and the private industry may have adverse effects. But, if the demand for the products is not adversely affected even with the rise in prices, private industry is not adversely affected in respect of cost of production.

(xi) Effects on Economic Development

In underdeveloped countries where there is a large non-monetised sector public debt has a favourable impact on economic development. The financial structure of economic and credit system, the banking system and financial transactions develop as a result of the creation of public debt. The capital deficiency of underdeveloped countries is again reduced. The prevailing unutilized economic resources and idle manpower is activated when public borrowings are used to finance the government investment projects to provide economic infrastructure for development of agriculture and industry.This will have favourable impact on growth of incomes and economic development.

(xii) Effects on Growth and Stability

Public debt can be used as a compensatory fiscal device to bring about economic stability when the country suffers from unemployment or inflation. During the period of depression and unemployment, the economy requires enough of purchasing power. The central bank on purchase of these bonds pays in terms of cheques drawn on the commercial banks and when the recipients of these cheques deposit in the commercial banks, the latter finds their cash reserves increased. They can create credit by a multiple of the additional reserves held. During inflation, the need to reduce excess purchasing power can be done by sale of government securities or new issue of government bonds. The result will be reverse of debt repayment i.e. the contractionary economic activities. Thus, public debt can be used as an anti-cyclical fiscal policy to restore economic stability. Hence, public debt can be a very powerful instrument in regulating the economy.

(xiii) Effects of External Loans

Foreign loans are likely to create favourable effects on the economy in a number of ways. (1) They make possible to import capital goods, improved technology, raw materials and the like. They are of immense help in a policy of industrialization which is necessary for accelerating the pace of economic development. (2) Foreign loans help to import goods which are in short supply in the domestic market and thereby help in maintaining balance between their demand and supply. It would prevent the prices of such goods from escalating. (3) Availability of external loans helps in the saving of scarce foreign exchange reserves. (4) They supplement the national resources and make possible higher rate of investment and production. (5) External loans, if properly utilized can increase the output and in turn raise the standard of living.

If external loans are not utilized productively and prudently, they will create unfavourable consequences for the economy and would become a burden to the nation. Repayment of the principal and servicing of interest would cause a drain of hard – earned foreign exchange. It means the capacity to pay debt servicing charges depends upon the continuing increase in percapita production.

3.6 CONCLUSION

At moderate levels, public debt improves welfare and enhances growth. But high levels of debt can be damaging. Debt provides means of combating inflation by reducing money in circulation. The sale of securities effectively withdraws money from the private sector. The crowding out or displacement of private economic activity by public investment has various economic effects. It also depends on the nature, form, conditions, duration, rate of interest and the mode of payment of public debt. As a matter of fact all types of loans affects different sections of society. Its uniqueness lies in the fact that it has revenue effects as well as expenditure effects.Raising of money by way of loans makes people change their budgets and consumption expenditure. The benefits conferred upon the people money raised through public loans have another kind of effects on the economy. Public debt has various effects on economic life, production, distribution and employment. Therefore, the desirability of a particular borrowing can be best judged by its effects. Thus public debt may be used as an instrument of fiscal policy and the wider economic policy of the government.

3.7 GLOSSARY

1. Outstanding
2. Sluggish
3. Fiscal Shocks
4. Requisite
5. Deterrent
6. Harmony
7. Arbitrary

8. Two – edged sword
9. Crowding out
10. Excessive
11. Rescue
12. Redeem
13. Refunding
14. Perpetual
15. Displacement
16. Offsetting
17. Squeeze
18. Multiplier effect
19. Atomic energy
20. Refrain
21. Imposition
22. Negotiable
23. Obligation
24. Precautionary motive
25. Subsidies
26. Anti – cyclical
27. Supplement
28. Consequences
29. Foreign exchange
30. Combatting

3.8 REVIEW QUESTIONS

1. Explain the impact of public debt on price stability.
2. How public borrowings can be used to control inflation?
3. Critically examine the limits of public debt.
4. What do you mean by crowding out? Explain its effects on private investment and activity.
5. Discuss the effects of public debt on consumption, production and distribution.
6. Explain the effects of external loans? How they are different from internal loans.

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LESSON NO. 16

INDIAN TAX SYSTEM –IMPORTANT CHARACTERISTICS AND DEFECTS

Structure

17.0. Objectives

- After going through this lesson, you will be able to know the
- Objectives of tax system in India
- Salient features of Indian Tax System
- Defects of the Indian Tax System
- status of the Indian tax system

17.1 Introduction

Taxation is an important source of government revenue. It is also a crucial Macro economic policy instrument which contributes to ensure social justice and reducing the inequalities of income and wealth in the economy. The Economic Bulletin for Asia and Far East observes "Taxation, therefore, remains as the only effective financial instrument for reducing private consumption and investment and transferring resources to the government for economic development". In this lesson, we shall attempt to study the Indian tax system and also examine its merits and demerits.

In the earlier period, the Indian tax system was unorganized, unregulated and unplanned. During the British period, no serious attention was paid for bringing about uniformity in it. Its main aim was only to finance the administration. In this era, it possessed the following features:

1. Vast disparity exists between tax in states and provinces.
2. Prime objective was to get maximum possible revenue.
3. No specific principle was followed to collect taxes.

4. It lacked certainty, flexibility and equity.
5. Tax evasion was frequent.

After1947, tax system was studied in detail and lot of changes were introduced to make it equitable, productive and economical. With the introduction of Five Year Plans, government needed more and more finances to achieve certain social and economic goals. As modern states are welfare states and financial structure of central and state government has consistently been expanding, it has now been felt that government has not to discharge administrative functions only but also welfare activities. Therefore, in a country like India, tax system must aim at:

i) Encouraging savings and investments
ii) Raising public resources
iii) Improving the allocation of resources,
iv) discouraging consumption of goods and services which are harmful to the community's progress.
v) Providing incentives to private sector
vi) Reducing inequalities of income and wealth.
vii) Controlling inflationary tendencies in the economy.

A study of the tax system reveals that taxes on commodities and especially on the commodities of domestic consumption occupy central place. But this tax system was unorganized and loosely regulated and lacked coherent planning in its early stage. However, in the recent past it has changed. Major taxes are: import duties, inter-state transit duties, central excises, state excises, sales tax etc.

SALIENT FEATURES OF ATAX

Tax is not a voluntary payment or donation. Its imposition is no way dependent upon the will or assent of the persons taxed. Tax is an exaction to be discharged alone in money which must be in legal tender. It is normally based on the ability to pay. Tax may be imposed on activities or transactions or contracts. The persons or property must be subject to the jurisdiction of the taxing state. The power to tax is a legislative power which only the legislative body can exercise through the enactment of statutes or ordinances. Taxation and tax involves a charge or burden imposed to provide income for public purpose.

17.2 OBJECTIVES OF TAX SYSTEM IN INDIA

Objectives of a tax system in an economy cannot be considered in isolation from other relevant factors. They are intimately connected with the overall economic and non-economic policies of the government, the non-tax components of its fiscal policy and institutions and other circumstances faced by the economy. The following are the objectives of the tax system in India.

1. To remove poverty and economic inequalities,
2. to remove unemployment and regional disparities.
3. to promote specific products to fill both the supply and demand gaps
4. to promote agricultural and industrial development in backward areas of the country
5. to provide a foundation for the industrialization of the economy
6. to restrict unnecessary imports and promote exports
7. to promote savings on the one hand and direct them into investment in priority industries on the other.
8. to introduce optimum tax structure in India.

17.3 SALIENT FEATURES OF INDIAN TAX SYSTEM

The Indian tax structure, like that of any other country, has developed in response to many influences of social, political and economic. India is maintaining a broad-based and extensive tax structure. Various types of taxes are being levied in the country which are broadly classified as direct and indirect taxes. In terms of tax effort, the rate of taxes are quite heavy but coverage of such taxes are not very wide in the country. In analyzing the tax structure it is useful to note that properties of an ideal tax structure, which are as follows:

i) the distribution of tax burden should be equitable
ii) the tax structure should facilitate the use of fiscal policy for stabilization and growth objectives
iii) the tax structure should improve efficiency of the market rather than distort it
iv) tax policy should be easy to implement administratively with a low cost of collection of taxes.

1. Tax structure :

Indian tax structure consists of land revenue, Import duties, excise duties, sales tax, octroi and terminal taxes. Land revenue provides 8 per cent of the total revenue to the government. Other taxes contribute 45 per cent of the total tax revenue. Central Government's revenue from taxes shows that the amount of revenue from Union excise duties and customs is significantly higher than income tax. For instance, in the year 2012-13 B.E. the percentage of tax revenue from Corporation Tax, Customs Duties, Central Excise, personal Income tax and Service Tax are 34.6, 17.3, 18.0, 17.6 and 11.5 respectively. It implies that the Union Government and the States depend largely on a few taxes which contribute more than ninety per cent of the total tax revenue.

2. Larger share of indirect taxes

In India the indirect taxes have contributed a large share in total revenue. For instance, the indirect taxes contributed about 63 per cent of the Union Government's total tax revenue in 1950-51 which increased to as much as 82 percent by 1990,though at present its contribution has declined substantially after the reforms. As per the B.E. 2012-13, the percentage of indirect tax revenue of the central government was only 46.8 per cent. The situation is more or less the same at the States level even today. It shows that direct taxes have not been exploited at the Centre for a long time in India. However, at the State level still the revenue from indirect taxes is far higher than the revenue from direct taxes.

3. Increasing Trend in tax revenue

Tax revenue has been used as one of the important sources of financing Five Year Plans in India. Tax revenue both at the Centre and States have been rising since 1950-51 though the tax revenue is relatively small compared to the advanced countries. The total tax revenue from Centre, State ad Union Territories amounted to Rs. 627 crores in 1950-51 which rose to Rs.1350 crores in 1960-61, Rs.4,752 crores in 1970-71 and further to Rs.19,844 crores in 1980-81.The tax revenue has substantially increased after 2000.

4 Inadequate tax revenue

Though the tax revenue is increasing continuously, it is not adequate when compared with advanced countries. The percentage share of tax revenue in GDP is 13 per cent in India. It is very low compared to advanced countries like Sweden, France, U.S.A and others where it contributes about not less than 25 per cent of their GDP. Both the Centre and States need to expand their tax bases simultaneously plugging the loopholes in tax evsion and tax avoidance.

5. High rates of Taxes:

The governments both at the Centre and States level adopted high rates to all the taxes. For instance, at one time the highest Income Tax rate was as high as 97.5 per cent. The average effective Union Excise Duty was about 45 per cent and the average effective CustomsDuty was about 85 per cent. Similar is the trend of other Central and State taxes prior to tax reforms of 1991. High tax rates have resulted in large scale tax evasion and tax avoidance. The tax reforms, especially after Chelliah Committee recommendations were implemented, the tax rates have been drastically reduced.

6. Incidence of taxation

The impact of taxation has been more on the people living in cities compared to the people in rural areas. It is due to the purchase of more luxury and semi-luxury commodities having high tax rates. However, the proportion of urban population is in smaller than the rural population. As a result total contribution to the indirect taxation is greater by rural people.

7. Tax revenue of the Central Government consists of three types:

a. Taxes on income:a) Personal income tax, and b) capital gains tax and corporation income tax.

b. Taxes on property and capital transactions:a)Estate duties; b) Wealth tax and c) Gift tax.

c. Taxes on commodities: a) Excise duties; and b) Customs duties.

Income Tax

Personal income tax is levied on individuals by the Central Government. The income tax does not fall on all people but only on those people who are better off. It is based on the principle of "ability to pay" that is, those who can pay more should pay more to the Government. On the basis of those principle, certain people with low income are exempted and the exemption of income has been changing from time to time. The exemption limit was raised periodically.

According to the Union Budget 2015-16 the threshold limit of exemption of income is as follows

a) all assessees at Rs.2,50,000
b) all women assessees at Rs.2,50,000
c) all senior citizens at Rs.3,00,000

In India, the income tax is levied on the net income of all individuals, Hindu undivided families, unregistered firms, and other associations of persons (excluding joint stock companies registered under the Companies Act 1956, and statutory corporations)

The main characteristics of the personal income tax in India are:

1. It is levied on the income earned annually.
2. Agricultural incomes are not taxable.
3. Income of religious and charitable trusts are exempted.
4. For administrative convenience as well as from the viewpoint of ability to pay, there is an exemption prescribed from income tax limit. The correntption limit is Rs.50,000. Thus, a person within this limit of annual income is not liable to pay income tax.
5. For calculating income tax, a slab system is followed. Progressive taxation is introduced by taxing the successive slabs or slices of income at rising rates.
6. As a saving incentive measure, since 1970-71, the Government of India had exempted from tax annual income upto Rs.3,000 earned from investment in Unit trust or shares, bank deposits, new small saving schemes and post office deposit accounts, etc. This limit is now raised to Rs. 13,000
7. Income tax is steeply progressive in India. Till 1975, the marginal rate of tax on the highest slab of income was 97.25

Integration between Centre and State revenues

During British period, there was no integration between center and state tax revenues. In order to get maximum possible income, the system was made regressive. But after independence, financial structure of the center and state government has considerably changed. Now there is coherent machinery for the collection, distribution and expenditure of the revenue. In this way Indian tax system is better organized to yield sufficient revenue to meet the requirements of development plans in the country.

17.4 Shortcomings in Tax Structure

The present tax system is not satisfactory. It does not fulfill the basic canons of taxation like equity, ability to pay,elasticity and economy. So the system has the following drawbacks.

1. Traditional nature of taxation

Tax structure is traditional and conservative. Much attention is given to the indirect taxes. In other countries, direct taxes like gift tax, estate tax, expenditure tax etc. , are considered most important. Prof. Kaldor has suggested few new taxes in this regard but not much headway has been made so far.

2. Inadequate Revenue

The income derived from the taxes is not sufficient to fulfill the needs of the government. Therefore, the government resorts to deficit financing which results in rise in prices.

3. Predominance of indirect taxes

Indirect taxes are the major source of revenue in India.More than 77 per cent of income was derived from indirect taxes. It may be noted that in countries like Japan and Australia, about 70 per cent and 80 per cent of tax income is derived from direct taxation respectively.

4. Unequal distribution

The distribution of taxes is also not fair. In other words, it is not progressive. Besides, it burden falls on small portion of population while majority of the people are not covered. Consequently, this system fails to bring about reduction in inequalities in income and wealth.

5. Low share of taxation

The amount of tax revenue derived out of the total national income is very small as compared to advanced countries of the world. The share of tax revenue in GNP is 41 per cent in Sweden 39 per cent in France while it is only13 per cent in India

Taxation structure of the country can play a very important role in working of our economy. In the present economic structure, income tax plays a vital role as a source of revenue and measure of removal of economic disparity. Excise and customs duty are also playing a major role in earning revenue for the country development. To achieve this every individual should pay tax according to their ability to pay. Rich should be taxed more and poor should be taxed less.

The revenue generated through tax system is to be channelized for the purpose of benefiting society at large, laying roads, construction of bridges and dams, maintaining armed forces etc.,

Saving is the proportion of income that is not spent, when a tax is levied on interest or dividend, it reduces the reward for saving. On the other hand, when interest is taxed, an individual most save more to achieve any particular savings goal. This effect tends to increase the amount of savings.

In our tax structure, commodity and the taxes on domestic consumption, such as import duty, Central excises, State excise, Sales Tax occupy a key position. They are responsible for more than 70 per cent of the total tax revenue.

17.5 AN OVERVIEW OF TAX SYSTEM IN INDIA

Article 245 empowers Parliament to make laws. It also empowers the Legislature of a State to make law. The Central Government levies taxes on income, customs duties, central exercise and service tax. The state Government levies taxes on Sales, stamp duty, State excise, Land revenue, tax on professions, and tax on agriculture. The local bodies are empowered to levy tax on properties, Octroi and for Utilities like water supply drainage.

From the above, it is very clear that India has well-developed tax structure with clearly demarcated division between central, state and local bodies. The basic features of tax structure in India are as follows: The ration of direct taxes to indirect taxes was about 12:88 in 1990-91. It was 26 : 74 in 2005-06. That means indirect taxes are more than twice of that of direct taxes.

Income tax from agricultural sector is exempted from income tax. The tax burden on Indians is very high because of rise in defence expenditure and government developmental expenditure.

Tax revenue constitute about 1/5th of the National Income, which is very low. The governments a collection of tax revenue is insufficient to meet the expenditure requirements. Out of a working population of 40 per cent only 1 per cent people pay direct taxes. There is a sharp increase in the tax income collection. The rise is from Rs.460 crores in 1951-52 to more than Rs.3,30,229crores in 2001-2002 and Rs.4,38,300 crores in 2003-04.

17.6 CRITICAL EVALUATION or BASIC DEFECTS IN THE INDIAN TAX SYSTEM

Indian tax system suffers from a number of defects since independence; taxation has been used as a tool for raising revenue to meet the government needs. No attention has been paid to other effects of taxation such as those on people’s ability to work and save, willingness to work and save, efficiency, saving, investment, employment etc. A peep into the Indian tax system as a whole, and also at each independent tax separately will reveal the defects. The very defects suggest the possible remedies and the required tax reform.

Regressive Taxation: The reliance of Indian tax system more on indirect taxes since1950-51 resulted in regression. The government had relied more on direct taxes which are progressive, it could have been better.

SHARE OF DIRECT AND INDIRECT TAX REVENUE OF THE CENTRAL GOVERNMENT

(Rs.Crore)

YEAR	Direct Taxes	Indirect Taxes	Total Taxes
1950-51	230	430	660
1960-61	420	1,040	1,460
1970-71	1,100	3,590	4,600
1980-81	3,268	16,576	19,844
1990-91	13,397	75,906	98,303
2010-11	438477	344530	793072
2012-13(B.E)	564337	504423	1077611

A more look at the table shows predominance of indirectly taxes in the Indian tax structure. The share of indirect taxes in total tax revenue has increased to more than 80 per cent. The burden of indirect taxes falls more heavily on poor than on the rich. This makes tax system regressive.

Inelasticity:

Another defect of Indian tax system is to absence of flexibility of elasticity. Tax system depends a more on urban incomes rural incomes, especially the agricultural income fall outside the tax net. As a result, even if the national income increases, tax revenues will not increase. The reason is a major chunk of national income from agriculture in rural areas and they fall outside the scope of taxation. The indirect taxation is also deprived of elasticity. But with the adoption ad valoerm basis, this defect can be rectified.

Large tax evasion:

This is more serious problem tax evasion is illegal people resort to tax evasion by submitting false accounts with “maneuvers involving an element of direct misrepresentation of facts, falsification of accounts including of downright fraud”. This accounted for Rs.1400 crores for single year of 1989. The reason for tax evasion are many and not to go into multifarious reasons, may experts believe that the high rates of taxation in India is responsible for large scale tax evasion. Tax evasion generates black money with all its resultant in countering this level.

Tax avoidance:

Tax avoidance is different form tax evasion, it means avoiding the tax liability in a legal way. Generally people take advantage of the loop holes in the tax system and tax laws. The lawyers in the court aid and abet it with their legal knowledge.

Adverse effects on savings and investment:

A good tax system should promote savings and investment in economy. But the direct tax system in our country has been adversely affecting the saving and investment. The Direct taxes Enquiry Committee (1971) opened that out high marginal rates of taxation eroded out capacity to save and invest Marginal rates taxation of income means the tax rates applicable to incremental incomes.

Unequal treatment:

The tax system in India favours people with higher incomes. The various rebates, concessions and exemptions permitted in the direct taxation make the legal or nominal progression different form the real or effective progression indirect taxes, it is this factor that failed to bring down in ethical justice. Taxation filed to curt conspicuous consumption. The economic inequalities in the country are on increase because of another factor i.e., preponderance of indirect tax. The former helped the rich to become richer and the latter helped the poor to be come poorer.

Absence of simplicity and certainty:

The Indian tax system lost the qualities of simplicity and certainty. The complicated tax procedures, frequent changes tax rates and tax laws contributed to this. More over the tax laws in the country suffer from defective definitions. Concepts are not clearly defined. This results in a number of loop holes in tax laws and tax avoidance.

Inflationary trends:

The greater dependency on indirect taxes resulted in an increase in the prices of essential goods. It is contributing to the inflationary spiral. The indirect taxes being part of the cost of production. The one factor that has been adding fuel to the fire of inflation in our country is high doses of indirect taxes. They are distorting the cost-price structure of the economy to a great extent.

17.7 PRESENT STATUS OF INDIAN TAX SYSTEM STRUCTURE

On the basis of recommendations made by Prof. Kaldor, Tyagi committee, Boothalingam committee, Wanchoo committee several changes were made in the Indian tax system. The following is the present position of Indian Tax operations.

On the basis of Prof. Kaldor's recommendations, new direct taxes were imposed. They are wealth tax, capital gains tax, expenditure tax, and gift tax etc. Because of various reasons, expenditure tax was abolished.

The rates of taxation of income tax and corporate tax were increased. The coverage of excise duties was increased. Several rebates and exemptions were given in the tax to encourage domestic investments.

Several steps were taken to prevent tax evasion

On the basis of the recommendation of K.N.Raj committee, agriculture income is also taken into account of determining the rate of income tax. Very recently on personal income, the marginal rate of tax is reduced to 30 per cent as per the Raja Chelliah committee recommendations. The Indian government introduced some changes in the direct and indirect taxes from 1991 onwards as suggested by Raja Chelliah committee.

The important sources of revenue of the Indian Government may be broadly classified as tax revenue and non-tax revenue. Tax revenue is mainly obtained from central excise duties, customs duties, Income tax, Wealth tax and corporate tax etc. Non tax revenue mainly obtained from railways, post and telegraph, currency and mint, broadcasting etc.,

The tax rates have been rationalized and tax laws have been simplified resulting in better enforcement and better tax payment. Tax reforms are not one time process. The process of rationalization of tax administration is ongoing in India. Since April,2005, most of the state governments in India have replaced sales tax with VAT (Value Added Tax).

17.8 EVALUATION OF THE INDIAN TAX SYSTEM

The specific evaluation of the Indian tax system in the concept of sound principles of a good tax system is as follows

- Direct taxes fulfill the principle of equity but indirect taxes not fulfill the principle of equity.
- Indirect tax fulfills the principle of convenience from the collection point of view .Advance payments, Deduction of Tax at source, self-assessment, assessment on the basis of returns were introduced in direct taxes to ensure convenience.
- Indian tax system has complicated laws, provisions, concessions and exemptions. Attempts have been made to simplify the tax system. The Chelliah committee has made variety of recommendations for simplification.
- The tax yields are not income elastic. It means an increase in national income does not lead to increase in direct taxes. The Indian tax system is not sufficiently productive. It does not yield adequate amount of revenue to meet the government expenditure.
- Direct taxes fulfill the principle of certainty. The government and the tax payer are certain indirect taxes not fulfill this principle of certainty. Indian Tax system lacks both efficiency and economy. This is because of continuous changes which cause wastage of time and money. Cost of collecting indirect taxes is very high.
- The Indian tax system is not flexible. The reason is it mainly depends upon urban income and exempts agricultural income but agricultural income accounts for more than 30 per cent of the total National

Income. Due to exemption on agricultural income, income tax collection is very less and lot of scope for generating black money.

- Due to built-in loopholes in the tax system, tax evasion is high. The growth of black money in our country is an indicator of tax evasion. A large part of black money is wasted on social functions and anti-social activities.
- Indian tax system adversely affects savings. There are hardly any direct incentives to save. Our fiscal policy encourages capital intensive techniques, which raises unemployment. The regressive nature of indirect taxes and evasion of direct taxes leads to widening of income inequality gap between the rich and the poor.

17. 8.1 Remedial Measures:

Imposition of agricultural income tax: Exemption of agricultural incomes from income taxation is historical accident in our country. Upper income groups in agricultural sector should be brought into the tax net. There is virtually no tax on agricultural incomes and on the other hand, it is lightly subsidized sector.

Equity should be ensured: The Indian tax system and tax administrators always aimed at raising tax revenues though an upward revision. It goes without saying that the upward free vision. Has its own limitation . It is for this reason, Indian tax system has unduly concentrated on indirect taxes for tappint additional revenues. This has made out system inequitable. The tax administrators should realize that it is only direct taxes that can make our tax system equitable and progressive. A through revision of our tax system is the urgent need.

Elasticity and Flexibility should be ensured: Simplicity means any system of taxation should be simple, plain and intelligible to common people and common understanding. The general incidence (i.e. the ultimate burden of taxation) should be traceable with some degree of certainly complex tax laws should go . Frequent changes in tax laws should be stopped. Tax elasticity implies three things.

a) Tax system should permit of modifications (or changes) of existing taxes. This facilitates adjustment of revenue to the increased expenditure

b) the Tax yield should automatically increase with increase in wealth and population of the country.

c) There should always be risk margin for new taxes. Keeping these things inview, the tax structure should be simplified, tax rates should be rationalized.

Promotion of Economic growth: The objective of taxation should be growth-oriented. The strategy of taxation should be to encourage savings, investment and growth is, the ultimate end taxation should promote growth and growth should promote tax yields. Any appropriate tax system should encourage investment in the economy with reasonable profits to the business organizers.

Expenditure tax : Prof. Kaldore has suggested expenditure tax in place of income tax It is not a sound proposition because income is accepted as sound base of taxation all the world over. Moreover, expenditure tax was tried and abandoned in our country. It was imposed abolished, reimposed and abandoned now.

The above measures implemented in all earnestness will go along way in removing the defects of Indian tax structure.

NEW CODE PROMISES LOWER DIRECT TAX RATES

India has taken the next step towards structural changes in direct taxes by releasing a draft of the proposed new Direct Tax Code for public debate.

17.8.2 Greater Role for Direct Taxes Necessary in India

Though indirect taxes play an important role in India, heavy reliance on them only reveals the backwardness and underdevelopment of these taxes cannot be made progressive. Though these taxes are proportional, they are regressive in their effect. The real burden of these taxes, as we have seen earlier, falls more on the poor than on the rich. The poor already suffer from a low standard of living. Their living standard falls further when goods in their budgets are taxed.

Experience shows that heavy indirect taxes covering larger and larger number of goods has contributed to the inflationary pressure in India. Every annual budget during the past has come out with taxes covering newer and newer goods and increases in the existing rates of in direct taxes. To what extent this policy of relying on indirect taxes has achieved other goals, such as diversion of resources, reducing inequalities of income, balanced regional development, etc. is still a matter of great controversy. Perhaps the only purpose served by indirect taxes has been to swell the funds of the government.

Direct taxes are more equitable. They can be made progressive, and their real burden is on the rich. It is, therefore, necessary that they are assigned a greater role in countries like India. Revenue collection can be improved considerably if large-scale tax evasion is prevented, unaccounted money is traced, illiteracy is removed, political power is wielded by the true leaders of the masses, and above all, if the administrative machinery is made more efficient, more effective and incorrupt. But these are only "ifs" which must be fulfilled. There are long miles to go to realize these IFS.

17.9 Summary

Taxation these days is not used as a means of raising revenues only, but it is an important instrument for acheiving socio-economic objective, such as regulation of comsumption & production, controlling booms and depressions, promoting economic-growth and removing inequalities of income. Modern economists have laid great stress on the diversity of taxation. It implies that there should be all types of taxes direct and indirect, so that every clasas of citzen may be called upon to contribute something towards the State Revenue.

17.10 Self Assessment Questions

1. Briefly explain the salient features of Indian Tax System.
2. Account for the main short-comings of Indian Tax System. Suggest remedies to improve the tax structure
3. Briefly explain the present system of taxation in India.
4. What are the defects do you noticed in the Indian Tax Policy? Suggest remedies.

17.11 Reference Books

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LESSON No. 17

Revenue of the Union States and Local Bodies and Major Taxes is India – Taxation of Agricultural Income and Expenditure Tax

STRUCTURE

18.0 OBJECTIVES

The following are the major objectives of this lesson:

1. To study the tax revenue of the Central Government.
2. To study the non-tax revenue of the Central Government
3. To study the tax revenue of the State governments.
4. To study the non-tax revenue of the State Governments.
5. To study the revenues of local self governments.

18.1 INTRODUCTION

This lesson deals with the tax revenue and non-tax revenue of the Centre, State and local governments in India. In India, the revenues of the Union, State and local governments come from taxes and non-tax sources. Taxes are the major sources. Among taxes, indirect taxes yield the largest part of revenue. Direct taxes nonetheless are important sources of revenue.

18.2 REVENUE OF THE CENTRAL GOVERNMENT

The estimates of receipts on revenue account have been grouped under two broad headings. Tax Revenue and Non-Tax Revenue. The important sources of Tax revenue are explained below.

18.2.1 Tax Revenue

The revenue which is accrued by levying of taxes. Tax revenue has been divided into:

a) Taxes on income and expenditure
b) Taxes on property and capital transactions
c) Taxes on commodities and services

Taxes on Income and Expenditure

There are two types of income taxes, viz., personal income tax and corporation tax or tax on company profits.

i) Income Tax

Personal income tax is levied on individuals by the Central Government and proceeds are shared between the Centre and States. Income tax is levied on those people who are better off based on the principle of ability to pay. There are four income groups, viz., upto Rs.2,50,000; Rs.2,50,001-5,00,000; Rs.5,00,001-10,00,000 and above Rs.10,00,001. The lowest income group does not pay any tax because exemption limit of income tax is Rs.2,50,000. The remaining groups pay income tax ranging between 10 to 30 per cent.

The Income Tax Act permits certain deductions from the gross annual income e.g. standard deduction upto maximum Rs.30,000. The Income Tax Act also permits 20 per cent of savings is deductible from the income tax payable by an individual.

ii) Corporate Tax

The Corporate Tax is a tax on income of the companies. The Central Government imposes Corporate Tax on the profits of the large and small companies. The rates of Corporate Tax during 1998-99 were 35% of their net profit for domestic companies and 48% of their net profit for foreign companies.

iii) Interest Tax

The Interest Tax Act, 1974 provided for the levy a special tax en the gross amount of interest accruing to the commercial banks on loans and advances made by them in India.

The Government withdrew the interest tax in 1985 but later reintroduced it as an anti-inflationary measure. The revenue from interest tax was estimated at Rs.1000 crores in 1999-2000. In 2000-2001 budget, the interest tax of 2% paid by banks and financial institutions was abolished.

iv) Expenditure Tax

The expenditure tax was introduced by T.T. Krishnamachari when he was Finance Minister. This tax was imposed on hotels when the room charges for any unit of residential accommodation are Rs.400 or more per day per individual. In 2002-2003 budget anticipated a revenue of Rs.300 crores from this head.

The total revenue collected by the Central Government from all the taxes on income and expenditure is shown in the following table.

Table 18.1. Central Government Revenue from Taxes on Income and Expenditure

Items	1950-51 Actual	1980-81 Actual	2001-02 Actual	2011-12 Budget
1. Net personal income tax	90	510	32,000	
2. Corporation Tax	40	1,310	36,610	
3. Other taxes on income and expenditure	-	90	450	
Net Revenue	**130**	**1,910**	**69,060**	**4,94,799**

b. Taxes on Property and Capital Transactions

The Central Government also imposes certain taxes on wealth and capital transactions. The net income from this group was Rs.4 crores in 1950-51 and it rose to Rs.240 crores in 1990-91. But the revenue from these taxes is insignificant.

i) Estate Duty

Estate duty was imposed on the estates of a person which was inherited by his heirs. The Central Government imposes and collects this duty but the proceeds were passed on to the States. The rate of estate duty ranged between 4 per cent to 40 per cent. The Government collected estate duty of Rs. 15 crores and the entire proceeds were transferred to the States. As the tax yield was too low while the cost of administration was high, the Government abolished this tax **in March, 1985.**

ii) Gift Tax

A tax which is levied in every financial year, on gifts made in previous year is known as gift tax. This is levied in the same way as income tax on progressive rates. For the first time, the Gift Tax was imposed in April, 1958. It is a tax on gifts made during the previous year. The main aim of this tax is to check expenditure. Mr. Yashwant Sinha abolished the gift tax on the ground of its ridiculously low yield.

iii) Wealth Tax

This tax came into force in the year 1957. Wealth Tax has been imposed on accumulated wealth or property of every individual whose wealth is above Rs.2.5 lakhs. The rate of wealth tax is now quite low, ranging from 0.5 to 2 per cent. The collection from this source has gone down substantially. This tax was also abolished in the union Budget 2015-16 due to its meager net revenue.

2. Taxes on Commodities and Services (Indirect Taxes)

Revenue from commodity taxation is the most important source of taxation for the Central Government. Central Excise Duties and Customs duties are two important taxes of the Central Government.

i) Central Excise Duties

These duties are levied by the Centre on commodities which are produced within the country. They are popularly known as union excise duties. But commodities on which State Government impose excise duties, for example liquor and drugs, are exempted from Central Excise duties. Initially sugar, cotton, mill cloth, tobacco etc., were the goods, which yielded the most revenue by way of excise duties. Gross revenue from Central Excise Duties has risen from about Rs.70 crores in 1950-51 to Rs.6,500 crores in 1980-81 and Rs.1,21,633 Crores in 2004-05.

ii) Service Tax

The Government of India is now imposing service tax on telephones, insurance etc., with every pasing years, new services are brought under service tax. This tax is one of the fastest growing taxes for the Central Government. For instance, the yield from service tax has risen from Rs.407 crores in 1994-95 to Rs.2,610 crores in 2000-01. TheUnion Government expected an amount off Rs.1,24,000 crores in 2012-13. The Union Government has proposed a negative list of services in which services like education and health are exempted. All services which are not included in the negative list attract service tax.

iii) Custom's Duties

Customs duties or taxes are imposed on the export or import of any article. There are two types of levying customs duty on different commodities. If the customs duty is levied according to the price of the commodity it is called advalorem duty. If the duty is imposed according to quantity of the commodity is known as specific duty. There are wide range of imported items namely cars, woolen goods, television, VCRs etc. The proceeds from custom duty in the year 1990-91 were Rs. 20,644 crores which rose to Rs. 35,757 crores in 1995-96. The Government expected Rs.1,86,694 crores in the year 2012-13. The following table shows revenue from commodities and services.

Table 18.2. Revenue from Commodity Taxes

Rs. in crores

Items	**1950-51 Actual**	**1980-81 Actual**	**2001-02 Actual**	**2012-13 (B.E)**
1. Net Central Excise Duties	70	3,720	68,530	1,93,729
2. Customs Duties	160	3,410	47,540	1,86,694
3. Service Tax	-	-	2,610	1,24,000
4. Other commodity Taxes	**-**	**310**	**1,590**	
Total	**230**	**7,440**	**1,20,270**	**1,55,790**

Magnitude of Direct and Indirect Taxes

The following Table 18.3 exhibits magnitude of direct and indirect taxes of the Central Government.

Table 18.3 Direct and Indirect Taxes of the Central Government

Rs. in crores

Items	**1950-51**	**1990-91**	**2012-13**
Direct	174(43%)	11.030(16%)	5,64,337 (52.4)
Indirect	227(57%)	57,470(84%)	5,04,423(47.6)
Total Tax Revenue	401(100%)	68,500(100%)	10,77,611(100%)

From the above table, it may be observed that the share of the direct taxes in the total tax revenue has been coming down over the years from 43% to 16 per cent between 1951 and 1991 while the share of indirect taxes has been increased from 57 to 84 per cent. However, direct tax revenue is gradually growing in importance once again. For example, in recent years the ratio between direct and indirect taxes has been about 55 and 45. This change in favour of direct taxes is mainly due to the implementation of tax reforms.

18.2.2 Non-Tax Revenues of the Central Government

Besides tax revenue, the Central Government gets revenue from other sources also, which are called non-tax revenue. These non-tax revenues include receipts from fiscal services, interest receipts, dividends and profits of Government enterprises, general services etc.

The following table 18.4 shows receipts from non-tax revenue

Rs. in crores

Items	1970-71 Actual	2003-2004 Budget	2013-14 Budget
1. Interest Receipts	590	39,160	
2. Dividends and Profits	120	17,860	
3. Fiscal and other services	180	12,750	
Total	**890**	**69,770**	**16,65,297**

Non-tax revenue of the Central Government amounted to only Rs.890 crores in 1970-71 which has increased to Rs.1,64,694 crores in 2012-13.

18.3 REVENUE OF STATE GOVERNMENTS

According to the Constitution, the State Governments have financial power to raise their own revenues. State Governments in India to collect revenue from two sources to meet their expenditure. They are:

a) State Tax revenue
b) State Non-Tax Revenue

a. State Tax Revenue

The tax revenue of the States comprises of two parts. Taxes on income, taxes on property and capital transactions and taxes on commodities etc., come under one category and share in the Central Government taxes are the other. The first category is known as own tax revenue of the States and the latter is known as shared tax revenue

1. Taxes on Income

The State Government is getting revenue from taxes on income in three ways they are share in the income tax levied and collected by the Centre, agricultural income tax and profession tax. The share of income tax is the most important tax revenue. Agricultural tax and profession tax are the two taxes that are imposed and collected by the States themselves. In 2002-2003 budget, the proceeds of taxes on income were estimated at Rs.2,630 crores.

2. Taxes on Property and Capital Transactions

State Governments receive income from taxes on property and capital transactions. The main sources are land revenue, stamps and registration, and tax on urban immovable property. Land revenue is the most important source of income of States since 1951-52. During 2002-03, land revenue is expected to yield Rs.2,630 crores. At present, stamps and registration occupy a very important position in the group. The amount expected to be collected is about Rs. 13,260 crores in 2002-03.

3. Land Revenue

Land revenue is a tax levied and collected just after the harvest season. It is paid by the agriculturist after harvesting and marketing. It is based on the principles of certainty, convenience and economy. It is inelastic and bigger source of revenue to State Governments. But due to improvement of standard of living, flourishing business, excise duty and sales tax are getting dominance over land revenue. Different States have different rates of land revenue. In difficult situations like floods, famines and difficult circumstances, State governments either abolish or give rebate. In such case, the percentage of revenue from this source gets reduced. Several States have abolished land revenue and collecting only irrigation cess.

4. Agriculture Income Tax

The tax that is levied by the State Government on net agricultural income is called as agriculture income tax. Net agricultural income can be calculated by deducting expenses on irrigation, local taxes and land revenue paid etc. from gross income. This tax is levied on a slab system. At present, this tax is levied by Kerala, West Bengal, Maharashtra, Odissa, Tamil Nadu, Uttar Pradesh, Karnataka, Assam and Bihar. In order to achieve socialist pattern of society, small farmers are exempted from the tax and more tax is levied on rich farmers. The tax rate differs from State to State. The states which are imposing agricultural income tax are also imposing the tax mostly on plantation crops only and the revenue yielded very small.

5. Taxes on Commodities and Services

Like the Union Government, the State Governments too have found commodity taxes as the best sources of revenue. Share in union excise duties, state excise duties, general sales tax, motor vehicle tax, electricity duties, entertainment tax etc., are commodity and indirect taxes.

(a) State Excise Duties

Excise duties levied by Government of India are Central Excise duties. Some excise duties are also levied by the State Governments. The State levies excise duties on Ganja, Bhang, Charas, Opium and country liquor. The twin objectives of levying this tax is to increase revenue and to minimise the use of intoxicants and harmful shrubs.

In the beginning, the share of states in excise-duties was not much which is less than one crore in 1951 -52. Since 1956-57, the share has considerably increased and now it became an important source of revenue to States.In several states, it is the second largest source of revenue after sales tax.

(b) Sales Tax

The major and most important source of state revenue is sales tax. This is a tax levied on the sale and purchase of goods. This tax was first imposed in India since 1935. The Sales taxes are of two types 1) selective, and 2) general. Selective items are chosen depending on the social urgency of the concerned goods. Generally sales tax rate is more on luxury goods whereas it is less on necessary goods. The revenue from sales tax had increased from Rs.59 crores in 1951-52 to 3,890 crores in 1980-81 and is about **Rs.to yield 93,070 crores during 2002-2003.**

(c) Entertainment Tax

A tax levied on cinemas, theatre performance, exhibition, games etc., is known as entertainment tax. This tax is levied by State Government. The tax rate and procedure of levying entertainment tax varies from State to State. This is also an important source of state revenue. It is most elastic source of income as a small change in tax rate brings substantial increase in income. Due to rapid urbanisation, the collections of this tax have been increasing.

(d) Stamps and Registration Fee

The State Government collects stamps and registration fee. The stamps sold by the State government are two types, viz., court stamps and revenue stamps. The people who file suits in courts have to pay fee in the form of court stamps. On the other hand, revenue stamps are affixed on commercial items which is popularly known as 'pro note'. The revenue from this fee is considerable.

6. Revenue from miscellaneous taxes

In addition to the above important taxes, the^ State Government levies some other taxes such as passenger tax, electricity duty, profession tax etc. These are called miscellaneous items and provide considerable revenue to the State.

b) Non-Tax Revenues of the State

As indicated earlier, states have two non-tax revenue sources.

I. Grants-in-aid from Central Government

The State Governments are entitled for grants-in-aid from Central Government. The allocation of grant-inlaid to state government is based on the necessity and utilisation of the concerned state government. In special circumstances such as floods, drought and famines etc., the state government draws extra grant. After Independence, the grant-in-aid to states has considerably increased due to various developmental activities undertaken by the states. Grant-in-aid are provided to the State Governments according to the recommendations of the Union Finance Commission.

2. Share of Income Tax, Excise Duties and Estate Duty from Central Government

State Governments are entitled to get a definite proportion of net proceeds from income tax, central excise duty and estate duty collected by the Central Government. The sharing principles will be decided by the recommendations of finance Commission from time to time.

II. Other Non-Tax Revenues

Some of the Non-Tax Revenues of State Government are discussed below:

1. Contributions from Public Undertakings

The revenue from public enterprises and control over some trade functions come under this category. State Governments have control over state roadways and irrigation. Those who utilise the services have to pay charges. In addition, the State Governments are establishing industrial units and the profits of these units are a source of income to the States.

2. Market Loans, Overdrafts and Loans from Centre

According to Article 293(3) and (4) of the Constitution of India, the State Governments can take loans from the public with the permission of Parliament. In the same way, the state governments have also provision of overdrafts and loans from central government.

The revenue of State Governments is continuously increasing. The tax revenues of the states increased from Rs.280 crores in 1952 to Rs.2,15,050 crores in 2003. At present, 42 per cent of the net tax revenue of Central Government comes to state as share. Besides tax revenue, the other two important services of revenue are: non-tax revenues and grants from the Centre. Between 1952 to 2003, total non-tax revenue increased from Rs.120 crores to

Rs.91,890 crores. There is a manifold increase of Grants-in-aid from Centre. From 1952 to **2003,** the grants-in-aid increased from Rs. 30 crores to Rs. **54,100** crores.

18.4 REVENUE OF THE LOCAL GOVERNMENTS

There are four sources of revenue of local bodies in India. They are:

a. Taxes
b. Assignment of shares of taxes levied and collected by State Governments.
c. Grants-in-Aid from State Governments, and
d. Revenue from non-tax sources.

a. Taxes

The Taxation Enquiry Commission recommended that there should be certain taxes clearly earmarked for local bodies. These include taxes on land and buildings, octroi, and terminal taxes, taxes on vehicles, taxes on animals and boats, profession tax etc. The local bodies, now-a-days, are getting revenue from these sources. Some important taxes are discussed below:

(i) House Tax or Property Tax:

A tax which can be levied on all houses under the jurisdiction of a local body is known as house tax or property tax. This tax can be levied once in a year.

(ii) Profession Tax:

A tax that is levied on professions, calling etc., is called as profession tax. This tax is levied on a progressive nature but in many places it is proportional.

(iii) Vehicle Tax:

Vehicle tax is levied as a price for making use of the roads maintained by local bodies. This is levied on all types of vehicles except motor vehicles.

(iv) Toll Tax:

This tax is levied on the individuals, cattle and vehicles entering or passing through a particular area.

(v) Entertainment Tax:

This tax is levied on entertainments and amusements etc. This tax is levied and collected by State Government and proceeds are transferred to local bodies.

(vi) Octroi:

A tax that is levied on those commodities which are brought from outside into the territorial jurisdiction of a local body for sale and consumption.

(vii) Terminal Taxes:

A tax which is levied on every individual or thing who/which enters or leaves the territorial jurisdiction of a local body.

Apart from the above, the local government levies some other taxes, such as, conveyance tax, market tax, water tax etc.

b. Share of Taxes

There are few taxes which are imposed and collected by State Governments and the proceeds are shared by them with local bodies. Local bodies in all States receive a share of the proceeds of taxes like profession tax, motar vehicle tax, entertainment tax tax on registration etc. which are imposed and collected by the States. However, shared taxes or assigned revenues differ from state to state.

c. Grants-in-Aid from the State Government

Grants-in-Aid from the States form an important part of the revenues of the district local boards but not of other local bodies. The larger grants are given mainly for education, although in some states they are also given for medical and public health purposes. Road grant, JGSY grant. Union Finance Commission grant etc., are some of the grants provided to local governments.

d. Non-Tax Revenue

The non-tax revenue of local bodies consists of fees, fines and income from some public undertakings such as tramway, buses, distribution of electricity etc., Fees and fines are good sources of revenue for some municipal corporations. In rural local bodies, non-tax revenues' share in total revenue is very small.

TAXING THE AGRICULTURE SECTOR

Taxation of agriculture has a critical role to play in the acceleration of economic development since it is only the imposition of compulsory levies in the agricultural sector itself which enlarges the supply of saving for economic development. (N.Kaldor) Historically, differential tax treatment has been accorded to the agricultural and non-agricultural sectors. This has, indeed, violated the principle of horizontal equity. When the Central income-tax was introduced in 1886, agricultural incomes were excluded from the taxation powers of the central government, and the provinces were endowed with the power to tax agricultural income. Today, in the post-independence India, the same system continues. Item 82 of the Union List in the Constitution of India which includes specific powers of taxation to the Central Government reads. "Taxes on income other than agricultural Income". Thus, the power to tax agricultural income is kept outside the ambit of the Central Government's taxation powers.

Agricultural income tax, is being much debated since long. It has also acquired much importance in the context of current tax reforms. Much is being said about taxing of agricultural incomes. Several experts and committees have favoured the imposition of such a tax. At the same time arguments against this measure are also being put forward. We, therefore, deal with the subject to analyse the pros and cons of this issue.

Taxation of agriculture has a crucial role to play in the acceleration of development since it is only the imposition of compulsory levies in the agricultural sector itself, which enlarges the supply of savings for economic development. This view is based on the historical experience of Japan and Soviet Russia which had successfully mobilized agricultural surplus through land taxes and other compulsory levies. Burma and China have also raised large resources from the agricultural sector.

Agricultural taxation raises marketable surplus and thereby large resources are mobilized for development. When the economy develops, agricultural population gets absorbed in the non-agricultural activities. To feed them it is necessary that a part of the food-grains should be transferred from rural to urban areas. This is possible only if taxes are imposed on agricultural commodities especially food grains. Agricultural taxation induces farmers to improve their productivity and hence agricultural production thereby expands the base for indirect taxation. There is another reason why agricultural taxation is suggested. It is argued that the government has been investing increasingly larger amounts in agriculture. At the same time it has not taken considerable efforts to mop up a portion of the increase in income of the farmers. This is particularly true in the case of large farmers whose incomes have risen as a consequence of the process of economic development.

Agricultural tax has a long history in India. Before Independence the British provinces have different forms of land revenue assessment. After Independence, the Indian Constitution has assigned the subject of agriculture to the States. At present, agriculture is subjected to direct and indirect taxes. The direct taxes are levied by the state governments. Direct taxes include the land revenue and agriculture income tax. Agriculture income tax, land revenue and surcharge on cash crops are the state taxes on agriculture. Moreover, farmers are subjected to Gift Tax and Estate Duty before they were abilished. Agricultural property is exempted from Wealth Tax.

Land Revenue:

In ancient times, land revenue was a major source of revenue for various states in the world. In India, land revenue swelled the treasuries of the rulers since times immemorial. Land revenue refers to a State's share in the gross produce of land. The normal rate of land revenue was l/i2lh or l/6lh of the total produce. During an emergency, collection of more funds would become necessary for meeting the expenses of war, etc, when the rate of land revenue would be raised to almost 25 per cent.

Traditionally, land revenue is the oldest of all taxes and at present, the most important tax on agricultural land in several countries. In India,the land tax is levied and collected by State governments. They have followed different bases for the assessment or land revenue. For instance the land tax may be on net assets or on the value of the net produce. In the past, land tax assessment used to be revised periodically but this has been given up in recent years. Hence, its yield is very low and now it has become a crude acreage tax. The importance of land revenue has gradually declined in recent times as a result of the introduction and extension of many new taxes In 1951-52 land revenue accounted for 17 per cent of the total state tax revenue but by 1992-93 its share has declined to 1.3 per cent. More over, several staes in India have abolished the imposition of Land Revenue.

Defects of Land Revenue

The levy, collection and administration of Land Revenue suffers from certain defects.

1. The burden of land revenue is heavier on the poorer than the rich agriculturists, as its fixation is based on the taxpayer's net assets or on the annual value of the assets. Hence it becomes regressive. Of course, it can be made progressive also.
2. It is painful to the taxpayers because it is fixed; no consideration is given to the circumstances of a particular year.
3. Land revenue administration is complicated and the cost of collection is high.
4. It is the most inelastic source of revenue.
5. The pattern of land revenue is highly diversified. Even the basis of collection of land revenue is not uniform in all the States.
6. The basis of fixation of the rate of land revenue also varies form state to state. In few states, it is determined on the basis of the quantity of total crops, in other states it is based on the value of the crop.

Thus it is true to say that "it is uncertain in incidence, incorrect in assessment and collection, uneconomic in its administration, unequal in the distribution and inelastic and far from benefiting the cultivator who pays the tax; it is prejudicial to the growth of capital and improvement in agriculture",. However, it is not true to say that land revenue remained stagnant. Receipts from land revenue have increased in recent years, but its percentage to total tax revenue is declining. II: is interesting to note that the Taxation Enquiry Commission expressed the opinion that there is no real substitute for land revenue.

18.5 Agricultural Income Tax:

Agricultural Income Tax is levied and collected by the states. Bihar was the first to levy this tax in 1938. At: present the States, which are levying Agricultural Income Tax, are Assam, West Bengal, Bihar, Uttar Pradesh, Rajasthan Madya Pradesh, Orissa, Karnataka, Tamil Nadu and Kerala. it is levied in some States only on planation crops. The revenue from agricultural income tax was just one per cent in 1951-52, which declined to 0.1 per cent of the states revenue in 1997-98.and the situation is not much different now in almost all the staes where it is imposed.

1. Tax on agricultural income gives more income to the states and this is necessarily to enable them to perform their function effectively.
2. In the absence of a tax on agricultural income, there will be a great economic disparity between the agriculturist on the one hand and non-agriculturist on the other

3. A number of persons get their income from both agriculture and business. If only business income is taxed and the agricultural income is untaxed this is gross injustice to those who get only business income.
4. One of the defects of land revenue is that it is not in conformity with the ability to pay of the peasants. This defect is removed by the levy of agricultural income tax, which tends to remove the inequalities in land revenue.
5. Agricultural income tax will check the present tendency fo.' savings accumulated in industry to be invested in land to escape taxation.

The direct agricultural taxes consisting of land revenue and agricultural income tax have been yielding more incomes to the state governments. At present the increase in the yield of these taxes is much lower than the increase in state tax revenues. Accordingly, direct agricultural taxes as percentage of state tax revenue has rapidly declined from 18.6 per cent in 1951-52 to 1.3 per cent in 1997-98. This shows that agricultural sector is under taxed in our country.

An important issue is whether agriculture is under taxed. Following arguments have been put forward to support the view that agriculture is under taxed.

In spite of the rise in agricultural incomes, income to the states from land revenue and agricultural income tax as percentage to total agricultural taxes.

(Rs. In crores)

Year	Land Revenue	Percentage	Agri.Income Tax. Rs.	Percentage	Total Direct Agri. Tax. Rs.	Percentage
1951-52	48	92.30	4	7.70	52	100
1970-71	113	91.13	11	8.87	124	100
1997-98	1400	86.95	210	13.04	1610	100
2000-01	172	9.66	1608	90.34	1780	100

Source: RBI, Report on Currency and Finance, Various issues.

The percentage share declined in the case of land revenue in 1951-52 , 92.30 percent to 9.66 per cent in 2000-2001. **Where as in the case of agricultural income percentage increased slightly 7.70 in 1951-52 to 90.34 per cent in 2000-01.**

Agriculture sector has been a major beneficiary of expenditure under the plans. Ft has been heavily subsidized through low cost pricing of water, power, fertilizers etc., There has been a considerable improvement in productivity of agricultural crops under green revolution. Hence, this sector cannot be left over from the tax net.

RAJ COMMITTEE REPORT:

On the recommendation of the Chief Ministers Conference on resource mobilization, the central government appointed the committee on Taxation of Agricultural Wealth and income under the Chairman ship of Dr.K.N. Raj in February 1972 to examine the question of taxation of agricultural wealth and income. It: submitted its report on 31st October 1972.

The major recommendations of the committee were

1. A progressive Agricultural Holding Tax (AHT) should be imposed on agriculturists who have no other income.
2. Income from agriculture should be included in the total income for the purpose of calculating tax.
3. Income from Livestock, fisheries, poultry dairy farming etc., should be subject to tax.
4. An integrated taxation of agricultural property through wealth tax should be introduced.
5. Capital gains tax on transfer of agricultural lands should be imposed.

Partial integration of agricultural and Non-Agricultural Income:

Another major recommendation of the Raj Committee was integration of both agricultural and non-agricultural incomes for the purpose of income tax. This aggregation would be done only if an assesses, had taxable income exceeding the minimum exemption limit for Income Tax. The rate of income tax on non - agricultural income would be determined in the following manner and order.

i. the initial exemption allowed out of non-agricultural income (RS.8000),
ii. agricultural income
iii. balance of non-agricultural income.

Besides the central income tax, the tax payer will pay AHT as well if his farm income is above Rs.5000, as recommended by the Committee. Agricultural income for purposes of partial integration will comprise broadly:

I. Rent or revenue derived from agricultural land situated in India.
II. Income derived from agricultural operations and
III. Income derived from agricultural house property.

The first category of income will be computed after allowing for expenditure incurred for earning such income.

In the second category of income, procedure followed for computing profits and gains of business or profession under the income tax act would be applicable.

For the third category, the rules applicable for computing income from house property under the Income Tax Act will be applicable .

Integrated Taxation of Agricultural Property through Wealth Tax,

The Raj Committee recommended that the AHT should be supplemented with a tax on agricultural property and capital gains arising out of transactions in such property. For this purpose, the valuation of farmland may be done by taking 4 to 6 times the retable value of holding averaged over a period of years. The exemption limit; for this tax should be Rs. 1.5 lakhs. The tax should be levied on family basis.

The Committee has further suggested that Hindu undivided family should not be recognized as a tax entity. Income from livestock, fishery, dairy farming and poultry should be subjected to income tax. Irrigation water should be viewed as an input and should, therefore, be priced to cover the cost of providing it.

Agricultural Holding Tax (AHT)

Agricultural Holding Tax is the most important recommendation of the K.N. Raj Committee, which seeks to remove the two most serious shortcomings of the present land revenue system.

Firstly, the incidence of land revenue in relation to the productivity of land is not uniform over different parts of the country because land revenue settlement has been done under different systems and at different times in different parts of the country.

Secondly, land revenue is assessed at a flat rate per hectare and hence is not progressive. AHT is expected not only to correct these two defects but also to yield substantial revenue for financing development plans of the states. This tax would consider the differences in the productivity of land all over the country. The basis of this consideration would be the adoption of certain objective criteria

And uniform procedures. The tax would further reflect broadly the degree of progression applicable to other sectors of the economy.

Computation of Agricultural Holding Tax

In order to compute Agricultural Holding Tax, first there is every need to know what is meant by Agricultural Holding. Agricultural Holding was defined as an operational land, minus leased out land, plus land leased in. Only registered leases are to be taken into account.

Agricultural Holding Tax is defined as a tax of the net rateable value of an agricultural land holding. In other words it is a tax on net farm business income.

AHT = X/2 per cent of the net ratable value of a holding in which X = number of thousand rupees

Net ratable Value: gross ratable value minus the development allowance (which is 20% of ratable value subject to a maximum of Rs. 1000)

The committee gave the following example. Suppose the rateable value of an agricultural holding is Rs. 10,000 and the development allowance is Rs. 1000.The

A H T should be calculated as follows.

Gross Rateable Value =	Rs. 10,000
Development Allowance	=Rs. 1,000
	Rs. 9,000

X = 9

Now AHT $= \frac{X}{2}\%$ X Rs.9000

$= \frac{9}{2}\%$ X Rs.9000

= Rs. 405.

If the gross ratable value of agricultural holdings is Rs. 20,000 and its net ratable value is Rs. 19,000, the AHT will be

$$= \frac{19}{2} x \frac{1}{100} x\, Rs.19{,}000$$

= Rs.1,805

For holdings of rateable value below Rs.600/- AHT may be fixed at a flat rate or Re. 1 per holding.

Wealth Tax:

Wealth tax is a tax, which is levied on the net wealth of an individual. It is also known as a tax on capital or property taxation. Wealth tax is different from income tax, which is a tax on income and paid out of income. Wealth is a stock whereas income is a flow. Wealth taxation comprises all those taxes, which are assessed on wealth or capital but paid out of income, and those taxes, which are levied on capital and paid out of capital.

Capital tax is a tax on the value of the capital asset. It may be imposed upon the annual yield of the capital asset or upon the annual value of the capital asset. A capital levy on the other hand is a once for all tax levied upon capital assets. It may be collected in installments from the tax payers. It is general when it is levied on all capital assets at a particular time for a specified purpose usually to pay off national debt during war. It is particular when it is levied on a few capital assets only as in the case of inheritance tax.

Case for Wealth Tax

1. The welfare of an individual not only depends upon the income, which he enjoys, but also the wealth he owns. The possession of wealth confers many advantages to the owner. Thus, the basic justification of wealth tax is that personal wealth is a good base for direct taxation.

2. An annual wealth tax is preferable to the income tax on the ground that it does not differentiate risky investment, and this will not have disincentive effect. On the other hand, a steeply progressive income tax creates adverse effects on investment.
3. Wealth tax is justified on equity grounds also. Equity in taxation means that tax burden should be imposed according to taxable capacity. Income and wealth together determine the economic well being of a person. Hence a combination of income and wealth tax will satisfy the canon of ability to pay.
4. A combination of income tax and wealth tax provides a better check on tax evasion and avoidance. It is for this reason that N. Kaldor strongly recommended this tax in India.
5. Under income tax, certain forms of socially unproductive wealth, such as gold or jewelry are completely exempted, as they do not yield income. Wealth tax prevents socially unproductive hoarding.
6. A wealth tax being an additional tax on property incomes, helps to reduce inequalities, of wealth and concentration of wealth.
7. Wealth tax is paid out of current income and therefore reduces current consumption. This diverts resources from consumption to investment, and helps as an anti-inflationary measure.
8. In a developing economy wealth tax mobilizes resources for economic development.

18.5.1 Case Against Wealth Tax

1. It is argued that wealth tax is not equitable as it imposes a heavier burden on the taxpayers who possess wealth but receive no income.
2. The general argument that a direct taxs discourage production is applicable to Wealth tax.
3. It is a poor tax from the administrative point of view. Two problems have been stated in this regard, namely the problem of discovery and the problem of valuation. The understatement and concealment of property reduce the revenue from wealth tax.

18.5.2 Wealth Tax in Developing Countries:

A tax in a developing economy should be able to divert resources from consumption to development. An annual tax on wealth will prove to be a good source of revenue to the government. According to Kaldor it should become an essential element in the tax structure of an under developed economy. Its incidence falls equally on all kinds of property. In a developing economy increased government investment in agriculture and irrigation, has appreciated the property values. Therefore a general capital tax is justified. Thus wealth tax can be used as a good source of development finance.

18.5.3 Wealth Tax in India

Following the advice of Kaldor, the Indian Government has introduced the personal net-wealth tax in India. This tax was imposed on the net wealth of the individuals, Hindu undivided families and companies. It was justified on the grounds of equity and administrative efficiency. The wealth tax is progressive with exemption limit of Rs.1 Lakh in the case of individuals and Rs.5 lakhs for companies. According to 1979 Act, no wealth tax is payable where the net wealth is less than Rs. I lakh. In 1980 the exemption limit has been increased from Rs. 1 lakh to Rs. 1,50,000. Restructuring the wealth tax rate schedule the exemption limit was again raised to Rs.2,50,000 in 1985-86 and to Rs. 15,00,000 in the year 1992-93, which has remained the same since then. Wealth exceeding this limit would be taxed at the rate of one per cent.

Certain exemptions and concessions are allowed for agricultural property, charitable trusts, personal assets, provident funds, insurance, policies etc. The revenue growth of wealth tax is significant. It was only Rs.8 lakhs in 1960-61, which has grown to more than Rs.1000 croresby 2014-15. The Union Government abolished this tax from the financial year 2015-16 as the cost of collectionand litigation is more than the revenue actually accrues to the government. So at present there is no wealth tax in India.

18.6 Summary

- In India, the revenue of the Central, State and local governments come from tax and non-tax revenues. Taxes are the major source of revenue.
- Revenue of the Central Government has been grouped under two categories. They are: Tax revenue and non-tax revenue. Tax revenue has been divided into taxes on income and expenditure, Taxes on property and capital transaction, and taxes on commodities and services. Besides tax revenue, the Central Government gets revenue from non-tax sources. Receipts from fiscal services, interest receipts, dividends and profits etc., are included in the non-tax revenue.
- Revenues of the State Governments are also categorised into tax revenue and non-tax revenue.
- The tax revenue of the States comprises taxes on income, taxes on property and capital transactions and taxes on commodities.
- The non-tax revenue of States includes grants-in-aid from the Central Government and other non-tax revenue which comprises fees, fines, dividends.
- In India, local bodies have four types of revenue sources. They are: taxes, assigned revenue, grants-in-aid from the state governments and non-tax revenue.

18.7 SELF ASSESSMENT QUESTIONS

1. Examine the Chief Sources of Revenue of the Central Government.
2. What are the main sources of revenue of the State Governments in India?
3. which of the two taxes ie., direct or indirect taxes dominate the Indian scene?
4. Importance of Agrcultural taxation in India.
5. Discuss the role of Indirect taxes in India. Why do such rely heavily on indirect taxes ?
6. “Contribution from direct taxes is meager in India”Discuss. Would you assign a greater role to direct taxes in India? Give reasons for your answer ?

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LESSON No. 18

Reforms in Direct and Indirect Taxes, Taxes on Services

Structure

19.0 Objectives:

- After going through this lesson, you should be able to know the
- Salient features of Indian Tax System
- Defects of the Indian Tax System
- The major recommendations of various taxation enquiry committees
- A brief explanation about the implementation of VAT in India.

19.1 Introduction:

Taxation is an important source of revenue. It helps in securing social justice, reducing inequalities in income and wealth, mobilizing savings and discouraging undesirable investment. The Economic Bulletin for Asia and Far East observes, "Taxation remains as the only effective financial instrument for reducing private consumption and investment and transferring resources to the government for economic development".

After independence, Government of India has appointed various committees to suggest ways for improving the tax structure in the country. We here give the recommendations of some important committees.

19.2 Taxation Enquiry Commission

In 1953, the government of India appointed Taxation Enquiry Commission under the Chairmanship of Dr.John Mathai. It examined the incidence of taxation, the suitability of the tax system, effects of taxation on capital formation and the use of taxation as a fiscal instrument to control inflation and deflation. The Commission submitted its report in February 1955. It is divided into three volumes. The first deals with tax system as a whole, the second with central taxation and the third with the state and local taxation.

19.2.1 TAX SYSTEM:

The Commission analysed only formal incidence and not effective incidence. Formal incidence refers to the money burden of tax while effective incidence signifies the real burden of tax. The Commission confined itself to formal incidence due to the complexity of effective incidence. It also studied the problem of incidence with reference to rural and urban population. There have been no major shifts in income from the urban to the rural sector of the economy and vice versa. Urban indirect taxation is more progressive than rural taxation. Indirect taxes can be used as a means of progressive taxation in a limited way. There is scope for widening the base of taxation. On the whole, it can be stated that the total burden of taxation has increased in urban sector as compared to the rural sector.

The Commission also suggested that direct taxes should be made more progressive to avoid inequality. It also recommended additional taxation of luxury and semi luxury products. With regard to the suitable tax system for the country the Commission observed that "on the whole the kind of tax system which would be best adopted to meet the requirements of the Indian economy, having regard to the development programme and the resources required for it appears to be one which would increase the resources for investments available to the public sector with as small a diminution as practicable of investment in private sector, and which, therefore is accompanied by the largest possible restriction on consumption by all classes. Restraint on the consumption of higher income groups must of course, be greater than in respect of low income groups"

The Commission felt that the difference in consumption levels will affect the willing ness to work of the people. Therefore, it suggested a ceiling on net personal income, which should not exceed 30 times of the prevailing average per family income in the country. This should be achieved gradually over a period of time.

Additional revenue can be raised by an increase in income tax and excise duties, a moderate land revenue surcharge, an increase in the rates of agricultural income tax, more extensive use of property taxation, taxes on transfer of property by local bodies and widening of coverage and rates of sales taxes.

As the tax revenue in India is only seven to eight percent of the national income, there is every possibility of additional taxation before the limit of taxable capacity is reached. The Commission also pointed out that there is greater scope for indirect taxes like Central excise and State sales taxes. It also suggested the setting up of an All India Taxation Council for securing coordination of tax policies and administration between the Centre and the States. The council should have a permanent secretariat in the form of a tax setting up of a committee for formulating an adequate railway freight rates policy. This committee should have some officials of Railways, of the ministries concerned and Planning Commission as members.

19.2.2. Central Taxation

With regard to central taxation, the commission recommended that certain receipts like premium on lease, sale proceeds of patent rights; copy rights and compensation for loss of employment should be taxed. No distinction should be made between agricultural and non-agricultural income for purpose of taxation. Debts foregone by a creditor should be treated as income to the debtor. Unclaimed wages should be treated as income after three years. Business losses should be allowed to be carried forward indefinitely and should be allowed to be adjusted against any business.

The commission also recommended the continuation of the existing system of giving rebate at the rate of one anna per rupee on the undistributed profits. Tax holiday for a period of six years should be given to new firms.

Regarding the rate structure of income tax, the commission felt that 85 per cent on incomes above 1.5 lakhs is the limit. It recommended the reduction in the lowest taxable limit from Rs.4200 to Rs.3000. Tax exemption limit should be increased from Rs.1500 to Rs.2000 for married persons and reduced to Rs. 1000 for bachelors. All incomes above Rs.24,000 should be treated as unearned income. The, commission also suggested that the existing system of abatement should be increased from one sixth to one fifth with a maximum limit of Rs.dl6,000 for undivided Hindu Joint Families and of Rs.8,000 for others. It also recommended that the name 'super tax on companies' should be changed as corporation tax.

In order to solve the problem of tax evasion, it recommended the following measures:

i. Income tax officers should be given permission to enter into business premises to inspect the accounts and the documents.
ii. Every assesses should submit a statement of his assets and liabilities every three years.
iii. The maximum limit of penalty should be increased to three times of tax evaded.
iv. An income tax investigation commission should be set up to investigate cases of tax evasion.

Regarding estate duty, the commission suggested a reduction in the existing limit of one lakh of rupees. It also felt that there is no possibility of increase in income from import duties. Export duties may bring in more revenue as exports get diversified. In the field of excise duty, the commission made a number of recommendations.

i. It recommended enhancement of duty on all varieties of cloth on a moderate scale
ii. It also recommended an increase in the rates of taxes in the case of sugar, kerosene, loose and packed tea.
iii. Surcharge on cigarettes should be abolished. The loss of revenue should be compensated by an increase in the rate of cigarettes.
iv. It also suggested the imposition of new duties on woolen textiles, electric lamps, paper sewing machine etc.

19.2.3. SERVICE TAX

The introduction of service tax in 1994-95 ushered in a major structural change in indirect taxes in the form of a wider tax base and facilitated for process of rationalization of excise duties resulting in lower tax burden on productive sectors. Over the years , there has been an increase in the number of services and the rate of service tax leviable. The budget for 2011-12 retained the sercice tax rate at 10 per cent and focused on achieving a closer fit between the present service tax regime and the proposed GST. This was sought to be done by adding a few new services on the ability to pay principle, expandig or rationalizing the scope of existing services, rationalizing certain provisions relating to important services and valuation, modifying provisions of the Cenvat credit scheme seeking to effect the right balance between input credits and output tax, and harmonizing the provisions of the scheme across goods and services, incentivizing honesty and penalizing dishonesty in compliance, and adoption of point of taxation rules to facilitate accrual basis of the collection. During 2012-13, 2015-16 the rate of service tax was raised to 12 to 14 per cent .As against the usual practice of expanding the list of services, the budget for 2012-13 introduced a negative list approach effective July 1,2012.

19.2.4. STATE TAXATION:

The commission felt that sales tax should be a State tax. Inter state sales may be the concern of the Union. It was against the levy of sales tax on services and newspapers. In order to cover the low-income group under taxation, the commission suggested a low rate of multipurpose tax system. There should also be a single tax for the middle and higher incomes. In order to bring about coordination and uniformity the committee suggested the Heads of the Sales Tax Departments of all states to meet atleast once In a year. It also recommended the establishment of Sales Tax Advisory Committees and Sales Tax Tribunals in each state.

The commission considered that uniformity In the rates of stamp duties Is neither necessary nor desirable. The commission recommended the replacement of slab rate of entertainment tax by tax imposed on per centage basis. It should be graded on a very broad basis. Tax on prize should be taken over by the Central Government. Duties on lights and fans should be low; tax on domestic appliances should be lowered and tax on Industrial consumption should be extremely low. Since sales tax on motor vehicles is a tax on passengers and goods, is recommended its abolition where sales tax on vehicles is high. The commission recommended the adoption of Agricultural Income Tax by all the states to achieve unity in the tax structure. All agricultural income above Rs. 3,000 should be taxed. Betterment levy should be fixed at t maximum of 50 per cent of the increase in the value of land due to irrigation and its recovery should be spread over a long time.

19.2.5. Local Taxation

The commission recommended the following taxes for the local authority:

1) tax on land and buildings; 2)taxes on goods entering into the local area. 3) tax on vehicles 4) taxes on professions, trades, callings and employments; 5) taxes on animals and boats; 6) taxes on advertisements; 7) taxes on theatre,-8) taxes on goods and passengers carried by road and inland waterways; and 9) tolls.

The commission also recommended a system of grants in aid. The local bodies should be given a basic general-purpose grant. For this purpose, local bodies should be classified on the basis of population, area and resources. The basic grant should be given for three or five years. In addition to this, specific grants should also be given to the local bodies.

Though the commission recommended the abolition of Octroi duty, it could be achieved only in the long run. Therefore, it made the following suggestions to remove the defects of the tax:

i. Octroi should be levied on the basis of weight and not ad valorem;
ii. The collection of octroi should be supervised frequently;
iii. Existing rates on food articles should not be permitted.
iv. The Introduction of terminal tax may be permitted in suitable cases.

Other important recommendations are as follows:

i. The annual value of the property should be the basis for property tax.
ii. The levey of land cess should be replaced by surcharge on land revenue.
iii. A tax on profession should be replaced by Surcharge on land revenue
iv. Tolls should be abolished except on bridges costing above Rs.5lakhs. The loss of revenue should be compensated by motor vehicles tax.
v. A tax on profession should be a tax belonging to the local bodies, It should be assessed on the basis of income. The maximum limit should be increased from Rs.250 to 500.

19.3 Kaldor's Recommendations:

Though the recommendations put forward by the Taxation Enquiry Commission were significant and were accepted with some modifications, but it was felt that it failed to explain how to explore the resources for the Second Five Year Plan.In January 1956 Government of India invited Prof. Nicholas Kaldor to review the entire tax system and suggest appropriate measures for making improvements. Kaldor submitted his report," Indian Tax Reform" in March 1956. He gave a number of far-reaching suggestions. He pointed out that the revenue of the centre and states was only seven per cent of the national Income and the tax revenue did not show any increase in yield with the increase in production. He considered India's direct taxation as inequitable and inefficient. It is inequitable because the base of taxation i.e., income is defective as income can be easily manipulated by the taxpayers. It is inefficient because of large-scale evasion through concealment or understatement of profits. To remove these defects, Kaldor recommended an annual tax on wealth, a tax on capital gains, a general gift tax and a personal expenditure tax.

Expenditure tax is a tax on personal consumption expenditure of the taxpayer. This tax is payable on expenditure in excess of Rs.10,000 per annum. Tax rate is calculated on a slab system rising from 25per cent for expenditure between 10, 000 and Rs.12,500 to 300 per cent on expenditure in excess of Rs.50,000 per annum. All investment expenditures will be exempted from taxation. Business expenses, gifts, dowries, funeral and birth expenses, medical expenses up to a certain amount will be exempted. Expenditure on durable consumer goods can be spread over a period of years.Wealth tax is a tax on the wealth of a person based on the value of total net assets. Wealth tax includes all forms of property including agricultural property, real estate, ownership of stocks and shares, bank balances, jewels and valuables.

Kaldor recommended that all capital gains should be taxed. A flat rate of seven annas in a rupee will be levied once the income (including all capital gains) exceeds Rs.25,000. Kaldor also suggested that substitution of gift tax to estate duty. It will be a tax on all gifts. Gifts over and above Rs.10,000 will be taxed at a rate of 10 per cent if the net wealth is between Rs. 1,00,00.0 and Rs. 1,50,000; 20 per cent between Rs. 1,50,000 and Rs.2,00,000 and so on; and the rate becomes 80 per cent if the total estate (including the gift) of the donee exceeds Rs.20,00,000.

Kaldor justified his proposals by arguing that they would prevent tax evasion because "If all these taxes were assessed at the same time, by the same authority, and on the basis of a single comprehensive account submitted by the taxpayer, evasion and concealment would become more difficult, not only on account of the difficulty of the individual taxpayer to conceal consistently particular receipts on items of property but owing to the fact that the evidence furnished by one taxpayer directly serves as a check on the return furnished by others".

It is opined that if Kaldor's recommendations, if implemented would bring equity and fairness in the distribution of tax burden. But the capital gains tax, the gift tax and wealth tax would reduce the incentive to save and curtail capital formation. Kaldor did not recognize the problem of tax evasion. Further, the new taxes would create a multiplicity of taxes, which would be difficult to administer. Such a tax system should be condemned. It is further observed "First of all, there is income tax on what you earn. Then there is the expenditure tax levied on what you spend, the wealth tax on what you save, the gift tax on what you give in your life-time and finally the estate duty on what you are unwise enough not to give away or spend before you die. India has too little to save, to little to invest, too little to gift and too little to spend, then all this multiplicity of taxes seems like much of a muchness for nothing very much at all".

19.4 BOOTHALINGAM COMMITTEE REPORT

Boothalingam Committee submitted its report on rationalization and simplification of the tax structure in 1967. The recommendations of the Committee are as follows:

1. The committee recommended the continuation of the existing system of excise duties on commodities like tea, coffee, sugar, unmanufactured tobacco, mineral oils, rayon, paper cement etc. It recommended the introduction of a "General Excise Duty". It should be ad valorem in nature. As it will be of universal application, it is necessary that the rate should be relatively low.
2. As regards customs duties, the Committee recommended rationalization and simplification of import duties. It recommended only few rates of customs duties instead of large number of rates.
3. With regard to the determination of business profits and corporation tas, the Committee stated that a distinction has been made between income tax on companies and other non-corporate assesses. Progression was applied only to the latter. The Committee felt that the difference between closely held companies and other companies, has no justification. Therefore it recommended that the principle of progression is relevant to personal taxation and not to company taxation.
4. The dividend Tax aimed at the retention of profits by the companies for further development. But the Committee recommended the abolition of the tax as nothing good came out of the dividend tax.

5. The committee examined the case for the Sur-tax on profits or Super Profits Tax and came to the conclusion that it has no validity in the long run. It penalizes the more effective use of capital.
6. In Income-tax Acts, total income is the tax base. But the Committee wanted to use the term 'tax-base for the sake of clarity.
7. Though the development rebate was welcomed by industry generally, the Committee recommended its abolition as it led to wasteful use of capital.
8. With regard to depression, the committee stated that depreciation allowance is not adequate due to rapidly rising prices. Therefore, it recommended that depreciation should be allowed in such a way that 20 per cent more than the original cost should be provided for.
9. The committee recommended a uniform rate of 45 per cent profit tax to priority industries.
10. The Committee felt that as cooperative societies are subject to certain handicaps as compared With companies, the tax rate on cooperative societies should be 10 per cent less than on companies.
11. The Committee recommended that the exemption limit on income tax should be raised to Rs.7,500 for individuals and Rs.10,000 for Hindu Undivided Families.
12. The Committee pointed out that the liability to pay the gift tax is formally laid on donee. So all gifts received by a person in a year should be added up and the total should be subjected to gift tax.
13. The committee recommended that fiscal policy should be correlated with economic policies for mobilising the savings of community.

The government of India accepted the proposals to raise income-tax exemption limit and abolition of Annuity Deposit Scheme.

19.5 WANCHOO COMMITTEE REPORT (Direct Taxes Enquiry Committee)

The Government of India appointed a committee under the chairmanship of K.M.Wanchoo in 1970 to examine and suggest measures to check tax evasion and avoidance

The Committee submitted its Report in December 1971.

The term 'black money' is generally used to denote un-accounted money or concealed income and /or undisclosed wealth, as well as money involved in transactions wholly or partly suppressed. Tax evasion and black money are closely and inextricably inter-linked. While tax evasion leads to the creation of black money, the black money utilized secretively in business for earning more income inevitably leads to tax evasion. The effects of black money on the country's economy are disastrous. Economic development is seriously handicapped because resources needed for development are not adequately forthcoming as business is carried on in the black; it leads to a distortion in the use of resources, diverting them to lavish and conspicuous consumption. The committee estimated income on which tax has been evaded would probably be Rs.700 crores and Rs.1000 crores for the year 1961-62 and 1965 respectively. Projecting this estimate further to 1968-69 on the basis of the per centage of increase in the national income from 1961-61 to 1968-69 (about 100 per cent), the income on which tax was evaded for 1968-69 can be estimated at a figure of Rs. 1,400 crores. The extent of income tax evaded during 1968-69 would be of the order of Rs.470 crores, being one-third of Rs. 1,400 crores. The money value of deals involving black money may, therefore, be not less than Rs.7000 crores for 1968-69.

The committee listed the causes of tax evasion as follows:

1. High rates of taxation under the direct tax laws.
2. Economy of shortages and consequent controls and licences.
3. Corrupt business practices
4. Donation to political parties

5. High rate? of sales-tax and other levies.
6. Ceilings on, and disallowances of, business expenses.
7. High rates of sales-tax and other levies.
8. Deterioration In moral standards.
9. Ineffective enforcement of tax laws.

Certain measures have been taken from time to time in the past for preventing tax evasion e.g., stiffening of penalties for evasion, greater publicity in respect of tax offenses and gearing up the tax administration. Similarly, measures for tackling black money built up out of past evasions have included the denomination of high denomination notes and voluntary disclosures of suppressed incomes in 1951 and again in 1965. The committee did not favour a voluntary disclosures scheme as it would shake the confidence of honest tax-payers and would have a deleterious effect on the level of compliance among tax-payers and on the morale of the administration.

19.6 RAJ COMMITTEE On Taxation of Agricultural Wealth and Income

The Government of India appointed a Committee on Taxation of Agricultural Wealth and Income under the Chairmanship of Dr. K.N.Raj in February 1972 to examine the question of taxation of agricultural income and wealth from all aspects. It submitted its report in 1972. The major recommendations of the Committee are:

1. A progressive Agricultural Holding Tax should be imposed on agriculturists who have no other assessable income.
2. In the case of assesses having non-agricultural taxable income, income from agriculture should be included in the total income for the purpose of calculating income tax.
3. Income from livestock, fisheries, poultry, dairy farming etc should be subject to tax.
4. An integral taxation of Agricultural property through wealth tax should be introduced.
5. Capital gains tax on transfer of agricultural lands should be imposed.

Raj committee recommended integration of agricultural and non-agricultural incomes only if the assesses had taxable income exceeding the minimum exemption limit for income tax. The tax rate suggested by the Committee is given below.

IT on the first Rs. 5,000	Nil
IT on the new Rs. 5,000	10%
IT on the new Rs. 5,000	17%
IT on the new Rs. 5,000	23%
IT on the new Rs. 5,000	30%
IT on the new Rs. 5,000	40%
IT on the new Rs. 1,000	50%

Raj Committee recommended that the Agricultural Holding Tax should be supplemented with a tax on agricultural property and a tax on capital gains. It proposed to do away with all exemptions. Wealth tax should be levied on family basis. It also recommended that the definition of the capital as3et should be widened to permit taxation of capital gains from transfer of all agricultural land irrespective of their location. Gains from transactions in assets held for not more than a year should be treated as ordinary income and taxed accordingly. It also suggested that income from livestock breeding and poultry and dairy farming, should be subjected to income tax.

19.7 JHA COMMITTEE REPORT- INDIRECT TAXES ENQUIRY COMMITTEE

The Government of India appointed an Indirect Taxation Enquiry Committee under the Chairmanship of L.K.Jha in 1976. It submitted its final report in 1977.

The main recommendations are:

1. In order to achieve progression in tax structure and to fulfill economic priorities tax structure should be rationalized
2. Duties on raw materials should be rationalized so as to lower the cost of production in the economy as a whole.
3. Steps should be taken to solve the problem of cascading. Value Added Tax should be introduced. It is a tax on all goods and services and it falls on the value added at each stage.

Import duties fall mainly on raw materials, intermediate products and machinery. This will increase the cost-price structure making our industry less competitive in the international market. The Committee recommended a reduction in taxation on inputs and machinery. This will help in achieving our economic objectives.

In the field of Sale tax, the Committee recommended that the state governments should move to a single point sales tax at the final stage. The Sales of inputs to manufacturers should be free from taxation. The interstate sales tax now subject to ceiling of 4 per cent should be brought down to one per cent. The committee also recommended the abolition of octroi.

19.8 CHOKSI COMMITTEE REPORT

The Direct Tax Laws Committee was appointed under the chairmanship of C.C Choksi. It submitted its report in 1978.

The Committee observed that the problem of simplification and rationalization of tax should be done in the light of the background of the economic activity in which the tax laws operate. It also observed that it is impossible to simplify tax laws. It emphasized the need for continuous fiscal research. It also observed that it is impossible to simplify tax laws. It emphasized the need for continuous fiscal research. It did not accept a switch over from income to consumption as tax base.

Regarding income tax, the committee recommended that the tax rates should be specified in a schedule instead of being laid down from year to year in a separate Act of Parliament. The maximum marginal rate of tax should be 60 per cent for income above Rs.2 lakhs. The surcharge on income tax should be abolished. With regard to Agricultural Income Tax, the Committee insisted on the continuation of the scheme of integration of agricultural income with non-agricultural income. Agricultural income tax should be imposed under a Central Act. If the center is not in favour of imposing agricultural Income tax then the Central Government may advise the state governments to introduce it as an early date. The legislation should be uniform in all states, on all categories of income

Including plantations, cash crops or food crops. Further for easy administration, the law should provide for a flat determination of income taking into account the category of the land and the nature of agricultural activity carried out. The state law should provide for taking the non-agricultural income of a taxpayer into account for determining the rate of tax applicable to his agricultural income.

It considered the idea of having uniform definition for the term 'salary' for different purposes as unnecessary. The standard deduction should be fixed at 20 per cent at all levels of salary. The standard deduction should be applicable to pensioners at a rate of 10 per cent subject to a ceiling of Rs. 1000 per year. In case of arrears, it may be spread equally over five years including the year of payment. In the case of gratuity compensation etc, they may be spread over the last five years including the year of retirement.

Capital gains should also be taxed if the sale of immovable property is evidenced in writing. Capital gains accruing from self generated assets should also be taxed.

Regarding Sur-tax, the committee insisted that the levy of Sur-tax shduld not be merged with the income tax on companies. The statutory deductions under Sur-tax Act should be increased from 15 per cent to 20 per cent of the capital.

In calculating the net wealth for purposes of wealth tax, debts used for buying property should be disqualified from deduction. Provision should be made for avoiding double assessment. A specific provision should be made in the Wealth Tax Act to exempt the net wealth of all such institutions, which are exempted from income tax.

The committee recommended the continuation go Gift Tax Act in its present form. The definition of company as contained in the Income-Tax Act should apply for the purpose of the Gift Tax Act too. The committee suggested the following rates of gift tax.

Rs. 20 lakhs to Rs. 25 lakhs	65 per cent
Rs. 25 lakhs to Rs.30 lakhs	70 per cent
Rs.30 lakhs and above	75 per cent

In the case of estate duty, the miximum rate should be fixed at 80 per cent. For the value of Rs. 20 lakhs to Rs.25 lakhs, the rate should be reduced from 85 per cent to 60 per cent. For the value of Rs.25 lakhs to Rs.30 lakhs, the rate of duty should be brought down from 85 per cent to 70 per cent. For properties exceeding Rs.30 lakhs, the rate shuld be fixed at 80 per cent.

19.9 RAJA CHELLIAH COMMITTEE RECOMMENDATIONS

Chelliah Committee Report on Tax Reforms was submitted to the Government of India in 1992. The recommendations of the Committee are as follows:

19.9.1 Major objectives of Committee:

1. The Committee recommended the lowering of the corporate tax for all domestic companies from 51.75 per cent to 45 per cent in 1993-94 and to 40 per cent in 1994-95.
2. The multiplicity of rates of excise duty should be reduced to two or three rates at 10,15 or 20 percent.
3. The tax base should be enlarged by including services within the taxnet.
4. A high rate of 30,40 or 50 per cent could be levied on non-essential commodities or commodities injurious to health.
5. The present excise tax system should be gradually transformed into Value Added Tax at the manufacturing level.
6. The committee recommended the abolition of interest tax as it acts as a wedge between the reward to the savers and return on investments.
7. The law and procedure relating to valuation should be simplified and specific duties should be replaced by ad valorem duties in respect of most goods.
8. The committee recommended the continuance of the levy of gift tax, since it discourages transfer of assets for reducing the total tax liability of a family. The exemption limit may be raised to Rs.30,000 from the present level of Rs. 20,000.
9. As regards sales tax, the Committee was of the view that this tax could be converted into a form of state VAT within the manufacturing sector. There is no need for levying sales tax at more than two rates since the distribution and other non-revenue objectives could be left to be performed by the Central taxes which apply uniformly throughout the country.
10. The Committee was of the view that agriculturists whose income consists of only agricultural income or agricultural income below Rs.25,000 per annum may not be brought within the income tax net The agricultural income in excess of Rs.25,000 should be taxed to promote equity.
11. As the existing information system for collection and recovery of direct taxes is inefficient and unproductive, the committee recommended a new information system known as Tax

Account Information System. This new system will consist of manual and computerised procedures which would enable the Department to keep up-to-date tax information for each tax payer.

12. The committee also recommended the replacement of the existing system of combining in an assessment officer all the functions of collection and recovery by a new system based on functional classification of jobs.
13. In order to solve the problem of huge pendencies and slow justice, the Committee Recommended the following remedies.

a. Reduction in the number of duty rates.
b. A duty limit of Rs.25,000 has been suggested, below which no appeal should be filed.
c. The Board should be ensured that such disputes do not occur again.

14. For attracting foreign investment and technical know how double taxation of the foreign company should be avoided. The law should be amended for exempting the salaries paid to such personnel from Indian tax irrespective of the length of their period of stay.

19.10.1 Kelkar task force on tax reforms

The finance Minister of the Government of India set up two task forces under the chairmanship of Vijay Kelkar, advisor to finance minister to:

1. demystify the powers of budget-making and make it transparent;
2. recommend measures for simplification and rationalization of direct and indirect taxes; and
3. facilitate an informed discussion on tax reforms.

As per the terms of reference, the Task Force on Direct Taxes was required to submit a consultation paper to the Government containing.

a) its recommendations on rationalisation and simplification of direct taxes;
b) improvement in tax-payer services; and
c) redesigning procedures for strengthening enforcement.

The Task Force on Indirect Taxes was required to make:

i. recommendations on simplification, reduction in the cost of compliance of customs and Central excise duties;
ii. automation of tax administration
iii. simplification of statutory returns, records, procedures for time bound disposal of matters; and
iv. different aspects of legal provisions to facilitate tax-payers and to improve tax compliance.

The two consultation papers, one on direct taxes and the second on indirect taxes, were submitted in November 2002 and were immediately made public to lacilitate informal discussion on tax policy. There was an intense public debate in which tax professionals, tax officials, academicians, trade and industry association participated. After considering all these responses, the final reports of the two task forces were submitted to the Government in December 2002 making important recommendations. The final major recommendations of the Task Forces are summarized below:

Task Force Recommendations on Direct Taxes

a) Personal Income Tax

i. Increase in exemption limit from the present Rs.50,000 to Rs. I lakh for the general categories of tax-payers and higher exemption limit of Rs. 1.50 lakhs was recommended for widows and senior citizens. With the increase in exemption limit, the standard deduction eliminated.

ii. Instead of the present three tier, there would be two rate schedule - 20 per cent upto an income of Rs.4 lakhs and 30 per cent of incomes above Rs.4 lakhs. There would be no surcharges on personal income tax.

iii. Elimination of all tax incentives under section 88,801 and interest income under Section 10.

iv. Two alternative recommendations were made regarding housing finance. First: Incentive-wise borrowing for Housing by providing 2 per cent interest subsidy on all loans below Rs.5 lakhs. Second: continue with tax treatment of mortagage interest for owner occupied houses/ flats but with a reduction of motgage interest deductible form the present Rs. 1,50,000 to Rs.50,000 only.

v. Through an agreement, the states would authorize the Central Government to impose income tax on agricultural income and assign the proceeds to States. This arrangement would encourage: a) States to tap the full potential of their tax powers, and b) prevent the laundering of non-agricultural income as agriculture income. Since the exemption limit is Rs.l lakh, most farmers would continue to remain out of the tax net.

b) Corporate Tax Reform:

i. Coroirate tax rate to be reduced to:

30 per cent for domestic companies.

35 per cent for foreign companies.

ii. Exemption of dividends from tax also in the hands of Shareholders. There will be no tax on distribution of dividends by a company.

iii. Exemption of long-term capital gains on listed equity

iv. Elimination of minimum alternate tax (NAT)

v. The general rate of depreciation for plant and machinery to be 15 per cent instead of the existing 25 per cent.

vi. Removal of exemption under Section33 and 35 and elimination of these sections.

vii. Abolition of wealth tax.

viii. Merger of tax on expenditure in hotels with service tax.

c) Tax Administration:

i. Extension of PAN(Permanent Account Number) to Coverall citizens ai%. economic agents.

ii. Expansion of tax-payer services both quantitatively and qualitatively. The Task Force has recommended easy access to taxpayers through Intern and e-mail and extension of facilities such as tele-filing and tele-refunds.

iii. Introduction of transparency and objectivity in the process of selection of cases.

iv. Abolition of block assessment of search and seizure cases. It would be clear from the above summary of the major recommendations on Direct taxes, that the emphasis was on: ct taxes, were submitted in November 2002 and were immediately made public to facilitate informed discussion on tax policy. There was an intense public debate in which tax professionals, tax officials, academicians, trade and industry association participated. After considering all these responses, the final reports of the two task forces were submitted to the Government in December 2002 making important recommendations. The final major recommendations of the Task Forces are summarized below:

19.11 KELKAR TASK FORCE RECOMMENDATIONS ON INDIRECT TAXES

In respect of indirect taxes, the major recommendations of the Task Force related to widening of coverage of service tax, etc. The major recommendations are summarized under three headings, viz., Customs Tariff, Central Exercise Duties and Tax Administration.

a) Customs Tariff

i. Multiplicity of customs levies to be reduced to three viz., basic customs duty, additional duty of customs and anti-dumping duties.

ii. (a) zero per cent duty on items like life saving drugs and equipments, sovereign imposts and imposts by RBI.

b) 5 per cent duty on basic raw materials, like coal.

c) 10 per cent duty on raw materials, inputs and intermediate goods. 10 per cent duty on finished goods other than consumer durables; and

(d) 20 per cent duty on consumer durables.

iii) From 2003-04, a duty of 8 per cent on crude oil and 15 per cent on petroleum products. From 2004-05,a duty of 5 per cent on crude oil and 10 per cent on petroleum products.

iv) A higher duty upto 150 per cent on specified agricultural Products and demerit goods.

v) All exemptions to be removed except in the case of life saving Drugs, goods of security and strategic interest and goods for relief and charitable purposes.

(b) CENTRAL EXCISE DUTIES

1. All excise duties are to be reviewed and to be replaced by CE1WAT.

a) Zero excise duty on life saving drugs and equipments, security items and agricultural products.

b) 6 per cent duty on processed food products and matches

c) 14 per cent standard rate for all items not mentioned against the rates

d) 20 per cent on motor vehicles, air conditioners and aerated water.

e) Separate rates for tobacco products.

f) A uniform rate of 16 per cent on all fiberes and yarns; on all exemptions to be removed on the textile sector except handloom products certified on khadi etc.,

g) Duty exemption in respect of small scale sector only to small scale units with turnover of Rs.50 lakhs.

h) Uniformity in all State legislations, to VAT.

i) Extension of service tax in a comprehensive manner, leaving only a few services by including them in a negative list.

It is proposed to have a separate law on service tax to be integrated finally with the Central Excise Law.

C) TAX ADMINSTRATION

i. Time limit for processing an import or export document.

ii. Customs clearance to be based on trust and to be uniformly applied To all importers and exporters.

iii. A system of self-assessment of bill of entry by the importer to be introduced.

iv. Levy of Central excise to be progressively based upon value addition upto Processing stage.

v. Guidelines on determination of cost of production to be issued at the earliest.

vi. CEIWAT credit rules to be amended to abolish the distinction between Capital goods and inputs.

The recommendation of the Task Force on Indirect Taxes aim at toning up tax administration , put in place a system, that is simple effective and at par with international standards. They also attempt to widen the tax base , remove exemptions, expand coverage of service tax and so on.

Evaluation of Kelkar Task Force Recommendations

When the Kelkar Committee's consultation paper was released in November 2002, there was bitter criticism regarding some of the suggestions made by the task force on direct taxes, Economists and taxation experts broadly welcomed the proposals regarding raising of minimum exemption limit to Rs. 1 lakh, abolition of standard deduction, abolition of all exemptions, fixing of two tax rates instead of the existing three, abolition of dividend tax, wealth tax, etc. These proposals promote simplicity, removal of arbitration on the part of the tax administrators. However, the general public bitterly argued for the retention of standard deduction, exemptions for promotion of savings and for special treatment of interest on housing loans. The final recommendations of the Kelkar Task Force accommodated some of these suggestions.

The recommendations of the Task Force on indirect Taxes did not attract any serious criticism. Surprisingly, the 2003-04 Budget of Jaswant Singh incorporated most of the recommendations regarding indirect taxes but did not accept most of the recommendations regarding direct taxes.

MODVAT

To avoid multiple tax- a tax on tax- a major reform in the form of MODVAT has been introduced in India. It is called Modified Value Added Tax which avoids a tax on tax and taxes on inputs which are already taxed earlier. For example, an excise duty on any good is also a tax on the already paid excise duty on inputs which are already taxed. Thus, there is triple taxation -

a) a tax on final product
b) the value of the final product includes the taxes already paid on its inputs. Hence, there is a tax on taxes paid earlier and
c) taxes already paid on inputs

To avoid this multiple taxation, the MODVAT system has been introduced partially since 1985-86 at the central level.

Merits:

1. The chief merit of the MODVAT system is that it avoids the cascading effect of a tax on tax.
2. Since under this system, taxes paid on inputs are deducted from the cost of the final product, double taxation is avoided. Secondly, since the taxes on inputs used are deducted, a tax on taxes paid is also avoided. Thus, double and multiple taxation is avoided. Therefore, import and export substitutes are encouraged. The cost of export substitutes is reduced, since taxes paid on inputs are deductible. Import substitutes are also encouraged, since taxes on imported inputs used in import substitutes are reimbursed.
3. It is expected that an impact on inflation will be reduced because of MODVAT system.
4. Less money is necessary to finance inventories, because taxes on inputs are set off and a tax on taxes paid is avoided. There is, thus, a saving of working capital.

Demerits:

However, it is pointed out that MODVAT has more disadvantages than advantages:

i. The paper work is increased enormously.
ii. There is hardship to small manufacturers and traders. In the case of small purchases, it is not possible to maintain a record of gate passes.
iii. Since the rates of excise duties on certain items are increased simultaneously, the benefit of MODVAT has become meaningless.
iv. The benefit of MODVAT is not passed on to the consumers and prices have been raised by the manufacturers despite the benefits of MODVAT scheme.

VALUE ADDED TAX (VAT)

Value Added Tax was adopted through historical evaluation by France in 1954 to replace turnover taxes. Since 1967 other countries of the European Economic Community also started opting for VAT. It is in use in some underdeveloped countries as well. In India, it was introduced on the recommendation of the Jha Committee (1978).

Value Added Tax is levied on the sellers of goods and services based on value added by them. According to L.K.Jah Committee. Vat in its comprehensive form is a tax on all goods and services (except export and government services),its special characteristics being that it falls on the value added at each stage from the stage of production to retail stage.

Under the Indian constitution, the States have exclusive power to tax sales and purchases of goods other than newspapers. The central government has exclusive power to tax sales and purchase of goods in the course of inter-state trade but the proceeds of any such tax will be collected and retained by the States in which the movement of the goods in inter-state commerce.

There has been much confusion on the levy and collection of sales taxes in different states-general sales tax, specific sales tax and Central sales tax and so on. despite many criticisms, the sales taxes today are by far the largest single source of venue to the State Governments in India. They have helped to bridge the gap created by declining land revenues in the State budgets. In 2001-02 sales taxes are expected to contribute Rs.86,620 crores. However, States had agreed in principle to convert sales taxes to a uniform value-added-tax (VAT) by the end of arch 2001. This decision could not be implemented.

In January 2002, at the Conference of state Finance ministers, a final decision is taken that all States and union Territories would introduce VAT

From April 2003. It was decided that every State legislation on VAT should have a minimum set of common features. Accordingly, a model VAT bill was circulated to all the States. The decision to introduce VAT from April 2003 was again reiterated in the meeting of the Finance Ministers in January, 2003. It was decided in that meeting that:

a) The VAT legislations of all States and UTs would have common provisions in respect of all important matters and that a simple VAT legislation with maximum convergence would be implemented.
b) With the introduction of VAT, the origin based Central Sales Tax would be Phased out;
c) The additional duties of Excise (Goods of Special Importance)Act would be suitably amended to empower States to levy Sales Tax/VAT on sugar, textiles and tabacco with a ceiling rate of 4 per cent . This would be done without affecting the existing levy of Additional Duties of Excise on these items by the Governments.
d) As many States expressed possible revenue losses in the initial years of introduction of VAT, the Central Government has agreed to compensate the states to the extent of 100 per cent of revenue loss in the first year, 75 per cent in the second year and 50 per cent in the third year.

In spite of the best efforts of the Empowered Committee of State Finance Ministers, the States have failed to pass the model bill. Of course, not withstanding the opposition of the traders and business community throughout the nation finally the VAT at the state level has been introduced from 1st April 2005 by most of the major states except Uttar Pradesh and the BJP-ruled states because of the spirited opposition of the traders lobby throughout the country.

Following the June 18, 2004 decision of the Empower3ed Committee (EC) of State Finance Ministers to implement State-level VAT from April1, 2005 25 States/Union Territories had introduced VAT to replace the sales tax by December 31, 2005. Andaman and Nicobar Islands and Lakshadweep do not have a sales tax . All the five BJP ruled states-C .

Other important taxes on commodities and services include taxes on passengers and goods and electricity duties. In fact, electricity duties have been a significant source of revenue to states.

19.11 Summary

Taxation these days is not used as means of raising revenue only but it is an important instrument for achieving socio-economic objectives, such as regulation of consumption and production, promoting economic growth and removing inequalities of income. In order to achieve these objectives there is every need to reform taxation to the changing needs. Of the respective countries. In order to strengthen the India Tax structure, the government of India appointed several commissions to analyse the defects and make suitable recommendations.

Important recommendations of select commissions of the central government are discussed. Taxation enquiry commission (1953) examined the incidence of taxation, the suitability of the tax system, effects of taxation on capital formation and the use of taxation as a fiscal instrument to control inflation and deflation. Prof. Nichlas Kaldor (1956) on "Indian Tax Reforms". We recommended an annual tax on wealth, a tax on capital gains, a general gift tax and a personal expenditure tax. Boothalingam committee (1967) study on rationalization and simplification of the tax structure, K.N. Wanchoo (1970) examine and avoidance. Dr. K.N. Raj (1972) examine the question of agricultural income and wealth from all aspects. L.K. Jha (1976) examine the Indirect Taxation Enquiry Committee. C. C Choksi (1978) observed that the problem of simplification and rationalization of tax should be done in the light of the background of the economic activity in which the taxes laws operate.

Chelliah (1972) submitted report on tax reforms. Kelkar task force on tax reforms to widening of coverage off service tax etc., Value Added Tax, (2005) the States have exclusive Power to tax sales and Purchases of goods other than news papers.

19.12 Self Assessment questions:

1. Explain the importance of tax reforms in developing countries and with special reference to India.
2. Briefly explain the Recommendations of the Raja Chelliah committee Report.
3. Give an account of the major recommendations of Prof. Kaldor.
4. Analyse the suggestions made by Wanchoo committee to reduce tax evasion.
5. Explain the importance of Value Added Tax and its implications in Indian context.
6. State the major recommendations of Direct Taxation Enquiry Committee Report.
7. Briefly explain the committee on rationalization and simplification of the tax structure in India.
8. Critically examine the recent changes in the tax pattern. Is it a boon or a curse to the taxpayer?.

19.13 Reference Books

1. R.N. Bhargava - Theory and working of Union Finance in India.
2. Taxation Enquiry Committee Report 1971.
3. N. Kaldor - Indian Tax reform.

Lesson-19: Central and State Government Budgets and Non-tax Revenue of Centre, State and Local Governments

Contents

20.1 Objectives

The purpose this unit is to explain the Central and State Government Budgets and Non-tax Revenue of Centre, State and Local Governments. After reading this unit, you will be exposed to:

- To understand concept of budget and its various types of it.
- To understand different concepts of deficit.
- To analyze the components of budget, tax and non-tax revenue.
- To know the non-tax revenue trends of centre, states and local governments in India.

20.2 Introduction

According to Constitution of India, there is three-tier system of government, namely. Central (or Union) government, State government and Local government (like Municipal Corporation, Municipal Committee, Zila Parishad, etc.). Accordingly, these governments prepare their own respective budgets (called Union Budget, State Budget and Municipal Budget) containing estimates of expected revenue and proposed expenditure. The basic structure of government budget is almost the same at all levels of government but items of expenditure and sources of revenue differ from budget to budget. Again, there is no clash with regard to sources of revenue because functions of Central, State and local government have been clearly demarcated and laid down in the Indian Constitution. However, we shall discuss here the budget of the Central Government.

The budgets in the parliamentary kind of system similar to what exists in a country like India become a tool of political negotiations where the budgeting powers are delegated to the Finance Minister of the country. In a single party government, the entire party shares the same views regarding the spending of the resources however; the disagreement arises when individual members may differ on the cost of the distributive policies and would want the government funds to be diverted to their respective electoral constituencies. In a coalition government, the differing opinions are tackled through compromise and contracts approach where the coalition parties keeps the check on the budget process ensuring that it lies within the boundaries of the agreed contract.

The budget process in different systems of government may vary but they are all aligned to achieve the relevant economic and social goals of that country. With increasing globalization and interdependent economies, several external considerations also come into play when the budgets are designed. The Central Government is constitutionally required to lay an "annual financial statement" before both the houses of Parliament. This statement is conventionally called Government Budget. Accordingly, in India, every year Central (Union) Budget for the coming financial year is presented by the Union Finance Minister in the Lok Sabha normally on the last working day of the month of February. It gives item wise details of government receipts and expenditure for three consecutive years, i.e., Actuals for the preceding year. Budget estimates for the current year. Revised estimates for the current year and Budget estimates for the ensuing (coming) year.

20.3 Definition of Budget

"A Budget is the master financial plan of the government. It brings together estimates of anticipated revenue and proposed expenditure for the budgeted years"-Taylor

According to Findley Shirras "the budget is an annual statement of expenditure and revenue to meet that expenditure prepared by public authorities and usually covers at least two fiscal periods- the closing period and the period to come".

To put it precisely, A Budget is a statement of the estimated revenue and expenditure of the government in respect to a particular financial year.

20.4 Types of Budget

A) Surplus Budget

A situation in which income exceeds expenditures. The term "surplus budget" is most commonly used to refer to the financial situations of governments; individuals speak of "savings" rather than a "surplus budget". A surplus is considered a sign that government is being run efficiently. A budget surplus might be used to pay off debt, save for the future, or to make a desired purchase that has been delayed.

B) Deficit Budget

A status of financial health in which expenditures exceed revenue. The term "budget deficit" is most commonly used to refer to government spending rather than business or individual spending. Countries can counter budget deficits by promoting economic growth, reducing government spending and increasing taxes.

Merits of deficit budget: A deficit budget has its own merits especially for developing economy For example (i) It accelerates economic growth and (ii) It enables to undertake welfare programmes of the people, (iii) It is a cure for deflation as it checks downward movement of prices. At the same time.

Demerits of deficit budget: (i) It encourages unnecessary and wasteful expenditure by the government, (ii) It may lead to financial and political instability, (iii) It shakes the confidence of foreign investors.

The situation of excess demand leading to inflation (continuous rise in prices) and the situation of deficient demand leading to depression (fall in prices, rise in unemployment, etc.). A surplus budget is recommended in the situation of inflationary trends in the economy whereas a deficit budget is suggested in the situation of recession.

C) Balanced Budget

As suggested by the name a balanced budget is that which has no deficit or surplus. The revenues arising from all sources are equal to the expenditures. Two main merits of a balanced budget are: (a) It ensures financial stability and (b) It avoids wasteful expenditure; and also demerits are: (i) Process of economic growth is hindered and (ii) Scope of undertaking welfare activities is restricted.

According to Adam Smith, public expenditure should never exceed public revenues, i.e., he advocated a balanced budget. But Keynes and modern economists do not agree with the policy of a balanced budget. They argue that in a balanced budget, total expenditure (public and private) falls short of the amount necessary to maintain full employment. Therefore, government should increase its expenditure to close the gap between the expenditure essential for full employment and expenditure that actually takes place. Ideally, a balanced budget is a good policy to bring the near full employment economy to a full employment equilibrium. However, balanced budget is not an ideal type of budget as argued by economist

John Maynard Keynes.

D) Performance Budget

This type of budget is mostly used by the organizations and ministries involved in the developmental activities. This process of budgeting, takes into account the end result or the performance of the developmental program thus insuring cost effective and efficient planning. With the increasing developmental challenges and awareness regarding the usage of tax payer's money, new methods of budgeting are required of which the performance based budgeting has emerged as a transparent and accountable method. It relies on three aspects of understanding of the final outcome, the strategies formulated to reach those final outcomes and the specific activities that were carried out to achieve those outcomes. With a very detailed and objective analysis, this budgeting process is very result oriented in its approach.

) Zero based budget

Zero based budget was adopted by India in 1986 as a technique for determining expenditure budgets. Zero based budgeting has its clear advantage when the limited resources are to be allotted carefully and objectively. It is quite flexible in nature and relies on rational methods, systematic evaluation to reallocate resources and justify the usage of funds. It starts from a zero base unlike traditional budgets where incremental approach is used. Here, the needs and costs of every function of the organization are taken into consideration for the next year's budget. So the budget is futuristic and may or may not be equal or more from the last year's budget as traditionally calculated.

20.5 Types of Budget Deficits

1. Revenue Deficit: The excess of expenditure on revenue account over receipts on revenue account measures revenue deficit. Receipts on revenue account include both tax and non-tax revenue and also grants. Tax revenue is net of States' share as al so net of assignment of Union Terri Tory taxes to local bodies. The non-tax re venue includes interest receipts, dividends and profits, and non-tax receipts of Union Territory's Grants include grants from abroad also. Expenditure on revenue account includes both Plan and Non-Plan components. Thus, the Plan component includes Central Plan and Central Assistance for States and Union Territory Plans.

Non- Plan expenditure includes interest payments, defence expenditure on revenue account, subsidies, debt-relief to farmers, postal services, police, pensions, other general services, social services, economic services, non-plan revenue grants to States and Union Territories, expenditure of Union Territories with legislature, and grants to foreign governments. Revenue deficit means dissavings on government account and the use of the savings of other sectors of the economy to finance a part of the consumption expenditure of the government. An important objective of fiscal policy should be to ensure surplus in the revenue budget so that the government also contributes to raising the rate of saving in the economy.

2. Capital Deficit: The excess of capital disbursements over capital receipts measures the capital deficit.

Capital Deficit = Expenditure on Capital Account – Capital Receipts

Plan capital disbursements include those on Central Plan and Assistance for States and Union Territories. Non-Plan Capital disbursements include defence expenditure on Capital account, other non-plan capital outlay, loans to public enterprises, States and Union Territory Governments, foreign governments and others; and non-plan capital expenditure of Union Territories without legislature. The items of capital receipts include recoveries of loans extended by the centre itself, but only net receipts of loans raised by it. It may be noted that receipts on account of sale of 91 days treasury bills and drawing down of cash balances do not form a part of capital receipts. However, net receipts on account of sale of 182 days and 364 days treasury bills and sales proceeds of government assets are included in capital receipts.

3. Fiscal Deficit: Fiscal deficit is the difference between revenue receipts plus certain non-debt capital receipts and the total expenditure including loans net of repayments.

Fiscal Deficit = Total Expenditure – (Revenue Receipts + Non-debt Capital Receipts)

In short, fiscal deficit indicates the total borrowing requirements of the government from all sources. This may also be called Gross Fiscal Deficit (GFD). It measures that portion of government expenditure which is financed by borrowing and drawing down of cash balances. It should be noted that in India, borrowings are net amounts (that is, gross borrowings less repayments). Similarly, loans extended by Government of India are included on the expenditure side of capital account while 'recoveries' are included on the receipts side. Therefore, the amount of loans and advances by Government of India is also reduced. The servicing of this debt has become a serious problem. Public debt in India is mostly subscribed to by commercial banks and financial institutions. A judicious macro-management of the economy requires a progressive reduction in the fiscal deficit and revenue deficit of the government.

4. Primary Deficit: It is simply fiscal deficit minus interest payments. In the 2008-09 budget, primary deficit was shown at a figure of Rs. 1, 33,821 crore (Revised estimates). This measure is also referred to as Gross Primary Deficit (GPD). Measures of deficit described above (except capital deficit) include payments and receipts of interest. These transactions, however, reflect a consequence of past actions of the government, namely, loans taken and given in years prior to the one under consideration.

Exclusion of interest transactions would, therefore, enable us to see the way the government is currently conducting its financial affairs. Accordingly, Primary deficit is defined as Fiscal Deficit less net interest payments, (that is less interest payments plus interest receipts). Net primary deficit is obtained by subtracting 'Loans and Advances' from net fiscal deficit. It is also equal to Fiscal Deficit less interest payments plus interest receipts less loans and advances. The primary deficit which was 4.3 per cent of GDP during 1990-91 came down to 1.5 per cent of GDP during 1997-98 and in the revised estimates for the year 2008-09 it was

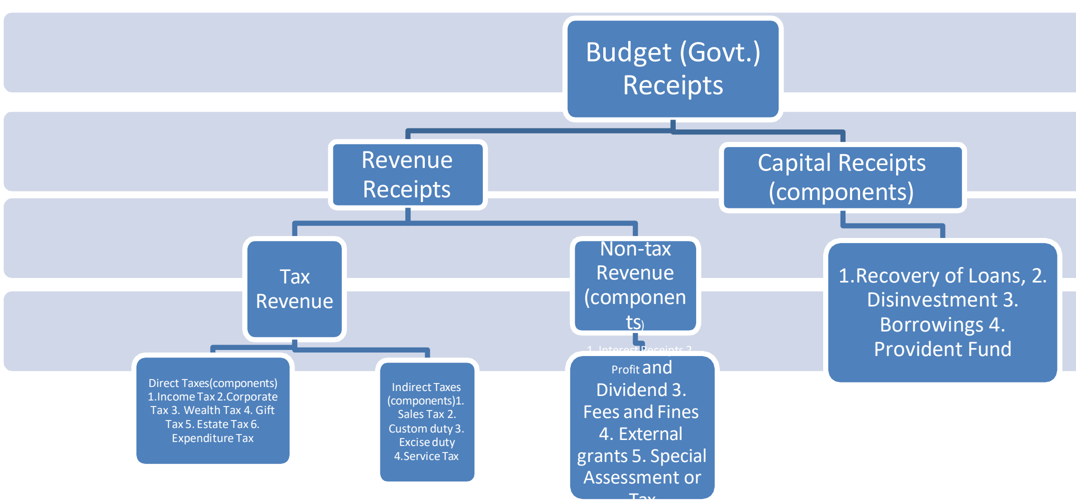
2.5 per cent of GDP.

5. Monetized Deficit: Besides ways and means advances, the Reserve Bank of India also supports the government's borrowing programme. Monetised deficit indicates the level of support extended by the Reserve Bank of India to the government's borrowing programme. Monetised deficit is defined as net increase in net Reserve Bank of India credit to central government. The rationale for this measure of deficit flows from the inflationary impact which a budgetary deficit exerts on the economy. Since borrowings from Reserve Bank of India directly add to money supply, this measure is termed monetised deficit. It is obvious that monetised deficit is only a part of fiscal deficit.

20.6 Components of the Union (Central) Budget of India

The budget is divided into two parts: (i) Revenue Budget and (ii) Capital Budget. The Revenue Budget comprises revenue receipts and expenditure met from these revenues. The revenue receipts include both tax revenue (like income tax, excise duty) and non-tax revenue (like interest receipts, profits). Capital Budget consists of capital receipts (like borrowing, disinvestment) and long period capital expenditure (creation of assets, investment).

Capital receipts are receipts of the government which create liabilities or reduce financial assets, e.g., market borrowing, recovery of loan, etc. Capital expenditure is the expenditure of the government which either creates assets or reduces liability. Capital budget is an account of assets and liabilities of the government which takes into consideration changes in capital. Structure or components of a government budget broadly consists of two parts - Budget Receipts and Budget Expenditure as shown in the following chart with their classification.



20.7 Revenue Sources of the Union Government

Revenue receipts of the government are divided into two groups, namely, (i) tax revenue and (ii) non-tax revenue. Tax revenue consists of proceeds of taxes and other duties levied by the Union government such as income tax, corporate tax, excise duty, customs duty, service tax, etc. These are shown in the chart earlier. Components or sources of revenue receipts are explained below:

(A) Tax Revenue: Tax revenue consists of proceeds of taxes and other duties levied by the Union government. It is the main source of government revenue. Remember, main objective of any tax system is to raise revenue to fund govt. expenditure in the budget. A tax is legally a compulsory payment imposed by the government on income and profit of persons and companies without reference to any benefit. Similarly government levies taxes on sales of goods, manufacturing of goods, excise duty, wealth, gifts, properties, exports, imports, etc. The money received from taxes is used by the government to meet the expenditure incurred on providing common benefits to the people. No one can refuse to pay the tax; otherwise, the defaulter is prosecuted and penalised.

(B) Non-tax Revenue: The revenue obtained by the government from sources other than tax is called Non-Tax Revenue. The sources of non-tax revenue are:

(i) Fees and Fines: Fee age another important source of revenue of the government. A fee is charged by public authorities for rendering a service to the citizens. Unlike tax, there is no compulsion involved in case of fees. The government provides certain services and charges certain fees for them. For example, fees are charged for issuing of passport, driving licenses, etc. Similarly, government gets income by way of fines and penalties imposed by it on various types of offences committed by the law-breakers.

(ii) Interest: It is an important source of Government non-tax revenue. Government receives interest on loans given by it to state governments, union territory governments, local governments, private enterprises and the people.

(iii) Profits and Dividends: Of late government has developed a new source of income by starting its own production units called public enterprises which like private enterprises produce and sell goods and services. For instance Nationalized Banks, Industrial Finance Corporation of India, LIC, STC, HMT, MMTC, BHEL, etc. provide profits. Government also gets dividends on investments made by it.

(iv) Special Assessment: When government undertakes development activities like construction of roads, provision of drainage, street lighting in a particular area, the value of nearby property or rental value of houses goes up in the vicinity. Clearly the additional income and profit which the owners of the landed property get is not the result of efforts on their part. Special assessment is, therefore, like a special tax that government levies in proportion to the benefit accruing to property owners to defray the cost of development. It is a payment made once-for-all by the owners of properties for increase in the value of their properties resulting from development activities of the government.

(v) External grants-in-aid: Government receives financial help from foreign governments and international organisations in the form of grants, donations, gifts and contribution. The growth of non-tax revenue in recent years can be seen from table 20.1.

20.1- Non-tax Revenue of the Govt. of India (Rs. crores)

Item	1970-71 Actual	2010-11 Budget	2011-12 Actual	2012-13 Budget	2012-13 Revised	2013-14 Budget
1 .Interest Receipts	590	19,253	20,252	19,230	16,595	17,764
2. Dividends and Profits	120	51,303	50,608	50,152	55,443	73,886
3. Fiscal and other Services	180	77,556	1,21,672	1,64,,673	1,29,712	1,72,252
Total	890	1,48,118	1,92,532	2,34,055	2,29,712	2,63,902

Source: Govt. of India, Budget as a Glance, 2013-14.

In 1950-51, non-tax revenue of the centre amounted to Rs. 49 crores but in 1970-71 it went up to Rs. 890 crores. The budget for 2010-11 places it at Rs. 1, 48,118 crores and in 2013-14 budget 2, 63,902 crores. Interest receipts which constitute an important source of non-tax revenue comprise of interest on loans to states and union territories, interest payable by railways and postal services and other interest receipts. Profits and dividends relate to profits of RBI, profits of nationalized banks, LIC, public enterprises etc. fiscal services relate to revenue received by the central govt. from a) currency, coinage and mint, b) other fiscal services relating to Indian Security Press, Nasik, Hyderabad, etc., and c) general services include social community services, economic services and grants-in-aid and contributions.

20.8 Budgets of State Government

In India, each state government prepares its own budget of income and expenditure every year. Table 20.2 explains the budgetary position of the state since 1951-52. An important fact revealed by table 20.2 is that the receipts and expenditure of the sates on the revenue account have been continuously increasing. For instance, in 1951-52, the current revenue of the states was a mere Rs. 396 crores, but it went upto Rs. 16,290 crores in 1980-81 and finally it is expected to exceed Rs. 8,04,943 crores in 2009-10 (budget estimates).

The basic reason for this huge increase in state revenues is the necessity to finance the continuously rising expenditure of states which has gone up 392 crores in 1951-52 to Rs. 8, 37,238 crores in 2009-10 (budget). Increase in the state revenues over the last five decades are: imposition of new taxes, especially on commodities, rise in the rates of taxes, greater share in Central Government taxes and increasing receipts from the Central Government by way of general and particular grants, etc.

There are many reasons for the increase in the expenditure of the states over the years. The most important reasons are expansion in civil administration, higher salaries and wages due to prices and cost of living, increase in the provision of government services in the form of education, public health, etc., as well as increased development expenditure.

Table-20.2: Budgets of Sate Governments (Rs. Crores)

Item	1951-52 Actuals	1980-81 Actuals	2000-01 Actuals	2009-10 Budget
A. Revenue Account				
Receipts	396	16,290	2,37,950	8,04,946
Expenditure	392	14,810	2,91,520	8,37,238
Surplus(+)Deficit(-)	+4	+ 1,480	-2,340	-32,295
B. Capital Account				
Receipts	137	5,580	1,11,590	22,514
Disbursements	189	7,960	55,680	2,18,540
Surplus/Deficit	-52	-2,380	+55,910	+5,574
Over All Surplus/ Deficit	48	-900	+2,340	-26,721

Source: RBI, State Finances. A Study of Budgets of 2009-10.

The first part of states' budget is revenue receipts and revenue expenditure. A very interesting point was the surplus revenue over current expenditure which states made regularly for many years in the past. In table 20.2, current account surplus was Rs. 4 crores in 1951-52 and it rose to Rs. 1,480 crores in 1980-81. Since 1986-87, however, states too, like the centre, have started incurring heavy deficit in their current account. The 2001-02 state budgets incurred a revenue deficit of Rs. 53,570 crores. Finance Commissions have transferred huge funds from the centre to the states. Accordingly, states have avoided revenue deficits in recent years. In 2008-09, states expected a revenue surplus Rs. 28,426.

The second part of state budgets consists of capital receipts of states and disbursements out of them. Capital receipts of market loans, borrowing from the central government, collecting small savings of the public and provident fund contributions. Capital outlay or disbursements are on various development projects like river valley projects, schemes for agriculture development, etc. as capital revenue was less than capital disbursement, state governments had experienced deficit in the capital accounts in the first decades since 1951-52. Later, they had budgeted for larger surpluses in the capital account. We take revenue deficit and surplus and capital deficities surpluses together and calculate the overall surplus/deficit of the states. In 2008-09 budgets, states anticipate a revenue surplus of Rs. 28,426 crores, but a capital deficit of Rs. 25, 902 crores – the net over – all surplus is Rs. 2, 524 crores. It would be clear that states have generally managed to get over-all budget surpluses meaning that the aggregate disbursements are below aggregate receipts.

20.9 Non-Tax Revenue Sources of State Governments

Non-tax revenue as a percentage of GSDP (gross state domestic product) is an indicator of the efficiency in mobilization of these revenues in the total revenue receipts. While the proportion of States own non-tax revenue to GSDP in Indian States has varied between 1.5 and 2.4 percent over the years. The tax revenue of the states consists of two parts; viz. 1. Revenue from states' taxes, 2. Shares in central taxes. The second source of current revenue to the states is known as non-tax revenue. This consists of: 1. Grants from the Central Government and 2. States' own non-tax revenue. Components of States' own non-tax Revenue are interests, dividends and profits, general services, economic services and social services.

State governments in India collect revenue from different sources to meet their revenue expenditure. Table-20.3 shows that the important sources of revenue for the states.

Table-20.3 Non-Tax Revenue of the State Governments (Rs. Crores)

Item	1951-52 Actuals	1980-81 Actuals	2000-01 Actuals	2009-10 Budget
Tax Revenue	280	10,400	1,68,710	5,52,243
Non-Tax Revenue	120	5,890	69,240	2,52,700
Of which				
a). Grants from the Centre	30	2,620	37,780	1,68,683
b). States' own Non-Tax Revenue	90	3,270	31,460	84,017
Total Receipts	400	16,290	2,37,950	8,04,943

Source: RBI Handbook on State Finances. A Study of Budgets of 2009-10.

20.10 Non-Tax Revenue Sources of Local Governments

Local Self-Government or Local Bodies directly influence the welfare of the people by providing civic, social and economic infrastructure services and facilities in both urban and rural areas. Given their strategic position in delivering services in the hierarchy of Government set up, following the Constitutional (73^{rd} & 74th) Amendment Acts, more functions, powers and resources have been provided to them.

After independence, the Indian government has revived the system of Village Panchayats. In its directive principles of state policy (Article 40), the constitution of Indian states: "The states shall take to organize Village Panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government."

Today, there is no uniform system of local self-government in India. Different states have different types of local bodies with varied functions. There are the following four types of local governments in the various states. 1. Village Panchayats 2. Zilla Parishads 3. Municipalities and 4. Municipal Corporations. The local governments look after certain functions of a local nature, i.e. construction and maintenance of local roads, lighting, water supply, cleaning of streets, maintenance of hospitals, sanitation, provision of drainage works, vaccination, provision of primary education, maintenance of parks and gardens, etc. however, all these functions are performed subject to the control of State Government.

As the system provides today, the states have delegated some financial powers to the local governments. But these govts, more or less depend upon the grants from the state and cannot deal with their problems independently for want of adequate revenue resources. These local govts. Hesitate to tap whatever meager sources of finances available to them for fear of losing popularity.

Revenue Sources of Local Governments: Generally, the following items constitute the non-tax revenue of the local governments.

1. Fees;

2. Fines; and

3. Income from public undertakings run the local govts. Like municipalities and municipal corporations in towns and big cities. For example, many municipalities and municipal corporations run local bus services, tramways, distribution of electricity, water supply, etc. however, some states have taken over these activities of the municipalities and municipal corporations which were, in fact, local in character, e.g., in some states, the supply of electricity and public road transport are taken over by the State Government.

Fees and fines are a good source of revenue for some local govts, but still for some, these are not adequate. Public undertakings provide, a very lucrative source, but as states above, these are taken over by the state govts, in the some states. The taxation inquiry commission had suggested that municipalities and municipal corporations should take initiative in these functions and augment their resources.

For village panchayats, there are some sources of non-tax revenue, such as revenue from lakes, ponds, trees, etc. income is also obtained from rents charged to shops and stalls in market places. Where there is no corporation, the panchayats undertake the work of supplying manures, hiring out agricultural equipment and running small flour mill, etc. besides adding to the revenue of the local govts., these services enhance their utility as local governments.

20.11 Summary

Budget is a government document presenting the government's proposed expenditure and anticipated revenue from various sources in respect to a particular financial year. Surplus budget is a situation in which income exceeds expenditure. Deficit budget is a situation in which expenditure exceeds revenue. Balanced budget is that which has no deficit or surplus. Performance budget is the process of budgeting which takes into account the end result or performance of the development program. Zero based budget starts from a zero base, and hence flexible in nature, feasible to reallocate resources and justify the usage of funds. Budget focuses on two important accounts: Revenue and Capital accounts. The budget process in different systems of government may vary, but properly aligned and to achieve the relevant economic and social goals of that country.

20.12 Glossary

Appropriation Bill: A Bill presented to Parliament for approval providing for the withdrawal or appropriation by the government from and out of the consolidated fund of India.

Budget Estimates: The estimates of government spending on various sectors during the year, together with an estimate of the income in the form of tax revenues, from the budget estimates.

Balance of Payment: Statement showing the country's trade and financial transactions (all economic transactions) in terms of net outstanding receivable or payable from other countries with the rest of the world for a period of time.

Bill: The draft of a legislative proposal which, when passed by both the Houses of Parliament and assented to by the President, becomes an Act.

Budget Deficit: It is part of the fiscal deficit. It represents the borrowing requirement of the center.

Consolidated Fund: All revenues received by Government, the loans raised by it, and receipts from recoveries of loans granted by it, form the Consolidated Fund.

Contingency Fund: Fund into which the Government dips its hands in emergencies, to meet urgent, unforeseen expenditures and can't wait for authorization by Parliament.

Current Account Deficit: An excess of expenditure over receipts on current account in a country’s balance of payments.

Disinvestment: The selling of the Government's stake in public sector undertakings.

GSDP: gross state domestic product.

Revenue Expenditure: Revenue Expenditure is for the normal running if the govt’s department and various services, interest charged on debt incurred by Govt, subsidies etc.

20.13 Preparatory Questions

1. What is the traditional view on a government budget?

2. Explain different types of the budget.

3. Critically explain the types of Budget Deficit.

4. Write a note on non-tax revenue of the central government.

5. Discuss the revenue sources of local governments.

20.14 Books for Study

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2. R.K. Lekhi: **Public Finance,** Kalyani Publishers, Ludhiana, 2011.
3. H.L. Bhatiya: **Public Finance,** Vikas Publishing House, New Delhi, 2010.
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Lesson -20: TRENDS IN PUBLIC EXPENDITURE AND IN PUBLIC DEBT

21.1 Objectives

The purpose this unit is to explain the trends in public expenditure and in public debt. After reading this unit, you will be exposed to:

- The origin and meaning of public expenditure;

- The classification and reasons for the growth of public expenditure;
- To analyze the need, classification, sources and redemption of Public Debt; and
- To know the trends of public expenditure, debt and interest payments of the government of India.

PART-1: TRENDS IN PUBLIC EXPENDITURE

21.2 Introduction

Public Expenditure refers to Government Expenditure. It is incurred by Central and State Governments. The Public Expenditure is incurred on various activities for the welfare of the people and also for the economic development, especially in developing countries. In other words The Expenditure incurred by Public authorities like Central, State and local governments to satisfy the collective social wants of the people is known as public expenditure**.**

This chapter is divided in to two parts. First part deals with Public expenditure and the second part deals with the Public debt. In the first part and introduction, its importance and the definitions of the public expenditure are given. Need and the significance of the public expenditure is also discussed the objectives of the public expenditure is also discussed. Another important one in the discussion of the public expenditure is its classification. This is discussed in this chapter. Causes of increase of public expenditure and its trends in different heads are also given for student's interest. The trends in public expenditure are also discussed. In this the public expenditure with regarding to development and non development, subsidies, economic services The second part deals with the public debt and debt position f the central government and its share in the GDP the reason for the debt and major causes for the debt is given.

21.3. Meaning of Public Expenditure

Public expenditure is an important instrument of the fiscal system of a federal nation. The size and pattern of the public spending has great relevance in the growth process and in the reduction of economic disparities. The study of public expenditure was neglected till 1920s because of the belief that all public expenditure was waste. Infact, this belief was strengthened by the writings of the classical economists and especially that of Adam Smith (1776: who advocated that the government should restrict its activities to "justice, police and arms" To J. B. Say, public spending was usually for useless gratification of the wasteful whims of rulers; also it usually interfered with the process of the private capital formation necessary to the development of trade and industry by draining of funds that otherwise might have been accumulated by thrifty savers. Ricardo, too, viewed public spending as wasteful because of its possible effects on private capital formation. On the question of government's role, Malthus was also of the view that public expenditure could be excessive, leading to "injudicious taxation" or too large a national debt.

Contrary to it, in 1936, Lutz favoured public expenditure as it directly adds to the community wealth. He said, "Well run government commercial enterprises, reforestation and reclamation projects, and other forms of state business are the most obvious illustrations. Even the expenditure on ordinary services may result in the accumulation of certain assets, such as public buildings, which are a useful addition to the aggregate of community wealth". Keynes, a revolutionary economist, regarded public expenditure as an exogenous factor which can be utilized as a policy instrument to stimulate economic growth.

Taylor favored public expenditure by saying, "Government funds may not only help to fill in the troughs of deficiencies in national income, but under proper circumstances may generate increase in private spending which constitute recovery and prosperity". R. A. Musgrave, a twentieth century economist, advocated public expenditure since a government is forced to do many activities such as: (i: redistributive activities; (ii: activities to secure a re-allocation of resources; (iii: commercial activities, and stabilizing activities.

Governments today incur expenditure in order to fulfill the following roles in the economy: (a) to correct distortions of market failures; (b) regulate private activity that might harm society; (c) provide public goods and services i.e., economic and social infrastructure: and (d) often engage in production activity. The increased participation of the government in economic activities has brought public spending to the forefront among the fiscal instruments. Through public expenditure, the government influences directly or indirectly production, consumption and distribution of the nation. It thus helps towards the economic and social development of the society. "It can be used for stabilization, business cycle inversion, and growth purposes. It gives rise to positive externalities to economy and society, the more so through its capital component".

21.4 Importance of Public Expenditure

In modern economic activities public expenditure has to play an important role. It helps to accelerate economic growth and ensure economic stability. Public Expenditure can promote economic development as follows:-1. To promote rapid economic development 2. To promote trade and commerce 3. To promote rural development 4. To promote balanced regional growth 5. To develop agricultural and industrial sectors 6. To build socio-economic overheads. Ex. roadways, railways, power etc. 7. To exploit and develop mineral resources like coal and oil 8. To provide collective wants and maximize social welfare 9. To promote full - employment and maintain price stability and 10**.** To ensure an equitable distribution of income.

Thus public expenditure has to create and maintain conditions conducive to economic development. It has to improve the climate for investment. It should provide incentives to save invest and innovate.

23.5 Objectives of Public Expenditure

The major objectives of public expenditure are: 1. Administration of law and order and justice; 2.Maintenance of police force; 3.Maintenance of army and provision for defence goods; 4. Maintenance of diplomats in foreign countries; 5. Public Administration; 6. Servicing of public debt; 7. Development of industries; 8 Development of transport and communication; 9. Provision for public health; and 10. Creation of social goods.

In a modern welfare state, the importance of public expenditure has increased. The total Central Government's expenditure (Revenue and Capital: rose from Rs. 98,272 crores in 1990-91 to Rs. 10, 18,526 crores in 2009-10.

21.6 Classification of Public Expenditure in India: Classification of public expenditure refers to the systematic arrangement of different items on which the government incurs expenditure. Public expenditure can be classified as follows:-

1. Capital and Revenue Expenditure

Capital Expenditure of the government refers to that expenditure which results in creation of fixed assets. They are in the form of investment. They add to the net productive assets of the economy. Capital Expenditure is also known as development expenditure as it increases the productive capacity of the economy. It is investment expenditure and a non-recurring type of expenditure. For Ex. Expenditure - on agricultural and industrial development, irrigation dams, and public -enterprises etc. are all capital expenditures.

Revenue expenditures are current or consumption expenditures incurred on civil administration, defence forces, public health and, education, maintenance of government machinery etc. This type of "expenditure is of recurrent type which is incurred year after year.

2. Development and Non - Developmental Expenditure / Productive and Non - Productive Expenditure

Expenditure on infrastructure development, public enterprises or development of agriculture increase productive capacity in the economy and bring income to the government. Thus they are classified as productive expenditure. All expenditures that promote economic growth development are termed as development expenditure.

Unproductive (non - development: expenditure refers to those expenditures which do not yield any income. Expenditure such as interest payments, expenditure on law and order, public administration, do not create any productive asset which brings income to government such expenses are classified as unproductive expenditures.

3. Transfer and Non - Transfer Expenditure

Transfer expenditure refers to those kind of expenditures against there is no corresponding transfer of real resources i.e., goods or services. Such expenditure includes public expenditure on: National Old age pension Scheme, Interest payments, subsidies, unemployment allowances, welfare benefits to weaker sections etc. By incurring such expenditure, the government does not get anything in return, but it adds to the welfare of the people, especially to weaker sections of society. Such expenditure results in redistribution of money incomes within the society.

The non - transfer expenditure relates to that expenditure which results in creation of income or output The non - transfer expenditure includes development as well as non - development expenditure that results in creation of output directly or indirectly. Economic infrastructure (Power, Transport, Irrigation etc.:, Social infrastructure (Education, Health and Family welfare:, Internal law and order and defence, public administration etc.) By incurring such expenditure, government creates a healthy environment for economic activities.

4. Plan and Non - Plan Expenditure

The plan expenditure is incurred on development activities outlined in ongoing five year plan. In 2009-10, the plan expenditure of Central Government was 5.3% of GDP. Plan expenditure is incurred on Transport, rural development, communication, agriculture, energy, social services, etc.

The non - plan expenditure is incurred on those activities, which are not included in five-year plan. It includes development and non - development expenditure. It includes:-Defence, subsidies, interest payments, maintenance etc.

5. Other Classification (Mrs. Hicks)

Mrs. Hicks classified Public Expenditure on the basis of duties of government. It is as follows:- It is expenditure on defense equipments, wages and salaries of armed forces, navy and air force etc. It is incurred by government to provide security to citizens of country from external aggression.

Civil Expenditure: Government/incurs this expenditure to maintain law and order and administration of justice.

Development Expenditure: It is expenditure on development of agriculture, industry, trade and commerce, transport and communication etc.

21.7. Causes of Increase in Public Expenditure in India

During the planning period, the expenditure of Central and State Government's have increased. The Central Government's expenditure has increased over 10 times. Let us see central governments expenditure. The following are the main causes of growth of public expenditure in India.

1. Growing Population: A high growth of population naturally calls for increase in public expenses as all state functions are to be performed more extensively^ Population growth has made necessary for governments of most countries to spend increasing amounts on education, health, infrastructure, subsidies and social security. In 2011, the population of India has increased to 121 crores.

2. Defence Expenditure: The defence expenditure of the Central Government has increased over the years. The defence expenditure minimizes the possibility of external threats, which in turn creates a good environment for social and economic activities of the nation. In India Defence expenditure has increased from Rs. 15,427 crores in 1990-91 to Rs. 1, 41,781 crores in 2009-10.

Table-21.1: Defence Revenue Expenditure (Central Govt.)

Year	Rs. Crore
1980-81	3,600
1990-91	15,427
2000-01	49,622
2009-10	1,41,781
2010-11	1,54,117
2011-12	1,70,913
2012-13(BE:	1,93,407
2012-13(RE:	1,78,504
2013-14(BE:	20,3672

Source: - Economic Survey 2013-14

Note: BE: Budget Estimates; RE: Revised Estimates.

3. Interest Payments: Government borrowings are on increase. The government borrows funds from domestic market and foreign sources to meet expenditure on various government activities. As a result, the government has to incur huge interest payments. The interest payment of Central Government has increased from Rs. 25,006 crores in 1990-91 to Rs. 3, 17,287 crores in 2009-10.

Table-21.2: Interest Payments (Central Govt.)

Year	Rs. In Crores
1980-81	2,957
1990-91	25,006
2000-01	1,22,792

2009-10	3,17,287
2010-11	3,51,145
2011-12	4,03,235
2012-13(BE:	4,69,592
2012-13(RE:	4,65,129
2013-14(BE:	5,39,034

Source: - Economic Survey 2013-14**.**

5 Subsidies: Government of India has been providing subsidies on number of items such as food, fertilizers, fuels, education etc. Because of massive amount of subsidies, the government expenditure has increased over the years.

One of the major reasons for the increase in the centre's Fiscal deficit after 2008-09 has been the build-up in subsidies. As per the provisional actual figures of the CGA, the major subsidies in 2013-14 amounted to `2, 47,596 crore, well above the revised estimated figures. There has been a sharp increase in total subsidies from 1.42 per cent of GDP in 2007-08 to 2.26 per cent in 2013-14 (RE)

Food subsidy has been increasing owing to the widening gap between the economic cost of procurement by the Food Corporation of India (FCI) and the central issue prices fixed for cereals under the public distribution system (PDS). There has been partial decontrol of fertilizer subsidy, although prices of urea are still range bound; similarly petrol prices have been decontrolled and diesel prices are being subjected to monthly increases of 0.50 paise per litre. The under-recoveries of the oil marketing companies (OMCs) have been rising in tandem with international oil prices. The under-recoveries have increased from 77, 123 crore in 2007-08 to `1, 39,869 crore in 2013-14. The cap set on the number of subsidized liquefied petroleum gas (LPG) cylinders per month per family has also been increased from 9 to 12 from April 2014. The single largest component of the wider levels of FD as well as the current account deficit (CAD) owes to the inability to pass through rise in global oil prices to the domestic market. In addition, leakages from the system also contribute substantially to the overall increase in subsidy.

Table-21.3: Subsidies of the Central Government

Subsidy heads	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14(RE☺**
food	58443	63844	72822	85000	92000
Fe3rtilizer	61264	62301	70013	65613	67971

Petroleum	14951	38371	68484	96880	85480
Major subsidies	134658	164516	211319	247493	245451
Total subsidies	141351	173420	217941	257079	255516
As % of GDP	2.18	2.22	2.42	2.56	2.26

Source: Union Budget Document.

6. Administration: The Central Governments expenditure on administration has increased due to growth in population and economic development. Government incurs on law and order, tax administration, civil administration etc. Due to inflation the government has to revise the pay scale periodically. The production cost of public goods and services has also risen due to rising prices.

7. Rise in National Income: The national income of the country has increased over the years. The increase in national income resulted in more revenue to the government by way of tax revenue and other income, which in turn enabled the government to increase its expenditure. For ex. From 1980-81 to 2007-08, the N.I. has increased at the rate of 5.7% p.a. per capita Income has also risen.

8. Urbanization: Urbanization has led to increasing expenditure on civil administration. Government expenditure on courts, police, transport, railways, schools and colleges, public health measures, water and electricity supply, public parks, libraries etc. have increased due to growth of towns and cities.

9. Rural Development: In developing countries, government has to undertake community development projects and other social measures to promote rural development. Such measures cause a rise in public expenditure.

10. Inflation: Rise in prices has caused an increase in public expenditure. The cost of supplying public goods and services has increased. Rising prices have also necessitated the payment of higher salaries and dearness allowances.

11. Democratic Government: A democratic government has to incur increasing expenditure on elections, legislatures, ministries, international conferences, embassies abroad etc. Public expenditure also increases when a country becomes a member of international organizations like UNO, WHO etc.

12. Social Security Measures: For the welfare of the people government provides social security measures which increase its expenditure. It provides measures such as sickness benefits, old - age pensions, free education, medical facilities, public works and relief programmes etc.

13. Growth of Transport and Communication: The government has to incur huge expenditure on construction of railways, roadways, national highways, bridges etc. to promote mobility and economic development. Thus with growth of transport and v- communication public expenditure have increased.

14. Development of Agriculture: The government may develop agriculture by providing seeds, fertilizers, irrigation facilities, modern implements, cheap loans etc. All these will increase public expenditure.

15. Development of Industry: The government may encourage the growth of private sector industries through protection, subsidies to exporters, loans at cheap rate of interest etc. causing a rise in public expenditure.

16. Poverty Alleviation Programmes: In developing countries, governments are spending a good amount of funds on poverty alleviation and employment generation programmes. Some of the programmes are Swarnajayanti Gram Swarojgar Yojana, Indira Awas Yojana, National Food for Work Programme etc.

17. Research and Development: Research and Development is important to improve quality and to reduce costs. The government finances Research and Development projects undertaken by non - government organisations, universities and i other educational organisations.

18. Economic Planning: To promote rapid economic development modern governments adopt economic planning. The public sector outlay on various sectors has been increasing with the increasing role of government.

21.8 Trends in Public Expenditure

Gross voted public expenditure for the period 1997 to 2013 is summarised in the table below. The figures represent all current and capital spending by Government Departments and some of their agencies, including spending from the Social Insurance Fund, but does not include non-voted spending directly from the Central Fund such as debt-servicing costs. All figures are actual outturn figures.

Table-21.4: Trends in Public Expenditures (1997-2013)

Year	Total	Variations (%)	Current	Variations (%)	Capital	Variations (%)

1997	18,857,499	8.1%	16,851,240	8.0%	2,006,259	8.9%
1998	20,512,341	8.8%	17,978,261	6.7%	2,534,080	26.3%
1999	22,810,750	11.2%	19,737,640	9.8%	3,073,110	21.3%
2000	26,077,114	14.3%	22,146,662	12.2%	3,930,452	27.9%
2001	31,303,197	20.7%	26,327,524	19.7%	4,975,673	26.6%
2002	35,808,391	14.4%	30,224,518	14.8%	5,583,873	12.2%
2003	38,364,390	7.1%	33,003,585	9.2%	5,360,805	-4.0%
2004	40,750,645	6.2%	35,546,468	7.7%	5,204,177	-2.9%
2005	45,095,031	10.7%	39,212,152	10.3%	5,882,879	13.0%
2006	50,016,306	10.9%	43,355,261	10.6%	6,661,045	13.2%
2007	56,426,010	12.8%	48,606,873	12.1%	7,819,137	17.4%
2008	62,395,041	10.6%	53,383,957	9.8%	9,011,084	15.2%
2009	63,051,261	1.1%	55,718,650	4.4%	7,332,611	-18.6%
2010	60,563,570	-3.9%	54,178,899	-2.8%	6,384,671	-12.9%
2011	57,361,945	-5.3%	52,847,163	-2.5%	4,514,782	-29.3%
2012	55,838,480	-2.7%	52,137,699	-1.3%	3,700,781	-18.0%
2013	54,576,917	-2.3%	51,145,625	-1.9%	3,431,292	-7.3%

After a look at the trends in expenditure at the central level in the end, it is concluded that total expenditure of the central government has been rapidly growing and it increased at the rate of 14 per cent per annum throughout the study period. This sharp increase has been mainly on account of continuous increase in the share of revenue expenditure which created serious fiscal imbalance in the fiscal sector of the economy. What is more disturbing is that revenue expenditure shot up at the cost of capital expenditure. Besides it, as a result of reform measures, revenue expenditure has grown at a lower rate in the post-reform period than the pre-reform period. On the other hand, capital expenditure has recorded a higher growth in the post-reform period than the pre-reform period. As a proportion of GDP, total expenditure of the central government increased from 12 to 18 per cent in the pre-reform period but again declined to 12 per cent by mid-2000 in the post-reform period. Revenue expenditure as per cent of GDP was not only high and continuously growing in the pre-reform period but the gap between revenue expenditure and capital expenditure started widening in the mid-eighties. During the post-reform period, no doubt, it has followed a stable path but has not only much higher than capital expenditure and the gap between these two widened extremely up to mid-2000s.

While analyzing the components of revenue expenditure, it can be observed that non-developmental revenue expenditure contributes a significant proportion (more than 60 per cent: of total revenue expenditure of the central government. With the significant measures introduced by the government, only during 2000s, the share of growth of non-developmental revenue expenditure has started declining in the post-reform. Looking at the share of non-developmental and developmental capital expenditure in total capital expenditure of the central government, it is observed that the share of developmental capital expenditure has remained more than non-developmental capital expenditure in the pre-reform period, but this situation has been reversed in the post-reform period. It may thus be concluded that there is a need to give more emphasis in the reform process on improvement in the composition of revenue expenditure as well as of capital expenditure.

21.9 Expenditures in the Recent Budget

The recent Budget 2013-14 estimated total expenditure at `16, 65,297 crore which was 16.3 per cent and 18.1 per cent higher than 2012-13 (RE: and 2012-13(actual: respectively. The anticipated growth in total expenditure in 2013-14(BE: was mainly based on expected growth in capital expenditure (36.6 per cent over RE 2012-13:, while revenue expenditure was anticipated to grow by 13.7 per cent over RE 2012-13. 3.18 The Budget for 2013-14 estimated plan expenditure at `5, 55,322 crore which was 4.9 per cent of GDP and 29.6 per cent higher than RE 2012-13. Non-plan expenditure in BE 2013-14 at `11, 09,975 crore—9.8 per cent of GDP—reflected a growth of 10.8 per cent over RE 2012-13.

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Table-21.5: Development and non development expenditure

Year	Develop (DE)	Economic services (ES)	Social services (SS)	Non-Developm (NDE)	As % of GDP			
					DE	ES	SS	NDE
1980-81	133.27	56.44	10.08	98.67	8.91	3.77	0.67	
1981-82	137.91	67.37	12.44	126.44	7.84	3.83	0.71	7.19
1982-83	163.33	76.53	15.09	158.97	8.31	3.89	0.77	8.08
1983-84	194.07	90.43	16.89	183.64	8.47	3.95	0.74	8.02
1984-85	273.75	120.21	21.46	185.25	10.67	4.68	0.84	7.22
1985-86	329.09	140.14	14.96	208.99	11.37	4.84	0.52	7.22
1986-87	354.98	162.75	21.61	269.06	10.96	5.02	0.67	8.04
1987-88	365.73	157.22	23.69	302.61	9.93	4.27	0.64	8.22
1988-89	415.36	180.22	27.69	355.19	9.51	4.13	0.63	8.13
1989-90	542.04	256.02	30.61	410.02	10.08	5.01	0.61	8.17
1990-91	586.45	245.88	32.74	493.49	10.00	4.19	0.56	8.42
1991-92	593.13	236.81	35.69	551.07	8.08	3.51	0.53	8.19
1992-93	654.79	262.48	40.09	605.84	8.45	3.39	0.52	7.82
1993-94	724.64	275.07	48.03	735.86	8.13	3.09	0.54	8.26
1994-95	828.03	338.97	58.73	824.02	7.92	3.24	0.56	7.88
1995-96	844.27	350.29	76.55	986.32	6.88	2.86	0.62	8.04
1996-97	941.97	372.53	96.72	1,122.17	6.64	2.62	0.68	7.91
1997-98	1,109.94	442.46	118.45	1,278.02	7.06	2.81	0.75	8.13
1998-99	1,372.57	543.75	146.56	1,502.98	7.61	3.02	0.81	8.33
1999-00	1,291.51	609.56	172.21	1,779.28	6.42	3.03	0.86	8.84
2000-01	1,393.86	717.31	176.79	1,974.07	6.43	3.31	0.82	9.11
2001-02	1,593.64	808.68	151.03	2,154.56	6.79	3.44	0.64	9.17
2002-03	1,841.97	1,038.02	220.07	2,427.49	7.28	4.01	0.87	9.59
2003-04	1,954.28	1,080.71	238.59	2,432.98	6.89	3.81	0.84	8.57
2004-05	2,149.55	1,150.03	299.06	2,629.04	6.63	3.55	0.92	8.11
2005-06	2,290.06	1,330.53	382.64	2,906.77	6.02	3.06	1.04	7.87
2006-07	2,557.18	1,427.72	437.62	3,412.78	5.95	3.32	1.02	7.95
2007-08	3,256.07	1,729.55	616.48	4,007.28	6.53	3.47	1.24	8.04
2008-09	4,713.99	2,732.22	897.97	4,281.45	8.37	4.85	1.59	7.06
2009-10	5,282.42	3,044.04	1,026.28	5,141.01	8.18	4.71	1.59	7.96
2010-11	6,660.69	4,043.12	1,249.09	5,514.71	8.68	5.27	1.63	7.19
2011-12	1,605787			11,18,222				
2012-13	18,79,870			13,70,804				
2013-14	21,08,656			15,46,850				

2011-14 - in crores of Rupees; Other years in Billions of Rupees.

With total revenues falling short of budgeted levels by 5.1 per cent, total expenditure was later revised downwards by about 4.5 per cent to `15,90,434 crore in RE 2013-14 with a significant cut in plan expenditure, especially capital expenditure, while the non-plan expenditure (NPE: was left untouched (Figure 3.3:. Owing to continued economic slowdown, government spending needs to provide effective protection against inflation especially for poor. Thus as tax buoyancy (ratio of growth in tax revenues to growth in nominal GDP: continued to be weak on account of the economic slowdown, expenditure had to be rationalized and curtailed to consolidate the overall fiscal position in RE 2013-

PART-II: TRENDS IN PUBLIC DEBT

21.10 Introduction

Earlier, public debt was consider an important instrument for temporarily augmenting revenue or purchasing power in exchange for an obligation (under a promise: on the part of the government to repay the principal sum borrowed and in most instances interest on that principal. However, it has become a permanent feature. As mentioned in the “Encyclopedia of Britannica”,

Public debt refers to “obligations of Governments, particularly those evidenced by securities to pay certain sums to the holders at some future date.” Infact public debt is constituted when the government floats loans and borrows from the public. “The instrument of public borrowing is in the form of various types of government bonds and securities” (Saket, 2006:. Government needs to borrow when current revenue falls short of public expenditure.

Attitude towards public debt has also been changing from time to time. As classical economists viewed the economy as always being or tending to be fully employed, they opposed public debt on the ground that “somehow government borrowing diverts resources from “useful” or “productive” use in the private sector to “wasteful” public use” .Hence, in the 18 th century, their thinking on public debt stressed real rather than monetary aspects. Public debt was condemned by the early classical economists, mainly because of their lack of faith in the role of state in economic development. Adam Smith and Ricardo had very liberal attitude towards public debt though they did not fully subscribe to the Merchentalist view that public debt creation is in the public interest.

In the whole classical belt, T.R. Malthus is “an outstanding dissenter and it remained for Malthus alone among the Prominent classists to give a decidedly modern tone to the case for public debt”. To him, public debt not only augments production in the economy but also avoids glut in the market. By 1892, C.F. Bastable observed that “any State that pretends to be civilized regards the creation of a debt as one of the essential marks of having reached that position”. However, classical economists were not against all types of public debt. They approved public debt for productive purpose i.e. for self-liquidating projects.

It was Keynesian economics that effected a truly significant revision in the theory of public debt. Keynes completely dismissed the classical idea that a free enterprise economy is self-liquidating at full employment level. Instead, he argued that such an economy may tend toward under-employment equilibrium. According to him, borrowings are considered for financing government income- creating expenditures, when it takes the form of selling securities to the banking system. He held the views that increase in public debt through multiplier effect would raise the national income.

A.P. Lerner a profounder of the functional finance while approaching public debt argued that "a large public debt (provided that it was internally held: could never constitute a burden once it was incurred, and its incurring too would be painless given enough unemployed resources" (Newman, 1968:. Modern economist Musgrave is also not against all types of public debt. He observed that "borrowing in the capital budget is sound while borrowing in the current budget is unsound" (Musgrave, 1959)

21.11 Sources of Public Debt

There are two important sources of public borrowings, viz., internal sources and external sources. Internally, the government may borrow funds from individuals, charitable trusts, financial institutions, commercial banks and other financial intermediaries and the central bank in the country. Externally, the government may borrow from individuals, international financial institutions, and foreign governments.

1. Borrowing from Individuals: If an individual purchases government bonds, some adjustment in his consumption pattern or in the use of his accumulated savings must occur. When government bonds are sold to individuals, there will be very little direct effect in curtailing either consumption or business investment.

2. Borrowing from Non-Banking Financial Institutions: The non-banking financial institutions such as insurance companies, investment trusts, mutual savings banks, etc. buy government bonds; they reduce their idle cash balances by making investment in government bonds. However, these institutions prefer to invest their funds in government bonds on account of these bonds being perfectly free from credit-risk and also due to their high negotiability and liquidity. The rate of interest paid on government bonds is, however, relatively low.

3. Borrowing from Commercial Banks: Commercial banks can do so by creating additional purchasing power. The commercial banking system can make additional loans up to an amount determined by the credit multiplier which is determined by their excess cash reserves and the required reserves ratio.

4. Borrowing from Central Bank: The central bank of the country subscribes, and at times substantially, to government loans by supporting these loans in the money and capital markets.

This action creates purchasing power in the same manner as the commercial banks do. By purchasing government bonds, the central bank's credit the account of the government

5. Borrowings from External Sources: Apart from borrowing from different individual and institutional sources in the country, the government may also borrow from other countries. These borrowings can be used to finance war expenditure or to buy the much-needed defense equipments or to pay for the import of capital goods required for the various development projects etc In recent years, the two important external sources of government borrowings are firstly, the international financial institutions like the International Monetary Fund World Bank, International Development Association and International Finance Corporation. These financial institutions provide loans to member countries for short-term for overcoming the temporary balance of payments difficulties and for long-term for the development purposes.

The second external source of borrowing is the government assistance from Lending nations which is generally received for development projects. In modern times, for the less developed countries like India, external sources of government borrowing have become considerably important. Up to the end of June 2012, India had received massive long-term loan assistance of $850.6 billion from 68 World Bank loans and 142 IDA credits. She has also received massive assistance from the 'Aid India club.

21.12 Debt Position of the Government of India

Under Article 292 of the constitution of India, the central government is empowered to resort to borrowings either within or outside India, upon the security of the Consolidated Fund of India, within limits permitted by the Parliament to meet certain unavoidable expenditure. Likewise, the state governments, with the permission of the central government and approval of the respective state legislatures, can resort to market borrowings to meet their financial obligations. Public debt in India consists of internal liabilities and external debt. Internal liabilities are composed of internal debt and other internal liabilities. Internal debt includes market loans and bonds, treasury bills, special securities issued to Reserve Bank of India (RBI: and special bearer bonds. These are secured under Consolidated Fund of India. The other internal liabilities include small savings collections, provident funds, reserve funds and deposits.

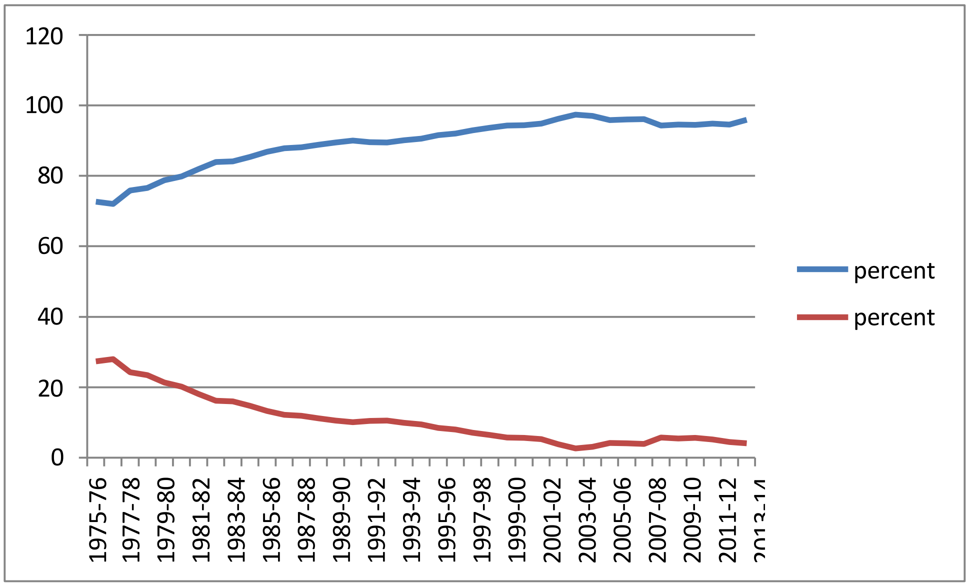
These are not secured under Consolidated Fund of India. External debt represents loans received from foreign governments and bodies. These are secured under Consolidated Fund of India.

Table-21.6: Public Debt of the Government of India (Amount outstanding at the end of March)

	Internal Debt		**External Debt**		
Year	**Per cent**	**Rs. In crores**	**Per cent**	**Rs. In crores**	**Total**
1975-76	72.66	19,904	27.34	7,489	27,393
1976-77	72.02	22,167	27.98	860	30,777
1977-78	75.78	28,125	24.22	8,985	37,110
1978-79	76.55	30,611	23.45	9,373	39,984

1979-80	78.07	36,806	21.03	9,964	46,770
1980-81	79.86	44,817	20.14	11,298	56,115
1981-82	81.92	55,858	18.08	12,328	68,186
1982-83	83.88	71,190	16.12	13,682	84,872
1983-84	84.06	79,784	15.94	15,120	94,904
1984-85	85.33	96,804	14.67	16,637	1,13,441
1985-86	86.79	1,19,331	13.21	18,153	1,37,484
1986-87	87.81	1,46,247	12.19	20,299	1,66,546
1987-88	88.12	1,72,338	11.88	23,223	1,95,561
1988-89	88.79	2,04,025	11.21	25,746	2,29,771
1989-90	89.43	2,39,850	10.57	28,343	2,68,193
1990-91	89.97	23,950	10.03	31,525	3,14,558
1991-92	89.58	3,17,714	10.42	36,948	3,54,662
1992-93	89.48	3,59,655	10.52	42,269	4,01,924
1993-94	90.09	430623	9.91	47345	477968
1994-95	90.54	487682	9.46	50929	538611
1995-96	91.54	554983	8.46	51249	606232
1996-97	91.97	621437	8.03	54239	67566
1997-98	92.89	722962	7.11	55332	778294
1998-99	93.58	834552	6.42	57254	91806
1999-00	94.27	962592	5.73	58437	1021029
2000-01	94.35	1102596	5.65	65945	168541
2001-02	94.76	1294863	5.24	71546	1366409
2002-03	96.17	1499589	3.83	59612	1559201
2003-04	97.34	1690554	2.66	46124	1736678
2004-05	96.95	1933544	3.05	60877	1994421
2005-06	95.83	2165902	4.17	94243	2260145
2006-07	95.95	2435880	4.05	102716	2538596
2007-08	96.11	2784351	3.89	112686	2897037
2008-09	94.26	2019841	5.74	123046	2142887
2009-10	94.56	2328339	5.44	134083	2462422
2010-11	94.42	2667112	5.58	157639	2824751
2011-12	94.80	3230622	5.20	177289	3407911
2012-13	94.51	3764566	4.49	177289	3941855
2013-14	95.88	4250297	4.12	182729	4433026

Graph-21 1: Trends in Public Debt



Graph 1 shows that public debt of the central government has been continuously increasing in India since 1975. Public debt of the central government of India increased from Rs. 27393 crore in 1975-76 to Rs. 2260145 crore in 2005-06 – recorded the growth of 16 per cent per annum (Table 6.2 and Table 6.3:. It was Rs. 2897037 crore in 2007-08 (R.E.) The reliance on borrowing increased substantially in 1980-81 as the borrowings increased to Rs. 56115 crore from Rs. 46770 crore in 1979-80. This was due to the serious erosion in the current savings of the central government in 1979-80 (Economic Survey, 1980-81:. The increase in the resources of the public sector undertakings tapered off after 1982-83. This led to substantial increase in borrowings in 1984-85 i.e., Rs. 113441 crore. This larger recourse to borrowing was facilitated due to various factors such as the availability of non-recurring receipts like the IMF loan and special bearer bonds in 1981-82 (Economic Survey, 1984-85). By 1985-86, the deficit on revenue account had risen to about 2.09 per cent of GDP. To meet its expenditure commitments (Economic Survey, 1986-87) the reliance on borrowed funds rose to Rs. 268193 crore in 1989-90. Total public debt, as a whole, registered a sharp increase from Rs. 27393 crore in 1975-76 to Rs. 268193 crore in 1989-90 - registered the growth of 18 per cent per annum. Increasing dependence on borrowings to meet the deficit on revenue account has led to a continuous growth in the total indebtedness. However, an increase in debt puts pressure on interest payments which in turn necessitates a further build up of debt (Economic Survey, 2003-

04:. It rose from Rs. 354662 crore in 1991-92 to Rs. 2260145 crore in 2005-06 – showing therein the growth of 14 per cent per annum during the post-reform period. Internal liabilities, as a component of public debt, registered a sharp increase from Rs. 19904 crore in 1975-76 to Rs. 239850 crore in 1989-90 – recorded the growth of 20 per cent per annum during the pre-reform period of fifteen 15years. The major contributory factors were oil shocks and political expediency (Singh, 2005:. This increase was also on account of increase in other internal liabilities vis-à-vis market borrowings (Economic Survey, 1991-92:. The share of this category in total public debt increased from 72.66 per cent in 1975-76 to 89.43 per cent in 1989-90. The declining trend in the fiscal deficit had a salutary impact in the economy. After liberalization the public debt continues in the same trend. In the year 190-91 it was 55.22 percent it has increased to 63.51 in the year 2002-03. It is more or less the same in the next years up to 2012-13, It varies around 62 percent.

Table-21.7: Total Public Debt of the Government as Percent of GDP

Year	Internal Debt	Other Debt	Total internal Debt	Total External debt	Total percent
1975-76	16.5	7.13	23.63	8.89	32.52
1976-77	15.93	8.49	24.42	9.49	33.91
1977-78	18.48	8.88	27.36	8.74	36.1
1978-79	17.83	9.63	27.46	8.41	35.87
1979-80	19.91	10.22	30.13	8.15	38.28
1980-81	21.23	9.6	30.83	7.77	38.6
1981-82	20.87	11.83	32.7	7.22	39.92
1982-83	24.57	12.68	37.25	7.16	44.41
1983-84	22.59	13.27	35.86	6.8	42.66
1984-85	23.48	15.36	38.84	6.67	45.51
1985-86	25.25	17.16	42.41	6.45	48.86
1986-87	27.42	19.03	46.45	6.45	52.9
1987-88	27.57	20.59	48.16	6.49	54.65
1988-89	26.97	21.08	48.05	6.06	54.11
1989-90	27.31	21.87	49.18	5.81	54.99
1990-91	27.04	22.65	49.69	5.53	55.22
1991-92	26.38	22.14	48.52	5.64	54.16
1992-93	26.46	21.32	47.78	5.61	53.39
1993-94	28.38	21.35	49.73	5.46	55.19
1994-95	26.23	21.78	48.01	5.01	53.02
1995-96	25.83	20.73	46.56	4.3	50.86
1996-97	24.99	20.08	45.07	3.93	49.00
1997-98	25.47	21.87	47.34	3.62	50.96
1998-99	26.26	21.39	47.65	3.27	50.92

1999-00	36.59	12.72	49.31	2.99	52.30
2000-01	38.23	14.21	52.44	3.13	55.57
2001-02	40.06	16.75	56.81	3.14	59.95
2002-03	41.58	19.51	61.09	2.42	63.51
2003-04	41.45	19.92	61.37	1.67	63.04
2004-05	40.51	20.88	61.39	1.93	63.32
2005-06	38.81	21.68	60.49	2.63	63.12
2006-07	37.27	21.49	58.75	2.48	61.23
2007-08	39.04	19.90	58.94	2.39	61.33
2008-09	38.02	20.12	58.14	2.35	60.49
2009-10	39.12	21.20	60.32	2.36	62.68
2010-11	40.12	22.03	62.15	2.37	64.52
2011-12	39.88	21.03	60.91	2.45	63.36
2012-13	40.35	21.03	61.38	2.11	63.49

Table -21.8:
Trends in Debt and Interest Payments of the Central Government (Rs. In Crores)

Year	**Interest payments**	**Public debt**	**Year**	**Interest payments**	**Public debt**
1975-76	1,228.16	27,393	1995-96	50,045.03	6,06,232
1976-77	1,374.44	30,777	1996-97	59,478.41	6,75,676
1977-78	1,521.35	37,110	1997-98	65,637.27	7,78,294
1978-79	1,828.97	39,984	1998-99	77,882.38	8,91,806
1979-80	2,209.86	46,770	1999-00	90,249.32	10,21,029
1980-81	2,604.03	56,115	2000-01	99,314.21	11,68,541
1981-82	3,194.68	68,186	2001-02	10,7460.02	13,66,409
1982-83	3,937.61	84,872	2002-03	117803.07	15,59,201
1983-84	4,795.46	94,904	2003-04	124087.08	17,36,678
1984-85	5,974.05	1,13,441	2004-05	126933.07	19,94,421
1985-86	7,503.46	1,37,484	2005-06	132630.05	22,60,145
1986-87	9,245.94	1,66,546	2006-07	150271.6	25,38,596
1987-88	11,251.36	1,95,561	2007-08	171971.01	28,97,037
1988-89	14,278.46	2,29,771	2008-09	2,53,614.00	21,42,887
1989-90	17,756.94	2,68,193	2009-10	3,17,227.00	24,62,422
1990-91	21,498.25	3,14,558	2010-11	3,51,145.00	28,24,751
1991-92	26,595.63	3,54,662	2011-12	4,03,235.00	34,07,911
1992-93	3,1075.47	4,01,924	2012-13	4,69,592.00	39,41,855
1993-94	36,740.55	4,77,968	2013-14	5,39,034.00	44,33,026
1994-95	44,060.01	5,38,611			

21.13 Methods of Debt Redemption

It was earlier thought that public debt should be paid off as quickly as possible. However, today, there is no cause of concern of internally-held debt and the magnitude of such public debt is not a correct measure of the burden of public debt. Even then, let us examine the various ways of ending debt obligations called debt-redemption or retirement of debt. Though debt redemption means repayment of public debt, in actually, there is replacement of maturing debts by new debts rather than the net retirement or repayment. The following are some methods of debt redemption or ending debt-obligations:

1. Sinking Fund Method: This method was first established by Hugh Walpole in England and later was adopted by most of the countries in the world including India. In this system, the government creates a separate fund known as 'Sinking Fund'.

2. Budget Surplus Method: Generally policy of surplus budgets may be utilized for clearing off public debts. But in recent years due to ever – increasing public expenditure, deficit budget has became the practice and arrangements have been made to repay a part of the debt from budget revenues

3. Terminal Annuities Method: This method of is similar to that of the sinking fund. In this method, the fiscal authorities clear off a part of the public debt every year by issuing terminable annuities to the bond holders which mature annually. By this method, the burden of debt goes on diminishing annually and by the time of maturity, it is fully paid off

4. Capital Levy Method: Capital levy provides for imposing 'all at once' tax on all the capital value possessions of the people. All capital goods are taxed above the capital possessions of minimum limit of value.

5. Refunding Method: Refunding of debt implies the issue of new bonds and securities by the government in order to repay the matured loans. This method is adopted by the government at a time when the debt burden is too heavy and when the scope for raising fund from the sources is limited

6. Conversion Method: In this method new debt replaces old debt. The process of conversion consists generally of converting public debt from a higher to a lower rate of interest. The government might have borrowed at a time when the rate of interest was high. Now, when the rate of interest falls, it may convert the old loans into new ones at a lower rate in order to minimize the burden.

21.14 Summary

In the above discussion the meaning of public expenditure and debt is discussed with definitions of the different authors of public economics. Public expenditure is the sum of expenditures incurred by the central, state and local self governments to provide social goods to satisfy the merit wants of the society that promotes their economic and social welfare. Public expenditure is classified into different categories in this unit. Public expenditure increases as a result of increasing economic activities of the government. Public expenditure involves transfer of purchasing power within the economy and its increases the productive capacity of the country. Public expenditure acts through its effects on the ability to work, save and invest. Public expenditure diverts the resources from present consumption to future consumption.

In developing economies like India, the dependence on public debt is increasing over a period, because debt has become an individual evil. Public debt relates to all kinds of obligations of the government. It depends upon the purpose and nature of arrangements made for borrowing funds. The sources from which government borrows funds may be classified into internal and external sources. Public debt may take the two forms; One is waste of productive efficiency for the economy as a whole. Second, Undesirable economic burdens imposed on sum classes or sections of the people. Loan finance necessarily spreads the burden among different generations while tax finance causes the present generations to bear the burden. If the burden of debt is viewed as a ratio of total debt to national income as explained by Domar, the burden of debt varies in relation to the variation in national income. If Public debt is used to finance the construction of productive assets, like railways, roads, irrigation projects, capital goods, industries there will be no real burden of internal debt.

21.15 Glossary

1. Public debt: The total borrowings of the government firm internal and external source.
2. Private debt: the amount that the individuals have to pay to others.
3. Productive debt: the debt that should be spent on productive activities are called productive debt.
4. Unproductive debt: the expenditure that should be spent on social activities is called unproductive debt.
5. Voluntary debt: the loans that are given to the government voluntarily.
6. Compulsory debt: Which the government compels the citizen to lend to the government.
7. BE: Budget Estimates.
8. RE: Revised Estimates.
9. CAD: Current Account Deficit.
10. Redemption of Debt: Borrowing and repayment of debt by the government for economic growth and stability. Debt management is related to the obligations of interest and principle repayment.

21.16 Preparatory Questions

1. Explain the meaning of the Public Expenditure and Public Debt.

2. Explain the need and importance of the public expenditure.

3. What are the objectives of the public expenditure?

4. Explain the classification of the public expenditure.

5. What are the causes of the increasing in public expenditure?

6. Explain the role of the subsidies in the public expenditure.

7. Explain the trends in the public expenditures since 1997.

8. Explain the trends in the expenditure in the recent budget.

9. Explain the development and non development expenditure.

11. What are the sources of public debt?

12. What are trends in public debt in India?

13. What are the redemption methods of public debt?

21.17 Books for Study

1. B.P. Tyagi: **Public Finance,** Jayaprakash Nath & Co. Meerut, 2012.
2. R.K. Lekhi: **Public Finance,** Kalyani Publishers, Ludhiana, 2011.
3. H.L. Bhatiya: **Public Finance,** Vikas Publishing House, New Delhi, 2010.
4. H. Dalton: **Principles of Public Finance,** Rowtledge and Kagan Paul, 1936.
5. R. A. Musgrove: **The Theory of Public Finance,** Mc Grew Hill, 1959.
6. M.C. Vaish & H.S. Agarwal **Public Finance,** Wiley Eastern.

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Lesson N0:21

Fiscal Crisis and fiscal sector reforms in India.

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22.0 Objective

The Objective of this lesson is to analyse that whether fiscal reforms taken by the States and Central Governments for resources mobilization led to reduction in deficits at the time of Fiscal crisis. The present strategy of Fiscal Policies and Fiscal Reforms in India is to test the status of existing financial crisis. Fiscal Reforms have helped the states in improving their fiscal health. This topic "Fiscal crisis and Fiscal Sector Reforms in India" makes a modest attempt to study and to identify the Indicators, Causes, Consequences and The Role of Fiscal Reforms at the time when economies passing through the difficult situations of Fiscal Crisis at domestic and International arena determinant of tax revenue and non-plan revenue expenditure of the states towards making their medium term projections. The main objective of fiscal reforms programme for states was to progressively improve the ‗Balance on Current Revenues' and reduce the revenue deficit in the medium term.

22.1 Fiscal Crisis its Impact on Growth and Development of Economy

Introduction

A fiscal crisis is a situation where government cannot finance its regular activities, including providing social services, paying for defence, and managing other government functions. There are a number of ways nations can attempt to address a fiscal crisis and they often involve hardship for many citizens. It is also possible for lesser units of governments, like states, provinces, and municipalities, to experience their own fiscal crises. These may occur as part of a larger economic problem or an independent issue.

Governments in a state of fiscal crisis cannot balance their budgets. They do not take in enough in tax revenues to cover their expenses and they cannot raise funds by floating government debt. The nation may already be servicing a large debt and can start to go into default. Usually, governments begin to slash as much funding as possible in an attempt to free up money for key functions, but this may not be enough to bring the government's spending back on an even keel.

The magnitude of fiscal consolidation which has taken place in India in the process of economic reforms and identifies the fiscal crisis ahead, the analysis is that while there has been some notable success in reducing the deficits of the budgets, the fiscal situation marked by large revenue deficits remains keeps the budget fragile. Fiscal correction has also had an adverse impact on government's capital spending. For the economic growth budgetary support for investment in infrastructure must be stepped up and government expenditure restructured. If these are to be achieved while adhering to norms of fiscal prudence/ the revenue-ratio would need to be raised by nearly 5 to 6% of GDP. That would call for massive effort towards augmenting tax and non-tax revenues at both levels of Government. Fundamental Fiscal and Institutional reforms will be needed in present situation Viz: in the system of federal transfers, the legal system, and the administrative methods. In 1980, the growing burden of non- plan expenditure caused deterioration in the fiscal situation of India. Later this resulted in a fiscal crisis at the beginning of 1991-1992.

Indicators of Fiscal Crisis

The main indicators of fiscal crisis are various deficits such as :-

1. **Revenue Deficit (RD)** : difference between revenue receipts (income) and revenue expenditure.
2. **Budgetary Deficit (BD)** : difference between total expenditure and total receipts. Here, both revenue and capital expenditure and receipts are considered.
3. **Fiscal Deficit (FD)** : excess of total expenditure over revenue receipts and grants. In other words, fiscal deficit is the budget deficit plus government borrowings and other liabilities.
4. **Primary Deficit (PD)** : fiscal deficit minus interest payments.

Government of India's Deficit

(As Percentage of GDP at Current Prices - Base 1993 - 94 Prices)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit
1990 - 91	3.3	6.6	2.8
1995 - 96	2.5	4.2	0.0
1999 - 00	3.5	5.4	0.7
2005 - 06	2.7	4.1	0.4
2006 - 07	1.9	-0.2	3.5
2007 - 08	1.1	-0.9	2.7
2008 - 09 (RE)	4.5*	2.5	6.1*
2009 - 10	5.3	6.7	3.2
2010 - 11	3.4	4.9	2.1
2011 - 12	4.4	5.7	2.7
2012 - 13	3.9	5.2	2.0
2013 - 14	3.3	4.8	1.5

From the above table, it is clear that fiscal deficit is about 4.1% of GDP. Overall the revenue deficit has declined from 3.3% in 1990-91 to 2.7% of GDP in 2005-06. The Interim Budget

2009-10 had placed the Revenue Deficit of 2008-09 (RE) at 4.4 per cent and the Fiscal Deficit at 6.0 per cent, based on GDP data available at that time. During the last decade (from 2001-02 to 2010-11) revenue deficit never touched zero. That‘s average was 3.33 during that period. Revenue deficit was very high in 2009-10 i.e., 5.18,and very low in 2007-08 i.e., 1.05 in 2007-08. This indicates that the Government has to take needy measures to curtail revenue deficit. The figures may not add up to the total due to rounding/approximations. The 2013-14 figures are RE and the 2014-15 figures are BE; BE - Budget Estimates Revenue deficit - 2.8%

Note: 1. The ratios to GDP at current market prices are based on CSO‘s National Accounts 19992000 series. 2. Fiscal deficit excludes transfer of states‘ share in small savings collections. 3. The ratios to GDP at current market prices are based on the CSO's National Accounts 2004-05 Series. Central Government : Revenue, Expenditure and Fiscal Deficit (% of GDP at current market prices) Note: 1- Deficits have been calculated on the basis of the following estimates of GDP (i) 2012-2013 (RE) Rs 10028118 crore (ii) 2013-2014 (BE) Rs 11371886 crore 2- GDP Estimates as per revised series with 2005-06 as base year, have been adopted for working out deficit as percentage of GDP

Source - a. Based on Economic Survey 2006 - 07, Union Budget documents.

b. Government of India, Various Budget Documents. Data book for PC; 22nd December, 2013

Causes of Fiscal Crisis

The main factors responsible for the fiscal crisis in India are as follows:-

1. Increase in Subsidies

The government has been providing subsidies on a number of items such as fertilizers, exports, food items, etc. This has resulted in a fiscal imbalance. The major subsidies provided by the Central Government of India have increased over the years resulting in fiscal imbalance.

2. Payment of Interest

One of the major components of government expenditure is the interest payment both on domestic loans and foreign loans. The government debt has increased considerably over the years.

3. Defence Expenditure

The defence expenditure is increasing over the years. The government has limited scope to reduce defence budget due to security reasons across the Indian borders.

4. Poor Performance of Public Sector

The poor performance of public sector has also resulted in fiscal imbalance. The poor performance of public sector is due to various reasons such as political interference, inefficiency and corruption of management, low labour efficiency, lack of professionalism, surplus staff, etc. Due to poor performance of public sector, the Government gets low revenue by way of dividend from public sector units.

5. Excessive Government borrowings

The internal and external debt of the government has increased considerably during the past decade. Due to the debts; the government has to incur high expenditure in the form of repayments.

6. Tax Evasion

Indian tax system is made up of complex procedures with numerous exemptions. Corruption is rampant at all levels, which leads to the fiscal imbalance.

7. Weak Revenue Mobilisation

Increase in government expenditure is the major cause of fiscal imbalance, inadequate rise in revenue receipts also contributed to fiscal imbalance. The payments of the centre, net of state's share and non-tax revenue, has increased at slower rate than that of growth in expenditure.

8. Huge Borrowings

The gap between expenditure and revenue is financed through loans, both internal and external. The borrowings have been spent on unproductive purposes as well. The huge borrowings resulted in large interest payments.

9. Other Causes

a) Unproductive expenditure by the government, b) Weak resource mobilisation and c)Low Capital Formation.

Consequences of Fiscal Crisis ↓

The fiscal imbalance has resulted in harmful consequences like mounting inflation, deficit in balance of payment, etc. It has also adversely affected the growth of economy. The government must introduce major fiscal correction policies to overcome the fiscal crisis. The consequences of fiscal crisis i.e. sustained high fiscal deficits over 20 years are as follows:-

1. Debt Trap

With increasing levels of borrowing for financing activities, which have zero or low yields, interest payments increase at faster rate. Thus rise in non-productive expenditures result to higher and higher revenue deficits.

2. Cut in Capital Expenditure

Because of debt service payments forming a higher proportion of expenditures, all other activities of the government suffer. The main sufferer in this process is government capital expenditure in both economic and social infrastructure.

3. No Increase in Expenditure on Education and Health

High debt service payments also prevent increase in or even maintenance of real expenditure on social services, i.e. on education and public health.

4. High Interest Rates

The continued high level of public borrowings has an effect on the rest of the economy through prevalence of high interest rates.

5. Slow Economic Growth

The fiscal imbalance affects economic growth in the country. Fiscal imbalance first affects capital formation which in turn affects the economic growth.

6. Other Consequences

Some other consequences of fiscal crisis are :-

1. Fiscal imbalance may also lead to inflation in the economy.
2. High fiscal deficit may discourage foreign investment in the country.
3. The government has to borrow additional funds to solve fiscal deficit, which put extra burden on the government for payment of interest. It further worsens the fiscal imbalance.

Conclusion on Fiscal Crisis ↓

The fiscal imbalance however still continues as the Government has failed to reduce its own expenditure. The extravagant expenditure done by politicians and minister continues without any restriction. The populist policy followed by the Government, failure to reduce fertilizer subsidy, and massive burden of interest payment has still not take out the Indian economy from a situation of severe fiscal imbalances.

The Role of Fiscal Policy in Crisis

Fiscal policies are often considered distinct from the monetary policies -- such as interest rate changes -- of the Federal Reserve.

The most important role of fiscal policy in crisis is to prevent further economic deterioration and restore overall vitality to the macro economy. One of the techniques used by most national governments is to force an increase in the money supply by reducing interest rates. Governments also attempts to increase overall spending, consumer confidence, and production output through fiscal policy. A national government may temporarily reduce taxes and increase its own spending in order to improve the overall health of the macro economy, rather than the financial health of individual population segments.

In order to prevent a complete economic collapse, a national government will employ fiscal policy in crisis in order to stimulate aggregate demand. An economic crisis is typically referred to as a severe recession or depression, where the monetary value of an economy's output stagnates or sharply declines. This usually occurs due to a gap between the costs of basic goods and services and the average consumer's income, in addition to businesses' ability to make adequate profit margins. When the government reduces the interest rate that it charges banks to borrow money, the hope is that consumers and businesses will be encouraged to secure the financing they need to purchase big ticket items such as homes, vehicles, and new facilities.

By encouraging an increase in spending, the average demand for goods and services usually goes up. Using the techniques of a fiscal policy in crisis helps stimulate the overall output and activity of a macro economy, but it does not guarantee that every business or individual will benefit. Tax incentives may be given to businesses in order to create more jobs or even higher-paying jobs. Temporary reductions in consumer taxes or incentives to purchase certain items, such as homes, might also be given to provide relief from financial burdens and allow for additional discretionary income.

Besides encouraging more consumer spending, government spending is another common part of fiscal policy in crisis. Sometimes consumers do not spend enough to lift a macro economy out of recession, despite interest rate reductions and tax incentives. Since a portion of an economy's gross domestic product (GDP) consists of government spending, it may invest in several projects, such as military experiments, energy research, or improvements to transportation infrastructures. In order to complete many of these projects, the government must employ outside contractors, which in turn creates jobs and pumps more money back into the consumer sector.

As the results of using a fiscal policy in crisis are seen, consumers and businesses tend to gain confidence in the economy's potential and health. They begin to become less conservative and restrictive in their willingness to spend and invest. In order to meet increased demand, suppliers must find ways to supply more products and services, which increases the amount of money circulating in the macro economy. Governments may then start to raise interest rates slightly to discourage high inflation and keep growth at an optimal rate.

Fiscal Policy for the Crisis

By encouraging an increase in spending, the average demand for goods and services usually goes up. Using the techniques of a **fiscal policy** in **crisis** helps stimulate the overall output and activity of a macro economy, but it does not guarantee that every business or individual will benefit.

- There are a number of ways nations can attempt to address a **fiscal crisis** and they often involve hardship for many citizens.

22.2 Fiscal Policy Meaning

Fiscal policy is the set of principles and decisions of a government regarding the level of public expenditure and mode of financing them. It is about the effort of government to influence the economy‘s output, employment and prices by altering the level of public expenditure, taxation and public debt. Arthur Smithies points out, ―Fiscal policy is a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment‖.

The Importance of Fiscal Policy -

The significance of this policy was not at all recognized by economists before the publication of Keynes‘s General Theory of Employment, Interest and Money. Keynes gave the concept of fiscal policy new meaning and operation of the public finance a new perspective. He made it clear that taxation, public spending and public debt are the effective instruments of public policy capable of determining the level of output and employment.

The importance of fiscal policy in modern economies arises from the fact that the State under democracy is called upon to play an active and important role in promoting economic development and providing a vast number of essential public utilities and services like drinking water, sanitation, civic services, primary education, public health, social welfare, defence, etc. Most of these goods are characterized by the property viz. non-marketable; that it cannot be sold in the market to the consumer. But payment has to be regulated in another way, through taxation.

In the underdeveloped economies, public finance has to assume yet another role, whereas in developed economies, it aims at maintaining economic stability. In underdeveloped economies, desirous of achieving rapid economic development, the function of public finance is to promote rapid economic development of the country, besides maintaining economic stability.

Objectives of fiscal policy

The principal objectives of fiscal policy in an economy are as follows:

1. **To mobilize resources for financing the development programmes in the public sector** - Tax policy is to be directed towards effective mobilization of all available resources and to harness them in the execution of development programmes. This implies, on the one hand, diversion of wasteful and luxury spending to saving and on the other hand productive investment of increments that accrue to production as a result of development efforts. Taxation can be a most effective means of increasing the total quantum of savings and investments in any economy where the propensity to consume is normally high.

2. **To promote development in the private sector** - In a mixed economy, private sector forms an important constituent of the economy. In spite of the growing importance of the public sector in accelerating the process of economic development, the interest of the private sector cannot be neglected. Therefore rebates, reliefs and liberal depreciation allowances may be granted to boost the private sector.

3. **To bring about an optimum utilization of resources** - The above objective can be achieved through proper allocation of resources. We must direct investment in the desirable channels both in the public and private sectors by providing suitable incentives. Productive resources are, within limits capable of being used in various ways, which may accelerate economic growth. The available resources must find their way into the socially necessary lines of development.

4. **To restrain inflationary pressures in the economy to ensure economic stability** - The fiscal policy must be used as an instrument for dealing with inflationary or deflationary situations. One way to achieve this is to devise a tax structure, which will automatically counter the economic disturbances as they arise. The second is to make changes in the tax system in order to deal with inflationary or deflationary situations. In countries like India, it is through the direction of the public expenditure rather than taxation that more effective action can be taken to remove the effect of a deflationary spiral. In terms of inflation, anti-inflationary taxes such as excess profit tax and commodity taxes on articles of both general and luxury consumption can be imposed.

5. **To improve distribution of income and wealth in the community for lessening economic inequalities** - The national income should be properly distributed so that the fruits of development are fairly shared by all people. Equality in income, wealth and opportunities must form an integral part of economic development and social advance. Moreover, redistribution of income in favour of the poorer sections of the society is essential. This can be achieved through taxation. We can also achieve this through an increase in public expenditure for promoting welfare to the less privileged class. Expenditure on agriculture, irrigation, education and health and medical expenses will improve the economic conditions of the weaker sections of the society. Fiscal policy can affect total spending. (aggregate demand determinant) in two ways. The first is the direct change in total spending brought about by the government increasing or decreasing its own expenditure. And the second one is increasing or reducing private spending by varying its own tax revenue.

6. **To obtain full employment and economic growth** - The fiscal policy to achieve full employment and to maintain stable price in the economy has been developed in the recent past. The ineffectiveness of monetary policy as a means to remove unemployment during the Great Depression paved the way for the development of fiscal policy in achieving this objective. For accelerating the rate of growth, allocation of higher proportion of the fully

employed resources is needed. Those activities increase the productive capacity of the economy. Therefore fiscal policy is used through its tax instrument to encourage investment and discourage consumption so that production may increase. It is also necessary to increase capital formation by reducing the high income tax on personal income. To increase employment, the state expenditure should be directed towards providing social and economic overheads. The state should undertake local public works of community development involving more labour and less capital per head.

7. **Fiscal policy and capital formation** - Fiscal policy such as taxes, tariffs, transfer payments, rebate and subsidies are expected to spur long run economic growth through increased capital formation. Capital formation is considered an important determinant of economic growth. The economic theory tells us that the optimal amount of capital formation serves a useful key to economic growth in developing economies. At the same time, the economic distortions brought about by lack of adequate fiscal incentives can cause capital formation to fall short of the socially optimal level.

Limitations to fiscal policy - Though the fiscal policy has an important place in economic development and in particular, in the stepping up of saving and investment both in public and in private sectors, it has the following limitations.

1) **Size of fiscal measures** - The budget is not a mere statement of receipts and revenues of the government. It explains and shapes the economic structure of a country. When the budget forms a small part of the national income in developing economies, fiscal policy cannot have the desired impact on the economic development. Direct taxation at times become an instrument of limited applicability, as the vast majority of the people are not covered by it.

2) **Fiscal policy as ineffective anti-cyclical measure** - Fiscal measures- both loosening fiscal policy and tightening fiscal policy- will not stimulate speedy economic growth of a country, when the different sectors of the economy are not closely integrated with one another. Action taken by the government may not always have the same effect on all the sectors.

3) Administrative delay - Fiscal measures may introduce delay, uncertainties and arbitrariness arising from administrative bottlenecks. As a result, fiscal policy fails to be a powerful and therefore a useful stabilization policy.

Setting of Fiscal Policy

- Tax **policy** and revenue forecasting are perhaps the two biggest issues studied under **fiscal policy** analysis. Tax **policy** represents the structure whereby a government intends to impose taxes on its citizens.
- It is the counterpart to **fiscal policy**, which involves public spending and taxation.

Control of Fiscal Policy

- A link between **fiscal policy** and taxes can be seen in the manner in which **fiscal policy** is used to **control** the total rate of demand for final goods and services in an economy.
- Can take two forms — **fiscal policy** or **monetary policy**. **Fiscal policy** is controlled by government.

Fiscal Policy Unemployment

- As a result of the discretionary **fiscal policy**, **unemployment** is incrementally reduced, consumer confidence begins to increase, and the economy is stimulated by the gradual upswing in consumer spending.
- Where this is the case, the main aim of the **fiscal policy** would be to try and stimulate the economy to a desirable balance between demand and supply as well as to address other macroeconomic factors, such as **unemployment**. The application of **fiscal policy** in a recession may affect the economy in several ways, depending on the particular unique circumstances surrounding the economy and the factors of the depression.

22.3 Financial Crisis:

The term financial crisis is used in a wide variety of contexts to refer to a situation where, for some reason or other, an institution or institutions lose a huge part of their value. Financial crises are a common occurrence in the world today especially in specific sectors of the economy. It has to be noted, though that a financial crisis is unlike an economic crisis which affects the entire economy. A financial crisis can hit a single sector of an economy and not necessarily affect the other sectors.

The causes of a financial crisis vary with the type of crisis. Although many economists have come up with causes of financial crises, there is hardly a consensus between economists on these causes. This is partly because the different perspectives of economics sometimes rival each other, and partly because perhaps every financial crisis is peculiar to itself.

Types of financial crises

Banking crisis

Banks usually provide deposit accounts where people deposit their savings and can withdraw them anytime. The banks then use these deposits to provide loans which are paid over a long period of time. Therefore, if the depositors all want to withdraw their money at one time, the bank finds itself in a situation where it is bankrupt because of lack of cash flow. When this occurs, then we call the situation a banking crisis.

Alternatively, banks may see this situation coming, and in trying to avoid this situation, banks will then be reluctant to provide credit and loans to people because of fears that it may not have enough cash to lend out. Such a situation is usually referred to as a credit crunch and it also accelerates a financial crisis.

Speculative bubble

Ideally in a stock exchange, people buy stocks in order to gain from the income it generates. However, some people buy stock by speculating the price, and hoping to see it a higher price later. If most people in a stock market buy speculatively, then chances are high that the price of that stock will be very high. And when they all want to sell at the same time, then the price is likely to fall too. At the time of buying, when the price of a stock is more than its current price plus dividends and interest, then the stock is said to be exhibiting a bubble.

International Crisis

This kind of crisis occurs when a country is forced to devalue its currency, either because of a speculative attack, or because it is not in a position to pay its debts. When a country is not able to pay its debts, that situation is called a default. When this occurs, all the countries that were trading with this particular country will be adversely affected. The investors will also lose the value of their investments due the fact that the currency they are using will have a much lower value.

It is important to note than even though one can give many reasons for financial crisis, it all boils down to poor management and poor strategy. Governments and financial institutions therefore need to improve their financial strategies in order to avert the dangers of financial crisis.

22.4 Fiscal Sector Reforms in India

Fiscal sector reforms play an important role in overall macroeconomic framework in India. Fiscal sector reforms helps to raise the rate of saving and investment which further enhances the productivity of government expenditure. Fiscal sector reforms in India include tax reforms, expenditure reform and systematic reform in government borrowing process.

The main objective of this study is to analyse fiscal sector reforms in India, and emphasized that the need of the hour that main purpose of the fiscal reforms programme was to achieve reduction in the size of the deficit and debt in relation to GDP.

The specific objectives of the study of Fiscal Sector Reforms in India are as to focus the important aspects of reforms are:

- to examine the impact of fiscal reforms on the public finances of the Union and state governments
- to evaluate the outcome of the different tax measures and public expenditure,
- to analyze the effectiveness of fiscal reforms.

The fiscal policy of the government uses fiscal elements to achieve desirable objectives. In other words, fiscal policy deals with elements like taxation, expenditure and borrowing decisions of the government. Therefore, Fiscal position of the central government is determined through its taxation policy, growth and pattern of the public expenditure and process of public borrowing. Fiscal reforms thus encompass tax-reforms, expenditure reforms and reforms in the borrowing process of the central government.

The implementation of Fiscal reforms approach is to maintain fiscal discipline in the Indian economy and the Indian economy categorically successful in the application of fiscal sector reforms at the National level however there has been some discrepancies at the State level. Fiscal reforms have brought a new vision for the government both at Central and State towards competitiveness and Scientific advanced skill oriented technical efficiency for managing the economy.

India's fiscal sector reforms help to raise the rate of savings and investments in India, which further enhances the productivity of public expenditure.

22.4.1 Components of India's Fiscal Sector Reforms

Some of the major components of India's fiscal sector reforms include expenditure reforms, tax reform measures, public sector restructuring and systematic reforms in the government's borrowing process.

Economic Conditions at the time of Reforms

In the post-independence years, with the gradual abatement of political and economic uncertainty, stimulating and accelerating growth was one of the primary objectives of fiscal policy. Thus, India embarked on a planning process since 1950 which assigned a large role to the public sector and taxation was made the mainstay of public finances. Fiscal policy focused on achieving greater equity and social justice during the 1970s and both taxation and expenditure policies were employed towards fulfilling this objective. High marginal tax rates did not yield the necessary revenue to support the envisaged public expenditure.

The growth in receipts thus lagged behind the surge in disbursements despite substantial amount of resources mobilized through additional taxation and hike in the administered prices High marginal tax rates did not yield the necessary revenue to support the envisaged public expenditure. The growth in receipts thus lagged behind the surge in disbursements despite substantial amount of resources mobilized through additional taxation and hike in the administered prices

The fiscal imbalances of the 1980s spilled over to the external sector resulting in the macroeconomic crisis of 1991. Another disquieting feature of the fiscal system was the large size of monetized deficit which exerted inflationary pressures. The persistent and burgeoning revenue deficit which became endemic in the system pre-empted the borrowed resources, reducing the availability of resources for capital investment .Although the first half of the 1990s witnessed some fiscal correction, its retraction during the second half of the decade underlined the need for a consistent and sustainable fiscal consolidation process. The Government, therefore, formulated and enacted the fiscal responsibility legislation which signalled a new dawn in fiscal consolidation. In the ensuing paragraphs, a survey of the empirical research in the various areas listed above is undertaken.

Taxation

In the planned economy model adopted since Independence, taxation was used as an instrument for reducing private consumption and transferring resources to the Government to enable it to undertake large-scale public investment in an effort to spur economic growth. Taxation was also used to reduce inequalities through progressivity in respect of income and wealth, particularly during the 1970s.

The non-integrated and complex nature of the indirect tax structure and the problems it created in terms of multiplicity of levies and the resultant cascading effects received attention in the mid-1980s. Preliminary steps to reform the tax structure were taken in the form of introducing the modified value added tax (MODVAT). Tax reforms received a boost in the early 1990s under the structural adjustment programme initiated in the wake of the economic crisis of 1991. Since then, reforms in the tax structure, both direct and indirect, have been a continuous process

Phase I: 1947-1968

In the post-independence era, taxation policy was geared towards achieving the economic objectives of promoting employment through grant of tax incentives to new investment; reducing inequality through progressive taxes on income and wealth; reducing pressure on balance of payments through increase of import duties; and stabilizing prices through tax rebate in excise duties on consumption goods. Given the narrow tax base, the tax policy relied more on indirect taxes.

The first comprehensive attempt at reforming the tax system was by the Taxation Enquiry Commission (TEC)-1953-54 (Chairman: John Matthai). The first major official study on the incidence of direct and indirect taxation was brought out by the Matthai Commission. This was followed up by similar studies during 1961 and 1969 which employed derivatives of the original study. Shifting of corporate income tax incidence in India was studied by Lall (1967) and Laumas (1966) Major thrust was given on tax system. Taxation policy was geared to promote employment by providing incentives & tax holidays , reduce inequality of income through progressive taxation, reduce pressure on balance of payment through increase of import duty ,stabilizing prices through tax rebate in excise duty on consumption goods ,tax policy more relied on indirect tax.

Phase II: 1969-1980

During this phase, in addition to promoting economic growth, fiscal policy was also used as a means to reduce income inequality. Taxation was used as a prime instrument to achieve this objective during the initial years. To meet its objective of alleviating poverty and bringing about greater social justice, the Government raised the income tax rates to substantially high levels during the 1970s - marginal rate of taxation moved up to 97 per cent and, together with the incidence of wealth tax, crossed 100 per cent. Wealth tax, estate duty (on inherited wealth) and gift tax (on transfer of wealth) were imposed. Indirect taxes were hiked on goods considered luxuries or inessential.

Phase III: 1981-90

This phase began with a grim economic situation characterized by low economic growth, high inflation and deterioration in balance of payments due to sharp increase in prices of crude oil imports. The Government sought toreduce its deficit through tax increases. New tax savings instruments were introduced to enable financing of the large plan expenditure. Tax concessions were also given to non-residents to encourage flow of foreign exchange remittances to address the balance of payments problem. Customs duties were hiked to contain growth in imports, augment revenue and protect the domestic industry

The Long-term Fiscal Policy announced by the Government of India in 1985 presented for the first time a long-term perspective for fiscal policy in which the Central Government recognized the deteriorating fiscal position as the most important challenge of the 1980s and set out specific targets and policies for achieving fiscal turnaround. It indicated a direction of change in tax policy required to promote growth, increase built-in elasticity of the tax system, secure better tax compliance and move towards a more equitable distribution of the burden of financing the Plan.

A modified system of Value Added Tax (MODVAT) was introduced in 1986 in a phased manner to reduce the distortionary effect of tax on production, minimize tax cascading and increase progressively. Reforms in customs duty focused on increased reliance on tariff system rather than on quantitative restrictions to regulate imports in order to yield more revenue.

This phase marked the first real effort towards a long-term perspective for tax reform, which in turn was spurred by the realization on the part of the policy makers that:

(a) the economic effects of taxation have to be considered to ensure against distortions in resource allocation and adverse effect on economic growth;

(b) the administrative implications and the possible behavioural response of both tax administrators as well as tax payers have to be considered while designing the tax structure. Thus, considerable importance was given to the issue of tax evasion and the factors which determined

Phase IV: 1991 onwards

Tax reform efforts prior to 1991 focused on enhancing revenue productivity to finance large developmental plans and promoting equity. Tax reforms since 1991 were initially undertaken as a part of the structural reform process following the macroeconomic crisis of 1991 (Box1). The reforms aimed at augmenting revenues and removing anomalies in the tax structure through restructuring, simplification and rationalization of both direct and indirect taxes drawing mainly from the recommendations of the Tax Reforms Committee 1991 (Chairman:Dr.Raja J. Chelliah).

The key tax reforms include lowering the maximum marginal rate on personal income tax; widening of the tax base by way of a series of steps including introduction of presumptive taxes, adoption of a set of six (one-by-six) economic criteria for identification of potential tax payers in urban areas and taxation of services; reducing the corporate tax rate on both domestic and foreign companies; unification of tax rates on closely held as well as widely held domestic companies; rationalization of capital gains tax and dividend tax; progressive reduction in the peak rate of customs duty on non-agricultural products and rationalization of excise duties it.

22.4.2 Union Budget 2010-11: Fiscal Reforms in India

The Union Budget for 2010-11 was widely anticipated to signal a return to fiscal consolidation, while also making some announcements on the much awaited structural reforms in areas like implementation of Goods and Services Tax (GST), Direct Tax Code (DTC), and other subsidies. The Budget subsequently announced a roadmap for fiscal consolidation, including reduction of government debt, timelines for implementation of DTC and GST, and partial rollback of Excise Duty.

The focus of expenditure remains on promoting growth and infrastructure development, with 46% of the allocations being devoted to infrastructure while revenue expenditure growth has been budgeted at 6% for 2009-10. The higher target of Rs.400 billion set for disinvestment proceeds creates fiscal space for the budgeted 30% growth in capital expenditure, including expenditure on roads, recapitalization of public sector banks to the extent of Rs.150 billion, and a considerable increase in the defence sectors.

The Union Budget for 2010-11 has retained the previous year‘s target of 5.5% for the fiscal deficit in 2010-11. The forecasted improvement in the fiscal deficit in 2010-11, as compared to the revised estimate of 6.7% of the GDP in 2009-10, relies largely on the expectation that the revenue deficit would improve from 5.3% of GDP in 2009-10 to 4% of GDP in 2010-11.

The International Monetary Fund (IMF) expects the Indian economy to come back to its strength by 2010-11 by growing 8%, from 6.75% logged in the current fiscal year. The

IMF also believes that India's inflation to be 8.1% for the current fiscal and 5.5 % for 2010-11 based on the wholesale price index.

Growth in GDP at factor cost and its Components at 2004-05 prices

(Percent per annum)

	Agriculture Forestry & Fishing	Mining & Quarrying	Manu-fact-turning	Cons-truction	Electricity, gas, and water supply	Trade, hotels, storage, transport and communications	Finance, insurance, real estate & business services		GDP at Factor cost
1980-81	12.9	12.2	0.2	13.2	5.7	5.7	1.9	4.1	7.5
1981-82	4.6	13.7	8.2	5.5	9.5	6.2	8.1	2.1	5.7
1982-83	-0.3	11.9	3.3	-7.0	6.6	5.4	9.5	7.7	2.9
1983-84	10.1	2.9	10.2	5.4	6.9	5.1	9.8	3.7	7.8
1984-85	1.6	1.2	4.2	3.5	10.8	4.8	7.5	6.9	4.0
1985-86	0.3	5.5	3.2	5.7	7.9	7.9	9.8	5.7	4.3
1986-87	-0.4	12.2	5.5	2.4	10.3	6.0	10.5	7.5	4.5
1987-88	-1.6	3.8	5.6	5.7	7.8	5.3	7.3	7.2	3.7
1988-89	15.6	16.2	8.5	7.0	9.7	5.8	9.8	6.0	10.1
1989-90	1.2	7.6	8.8	7.0	9.7	7.4	12.4	7.9	6.3
1990-91	4.0	10.5	4.8	11.8	6.7	5.1	6.2	4.4	5.4
1991-92	-2.0	3.4	-2.4	2.1	9.7	2.6	10.8	2.6	1.6
1992-93	6.7	0.9	3.1	3.5	6.9	5.6	5.4	6.0	5.3
1993-94	3.3	1.4	8.6	0.6	7.5	6.9	11.2	4.5	5.7
1994-95	4.7	9.3	10.8	5.4	9.4	9.9	3.9	2.3	6.4
1995-96	-0.7	5.9	15.5	6.0	6.8	13.2	8.1	7.3	7.4
1996-97	9.9	0.6	9.5	1.9	5.4	8.1	6.2	8.1	7.8
1997-98	-2.6	9.8	0.1	10.5	7.7	7.5	11.7	8.3	4.5
1998-99	6.3	2.8	3.1	6.3	7.0	7.6	7.8	9.7	6.6
1999-00	2.7	3.2	3.2	8.4	5.5	8.2	9.2	11.5	6.5
2000-01	-0.2	2.4	7.7	6.2	2.1	7.3	4.1	4.7	4.4
2001-02	6.3	1.8	2.5	4.0	1.7	9.2	7.3	4.1	5.7
2002-03	-7.2	8.8	6.8	7.9	4.7	9.4	8.0	3.9	4.0
2003-04	10.0	3.1	6.6	12.0	4.8	12.0	5.6	5.4	8.4
2004-05	0.05	8.2	8.7	16.1	7.9	10.7	8.7	6.8	7.6
2005-06	5.1	1.3	10.1	12.8	7.1	12.0	12.6	7.1	9.5
2006-07	4.2	7.5	14.3	10.3	9.3	11.6	14.0	2.8	9.6
2007-08	5.8	3.7	10.3	10.8	8.3	10.9	12.0	6.9	9.3
2008-09	0.1	2.1	4.3	5.3	4.6	7.5	12.0	12.5	6.7
2009-10	1.0	6.3	9.7	7.0	6.3	10.3	9.4	12.0	8.4
2010-11	7.0	5.0	7.6	8.0	3.0	11.1	10.4	4.5	8.4
2011-12	2.8	-0.9	2.5	5.3	7.9	9.9	9.6	5.8	6.5

Source (Basic data): National Income Accounts, CSO

Note: for years prior to 2004-05, the 1999-00 base series is taken backwards based on splicing.

The framers of the Indian Constitution wanted to build a strong united India. The Commission on centre-state relations, 1988, observed, "In a country too large and diverse for a unitary form of government, the framers of the Constitution envisaged a system which would be worked in co-operation by the two levels of government - national and regional - as a common endeavour to serve the people." (Surry, 2007). So India has adopted federalism to actualize and uphold the values of national unity, cultural diversity, democracy, regional autonomy and rapid socio-economic transformation.

India is a classical federation with a constitutional division of the revenue powers and expenditure functions between the central government and state governments. The Constitution makes elaborate and complex arrangements relating to the distribution of revenue, expenditure and the power of borrowing between the central government and the state governments. The Indian Constitution has assigned the powers of the central government and state governments into three lists: a union list, a state list and a concurrent list.

Amongst the sources of revenue of the government, taxation being the major source, Article 265 of the Constitution specifically states that no taxes shall be levied or collected except by the authority of law. Entries 82 to 92(b) of union list in the Seventh Schedule refer to the taxation powers of the central government. Entries 45 to 63 of state list in the same schedule specify the taxation powers of the state governments. Concurrent list does not contain any head of taxation which means the union and the states have no concurrent powers of the taxation. The Constitution (73rd and 74th Amendment) Act 1992 has conferred constitutional status to the structure and mandate of Panchayats and Municipalities, respectively.

Fiscal experts have mentioned time to time that no doubt, there is a clear-cut distribution of tax powers between the centre and state governments but there are some problems in this system. The division of tax powers based on efficiency considerations and scientific principles have created a gap in the revenue resources and requirements of the states as the elastic and productive sources of tax revenue fall in the jurisdiction of the union government (Bhargava, 1984).

The Constitution assigns a number of important tax resources to the central government and a limited amount of tax resources to the states (Mohan, 2003). The states are allowed to levy taxes on the sale and purchase of goods (Entry 54 in the state list) but not on services (Singh, 2004). This besides providing avenues for tax evasion and avoidance has also posed problems in designing and implementing a comprehensive (VAT).

In the case of distribution of expenditure powers, "the functions of the central government are those required to maintain macro-economic stability, international trade and relations, and those having implications for more than one state. The major subjects assigned to the states comprise public health, agriculture, irrigation, land rights, fisheries, and industries and minerals. The States also assume a significant role for subjects in the concurrent list, such as: education and transportation, social security and social insurance." (Singh, 2004).

Some experts are of the view that more functions are assigned to the state governments so the amount required to spend is also more for the state governments. Rao and Singh (1998) observed that state and local governments have to incur expenditures on most quasi-public goods including many social services like education, preventive and curative health care, water supply and social security and welfare and economic services like building physical infrastructures. On the other hand, some experts are of the view that "the expenditure assignment of the government at the union, state and local levels is not based on the content of concentration of marginalized groups or population size." (Patel and Sapovadia, 2003).

So far as another important instrument of fiscal system i.e., the borrowing powers of the centre and state governments are concerned, it is regulated by Articles 292 and 293 of the Constitution. Article 292 of the Constitution empowers the Government of India to borrow upon the security of the consolidated fund of India, i.e., the resources of the centre; subject only to such limitations as Parliament by law may impose. The Government of India can borrow internally as well as externally. States too are empowered to borrow under Article 293. According to this Article, a state cannot borrow outside India. The borrowing powers of the states are limited. Furthermore, if a state is indebted to the centre, it may not resort to further borrowing without prior consent of the central government. It is a knotty problem of the fiscal system that the Constitution has restricted the borrowing powers of the states.

The Constitution recognizes that because of its design, assignment of tax powers and expenditure functions would create imbalances between expenditure 'needs' and abilities to raise revenue between the centre and the state governments. The imbalances could be both vertical, among different levels of government, and horizontal, among different units within a sub-central level (Rao and Singh, 2001). To correct this imbalance, the Constitution provided for statutory fiscal transfers from the centre to the states through the instrumentality of the Finance Commission.

The Finance Commission is constituted every five years to recommend allocations of central taxes to the states. It also forecasts the revenue and expenditure of the state governments and recommends additional assistance in the form of grants-in-aid to close the resource gap. In addition, the Planning Commission also gives assistance to the states on the basis of an established formula (Gadgil formula) and different central ministries give specific purpose transfers to states.

Under such a fiscal federation, the fiscal situation of both the centre and state governments remained comfortable till 1980. But there was a significant deterioration in the fiscal situation in 1980's, especially by the second half, which was marked by high and persistent fiscal deficits accompanied by large revenue deficits. This large fiscal deficit had some spill-over effects on the external sector which was reflected in the widening current account deficit in the early 1990s. In fact, there were two sources of external shocks which contributed the most to India's large current account deficit in 1990-91. "The first shock came from events in the Middle East in 1990 and the consequent run up in world oil prices, which helped precipitate the crisis in India. Second, the deterioration of the current account was also induced by slow growth in important trading partners." (Cerra and Saxena, 2002).

In the past also India had experienced macro-economic crisis in the mid-60s, in the mid-70s and in the mid-80s. It was mainly due to supply shocks, both internal and external. The economic crisis of the mid-sixties owed its origin to two successive droughts of 1965-66 and 1966-67 and the two wars: the Indo-China war of 1962 and the Indo- Pak war of 1965. The second major crisis occurred in the mid-seventies due to the combined effect of monsoon failures of 1972 and 1974, and the first external oil shock.

The third major crisis occurred in 1979, again due to the combined effect of bad weather and the second oil shock" (Klein and Palanivel, 2000). It was only after the crisis of the early 1990s, when India's foreign currency assets depleted rapidly to the extent that it could barely finance just two weeks of imports, India realized the need to start the process of fiscal reforms as a part of economic reform measures in 1991-92.

Fiscal sector reforms were the integral and the most critical part of the macro-economic stabilization and reforms programme taken by the government after 1991 crisis (JBIC Research Paper No. 11, 2001).

The primary objective of the fiscal reforms programme was to achieve a reduction in the size of deficit and debt in relation to GDP. Many least developed countries (Bangladesh, Malawi, The Gambia and the United Republic of Tanzania) also faced serious macro-economic difficulties during the 1980s, which included the growth of unsustainable fiscal deficits, and they implemented major tax and expenditure reforms as part of the stabilization and adjustment programme.

Moreover, an important feature of India's reform programme, when compared with reforms undertaken by many other countries, is that it has emphasized gradualism and evolutionary transition rather than rapid restructuring 'shock therapy'. The reform measures were initiated in the backdrop of a crisis but not a 'system collapse' (JBIC Research Paper No. 11, 2001).

The major structural change made during fiscal reforms programme was a step towards decentralization i.e., the conversion of two-tier structure into three-tier structure.

With the 73rd and 74th Constitutional Amendments in 1993, roles and responsibilities of rural and urban local governments have been specified. A list of 29 functions to rural local bodies has been specified in a separate list.

Another list of 18 functions has been specified for urban local bodies. These functions can be divided into 4 or 5 categories, viz. socio-economic schemes, beneficiary oriented schemes, national policy schemes, infrastructure creating schemes and State or Centrally Sponsored Schemes. This reform is a step towards strengthening the third layer of government in India. Fiscal position of the government is determined through its taxation policy, growth and pattern of public expenditure and process of public borrowings. Fiscal reforms thus encompass tax reforms, expenditure reforms and systemic reforms in governments' borrowing process of the central government and fiscal reform initiatives of the state and local governments.

22.4.3 Fiscal Reforms of the Central Government

(i) Revenue Reforms

In order to augment public revenue, the main focus has remained on taxation reforms. No doubt, since independence a number of attempts have been made at improving the tax structure in the sphere of direct as well as indirect taxes. The first comprehensive attempt at reforming the tax system was made by the Tax Enquiry Committee in 1953 (Rao, 2000). This provided the backdrop for the Second five year Plan (1956-60), and was required to fulfil a variety of objectives such as raising the level of savings and investment, effecting resource transfer from the private to the public sector and achieving a desired state of redistribution (Rao, 2005).

A number of attempts have been made to remedy various aspects of direct taxes from time to time. As regards the personal income taxes, the most drastic and visible changes have been seen in reduction in personal and corporate income taxes. In the case of personal income taxes, the attempt to achieve the desired state of redistribution caused the policy makers to design the income tax system with confiscatory marginal rates. Tax evasion, low profitability of detection and the ineffective legal system that failed to impose penalty within a reasonable time period (Rao, 2005) led the Direct Taxes enquiry committee in 1971 to recommend significant reduction in marginal tax rates. On the recommendation of the Direct Taxes Enquiry Committee, the highest marginal tax rate has been brought down to stimulate domestic demand from 77 per cent in 1974-75 to 66 per cent in 1976-77, to 50 per cent in 1985-86, to 40 per cent in 1992- 93 and further to 30 per cent since 1997-98.

A new scheme called "one by six" was introduced to widen the tax net during 1998-99. ¯Under this scheme, a person possessing a house, a telephone, motor vehicle, spending on foreign travel, holding of credit card and membership of expensive clubs was liable to file an income tax return. This scheme was introduced in 12 districts in 1997-98 budgets and was extended to 35 districts in 1998- 99, 54 districts in 1999-2000 and to 133 districts in 2000- 01."

(Gupta and Kaur, 2004). By 2003-04, it was applicable throughout the country. This scheme was abolished in 2005-06.

In Indian federal scenario, the mechanism of transfers from the centre to states also makes a significant impact on the resources of both these layers of government. The percentage share of gross revenue receipts of the central government transferred to the states reached to the peak level of 40.33 per cent during the award period of FC-IX (1989-95). However since 1979, 35 per cent to 40 per cent of gross revenue receipts of the central government of India are transferred to the state governments (Table 3.1). Central transfers dipped to around 35 per cent by FC-X and FC-XI. During the period covered by FC-XII, the percentage share.

Table 3.1: Revenue Transfers from Centre to States as Percentage of Gross Revenue Receipts of the Centre

Years	Transfers
FC-VII (1979-84)	38.11
FC-VIII (1984-89)	37.86
FC-IX (1989-95)	40.33
FC-X (1995-2000)	35.79
FC-XI (2000-2005)	35.27
FC-XII (2005-10)	38.51

Note: These are revenue account transfers. Prior to FC-XII, Plan assistance also carried a loan component, which varied as a share of total assistance from 70 per cent for general category states, to 10 per cent for special category states. Prior to 1999-2000, there was also on-lending by the centre to states of net collections in small savings schemes.

Source: Report of Twelfth Finance Commission (2005) and Thirteenth Finance Commission (2010).of transfers rose to 38.51 per cent. However, the percentage share of gross revenue receipts of the centre to states during FC-X, FC-XI and FC-XII has remained less than that was during FC-IX. So, by reducing the share of transfers from gross revenue receipts the central government is trying to improve its own fiscal position. On the other hand, such a change is deteriorating the fiscal position of state governments.

The share of total transfers through different mechanisms has been shown in the following Table. Transfers through the Finance Commissions are predominant, accounting for about 60 to 70 per cent of total central transfers to states and have shown variation over time. There has been an increase in the share of Finance Commission transfers from 60.13 per cent in the award period of FC-VIII to 69.38 per cent in the award period of FC-XI. It went down to 68.03 per cent in the award period of FC-XII. Within the Finance Commission transfers, there has been an increase in the share of grants, particularly in the periods covered by FC-XI and FC-XII. FC-XII felt that grants could be targeted better and that cost disabilities and distributive considerations could be addressed more effectively through grants than through tax devolutions (Report of Thirteenth Finance Commission, 2010-15). Accordingly, the Commission increased the share of grants in the transfers recommended by it.

Table : Percentage Composition of Revenue Transfers from the Centre to States

Years	Finance Commission Transfers: Share in Central Taxes	Grants	Total Finance Commission	Other Transfers: Plan Grants	Non Plan Grants	Total Other Transfers (5+6)	Total Transfers (4+7)
1	2	3	4	5	6	7	8
FC-VIII (1984-89)	53.48	6.65	60.13	35.80	4.07	39.87	100.00
FC-IX (1989-95)	52.98	8.48	61.46	35.91	2.63	38.54	100.00
FC-X (1995-00)	62.06	6.55	68.61	29.52	1.87	31.39	100.00
FC-XI (2000-05)	58.38	11.00	69.38	28.65	1.97	30.62	100.00
FC-XII (2005-10)	56.48	11.55	68.03	28.55	3.43	31.97	100.00

Source: Report of Twelfth Finance Commission, 2005.

Other transfers have declined from 40 to 30 per cent of total central transfers to states. The share of plan grants declined to 28.55 per cent in 2005-10 from 35.91 per cent in the period of FC-IX. This is on account of a shift in the composition of plan grants as well as higher transfers through CSS (Centrally Sponsored Schemes). Thus, over the years, the importance of FC in devolution of resources to the states has increased and of Planning Commission has declined.

In line with the Long term Fiscal Policy (LTFP), significant reforms were also carried out in the area of corporate taxation which aimed at increasing the generation of internal resources, while simultaneously providing stimulus to industrial investment, growth and modernization. Corporate income tax has been substantially rationalized in real earnest in 1983-84, with removal of the step system of taxation of corporate income. By the year 1991-92, widely held (shares quoted in stock market) and closely held (family concerns) domestic companies were taxed at 51.75 and 57.5 per cent, respectively and foreign companies were taxed at 65 per cent. Following the recommendations of Tax Reforms Committee (TRC) 1991, the distinction between closely held and widely held companies was unified at 46 per cent in 1994-95. The tax rate on foreign companies was reduced to 55 per cent in 1994-95 (Economic Survey, 1994-95). However, the rates were progressively reduced in 1997-98 to 35 per cent in case of domestic companies and 48 per cent in case of foreign companies. In 2002-03, the rate of tax for foreign company was further reduced to 40 per cent while the rate of tax for domestic company remained at 35 per cent. The corporate income tax for domestic companies was reduced to 30 per cent in 2005-06. Further, there has been no change in existing rates of corporate tax. Also, the dividend tax at the individual income tax level was abolished.

However, to tackle the phenomenon of zero tax, an effort was made by bringing such companies having substantial book profits under Minimum Alternative Tax (MAT) in 1997- 98. The rate under MAT was increased from 7.5 per cent of book profits in 2000-01 to 10 percent in 2006-07. The Expenditure tax, which was levied on the recommendation of the Kaldor Committee in 1957-58 to curb consumption did not generate the expected revenues, it had to be withdrawn after three years. It was again enacted and came into force from November 1, 1987. The tax was charged on expenditure incurred in a hotel on accommodation, food, drink and other services. "The exemption granted to payments made in foreign exchange was withdrawn in 1992. However, in order to give boost to tourism sector and reduce the incidence of tax on hotel industry, the Finance Act, 2003 provided that Expenditure Tax should not be charged on expenditure incurred in a hotel after May 31, 2003." (Dhingra, 2005). With effect from June 1, 2003, Expenditure Tax was again abolished.

As regards the wealth tax rate, the highest wealth tax rate was reduced from 8 per cent in 1974-75 to 2.5 per cent in 1976-77 and further increased to 5 per cent in 1979-80. In 1985-86, it was again lowered to 2.5 per cent and made applicable to net wealth over Rs. 20 lakh. On the recommendations of the Tax Reforms Committee, 1991, wealth tax was charged at the flat rate of 1 percent with a basic exemption of value of Rs. 15 lakh on taxable items of wealth. With this, the scope of wealth tax was drastically reduced. In fact, the Task Force on Direct Taxes had recommended the abolition of wealth tax. However, a major relief was provided in 2004-05 in the form of abolition of tax on long-term capital gains and reduction in tax on short-term capital gains from 30 percent to a flat rate of 10 per cent on securities transactions.

In 2005-06, a new tax i.e., fringe benefit tax was introduced which targeted at those benefits enjoyed collectively by the employees, and not attributable to individual employees, which were to be taxed in the hands of the employer. But fringe benefit tax was abolished after realization of its considerable compliance burden in 2009-10.

Indirect taxation has remained a major source of tax revenue in India. Therefore, measures were also taken in the area of indirect taxes to improve the efficiency of these taxes. However, on the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee in 1972. As the excise system had no built-in-checks against evasion, it recommended the conversion of specific duties into an ad valorem, unification of tax rates and introduction of input tax credit to convert the tax into a manufacturing stage value added tax (MANVAT), but it was not implemented until 1986-87.

Then, a wide ranging and systematic effort to minimize the incidence of taxation on inputs was undertaken, through the introduction of Modified Value Added Tax System (MODVAT) in 1987. It was introduced in a limited manner on a few commodities and the coverage was gradually extended over the years. As a result of simplifications and relaxations introduced in the MODVAT scheme, avail of MODVAT credit for payment of duty had gone up appreciably over the years.

Further after 1991, reform impetus on excise duties came with the implementation of the recommendations of the Tax Reforms Committee (TRC). 1999-00, almost eleven major ad valorem duty rates were reduced to three, namely, a central rate of 16 per cent, a merit rate of 8 percent and a demerit rate of 24 per cent. In order to bring further simplification in the rate structure, these were further merged into a uniform 16 per cent Central Value Added Tax (CENVAT) at production stage. Also, a special excise duty (SED) rates of 8 per cent, 16 per cent and 24 percent continued on specified goods in 2000-01. This was further improved in 2001-02 with the reduction of three special excise duty rates to a single rate 16 per cent. In 2008-09, the general CENVAT rate on all goods and services was reduced to 14 per cent.

The tariff rates were extremely high by the middle of 1980s. The Long Term Fiscal Policy (LTFP) presented in the Parliament in 1984-85 emphasized the need to reduce tariffs, have fewer rates and greater uniformity and reduce and eventually eliminate quantitative restrictions on imports. However, for reasons of revenue and also to counter unfair competition from imports, the tariffs were raised and the weighted average rate increased from 38 percent in 1980-81 to 87 per cent in 1989-90 (Rao, 2005). As a fiscal reform measure, there was drastic reduction in both the average and peak tariff rates to make Indian industry competitive in the long run in 1990-91. The peak rate of custom duty was reduced to 40 per cent in 1997-98 from 355 per cent in 1990-91 and lowered to 25 per cent in 1997-98 from 125 per cent in 1990-91. The peak rate of custom duty was further reduced to 35 per cent in 2001-02, to 30 per cent in 2002-03 and to 25 per cent in 2003-04.

The average rate of custom duty was further reduced to the level of 15 per cent in 2005-06 with steeper reductions for capital goods and raw materials and corrections for inverted duty structures. This was done due to pre-announced commitment to align tariffs to the levels prevailing in the South-East Asian countries (Economic Survey, 2005-06).

Further, the peak rate of custom duty was reduced to 10 per cent in 2007-08 with a few exceptions (Economic Survey, 2007-08). The Tax Reforms Committee (TRC), 1991 recommended the introduction of selective tax on services. As the service tax was never visualized by the framers of the Constitution and policy makers, it does not find any place in the Constitution of India. As a result, it belongs to the central government. But in view of Gupta (2007), the entire proceeds from service tax should form part of the divisible pool as it is more buoyant in future than commodity taxes.

However, the central government by invoking residency powers introduced a tax on services at the rate of 5 per cent since 1994-95 namely, non-life insurance, stock brokerage and telecommunications rate. In 2001-02, the coverage of service tax was extended to 15 new services at the rate of 5 per cent. It was extended to 10 new services including life insurance, insurance of auxiliary services, inland cargo handling, storage and warehousing etc. in 2002-03. However, subsequently life insurance was exempted from service tax. In 2003-04, service tax was raised to 8 per cent and the tax was imposed on 10 new services. Again in 2004- 05, "Service tax has been extended to over 75 separate services and the revenue yield accounted for nearly 5 percent of gross central revenues" (Acharya, 2005).

This sustained expansion in service tax was due to the growing need to find alternative revenue resources in the face of the declining role of customs and excise revenues However, the rate of service tax was raised to 10 per cent in 2005-06. The number of services liable for taxation was raised to 99 services in 2006-07 and then gradually to 100 services in 2007-08. The rate of service tax was further raised to 12 per cent in 2006-07 and was retained at this same rate in 2007- 08.

A comprehensive indirect tax reform in the country is going to take place in April 2011 with the implementation of dual Goods and Services Tax (GST), levied concurrently by the centre as Central Level GST (CGST) and by the states as State Level GST (SGST). GST would be further improvement over the VAT.

This new system, which is being steered by an Empowered Committee of State Finance Ministers and the central government will replace state level VAT and CENVAT. In case of Central GST, central excise duty, additional excise duty, service tax, additional custom duty (countervailing duty), special additional duty, surcharge and cesses would be subsumed with CGST which are at presently levied separately on goods and services by central government. In case of State GST, VAT/sales tax, entertainment tax, luxury tax, taxes on lottery, betting and gambling, state cesses and surcharges, and entry tax except for stamp duty, toll tax, passenger tax and road tax would be subsumed with SGST which are at present levied separately on goods and services by state government. This will mark a major step in unifying the tax regime across the country and do away with tax arbitrage that currently disturbs investment decisions.

(II) Expenditure Reforms

The fiscal position of the central government has been under stress since the mid-1980s as public expenditure has grown at a very rapid rate as compared to the growth rate of public revenue. Reflecting the fiscal stress, the expenditure for developmental activities, which are directly related to growth, has suffered. On the other hand, expenditure on non-developmental purposes, largely committed, has witnessed a steady rise. It was crucial to bring about improvement in the finances with a view to restructuring the expenditure in favour of developmental expenditure in order to enable higher growth. Therefore, successive central government budgets since 1990s have been contemplating a host of measures to curb built-in-growth in expenditure and to bring about structural changes in the composition of expenditure and effecting economy in non-plan expenditure.

The need to control public expenditure was realized even in 1979-80 and a Commission on public expenditure, the first in independent India, was set up by a resolution of the Government of India on May 29, 1979. But it was wound up on January 31, 1980 before it could submit its report. With a view to restraining the growth of expenditure, a package of measures was taken by the central government in January 1984. Plan expenditure was to be reduced by 5 per cent including supplementary grants. Non-plan expenditure (excluding interest payments and transfers to states) was cut by 3 per cent (Economic Survey, 1983-84). It was expected that these measures would result in a reduction of about Rs. 800 crore in non-plan expenditure during that year.

Recognizing the gravity of the expenditure problem, a system of zero-base budgeting was initiated in the course of the formulation of the budgets of all central government departments for 1987-88 (Economic Survey, 1986-87). Efforts were made by the government to check the fiscal imbalances in 1990-91 and emphasis was laid on curtailing unproductive expenditure by undertaking a number of measures. These measures included monthly budgeting of expenditure in all the departments, cut in the expenditure on staff cars, electricity and telephone bills, and a complete ban on the purchase of new vehicles (Economic Survey, 1990-91).

The government initiated few measures on the expenditure front to correct the fiscal imbalance during 1991-92. Such measures mainly were reduction in the fertilizer subsidy by 30 per cent, abolition of Cash Compensatory Support for exports, abolition of subsidy on sugar. Further the government had also ―imposed 5 per cent cut on the expenditure of all Ministries/Departments. Only a few items of expenditure, such as, statutory grants to state governments, block grants and loans for state Plan schemes, interest payments and pension payments were exempted from the expenditure cut‖ (Economic Survey, 1991-92).

The problem of high rate of growth of non developmental expenditure persisted for a long time, but the reforms on this front started very late with the beginning of the process of downsizing the government. The government abolished the four-secretary level posts through a process of merger and rationalization of central government departments with effect from April 1, 1999.

To carry this process forward in a systematic way towards reducing the role and the administrative structure of the government, an Expenditure Reforms Commission was constituted on February 29, 2000. Areas identified by the Expenditure Reforms Commission included creation of a national food security buffer stock and minimization of fertilizer subsidies through dismantling of controls in a phased manner. In 2000-01, government took number of measures to control growth in non-plan, non-developmental expenditure which included: a mandatory 10 per cent cut in the budgetary allocation for non-plan non-salary expenditure of all ministries/departments and autonomous institutions; a complete ban on purchase of new vehicles for one year; ten per cent cut in the consumption and allocation of funds for expenditure on petroleum oil and lubricants (POL) for staff cars; ban on creation of new posts for one year ; ban on foreign travel for study tours, seminars, etc.

The measure to improve the quality of expenditure includes subjecting all existing schemes to zero-based budgeting and only those that were demonstrably efficient and essential were decided to be retained from 2001-02. ―This was sought to be achieved by reviewing norms for creation of posts and fresh recruitment and introduction of voluntary retirement scheme (VRS) for surplus staff.

The process also involved review of all subsidies‖ (Kapila, 2003). Other important measures of expenditure reform undertaken were optimizing government staff strength through a ban on the creation of new posts for a period of two years and the redeployment of surplus staff in various government departments and autonomous institutions which have budgetary support through grants. Also, the central government has brought about pension reforms by introducing a new pension scheme with effect from January 1, 2004 for central government employees recruited on or after that date (except Armed Forces, in the first stage) replacing the existing defined benefit pension system. "The central government has also initiated the process for bringing out legislation for the appointment of an independent pension regulatory authority, which can ensure proper investment of pension funds" (Srivastava, 2005).

In 2006-07, government took a series of initiatives for fiscal reforms like avoiding rush of expenditure through releases in a time sliced manner and simplification of procedures (Economic Survey, 2006-07).

(III) Reforms in Borrowings Process

The significant changes in the process of central government borrowings to meet the budgetary and temporary mismatches have also been part of the fiscal sector reforms. During 1976-77, long-term borrowings and debentures were excluded from the capital base and a new National Savings Annuity Scheme was introduced to promote small savings from April 1, 1976. To mobilise the savings for development purposes, National Development Bonds of Rs. 10/-, Rs. 100/- and Rs. 500/- were introduced from August 31, 1977.

For canalising the unaccounted money for productive purposes, the Government of India announced the Scheme of Special Bearer Bonds on January 15, 1981. To mobilise private savings for public use, Capital Investment Bonds were introduced on June 28, 1982. These bonds with a ten year maturity period carried an interest rate of 7 per cent. With a view to mopping up excess liquidity in the banking system as also to mobilise some resources for public investment, the government introduced the ‗National Deposits Scheme‘ with effect from July 30, 1984. During 1984-85, for the first time long-dated securities with a maturity of 30 years were introduced with a coupon rate of 10.50 per cent. As the subscription to the deposits under the National Deposit Scheme since inception were placed at Rs. 68.3 crore as on March 8, 1987 as against a target of Rs 500 crore, this scheme was discontinued by government with effect from April 1, 1987.

In order to strengthen fiscal discipline as a significant step, the system of ad-hoc treasury bills as a means of financing the budget deficit was discontinued. With effect from April 1, 1987, this system was replaced by a system of Ways and Means Advances (WMA). To provide short-term investment opportunity to financial institutions and others, the 182-days treasury bills were introduced.

After the fiscal crisis of 1991, a number of policy changes during 1992-93 to activate internal debt management policy were made. The monetary policy of April 1992 heralded a new approach to internal debt management by introducing market operation in regard to absorption of Government of India dated rupee securities and longer term Treasury bills and this was to be facilitated by overall reduction in the borrowing programme in 1992-93. These were in line with the recommendations of the Chakravarty Committee and Narasimham Committee.

The Government of India for the first time, offered to sell dated securities on an auction basis in June 1992. In addition to this, government introduced 364-days treasury bills and 91-days Treasury bills on an auction basis from April 1992 and December 1992, respectively. Moreover, auctions of repurchase agreements (REPOS) of dated securities were introduced from December 1992. However, it was realised that these developments in the first place would have implications for monetized deficit. Moreover, they might lead to discipline in use of borrowed funds at relatively high rates of interest. Besides, they would import liquidity as well as flexibility to investors.

Another noteworthy reform in process of borrowing was the reduction of the difference between the interest rate on market borrowings and 'other internal liabilities' (small savings, provident funds, etc.) in 1993-94. Further in 1994- 95, there was inclusion of loans in conversion of maturing treasury bills and Zero Coupon Bonds and increase in the rate of interest on 'other internal liabilities‘. In 1999-00, there was conversion of other liabilities into central government securities which led to the sharp increase in internal debt and corresponding decline in 'other internal liabilities'. Thereafter, the most notable outcome of external debt management has been the control over short term debt.

22.4.4 Fiscal Reform Programme for the States

The Constitution of India has made elaborate provisions for demarcation of functional responsibilities and finances between the central government and the state governments. It is often mentioned by experts that the arrangement of distribution of financial resources relating to taxes and non-taxes and power of borrowing is not equitable. "Most of the buoyant sources of revenue, such as customs duty, corporation tax, etc, are in the purview of central government for the stated reason of administrative efficiency and the implicit desire to make the centre strong vis-à-vis the states. This has culminated in central government having a comparative advantage over the States in raising revenues. But the fiscal responsibilities in meeting huge expenditures remained with the state governments" (Jena, 2001). These factors have created acute problems for the fiscal adjustment in the states.

As the central government has continued with the reform process since 1991, the states have been slower in initiating the fiscal reforms. The fiscal position of the state governments has been under stress since 1980s. While the gross fiscal deficit was quite high, a very high proportion of the same resulted from the revenue deficit. The stress stemmed from the inadequacy of receipts in meeting the growing expenditure requirements. The low and declining buoyancies in tax and non-tax receipts, constraints on internal resource mobilisation due to losses incurred by state public sector undertakings, electricity boards and decelerating resources transfers from the centre had resulted in rising fiscal deficit of the state governments during mid-nineties.

The deterioration in the fiscal position of the states (and its peaking in 1998-99) was also reflected in the ways and means advances and overdraft position of the states with the Reserve Bank of India (RBI). ―State governments resorted to overdraft and Ways and Means Advances (WMA) much more frequently than prior to 1997-98. The central government was unable or unwilling to limit the borrowings of the state governments" (Sawhney, 2008). As a result, the debt of states had gone up. In order to remedy this situation, " several major states which were hesitant and lagging behind the central government in adopting the fiscal reforms have now come forward to initiate economic reforms with multiple goals to achieve" (Rao, 2005).

It was in the late nineties that some reforms in the field of taxation, management of public expenditure, and borrowings were undertaken by only a few states. ―Specific time bound fiscal reform programmes have, therefore been discussed in the National Development council on Feb 19, 1999 (represented by the Chief Ministers of States). It was felt that joint effort on the part of the central government as well as state governments is required to devise a medium term strategy for fiscal reforms programme for states.‖ (JBIC Research Paper No. 11, 2001).

The main objective of fiscal reforms programme for states was to progressively improve the ‗Balance on Current Revenues‘ and reduce the revenue deficit in the medium term. Consequently, nine states entered to an agreement with the centre during 1999-00 and availed of assistance under Fiscal Reform Programme for the states introduced in April 1999. These states were: Punjab, Rajasthan, Himachal Pradesh, Manipur, Nagaland, Mizoram, Orissa, Sikkim and Uttar Pradesh. In fact, "even states which were not facing with acute financial distress have recognised the need for prudent fiscal management and come forward to discuss their reform programme" (Singh, 2006), but the name of resource poor, heavily running into deficits, the state of Bihar was lagging behind. During the year 2000-01, thirteen states undertook their own Fiscal Reforms Programme. These states were: Punjab, Rajasthan, Himachal Pradesh, Manipur, Nagaland, Mizoram, Orissa, Sikkim, Uttar Pradesh, Madhya Pradesh, Assam, Andhra Pradesh and Jammu & Kashmir.

Measures initiated by the states are broadly grouped under revenue mobilization, expenditure containment, debt restructuring, and institutional reforms. In addition to states‘ own efforts, the central government has also taken initiatives to strengthen the reform process at the state level.

(i) Revenue mobilisation

There was no systematic attempt to streamline the reform process even after 1991 when market oriented reforms were introduced. Most of the reform attempts were ad hoc and were guided by exigencies of revenue rather than attempts to modernise the tax system (Rao and Rao, 2005). Even in 2000, Rao cautioned, ―A good deal of progress has been made in the tax system reform of central government; progress in the case of state tax systems has not been commensurate‖ (Rao, 2000). Recognising the need for strengthening state finances, ―States have initiated measures towards enhancement/restructuring of various taxes within their fold, such as, land revenue, vehicle tax, entertainment tax, sales tax, betting tax, electricity duty, tax on trades, professional tax and luxury tax" (Kapila, 2003 and State Finances : A Study of Budgets of 2003-04).

With a view to harmonising inter-State taxes and ultimately switch-over to state level value Added Tax (VAT), states were guided to introduce, uniform floor rate during 2000. In fact, "Gujarat was the first state to implement the uniform floor rate for sales tax" (Upadhay, 2006). The most important reform initiative in the case of the states is the replacement of the cascading type sales tax with the state level VAT from April 1, 2003, "based on a blue print finalized by the empowered committee of State Finance Ministries" (Bernardi and Fraschini, 2005). Accordingly, VAT was introduced by all states/UTs by 2007-08. Uttar Pradesh introduced VAT on January 1, 2008.

After deliberations with the Empowered Committee of states regarding inconsistency of the Central Sales Tax (CST) with the concept of VAT, the roadmap for Central Sales Tax was finalized in 2007-08. This provided a gradual phase out by reducing the CST rate from its level of 4 per cent from April 1, 2007, by 1 per cent every year, to be finally phased out completely by March 31, 2010. The scheme finalized in consultation with the Empowered Committee of State Finance Ministers (EC) provides for new revenue generating measures for states as the primary source of compensation. It also provides for meeting 100 percent of the residuary losses to a state, if any thereafter, through the budgetary resources of the centre. This reduction of CST rate by 1 per cent every year was entailed to eliminate CST coincidental with the introduction of Goods and Services Tax (GST).

The introduction of GST would entail a restructuring of state VAT and central excise and as such involves a degree of coordination and due process of consultation with various stakeholders. The GST would facilitate greater vertical equity in fiscal federalism.

Besides this, states have also undertaken a few measures to enhance non-tax revenues by reviewing the royalties payable to them, including ―those on major and minor minerals, forestry and wildlife, revision of tuition fees, medical fees, irrigation water rates and tariff on urban water supply‖ (State Finances : A Study of Budgets of 2003-04).

Some states have also initiated measures towards ―reviewing of user charges for power, water and transport; introduction of a new scheme of summary assessment by Maharashtra in April 2003; introduction of self-assessment scheme under Sales Tax and Entry Tax Act by Karnataka" (Dhanasekaran, 2006).

(ii) Expenditure Management

The state governments' measures to contain expenditure inter alia include restrictions on fresh recruitment/creation of new posts, review of manpower requirements and cut in establishment expenses and reduction in non-merit subsidies through better targeting (Kapila, 2003). Measures initiated by Orissa regarding expenditure restructuring include rightsizing the government by abolishing 24 thousand posts, introducing Voluntary Retirement scheme (VRS) for government employees, suspending CTC and surrender leave to employees. Punjab has constituted the Public Expenditure Reforms Commission. On the other hand, NCT Delhi has set up on expenditure review committee to review non-plan expenditure (JBIC Research Paper No.11, 2001). To monitor the government's fiscal performance, Kerala government appointed the Kerala Public Expenditure Review Committee (PERC) in November, 2005. It put much emphasis on expenditure rationalization which aimed to prioritize productive expenditures.

Most of the state governments have taken initiative towards rationalization of expenditures. Measures towards containment of committed revenue expenditure included introduction of new pension schemes based on defined contributed system by the states. The states that have introduced the new pension scheme are Andhra Pradesh, Assam, Gujarat, Goa, Himachal Pradesh, Manipur, Rajasthan, Tamil Nadu, Uttar Pradesh, Chattisgarh, Jharkhand, Madhya Pradesh, Bihar, Haryana, Karnataka, Maharashtra, Orissa, Sikkim, Uttranchal. State governments have also undertaken measures regarding ―identifying performance indicators to assess the quality of expenditure restructuring, conservation of resources by compressing non-plan revenue expenditure, introduction of Voluntary Retirement Scheme and introduction of zero-base budgeting" (Dhanasekaran, 2006).

(iii) Debt Restructuring

After one decade of economic reforms, the issue of debt restructuring and reforms in borrowing process has attracted the attention of policy makers. To address the growing burden of states and to supplement the effort of states in the direction of evolving of Medium Term Fiscal Reform Programme (MTFRP), the central government formulated a Debt Swap Scheme in 2002-03. Under the Scheme, with the mutual agreed between the states and the centre, states were allowed to return loans taken from the central government bearing a coupon rate in excess of 13 per cent. Up to Rs. 10,00,000 million of high loans contracted before April 1999 were to be replaced under the debt swap scheme by 2004-05. Subsequently, states replaced loans worth Rs. 1,37,660 million in the first year (2002-03), Rs. 4,45,660 million in 2003-04 and the balance of Rs. 4,16,680 million in 2004-05 .

The states have taken several policy initiatives to stabilize their finances. To help retire debt repayments, the states of Andhra Pradesh, Assam, Arunachal Pradesh, Goa, Maharashtra, Mizoram, Meghalaya, Tripura, Uttaranchal, West Bengal, Chhattisgarh, Gujarat, Kerala, Orissa, Punjab, Sikkim and Tamil Nadu have set up consolidated sinking funds. Fifteen states have legislated ceilings on guarantees i.e., Statutory Ceiling – Goa, Gujarat, Karnataka, Sikkim, West Bengal, Tamil Nadu, Nagaland, Andhra Pradesh, Assam and Manipur and Administrative Ceiling - Assam, Orissa, Punjab, Madhya Pradesh and Rajasthan. The states of Assam, Andhra Pradesh, Goa, Gujarat, Haryana, Jammu & Kashmir, Karnataka, Madhya Pradesh, Orissa, Sikkim, Tamil Nadu and Rajasthan have set up a Guarantee Redemption Fund.

(iv) Centre's Initiatives

Recognizing the nexus between the centre and state finances, the central government also initiated measures to encourage fiscal reforms at the state level. The Eleventh Finance Commission (FC) recommended a monitorable fiscal reform programme for all the states which aimed at reduction of revenue deficit of the states. Subsequent to the recommendations of the Eleventh FC, the Government of India has drawn up the States' Fiscal Reforms Facility 2000- 01 to 2004-05 and an incentive fund of Rs. 10,607 crore was earmarked to encourage states to implement fiscal reforms programme. All 28 states have drawn up medium term fiscal reforms programme. The Twelfth FC discontinued this facility.

As a prudent fiscal reform measure in order to introduce fiscal discipline, the central government enacted a FRBM Act on August 26, 2003 and the Act and the rules were notified to come into effect from July 5, 2004. "The objective of this Act is to ensure reduction in deficits, prudent debt management consistent with fiscal sustainability through limits on borrowings, transparency in fiscal operations, and conduct of fiscal policy in a medium term framework" (Singh, 2005). So far 26 out of 28 states have enacted Fiscal Responsibility and Budget Management Acts till 2008-09. Sikkim and West Bengal are yet to enact Fiscal Responsibility and Budget Management Acts.

To link the states to fiscal responsibility, the Twelfth FC recommended a Debt Consolidation and Waiver Facility (DCRF) for states. This facilitates states to achieve targets of elimination of revenue deficit and containing fiscal deficit to gross state domestic product (GSDP) at 3 per cent well ahead of 2008-09. So far, debt consolidation has been done for 19 states namely, Andhra Pradesh, Assam, Bihar, Chhattisgarh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Orissa, Punjab, Rajasthan, Tamil Nadu, Tripura, Uttarakhand and Uttar Pradesh. Central loans in respect of these states have also been consolidated.

22.4.5 Fiscal Reform Initiatives for the Local Governments

The Constitution of India recognized the division of functions and sources of revenue only between the centre and the states. Entry 5 of list II (state list) of the Seventh Schedule mentioned local bodies as institutions created by state governments. Furthermore, the Directive Principles of the Constitution (Article 40) requires the strengthening of the units of local self government in the states, particularly Panchayati Raj Institutions (PRIs). However, little was done in this regard during the first three decades of independence.

It may thus be concluded that Indian federal structure has changed from two-tier to three-tier administrative set up of centre, state and local governments with very high concentration of powers with the central government. In the Indian Constitution, there is division of the revenue powers, expenditure functions and the power of borrowing with the central and state governments.

In the early 1990s, the Indian economy suffered from a very acute macro-economic crisis the like of which it had never faced in the past. This crisis led to the deep structural imbalances in the fiscal system. This underlined the need for a comprehensive programme of fiscal reform. The central government started the reform process since 1991 but the states were slower and late by one decade in initiating the fiscal reforms. Important tax reforms undertaken by the central government relate to reduction in the highest marginal tax rate and in the basic rate of corporate tax. The main central commodity taxes, i.e., union excise duties and customs duties also underwent salient changes. In the case of customs duties, there were drastic reductions in the tariff rates across the rate categories including the peak rates.

Reforms also entailed reduction in the rate categories and exemption regimes. However, in the case of Union excise duties, a wide ranging and systematic effort to minimise the incidence of taxation on inputs was undertaken through the introduction of Modified Value Added Tax which was further converted into a uniform rate 14 per cent CENVAT. To align tariffs to the level prevailing in the South-East Asian Countries, the peak rate of import duty was reduced. Other important reforms that have been brought about since 1991 are the introduction of service tax, abolition of securities transaction tax and fringe benefit tax (now abolished).

Efforts have also been made to curb expenditure growth through the Expenditure Reforms Commission. Numbers of policy changes are made to activate internal debt management regard to absorption of Government of India dated rupees securities and longer term Treasury bills. Another reform in borrowings' process was the reduction of the difference between the interest rate on market borrowings and other internal liabilities. So far states are concerned; all states have undertaken their own fiscal reforms programme. To supplement the effort of states in the direction of evolving Medium Term Fiscal Reform Programme, a Debt Swap Scheme has been formulated by central government. States reduced the rate categories in the case of sales taxes, reduced exemptions, and introduced floor rates. The states are also trying to contain expenditure by compressing spending with the help of enactment of their FRBMAs. To provide a statutory backing to the fiscal reforms, 26 states have implemented fiscal responsibility acts.

Summary:

A reform and modernization of the administration of the major taxes through computerization and strict deterrent action to be taken by State and Central Governments against tax evaders and corruption at all levels which are the two important steps to be taken in order to increase their revenues that helps to overcome financial crisis. Main causes of fiscal crisis are the principal cause for Economic imbalance is the fact that inspite of limited resources base that states has to cope with the significant growth in their committed expenditure like wages, salaries, pension, interest payments which constitute a major portion of non plan expenditure.

Causes of this imbalance are also well known the chief amongst them are the inexperienced political leadership to counterproductive populism and avoidance of tough measures to stem the root. Political instability contributed to the above trend. It is not likely that there would be any drive towards financial prudency and corrective measures would be taken to stop the drain through Pensions, State Electricity Board,Irrigation,State Road Transport Corporation etc Therefore the question which assumes significance of Fiscal Crisis is that how long the States and Central Governments would sustain it.

Technical terms:

Fiscal Policy, Fiscal Crisis, Fiscal Reforms, Planned expenditure, Non-Planned expenditure, Revenue deficit, Budgetary deficit, Fiscal deficit, Primary deficit, Long term & medium term fiscal policy, Expenditure, Mobilization, Management, Debt restructuring.

Self Assessment Questions

1. Define Fiscal Crisis and explain the role of Fiscal Policy at the time of crisis in India.
2. Explain the Indicators, Causes and Consequences of Fiscal crisis in India.
3. Discuss the different types of financial crisis and their impact on growth and development of economy.
4. Write what do you Know about Fiscal Sector reforms in India,
5. Analyse Fiscal Reforms and Budget Management Act, 2003
6. Elucidate different Phases of implementation of Taxation Reforms and Fiscal Policy Reform in India.
7. Explain briefly the components of Fiscal Sector Reforms in India.
8. Analyse the Fiscal Reforms in the States.
9. Give a brief account on Expenditure Management & Debt Restructure.
10. Analyse the Fiscal Reform Initiatives for the Local Governments.
11. Write a note on Recommendations of Thirteenth Finance Commission of India
12. Make a critical analysis on the unproductive subsidies provided in India

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Lesson -22

Recommendations of Finance Commissions in India

Contents

23.1 Objectives

After reading this unit, you will be exposed to:

» To analyse the division of functions between Centre and States.

» To describe the structure of Finance Commission.

» To discuss the transfer of various tax revenues between the centre and states.

» To discuss the various problems in the centre and state financial relations.

» To analyse the recommendations of various Finance Commissions.

23.2 Introduction

Broadly speaking, the general rule of federal constitutions is that the proceeds of is to be appropriated by the authority which imposes it. Thus, if the Union authorities impose a tax in respect of a source assigned to its competence, they retain the proceeds accruing from such a tax. The revenue sources have been divided between the centre and states following the principles of federal finance strictly in the case of Indian federation. Due to this expensive and expansive functions have been given to the states comparative to the central government. When we compare centre and state financial resources, relatively more elastic tax powers are hand over to the central government. This has resulted in the existence of fiscal imbalances of central and state governments.

23.3 Need to origin or evaluation of Finance Commission

Indian constitutional makers have visualised the need and importance of reducing these fiscal imbalances by instituting a finance commission for every Five Years and through several methods of fiscal adjustments. From first finance commission to 13th finance commission, they have transferred fiscal resources in terms of shared tax revenues and grants to help in reducing fiscal imbalances, in addition to these transfers planning commission also transferred substantial amount of fiscal transfers for plan purposes. In sharing resources several problems have come up between the centre and states, which needs to be solved for smooth and maintain healthy central-state financial relations in the country. What follows is a brief account of trends in fiscal transfers, which govern the Union-State financial relations in India.

23.4 Division of Functions

Constitution of India, which became operative since 26th January 1950 adopted a federal structure in view of its ethnic, linguistic, cultural and religious diversities. In fact the seeds of federal structure were sown by the British India Government Act of 1935. Accordingly the constitution envisages a clear division of functions and revenue powers between the two layers of govt- centre and the states. In the Seventh Schedule of the Indian Constitution, there is a three-fold distribution of Legislative powers between the union and the states. Union list, state list and concurrent list matter in which the Parliament has exclusive power to make laws are enumerated in list-I (Union list). Subjects in which the state has an exclusive power to make laws are enumerated in list-II (State list). The parliament as well as legislature of any state specified in the first schedule have power to make laws with respect to any of the subjects enumerated in list III (Concurrent list). All the residuary powers of legislature vest with the union govt. that the parliament can make laws on matters that are not enumerated in any of the three lists.

The union list empowers the central govt. to make laws on 97 subjects of national importance. The state list includes 66 items and there are about 47 subjects included in the concurrent list. Constitution of India has provided revenue powers to the two layers of the govt. in order to enable them to discourage the functional responsibilities entrusted to them.

23.5 Division of Revenue Resources

Constitution has given rights to state govt. are provided with revenue powers on 19 categories of items as enumerated in the list-II of the 7th schedule, the important being land revenue, taxes on agricultural income, estate duties in respect of agricultural land, taxes on land and buildings, tolls, motor vehicles, entertainment tax, entry tax, stamp duty and taxes on profession, trades calling etc,. Similarly the union govt. is provided with revenue powers which are enumerated in list-II, Which can be divided four categories.

Firstly, income tax, other than the agricultural income tax is to be imposed and collected by the Union govt., but the net proceeds are to be distributed between the union and states. Similarly, excise duties which are imposed and realized by the union govt. are also distributable among the states. The constitution provides that a percentage of the net proceeds of these two types of levies, as may be determined by the president on the recommendations of the finance commissions, be allotted to the states. The reason for assigning the taxing power to the union govt. arose from the desirability of the uniformity of legislation throughout the country. Moreover, these taxes are essentially central in character, being capable of satisfying the principles of efficiency and economy in collection only if they are levied and collected by the central authorities. Resources transferred to the states under these two categories of union revenues from by for the most important method of devolution.

Secondly, the proceeds of certain taxes, although they are levied and collected by the union govt. are assigned to the states. Here again, the reason for assigning the taxing power to the union is the desirability of uniformity, efficiency and economy in collection. These taxes are enumerated in the Article 269.

Thirdly, there is a provision for the central grants-in aid of the states, revenue that are decided after taking into account the recommendations of the finance commission in this respect. Such grants are recommended in terms of the provisions of Article 275.

A close observation of the above division of functions and revenue powers indicates the most of the ‘expensive and expansive’ functions are entrusted to the states. Therefore, it implies that the very division of functions and resources between the union and states in the constitution has led to the vertical federal fiscal imbalances in the Indian federation. Similarly, the same level of functions and tax powers are given to the states uniformly which have different endowment positions of populations, natural resources etc. This has led to the existence of horizontal federal fiscal imbalances. Thus there exist both vertical and horizontal fiscal imbalances in India right from the beginning of the adoption of the constitution. The existence of the federal fiscal imbalances does not ensure smooth functioning of the federation. In other words, continuous and prolonged existence of fiscal imbalances may pose a threat to the very existence of the federation itself. Financial adjustments in the form of fiscal transfers is to be made to maintain healthy federal financial relations in any federation. In India, the constitutional makers visualized the need for such fiscal adjustment and accordingly made several provisions in the constitution for central fiscal transfers and an institution to channelize these transfers. So it is necessary to study the constitutional provisions, the institutional mechanism and the trends in central fiscal transfers in order to analyse the trends in centre-state financial relations in India, as the latter are governed by the formers. In India, the fiscal transfers are made by two agencies. Finance Commission and Planning Commission in the form of shared tax revenue, grant-in-aid and loans. These are also otherwise known as statutory transfers and non-statutory. Those transfers which are made through the finance commission for which provisions are made in the constitution are known as statutory fiscal transfers. What follows is a brief discussion of the mechanism and trends in fiscal transfers in India, which govern the trends in centre-state fiscal relations.

23.6 Structure of the Finance Commission

Under Article 280 of the constitution, the president of India has been empowered to appoint a finance commission for every Five Years or at such earlier time as he considers necessary. This is the main departure from the scheme of the govt. act 1935, regarding the financial relations between the centre and state. The commission is charged with the tremendous responsibilities of making requisite recommendations of the president.

According to Article 280(1), the president shall, within Four years from the commencement of the constitution and thereafter at the expiration of every 5th year or at such earlier time as the president considers necessary, constitute a finance commission which shall consist a chairman and four members to be appointed by the president. Parliament may by law, determine the qualifications which shall be requisite for the appointment as members of the commission and manner in which they shall be collected.

Accordingly, 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 Article 270 and 272 of the constitution and allocated between the states of the respective shares of such proceeds.
B) The principles which should given the grants-in-aid of the revenues of the states under Article 275(1) from the consolidated fund of India.
C) Any other matter referred to the commission by president on interests of the sound finance.
D) The commission shall determine the procedure and shall have such powers in the performance of their functions as parliament may confer on them by law.

Again, under the provision of Article 281, the president of India shall cause every recommendation made by finance commission with an explanatory memorandum as to the action taken, these are to be placed before the parliament house. Recently, report of 13th finance commission has been released. Now we may discuss the details of these finance commissions.

23.7 Functions of the Finance Commission

It shall be the duty of the commission to make recommendations to the President as to:

1) To suggest the criteria of distribution between the union and states of the net proceeds which are to be or may be divided between them.
2) It determines the allocation of net proceeds between different states according to their respective shares of proceeds.
3) Any modification or continuance of the term of any agreement entered to by the union govt. with the govt. of any state in part-B of the first schedule under clause V of Article 178 or Article 306.

4) The principle which should given the grants-in-aid of the revenue of different states out of the consolidated fund of India.
5) Any other matter referred to the commission by the president of India in the interest of sound finance.

The Finance Commission shall, thus, recommend to the President.

1) The percentage of net proceeds of the taxes which may divided between the centre and states.
2) The allocation of shares of the proceeds of such taxes in percentages between the different states.
3) To determine the principles to govern the grants-in-aid of the revenue out of the consolidated fund of the government of India between the states.
4) The modifications or continuances of the term of agreements regarding the levy of internal customs and duties with part B states.
5) Grants-in-aids in Tribal areas, and
6) Special grants for any particular state.

Here it must be in mind that the procedure in accordance with law conferred by parliament, is that the president of India shall able every recommendation made by the commission along with explanatory memorandum before parliament.

1) The distribution of net proceeds of taxes between the centre and the states.
2) The principles governing grant-in-aid of the revenues of the states from the consolidate fund of India. It must be remembered that it is obligatory to share income-tax where as sharing of excise duty is voluntary.

23.8 Implementation of the Recommendations

Regarding the implementation of the recommendations made by the finance commission is that a strong convention has been established that the govt of India will accept the recommendations in respect of the percentage to be assigned to the states and the manners in which the percentage will be determined and distributed among various states. However the share of the states does not form part of the consolidated fund of the union, but goes direct to the consolidated fund of the states. In accordance with the Article-272 of the constitution of India, the recommendations made by the finance commission are only recommendatory. The central govt. can ignore these recommendations and if so wants, may propose its own criteria to determine the excise duty by making such law. But the recommendations made by the finance commission are considered final and accepted into by the govt. of India for the purpose of distribution of shares excise duties on the basis of law placed before the parliament.

23.9 Different Finance Commissions in India (1st to 14th)

From time to time govt. of India appointed Finance Commission for pursue of resource allocation between Centre and States. Let us make a detailed analysis of each Finance Commission.

The following table gives the list of Finance Commissions and Chairmen during the periods mentioned.

Finance Commission	Year of Estab.	Chairman	Period
First	1951	K. C. Neogy	1952–57
Second	1956	K. Santhanam	1957–62
Third	1960	A. K. Chanda	1962–66
Fourth	1964	P. V. Rajamannar	1966–69
Fifth	1968	Mahaveer Tyagi	1969–74
Sixth	1972	K. Brahmananda Reddy	1974–79
seventh	1977	J. M. Shelat	1979–84
Eighth	1983	Y. B. Chavan	1984–89
Ninth	1987	N. K. P. Salve	1989–95
Tenth	1992	K. C. Panth	1995–00
Eleventh	1998	A. M. Khusro	2000–05
Twelfth	2003	C. Rangarajan	2005–10
Thirteenth	2007	Vijay L. Kelkar	2010–15
Fourteenth	2012	Y. Venugopal Reddy	2015–20

First Finance Commission

The First Finance Commission was appointed by the president on 20th November 1951, which was chaired by K. C. Neogy. The commission was asked to make recommendations regarding:

1. Allocations of income tax and Union Excise Duties and tax sharing.
2. Amounts payable as Grants- in-Aid to the States in need of Assistance under the ‘substantive portion of Clause 1 of Article275.
3. Grants-in-Aid to certain States in lieu of their share of export duty on jute and jute products according to Article 273 Continuation or adjustment of the terms of agreement with Part B States under Article 278 (1) or under Article 306.

Recommendations

- The share of States in the proceeds of income tax was to be 55 per cent.
- The First Commission recommended that shares of States in the Union excise duties be 40 per cent of the proceeds of the tax on three commodities, 25 per cent of the proceeds of the tax on eight commodities and 20 per cent of the proceeds of the tax on 35 commodities, respectively.
- As far as Horizontal Distribution is concerned, overwhelming weightage is given to Population (80%). Only residual weightage of 20% given to contribution.
- No recommendations regarding grants for meeting capital requirements of the state were made by the commission.
- The Commission provided Grants in- Aid (under Article 273) to only four states, namely, Assam, Bihar, Orissa and West Bengal. However, Grants were provided to many states under Substantive Portion of Article 275 (1) and under the head of Primary education grants.

All recommendations made by the commission were accepted by the Union Government.

Second Finance Commission

The Second Finance Commission was constituted by President Rajendra Prasad, on 1st June 1956. The Commission was chaired by K. Santhanam. The Commission was asked to make the following recommendations:

1. Grants-in-Aid to certain States, in need of assistance under Article 275, having regard to the requirements of Second Five Year Plan and the efforts made by those states to raise additional revenue.
2. Allocation of Estate Duty and Tax on Railway Passenger Fares proposed to be levied by the Railway Passenger Fares Bill, 1957, introduced in the Lok Sabha on 15 May 1957.
3. Grants-in-Aid to the States of Assam, Bihar, Orissa and West Bengal, to compensate for their share of the export duty on jute and jute products as per Article 273.
4. The principles which should govern the distribution under article 269 of the net proceeds of estate duty in respect of property other than agricultural land, levied by the Government of India in the States within which such duty is leviable.
5. Revisions, if any, of the rates of interest on loans made by the Centre to the States between 15th August 1947 to 31st March 1956 and their terms of repayment. The phenomenal growth of the Union loans to the States justified such adjustments.
6. The net proceeds of the additional Excise Duties proposed to be levied in view of States' Sales Taxes on the mill made textiles, sugar and tobacco, and the amounts which should be assured to the States as the income now derived by them from the levy on these commodities and the States Sales Tax (which is to be replaced by the additional duty of excise).

With regard to the distribution of income tax, the Commission made the following recommendations:

- Despite the receding contribution by the Income Tax to the devolution of revenue to the States, the Commission recommended an increase in the per cent of the net proceeds to the States from 55 to 60, and the share of the Union Territories should be 1 per cent.
- It was recommended that the distribution of the share of Income tax among the States should be 10 per cent on the basis of collection and 90 per cent of the basis of population, thereby giving greater importance to population than it was earlier.

As far as the allocation to the States from the Union duties of excise on matches, tobacco, vegetable products, tea, coffee, sugar, paper and vegetable non-essential oils was concerned, the Commission considered that it should be 25 per cent.

The Third Finance Commission

The Third Finance Commission was appointed in the year 1960, for the period 1960–64, by the president and was chaired by A. K. Chanda. The Commission was asked to make recommendations to the president with regard to the following.

1) On account of Tax Sharing between the Centre and the State and allocation of Income Tax and Central Excise Duties 2) Under Article 275, Grants-in-Aid to States in need of assistance, other than the sums specified in the provisos to Clause of article 275 a) With regard to the requirements of third five-year plan b) Secondly, with regard to the efforts to be made by those states to raise additional revenue amount 3) Allocation of duties, namely, additional excise duty and estate duty. The Finance Commission recommended the formulation of an independent commission to assess the tax potential of each state, to review its tax structure and to recommend rates under different heads of the levies of the state list: - Income Tax With regard to the divisible pool of income tax among the states the finance commission adopted the criterion of the first finance commission that 80% be distributed on the basis of population and 20% on the basis of collection. The recommended percentage share of the states in divisible pool of the Income Tax: Maharashtra-13.41, Bihar-9.33, Punjab-4.49, Uttar Pradesh-14.12, Kerala-3.55. Union Excise Duty With regard to the distribution of the proceeds of UED the finance commission decided to cover all commodities on the existing list. It recommended that 20% of the net proceeds of UED on all commodities on which such duties were collected and the yield of which exceeded Rs. 5 million in 1960-61 should be allocated to the state. The share of each state in the distribution of UED was determined by the Commission on the basis of population and it rejected consumption as the basis of distribution due to two major reasons a) Reliable data on consumption wasn't available b) As it would have given advantage to the more urbanised and financially stronger states. Percentage share of the 20% of proceeds of the UED for certain major states were:- Maharashtra-5.73, Bihar-11.56, Punjab-6.71, Uttar Pradesh-10.68, Kerala-5.46 Additional Duties of Excise. The Govt. of India in consultation with the state governments, decided that an AED be levied on mill-made textiles, sugar, tobacco, rayon among others and the net proceeds of which should be distributed among them subject to then income derived by each state being assured to it. The Commission rejected this contention as the rates of sales taxes had been revised by them since then. The commission distributed the guaranteed amount of Rs. 325.4 million among the States and the remaining amount was distributed, first, on the basis of the percentage increase in the collection of sales tax in each state since 1957-58, when AED were imposed and then on the basis of the population. The Act imposing a tax on the railway passenger fares was repealed after the Third Finance Commission had been constituted. Hence, the commission was asked to make recommendations on the principle on which the ad-hoc grant should be distributed among the states. The commission adopted the principle of compensation based on which the grants should be distributed.

The Fourth Finance Commission of India

The Fourth Finance Commission was constituted on 18th May 1964, under the chairmanship of Dr. P.V. Rajamannar. The Commission suggested in its report that there should be greater co-ordination between the Centre and the States in common financial interests for which it recommended the establishment of a permanent organization in the Ministry of Finance

Recommendations

Out of the net proceeds of the duty in each financial year, a sum equal to two per cent be retained by the Union as proceeds attributable to Union territories; The balance be apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year. The sum thus apportioned to immovable property is distributed among the States in proportion to the gross value of the immovable property located in each State.

The percentage of the net proceeds in any financial year of taxes on income other than agricultural income, except in so far as these proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments to be assigned to the States be 75 per cent; the percentage of the net proceeds of taxes on income which shall be deemed to represent proceeds attributable to Union territories be 21/2 (two and a half) per cent; and the percentage of the net proceeds assigned to the States be distributed among states. Under the substantive portion of article 275(1) of the Constitution, in each of the five financial years commencing from 1st April 1966, the sums specified, be charged on the Consolidated Fund of India as grants-in-aid of the revenues of the States mentioned against the states.

The Fifth Finance Commission of India

The Fifth Finance Commission was constituted by the President of India on 15th March 1968, under the chairmanship of Mahavir Tyagi. The terms of reference of the Fifth Finance Commission were wider than those of the earlier ones. Apart from the matters referred to in the earlier Commissions, this Commission was required to:

Examine the desirability or otherwise of maintaining the existing arrangements in regard to additional excise duties levied in lieu of Sales Tax and the scope for extension of such arrangements to other items. To inquire into the unauthorized overdrafts of the States and recommend the procedure for avoiding such overdrafts. Examine the scope for raising revenue from taxes and duties mentioned in Article 269, the scope for States in raising additional revenue from their sources as well their scope for better fiscal management and economy in expenditure, and make a comprehensive study of the States' expenditure on various subjects. Grants-in-aid recommended under Article 275 (1) are to be for purposes 'other than the requirements of the Five Year Plan', and while making its recommendations, the Commission was called upon to have regard to "the resources of the Central Government and the demands thereon" on account of expenditure on civil administration, defence, debt servicing, etc. The Commission was asked for the first time to indicate the basis of its findings and make available relevant information. Since then these were made clear in the Terms of Reference of every successive Finance Commission.

The Sixth Finance Commission of India

The Sixth Finance Commission was incorporated in the year 1972 consisting of Sri. K. Brahmananda Reddy as the chairman. The commission submitted its report in the first week of November 1973. The recommendations of the commission will cover the period of the fifth five year plan which is to commence from 1st April 1974.

Recommendations

The States demanded the inclusion of corporation tax into the divisible income tax and allocation of the net proceeds to them. The commission expressed that such inclusion was constitutionally forbidden, but it can be reviewed by National Development Council. States share was increase from 75 per cent to 80 per cent due to the decrease in the divisible pool as the arrears of the advance tax collection had been cleared. In view of the increasing integration of the national economy and for eliminating the regional imbalances the contribution factor was kept at 10 per cent in the distribution of share amongst the states. The distribution inter states should be on the basis of fixed percentages. Out of the net proceeds of the income tax, 1.79 per cent should be allocated to the Union Territories. The commission recommended the continuation of existing arrangement of distributing 20 per cent of the net proceeds of union excise duties. From the proceeds of the additional excise duties on tobacco, sugar and textiles, the commission recommended that 1.41 per cent be distributed to the union territories and the balance among the states. The commission also recommended extensive development programmes to be chalked out for the development of drought and flood prone areas. It also recommended a total debt relief of Rs.1969.62 crores.

The Seventh Finance Commission of India

The Seventh Finance Commission was incorporated in the year 1978 consisting of J. M. Shelat as the chairman. The final report was presented Oct 1978. The following were its recommendations.

Recommendations

The net proceeds of Estate Duty in respect of property other than agricultural land attributable to Union territories in each of the years 1979-80 to 1983-84 should be determined in the same manner and on the same principles as for the determination of the shares of each State, taking the Union territories as one unit for the purpose. The balance of the net proceeds of Estate duty in each year should be distributed among the States in proportion to the gross value of the immovable property and property other than immovable property taken together located in each State and brought into assessment. For this purpose property located abroad should be deemed to be located in the State where it is brought to assessment. Sikkim will also be entitled to a share in the net proceeds of this duty, calculated in the same manner as for the other States, as from the date the duty may become leviable in that State. There is no need to set apart any guaranteed amounts to the States out of the net proceeds of additional duties of excise as in our view there is no risk of the share of any States falling short of the revenue realised in the financial year 1956-57 in a State from the levy of the sales tax on the commodities subject to additional duties of excise in lieu of sales tax. A sum equal to 3.271 per cent of the net proceeds of the additional duties of excise on sugar in each of the years from 1979-80 to 1983-84 should be retained by the Central Government as attributable to the Union territories and the balance of 96.729 per cent of the net proceeds should be distributed among the States. A sum equal to 2.192 per cent of the net proceeds of additional duties of excise on textiles and on tobacco in each of the years from 1979-80 to 1983-84 be retained by the Central Government as attributable to the Union territories. The balance of 97.808 per cent of such net proceeds of the additional duties of excise on textiles and tobacco be distributed among the States in the percentages In any year in which the State Government of Sikkim gives up its sales tax on textiles, it would be entitled to a share, as from the date such sales tax is given up, in the net proceeds of the additional duties of excise thereon.

The Eighth Finance Commission of India

The Eighth Finance Commission was constituted by the President of India, on 28 April 1984 under the chairmanship of Y. B. Chavan. It was asked to make recommendations on:

The distribution of net proceeds of taxes between the union and the states which are to be or may be divided between them under chapter 1 of Part XII of the constitution and allocation between the states of the respective shares of the same. The principles which govern the grants in aid of the revenues of the states out of the Consolidated Fund of India and the amount to be paid to the needy States which seeks assistance by way of grants in aid of their revenues under Article 275 of the constitution for purposes other than those specified in the provisions to clause (i) of that article.

The commission is to examine the possibility for increasing revenue from the taxes and duties mentioned in article 269 of the constitution but which are not levied at present. It will probe into the scope for enhancing revenue from the duties mentioned in the article 268. Making an assessment of the non-plan capital gap of the states on a uniform and comparable basis for the 5 years ending with 1988–89 also comes under its agenda. It will review the policy and arrangement in regards to the financing of relief expenditure by the States affected by natural calamities and make appropriate suggestions. The commission shall make its report by 31 October 1986 on each of the matters aforesaid. The major objective of the Eighth Finance Commission was to reduce interstate disparities through their scheme of devolution

Recommendations

Sharing of Income Tax – To retain the share of the States in the proceeds of the income tax at 85 per cent level. Withdrawal of surcharge on income tax from the financial year 1985–86 is also recommended Union Excise Duties – Recommended its increase from 40 per cent to 45 per cent. It made a beginning by using one unified formula to distribute the net yield from Union Excise Duties and 90 per cent share of the income tax Additional Excise Duties – The distribution from the net yield from additional duties of the excise was made 50 per cent on the basis of the share of each state in the average state domestic products of all the states for the years from 1976–77 to 1978–79 and 50 per cent on the basis of the population figures as given in 1971 census Grants in Lieu of tax on railway passenger fair – It has boldly defended the case of the state government in regard to their claim on the tax on railway fair. The compensatory grant which replaced the tax was increased to Rs. 950 million Grants in Aid – They have been made more flexible. The commission has provided for an annual growth of 5 per cent in respect of the amount of grants payable in nature of the forecast period commencing from 1984 to 1985. The recommendation to write off a substantial portion of loan amounting to Rs. 22853.9 million is an appropriate step towards strengthening the state finances

The Ninth Finance Commission of India

The Ninth Finance Commission was set up in June 1987 under the chairmanship of N. K. P Salve. Terms of references of the commission has been asked to adopt a normative approach in assessing the receipts and the expenditures on the revenue account not only of the states but also of the centre with due regard to the special problems of each state and the special requirement of the centre. Generating surpluses on revenue account of both the states and centre for capital investment should also be considered. Changes in the principles that govern the distribution between the union and the states and also the states inter se of the net proceeds of central taxes are to be made

The commission will also make recommendations regarding the principles which should govern the grants in aid of the revenue of the state out of the Consolidated Fund of India. It is to assess the debt position of the states as on 31 March 1989 and suggest corrective measures. In regard to the financing of the relief expenditure by the states affected by natural calamities the commission is to examine the feasibility of establishing a National Insurance Fund to which the state governments may contribute a percentage of their revenue receipts. The government's decision to accept all the major recommendations of this commission which would bring substantial benefits to the state during the eighth five-year plan period (especially in relation to debt relief) shows the upper hand enjoyed by this body

Recommendations

Income Tax – 85 per cent of the divisible pool of the income tax to be assigned to the state and out of the net distributable proceeds a sum equal to 1.437 per cent should be deemed to represent the proceeds attributable to the union territories. Relief Funds – The existing arrangements to be replaced by a new order under which the states will have greater autonomy and accountability. A calamity relief fund to be constituted for each state to which contribution is to be made in the ratio 75:25 (centre: state) Debt Relief – The commission recommended that the RBI may work out a formula for amortization of the states' market borrowings. From 1990 to 1991 the direct central loans for states' plans should have a maturity period of 20 years with 50 per cent of the loans enjoying a grace period of 5 years. The loans given to the federating states for drought relief during 1986–89 as outstanding on 31st March 1989 are to be waived. The state plan loans advance to the states during the 1984–89 period and outstanding on 31st March 1990 should be consolidated, rescheduled to 15 years in the case of all the states.

The Tenth Finance Commission of India

The Tenth Finance Commission was incorporated in the year 1995 consisting of K. C. Pant as the chairman.

Recommendations

The share of the Union Territories would not be determined on the grounds used for state share but it would be decided on the basis of population solely. The percentage would be 0.927 per cent for the years 1995–2000. The proceeds from the 'penalties' and 'interest recovered' under the miscellaneous receipts should be included in the divisible income tax pool as recommended by Ninth commission with effect from 1st April 1995. The share of the net proceeds would be 77.5 per cent for five years. The commission dropped the collection factor as the criterion for distribution The distribution of the net proceeds among states would be as follows: 1) 20 per cent on the basis of population of 1971. 2) 60 per cent on basis of distance of per capita income. 3) 5 per cent on basis of area adjusted. 4) 5 per cent on basis of infrastructure index. 5) 10 per cent on basis of tax effort

The Eleventh Finance Commission of India

The Eleventh Finance Commission was appointed by the president on 3rd July 1998 for the period 2000–05. It was chaired by Prof. A. M. Khusro. The Commission was asked to make recommendations to the president with regard to the following:

(a) With regard to Chapter I of Part XII of the Constitution, the distribution between the Centre and the States of the net proceeds of taxes and the allocation between the States of the shares of these proceeds (b) The principles governing the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and with regard to article 275 the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues for purposes other than those specified in the provisos to clause (1) of that article; (c) With regard to the recommendations made by the Finance Commission of the State; the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State (d) Suggestions for a restructuring of the public finances so as to restore budgetary balance and maintain macro-economic stability. With regard to the TOR the following were the recommendations made by the finance commission:

a) The total share of the States in the net proceeds of central taxes and duties would be 29.5 per cent for the next five years b)With regard to the revenue deficit grants to States, a lump-sum amount of Rs. 110 billion in the Central Budget 2000–01. c) Grants – For the five years commencing from 1 April 2000, Rs. 49726.3 million be given for upgradation of standards of administration and specific grants to certain States for special problems. – For the five years commencing from 1 April 2000, Rs. 100 billion for local bodies, to be directed for maintenance of civic services Rs. 16 billion per annum is for rural local bodies and Rs.4 billion per annum is for urban local bodies. d) With reference to the Grants-in-Aid under Article 275 (1) of the Constitution, which amounts to a total of Rs. 353.59 billion for the period 2000–2005 to be provided to such States (15 States) which will have deficit non-plan revenue account even after the devolution of central tax revenues, equal to the amount of deficits assessed during the period 2000–2005. e) With regard to the Calamity

Relief Funds in States with an aggregate size of Rs. 110075.9 million during 2000–05. – The tax devolution from the Centre to the State should not exceed 37.5 per cent of total Centre's revenues this should be inclusive of the Central taxes/duties to States and grants-in-aid to States. The FC recommended that each State be given a share as specified the net proceeds of all shareable union taxes and duties except the expenditure tax and service tax. Data for percentage share for certain states is Bihar-14.597, Maharashtra-4.632, Kerala-3.057, Uttar Pradesh-19.798, and Punjab-1.147.

Terms of Reference The commission shall make recommendations on the following matters:

(1) The distribution of net proceeds of taxes between union and states which are to be divided under chapter 1 part 12 of the constitution.

(2) The policies required to increase the consolidated fund of states on the basis of recommendation made by the finance commission of states to supplement the resources of municipalities and panchayats in the state.

In making the recommendation, the commission shall have its regard, among other considerations to:

(1) The resources of the union government and state government for five years starting from 1 April 2005 on the basis of the total tax and non-tax that it will likely to receive by the end of 2003–04.

(2) The demand of the resources by the central government, in particular the need of expenditure on civil administration, internal security, defence, debt servicing and other committed expenditure and liabilities.

The Twelfth Finance Commission of India

The Twelfth Finance Commission was appointed on 1st November 2002 to make recommendations on the distribution of net proceeds of shareable taxes between union and states. The commission was headed by veteran economist of India, C. Rangarajan. The commission submitted its report on 30 November 2004 and covered the period from 2005 to 2010.

Major Recommendations of 12th Finance Commission are:

(a) Macro-economic stability: centre and states to improve the combined tax-GDP ratio to 17.6 per cent by 2009-10. Combined debt-GDP ratio, with external debt measured at historical exchange rates, to be brought down to 75 per cent by 2009-10. The revenue deficit for the centre and states combined to be reduced to 0 per cent by 2008.

(b) Distribution of Union Tax: The total share of states in the total shareable central taxes to be fixed at 30.5 per cent and the share of states will come down to 29.5 per cent, if the states levy sales tax on sugar, textiles & tobacco.

(c) Grants to local bodies: The total grant that will have to given to the states for panchayati raj institutions and local urban bodies for the period of 2005–09 will be Rs. 200 billion and Rs 50 billion respectively.

(d) Calamity Relief Fund: The calamity relief fund scheme will continue as it was in the previous plans with central & states contributing in the ratio of 75:25. The size of fund will be Rs. 213.33 billion for the period of 2005-10.

(e) Grant in aids to the states: For the period of 2005–10, the total non-plan revenue deficit grant of Rs. 568.56 billion is recommended to 15 states and the total grant of Rs. 10172 is recommended for 8 educationally backward states. A grant of Rs. 150 billion is recommended for building roads & bridges which is in addition to the normal expenditure of the states while the grants that is recommended to the states for maintenance of public buildings, forests, heritage conversation and specific needs of states is Rs 5 billion, Rs 1 billion, Rs. 6.25 billion & Rs. 71 billion.

Terms of Reference

The commission shall make recommendations on the following matters:

(1) The distribution of net proceeds of taxes between union and states which are to be divided under chapter 1 part 12 of the constitution.

(2) The policies required to increase the consolidated fund of states on the basis of recommendation made by the finance commission of states to supplement the resources of municipalities and panchayats in the state.

In making the recommendation, the commission shall have its regard, among other considerations to:

(1) The resources of the union government and state government for five years starting from 1 April 2005 on the basis of the total tax and non-tax that it will likely to receive by the end of 2003–04.

(2) The demand of the resources by the central government, in particular the need of expenditure on civil administration, internal security, defence, debt servicing and other committed expenditure and liabilities.

The Thirteenth Finance Commission:

The Thirteenth Finance Commission was constituted by the President under for the period 2010-15. Dr. Vijay Kelkar was appointed the Chairman of the Commission. The important recommendations of the Thirteenth Finance Commission can be categorized under the following heads:

1. The share of states in the net proceeds of the shareable Central taxes should be 32 per cent. This is 1.5 per cent higher than the recommendation of 12th Finance Commission
2. Revenue deficit to be progressively reduced and eliminated, followed by revenue surplus by 2013–14.
3. Fiscal deficit to be reduced to 3 per cent of the GDP by 2014–15.
4. A target of 68 per cent of GDP for the combined debt of centre and states.
5. The Medium Term Fiscal Plan (MTFP) should be reformed and made the statement of commitment rather than a statement of intent.
6. FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.
7. Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act(GST).To incentivise the states, the commission recommended a sanction of the grant of Rs500 billion.
8. Initiatives to reduce the number of Central Sponsored Schemes (CSS) and to restore the predominance of formula based plan grants.
9. States need to address the problem of losses in the power sector in time bound manner.
10. Grants for local bodies amounting to 2.5 per cent of the central pool of taxes

The Fourteenth Finance Commission:

The government of India has constituted the 14th Finance Commission under the chairmanship of former RBI Governor Y. V. Reddy and other members of the Commission. The five-member panel is to submit its report by October 31, 2014.

Apart from its recommendations on the sharing of tax proceeds between the Centre and the States which will apply for a five-year period beginning 1st April 2015, the Commission has been asked to suggest steps for pricing of public utilities such as electricity and water in an independent manner and also look into issues like disinvestment, GST compensation, sale of non-priority PSUs and subsidies. Among other things, the Commission would look into the “need for insulating the pricing of public utility services like drinking water, irrigation, power and public transport from policy fluctuations through statutory provisions.

23.10 Summary

After a lengthy discussion about the division of functions and revenue sources between the Centre and States in India, the reasons for the existence of fiscal imbalances are explained. In view of the need for fiscal transfers between the centre and states to reduce the fiscal imbalances, the fiscal transfers made through the finance commission. The procedures and principles followed have been discussed of enoroumous transfer of resources the fiscal imbalances still persist in India giving rise to same fiscal problems. Some suggestions have been made at the end to maintain harmonious fiscal relations between centre and states and to highlight some of the important recommendations of the Finance Commissions.

23.11 Glossary

Grant-in-Aid: These grants are used to ensure that public services can be maintained in poorer states or in times of depression.

Devolution: Devolution is the statutory granting of powers from the central government of a sovereign state to government at a sub-national level, such as regional, local, or state level. It is a form of decentralisation.

Vertical Imbalance: When the fiscal imbalance is measured between the two levels of government (Central and States) it is called Vertical Fiscal Imbalance.

Horizontal Imbalance: When the fiscal imbalance is measured between the governments at the same level it is called Horizontal Fiscal imbalance. This imbalance is also known as regional disparity.

Fiscal Federalism: Fiscal federalism is the understanding of what functions and instruments are allocated across different parts of administration. An important part of this is the transfer of payments.

23.12 Preparatory Questions

1. Bring out the functions of finance commission?
2. Critically explain the division of functions and revenue resources between the centre and states in India.
3. Analyse the Thirteenth Finance Commission's recommendations.
4. Examine the financial relations between the Union and the States under different categories of taxation.
5. Discuss the fiscal transfers recommended by the successive finance commissions.

23.13 Books for Study

1. Tyagi, B.P. (2011), *Public Finance*, Jai Prakash Nath & Co.Meerut.

2. Musgrave, R.A. and P.B. Musgrave (1976), *Public Finance in Theory and Practice*, McGraw Hill, Kogakusha, Tokyo.

3. Vaish M.C. & Sundaram: public Finance, Himalaya publishing House.

4. Reports of Finance Commission of India.

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