PUBLIC FINANCE ADMINISTRATION

M. A. Economics First Year

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Director, I/c

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PUBLIC FINANCE ADMINISTRATION - II – 204EC21

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READING LIST

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5 Friedman, A. (1986), Welfare Economics and Social Choice Theory. Martins Nijhoff, Boston.

6 Premchand, A. (1966), Control of Public Expenditure in India. Allied Publishers, New Delhi.

7 Buchanan. J.M. (1958). Public Principles of Public Debt, A Defence and Restatement.

Module-I---Budget

Lesson-I

Meaning Objectives and Types of Budget

1.7 Technical terms

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1. O Objectives:

After reading this lesson, the student should be able to

- Know the meaning and definition of the budget and its Components
- Learn the important objectives of the Budget
- Understand the various types of Budget
- Make their own Budget in Practical

1.1 Introduction: Public finance is a much wider title which includes all those matters which are connected with public money, the money a government gets, spends, borrows, lends, raises or prints. Public finance, i.e., finances of the government now named as public economics does not only discuss the issue that how much of the country's resources the government should acquire for its own use but also discuss the 'efficiency' with which the money should be used. Public finance gets reference in the ancient treatise' Arthasastra' of Kautilya which covers 'treasury, sources of revenue, accounts and audit' in a very detailed way—however, the subject has gathered much significance in the post Second World War period once the government' role in the economy started expanding due to various reasons namely, the rise of public sector, delivery of public goods, law and order, defense, etc. By the Second World War, the importance of the government's role in the economy was emergently felt and it was believed that all needs of the people cannot be met if the economy is left to the market (i.e., private market) in its entirety. For example, national defense, law enforcement and other major areas which must be cared for by the national government besides the supplies of affordable or free healthcare, education, social security measures, etc. could only be taken care of by the governments(as they are not profit driven). This is why there was an agreement among the experts and the policymakers to expand the government's role in the economy. This led to the ultimate rise of the public sector around the world.

Government of each nation is necessitated to undertake several social economic as well as other activities. In addition to that Government will also implement different policies to attain different objectives like reducing of inequalities of income and wealth, economic development etc., for which it has to incur certain expenditure. For this purpose government raises necessary revenue to meet this expenditure. A statement of receipts and expenditures of government is prepared for every financial year and integrated in a document is called budget which is placed before the parliament. Budget provides actual financial accounts for previous year along with budget estimates of current year.

The term Budget has been derived from the French word " Bougette" means a small leather bag or a wallet i.e., money bag or purse. The chancellor of Exchequer in London used carry financial proposals in a leather bag to the House of Common each year. According to the Indian Constitution Budget implies annual financial statement containing estimate of all expected revenue and expenditure of government for coming financial year. Government of India Budget is a Constitutional obligation under article 112 of the constitution. It is a statement of receipts and expenditure of central government prepared for every financial year and placed before the parliament. It provides actual financial accounts for previous year along with budget estimates of current year.

Budget is a detailed financial statement containing income and expenditure of government of any one financial year.

1.1.1 Need of Government Budget:

Following are need of Government budget on account of following reasons;

1. Increase in Government activities
2. Solving various problems in the economy
3. Stimulating Production level
4. To acquire knowledge about government activities
5. Reduction of inequalities of wealth and income

1.2 Meaning and Definition of the Budget;

"A government budget is an annual financial statement showing item wise estimates of expected revenue and anticipated expenditure during fiscal year." In the beginning of every year, Government presents before Lok Sabah an estimate of its receipts and expenditure for the coming financial year.

The Government expenditure according to its objectives and then tries to raise resources to meet the proposed expenditure. Government earns money broadly from taxes. Fees and fines, Interest on loans given to states and dividend by public sector enterprises. Government spends mainly on 1. Securing and providing goods and services to citizens. 2. Law and order and 3.Internal security, defence, staff salaries, etc. Obviously, the budget is the most important information document of the government because government implements its plans and programmes through the budget.

The Annual financial statement or the statement of estimated receipts and expenditure of the Government in respect of each financial year is popularly known as the Budget. Derived from the French word ‘ Bougette” meaning “sack or pouch.” Bag used by the British Chancellor to keep his papers to be presented to the parliament. Present sense of the term was used for the first time in1873.

Definition of the Budget: “A Government budget is a statement showing estimated receipts and estimated expenditure of the government during a financial year.”

1.2.**1. Main Components of Budget**:

It is a statement of estimates of Government receipts and expenditures. Budget estimates pertain to a fixed period, generally a year. Expenditure and sources of finance are planned in accordance with the objectives of the government. It requires to be approved (passed) by parliament or Assembly or some other authority before its implementation.

Broadly, Government budget has three components:

1st Component--- showing all receipts of the Government which include (a) revenue receipts and (b) capital receipts

2nd Component--- showing all expenditure of the Government which include (a) revenue expenditure and (b) capital expenditure and

3rd Component--- showing Government deficits which include (a) revenue deficit (b) fiscal deficit and (c) primary deficit

1.2.2: Data in the Budget: The Union Budget has three sets of data for every concerned sector or sub-sector of the economy;

(1) Actual data of the preceding year (here preceding year means one year before the year in which the Budget is being presented)

(2) Provisional data of the current year, it provides Provisional Estimates for this year (shown as 'PE' in brackets with the data)

(3) Budgetary Estimates for the following year (here following year means one year after the year in which the Budget is being presented or the year for which the Budget is being presented)This is shown with the symbol 'BE' in brackets with the concerned data.

One comes across certain other kinds of data, too in day-to-day government economic literature. There are such three other kinds of data-

Revised Estimate (RE): Revised Estimate is basically a current estimation of either the budgetary estimates (BE) or the provisional estimates (PE). It shows the contemporary situation. It is an interim data.

Quick Estimates (QE): Quick estimate is a kind of revised estimate which shows the latest situation and is use full in the process of going for future projections for some sector or sub-sector. It is an interim data.

Advance Estimate (AE): Advance Estimate is a kind of quick estimate but done ahead (is advance) of the final stage when data should have been collected. It is an interim data.

Developmental and Non-developmental Expenditure: Total expenditure incurred by the government is classified into two segments—developmental and non-developmental. All expenditure of productive nature are developmental such as on the heads of new factories, dams, bridges, roads, railways, etc.—all investments.

The expenditures which are of consumptive kind and do not involve any production are non-developmental, i.e. paying salaries, pensions, interest payments, subsidies, defence expenses, etc.

This classification is not used in the Indian public finance management now plan and non-plan expenditure.

1.3 Objectives of the Budget:

It should be kept in mind that rapid and balanced economic growth with equality and social Justice has been the general objective of all our policies and plans.

General objectives of a government budget are as under;

The budget should be to;

- Strengthen the foundation of the economy to deal effectively with an inherently uncertain external environment.
- Reverse the decline in agriculture and strengthen the rural economy
- Restore the momentum of industrial growth, especially of small scale enterprises, and revive the capital market.
- Accelerate the development of infrastructure
- By these and other means rapidly expand productive job opportunities
- Give special impetus to social sector development
-
- Ensure macro-economic stability and control over inflation.

Government prepares the Budget for fulfilling certain objectives. These objectives are the direct outcome of Government economic, social and political policies. Some of the important objectives of Government budget are as follows:

1. Reallocation of Resources
2. Reducing inequalities in income and wealth
3. Economic Stability
4. Management of Public enterprises
5. Economic Growth
6. Reducing Regional disparities

1.3.1 Reallocation of Resources:

Through the budgetary policy Government aims to reallocate resources in accordance with the economic and social priorities of the country. Government can influence allocation of resources through;

a) Tax concessions or Subsidies:

To encourage investment, Government can give tax concession, subsidies etc. to the producers. For example, Government discourages the production of harmful consumption goods (liquor, cigarettes etc) through heavy taxes and encourages the use of khadi, by providing subsidies.

a) Directly producing goods and services. If private sector does not take interest, Government can directly undertake the production.

1.3.2 Reducing inequalities in income and wealth:

Economic inequality is an inherent part of every economic system. Government aims to reduce such inequalities of income and wealth, through its budgetary policy. Government aims to influence distribution of income by imposing taxes on the welfare of the poor. It will reduce income of the rich and raise standard of living of the poor, thus reducing inequalities in the distribution of income.

1.3.3 Economic Stability:

Government budget is used to prevent business fluctuations of inflation or deflation to achieve the objective of economic stability. The Government aims to control the different phases of business fluctuations through its

Budgetary policy Policies of surplus budget during inflation and deficit budget during deflation helps to maintain stability of prices in the economy.

1.3.4 Economic Growth ;

The growth rate of a country depends on rate of saving and investment. For this purpose, budgetary policy aims to mobilize sufficient resources for investment in the public sector. Therefore, the government makes various provisions in the budget to raise overall rate of savings and investments in the economy.

1.3.5 **Reducing regional disparities**;

The Government budget aims to reduce regional disparities through its taxation and expenditure policy for encouraging setting up of production units in economically backward regions.

1.3.6 **Management of Public Enterprises**:

There are large numbers of public sector industries, which are established and managed for social welfare of the public. Budget is prepared with the objectives of making various provisions for managing such enterprises and providing those financial help.

1.4 Types of Budgets:

1.4.1 Balanced Budget: Balanced budget is a budget where receipts are equal to current expenditure. That means that taxes on income and expenditure etc. are sufficient to meet payments for goods and services, interest on the national debt etc. A balanced budget is, however, not necessarily an ideal one-economist J.M.Keynes has shown, how budget surpluses and deficits can be used to stimulate or regulate the economy, by affecting the levels of demand and prices.

1.4.2 **Revenue Budget**: Revenue Budget consists of revenue receipts of government (revenue from tax and other sources) and the expenditure met from these revenues. Tax revenues are made up of taxes and other duties that the Union government levies. The other receipts consist mainly of interest and dividend on investments made by government, fees and other receipts for services rendered by government.

1.4.3 **Receipts Budget**: Estimates of receipts included in the Annual Financial statement are further analyzed in this document. The document also gives details of revenue and capital receipts, the trend of receipts over the years and more importantly the details of external assistance received by the government.

1.4.4 **Performance Budget**: These budgets are prepared by all ministries dealing with development activities. Also provided are separate appraisal reports in respect of certain major central sector projects/ programs. A statement is included on the programs and performances of each public sector undertaking under the respective administrative ministry, including the installed and utilized capacity, physical targets and achievements, results of operations and return on capital.

1.4.5 **Capital Budget**: It constitutes the capital transactions i.e. capital receipts and capital expenditure along with the public account transactions.

1.4.6 **Outcome Budget**: Outcome budget contains a brief introductory note on the organization and function of the Ministry/ Department, list of major programs/schemes implemented by the Ministry/ Department its mandate, goal and policy framework, budget estimates, Scheme wise analysis of physical performance and linkage between financial outlays and outcome, review covering overall trends in expenditure viv-a-vis budget estimates in recent years, review of performance of statutory and autonomous bodies under the administrative control of the Ministry/Department, reform measures, targets and achievements and plan for future refinements.

1.4.7 **Zero-base budget**: Following a considerable period of investigation and examination Zero-base budgeting was adopted in India in 1986 as a technique for determining expenditure budgets. Accordingly the Ministry of Finance instructed all the administrative ministries to review their respective programs and activities in order to prepare expenditure budget estimates based on the principles of Zero-base budgeting. Zero bases means that the justification of every fund outlay shall have to be provided afresh. If a fund outlay in a particular program/project is found to be justified, its minimum/ base level will be fixed as a percentage(say 80 percent) of the current year's budget, on the assumption that inefficiencies and/ or scope of budget reduction may exist in marginal cases only (say, the balance 20 percent)

1.4.8 **Expenditure Budget**; Contains expenditure estimates made for a scheme or program under both revenue and capital heads. These estimates are brought to give effect to the financial proposals introduced in the budget.

1.4.9 **Deficit Budget**: Deficit budget is that budget in which government receipts are less than government expenditure. Deficits, as the meaning of the word itself suggests, mean shortfalls in government revenues vis-à-vis its expenditure. Deficit budget is a common feature of developing economies in the world.

1.4.10 **Surplus Budget**: Surplus budget is that budget in which the government receipts are more than government expenditure. It is a rare feature in the developing countries.

1.4.11 **Gender Budget**; A general budget by government which allocates funds and responsibilities on the basis of gender is gender budgeting. It is done in an economy where socio-economic disparities are chronic and clearly visible on a sex basis(as in India). Gender budgeting started in India with the Union Budget 2006-07 which proposed an outlay of Rs.28,737 crore dedicated to the cause of women and created gender budgeting cells in 32 ministries and departments.

1.5 Importance of Government Budget:

India is a Union of States. The responsibilities and powers of the Union and the States, and the relationship between them, are set out in the Constitution of India. The financial year in India is from 1 April to the 31 March of the following year. The annual financial statement of receipts and expenditure of the Government is required to be placed before the parliament/State Legislature which, in each case, confers specific authority for raising revenue through taxation and incurring expenditure. In this regard, no tax can be levied or collected except by authority of law while, similarly, no moneys can be appropriated from the consolidated Fund except in accordance with law and for the purposes and in the manner provided in the Constitution. The Finance Minister, assisted inter alia by the Budget Division of the Department of Economic Affairs of the Ministry of finance, has responsible for producing the Budget. The budget is classified in various types. The Budget division is responsible for issuing all instructions and guidelines for the preparation of budget estimates and for monitoring the timely receipt of the same from all the Ministries concerned.

Government budgeting is important because it enables the government to plan and manage its financial resources to support the implementation of various programs and projects that best promote the development of the country. Through the budget, the government can prioritize and put into action its plants, programs and policies within the constraints of its financial capability as dictated by economic conditions.

1.6 Summary:

Government Budgeting is the critical exercise of allocating revenues and borrowed funds to attain the economic and social goals of the country. It also entails the management of government expenditures in such a way that will create the most economic impact from the production and delivery of goods and services while supporting a healthy fiscal position.

According to Article 112 of the Indian Constitution, the Union Budget of a year, also referred to as the annual financial statement, is a statement of the estimated receipts and expenditure of the government for that particular year. Union Budget keeps the account of the government finances for the fiscal year that run, from 1st April to 31st March. Union Budget is classified into revenue budget and capital Budget.

Revenue budget includes the government's revenue receipts and expenditure. There are two kinds of revenue receipts—tax and non-tax revenue. Revenue expenditure is the expenditure incurred on day to day functioning of the government and on various services offered to citizens. If revenue expenditure exceeds revenue receipts, the government incurs a revenue deficit.

Capital Budget includes capital receipts and payments of the government, loans from public foreign governments and Reserve Bank of India from a major part of the government's capital receipts. Capital expenditure is the expenditure on development of machinery, equipment, building, health facilities; education etc. fiscal deficit is incurred when the government's total revenue. Budgeting is the most basic and the most effective tool for managing our resources.

1.7 Technical terms:

1. Economic Stability
2. Subsidies
3. Economic growth
4. Regional disparities
5. Balanced budget
6. Revenue budget
7. Receipts budget
8. Zero base budget
9. Gender budget
10. Performance budget

1.8 Self Assessment questions:

1. What is Government Budget? And explain its components

2. Explain the objectives of the Budget

3. Describe the Types of Budgets detailed

4. Explain the importance of Budget in Government activities

1.9 Reference Books:

1. Hugh Dalton, public Finance (1956)
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3. P.E. Taylor , The Economics of Public Finance
4. J.Cullis and p. Jones, Public finance and Public choice, Oxford University press
5. S.R.Maheswari, A Dictionary of Public administration, Orient Longman, New delhi.
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Lesson Writer Name: Dr.p.Jayalakshmi

Module-I

Lesson-2

Preparation of Central Budget in India

2.0 Objectives: After studying this lesson the student should be able to

- To know the names of Budget Documents
- To understand the requiring Documents of the Budget
- To learn the process of presentation of Budget
- To understand the importance of Budget preparation

2.1 Introduction; Government budgeting is the critical exercise of allocating revenues and borrowed funds to attain the economic and social goals of the country. It also entails the management of government expenditures in such a way that will create the most economic impact from the production and delivery of goods and services while supporting a healthy fiscal position. Government budget is important because it enables the government to plan and manage its financial resources to support the implementation of various programs and projects that best promote the development of the country. Through the budget, the government can prioritize and put into action its plants, programs and policies within the constraints of its financial capability as dictated by economic conditions.

The preparation of the annual budget involves a series of steps that begins with the determination of the overall economic targets, expenditure levels, revenue projection and the financing plan the authorities.

2.1.1 Objectives and purposes of Budget preparation:

During budget preparation, trade-offs and prioritization among programs must be made to ensure that the budget fits government policies and priorities. Next, the most cost-effective variants must be selected. Finally means of increasing operational efficiency in government must be sought. None of these can be accomplished unless financial constraints are built into the process from the very start. Accordingly, the budget formulation process has four major dimensions:

1. Setting up the fiscal targets and the level of expenditures compatible with these targets. This is the objective of preparing the macro-economic frame work.
2. Formulating expenditure policies
3. Allocating resources in conformity with both policies and fiscal targets. This is the main objective of the core processes of budget preparation.
4. Addressing operational efficiency and performance issues.

The budget can serve a number of important purposes, including

a) Monitoring the income and expenditures over the course of a year
b) Helping to determine if adjustments need to be made in programs and goals
c) Forecasting income and expenditures for projects including the timing and the availability of income (such as additional grant funds)
d) Providing a basis for accountability and transparency

2.2 Needful Documents for Budget preparation

The budget documents comprise, besides the Finance Minister's Budget speech, The following:

2.2.1 **Annual Financial Statement**: annual financial statement, the document as provided under Article 112, shows estimated receipts and expenditure of the Government of India. The receipts and disbursements are shown under the three parts, in which Government accounts are kept viz, (1) Consolidated Fund, (2) Contingency Fund and (3) Public Account. Under the constitution, annual financial statement distinguishes expenditure on revenue account from other expenditure, Government Budget, therefore, comprises Revenue budget and capital budget. The estimates of receipts and expenditure included the annual financial statement are for the expenditure net of refunds and recoveries, as will be reflected in the accounts.

Consolidated Fund: The existence of the consolidated Fund of India (CFI) flows from Article 266 of the Constitution. All revenues received by Government loans raised by it, and also its receipts from recoveries of loans granted by it from the consolidated Fund. All expenditure of Government is incurred from the consolidated Fund of India and no amount can be drawn from the consolidated Fund without authorization from parliament.

Contingency Fund: Article 267 of the constitution authorizes the contingency Fund of India which is an imp rest placed at the disposal at the disposal of the president of India to facilitate Government to meet urgent unforeseen expenditure pending authorization from parliament. Parliamentary approval for such unforeseen expenditure is obtained, post-facto, and an equivalent amount is drawn from the consolidated Fund to recoup the contingency Fund.

Public Account: Moneys held by Government in Trust as in the case of provident Funds, small savings collections, income of Government set apart for expenditure on specific objects like road development, primary education, Reserve/ special Funds etc. are kept in public account. Public account funds do not belong to Government and have to be finally paid back to the persons and authorities who deposited them, parliamentary authorization for such payments is, therefore, not required, except where amounts are withdrawn from the consolidated fund with the approval of parliament and kept in the public account for expenditure n specific object is gain submitted for vote of parliament for drawl from the public account for incurring expenditure on the specific object. Revenue Budget consists of the revenue receipts of government (tax revenues and other revenues) and the expenditure met from these revenues. Tax revenues comprise proceeds of taxes and other duties levied by the Union. The estimates of revenue receipts shown in the annual financial statement take into account the effect of various taxation proposals made in the finance bill. Other receipts of Government mainly consist of interest and dividend on investments made by Government, fees, and other receipts for services rendered by Government.

Revenue expenditure is for the normal running of Government departments and various services, interest payments on debt, subsidies etc. Broadly, the expenditure which does not result in creation of assets for Government of India is treated as revenue expenditure. All grants given to state governments/Union territories and other parties are also treated as revenue expenditure even though some of the grants may be used for creation of assets.

Capital Budget consists capital receipts and capital payments. The capital receipts are loans raised by Government from public called market loans, borrowings by Government from Reserve Bank and other parties through sale of Treasury Bills, loans received from foreign Governments and bodies, disinvestment receipts and recoveries of loans from state and Union Territory Governments and other parties.

Capital payments consist of capital expenditure on acquisition of assets like land, buildings, machinery, equipment, as also investments in shares, etc., and loans and advances granted by central Government to State and Union Territory Governments, Government companies, Corporations and other parties.

2.2.2 Demand for Grants: Article 113 of the Constitution mandates that the estimates of expenditure from the consolidated Fund of India, included in the Annual Financial Statement and required to be voted by the Lok sabha, are submitted in the form of Demand for grants. The Demands for Grants are presented to the Lok sabha along with the Annual Financial Statement. Generally, one Demand for Grant is presented in respect of each Ministry or Department depending on the nature of expenditure. In regard to Union Territories without Legislature, a separate Demand is presented for each of the Union Territories. Each Demand first gives the totals of 'Voted" and 'Charged' expenditure included in the demand separately, and also the grand total of the amount of expenditure for which the Demand is presented. This is followed by the estimates of expenditure under different major heads of account. The breakup of the expenditure under each major head between 'plan' and "Non-plan' is also given. Each demand normally includes the total provisions required for a service that is provisions on account of revenue expenditure, capital expenditure, grants to state and Union Territory Governments and also loans and advances relating to the service.

Where the provision for a service is entirely for expenditure charged on the consolidated Fund of India , for example, interest payments , a separate Appropriation, as distinct from a demand, is presented for that expenditure and it is not required to be voted by Lok sabha. Where, however, expenditure on a service includes both 'voted' and 'charged' items, of expenditure, the latter are also included in the demand presented for that service but the 'voted' and 'charged' provisions are shown separately in that demand.

2.2.3 Appropriation Bill: Under Article 114(3) of the Constitution, no amount can be withdrawn from consolidated Fund without the enactment of such a law by parliament. After the demands for grants are voted by Lok sabha, parliament's approval to the withdrawal from the Consolidated Fund of the amounts so voted and of the amount required to meet the expenditure charged on the Consolidated Fund is sought through the Appropriation Bill. The whole process beginning with the presentation of the Budget and ending with discussions and voting on the Demands for Grants requires sufficiently long time. The Lok Sabha is, therefore, empowered by the Constitution to make any grant in advance in respect of the estimated expenditure for a part of the financial year pending completion of procedure for the voting of the Demands.

The purpose of the 'vote on account' is to keep Government functioning, pending voting of 'final supply'. The Vote on account is obtained from parliament through an Appropriation Bill.

2.2.4 Finance Bill: At the time of presentation of the Annual Financial Statement before parliament, a Finance Bill is also presented in fulfillment of the requirement of Article 110(1)(a) of the Constitution, detailing the imposition, abolition, remission, alteration or regulation of taxes proposed in the Budget. A Finance Bill is a Money Bill as defined in article 110 of the Constitution. It is accompanied by a Memorandum explaining the provisions including in it.

2.2.5 Memorandum explaining the provisions in the Finance Bill: To facilitate understanding of the taxation proposals contained in the Finance Bill, the provisions and their implications are explained in the document titled Memorandum Explaining the Provisions of the Finance Bill.

2.2.6 Macro-economic Framework statement: The Macro-economic Framework Statement, presented to Parliament under section3(5) of the Fiscal responsibility and Budget Management Act,2003 and the rules made there under, contains an assessment of the growth prospects of the economy with specific underlying assumptions. It contains assessment regarding the GDP growth rate, fiscal balance of the Central Government and the external sector balance of the economy.

2.2.7 Fiscal Policy Strategy Statement: The Fiscal Policy Strategy Statement, presented to Parliament under section 3(4) of the Fiscal Responsibility and Budget Management Act,2003, outlines the strategic priorities of Government in the fiscal area for the ensuring financial year relating to taxation, expenditure, lending and investments, administered pricing, borrowings and guarantees. The statement explains how the current policies are in conformity with sound fiscal management principles and gives the rationale for any major deviation in key fiscal measures.

2.2.8 Medium-term Fiscal Policy Statement: The Medium-term Fiscal Policy statement, presented to parliament under section 3(2) of the fiscal responsibility and Budget Management Act, 2003, sets out three-year rolling targets for four specific fiscal indicators in relation to GDP at market prices namely (i) Revenue Deficit, (ii) Fiscal Deficit, (iii) Tax to GDP ratio and (iv) Total out-standing Debt at the end of the year.

The statement includes the underlying assumptions, an assessment of sustainability relating to balance between revenue receipts and revenue expenditure and the use of capital receipts including market borrowings for generation of productive assets.

2.2.9 Expenditure Budget Volume – 1: This document deals with revenue and capital disbursements of various Ministries/Departments and gives the estimates in respect of each under 'Plan' and 'Non-Plan'. It also gives analysis of various types of expenditure and broad reasons for the variations in estimates.

Expenditure Budget Volume – 2: The provisions made for a scheme or a program may spread over a number of Major Heads in the Revenue and Capital sections in a Demand for Grants. In the Expenditure Budget Vol.2, the estimates made for a scheme/program are brought together and shown on a net basis at one place, by Major Heads.

2.2.10 Receipts Budget: Estimates of receipts included in the Annual Financial Statement are further analyzed in the document 'Receipts Budget'. The document provides details of tax and non-tax revenue receipts and capital receipts and explain the estimates.

The document also provides the arrears of tax revenues and non-tax revenues, as mandated under the Fiscal Responsibility and Budget Management Rules, 2004. Trend of receipts and expenditure along with deficit indicators, statement pertaining to National Small Savings Fund (NSSF), statement of revenues foregone, statement of liabilities, statement of guarantees given by the Government, statements of assets and details of external assistance are also included in Receipts Budget.

2.2.11 Budget at a Glance: This document shows in brief, receipts and disbursements along with broad details of tax revenues and other receipts. This document also exhibits broad break-up of expenditure – Plan and Non-Plan, allocation of Plan outlays by sectors as well as by Ministries / Departments and details of resources transferred by the Central Government to State and Union Territory Governments.

This document also shows the revenue deficit, the gross primary deficit and the gross fiscal deficit of the Central Government. The document also includes a statement indicating the quantum and nature (share in Central Taxes, grants/loan) of the total Resources transferred to States and Union Territory Governments.

2.2.12 Highlights of Budget: This document explains the key features of the Budget 2011-2012, inter alia, indicating the prominent achievements in various sectors of the economy. It also explains, in brief, the budget proposals for allocation of funds to be made in important areas. The summary of tax proposals is also reflected in the document.

2.2.13 Detailed Demands for Grants: The Detailed Demands for Grants are laid on the table of the Lok Sabha sometime after the presentation of the Budget, but before the discussion on Demands for Grants commences. Detailed Demands for Grants further elaborate the provisions included in the Demands for Grants as also actual expenditure during the previous year.

A break-up of the estimates relating to each program/organization, wherever the amount involved is not less than Rs.10 lakhs, is given under a number of object heads which indicate the categories and nature of expenditure incurred on that program, like salaries, wages, travel expenses, machinery and equipment, grants-in-aid, etc. At the end of these Detailed Demands are shown the details of recoveries taken in reduction of expenditure in the accounts.

2.2.14 Outcome Budget : Outcome Budget contains a brief introductory note on the organization and function of the Ministry/ Department, list of major programs /schemes implemented by the Ministry / Department, its mandate, goal and policy framework, budget estimates, scheme-wise analysis of physical performance and linkage between financial outlays and outcome, review covering overall trends in expenditure vis-à-vis budget estimates in recent years, review of performance of statutory and autonomous bodies under the administrative control of the Ministry / Department, reform measures, targets and achievements and plan for future refinements.

2.2.15 Annual Reports: A descriptive account of the activities of each Ministry / Department during the year 2010-2011 is given in the document Annual Report which is brought out separately by each Ministry / Department and circulated to Members of Parliament at the time of discussion on the Demands for Grants.

2.2.16 Economic Survey: The Economic Survey brings out the economic trends in the country which facilitates a better appreciation of the mobilization of resources and their allocation in the Budget.

The Survey analyses the trends in agricultural and industrial production, infrastructure, employment, money supply, prices, imports, exports, foreign exchange reserves and other relevant economic factors which have a bearing on the Budget, and is presented to the Parliament ahead of the Budget for the ensuring year.

2.3 Budgetary Process:

Distribution of Budget Papers : In the case of the Railway Budget, the sets are distributed to members from the Publications Counter after the Railway Minister has concluded his speech.

The sets of General Budget are distributed to members from several booths in the Inner and Outer Lobbies arranged according to the Division Numbers of members.

In case Division Numbers have not been allotted, these booths are arranged State-wise. The budget papers are made available to members after the Finance Minister’s speech is over, the Finance Bill has been introduced and the House has adjourned for the day.

Discussion on the Budget: No Discussion on Budget takes place on the day it is presented to the House. Budgets are discussed in two stages-the General Discussion followed by detailed discussion and voting on the demands for grants.

Allotment of Time for Discussion: The whole process of discussion and voting on the demands for grants and the passage of the Appropriation and Finance Bills is to be completed within a specified time. As a result, often the demands for grants relating to all the Ministries / Departments cannot be discussed and demands of some Ministries get guillotined i.e. voted without discussion.

The Minister of Parliamentary Affairs, after the presentation of the Budget, holds a meeting of leaders of Parties / Groups in Lok Sabha for the selection of Ministries / Departments whose demands for grants might be discussed in the House.

On the basis of decisions arrived at this meeting, the Government forwards the proposals for the consideration of the Business Advisory Committee. The Business Advisory Committee after considering the proposals allots time and also recommends the order in which the demands might be discussed. It is generally left to the Government to make any change in the order of discussion.

After the allotment of time by the Business Advisory Committee, a time table showing the dates on and order in which the demands for grants of various Ministries would be taken up in the House is published in Bulletin-Part II for the information of members.

General Discussion on the Budget: During the General Discussion, the House is at liberty to discuss the Budget as a whole or any question of principles involved therein but no motion can be moved. A general survey of administration is in order.

The scope of discussion is confined to an examination of the general scheme and structure of the Budget, whether the items of expenditure ought to be increased or decreased, the policy of taxation as expressed in the Budget and in the speech of the Finance Minister.

The Finance Minister or the Railway Minister, as the case may be, has the general right of reply at the end of the discussion.

Consideration of the Demands for Grants by Departmentally Related Standing Committees of Parliament: With the creation of Departmentally Related Standing Committees of Parliament in 1993, the Demands for Grants of all the Ministries / Departments are required to be considered by these Committees. After the General Discussion on the Budget is over, the House is adjourned for a fixed period.

During this period, the Demands for Grants of the Ministries / Departments are considered by the Committees. These Committees are required to make their reports to the House within specified period without asking for more time and make separate report on the Demands for Grants of each Ministry.

Discussion on Demands for Grants: The demands for grants are presented to Lok Sabha along with the Annual Financial Statement. These are not generally moved in the House by the Minister concerned.

The demands are assumed to have been moved and are proposed from the Chair to save the time of the House. After the reports of the Standing Committees are presented to the House, the House proceeds to the discussion and voting on Demands for Grants, Ministry-wise.

Cut Motions: The motions to reduce the amounts of demands for grants are called ‘Cut Motions’. The object of a cut motion is to draw the attention of the House to the matter specified therein.

Cut Motions can be classified into three categories:-

a) Disapproval of policy cut.
b) Economy Cut.
c) Token Cut.

For the facility of members, printed forms for giving notices of cut motions are kept in the Parliamentary Notice Office.

Notice period for tabling Cut Motions: The notices of cut motions can be tabled after the presentation of Budget.

The notices of cut motions tabled up to 15.15 hours on a day are printed and circulated before the day the relevant demands for grants to which they relate are to be taken up in the House.

Accordingly, members should table the notice of cut motions at least two days before the day the demands for grants to which they relate, are to be taken up in the House, but in any case not later than 15.15 hours on the previous day.

A cut motion to be admissible should satisfy under certain conditions.

The speaker decides whether a cut motion is or is not admissible and may disallow any cut motion when in his opinion it is an abuse of the right of moving cut motions or is calculated to obstruct or prejudicially affect the procedure of the House or is in contravention of the Rules of Procedure of the House.

It is a well- established Parliamentary convention that cut motion seeking to discuss the action of the Speaker or relating to Speaker's Department or matters under the control of Speaker are not allowed.

Likewise, cut motions relating to the office of the vice-president (who is also ex-officio Chairman of Rajya Sabha) are not admissible. Cut motion relating to matters under consideration of a Parliamentary Committee is not admissible.

Cut motions are not admissible if they ventilate personal grievances, or if they cast aspersions on individual Government officials. Cut motions seeking to discuss a matter affecting relations with a friendly foreign country or details of internal administration of an autonomous body are out of order as also those which seek omission of a whole grant.

Token cuts seeking to discuss inadequacy of provision in respect of a particular demand are, however, in order.

Normally members of ruling party do not table cut motions.

Annual Reports, Outcome Budgets and Detailed Demands for Grants of the Ministries: In connection with discussion on demands for grants, copies of the Annual Reports and Outcome Budget of the various Ministries and Departments are made available to members through the publications Counter. Detailed demands for grants in respect of various Ministries/Departments are laid on the Table of Lok Sabha some time before the demands for grants are considered by the Departmentally Related Standing Committees.

Vote on Account: As the whole process of Budget beginning with its presentation and ending with discussion and voting of demands for grants and passing of Appropriation Bill and Finance Bill generally goes beyond the current financial year, a provision has been made in the constitution empowering the Lok Sabha to make any grant in advance through a vote on account to enable the government to carry on until the voting of demands for grants and the passing of the Appropriation Bill and Finance Bill.

Normally, the vote on account is taken for two months for a sum equivalent to one sixth of the estimated expenditure for the entire year under various demands for grants. During an election year, the vote on account may be taken for a longer period say, 3 to 4 months if it is anticipated that the main demands and the Appropriation Bill will take longer than two months to be passed by the House.

As a convention vote on account is treated as a formal matter and passed by Lok Sabha without discussion.

Vote on account is passed by Lok Sabha after the general discussion on the Budget is over and before the discussion on demands for grants is taken up.

The Supplementary Demands for Grants are presented to and passed by the House before the end of the financial year while the demands for excess grants are made after the expenditure has actually been incurred and after the financial year to which it relates, has expired.

Copies of the Books of Demands for Supplementary or Excess Grants, received from the Ministry of Finance, are made available to members from the Publications Counter after the presentation of such demands.

Procedure for Discussion: Supplementary and Excess Grants are regulated by the same procedure as is applicable in the case of demands for grants of the main Budget subject to such adaptations, whether by way of modification, addition or omission, as the Speaker deems necessary or expedient.

Appropriation Bill: After the demands for grants have been passed by the House, a Bill to provide for the appropriation out of the Consolidated Fund of India of all moneys required meeting the grants and the expenditure charged on the Consolidated Fund of India is introduced, considered and passed.

The introduction of such Bill cannot be opposed. The scope of discussion is limited to matters of public importance or administrative policy implied in the grants covered by the Bill and which have not already been raised during the discussion on demands for grants.

The speaker may require members desiring to take part in the discussion to give advance intimation of the specific points they intend to raise and may withhold permission for raising such of the points as in his opinion appear to be repetition of the matters discussed on a demand for grant such advance intimation much be given before 10.00 hours on the day the Appropriation Bill is to be taken into consideration. No action is taken on intimations received after 10.00 hours.

No amendment can be proposed to an Appropriation Bill which will have the effect of varying the amount or altering the destination of any grant so made or of varying the amount of any expenditure charged on the Consolidated Fund of India, and the decision of the Speaker as to whether such an amendment is admissible is final. An amendment to an appropriation Bill for omission of a demand voted by the House is out of order.

In other respects, the procedure in respect of an Appropriation Bill is the same as in respect of other Money Bills.

Finance Bill: "Finance Bill" means a Bill ordinarily introduced every year to give effect to the financial proposals of the Government of India for the next following financial year and includes a Bill to give effect to supplementary Financial Proposals for any period.

The Finance Bill is introduced immediately after the presentation of the Budget. The introduction of the Bill cannot be opposed. The Appropriation Bills and Finance Bills may be introduced without prior circulation of copies to members.

As the Finance Bill contains taxation proposals, it is considered and passed by the Lok Sabha only after the Demands for Grants have been voted and the total expenditure is known. The scope of discussion on the Finance Bill is vast and members can discuss any action of the Government of India. The whole administration comes under review.

Budgets of Union Territories and States under President's Rule: Budgets of Union territories and States under President's Rule are also presented to Lok Sabha. The procedure in regard to the Budget of the Union Government is followed in such cases with such variations or modifications, as the Speaker may make.

2.4 Summary: India is a Union of States. The responsibilities and powers of the Union and the states, and the relationship between them, are set out in the constitution of India. The control over finances of Government has traditionally been confined to the Ministry of Finance. With the phenomenal growth and the complexity of Government activities, several powers have been delegated to Administrative Ministries, but the Ministry of Finance continues to have the overall responsibility of co-ordination and control. For speedy and effective discharge of their functions in financial matters which include planning, programming, budgeting, internal control, monitoring and evaluation, an integrated Financial Adviser is attached to each Administrative Ministry.

The Budget documents comprise, besides the Finance Minister's Budget speech, the following: Annual Financial Statement, Demands for grants, Appropriation bill, Finance bill, Receipts Budget, Outcome budget, Annual reports, etc. The documents shown at serial A to Z are mandated by Art, 112, 113, 114(3) and 110(a) of the Constitution of India respectively, while the documents at serial A to Z are presented as per the provisions of the Fiscal responsibilities and budget management act, 2003. Other documents are in the nature of explanatory statements supporting the mandated documents with narrative or other content in a user friendly format suited for quick or contextual references.

In addition to the above, individual Departments/ Ministries also prepare and present to parliament their detailed demands for grants. Outcome Budget, and their annual reports. The Economic Survey, which highlights the economic trends in the country and facilities a better appreciation of the mobilization of resources and their allocation in the, Budget, is brought out by the Economic Division of Department of Economic affairs, Ministry of Finance. The Economic Survey is presented to parliament in advance of the Union Budget.

2.5Technical terms:

1. Budget documents
2. Appropriation bill
3. Finance bill

4. Medium term fiscal policy statement
5. Receipts budget
6. Economic survey
7. Demand for grants
8. Cut motions
9. Token cut
10. Economy cut

2.6 Self Assessment questions:

1. Explain the required documents for Budget preparation?
2. Describe the process of Budget presentation?
3. Explain the Finance Bill?
4. What is meant by Appropriation Bill?

2.7 Reference Books:

1.Union Budgets for various years

2. www.google.com

3. Economy at Glance-Monthly Magazines

4. News Papers

5. Budget Reports of various Years

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Module-I--Budget

Lesson-3

Deficit Financing

3.0 Objectives of the Lesson

Structure of the Lesson

3.1 Introduction

3.1.1 Meaning and definition of deficit Financing

3.1.2 Need for deficit financing

3.1.3 Concepts of Deficit

3.2 Objectives of Deficit Financing

3.2.1 Means of deficit financing

3.3 Purposes of deficit Financing

3.3.1To finance War- expenditure

3.3.2 To lift the economy out of the depths of Depression

3.3.3 To promote the economic development of the country

3.4 Causes of deficit Financing

3.5 Uses of deficit Financing

3.6 Deficit Financing in India

3.7 Summary

3.8 Technical terms

3.9 self assessment questions

3.10 Reference Books

3.0 Objectives: After studying this lesson the student should be able to

-> Know the meaning and different concepts of Deficit Financing.

-> Understand the purposes of Deficit Financing.

-> Learn the importance of Deficit Financing in under developed countries.

-> Study the Deficit Financing in India since 1991.

3.1 Introduction: A government may be said to be practicing deficit financing when it spends in excess of its current revenues. The term 'deficit financing', however, carries different connotations in the U.S.A. and in India. In India, the term 'deficit financing' is, however, interpreted in a narrower sense. Deficit financing in the Indian sense may be said to occur when the budgetary deficit is financed by the government through the creation of new or additional money. Thus, according to the Indian interpretation of the term, the utilization of public loans by the Government to cover the budgetary deficit would not be considered as deficit financing, the reason being that public loans are raised out of the genuine savings of the people and that they result merely in the transfer of purchasing power from the hands of the public to the Government without adding anything to the total money supply of the community. In short, deficit financing in the Indian sense involves the creation of new purchasing power in the economy.

3**.1.1 Meaning and definition of deficit financing**: When the government is running a deficit, it is spending more than its receipts. Of late, deficit financing has emerged as an important instrument for financing the government expenditure. Deficit financing means bridging the gap caused by the excess of government expenditure over its receipts through the creation of new currency. In this case, public expenditure consists of the disbursement on revenue and capital accounts, while government receipts include the revenue on current and capital account. However, the term deficit finance has been differently used in advanced countries and in the developing countries like India. In western countries deficit financing is referred to excess of expenditure over revenue financed by public loans and the creation of new money. Thus, any expenditure of the government over and above its current income is known as deficit financing. However, the term deficit financing is interpreted in a different manner in the context of India. According to Planning Commission, "the term deficit finance is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on current revenue or of capital account. The essence of such a policy lies therefore, in government spending in excess of the revenue it receives in the shape of taxes, earning of state enterprises, loans from the public, deposits, funds and other miscellaneous sources. The government may cover either by running down its accumulated balances or by borrowing from the banking system (mainly from the Central Bank of the country ad thus, creating new money)". Thus, deficit financing refers to the Government spending in excess of its income through revenue, loans from the public, and borrowings from banking or by running down its cash balances. The government transfers its securities to the Reserve Bank and the bank in turn issue new currency which can be put for circulation.

3.1.2 Need for deficit financing: It was in late 1920s that the idea and need of deficit financing was felt. It is when government needs to spend more money than it was expected to earn or generate in a particular period, to go for a desired level of growth and development. Had there been some means to go for more expenditure with less income and receipts, socio-political goals could have been realized as per the aspirations of the public policy! And once the growth had taken place the extra money spent above the income would have been reimbursed or repaid! This was a good public/government wish which was fulfilled by the evolution of the idea of deficit financing.

It was by early 1930s that the US first tried its hand as deficit financing soon to be followed by the whole Euro-American governments. Through this route the developed world was able to come out of the menace of the Great Depression (1929). The idea became popular around the world by the 1960s., India tried its hand at deficit financing in 1969 and since the 1970s its became a routine phenomenon, till it became wild and illogical, demanding immediate redressal., The fiscal deficits in India did not only peak to unsustainable levels but its composition was also not justified and not based on sound fundamentals of economics. Finally, India headed for a slow but confident process of fiscal reforms that is also known as the process of fiscal consolidation.

3.1.3 Concept of Deficit: When the government expenditure exceeds revenues, the government is said to have a budget deficit. Thus, the budget deficit is the excess of government expenditures over Government receipts (income). When the government is running a deficit, it is spending more than its receipts. The government finances its deficit mainly by borrowing from the public, through selling bonds, apart from borrowing from the Central Bank. Deficit can be discussed in different types.

Revenue Deficit: Revenue Deficit takes place when the revenue expenditure is more than revenue receipts. The revenue receipts come from direct & indirect taxes and also by way of non-tax revenue. The revenue expenditure takes place on account of administrative expenses, interest payment, defence expenditure and subsidies.

Budgetary Deficit: Budgetary Deficit is the difference between all receipts and expenditure of the government, both revenue and capital. This difference is met by the net addition of the treasury bills issued by the RBI and drawing down of cash balances kept with the RBI. The budgetary deficit was called deficit financing by the Government of India. This deficit adds to money supply in the economy and therefore, it can be a major cause of inflationary rise in prices. The concept of budgetary deficit has lost its significance after the presentation of the 1997-98 Budget. In this budget, the practice of adhoc treasury bills as source of finance for Government was discontinued. Adhoc treasury bills are issued by the government and held only by the RBI. They carry a low rate of interest and fund monetized deficit. These bills were replaced by ways and means advance. Budgetary deficit has not figured in union budgets since 1997-98. Since 1997-98, instead of budgetary deficit, Gross Fiscal Deficit (GFD) became the key indicator.

Fiscal Deficit: The difference between total revenue and total expenditure of the government is terms as fiscal deficit. It is an indication of the total borrowings needed by the government. While calculating the total revenue, borrowings are not included. Generally fiscal deficit takes place due to either revenue deficit or a major hike in capital expenditure. Capital expenditure is incurred to create long-term assets such as factories, buildings and other development.

Primary Deficit: The fiscal deficit may be decomposed into primary deficit and interest payment. The primary deficit is obtained by deducting interest payments from the fiscal deficit. Thus, primary deficit is equal to fiscal deficit less interest payments. It indicates the real position of the government finances as it excludes the interest burden of the loan taken in the past.

Those entire budgetary deficits reveal fiscal imbalance. Fiscal imbalance and budget deficit result in harmful consequences like mounting inflation, deficit in balance of payment, etc. It has also adversely affected the growth of the economy. The government should introduce fiscal correction policies to overcome the deficit budget and fiscal crisis.

3.2 Objectives of Deficit Financing: The following are important objectives of deficit financing:

i) The deficit financing is a method of fulfilling the financial requirements of the government during the crisis time such as war. It is because; the Government requires a quick command over financial resources so as to finance the growing war expenditure.

ii) J.M.Keynes advocated the deficit financing as an instrument of economic development, level of output and employment.

iii) Deficit financing is advocated as an instrument for mobilizing idle and unutilized resources for promoting economic growth in not only developing countries, but also in developed countries.

iv) Deficit financing can be considered as an instrument for financing the plans.

v) Deficit financing can be considered as an instrument to raise the level of effective demand and stimulate private investment.

vi) It helps in the mobilization of resources for financing economic planning.

3.2.1 Means of deficit financing: Once deficit financing became an established part of public finance around the world, the means of going for it were also evolved by that time. These means basically are the ways in which the government may utilize the amount of money created as the deficit to sustain its budget for developmental or political needs. These means are given below in order of their suggested and tried preferences.

i) External Aids are the best money as a means to fulfill a government's deficit requirements even if it is coming with soft interest. If they are coming without interest nothing could be better.

ii) External borrowings are the next best way to manage fiscal deficit with the condition that the external loans are comparatively cheaper and long-term.

iii) Internal Borrowings comes as the third preferred route of fiscal deficit management. But going for it in a huge way hampers the investment prospects of the public and the corporate sector. It has the same impact on the expenditure pattern in the economy. Ultimately, economy heads for a double negative impact-lower investment (leading to lower production, lower GDPs and lower per capita income, etc.) and lower demands (by the general public as well as by the corporate world) in the economy – the economy moves either for stagnation or for a slowdown (one can see them happening in India repeatedly throughout the 1960s, 1970s, 1980s). The situation improved after the mid-1990s.

iv) Printing Currency is the last resort for the government in managing its deficit. But it has the biggest handicap that with it the government cannot go for the expenditures which are to be made in the foreign currency. Even if the government is satisfied on this front, printing fresh currencies does have other damaging effects on the economy:

a) It increases inflation proportionally. (India regularly went for it since early 1970s and usually had to bear double digit inflations.)
b) It brings in regular pressure and obligation on the Government for upward revision in wages and salaries of Government employees- ultimately increasing the Government expenditures necessitating further printing of currency and further inflation- a vicious cycle into which economies entangle themselves.

Now, it remains a matter of choice and availability of the above given means, and which means a Government adopts and in what proportion, for fulfilling its deficit requirement.

3.3 Purposes of deficit financing: Deficit financing becomes essential in the following three situations:

i) to finance war expenditure, (ii) to lift the economy out of depression, and (iii) to promote the economic development of the country.

3.3.1 To Finance War Expenditure: The financial resources raised through taxation and public borrowings, do not suffice to meet the cost of the war. Willy-nilly, therefore, the government of a country may resort to deficit financing to raise the necessary financial resources for the successful prosecution of the war. During the First as well as the Second World War several governments resorted to deficit financing as a method of war finance. It is clear that deficit financing during wartime cannot be productive in any sense of the term. The newly created money is not matched with any addition to the productive assets of the nation. Even the existing assets suffer destruction and devastation as a consequence of the war. The result is the inflationary spiral which may play havoc with the country's economy and may ultimately lead to its complete ruination.

3.3.2 To Lift the Economy out of Depression: Keynes advocated the use of deficit financing as a means to uplift the economy out of the depths of economic depression, which is often accompanied by unemployment in the country. At such a time, private investment becomes slack on account of the all-round pessimism in the economy. Keynes looked upon public investment as an effective antidote to declining private investment during depression. Since any public investment expenditure to be effective must be on a large scale, this naturally raises the question of funds. Obviously, there are three methods open to the Government for financing the public expenditure. Taxation as a method of finance should be considered to be the most unsatisfactory. Public investment, if it is to alleviate unemployment, must represent an altogether new expenditure. The use of taxation to finance public works does not represent new expenditure. It simply represents the transfer of purchasing power from the citizens to the State, the purchasing power which was already being spent upon private consumption.

As a method of financing public works, the method of public borrowing is better than taxation insofar as it does not represent substitution of private expenditure by government expenditure. There are, however, certain objections against public borrowing as a method of finance. It is pointed out that public borrowing inflates public debt and the community has to bear the heavy burden of interest charges. Why cannot the government itself issue new money (i.e., resort to deficit financing) to finance public investment programme? The Government has simply to put the printing press in motion to secure the requisite supply of money to put idle resources to work. Some writers have, however, raised objections to deficit financing as a method of financing public investment on the ground that such a method would lead directly to inflation, placing the economy in a difficult and even dangerous position. The Keynesians, however, argue that so long as there are idle or unemployed resources present in the economy, deficit financing is not going to produce inflationary symptoms.

3.3.3 To promote Economic Development: Deficit financing is also being increasingly utilized by the developing countries for promoting their economic growth. Taxation, in these countries, had a very narrow base on account of the universal poverty of the people. Public borrowings, as a source of finance, had a limited scope on account of low incomes and high marginal propensity to consume of the people. Further, most of the under developed countries had a democratic political set-up. There was, therefore, limited scope for additional taxation on political grounds. The governments of these countries, therefore, found it more expedient to raise additional financial resources through deficit financing, i.e., printing more paper currency. Further, deficit financing, as a method of finance, arouses little opposition from the public. As such, there are few developing countries which did not avail of the opportunity of raising additional fund through deficit financing. The technique of deficit financing, as a method of developing finance has, therefore, come to stay.

Regarding the third part of the question, it may be said that deficit financing will not produce inflationary symptoms so long as there are idle or unutilized resources present in the economy. The inflationary spiral will appear only if deficit financing is continuing beyond the point of full employment of resources according to the Keynesian theory of employment.

3.4 Causes of deficit financing: Since the beginning of the first five year plan, India resorted to deficit financing and several factors are responsible for the same. The can be listed as follows:

a) Non Development Expenditure: Increase in the non development expenditure such as salaries and dearness allowances of employees, maintenance of defence personnel and production of defence equipment, wasteful expenditure on administration etc., are said to be factors forcing the government to resort to deficit financing. As the government is not in a position to meet the growing expenditure through the available revenue, often it is resorting to deficit financing.

b) Sources for Development Activities: India is resorting to deficit financing, so as to provide the resources for financing development plans. Plan outlays in different Plans could not be met only by mobilizing resources through taxation and borrowings. Hence, the only alternative for the government is to resort to deficit financing.

c) To Boost the Revenue: The Government is not able to raise the revenue through taxation, on account of tax evasion, exemptions and heavy expenditure incurred on tax collections. Hence, tax revenue of the government remains low when compared to expenditure and thus, forced to resort to deficit financing to boost the revenue.

3.5 Uses of deficit financing: Deficit financing is useful in the following manner.

a) Best Use a resources: Deficit financing may help for making the best use of unutilized and surplus resources. Further, deficit financing provides the necessary funds for the development of existing as well as new projects.

b) Helpful to Developing Countries: A country like India finds it difficult to mobilize the revenue through taxation, as the Government face opposition from the public for increased taxation. Further, the scope for internal borrowings is also limited on account of low level of incomes. Hence, deficit financing is said to be an important instrument to create additional resources.

c) Additional purchasing power: A small dose of deficit financing helps to increase the money supply which in turn pushes up the demand. The deficit financing in fact adds to the purchasing power of the public and pushes the aggregate demand for goods and services and in turn results in increased production, income and employment.

d) Helpful despite inflationary nature: In fact, deficit financing is said to result in inflationary conditions which are against the common man. However, it is not a permanent feature. It is because, with the increase in the supply of goods and services on account of increased production met through the deficit financing, prices will come down automatically. Thus, deficit financing is often described as helpful, even it is of inflationary nature.

3.6 Deficit Financing in India:

In India, the deficit financing resorted mainly to enable the Government to obtain the necessary resources for the plans. The levels of outlay laid down are of an order which cannot be met only by taxation and borrowing from the public.

The gap in resources is made up partly through external assistance, but when external assistance is not enough to fill the gap; deficit financing has to be resorted to. The targets of production and employment in the plans are fixed primarily with reference to what is considered as the desirable rate of growth for the economy. When these targets cannot be achieved by levels of expenditure possible with resources obtained from taxation and borrowing additional resources have to be found.

India was declared to be a planned economy right after Independence. As development responsibilities of the government were very high, there was a need of huge funds in rupee as well as in foreign currency forms. India faced continuous crises in managing the required fund to support its Five Year Plans—neither foreign fund came nor could internal resources be mobilized in sufficient amount. Due to lower tax collections, weaker banks that too privately owned, and negligible saving rate etc. By the late 1960’s the government headed for deficit financing and the 1970’s onwards, India started going for higher fiscal deficits and became more and more dependent on increased deficit financing with every fresh year. We may classify deficit financing in India into three phases.

1. The First Phase (1947-1970): This phase had no concept of deficit financing and the deficits were shown as Budgetary Deficits.

2. The Second Phase (1970-1991): This is considered the period of deficit financing, follow up of unsound fundamentals of economics and finally culminating in severe financial crisis by the year 1990-91.

3. The Third Phase (1991 onwards): This started with the initiation of the economic reforms process under the conditionality's put forth by the IMF (controlling fiscal deficit was one amongst them). As the economy moved from government dominance to market dominance, things needed a restructuring and public finance also needed a touch of rationality. Till date, the government had been doing pure politics with the public money in the name of development. Now the IMF dictated and the economy headed towards greater and fiscal responsibility in the coming times. India is better today in this regard but we cannot say that public finance is based today on the sound principles of economics. But the rigorous process of fiscal reforms aiming at fiscal consolidation started in India.

3.7 Summary:

The act/process of financing/supporting a deficit budget by a government is deficit financing In this process, the government knows well in advance that its total expenditures are going to turn out to be more than its total receipts and enacts/follows such financial policies so that it can sustain the burden of the deficits proposed by it. India tried its hand at deficit financing in 1969 and since the 1970's it became a routine phenomenon, till it became wild and illogical, demanding immediate redressed. The fiscal deficits in India did not only peak to unsustainable levels but its composition was also not justified and not based on sound fundamentals of economics. Deficit financing, in the Indian sense, does involve the creation of new purchasing power in the economy. It is evident that deficit financing which serves as meat for developed economy during depression may actually turn out to be poison for developing economy intent upon liquidating mass unemployment in developing country with due precautions and necessary safeguards for the purpose of eliminating unemployment.

3.8 Technical terms:

1. Deficit finance

2. Primary deficit

3. Revenue deficit

4. Budget deficit

5. Capital deficit

6. Consolidated fund

7. Contingent fund

8. Depression

9. Fiscal deficit

10. Economic growth

3.9 Self Assessment Questions:

1. What do you mean by deficit financing? Does it necessarily lead to inflation?

2. Examine the role of deficit financing in promoting economic growth in a developing country?

3. Critically examine the extent of deficit financing adopted in financing the Five Year plans in India?

4. What are the purposes of deficit financing?

5. Explain the limitations of deficit financing?

3.10 Reference Books:

1. Ahulwalia, Montek.s/ Reddy,Y.V and Tarapore, S.S.(eds); Macroeconomics and Monetary policy: issues for a Reforming Economy

2. Bagchi, Amaresh(ed): Readings in public finance

3. Buchanan,J.M.(1970) Public Finances, Richard D,Irwin Homewood

4 Musgrave,R.A.(1959), The Theory of Public Finance, McGraw Hill, Kogakhusa,Toky

5.Musgrave,R.A and P.B.Musgrave(1976), Public Finance inTheory and Practice,

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Module-I--Budget

Lesson-4

Effects of Deficit Financing

4.0 Objectives: After studying this lesson the student should be able to

- Know the effects of Deficit financing on price level, employment, income distribution and capital formation.
- Understand the role of Deficit Financing in the economic development of developing countries

- Know the limits of Deficit Financing
- Learn the impact of Deficit Financing on Inflation

4.1 Introduction: When the government is running a deficit, it is spending more than its receipts. Of late, deficit financing has emerged as an important instrument for financing the government expenditure. Deficit financing means bridging the gap caused by the excess of government expenditure over its receipts through the creation of new currency. In this case, public expenditure consists of the disbursement on revenue and capital accounts, while government receipts include the revenue on current and capital accounts. However, the term deficit finance has been differently used in advanced countries and in the developing countries like India. In Western countries deficit financing is referred to excess of expenditure over revenue financed by public loans and the creation of new money. Thus, any expenditure of the government over and above its current income is known as deficit financing. However, the term deficit financing is interpreted in a different manner in the context of India.

4.2 Effects of Deficit Financing: Deficit financing could be a helpful device and a valuable instrument in promoting economic development in an under-developed country in the initial stages. The increase in the volume of money results in higher demand for labor and other resources. As such, deficit financing is regarded as a good tool to active a backward and developing economy. But, extreme caution is necessary in using deficit financing for economic development. For, it is intrinsically inflationary in character, and hence, proper controls are necessary. Besides, experiences of other countries clearly shows that deficit financing may lead to excessive printing of currency notes which will greatly reduce the value of money. Deficit financing, like fire, is a good servant but a bad master.

4.2.1 Effects of Deficit financing on price level: Deficit financing is invariably associated with an inflationary rise in prices. The reason is not far to seek. Deficit financing, through creation of new money, results in an increase in the aggregate monetary demand for the existing supply of goods and services in the community. While aggregate monetary demand increases consequent upon deficit financing, the supply of goods and services in the community does not increase in the same proportion. This produces the inevitable inflationary gap in the economy, causing the prices to rise to higher levels. This happens particularly at a time of war, when the money supply n the economy rises at an extraordinary fast rate while the available supply of goods and services for civilian consumption actually registers a fall, causing severe scarcity conditions in the economy. The rise in the price-level in war-time economy may be in a proportion greater than that warranted by the increase in the supply of the newly-created money by the Central Bank, the reason being that this newly-created money will, in course of time, form the basis of additional credit creation by the commercial banks. Deficit financing, during war, therefore, inevitably results in an inflationary spiral which worsens with the passage of time.

As against this, deficit financing in a developing economy may not always be associated with an inflationary rise in prices. Developmental deficit financing no doubt, increases the money supply in the economy, but it also increases at the same time the output of goods and services for civilian consumption. The excessive monetary demand for goods and services is neutralized by the expanding output of goods and services in the economy with the result that there is no inflationary rise in the price-level. Deficit financing in a peacetime developing economy may not, therefore, be considered as unsafe and dangerous as in a wartime economy. It is this realization which has led several developing countries in the post-war period to resort to deficit financing as an instrument of economic growth. Following arguments are generally adduced to show that deficit-financing in a peace-time developing economy may not create inflationary pressures.

4.2.2 Effects of Deficit Financing on employment: Keynes advocated the use of the technique of deficit financing as a means to eliminate mass unemployment in a depressed economy. According to Keynes, the main cause of unemployment in a developed economy is the deficiency of effective demand. Since private investment becomes slack at a time of depression, the only way to step up effective demand was a substantial increase in public investment. The problem, however, was where to find the necessary financial resources to finance the public investment programme in the economy. Taxation would not be suitable because it would merely transfer the funds from the private sector (where they could be used for increasing production) to the state sector. Public borrowing too would have the same effect, Keynes, therefore, ruled out both taxation and public borrowings as a means to finance public investment in the economy. In his view, deficit financing or creation of new money was the most suitable method of financing public investments as an anti-unemployment device. The injection of new money in the context of unemployed resources would set the multiplier into motion. The ultimate increase in income and employment would be several times higher than the original investment undertaken through deficit financing on account of the operation of the multiplier in the economy. Deficit financing was, therefore, looked upon as an eminently suitable measure to cure involuntary unemployment in a developed capitalistic economy. Several countries, particularly the U.K. and the U.S.A., resorted to deficit financing during the Great Depression of 1930 to deal with the problem of mass unemployment.

The situation, however, is quite different in an underdeveloped economy. The technique of deficit has, at best, only a limited role as an anti-unemployment device in such an economy for several reasons. Firstly, the nature of unemployment in an underdeveloped economy is quite different from that in a developed economy. Unemployment in a developed economy is mostly cyclical in nature, whereas it is long-term chronic unemployment in an underdeveloped economy may not be due to deficiency of effective demand (as in developed countries), but due to the deficiency of capital resources. Secondly, the problem becomes more complicated due o the existence in underdeveloped countries of still another type of unemployment known as disguised unemployment. This type of disguised unemployment is caused by the chronic shortage of capital resources in relation to the rapidly increasing population. The existence of disguised unemployment (in place of involuntary unemployment) in India hinders the working of the principle of multiplier, because the secondary, tertiary and other effects of initial investment do not follow mainly for the reason that there is no surplus labour force willing to accept employment at the current wages. Thirdly, the technique of deficit financing helps to increase the volume of employment in a developed economy through the operation of the multiplier principle. But the multiplier principle, as enunciated by Keynes, does not operate in an underdeveloped economy. If an attempt is made to liquidate unemployment in an underdeveloped economy through the application of the technique of deficit financing, then, far from eliminating unemployment, it may plunge that country into an inflationary spiral on account of the inelasticity of the supply curve of output.

4.2.3 Effects of Deficit Financing capital formation: Deficit financing may be said to be generally conducive to capital formation in an economy. And capital formation, it should be remembered, is the key-determinant of economic growth in an underdeveloped economy. Capital formation includes not only saving, but also an act of investment. Capital formation is supposed to take place when the savings of the community are diverted to the making of capital goods, such as, tools, implements, machines, etc., which, in turn, help in the economic development of the country concerned. By leading to an inflationary rise in prices, deficit financing helps in the process of capital formation in the economy. Since under inflationary conditions, wages always lag behind prices, the entrepreneurial and business classes are gainers while the workers, fixed-salaries middle calss employees and industrial labourers are the losers. A larger portion of the national income accrues to the entrepreneurial and business classes who have a high propensity to save (or, a low propensity to consume). A major portion of the newly-acquired incomes goes into savings which are utilized for capital formation by these class s. Inflation, it should be remembered, always widens economic inequalities in a country. Greater the economic inequalities, greater will be the scope for capital formation. A prolonged period of inflation is always accompanied with an increase in the rate of capital formation.

Further, the inflationary trend generated by deficit financing also gives rise to ‘forced savings’, which are a fruitful source of capital formation in an economy. The inflationary rise in prices consequent upon deficit financing leads to a fall in the demand for consumer goods on the part of the people. Some of the productive resources which were formerly being employed in the consumer goods industries are now released for being utilized in capital goods industries. This amounts to ‘forced savings’ of real resources for being diverted to the capital goods sector which directly helps the process of capital formation in the economy. There is, therefore, no doubt, that deficit financing directly and actively promotes capital formation in a country.

4.2.4 Effects of Deficit Financing on income distribution: Deficit financing may not be conducive to an egalitarian income distribution in society. It not only produces, but also accentuates economic inequalities in a community. Deficit financing invariably creates an inflationary rise in prices, particularly in a wartime economy. The inflationary rise in prices benefits certain sections, such as, businessmen, traders, merchants, industrialists, profiteers and speculators while it adversely affects certain other sections, such as, industrial labourers, farm workers, fixed income and salaried people. The rich become richer, while the poor get further pauperized on account of the loss of purchasing power. Economic inequalities are further accentuated. Deficit financing, as such, results in redistribution of income and wealth in favour of the already affluent sections of the community. Socially, deficit financing is highly unjust and inequitable in content. It not only rules out the attainment of the socialist objective, but also baulks any attempt to improve the living standards of the masses and their general welfare.

4.2.5 Deficit financing and impact on Inflation: Every deficit financing has some inflationary implications. There is bound to be some initial in the economy consequent upon deficit financing by the Government. If this inflation is not controlled within time, it may soon degenerate into that horrible type of inflation which is known as “galloping inflation” in the economists' jargon. It is therefore, imperative to apply the brake well in time if the economy is to be spared the terrible consequences of hyper-inflation. What is necessary is an all-round frontal attack on inflationary forces generated by deficit financing. Of course, prevention is always better than cure. The Government may not allow an inflationary situation to develop in the economy by keeping deficit financing within reasonable limits. But sometimes deficit financing gets out of control (say, at a time of war), and an ugly situation develops in the economy with all the potential of "runaway inflation" as it did develop in Germany in 1919 and in China in 1948. Shall the Government then sit quiet and watch the situation getting from bad to worse? No. The Government, as said above, should launch a frontal attack on the monster of inflation. The government should come forward, at such a time, with a whole package of measures to hold the inflationary demand in check. This package should comprise a wide variety of measurers, such as, monetary, fiscal, physical and others to cope with the inflationary forces in the economy. What is necessary is that this package of measures should be implemented simultaneously to produce effective results on the inflationary front. As regards monetary measures, the Government should put a brake on further expansion of money supply in the economy. Further expansion of credit should be discouraged by putting up the bank rate, by open market sale of securities by the Central Bank, by raising the cash reserve ratio to be maintained by commercial banks, by raising the margin requirement of secured loans, by increasing the quantum of reserves to be maintained by commercial banks with the Central Bank, and by resorting to rationing of credit. All these measures would have the effect of reducing the money supply in the economy and help contain the dreaded inflationary forces.

As said above, the monetary measures would have to be supplemented by appropriate fiscal measures to reduce the inflationary impact of deficit financing. The fiscal measures to be applied include increase in taxation (both direct and indirect), public borrowings and increase in small savings by the public. Even compulsory savings may be called for in a serious inflationary situation. The effect of these fiscal measures would be to cut down the purchasing power in the hands of the public and thus lessen the inflationary pressure on limited supplies of essential to step up the production of goods and services in the agricultural and industrial sectors of the economy. Increased production would go a long way to neutralize the expanded money supply in the economy. It would also be necessary in an inflationary situation to resort to direct controls, such as, price control and rationing to keep the rising prices in check. For a detailed treatment of the various measures to be adopted to curb inflationary forces generated by deficit financing, the reader is referred to the section, “Anti-Inflation Policy” to be found in the chapter in the chapter entitled “Inflation, Deflation, Reflation”.

4.3 Role of Deficit financing in the economic development of Developing countries: Deficit financing is an extraordinary technique of development finance and occupies today an important place in the financing of economic development in an underdeveloped country. If used skillfully with proper safeguards, it can prove to be a positive means for promoting the economic development of an underdeveloped economy. There is a definite place for the technique of deficit financing in promoting the economic growth of underdeveloped countries.

i) An underdeveloped country happens to have large unutilized or underutilized physical and manpower resources which would remain inactive or dormant unless they are mobilized with the help of created money through deficit financing. As long as there are unutilized or underutilized resources, no amount of created money would have any inflationary impact on the economy.

ii) The national income in a developing economy is constantly increasing on account of planned economic development. The expansion of money supply will not only not lead to inflationary consequences but may even be necessary to prevent a decline in prices.

iii) An underdeveloped economy generally starts with a large non-monetized sector in the rural areas and as the economy develops, the non-monetized sector shrinks in size. The shrinkage of the non-monetized sector necessitates, in course of time, a gradually increasing demand for money.

iv) As the living stands rise, there is greater demand for money on account of the increased liquidity preference of the people who would like to have increased cash balances at their disposal.

As against this, much could be said for the other side of the picture.

i) It is pointed out that although unemployed idle manpower is there is an underdeveloped country, yet there is the scarcity of complementary capital resources on account of which the aggregate output shall not increase appreciably. To this, it may be said that much could be done to increase aggregate output through labour-intensive techniques, if there is, as it is, a shortage of capital resources.

ii) It is pointed out that deficit financing may lead to an inflationary rise of prices. If that happens, it may even check the process of economic growth. The inflationary rise of prices may even distort the pattern of State investment. Further, rising profits may even divert the resources to non-essential speculative channels. What is more, the burden of development under inflationary conditions shall fall more heavily on lower-income groups. It is, undoubtedly, true that all these economic monstrosities will occur if deficit financing leads to an advanced state of inflation in the absence of proper regulatory checks. Deficit financing itself is not dangerous, if kept within proper checks. The authorities have, therefore, to be very cautious in the matter of deficit financing. Two things should always be borne in mind by the authorities concerned:

a) Deficit financing should be resorted to only sparingly and, at best, in limited quantities with due regard to the absorption capacity of the economy.
b) The authorities should take special steps to keep the prices of essential goods in check through price-control and rationing if found necessary at any stage.
c) A well-devised and well-executed taxation policy can also effectively control inflationary forces in the economy. It can be used to reduce pressure of demand as well as to increase supply of essential goods
d) The authorities should utilize the amount secured through deficit financing, as far as possible, for quick-yielding productive schemes so that the time-interval between original investment and ultimate production is not unnecessarily long. This could ensure early increase in output which would neutralize the increased purchasing power in the economy, keeping the prices at stable levels.

Despite all these safeguards, some inflation is bound to arise in an underdeveloped economy. But this inflation would, at best, be only mild inflation. Such an inflation may not actually be harmful for the economy. It may, on the contrary, serve as a tonic for the underdeveloped economy. By providing price stimuli, it will quickly add to the volume of production, both agricultural as well as industrial. What is more, this mild inflation will induce greater capital formation for economic growth, being stimulated by rising profits.

4.4 Limits of deficit financing: Of the three methods of financing public expenditure, deficit financing is the most empting for the government of a country. Taxation provokes public agitations borrowing increases the burden of interest-charges on the government. But deficit financing provokes neither agitation nor does it put additional burden on the government of the country. For the government, deficit financing is perhaps the smoothest and the most convenient method of financing public expenditure. The Government have simply to put the printing press into motion to print additional currency to finance its soaring expenditure. There is, therefore, an irresistible temptation on the part of the government to resort to deficit financing as a method of financing increased public expenditure. The government has, however, to be extra-cautious when it resorts to deflect financing. A slight indiscretion or carelessness units part may land the country into an inflationary spiral which may do irreparable damage to the economy. Administered in controlled doses, deficit financing may function as nectar (tonic) for the economy. But when injected in uncontrolled doses spread over a long period of time, deficit financing may well turn out to be a poison for the economy of the country. It is bound to give birth to the worst type of inflation (runaway or galloping inflation) which may distort or even ruin the smooth functioning of the economy. The government has, therefore, to be extra-alert when it decides to make use of deficit financing as a method of finance.

i) The government should bear in mind the rate at which the real national income is growing while determining the quantum of deficit financing. If the real national income is growing at fast rate, it will do no harm to the country's economy if the Government administers a big dose of deficit financing for developmental purposes.

ii) The quantum of deficit financing is also determined by taking into account the nature of the project or projects upon which the amount is proposed to be spent by the government of the country. If the amount of deficit-financing is to be spent on quick-yielding projects (or, projects which cause an increase in production during the short period), no harm may come to the economy of the country.

iii) Deficit financing again may do no harm if there is considerable unutilized capacity or under-utilized capacity in the agricultural and industrial sectors of the economy.

iv) Deficit financing resorted to by a Government to finance a destructive was or some unproductive scheme or some project with a long gestation period is bound to be inflationary in content.

v) The quantum of deficit financing is also limited by the nature of the balance of payments of the country concerned-whether the balance of payments is favorable or unfavorable.s

vi) The quantum of deficit financing may also be decided by a government by bearing in mind the limitations of its own administrative capacity. Every deficit financing causes some inflationary pressures in the economy.

It is well-known that governments in underdeveloped countries have a poor administrative set-up which is neither adequate nor competent nor incorrupt to counteract the inflationary forces in the economy. Such Government has, therefore, to be extra cautions in deciding upon the quantum of deficit financing in any context.

4.5 Summary: Deficit financing can turn out to be a dependable means of financing economic growth in an under developed economy. In recent years, most of the developing nations including India have employed the technique of deficit financing to a greater or lesser extent, as a means of financing economic development.

4.6 Technical terms:

a) Deficit finance

b) price-level

c) Economic growth

d) Income distribution

e) Capital formation

f) Inflation

g) Depression

4.7 Self Assessment Questions:

1. What are the effects of Deficit financing on price level and employment?

2. Discuss the role of deficit financing in promoting the economic development of a country?

3. Explain the limits of Deficit financing?

4 explain the effects of Deficit financing on capital formation?

4.8 Reference Books:

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LESSON – 5

SOURCES OF REVENUE OF THE CENTRAL GOVERNMENT

5.0 Objectives:

In this guideline we shall learn the following topics:

After completing this lesson you are able to understand the following.

- What are the various sources of central revenue
- What do you mean by direct taxes and its share
- What do you mean by indirect taxes and its share
- What are the various measures taken by Govt. for improving tax revenue sources.
- What are the various sources of non-tax revenue to the central government.

STRUCTURE:

5.1 INTRODUCTION :

India became independent on 15th August 1947. A new constitution was framed under the chairmanship of Dr. B.R. Ambedkar which came into existence with effect from 26th January 1950. The Constitution of India provides for the division of powers to raise revenue between the centre and the states. Similarly, the matter of public expenditure has been dealt with the same manner constitutionally. All the incomes of the central government have to be deposited in the consolidated fund of India and nothing can be spent out of it without prior sanction of the Parliament. The sum to be spent is kept in the public account in which some of the receipts are also deposited. The centre as well as the states have the authority of setting up a contingency fund to meet the contingent demands on revenue.

5.2 SOURCES OF REVENUE :

The sources of revenue of the central government may be divided under two broad heads i.e.,

1) Tax Revenue and

2) Non-Tax revenue

5.3 TAX REVENUE :

The central levies different types of taxes, such as, income tax, corporate tax, capital gains tax, excise duties, customs duties, service tax etc., During the period from 1950 – 51 to 2013-14(B.E.) tax revenue of the Government of India including resources of public sector undertakings has increased by leaps and bounds. The following table shows that it has increased from Rs.357 crores to Rs.2032489 crores (B.E.).

Current Tax Revenue for the Governments (in crores)	
Year	**Tax Revenue**
1980 – 81	19844
1990 – 91	87723
2000 – 01	305320
2010 – 11	1271665
2011 – 12	1467890
2012 – 13 (BE)	1751124
2012 – 13 (RE)	1726549
2013 – 14 (BE)	2032489

Source : Economic survey – 2014 – 15.

The over tax receipts for the central government including state's share will be Rs.2032489 crores according to the 2013-14 budget estimates as compared to Rs.1726549 crores according to the revised budget estimates for 2012-13.

This revenue is mainly collected through a taxes on income and expenditure. (b) taxes on property and capital transactions. (c) taxes on commodity and services and (d) Taxes of union territories without legislature.

5.3.1 Taxes on Income and Expenditure : The taxes on income and expenditure are a major source of government revenue which comprise of (i) personal income tax and (ii) corporation income tax. Let us now discuss these two components in detail.

5.3.1.1 Income Tax : The income tax was first introduced in India in 1860. During the last 100 years there had been numberless changes and amendments in the income tax structure and accordingly a number of Acts replaced the Act of 1860. The first replacement took place in 1886. The Act of 1886 was replaced in 1916 in which a graduated income tax and the various categories of incomes were subjected to different rates. This Act was replaced in 1918 which again was replaced in 1922. The Act of 1922 spelt out the mechanism of administering the taxes. It also laid down that the rates of tax would be determined in the Annual Finance Acts. These provisions introduced an element of flexibility in the income tax system and made it more elastic. The Act of 1922 was replaced by the Act of 1961 which is in operation even today.

Income tax, today is very important source of revenue both for the Central Government as well as for the State Governments. According to the Act the tax-payers are broadly divided into following categories as follows: (i) Individuals; and Hindu Undivided Families or Joint Hindu Families; (ii) Companies: public or private; (iii) Local Authorities; (iv) Firms of Partnerships; and (v) Association of Persons.

Accordingly the incomes have also been classified under six categories as under: (a) salaries; (b) interests on securities; (c) income from property; (d) profits and gains of business, profession or vocation; (e) income from other sources like dividends; and (f) capital gains. The tax is imposed on the net income and not on the gross income. This categorisation of income has been done mainly to facilitate the applicability of the prescribed rules for computing taxable income of each category of taxpayers. Taxable income from all sources is to be computed on a single return (form) and only one assessment is made of income from all sources for each unit of taxpayer under all categories. But, the income from capital gains is shown separately and is also taxed at a different but uniform rate.

The Personal Income Tax in our country is imposed on the total income of an individual, Hindu undivided family, unregistered family, association of persons etc. for the whole year. It is limited to non-agricultural incomes only. However, agricultural income is integrated with the non-agricultural income for assessing the tax liability on non-agricultural income, in pursuance of the recommendations of the Committee of Taxation on Agricultural Income and Wealth. Currently the tax base consists of net income or net profits, which remains with the individual or the firm after paying business expenses, depreciation charges and meeting business losses. Thus after deducting all these from the gross income, the net income is arrived at. Besides, other statutory deductions are also made before finally arriving at the taxable income. These deductions may include incentives or development rebate, deduction from profits allowed to certain priority industries etc.

Similarly in the case of an individual, various types of deductions and exemptions are allowed in computing the taxable income. These exemptions and deductions are decided by the Parliament. The chief objective of these concessions is to bring the tax structure in conformity with the principle of ability to pay. During recent years deduction has also been allowed in respect of the expenditure incurred on medical treatment of physically/ permanently handicapped dependent.

The minimum limit of exemption of income tax has been revised from time to time. Similarly, the income tax rates have also been revised from time to time and this revision has been towards the lowering of the rates. In Budget 2015-16, Government of India continued most of the slabs and very few changes were made. It is now is follows :

Income Tax slabs according to 2015 – 16, central budget are broadly classified into two major categories, viz., (A) Slabs for individuals and Hindu undivided families and (B) Slabs for Business.

(A) Slabs for Individuals, HUF and women

Tax Slabs (Rs.)	Tax rates
0 – 2,50,000	No Tax
2,50,001 to 5,00,000	10%
5,00,001 to 10,00,000	20%
10,00,001 and above	30%

Senior Citizens (Aged between 60 – 80 years)

Tax Slabs (Rs.)	Tax rates
0 – 3,00,000	No Tax
3,00,001 to 5,00,000	10%
5,00,001 to 10,00,000	20%
10,00,001 and above	30%

Very Senior citizens (Aged above 80 years)

Tax Slabs (Rs.)	Tax rates
0 – 5,00,000	No Tax
5,00,001 to 10,00,000	20%
10,00,001 and above	30%

(B) Slabs for Business

Income Tax slabs for Business are as follows.

For cooperative societies, where total income does not exceed Rs.10,000 tax rate will be 10 per cent when it is 10000 to 20000 tax will be 20 per cent and it is 20,000 and above tax is 30 per cent.

For firms, local authority and domestic companies : Income tax slab rates won't apply in this case and tax @ 30% flat shall be completed on the total income. Surcharge shall not be levied on incomes of firms and local authorities but shall be levied on the total income tax of domestic companies @ 5% provided that the total income tax of domestic company exceeds Rs. 1 crore.

However, there are no major changes in Income tax slabs in Budget 2015-16, but provided relief in other areas including an increase in deductions on health cover premiums from Rs.15,000 to Rs.25,000. Deduction for pension contribution increased to Rs.1.5 lakh from earlier 1 lakh. Transport allowance also increased to Rs.1600/-

Education cess @ 2% and SHEC @ 1% shall be levied on income tax so computed.

5.3.1.2 Corporation Income Tax : The corporation income tax is a tax on the net income of the companies. This tax has been in vogue for a long time. In most of the countries it is on the net income of corporations. It is paid out of a taxable profit (net profit) after meeting all costs i.e., interest charges, wages, salaries, depreciation costs etc., during a particular year by a company and the balance is distributed in such proportion as decided by corporations. The tax base for corporation tax is company's profit minus the deductions allowed under the Act and also the tax concessions and incentives provided under the Act. In budget 2015 – 16, it is proposed to reduce 5 percent in corporation tax over the next 5 years. This will reduce the tax from 30 percent to 25 percent.

In the beginning, the yield of corporation income tax was quite small as compared to that of personal income tax. However, during this period the corporation income tax has outpaced the personal income tax. The personal income tax and corporation income tax put together increased from Rs.2817 (in 1980 – 81 to Rs.66,0442 crore, by the year 2013-14 (BE).

5.3.1.3 Interest Tax : Another form of tax on income and expenditure, which the Government of India started imposing, is interest tax under the Interest Tax Act, 1974. This Act provided for the imposition of a special tax on the gross amount of interest accruing to the commercial banks on loans and advances paid by them in the country. This tax was withdrawn in 1985. It was reintroduced later as an anti-inflationary measure. This tax is levied on the gross interest income of credit institutions viz., banks, financial institutions and companies. But its share is very marginal.

5.3.1.4 Expenditure Tax : An expenditure tax on personal consumption was imposed for the first time in 1958 in accordance with the recommendations of Professor Kaldor. Professor Kaldor had suggested the imposition of this tax to prevent the possibility of tax evasion and to discourage superfluous consumption. Since the yield of this tax was quite small and administratively it was expensive, it was abolished in 1962. It was again introduced in 1964 and again abolished in 1966. Again from November 1987, the Government of India introduced it under the Expenditure Tax Act, 1987. The Act provides for a tax on expenditure incurred in hotels where the room charges for any unit of residential accommodation were Rs. 400 or more per day per individual. The rate of expenditure tax was later revised from 10 to 20 per cent and the tax was extended to expenditure incurred in restaurants providing superior facilities of air-conditioning etc. In the budget proposals for 1997-98, it was proposed that expenditure tax will not be charged for a period of 10 assessment years commencing from April 1, 1998 on any expenditure incurred in a new hotel in hilly area, rural area or a place of pilgrimage or such other places that the Central Government may specify in accordance with the provision of the Act. According to the proposal the concessions will be available to eligible hotels established during the period from April 1, 1998 to March 31, 2002. However, hotels located in metropolitan cities like Kolkata, Chennai, Delhi and Mumbai are not eligible for these expemptions.

5.1.3.5 Fringe Benefit Tax (FBT) : This tax was levied for the first time by the Central Government in 2005-06. Fringe benefit is defined as any privilege, service, or amenity, directly or indirectly provided by an employer whether by way of reimbursement or otherwise to his employees. The FBT does not cover: (a) the government sector, (b) Charitable institutions, trusts and funds, already enjoying tax exemption, (c) individuals and HUF, engaged in business or profession, and (d) expenses on statutory obligations work hazards minimisation and first aid cover in company owned medical facilities. The FBT covers benefits like free or concessional ticket given by the employer for private travel of the employees and their family members, employer's contribution to an approved superannuation fund. The tax is charged at a uniform rate of 30% on a certain percentage (as listed in the budget) of the expense on an item considered as a fringe benefit.

The FBT has not been received well. It has been criticized on a number of grounds: (i) it is discriminatory as it has left out the government sector; (ii) most of the expenses, considered as fringe benefits, are legitimate business expenses and have to be incurred as an essential part of the corporate culture enforced by the global free market economy, and therefore are in no way to provide benefit to the employees, (iii) some expenses are clearly for sales promotion which if determined as fringe benefits may give rise to litigation.

5.3.2 Taxes on Property and Capital Transactions : The government of India has imposed from time to time certain taxes on property and capital transactions. The important taxes in this group are : (i) Estate Duty; (ii) Wealth Tax; (iii) Gift Tax; and (iv) Capital Gains Tax. Let us explain these taxes in turn :

5.3.2.1 Estate Duty : The estate duty came into force with effect from October 15, 1953. Formerly, estate duty was imposed on the estate of a person, as inherited by his or her heirs. The term 'estate' includes cash, bullion, jewellery, household assets, securities, business assets, debts due, house property, agricultural land, cars etc.

The rate of estate duty ranged between 4 to 40 per cent of the value of estate left behind. The tax was, thus, highly progressive and the burden of large properties was very heavy. It was meant to reduce the evasion of tax through inheritance. Unfortunately, the amount of revenue collected was very low considering the cost of its administration, indicating that there was widespread tax evasion. Consequently, the estate duty was abolished from the middle of March, 1985.

5.3.2.2 Wealth Tax : Wealth tax is imposed on the total value of a person's property or accumulated wealth of an individual, Hindu Undivided Family and closely held companies. This tax was imposed on the recommendation of Professor Kaldor. It was first introduced in 1957. The tax was considered justified on the grounds of equity, economic effects and administrative efficiency. In addition, a tax on wealth also reduces inequalities in income and wealth. It is removed in April 2015. But extra 2% additional surcharge on income of 1 crore and above will be levied.

5.3.2.3 Gift Tax : The gift tax was imposed in our country for the first time in 1958. It covered the gifts made by individuals, Hindu Undivided Families, companies, firms and association of persons. Initially, it was levied on the donor and not on the donee. All gifts made by a donor during a particular year were liable for gift tax.

Gift tax has a number of advantages. Firstly, it checks the avoidance of estate duty and evasion of income tax on unaccounted money. It helps in reducing the inequalities of income and wealth and brings revenue to the government. But it is a very small tax and its contribution to the tax revenue of the Government of India was not substantial. It has been discontinued since October 1, 1998. It was partially reintroduced in April 2005. Gifts received from any person or persons, if the aggregate value exceeds Rs.50,000 has been made taxable under the head "Income from other sources". With effect from 01.10.2009 even movable and immovable property given as gift will attract tax if its value exceeds Rs.50,000/.

5.3.2.4 Capital Gains Tax : Capital gains implies a financial gain arising from the sale of a capital asset. The gain arises because of the increase in the value of property or the asset. The tax is imposed on the net gains and not on the gross gains. The sale of an asset may result in two types of gains. If the gain arises out of the sale of mercantile goods as a regular business activity, then it is a business income like other incomes. If the gain arises from the sale of houses, lands, bonds and other types of assets by a person whose regular business is not to deal or trade in these types of assets, then it is a capital gain and is liable to capital gains tax. In short, capital gain is an irregular gain accruing outside a person's normal business. Profits from the 'stock in trade' held primarily in sale to customers in the normal course of business by a persona re not called capital gains. The budget 2015-16 proposed to levy 20% tax on long term capital gains and on short term gains it will be as pernormal income tax.

Securities Transactions Tax (STT)

This tax was introduced in 2004 – 05. The current tax structure is as given below :

Transaction	Purchase / Sale of equities, units of equity oriented Mutual Fund (Delivery based)	Sale of equities units of equity oriented Mutuval Fund (non-delivery based)	Sale of derivatives	Sale of units of an equity oriented Fund to the Mutual Fund
Rates paid by	0.125% Purchaser / Seller	0.025% Seller	0.17% Seller	0.25% Seller

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

5.3.2.5 Banking Cash Transaction Tax : This tax was imposed for the first time in 2005-06 on withdrawals of cash from a current account in a bank in excess of a specified amount on any single day. The objective is to track the black money transactions.

5.3.3 Taxes on Commodities and Services : Taxes on commodities and services are called indirect taxes. From the welfare point of view, these taxes are considered undesirable because they raise prices and change the expenditure pattern of the tax payers. Such taxes are also considered useful because they influence the pattern of resource allocation by introducing changes in the relative prices of different commodities and services. Further, any increase in commodity taxation, because of the reduction in consumption owing to the enhanced price, encourages savings. Tax on commodities, further, puts a check on the consumption of items of non- essential nature.

5.3.3.1 Customs Duties in India : Under the Indian Constitution duties on customs, as import and export duties, are levied and collected by the Government of India and wholly owned by it. There is no provision for their distribution among the States. These duties act as a powerful instrument for protecting home industries and trade as well as serve as a popular source of revenue. It may be mentioned, however, that the yield of customs duties is not always certain. It depends very much on international situations and domestic economic changes. In times of war and depression the revenue from customs duties diminishes. It may also fluctuate from year to year because of a number of factors like the fluctuations in the availability of foreign exchange, changes in the export and import policies, changes in the overseas demand for the country's primary exports, availability of supply, changes in the shipping policy and changes in the world prices of main items of export and import.

The items which are imported and on which import duties are levied are quite large in number. Some of the important items are: (i) petroleum products; (ii) mineral, fuels, oil, wax and bituminous substances; (iii) inorganic chemicals; (iv) organic chemicals; (v) animal or vegetable fats and oils; (vi) photographic and cinematographic goods; (vii) plastic and articles thereof; (viii) rubber and articles thereof; (ix) wool and other animal hair; (x) pulp paperboard and articles thereof; (xi) nickel; (xii) machinery; (xiii) machine tools; (xiv) electrical machinery; (xv) railway locomotives and materials; (xvi) essential life saving drugs and raw material for such drugs; (xvii) motor vehicles; (xviii) project imports; (xix) baggage etc.

Export duties occupy an important place in the Indian fiscal system. They have been imposed on various commodities from time to time. During the early stages of the British rule, such duties were imposed at ad valorem rates on many articles of exports. After 1867, most of the export duties were withdrawn. In 1914, export duty was only levied on rice and in 1916 on jute. In 1919 a duty on the export of raw hides and skins was introduced which was abolished in 1955. During the Second World War ad valorem duty was imposed on cotton cloth and yarn. Since 1946 export duties have been imposed on a number of new articles.

Customs duties are, as already stated above, a major source of revenue to the Government of India. In 1950 – 51 these duties brought a revenue of only Rs.157.15 crore which increased to Rs.20,644 crore in 1991 and were expected to yield Rs.187308 crore in 2013-14.

5.3.3.2 Excise Duties : Union excise duties are also a major source of tax revenue of the Government of India. These duties are levied by the government on commodities which are produced within the country. But commodities on which State Governments impose excise duties like liquor and drugs, are exempted from the Central Excise duties. Initially sugar, cotton, mill cloth, tobacco, motor spirit, matches, cement etc. were the goods which yielded the maximum revenue by way of excise duties. In recent years excise duties have covered a large number of goods.

L.K. Jha Committee's recommendations

The L.K. Jha Committee stressed the need for rationalizing the structure of the excise duties. According to the Committee the structure should be rationalized in such a manner that progression is achieved more easily and our economic priorities are also fulfilled. The committee also recommended that the rationalization of the rates of duties on raw materials and such materials that are close substitutes will be treated similarly unless special economic reasons demand otherwise. High rates of duties on particular materials imposed for some special reasons in the past should be curtailed in the interest of lowering the cost of production. Finally, the committee recommended that a time-bound schedule of action towards the solution of the problem of cascading should be undertaken. In this connection the Committee suggested the application of existing procedures of taxation for the relief of input taxation and finally moving over to a system of value added taxation at the manufacturing stage. This was the beginning of the introduction of the Modified Value Added Tax (MOVAT) scheme with effect from 1st April, 1986. Under this scheme the manufacturers were allowed to obtain complete reimbursement of the excise duty paid on the inputs of final products.

In order to overcome from the problems of MODVAT, the budget 2000 – 01 introduced CENVAT. Under CENVAT a manufacture of final product or provider of taxable service shall be allowed to take credit of duty of excise as well as service tax paid on any input received in the factory or any input service received by manufacturers of final product. The revenue from this tax in 1980 – 81 contributed Rs.6500 crores, which increased to 24514 crores by 1990-91. From then onwards they increased sharply and reached to Rs. 68526 by 2000-01 and to Rs.137701 crores by 2010-11. In 2013 – 14 they are expected to be Rs.196805 crores.

5.3.3.3 Service Tax : Taxation of services was introduced in 1994 – 95 initially by levying the tax on stock brokers, general insurance and telephone services. In the budget for 2002 -03, it was extended to ten new services, viz., life insurance and related auxiliary services, inland cargo handling, storage and warehousing, light agricultural products and cold storage, event management, rail travel agents, health clubs and fitness centres, beauty parlours, fashion designers, cable operators and dry cleaning services. Subsequently, life insurance was exempted from the tax. Hotels were exempted upto March 31, 2003.

Over the years the area of coverage increased to as well as the rate of tax has gradually increased. The rate 14% (2015-16) from the current 12.3%. It will be levyed on all services except very few.

5.4 GOODS & SERVICE TAX (GST) :

The introduction of proposed GST would be a significant step in the field of indirect tax reforms in India. By subsuming a large number of central and state taxes into a single tax, it would mitigate cascading or double taxation in a major way and pave the way for a common national market. From the consumer's point of view, the biggest advantage would be in terms of a reduction in the overall tax burden on goods, which is currently estimated at 25 per cent- 30 per cent. Introduction of the GST is also expected to make Indian products competitive in domestic and international markets. Studies show that this would instantly spur economic growth. Because of its transparent character, it is expected that the GST would be easier to administer.

The broad features of the proposed GST model are as follows:

i. GST would be applicable on supply of goods or services as against the present concept of tax on the manufacture or on sale of goods or on provision of services.

ii. GST would be a destination-based tax as against the present concept of origin-based tax.

iii. It would be a dual GST with the centre and the states simultaneously levying it on a common base. The GST to be levied by the centre would be called Central GST (CGST) and that to be levied by the states would be called State GST (SGST).

iv. An integrated GST (IGST) would be levied on inter-state supply (including stock transfers) of goods or services. This would be collected by the centre so that the credit chain is not disrupted.

v. Import of goods or services would be treated as inter-state supplies and would be subject to IGST in addition to the applicable customs duties.

vi. A non-vatable additional tax, not exceeding 1 per cent on inter-state supply of goods would be levied by the centre and retained by the originating state at least for a period of two years.

vii. CGST, SGST, and IGST would be levied at rates to be recommended by the Goods and Services Tax Council (GSTC) which will be chaired by the Union Finance Minister and will have Finance Ministers of states as its members.

viii. GST would apply to all goods and services except alcohol for human consumption.

ix. GST on petroleum products would be applicable from a date to be recommended by the GST Council.

x. Tobacco and tobacco products would be subject to the GST. In addition, the centre could continue to levy' central excise duty'.

xi. A common threshold exemption would apply to both CGST and SGST. Tax payers with a turnover below it would be exempt from GST. A compounding option (i.e.to pay tax at a flat rate on turnover without credits) would be available to small tax payers below a certain threshold. However, a taxable person falling within the limit of threshold or compounding could opt to pay tax at the normal rate in order to be part of the input tax credit chain.

xii. The list of exempted goods and services would be kept to a minimum and it would be harmonized for the centre and states as far as possible.

xiii. Exports would be zero-rated.

xiv. Credit of CGST paid on inputs may be used only for paying CGST on the output and the credit of SGST paid on inputs may be used only for paying SGST. In other words, the two streams of input tax credit (ITC) cannot be cross utilized, except in specified circumstances of inter-state supplies, for payment of IGST.

Over the past four decades, the value added tax (VAT) has been an important instrument of indirect taxation, with 130 countries having adopted it, resulting in one-fifth of the world's tax revenue. Tax reform in many of the developing countries has focused on moving to VAT. Federal countries like Canada, New Zealand, and Australia have successfully adopted the GST into their structure. Implementation of a comprehensive GST in India is expected, ceteris paribus, to lead to efficient allocation of factors of production thus bringing about gains in GDP and exports. This would translate into enhanced economic welfare and higher returns to the factors of production, viz. land, labour, and capital. However, in the near term, as GST replaces a number of state-level and central taxes, revenue gains may not be significant.

5.5 MEASURES INTRODUCED IN BUDGET 2014 – 15 :

5.5.1 Direct Taxes :

- Budget 2014-15 raised the basic exemption limit of personal income tax in case of every individual (below the age of 60 years), or Hindu Undivided Family (HUF) or association of persons or body of individuals, whether incorporated or not, or every artificial juridical person from Rs.2 lakh to Rs.2.5 lakh. The basic exemption limit in the case of an individual resident in India, who is of the age of 60 years or more but less than 80 years was raised from Rs.2.5 lakh to Rs.3 lakh.

- Investment allowance at the rate of 15 per cent of the cost of new plant and machinery extended up to 31.03.2017 and threshold of investment reduced to Rs.25 crore.

- Ten-year tax holiday extended to undertakings which begin generation, distribution, and transmission of power by 31.03.2017.

- Income to foreign portfolio investors arising from transactions in securities to be treated as capital gains.
- Concessional tax rate of 15 per cent on foreign dividends without any sunset date to be continued.
- The eligible date of borrowing in foreign currency extended from 30.06.2015 to 30.06.2017 for a concessional tax rate of 5 per cent on interest payments. Tax incentive extended to all types of long-term bonds instead of only long-term infrastructure bonds.
- Introduction of a 'roll back' provision in the Advanced Pricing Agreement (APA) scheme so that an APA entered into for future transactions is also applicable to international transactions undertaken in the previous four years in specified circumstances.
- Introduction of range concept for determination of arm's length price in transfer pricing regulations.
- Use of multiple-year data allowed for comparability analysis under transfer pricing regulations.
- Resident taxpayers enabled to obtain an advance ruling in respect of their income tax liability above a defined threshold.
- The scope of the Income-tax Settlement Commission enlarged.

5.5.2 Indirect Taxes :

- Budget 2014-15 raised the basic exemption limit of personal income tax in case of every individual (below the age of 60 years), or Hindu undivided family (HUF) or association of persons or body of individuals, whether incorporated or not, or every artificial juridical person from Rs.2 lakh to Rs.2.5 lakh. The basic exemption limit in the case of an individual resident in India, who is of the age of 60 years or more but less than 80 years was raised from Rs.2.5 lakh to Rs.3 lakh.
- Investment allowance at the rate of 15 per cent of the cost of new plant and machinery extended up to 31.03.2017 and threshold of investment reduced to Rs.25 crore.
- Ten-year tax holiday extended to undertakings which begin generation, distribution, and transmission of power by 31.03.2017.

- Income to foreign portfolio investors arising from transactions in securities to be treated as capital gains.
- Concessional tax rate of 15 per cent on foreign dividends without any sunset date to be continued.
- The eligible date of borrowing in foreign currency extended from 30.06.2015 to 30.06.2017 for a concessional tax rate of 5 per cent on interest payments. Tax incentive extended to all types of long-term bonds instead of only long-term infrastructure bonds.
- Introduction of a 'roll back' provision in the Advanced Pricing Agreement (APA) scheme so that an APA entered into for future transactions is also applicable to international transactions undertaken in the previous four years in specified circumstances.
- Introduction of range concept for determination of arm's length price in transfer pricing regulations.
- Use of multiple-year data allowed for comparability analysis under transfer pricing regulations.

- Resident taxpayers enabled to obtain an advance ruling in respect of their income tax liability above a defined threshold.

- The scope of the Income-tax Settlement Commission enlarged.

A. CUSTOMS

Agriculture/agro processing/plantation sector: Full exemption from customs duty granted to de-oiled soya extract, groundnut oil cake/oil cake meal, etc. up to 31.12.2014.

Basic customs duty (BCD) reduced in the chemicals and petrochemicals sector.

Energy sector: The duty structure on non-agglomerated coal of various types rationalized at 2.5% BCD and 2% countervailing duties (CVD).

Textiles and Exports: The duty free entitlement for import of trimmings and embellishments used by the readymade textile garment sector for manufacture of garments for export increased from 3% to 5%.

Metals: The BCD on certain stainless steel flat products increased from 5% to 7.5%. Export duty on bauxite increased from 10% to 20%.

Precious Metals: BCD on half-cut or broken diamonds increased from NIL to 2.5% and on cut and polished diamonds and coloured gemstones increased from 2% to 2.5%.

Electronics/Hardware: BCD on LCD and LED TV panels of below 19 inches and on colour picture tubes for manufacture of cathode ray TVs reduced from 10% to NIL. Education cess and Secondary and Higher Education (SHE) cess levied on imported electronic products.

Renewable Energy: BCD reduced for equipment used in wind-operated electricity generators and. solar energy production projects.

Health: Full exemption from customs and excise duty provided for HIV/AIDS drugs and diagnostic kits imported under the National AIDS Control Programme funded by the Global Fund to Fight AIDS, TB and Malaria.

(B) EXCISE

Agriculture/agro processing/plantation sector: Excise duty on machinery for the preparation of meat, poultry etc. reduced from 10% to 6%.

Metals: Excise duty on winding wires of copper increased from 10% to 12%.

Textiles: Excise duty at the rate of 2% (without central value added tax—CEN VAT) or 6% (with CEN VAT) imposed on polyester staple fibre and polyester filament yarn manufactured from plastic waste or scrap or plastic waste.

Health: Excise duty on cigarettes increased by 72% for cigarettes of length not exceeding 65 mm and by 11% to 21% for cigarettes of other lengths. Similar increases made on cigars, cheroots, and cigarillos. Basic excise duty s increased from 12% to 16% on pan masala, from 50% to 55% on unmanufactured tobacco, and from 60% to 70% on jarda-scented tobacco, gutkha, and chewing tobacco.

Full exemption from excise duty provided to DDT manufactured by Hindustan Insecticides Limited for supply to the National Vector Borne Diseases Control Programme (NVBDCP) of the Ministry of Health and Family Welfare.

Electronics/hardware: Excise duty on recorded smart cards increased from 2% without CEN VAT and 6% with CENVAT to a uniform rate of 12%.

Renewable energy: Full exemption from excise duty provided for machinery required for setting up of solar energy' production projects and compressed biogas plant (Bio-CNG).

Energy sector: Central excise duty on branded petrol reduced from Rs.7.50 per litre to Rs.2.35 per litre, so as to reduce the price differential between branded and unbranded petrol. Rate of clean energy cess levied on coal, lignite, and peat increased from Rs.50 per tonne to Rs.100 per tonne.

C. SERVICE TAX

Negative list of services and service tax exemptions were reviewed for broadening the tax base and also as a preparation for introduction of the Goods and Services tax (GST). Services like online and mobile advertising and services provided by radio taxis or radio cabs have been brought under the tax net whereas for services like clinical research on human participants and services provided by air-conditioned contract carriages tax exemption has been withdrawn.

Measures Taken Post-Budget 2014-15

CUSTOMS: Basic Customs Duty on raw and refined / white sugar was increased from 15% to 25%.

EXCISE: The basic excise duty on petrol and diesel (both branded and unbranded) was increased as under:

- Unbranded petrol from Rs.1.20 per litre to Rs.4.95 per litre;
- Branded petrol from Rs.2.35 per litre to Rs.6.10 per litre;
- Unbranded diesel from Rs.1.46 per litre to Rs.3.96 per litre; and
- Branded diesel from Rs.3.75 per litre to Rs.6.25 per litre.

5.6 NON-TAX REVENUES :

The non-tax revenue plays an important role in the fiscal system of our country. It is also an important source of income of the central government. During the post-world war, Indian Government also decided to undertake the responsibility of running public utility like railways, posts and telegraphs and coinage and currency to start with along with most of the countries of the world. Gradually the government went on expanding its area of activity to various fiscal services, general services, social services, economic services and commercial and business services. These grouped under non-tax sources of revenue of the government of India. Non-tax revenue of central government including all is shown in the following table.

Year	Non-Tax Revenue (in crores)
1980 – 81	4719
1990 – 91	22884
2000 – 01	87964
2010 – 11	448577
2011 – 12	374587
2012 – 13 (B.E.)	483863
2012 – 13 (RE)	347468
2013 – 14(B.E.)	504844

Source : Economic Survey, 2013-14.

Non-Tax revenue, in recent times, mainly consists of interest and dividend receipts and the receipts from services provided by the central government. After remaining at around 1.4 percent of GDP in 2011- 12 and 2012 – 13, non-tax revenue was at 1.8 percent GDP in 2013 – 14 (PA) and budget 2014 – 15 sought maintain it around 1.7 percent of GDP. The non-tax revenues were estimated to contribute about 17.9 percent and 16.8 percent of revenue receipts and non-debt receipts of the central government respectively in BE 2014-15. The lower estimates of non-tax revenue growth in 2014-15(BE) over 2013-14(PA) were mainly on account of higher base in 2013-14 due to higher dividends and profits and interest receipts.

We now discuss the various non-tax sources of revenue of the Government of India.

5.6.(a) Fiscal Services :

Fiscal services include currency, coinage and mint, receipts from penalties realised from the Enforcement Directorate from various companies, firms and individuals for violation of Foreign Exchange Regulation Act and receipts from forfeiture of property. The revenue from currency and coinage includes:

The profits of the Reserve Bank of India from: (a) the Currency Note Press, Nasik, (b) Bank Note Press, Dewas, and (c) Security Paper Mill, Hoshangabad. These organisations earn profits through the printing of notes and rendering services to the government. We also include under this head profits from circulation of coins which is the difference between the face value of the coins and the manufacturing costs, mints and silver refinery whose profits relate mainly to refining and assaying charges levied by the mints and the receipts from the silver refinery mainly due to the sale of silver. Other fiscal services include penalties which are realised by the enforcement directorate as stated above, receipts from the forfeiture of property under the Smugglers and Foreign Exchange Manipulators Forfeiture of Property Act, 1976, shares of profits from the sale of gold by the International Monetary Fund and revenue from Indian Security Press, Nasik, and Security Printing Press, Hyderabad and other receipts.

5.6.a.(i) Interest Receipts : As recommended by the Ninth Finance Commission and accepted by the Government of India, the State Plan loans advanced to State Governments during the period 1984 to 1989 and outstanding at the end of 1989-90 have been consolidated for 15 years with 9 per cent rate of interest since, no recommendation was made for change in respect of the pre-1979 consolidated loans, they continue carrying on a rate of interest of 4.75 per cent and loans advanced during 1979 – 84 and consolidated for terms ranging from 15 years to 30 years carry interest at rates varying from 6 to 6.75 per cent. The rates of interest on other Plan and non-Plan loans from June 1, 1984 to various states and Union Territories vary between 7.5 to 13 per cent. In short, the Government of India earns interest on all such loans.

The Government of India received interest on the capital invested in the railways. This is a fixed ratio which is determined by the Parliament on the basis of the recommendation of the Railways Convention Committee. It is also treated as dividend on the capital invested. Similarly the Government earns interest on the capital invested out of the general revenues in the post and telecommunication services. It is also treated as dividend on the capital invested. Other interest rates include interest on capital invested in departmental commercial undertakings other than railways and posts and telegraphs, loans and advances to financial institutions and industrial enterprises in the public sector, loans to local bodies, loans to co-operatives and other statutory bodies, government servants etc. Loans advanced to commercial undertakings earn interest at the rate ranging between 12.5 and 17 per cent per annum. But the loans to financial institutions, other bodies and government servants carry a much lower rate of interest.

Total revenue collected under the head of interest receipts from all sources by the Government of India amounted to Rs.8,730 crore in 1991 and was reached the figure of 12637 crore in 2007-08. It is estimated that it will be Rs.24,475 crore in 2014 – 15 (BE).

5.6.a.(ii) Dividends and Profits :

We include under this head income of the Government of India from dividends and profits from railways, posts and telegraphs, Reserve Bank of India, Nationalized banks and others. We now discuss each of these in some detail.

Railways : The Indian Railways are the largest national enterprise owned by the Government of India. While discussing the issues related to railway finance, we have already stated that the railway budget was separated from the general budget in 1924. Since then the Government of India has been receiving a fixed proportion of the dividend from the railways under an agreement which was entered between the government and the railway authorities in 1924 and renewed in later years. These agreements have been known as conventions. Since 1950, the Government of India appointed Railways Convention Committee of Parliament to investigate into the problems of Railway finance and suggest measures to solve financial problems of the railways. Since then a number of conventions have been held and according to their recommendations the railways are paying a fixed amount of dividend to the general revenues on the capital invested in the railways in place of interest charges. Currently the amount of dividend paid by the railways to the Government was determined under the railway convention of 1991. Subsequently the arrangement was readopted in 1995 and 1996-97 and the estimates for the year 1997-98 were based on the same. Railways made a net dividend payment of Rs. 3005 crore in 2005-06 and also paid Rs. 663 crore towards outstanding deferred dividend liability. Performance of railways in efficient Freight earnings during 2013-14, at Rs.93,906 crore, registered on growth of 10.1% over 2012 – 13 passenger earnings (including other coaching earnings) at Rs.40,211 crore registered an increase of 17.0% during 2013-14. Net rvenue as a portion of capital-at-charge and investment from the capital fund, which stood at 5.6% in 2013-14, in budgeted to improve to 6.3% during 2014-15.

Posts : This is the second important commercial undertaking of the Government of India. The department of posts and telegraph renders useful services to poor and rich alike. These are important for the development of the country. In India post cards are the cheapest means of communication for the poor people. Inland letters and envelopes are being used by the middle class while the rich people generally use the services of private couriers. Therefore, the incidence of increase in the rates of postal stationery chiefly falls on the poor and the middle class people and in this sense they are regressive in nature. The surplus or the losses arising out of the Department go to the general revenues.

The department of posts and telegraph has not been paying dividend to the general revenues on the capital invested by the government. During 2006-07 the Department of posts was to have a deficit of Rs. 1,379 crore. The gross receipts of the department of posts in 2013-14 were placed at Rs.10,730 crore. The gross and net working expenses during the year were Rs.16,797 crore and Rs.16,204 crore respectively, yielding a deficit of Rs.5473crore. In RE 2014-15, the deficit is projected to be Rs.6944 crore.

Other Dividends and Profits : Other dividends and profits include receipts like: (i) profits from Reserve Bank of India; (ii) profits from ntionalised banks; (iii) profits from Life Insurance Corporation; and (iv) dividends from public undertakings ad other investments. The receipts under this head. Dividends and Profits were estimated at Rs. 33,924.85 crore for the year 2007-08. During 2013-14 it was Rs.43,996.24 crores.

5.6.(c) Other non-Tax Revenue Sources

(i) General Services : under this head we include the revenue received from : (i) administrative services, Union Public Service Commission, Police etc.; (ii) contributions and recoveries towards pension and retirement benefits; and (iii) miscellaneous general services.

In the administrative services are included Union Public Service Commission, police, jails, supplies and disposals, stationery and printing, public works and others. The government provides pension as retirement benefits to its employees for which they are required to make a nominal contribution.

Under the head of miscellaneous general services, the revenue receipts relate to gain by exchange and unclaimed receipts of postal service and marked loans written off to revenue.

(ii) Social and Community Services

Income received by the government under this head includes income from services like education, art and culture, medical and public health, family welfare, public health, sanitation, water supply, housing, urban development, information and publicity, broadcasting, labour and employment, social security and welfare and other services. Rs.25,316.54 were received by central govt during 2013-14 from this source.

(iii) Economic Services

Economic services include: (i) agriculture and allied services; (ii) irrigation and flood control; (iii) energy; (iv) industry and minerals; (v) transport; (vi) communication; (vii) science, technology and environment; and (viii) general economic services such as foreign trade and export promotion; civil supplies and others. These broad heads include several minor heads. For example, agriculture and allied services include agriculture, minor irrigation, soil conservation and area development, food, animal husbandry, dairy development, fisheries, forests, community development etc. Similarly, other heads include various minor heads. In 2013-14 this source contributed Rs.88,968.07 crores.

(iv) Grants-in-aid and Contributions

The Government of India receives assistance from friendly countries in the form of loans, cash grants and commodity grants. India has received in the past cash grants and commodity grants from a number of countries like Canada, Czechoslovakia, Denmark, Japan, USA, USSR and UK. It has received loans and cash grants from financial institutions like IBRD, IMF, IDA, International Fund for Agricultural Development and UN Development Programme. The share of external grants is lsowly decreasing and reached to Rs.1456.13crore from 3141.45 during 2009-10.

5.7 CONCLUSION :

Despite of domestic challenges and external vulnerabilities, the government adhered to fiscal consolidation in 2013-14. The 4.1 per cent fiscal deficit target of 2014-15 seems achievable inspite of slow growth of revenues and delayed disinvestment. To meet this target the government may have to resort to some expenditure compression. Nevertheless, declining global oil prices, along with the diesel-price deregulation and direct transfer of domestic LPG subsidies to bank accounts, are expected to help lower the fuel subsidy bill. Increased revenues are expected through increase in excise duties on petroleum and diesel.

Going forward, enhanced revenue generation is a priority to the Government. To some extent this will be helped by raising the growth rate of the economy. The implementation of a well-designed GST and other tax reforms would also play a crucial role in this regard. Overhauling the subsidy regime which should entail further reducing fuel (LPG and kerosene) subsidies, tackling fertilizer subsidies, and moving to Aadhaar-based direct cash transfers of food subsidy and other transfers would pave way for expenditure rationalization. Fiscal consideration is a necessity but the quality of consilidation in imperative to make it sustainable. To achieve this end, it would be necssasary to put in place a medium-to-long term fiscal policy fram work with explicit revenue, expenditure and deficit targets.

5.8 MODEL QUESTIONS :

1. Write a breief note on trends of direct and indirect taxes in India?
2. Briefly examine the measures taken by Government of India to improve tax revenue in recent times.
3. What are the various non-tax revenue sources for the central grovernment.

5.9 SUGGESTED READINGS :

1. Economic survey, GOI, 2014-15
2. Report on Currency and Finance, RBI, 2014-15.
3. Budget speech of Finance Minister, Ministry of Finance, 2015-16.

LESSON – 6

EXPENDITURE OF CENTRAL GOVERNMENT

6.0 OBJECTIVES :

After completing this lesson you are able to understand the following.

- What is the nature of public expenditure in India.
- What do you mean by expenditure on revenue account and capital account.
- What is the distinction between plan expenditure and non-plan expenditure.
- What do you mean by developmental and non-developmental expenditure.
- What are the major trends of public expenditure in India in recent times.

STRUCTURE:

6.0 INTRODUCTION :

Expenditure is incurred by the Central Government either for satisfaction of collective needs of the citizens or for promoting the economic and social welfare. India is a welfare state, that is why the expenditure of the central government is rising continuously. The expenditure of central government exceeds its revenue income which leads to deficit financing. The amount of deficit financing is also showing a continuous upward trend since long. Actually, the central government is widening its activities in social and economic spheres to bring economic growth as early as possible.

In this way, it accelerates the paeo of modernization especially in backward and developing economies like India. According to Wagner, "concept of increasing activities is reflected in the growth of public expenditure".

6.2 PUBLIC EXPENDITURE IN INDIA :

In India, the increase in public expenditure has been extraordinary particularly in post-independence period owing to the expansion of social and economic services, strengthening of administrative services, increased participation of the government in capital formation, saving and investment and increase in the cost at all levels due to rising prices. In 1950 – 51 the total expenditure of Government of India was of the order of Rs.530 crore comprising Rs.350crore as revenue expenditure and Rs.180 crore as capital expenditure. In 2014-15 the estimated expenditure of the Government of India was of the order of Rs.17,94,892 crore comprising of Rs.1568112 crore as revenue expenditure and Rs.22,6780 crore as capital expenditure.

Before 1987-88 the revenue expenditure comprised of civil expenditure, defence expenditure and grants-in-aid to States and Union Territories: The civil expenditure included general services, social and community services and economic services. Simultaneously the Government of India had also adopted another classification of expenditure viz., development expenditure, defence expenditure and other expenditure. Defence and other expenditures were actually known as non-development expenditure. Under developmental expenditure were included the expenditure on social and community services, economic services and grants-in-aid to the States and Union Territories for development purposes. As already stated, defence expenditure was non-development expenditure and it included pensions given to the retired armed personnel and expenditure on the maintenance of armed forces. In other expenditure, were included the expenditure on collection of taxes and duties, administrative services, interest payments, pension and other retirement benefits and other grants to the States.

In the Budget 1987-88 the Government of India adopted a new classification under which public expenditure was classified into: Plan expenditure and Non-Plan expenditure. Plan expenditure includes expenditure on: (a) Central plans, such as development of agriculture, rural development, irrigation and flood control, energy, industry and minerals, transport, communications, science and technology and environment, social services and others, and (b) Central Assistance for the Plans of the States and Union Territories.

Non-Plan expenditure comprises of: (i) Expenditure on Revenue Account, and (n) Expenditure on Capital Account. We now explain these in the following paragraphs.

(i) Expenditure on Revenue Account: All expenditures incurred out of the proceeds of taxes and other revenue receipts are included in this category. It means that expenditure incurred out of money balances created or owned by the Government (like tax collection, receipts and payments of interest, dividends, profits, rents, fees and fines, grants, contribution of railways, posts and telegraphs, civil works etc.) is revenue expenditure, for example, expenditure on the maintenance of physical assets, general administration, police and judiciary and grants given to States and other parties. Revenue expenditure thus, does not result in the creation of physical assets.

(ii) Expenditure on Capital Account: Capital account includes all those moneys which are neither owned or created by the Government like loans, deposits, collections etc., which cause changes in physical assets owned by the Government (their creation, acquisition, disposal or addition/alteration thereof) and which lead to changes in financial claims upon third parties. All expenditures financed out of these moneys are known as capita] expenditure, for example expenditure on the acquisition of lands, buildings, equipments, machineries, investments in stocks and shares, loans and advances by government to other governments, government companies and corporations etc. for development purposes, capital expenditure on economic services, social and community services, social and community services, defence and community services, defence and general services, defence and general services. Capital expenditure thus, leads to the creation of physical assets.

6.3 COMPONENTS OF REVENUE EXPENDITURE :

Revenue expenditure is composed of the following :

(1) General Services and Defence Services, (2) Social Services, (3) Economic Services, (4) Grants-in-Aid to States. We now throw light on each of these.

(1) General Services : Expenditure under this head includes expenditure on the following:

(a) Organs of the State—Parliament, President, Vice-President, Council of Ministers, Administration of Justice, Elections, Comptroller and Auditor General and his office.

(b) Fiscal services like Collection of Taxes, Customs Duties and Currency, Coinage and Mint.

(c) Debt service i.e., Interest charges on internal and external loans.

(d) Administrative services like Public Service Commission, Secretariat, Supplies and Disposals, Public Works, Printing and Stationery.

(e) Salaries, allowances, pension and other retirement benefits to the government employees; including defence forces.

(2) Social Services : Expenditure on the following items is included under this head;

(a) Education, (b) Sports and Youth Services, (c) Art and Culture, (d) Medical and Public Health and Family Welfare, (e) Water Supply and Sanitation, (f) Housing and Urban Development, (g) Information, Publicity and Broadcasting, (h) Labour and Employment, (i) Nutrition,(j) Relief on account of natural calamities, (k) Social Security and Welfare, (l) Welfare of Scheduled Castes and Scheduled Tribes and Other Backward Classes, and Secretarial-Social Services.

(3) Economic Services : Expenditure in respect of Secretariat and attached offices of the following ministries and departments is included under this head: (a) Agriculture and Allied Activities; (b) Rural Development; (c) Special Areas Programmes; (d) Irrigation and Flood Control; (e) Energy; (f) Industry and Minerals; (g) Transport; (h) Communications; (i) Science, Technology and Environment, and (j) General Economic Services.

(4) Grant-in-Aid to Contributions : Grant-in-aid given to the state governments and UT's for filling up revenue gap and for other specific purposes.

6.4 COMPONENTS OF CAPITAL EXPENDITURE :

Capital expenditure of the Government of India is composed of the following expenditure: (1) General Services including defence services, (2) Social Services, (3) Economic Services, (4) Public Debt, and (5) Loans and Advances.

We now give some details about these expenditures in the following:

(1) General Services : Expenditure on general services of capital nature is included under this head, for example, expenditure on Currency Note Press, Bank Note Press, Security Paper Mill and Mints at Kolkata, Mumbai and Hyderabad. It also includes capital expenditure on other fiscal services such as collection of taxes on income and expenditure, collection of taxes on wealth and gift tax, Union excise duties and commodity taxes, stationery and printing, public works and other administrative services and miscellaneous general services. Besides, defence expenditure is also included under this head. The capital expenditure on general services is chiefly on the office and administrative buildings. So far as the defence expenditure is concerned it refers to the non-residential buildings, ordnance factories, machineries, tools and equipment etc.

(2) Social Services : Capital expenditure on education, sports, arts and culture, medical and public health, family welfare, water supply and sanitation, housing and urban development, information publicity and broadcasting, welfare of scheduled castes, scheduled tribes and other backward classes, social security and welfare and other social services, is included under this head. The expenditure increases the standard of living of people and thus leads to an increase in the efficiency and productivity of human resources of the country.

(3) Economic Services : Under this head, capital expenditure on agriculture and allied services (namely, crop husbandry, soil and water conservation, animal husbandry, dairy development, fisheries, forestry and wildlife, food, storage and warehousing; investment in agricultural financial institutions, cooperation) rural development programmes; special areas development programmes; irrigation and flood control, (major, medium and minor irrigation works); capital expenditure on power and energy projects, (petroleum, coal, lignite, non-conventional sources of energy); capital outlay on industry and minerals (small and village industries, iron and steel industries, non-ferrous mining and metallurgical industries, cement, fertilisers, petro-chemical, chemicals, and pharmaceutical engineering, telecommunications and electronics, consumer industries, atomic energy and other industries); capital expenditure on transport (railways, ports, and light houses, shipping, civil aviation, roads and bridges, inland water transport and other transport services); capital expenditure on technology and environment (atomic energy research, space, occeanographic and other scientific and environmental research; capital expenditure on general economic services (tourism, foreign trade and export promotion, financial and training institutions, investment in international financial institutions etc) is included. We have already explained that capital expenditure is one which leads to the creation of tangible assets of durable nature.

(4) Public Debt : This head includes internal and external debts of the Government of India.

(5) Loans and Advances : The Government of India advances loans to States and Union Territories for executing developmental projects in their jurisdiction. These loans and advances are given for the following purposes:

(a) Social Services such as education, sports, art and culture, family welfare, housing, information and publicity, medical and public health, water supply and sanitation.

(b) Economic Services, such as agriculture and allied activities, special areas programmes, energy, industry and minerals, transport, communications, science, technology and environment and general economic services.

(c) Other purposes: The Government of India also gives loans and makes advances for other purposes to States, Union Territories, foreign governments, government servants etc.

6.5 COMPARATIVE POSITION OF REVENUE AND CAPITAL EXPENDITURE :

As we already aware, the revenue expenditure is incurred on the normal running of the departments and services, interest charges on debts and grants to the state governments. On the other hand capital expenditure loads to creation of assets. From this point of view, a developing country like India, needs capital expenditure on a large scale for raising the level of production. The following table 6.1 shows a comparative analysis on the growth of public expenditure on both accounts in selected years.

Table – 6.1

(in Crore rupees)

Year	Expenditure on Revenue Account	Expenditure on Capital Account	Total
1950 – 51	350	180	530
1980 – 81	14540	9630	24170
2001 – 02	301610	60840	362450
2010 – 11	1145786	158579	1304365
2011 – 12	1243509	166858	1410367
2012 – 13 (R.E.)	1399539	190895	1590434
2013 – 14 (P.E.)	1375590	187895	1563485
2014 – 15 (B.E.)	1568112	226780	1794892

It is clear from the above table that there has been a greater increase in the revenue expenditure of the government of India. In the first five year plan, the volume of revenue expenditure was higher than capital expenditure, but the situation was reversed from 1956 – 57 onwards. Further since 1977 – 78 the revenue expenditure again started rising at a faster rate than capital expenditure, which means that the tax revenue had not been adequate to meet the revenue expenditure and the rate of capital formation and economic development of the country had not increase with the increase in tax burden.

6.6 DEVELOPMENT AND NON-DEVELOPMENT EXPENDITURE :

Simultaneously, the central government also adopted another classification viz., Development and non-development expenditure, since capital expenditure is considered to be developmental in nature and revenue expenditure is regarded as non-developmental, as increase in the latter at a faster rate than the increase in the former goes to show that the rate of capital formation in the country is not sufficient.

Expenditure on social services, economic services, grants-in-aid to the States and Union Territories for financing development projects is included under development expenditure on revenue account as already explained.

We have already listed the components of each of these before. This expenditure is considered developmental in the sense that all these services help in raising the efficiency and productivity of human resources and thus in raising the level of output, income and employment in the country.

Development expenditure on capital account includes expenditure of capital nature on social services, economic services and loans and advances to States and Union Territories and for financing public enterprises. We have already spelt out the various items of expenditure under each of these earlier.

Development expenditure has increased since 1950-51 manifold only because of the government's launching of the programme of economic and social development through its Five-Year Plans.

The non-development expenditure on revenue account includes expenditure on items, such as audit, collection of taxes and duties, currency, coinage, mint, interest payments, expenditure on administrative services such as police, public works, external affairs and other administrative services, pensions and other retirement benefits to the government employees, grants to States and Union Territories, defence expenditure on salaries, pension etc. All these services are put under the head of general services and therefore we can say that the expenditure on general services on revenue account is non-development expenditure.

Defence expenditure is the major head of non-development expenditure on capital account. It also includes expenditure on trading, currency, mint, security and printing press. Since this expenditure does not lead to promote development it is considered as non-developmental.

The increase in non-development expenditure has been caused chiefly because of increase in the state activities particularly after independence, increasing problems of defence and law and order etc.

However, a comparative study of both of these expenditures leads to the conclusion that the increase in development expenditure has been higher than the increase in the non-developmental expenditure. Developmental expenditure on revenue account is met out of the revenue collected from taxes whereas the developmental expenditure on capital account is financed from the funds raised through loans, internal as well as external.

PLAN AND NON-PLAN EXPENDITURE :

We have already stated earlier that the classification of public expenditure into Plan and non-Plan expenditure was adopted for the first time in the' budget of 1987-88. We have also spelt out the details of such expenditure before. We now discuss some of the general trends of these two types of expenditure. But before doing this we shall make some general observations.

Plan and non-Plan expenditure does not necessarily mean developmental expenditure and non-developmental expenditure respectively. The reason is that both these types of expenditures contain the element of development as well as non-development expenditure. As soon as plan project becomes operative, expenditure on its maintenance and operation are transferred to the non-Plan budget. That is why the non-Plan expenditure has been on the increase. Plan expenditure has also increased overtime, but has not grown as fast as non-Plan expenditure gives details of Plan and non-Plan expenditure of the Government of India. It would be observed that currently about 77 per cent of the Plan expenditure is used for financing the Central Plan while the balance is given as central assistance for Plans of States and Union Territories.

In the total non-Plan expenditure, capital expenditure comprises a little more than 1.2 per cent and therefore about 99 per cent of the non- Plan expenditure is incurred on revenue account which includes debt-servicing charges, defence expenditure, subsidies, grants and other non- Plan expenditure.

Table – 6.2

(in Crore rupees)

Plan	Plan expenditure	Non-Plan expenditure	Total Expenditure
6th Plan	12360	18698	31058
7th Plan	24146	47026	71172
8th Plan	227608	576884	804492
9th Plan	385940	1111408	1497349
10th Plan			1525639
11th Plan	1988737	4544436	6533173

6.7.1 Debt Servicing Charges :

We have already stated that debt servicing charges or interest payments are a committed change on government revenue. It has grown over the years by leaps and bounds. The rate has increased significantly with the new market oriented policy, and the increase has reached to such an extent that now it is being talked about that the government is on the verge of falling into a debt trap. From the table 6.3 it is clear that these charges are increasing at a rate of about 20% per year. The situation is really distributing and it is high time that this expenditure reduced.

Table – 6.3

Year	Interest to Payment (in Crores)	Per cent to GDP
2007 – 08	171030	3.4
2008 – 09	192204	3.4
2009 – 10	213093	3.3
2010 – 11	234022	3.0
2011 – 12	273150	3.0
2012 – 13	313169	3.1
2013 – 14 (PE)	377502	3.3
2014 – 15(BE)	427011	3.3

It can be depicted from the table interest paymetns constitute around 3.3 percent during the past few years. Fiscal deficit is a flow variable which gets added into the stock variable every year thus attracting interest liability. Interest payments were placed at Rs.4.27 lakh crore in BE 2014-15, accounting for 38.31 percent of non-plan expenditure. The average cost of Borrowings in placed 8.4 percent in 2014-15(BE) as against 7.7 percent in 2012 - 13.

6.7.2 Defence Expenditure : The expenditure on defence has been increasing alarmingly during the past few years. For instance, in 1979 they were just Rs.3164 crore, which has increased to Rs.83,000crore by 2006. After that, particularly, after 2009-10 there is a continuous rising trend (Table - 6.4).

Table – 6.4

Year	Defence Expenditure (in crores)	Percentage to GDP
2007 – 08	54219	1.1
2008 – 09	73305	1.3
2009 – 10	90669	1.4
2010 – 11	92061	1.2
2011 – 12	103011	1.1
2012 – 13(RE)	108925	1.1
2013 – 14 (PE)	123449	1.1
2014 – 15(BE)	134412	1.0

This increase may appear to be highly satisfying, but in real terms the situation is far from satisfactory. The real worth of funds made available for country's defence needs has been declining fast-owing to the fall in the rupee's purchasing power on the one hand and increased in the prices of defence equipment on the other. Expenditure on defence as percentage is more or less same with just around one percent during the past years. This neglect of defence preparedness may prove very costly to the country some day.

6.7.3. Subsidies : Subsidies are another major item of government expenditure. Subsidies can be open as well as hidden. Open subsidies can be given in the form of cash assistance, tax concessions, purchase preference prices and interest rate differentials, subsidized inputs etc. A subsidy implies that a section of the community is being protected at the cost of other. Subsidies are being used in many countries particularly for counteracting the failure of market mechanism, in bringing about optimum allocation of resources and distribution of income and wealth.

The amount of subsidies has been increasing continuously. Subsidies are good only upto a limited extent but they also create many problems for the Government as well as for the society. In our country the major portion of subsidies is consumed by food, fertilisers and export promotion. Fertilisers claim the largest share followed by food and export promotion. Other items include interest subsidies, debt relief to farmers etc. These subsidies can be justified on a number of grounds. Subsidies to individual industries promote employment and remove regional disparities. Subsidies on food prevent starvation and malnutrition. Subsidies for health care, education, drinking water etc. are necessary for maintaining the health of the society.

But it need not be forgotten that subsidies entail a cost to the economy and limit the scope of budgetary maneuverability. It is a sort of secret help to the beneficiary. It leads to the creation of vested interests. It also encourages other sections of the society to ask for subsidies. Sometimes it also happens that the benefit of subsidy does not reach the people for whom it is meant. Vested interests snatch this benefit at the cost of the poor people, backward areas and backward industries. In this respect subsidies do not promote distributive justice. Subsidies may also lead to waste of resources if these are given to sick and inefficient units indulging in under-utilisation of capacity, over-staffing etc. That is why it has been said that instead of checking market failures subsidies generate 'government failures and create distortions in the economy. It has, therefore, been suggested that subsidies should not be given on a permanent basis.

It may be interesting to note that open subsidies generally constitute a very small portion of the total subsidies. Hidden subsidies constitute a major portion like tax concessions, purchase preferences, losses of public sector undertakings, low administered prices, social welfare services like medical and health care, education etc.,

Table 6.5 gives the trends of subsidies in India. It can be observed from the table that the amount spent on subsidies has been about doubled with in a span of 5 years (i.e., between 2009 -10 to 2014 – 15 BE)

Table – 6.5
Trends in Subsidies

Subsidy Head	2009 -10	2010 – 11	2011 – 12	2012 – 13	2013 – 14 (P.A.)	2014 – 15 (B.E.)
Food	58443	63844	72822	85000	92318	115000
Fertilize	61264	62301	70013	65613	71280	72970
Petroleum	14951	38371	68484	96880	83998	63427
Major Subsidies	134658	164516	211319	247493	247596	251397
Total Subsidies	141351	173420	217941	257079	NA	260658

The subsidy bill for BE 2014-15 was placed at Rs.2.60 lakh crore which was 23.4 per cent of non-Plan revenue expenditure and 2.0 per cent of GDP. In the post financial crisis period, the subsidy bill had increased from 2.2 per cent of GDP in 2009-10 to 2.5 per cent of GDP in 2012- 13 (Table 2.6). The main items under this head from 2009-10 to 2012-13 were food and petroleum subsidies. The deregulation of diesel price in October 2014, along with the introduction of direct benefit (subsidy) transfer into the bank accounts of domestic LPG consumers, coupled with a sharp decline in global crude oil prices will help contain the petroleum subsidy bill. The under recoveries on petroleum products are expected to be Rs. 74,664 crore during 2014-15 against Rs.1,39,869 crore in 2013-14.

The rationalization of food subsidies is still an area where more effort is required. Recently, the High level Committee for Restructuring of Food Corporation of India recommended several measures including cash transfers to the beneficiaries of the public distribution system.

6.7.4 Grants : Most of the non-plan grants given by government of India to the states and union territories are statutory and are given on the recommendations of Finance commission. Their proportion is about 10 percent in the total non-plan expenditure. The government of India also has been providing assistance in the form of grants, although to very limited extent, to other under-developed friendly countries.

As a strategy for occurring fiscal consideration, expenditure rationalization has major constraints on account of expenditures like interest payments, subsidies, defence services, pension, and non-plan grants an aid to states and UTs, which constitute 87.4percent of the total non-plan revenue expenditure in BE 2014-15. The rationalization and reprioritization of non-plan revenue expenditure is expected to play a vital role in the process of fiscal consolidation and targeting expenditure more towards inclusive and sustainable development.

6.8 TRENDS OF CENTRAL GOVERNMENT EXPENDITURE :

The expenditure of central government of India has been increasing at a fast rate, particularly during the period of planning. For example, expenditure on revenue account increased from Rs.346 crores in 1950-51 to Rs.15,68,112 crores in 2014-15(B.E.). Similarly, expenditure on capital account of the central government has increased from Rs.180 crores in 1950-51 to Rs.226780 crore by 2014-15(BE).

Increased defence commitments, expansion of administration, the working of demographic institutions like the parliament, increase in economic development, provision of welfare measures, international commitments, increase in both development and non-development expenditure, consequent rise in wages and salaries of the government employees, misuse of funds by the central government for achieving political objectives etc., and above all, continuous rise in prises – all these are responsible for the rapid increase of the central government expenditure. The main factors responsible for this tremendous increase in central government expenditure may be summarized as under :

The two pillars of fiscal reforms, as mentioned earlier, are revenue augmentation and expenditure rationalization. Efficient and effective expenditure management is a key component of the Fiscal Responsibility and Budget Management Act. Budget 2014-15 estimated total expenditure at X 17.95 lakh crore which was 12.9 per cent higher than the 2013-14 (RE) and 14.8 per cent higher than 2013-14 (PA). Within this the expected growth in capital expenditure was 18.8 per cent and growth in revenue expenditure was 12.0 per cent over RE 2013 -14. At disaggregated level, the BE 2014-15 estimated Plan and non- Plan expenditure at Rs. 5.75 lakh crore and Rs. 12.20 lakh crore respectively, which amounted 4.5 per cent and 9.5 per cent of budgeted GDP, reflecting a growth of 20.9 per cent and 9.4 per cent respectively over RE 2013-14.

Plan Expenditure : In 2014-15, the centrally sponsored schemes were restructured into 66 programmes for greater synergy and effective implementation and reclassified whereby the funds under these programmes are now being released as central assistance to state plans giving the states greater autonomy, authority, and responsibility in implementation of schemes. As a result, central assistance to state and union territory (UT) plans recorded an increase from Rs. 1.19 lakh crore in RE 2013-14 to Rs. 3.38 lakh crore in BE 2014- 15. Further, the composition of net revenue and net capital expenditure has broadly remained the same since 2012-13, with both these components individually contributing roughly half of Plan expenditure. Furthermore, the broad sector-wise allocations of central Plan outlay (gross , budgetary support in central Plan plus internal and extra budgetary resources of the CPSEs) indicate that the energy, transport, social service, and industry and minerals, got the maximum share in BE 2014-15.

Non-Plan Expenditure : Non-Plan expenditure constituted around 68 per cent of total expenditure in BE 2014-15 which is 3 percentage points less than the levels of 2013-14 (PA). Out of the total non-Plan expenditure in BE 2014-15, the share of non-Plan revenue expenditure is 91.4 per cent, with the balance, a mere 8.6 per cent, being accounted for by capital non-Plan expenditure. Within capital non-Plan expenditure, it is defence expenditure which had the maximum share.

6.9 CONCLUSION :

It can be concluded from the above analysis that, thee is a mountaining rise in the public expenditure in India. In order to obviate the need for large scale expenditure reduction, the government has to put in place some revenue augmentation and mobilization efforts. some of the measures to boost revenue include increase in excise duty on petrol and diesel, a mid a dip in global oil prices. The forth coming recommendations of the expenditure management commission will also be helpful in reprioritizing expenditure and curtailing expenditure leakages.

As a strategy for achieving fiscal consolidation, expenditure rationalization has major constraints on account of expenditures like interest payments, subsidies, defence services, pension, and non-Plan grants and aid to states and UTs, which constituted around 87.4 per cent of total non-Plan revenue expenditure in BE 2014- 15. The rationalization and reprioritization of non-Plan revenue expenditure is expected to play a vital role in the process of fiscal consolidation and targeting expenditure mare towards inclusive and sustained development.

6.10 MODEL QUESTIONS :

1. Distinguish between Revenue expenditure and capital expenditure.
2. Write about plan and non-plan expenditure in India.
3. Write an essay on trends in Central Governemnt expenditure in India.

6.11 SUGGESTED READINGS :

1. Public Finance - R.C. Agarwal
2. Indian Economy - P.K. Dhar
3. 12th Plan Document - Government of India
4. Economic Services - 2013-14 Goverment of India

LESSON – 7

SOURCES OF REVENUE OF STATE GOVERNMENTS

OBJECTIVES : After reading this lesson you are able to understand the following.

- What are the constitutional authorized sources of revenue to the State Governments in India.
- What are the various ways of Revenue of the state governments.
- What do you mean by Tax revenue for state governments.
- What do you means by non-tax revenue for state governments.
- What do you mean by capital revenue for the state of governments.
- What are the trends in Revenue of the State Governments.

STRUCTURE:

7.1 INTRODUCTION :

India is a federal country. The federal structure adopted in India has made a clear cut distinction between the Union and State functions and also its sources of revenue. States have been given an exclusive authority to levy and collect some taxes and also to share the revenue realised from certain union taxes. Moreover, the states are receiving grants in aid from the Centre which are a kind of transfer of resources from the centre to the states.

Moreover, the constitution of India makes provision for clear-cut division of fiscal powers between the Central and the State Governments. Accordingly, the clear-cut classification principle adopted by the Government shows that taxes having inter-state base are levied by Centre and the taxes having local base are being levied by the States. But the residuary powers belong to the Union Government itself.

In India, financial dependence of states on the Central Government is a very common practice of most of the states and specially the degree of dependence is much for the financially weaker states. But too much dependence on the centre is not at all suitable for the smooth functioning of a federal set up. In the words of J.N. Sharma, "while it is scarcely possible to have an absolute equilibrium and independence for each layer of Government in a federal set up, the very concept of federation would be frustrated and thrown into jeopardy if the federation entities are obliged to depend on the federal apex to an extent of subservience." K.C. Wheare asserts that the 'essential point in a federal principle is that neither of the two tiers of government should be sub-ordinate to the other; both the general and the regional governments must each have under its own independent control financial resources sufficient to perform its exclusive functions.'

As regards financial self-sufficiency of the federal and the regional governments, it may be admitted that it is almost impossible in a federation nicely to adjust functions with resources. The Central Government is always left with more and the regional governments with less than their functions would normally require. Moreover, the states are not equal in respect of area, population or income. Some are able to raise more revenue per head than others. And so, in every federal constitution there are provisions for grants to be made by the Central Government to the State Government.

But, inter-governmental grants are criticized on the ground that they undermine the sense of financial responsibility on the part of recipient governments.[2] Professor J.R. Hicks suggests that the federal grants to the extent of 75 per cent of State's revenues can be safely relied upon within impairing a State's sense of financial responsibility. Of course, it depends on how much independent sources of revenue a state has.

On the other hand, financial autonomy of the unit governments is as essential and vital in the preservation of the federal principle as that of the Centre. It is pertinent to recall in this context that proper functioning of the federal principles of fiscal autonomy rests on adequacy and elasticity of the revenue resources of the Government.

7.2 INDIAN CONSTITUTION AUTHORISED SOURCES OF STATE'S REVENUE :

The financial system of India is of federal character and the powers to raise revenue are divided between the Centre and the States. The Indian Constitution separately provides for the Central and State lists in a schedule appended to it. Due to the partition of the country in 1947 and many alterations in boundaries of the states during the interim period after the independence, it was possible only in 1950 that we could draw a picture of the trends and composition of the sources of revenue of the State Governments. After reorganisation of the states in 1950, now we do not have part 'A', 'B' and 'C' states, we have states and besides them we have some centrally administered states called 'Union Territories'. Only the states have been provided with separate powers under the Indian Constitution to raise revenue from the definite sources and the Union Territories are financed by the Central Government itself. The sources of income of the states are divided into two parts : (i) taxes etc. realised directly by the states, and (ii) taxes realised by the Central Government but distributed among the Central Government and State Governments in a definite ratio fixed by the Finance Commission. Under this capital, we shall study only state finances — revenue and expenditure.

The Indian Constitution (1950) authorises the State Governments to raise revenue from the following sources :

1) Land revenue

2) Taxes on sales and purchase of goods except newspapers;

3) Taxes on agricultural income ;

4) Taxes on lands and buildings ;

5) Successions and estate duties in respect of agricultural land ;

6) Excise and alcoholic liquors and narcotics ;
7) Taxes on entry of goods into a local area ;
8) Taxes on mineral rights subject to any limitation imposed by Parliament;
9) Taxes on consumption and sale of electricity;
10) Taxes on vehicles, animals and boats ;
11) Taxes on goods and passengers carried by road and waterways;
12) Stamp duties except those specified in the Union list;
13) Taxes on luxuries including entertainments, betting and gambling;
14) Tolls;
15) Taxes on professions, trades and callings, and employment;
16) Capital taxes ; and
17) Taxes on advertisements other than those in newspapers. The non-tax revenue of State Governments includes the following :

    A. Administrative receipts;

    B. Net contribution of the public sector undertakings :

        a. Forests;

        b. Irrigation;

        c. Electricity scheme;

        d. Road and water transport; and

        e. Industries and others.

    C. Other revenues;

    D. Grants-in-aid and other contributions.

7.3 SOURCES OF REVENUE OF STATE GOVERNMENTS :

The sources of revenue of the State Government may be classified under the following two major heads :

(1) Tax Revenue :

(2) Non-tax Revenue.

7.3.1 TAX REVENUE : The tax revenue of a state is composed of proceeds from taxes on incomes, property and commodities etc. It also includes proceeds from the taxes imposed and collected by the centre but shared between the Central Government and the State Governments. Taxes levied by the states themselves cover a wide range with varying degree of importance namely, taxes on

i. Agricultural Income and Professions around 1.5%;

ii. Property and capital transactions around 9.7%; and

iii. Commodities and services around 88.8%.

The total income of the State Governments from tax revenue in 1950-51 was Rs. 280 crores only. It rose to Rs. 1,62,158 crores in 2000-2001 which increased to Rs.11,40,660 crore by 2013-14(BE) [Table 7.1]. The sources of tax revenue of the State Governments are as follows:

(1) Land Revenue : From times immemorial, land revenue had been an important source of income to the States. It is the oldest of the State Taxes. Land revenue is a compulsory payment and no agriculturist is exempted from it. There has been considerable variation among the States in the method of land revenue settlement as well as in the calculation of the tax. Land revenue administration machinery is more or less of uniform pattern in all the states. Each State has a board of revenue. The usual practice is to divide the areas into divisions and districts. The districts are again divided into Tehsils, Parganas, Tappa, etc. Land revenue is based on the principles of certainty, economy and convenience. This tax brings a definite amount of income to the State Government. The Governments have not to spend much on the collection of the land revenue and land revenue is paid by the farmers at the time when the harvest is reaped and sold in the market. The land revenue is one of the most inelastic sources of revenue and the income from it goes on declining as it does not increase in proportion to the income of farmers. For a long time, the land revenue topped the list of sources of State revenue. But after the Second World War due to enormous increase in the revenue from state excise duties and the sales tax, the relative importance of land revenue declined. During the plan period, due to various land reforms and abolition of intermediaries the yield from land revenue has recorded an increase and again it has become as one of the main sources of revenue. But due to the vagaries of monsoons and other uncertainties, land revenue has also become an uncertain source of revenue to the State Governments.

Table 7.1
Tax Revenue Receipts of the States

(In crores Rupees)

	1990-91	2000-01	2010-11	2011-12	2012-13(RE)	2013-14(BE)
A. Tax Revenue	44185.02	162157.68	69771.10	834546.48	984700.23	1140660.39
(a) Direct Taxes	5213.61	21583.83	144134.94	165587.43	185783.64	214182.74
1. Share of Income Tax	3983.27	13711.60	45547.16	51195.89	61120.78	70974.50
2. Hotel receipts Tax	0.71	9.68	53.23	66.07	73.64	90.04
3. Share of estate duty	0.00	0.00	0.00	0.00	0.00	0.00
4. Land Revenue	603.09	1377.54	7537.45	7077.62	9111.57	11740.26
5. Agricultural Tax	169.44	76.47	173.36	151.69	127.78	134.59
6. Share of Corporation Tax	-	4399.91	86104.24	100767.91	109338.31	124927.61
7. Share of Wealth Tax	-	15.42	176.90	388.88	320.86	379.24
8. Others	457.10	1993.21	4542.60	5939.37	5690.70	5936.82
(b) Indirect Taxes	38971.41	140573.85	553606.16	668959.05	798916.59	926477.65
1. Share of Union excise duties	10055.60	22311.52	27940.88	28728.43	35300.49	4084763
2. State excise duties	4798.35	15825.28	61407.73	74762.49	88559.70	98368.70
3. General Sales Tax	16476.01	68386.28	290682.85	358055.35	412486.76	484385.91
4. Motor spirit Sales Tax	984.02	4161.43	1167.97	1497.36	15543.13	17211.50
5. Stamp & Registration fees	2089.25	9343.53	54086.61	66697.19	7868.72	92021.40
6. Tax on vehicles	1535.39	6506.96	25023.65	29830.40	35056.62	40534.73
7. Tax on goods passengers	1061.76	2041.27	11302.03	11672.18	16471.16	16642.71

8. Tax and duty on electronics	1187.16	4396.11	17408.78	17283.86	20218.77	21994.62
9. Entertainment Tax	422.09	1203.66	1244.41	1920.22	1800.27	2030.87
10. Tax on purchase of sugarcane	88.28	189.61	192.32	269.40	266.79	349.41
11. Share of custom duties	-	4753.28	37817.12	44394.26	51498.42	59210.46
12. Share of Service tax	-	249.18	21561.17	30080.48	38609.45	47702.28
13. Others	273.50	1205.20	3770.64	3769.43	4424.31	5177.40

The basis of the tax and the rates varies from state to state. The land revenue system in a state depends upon the system of land tenure. Land tenure in different states differed widely in the past, but these differences are being gradually removed by the various land reforms which are being gradually introduced. The land revenue in different states has less variation now. The Taxation Enquiry Commission had made important recommendations regarding land revenue. The states have been advised to adopt a standard assessment on the basis of comprehensive survey and settlement operations. A sliding scale has been recommended for land revenue. Although it is levied at different rates in the different states, yet in most of the states it is charged on the net income of the farmers. It is an open secret now that the states have not been keen on levying substantial taxation on land due to (i) subdivision and fragmentation of holdings, (ii) division of land in small holdings, and (iii) poor financial position of the Indian farmer. However, it would be wrong to think that land revenue has been altogether stagnant. The trend of land revenue receipts is evident from the table below:

Table - 7.2 : Trend of Land Revenue Receipts

(Rs.in crores)

Year	Amount (Rs.)	Year	Amount(Rs.)
1950 – 51	40.00	2000 – 01	1377.54
1960 – 61	90.04	2010 – 11	7537.45
1970 – 71	122.06	2011 – 12	7077.62
1980 – 81	145.53	2012 – 13	9111.57
1990 – 91	603.09	2013 – 14 (B.E.)	11740.26

It is said that land revenue system, as it prevails in India, violates particularly all the major principles of taxation.

(2) Agricultural Income-tax : Under the Govt of India Act, 1935, the states were given the right to impose a tax on agricultural income and the same position has been maintained in the Constitution of India as well. Thus, while non- agricultural incomes are taxed by the Central Government, agricultural incomes are taxable by State Governments. The Government of India appointed a committee on 24-2-1972, known as the Committee on Taxation of Agricultural Wealth and Income under the chairmanship of Dr. K. N. Raj, to examine the question of taxation of agricultural wealth and income from all aspects. The committee was of the view that, "A scheme of the partial integration would, however, not be beyond the legislative competence of Parliament as, under such an arrangement no part of the agricultural income would itself be subject to income tax in the process. Since the centre is competent to tax non-agricultural income, it is well within the powers of Parliament to decide the manner in which such incomes are to be taxed." Agricultural income tax is not an entirely new tax for India. Both agricultural and non-agricultural incomes were included within the purview of the income tax when it was first introduced in 1860. But except for a short period (1960-65 and 1969-73) agricultural Income has been exempted from the general income tax till the year 1973, when states were empowered to tax agricultural income. The burden of this tax falls on the rich farmers rather than on the poor. Though agricultural income tax has been levied in most of the states in India but not with any particular success. Dr. K. N. Raj committee found, "The significant exceptions are Kerala and Assam where Agricultural income tax, derived mostly from plantations, contributed more than the land revenue. It is a significant source of revenue in only a few other states, namely Mysore, Tamil Nadu and West Bengal, over 90 percent of total tax collection accounted for these five States."

The revenue from agricultural income stood as under :

Table – 7.3

Trend of Revenue from Agricultural Income Tax

(Rs. In Crores)

Year	Amount (Rs.)	Year	Amount(Rs.)
1950 – 51	4.03	2000 – 01	173.36
1960 – 61	9.05	2010 – 11	151.69
1970 – 71	10.95	2011 – 12	127.78
1980 – 81	46.40	2012 – 13 (RE)	127.78
1990 – 91	169.44	2013 – 14 (BE)	134.59
2000 – 01	76.47		

(Source : Report on Currency & Finance, RBI)

Justification of Agricultural Income Tax :

Today, agricultural income tax can be justified on the following grounds :

i. To-day, agriculture is an important source of income.

ii. The number of rich farms is increasing rapidly due to sharp rise in the prices of agricultural produce.

iii. Due to mechanisation, agriculture production is increasing rapidly.

Now agriculture is a profitable business.

(3) General Sales Tax : Sales-tax is a tax on the sale of property or goods at the retailing, wholesaling or manufacturing stages. In Uttar Pradesh, salse-tax is leviable on the turnover of a dealer. Turnover means total sales proceeds of a businessman within the prescribed period of time. Sale means transfer of property or goods for cash or deferred payment. Thus, sales-tax is a tax which is levied on the total value of the sales of goods of businessmen in a particular period of time. Sales-tax was first levied in Madhya Pradesh in 1938. The sales-tax may be of several forms : (i) General Sales-Tax and Selective Sales-Tax, (ii) Multi-point and Singlepoint Sales-Tax, and (iii) A turnover tax or gross receipts tax.

The Act of 1935 empowered the State Governments to levy sales tax on sales and purchases of goods. Under the Indian Constitution, in its present form, the states have exclusive power to levy tax on sales and purchases of goods other than newspapers. The Government of India has exclusive power to tax sales and purchases of goods in the course of inter-state trade but the proceeds of any such tax must be distributed to the states in which they are collected. All the states except Jammu and Kashmir levy general sales tax on transactions of purchases and sales inside the state. Some of the states levied special taxes on sales of certain commodities, such as, motor fuels, tobacco, wine, sugarcane and jute. It is significant to note that the rates of sales tax differ from state to state, The sales tax may take several forms : (i) general sales tax and selective sales tax, (ii) multi-point and single-point sales tax, and (iii) a turnover tax or gross receipt tax. The income of the states from sales tax increased from Rs. 58.94 crores in 1950-51 to Rs. 4,84,386 crores in 2013-2014(B.E.). Income from sales-tax during the last few years is given below:

Table 7.4

Year	Income from Sales-Tax (Rs. in crores)
1950 – 51	58.94
1980 – 81	3,887.00
1990 – 91	16476.01
2000 – 01	68386.28
2010 – 11	290682.85
2011 – 12	358055.35
2012 – 13 (RE)	412486.76
2013 – 14 (BE)	484385.91

Source : Report on Currency & Finance, R B.I.)

(4) State Excise Duties

Excise duties refer to taxes on commodities produced within the country with a view to restricting their consumption. In India excise duties fall into two categories : (1) those which are levied at the time of production of the commodities not so much for the purpose of restricting their consumption as for the purpose of revenue and are the necessary corollary to import duties, and (2) those which are levied for the purpose of restricting consumption of commodities which are considered to be harmful. The State Governments in India do not levy excise duties of the former type, but of the latter one.

The excise duties have been divided between the centre and the states in one present financial set-up on the revenue as well as administrative considerations. The Constitution of India provides for the power of the State Governments to levy excise duties on alcoholic liquors and narcotics. Accordingly, the State Governments levy excise duties on bhang, ganja, charas, opium, country-made liquors and other intoxicants. State excise duties are levied at varying rates in all the states which have not prohibited their sales. The income of the states from excise duties increased from Rs. 49.4 crores in 1950-51 to Rs. 98368.70 crores in 2013-14 (BE) as per the table given below:

Table 7.5

Trend of State Excise Duties, Revenue Receipts

(Rs. in crores)

Year	Amount (Rs.)	Year	Amount(Rs.)
1950 – 51	49.4	2000 – 01	15825.28
1960 – 61	53.1	2010 – 11	61407.33
1970 – 71	139.9	2011 – 12	74762.44
1980 – 81	824.28	2012 – 13	88559.70
1990 – 91	4798.35	2013 – 14	98368.70

(Source : Report on Currency & Finance, R. B. I.)

(5) Entertainment Tax :

The entertainment tax was first introduced in Bengal in 1922. The State Governments have been empowered to levy the tax under the Government of India Act of 1919 and 1935. The Constitution of India, 1950 under entry 62 of list II of the Seventh Schedule also empowers the State Governments to levy entertainment tax.

An entertainment tax is levied by the state government in India on the value of tickets to places of entertainment in the state, such as, cinema, shows, theatres, circuses, sports etc. The tax is collected from the owners of entertainment houses and organisers of sports activities who in turn add the amount of the tax in the price of the tickets sold by them. They are usually levied at a flat rate and the incidence is therefore,proportional to the price of the tickets purchased by the consumer. Exemptions are granted if the entire proceeds of a show are to be devoted to any religious, charitable, philanthropic or national purpose or when the show is wholly for the advancement of education, agriculture or public health. The revenue of the states from entertainment tax increased from Rs. 6.4 crores in 1951-52 to Rs. 2030.87 crores in 2013-14 (Budget) as per the table given below:

Table 7.6

Trend of State Revenue from Entertainment Tax

(Rs. in crores)

Year	Amount (Rs.)	Year	Amount(Rs.)
1951 – 52	6.4	2000 – 01	1203.66
1960 – 61	9.8	2010 – 11	1244.41
1970 – 71	27.5	2011 – 12	1920.22
1980 – 81	255.4	2012 – 13	1800.27
1990 – 91	422.09	2013 – 14	2030.87

(Source: Report of Currency & Finance, R.B.I.)

(6) Stamp Duties, Court Fees and Registration Fees

The term itself denotes the duties levied on various deeds and documents executed as proof or record of certain legal transactions. Stamp duties are only popular with the government. In India, stamp duties are divided into judicial and non-judicial. Judicial stamps are levied under the Court Fees Act, 1870 and represent fees payable by persons having business in the law courts and public offences while non-judicial stamps are regulated by the Indian Stamp Act, 1899 duly amended by the Government of India from time to time. The stamp duties on bills, letters of credit, promissory notes, receipts etc. are within the legislative competence of the centre but proceeds are collected and appropriated by the State. Some States also apply surcharge on stamp duty.

Court fees were unknown in pre-British India and the existing system of levying court fees originated from Bengal Regulation No. 38 of 1875. Therefore, regulation was passed soon to use it in the form of stamp duties and this practice has since been continued. Now court fees are being levied under the Indian Court Fees Act, 1870. Moreover, surcharge of 33% was being levied on court fees from April, 1944. Since 1922, the subject of 'Stamp Duties' was transferred with certain reservations to the provincial lists, several states have transferred the duties on almost all the instruments in the schedule to the Indian Stamp Act except on those reserved for the Central Government. The trend of the revenue from these sources is given below.

Table 7.7

State Revenue from Stamp Duties, Court Fees and Registration

(Rs. in crores)

Year	Amount (Rs.)	Year	Amount(Rs.)
1951 – 52	55.06	2000 – 10	9343.53
1960 – 61	43.05	2010 – 11	54086.61
1970 – 71	139.90	2011 – 12	66697.19
1980 – 81	425.2	2012 – 13	66697.19
1990 – 91	2089.25	2013 – 14	92021.40

(Source : Report on Currency & Finance, R.B. I.)

(7) Taxes on Urban Immovable Property

When land is used for the purpose of agriculture, the return to the State is fixed under the land revenue settlements, giving regard to factors such as soil, yield, prices, rainfall, rental statistics, economic conditions of the area etc. But when land is put to nonagricultural uses like constructing a residential building or erecting an industrial plant, owner of the land gets an unearned increment because of the extraordinary increase in the value of land, particularly within or in the vicinity of growing towns and cities. This increment in land value can generally be attributed mostly to the expenditure incurred out of public revenues either by Government or by local bodies.

(8) Revenue from other Taxes

Besides the above important taxes, the state governments get considerable revenue from other taxes, such as, motor vehicle tax, passenger tax, profession tax, electricity duty, sugarcane cess, raw jute cess, betting tax etc. The income of the states from such taxes in 1980-81 was Rs. 49.1 crores which increased to Rs. 5177.40 crores in 2013-14 (Budget).

(9) Share in Union Taxes

The central government gives a definite share to the states over the net proceeds from taxes like income tax, excise duties and estate duty.

The share of each state is determined on the basis of recommendations of the latest Finance Commission. The Tenth Finance Commission in its report submitted to the President of India on November 26, 1994 and tabled on March 14, 1995 in Parliament recommended that the states' share in the centre's gross income tax collections be reduced from the existing 85% to 77.5%, while their share in the union excise duties be increased from 45 to 47.5%. The recommendations of the Tenth Finance Commission have been duly accepted and enforced by the Government of India. States' share in Central Government taxes during last few years stood.

Table – 7.8

Year	Rs. in crores
1951 – 52	54.0
1980 – 81	3788.9
1990 – 91	10055.60
2000 – 01	22311.52
2010 – 11	27940.88
2011 – 12	28726.43
2012 – 13	35300.49
2013 – 14	40847.63

(Source : Report on Currency and Finance, Reserve Bank of India)

7.4 Non-Tax Revenue :

Non-tax revenue of the states are of two types : grants received from the centre, and other non-tax revenue. The non-tax revenue of the states increased from Rs. 120 crores in 1950-51 to Rs. 81431 crores in increased from Rs.120 crores in 1950 – 51 to Rs.81431 crores in 2013 – 14 (B.E.) as shown in Table 7.9. The non-tax revenue of the states is given below.

Grants from Union Government: The central government gives grants-in-aid to the State Governments. These grants are utilised for making up the revenue gap in state budgets. The grants-in-aid to the states are constantly increasing on account of increasing expenditure of the states. Besides the regular grants-in-aid, the Central Government gives extraordinary grants to the states for meeting extraordinary situations, such as, natural calamities like floods, droughts, famines etc. The share of each state is determined on the basis of recommendations of the latest Finance Commission.

Table – 7.9
Non-Tax Revenue Receipts of States

	1990-91	2000-01	2010-11	2011-12	2012-13(RE)	2013-14(BE)
A. Non-Tax Revenue	5512.15	20148.68	63481.32	63030.12	36613.92	81431.31
(a) Net Contributions	-1435.72	-5071.19	-14724.83	-14658.52	-57409.41	-19251.14
1. Forest	395.47	-621.23	-2864.36	-2851.65	-3903.24	-4423.88
2. Power Projects	-73.09	-2798.17	-6300.86	-7947.84	-49007.85	-8871.29
3. Road & Water Transport Servicing	-89.88	-219.94	-541.34	-588.88	-832.73	-632.83
4. Dairy development	-90.49	-346.32	-257.61	-369.74	-279.58	-224.93
5. Industries	-103.97	637.75	-19.52	168.76	292.89	282.12
6. Mines & Minerals	62.33	952.39	6349.23	8698.40	10740.37	11899.09
7. Irrigation projects	-1568.86	-2830.18	-11781.20	-12801.60	-15922.17	-18535.61
(b) Dividends & profits	32.77	154.51	690.83	1034.03	1502.09	1256.19
1. Interest receipts	2414.40	11326.77	19362.95	18791.48	19866.15	20281.81
2. General services	1921.38	5934.30	19147.25	14992.57	20774.93	19054.99
3. Social and community services	586.94	2295.32	11848.79	12994.47	19832.53	22581.68
4. Economic services	2025.15	5663.48	27847.16	30910.12	33549.72	38763.97
(c). Grants from the Centre	12384.28	37430.69	169398.19	189407.55	267568.73	294119.81
(d). Transfer from funds	672.05	2054.21	1670.85	—	—	—
Total	62753.50	221791.26	932291.46	1086984.15	128882.88	1516211.51

Other Non-tax Revenue : Besides grants-in-aid, the state governments also receive revenue from interest receipts, dividends, income from general services, economic services (including income from State Public Enterprises), social and community services, their shows at various intervals are presented in Table 7.9.

7.5 CAPITAL RECEIPTS OF THE STATES :

With receipts to the capital receipts of the states, data in Table 7.10 reveals that, there found a rising trend during 1990-91 and 2013-14. It was Rs.118418 crores in 1990-91. It rose to Rs.181080 crores by 2010-11 and to Rs.245353 by 2013-14(B.E.). It consists of market loans, loans from central government. Other loans and miscellaneous capital receipts. It shows that there is a glancing rise in market loans during the past three decades. On the other hand, loans from central government showed a decreasing trend. With respect to other loans, table proves that repayments are more than gross receipts during 2013-14 (B.E.). In case of state provident funds also there is a tremendous rise from Rs.1886 crores to Rs.122306crores between 1990-91 and 2013-14. However, miscellaneous capital receipts increase from Rs.13848 crore in 1990-91 to Rs.35408crore by 2011-12 and to Rs.2882crore by 2013-14.

Table 7.10

Capital Receipts of the States

	1990-91	2000-01	2010-11	2011-12	2012-13(RE)	2013-14(BE)
1. Market loans(Net)	2434.30	12738.91	87817.75	126531.84	155391.10	214206.24
(i) gross receipts	2438.94	13108.01	103544.00	148944.52	185907.95	246805.93
(ii) Repayments	4.64	369.10	15726.25	22412.68	30516.85	32599.69
2. Loans from Central (Net)	9980.08	13812.45	5355.40	-450.81	6149.93	8719.49
(i)Gross receipts	14018.12	24139.92	15984.16	10638.68	16556.78	19753.53
(ii) Repayments	4038.04	10327.47	10628.76	11089.49	10406.85	11034.04
3. Other loans (net)	270.34	40567.11	35907.58	2330.65	6047.18	-2760.98
(i) Gross receipts	1398.72	43874.99	68784.86	39599.92	51923.73	48592.45
(ii) Repayments	1128.38	3307.88	32877.28	37269.27	45876.55	51353.43
4. State Provident funds (Net)	1885.64	9144.68	23674.80	22646.32	21049.54	22306.08
(i) Gross receipts	3960.04	20453.83	52445.94	58178.62	59554.15	65776.67
(ii) Repayments	2074.40	11309.15	28771.14	35532.30	38504.61	43470.59
5. Miscellaneous Capital receipts (net)	3848.04	16455.26	28324.02	35407.57	14612.12	2882.28
Total	18418.40	927118.41	181079.55	186465.57	203249.87	245353.41

7.6 TRENDS IN REVENUE OF THE STATE GOVERNMENTS :

The important trends in the revenues of the states may be summarized as follows :

(i) Revenues of the State Governments, as in the case of the central government, have shown in a continuous and steadily rising tendency. As the functions of the States have expanded and as their responsibilities have increased with rising population, their need for funds has increased considerably. New taxes have been imposed and the rates of old taxes have been raised.

(ii) Besides tax revenue, States have two other sources of income, viz., non-tax revenue which consists of income from administrative services profits of state-run enterprises, etc., and grans in-aid from the Centre.

(iii) Part of the tax revenue of the States is from taxes imposed and collected by the Centre but the proceeds of which are shared with the states i.e., the personal income tax, the estate duty and the Central excise duties. In other words, at present 35 per cent of the tax revenue of the states consists of their share in the central taxes.

(iv) Commodity taxes have always been important in state revenues; but since 1951-52 their dominance has increased considerably. This shows how the states depend upon the general masses of the people for their finance. Besides, the States' tax revenues are also predominantly regressive, falling heavily upon the middle and lower income groups.

(v) In 1951-52, sales tax brought the largest revenue to the states followed closely by the State excises and land tax. Even now, the sales tax is the single largest tax for the states.

7.7 CONCLUSION :

Every state government collects revenue from different sources to meet its expenditure. The important sources to meet its expenditure. The important sources of revenue for the state governments are state sales tax revenue, shows in central taxes, grants-in-aid and other contributions from central government. State governments also receive income from sources other than taxes. These sources include interest receipts, dividing, general services, social and community services and economic services.

7.8 MODEL QUESTIONS :

1. Give a brief note on various sources of revenue of state governments in India.
2. Examine the trends in revenue of state governemnts.
3. Write about non-tax revenue to the state governments.

7.9 SUGGESTED READINGS :

- R. Venkataraman : State Finances in India
- I.S. Gulati and K.K. George : Essays in Federal Financial Relations
- Economic Survey, GOI : Various issues
- Reserve Bank of India : State finances – A Study of Budgets of 2013-14.
- Indian Public Finance Statistics2013-14 : Ministry of Finance Department of Economic Affairs, GOI.

LESSON – 8

EXPENDITURE OF STATE GOVERNMENTS

Objectives:

After completing this lesson you are able to understand

1) What is the classification of state expenditure.
2) What do you mean by revenue expenditure of state government.
3) What do you mean by capital expenditure of the state government
4) What are the key features of state finances
5) What about recent trends in Fiscal performance of states.
6) What are the state level fiscal reforms and
7) What are the criticisms and suggestions on state finances.

STRUCTURE:

8.1 INTRODUCTION :

The Federal Fiscal scheme of Indian constitution leaves a yawning gap between the fiscal requirements of the states and their revenue resources there by putting them under surveillance of the centre on whom they chronically relay for covering their deficits. The main reasons for this persisting leg and consequential dependence of states are, state's jurisdiction over direct taxes though wide but administratively very inconvenient and interms of yield very inadequate and inelastic. Similarly, the states are involved in even increasing responsibilities and such need capital and current outlay of great magnitude. The social services like health, education, general welfare are devouring consumers of huge friends. Obviously, the states are troubled from both sides as them have less money and more responsibilities. Further, the two highly significant props of a Government, foreign and deficit financing are the monopoly of the centre.

8.2 CLASSIFICATION OF THE EXPENDITURE OF STATE GOVERNMENT :

Like the central government of India, the expenditure of the state governments is also divide into capital and revenue accounts. Revenue account covers the current receipts and expenditures, while the capital account deals with the acquisition and disposal of physical assets and liabilities such as loans, investments etc.,

(I) Revenue Expenditure : Expenditure on revenue account has three components viz. (A) developmental expenditure (B) Non-Developmental expenditure and (C) contribution to local bodies. Developmental expenditure constitutes about 51.5percent of the total expenditure where as non-developmental expenditure constitutes of 46.7 percent and the balance i.e., 2 percent goes to local bodies. The main features of expenditure on revenue account can be briefly stated as follows :

(i) It has grown faster than revenue receipts but the growth has been only marginal and therefore the state budgets are generally in deficit.

(ii) The developmental expenditure has increased at a fast pace. It is now around 65 percent of the total expenditure of the State Governemnts.

(iii) Over the years, the debt servicing changes have increased rapidly. A major portion of this expenditure is accounted by the indebtedness of the states to the government of India.

(iv) The huge increase was partly due to the expenditure on government activities but due to sharp rise in prices and wages consequent to continuous inflationary pressure during few decades.

(a) Development Expenditure : All the expenses which are incurred for the social and economic development of the respective states are included under the head ‘development expenditure’. Under social services, the main heads included are education, public health, sports, arts, culture, family welfare, water supply and sanitation, housing, urban development, relief and rehabilitation of displaced persons etc. these services confer a positive advantage on the community and the more developed these services are, the happier and better world be the people residing in the state concerned. The states provide free and compulsory primary education; they also provide facilities for higher education and also for technical and vocational education. The single most important item of state expenditure is education which accounts for nearly 32% of the total development expenditure. The states also establish and maintain hospitals, dispensaries etc. and keep a large staff of qualified doctors and trained nurses, compounders, public health workers etc.,

Under economic services, the main heads included are agriculture and allied services, rural development, special area programmes, irrigation, flood control, energy, industry, and minerals, transport and communications, road construction, science, technology, environment etc. The developmental expenditure of the states has been increased many folds during the last three decades. It was only Rs.40,360.28 in 1990 - 91 and increased to Rs.8,24,528.42 crores by 2013-14(B.E.) as shown in Table 8.1.

(b) Non-development Expenditure : The non-development expenditure consists of expenditure on the collection of the taxes and duties (fiscal services), administrative services, Interest payments, famine relief, pensions & miscellaneous general expenses. It also includes expenditure incurred on police, judiciary and jails. It is the responsibility of the state government to provide security, and maintain law and order in the state. It rose from Rs.26421.20 crore in 1990-91 to Rs.6,34,644.28 by 2013-14 (Table 8.1).

(c) **Others :** In addition to the above, State Governments have to make every year large grants to local bodies, such as, municipalities and district boards, Zila parishads, Corporations etc. for meeting deficits in their budgets and their expenditure for certain essential services.

Table 8.1

Revenue Expenditure of the State Governments

	1990-91	2000-01	2010-11	2011-12	2012-13	2013-14
A. Non-Developmental expenditure.	26421.20	129010.88	411375.50	482331.58	557275.05	634644.28
B. Develpmental expenditure	40360.28	138415.82	493771.85	576714.79	706917.65	824528.42
C. Transfer of funds	1078.74	4539.65	10782.68	-	-	-
Total	**67860.22**	**271966.35**	**915930.03**	**1059046.37**	**1264192.70**	**1459172.70**

(II) Capital Expenditure

The capital expenditure of the states has been increasing rapidly from the date of introduction of planning in our country. The capital expenditure is financed out of capital receipts, special loans and advances raised by the states along with advances and grants provided by the centre to the states. Part of the capital expenditure consists of capital outlays on such development projects as multipurpose river valley schemes, schemes of agricultural research and development, irrigation and navigation, power projects, road transport, buildings, roads, water works, industrial development etc. Another part of the capital expenditure consists of discharge of permanent debt, repayment of loans to the centre, loans and advances made to the states by others.

The capital expenditure of the states is also increasing rapidly. The trend has been very rapid ever since independence and particularly after the introduction of planning expenditure of the states has increased from Rs. 190 crores in 1951-52 to Rs. 44,952.1 crores in 1998-99 It increased to Rs.2,62,320.18 by 2013-14 (R.E.) and to Rs.3,01,674.19 by budget 2013-14(B.E.) as shown in Table 8.2. The largest part of the total disbursement has been on development of capital outlays. Considering the development requirements of the states, the capital expenditure of the states is expected to increase at much faster rate in times to come.

Table 8.2

Revenue Expenditure of the State Governments

	1990-91	2000-01	2010-11	2011-12	2012-13	2013-14
A. Non-Developmental expenditure.	14.16	252.58	2659.29	3173.50	7484.80	13682.77
B. Develpmental expenditure	9185.81	29985.60	152819.65	172450.72	229674.51	263609.83
C. Transfer of funds	4250.58	4484.82	19256.49	24776.63	25160.87	24381.59
Total	**13450.55**	**34723.00**	**174735.41**	**200400.85**	**262320.18**	**301674.19**

8.3 RECENT TRENDS IN STATE EXPENDITURES

State Finances in India have undergone a number of important changes in recent years during the post-independence period. The important ones are as follows :

(1) Rapid Increase in Revenue and Expenditure : Since the commencement of Five Year Plans, both revenue and expenditure of the State Governments have increased considerably. There has been an increase in revenues because not only rates of existing taxes, have been enhanced but several new taxes like entertainment tax, electricity duties, taxes on vehicles etc. have also been introduced. Similarly, expenditures of the state governments have increased as there has been rapid increase in expenditure on both social and community services since independence. Inflationary rise in the general price level has also contributed to bring about this situation.

(2) Sales Tax at the Top : The emergence of sales tax as a major contributor to the income of the sates is another important development.

(3) Alternative Trends in Excise Revenues : There has been a sharp decline in revenue from state excise. It is on account of the policy of prohibition which has been introduced completely or partially in several states. This made the financial position of several State Governments very weak. As a matter of fact before the adoption of the policy of prohibition, excise revenue formed a substantial part of the total state tax revenue. State Governments have been forced to look for other sources of revenue and restrict their activities.

(4) Political Announcements for Gaining Cheap Mass Popularity : Recently, a competitive spirit of making political announcements for getting cheap mass popularity have developed among the State Governments, such as, selling rice at Rs. 2 per kilo and similarly, selling wheat at Rs. 2 per kilo. These announcements have caused heavy strain on the limited financial resources of the State Governments. The object is simply to gain cheap popularity and win the public support. It is yet to be seen as to how long the State Governments are going to fulfil their promises. Is it not the sign of financial bankruptcy of the state governments on account of making such promises ?

(5) Regressive : The regressive character of state revenue has been accentuated all the more. This is mostly because of the imposition of sales tax even on necessaries and the introduction of several new taxes. State excise duties are regressive in nature because most of the burden falls on the lower income group people who mostly consume such intoxicants.

(6) Greater Reliance on Centre : On account of the rapid increase in the expenditure of State Governments, the)' have started receiving increasing grants from the centre ih recent years. The recommendations of the various Finance Commissions which have been duly accepted by the Central Government have substantially augmented the state revenues. For example, the Tenth Finance Commission has recommended that the grants given to state governments by the Central Government should be equal to the amount of deficits as estimated for each of the years between 1995-96 and 1999-2000.

(7) Development Expenditure: Another major recent trend is the rapidly increasing expenditure of the State Governments on development. Total development expenditure of the State Governments on revenue account increased from Rs. 196 crores in 1951-52 to Rs. 1,87,501.5 crores in 1999-2000 and to Rs.8,24,528.42 by 2013-14 (B.E.). The increase is particularly in education expenditure. It is a healthy sign and should be welcomed.

(8) Long-Term Borrowings : As compared with previous years, the State Governments are now resorting to long-term borrowings. They are doing so for financing their development projects. In this way, the strain on the future resources of the State Governments is increasing. It is not a healthy sign in any way.

(9) Diversification : There is also a trend towards diversification. Reliance on new taxes is increasing as compared to old taxes. Similarly, diversification lies in expenditure also.

8.4 KEY FEATURES OF STATE EXPENDITURES :

The fiscal deficit of state governments, as shown in Table 8.1 increased from 3.3% of GDP in 1990 – 91 to 1.5 percent by 2007 – 08. But in the light of global recession and higher growth of revenue expenditure has largely contribute to the deterioration and by 2014-15(BE) reached to 2.3 percent. The revenue deficit has nearly trebled from 0.9% of GDP in 1990 – 91 to 2.6% in 2001 – 02. But become of FR BMA implementation it reached to 0.9% by 2007 – 08 and reached to -0.4% by 2014 – 15 (BE).

8.5 FISCAL PERFORMANCE OF THE STATES :

Fiscal consolidation of states during recent years was largely revenue-led, with significant increases in both own tax revenue as well as current transfers from the centre, the latter reflecting the enhancements recommended by the Thirteenth Finance Commission. However, some deterioration in state government finances was seen in 2013-14, while improvement is budgeted in 201-15, Revenue surplus as a proportion of GDP during 2013-14 (RE) was negligible compared to the previous year's 0.2 per cent. Capital outlay GDP ratio during 2013 – 14 (RE) increased marginally by 0.4 per cent over the previous year, indicating improvement in the quality of expenditure. For the year 2014-15, the consolidated revenue surplus is projected to increase to 0.4 per cent of the GDP. Gross fiscal deficit (GFD) and primary deficit as proportions to GDP are budgeted to decline to 2.3 per cent and 0.8 per cent respectively in 2014 – 15 from 2.4 per cent and 0.9 per cent respectively in 2013 – 14 (RE) pointing out the intent for fiscal consolidation by states. The projected decline in GFD – GDP ratio in 2014-15 is mainly due to an increase in the revenue receipts resulting from the current transfers from the centre. The expenditure pattern shows that the committed expenditure GDP ratio (comprising interest payments, administrative services, and pension) will broadly remain unchanged during 2014 – 15 (BE), while overall expenditure as a ratio to GDP is budgeted to increase).

Table 8.3 Receipts and Disbursements of State and Consolidated General Government

(Crore)

Item	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
1	2	3	4	5	6	7	8	9
State Governemnts								
I. Total Receipts (A+B)	765735	891292	1007633	1173575	1367917	1547185	1826873	2173786
A. Revenue Receipts (1+2)	623747	694658	768137	935347	1098531	1241726	1486814	1796822
1. Tax Receipts of which	437948	482983	528075	680198	812987	943797	1083199	1232655
States Own Tax Revenue	286546	321930	363061	460709	557396	655223	753961	851807
2. Non-tax Receipts of which	185799	211675	240062	255149	285544	297929	403615	564167
Interest Receipts	12637	16.356	15.294	15625	18582	24061	23466	24475
B. Capital Receipts of which	141987	196634	239497	238227	269385	305460	340059	376964
Recovery of Loans and Advances	7770	11072	8088	4995	17157	7231	8930	4550
II. Total Disbursements (a+b+c)	752324	882332	1015330	1158730	1351612	1524371	1861298	2192984
a) Revenue	580805	681985	799154	932297	1074571	1222292	1482817	1746886

b) Capital	157258	184376	198689	207617	238150	272156	347904	423913
c) Loans and Advances	14261	15971	17487	18816	38891	29923	30577	22185
III. Revenue Deficit	-42943	-12672	31017	-3051	-23960	19434	-3997	-49936
IV. Gross Fiscal Deficit	75455	134589	188819	161461	168353	194066	278156	297944
State Governemnts	**As % of GDP**							
I. Total Receipts (A+B)	15.4	15.8	15.6	15.1	15.2	15.3	16.1	16.9
A. Revenue Receipts (1+2)	12.5	12.3	11.9	12	12.2	12.3	13.1	14
1. Tax Receipts of which	8.8	8.6	8.2	8.7	9	9.3	9.5	9.6
States Own Tax Revenue	5.7	5.7	5.6	5.9	6.2	6.5	6.6	6.6
2. Non-tax Receipts of which	3.7	3.8	3.7	3.3	3.2	2.9	3.6	4.4
Interest Receipts	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
B. Capital Receipts of which	2.8	3.5	3.7	3.1	3	3	3	2.9
Recovery of Loans and Advances	0.2	0.2	0.1	0.1	0.2	0.1	0.1	0
II. Total Disbursements (a+b+c)	15.1	15.7	15.7	14.9	15	15.1	16.4	17
a) Revenue	11.6	12.1	12.3	12	11.9	12.1	13.1	13.6
b) Capital	3.2	3.3	3.1	2.7	2.6	2.7	3.1	3.3
c) Loans and Advances	0.3	0.3	0.3	0.2	0.4	0.3	0.3	0.2
III. Revenue Deficit	-0.9	-0.2	0.5	0	-0.3	-0.2	0	-0.4
IV. Gross Fiscal Deficit	1.5	2.4	2.9	2.1	1.9	1.9	2.4	2.3

Source : Reserve Bank of India

BE : Budget Estimates Re : Revised Estimates

Notes : (1) Disinvestment proceeds are inclusive of miscellaneous capital receipts of the states.

(2) Negative (-) sign indicates surplus in deficit indicators

(3) Capital receipts include public accounts on a net basis

(4) Capital disbursements are exclusive of public accounts.

(5) General Government consists of Central Government & State Government combined.

8.6 STATE LEVEL FISCAL REFORMS :

The States have also taken a number of steps for fiscal adjustment viz; enactment of FRBMA and introduction of monthly cash flow system for improving their financial position. The Twelfth Finance Commission (TFC) also recommended a two stage benefit scheme, named as Debt consolidation and Waiver Facility (DCRF) for enabling the States to improve their fiscal performance. The first stage related to the consolidation of Central loans from Ministry of Finance contracted by States till March 31, 2004 and outstanding as on March 31, 2005 for a fresh term of 20 years at 7.5% rate of interest, prospectively from the year they enact FRBMA. The second stage was the debt write off scheme after debt consolidation linked to fiscal performance subject to: (i) reduction of revenue deficit every year starting from 2004-05, when compared to the average of the preceding three years in the process, if revenue deficit is eliminated completely by 2008-09, the State gets full benefit of waiver; (ii) reduction in revenue deficit should be equal to at least the interest rate relief on account of consolidation; and (iii) Containing fiscal deficit/ GSDP ratio at the 2004-05 level in all subsequent years.

According to TFC estimates, the debt award during 2005-10 for all States would be Rs. 21,275 crore in interest payments and Rs. 11,929 crore in repayment of consolidated central loans. If all states eliminate revenue deficit by 2008-09, the amount of debt waiver available to them would be around Rs. 33,205 crore. For eliminating revenue deficit and to bring down the fiscal deficit to 3% of GSDP and to achieve other targets of TFC, they are required to draw up their own ‘Fiscal Correction Paths’ (FCP). Till 2006-07 , 23

States had enacted FRBMAs and 21 States had drawn up their FCPs. Debt consolidation had been done for 19 States, viz, Andhra, Assam, Bihar, Chattisgarh, Gujarat, Haryana, H.P., Karnataka, Kerala, M.P., Maharashtra, Manipur, Orissa, Punjab, Rajasthan, T.N., Tripura, Uttarakhand and U.P., Six States viz. Assam, Bihar, Kerala, Maharashtra, Tripura and Uttarakhand were not found eligible for debt waiver in 2005-06. In case of 13 States the debt waiver amount was estimated at Rs. 3,856 crore.

Strengthening local bodies and panchayati raj institutions has also been envisaged by some states through devolution based on recommendations or constitution of state finance commissions (SFC's). While Himachal Pradesh has accepted the recommendations of tis SFC, Tamilnadu, taking into account the special needs of rural local bodies, has indicated so that it will continue to devolve funds between rural and urban local bodies in the existing 58:42 as against a ratio of 56:44 recommended by its Fourth S.F.C.

Over the years, state governments have implemented various intitutional measures which have helped them consolidate their finances and improve fiscal discipline and fiscal transparency. Institutional reforms implemented by state governments such as FRBM Act, VAT, new pension scheme, ceiling on gaurantees and dsetting up a consolidated sinking fund and a gurantee redumption fund etc.

The Twenteeth Finance Commission recommended annual targets for gross fiscal deficip - GDP ratio and revenue deficit - GSDP ratio upto 2014-15 for individual states. A comparision of the stipulated targets for 2013-14 and 2014-15 with rolling deficit target set by the state governments in their budget shows that the states expect to perform better than the FC-XII targets.

8.7 CRITICISM OR DEFECTS OF STATE FINANCES :

State finances are subject to severe criticism from different corners. They suffer from several serious defects. The major criticisms and defects are as follows:

(1) **Regressive Taxation:** The regressive character of the state taxes is subjected to severe criticism. The poor bear the heaviest burden of state taxes. On the contrary, the rich classes escape relatively with much lower burden of state taxation. For example, a large part of the sales tax is contributed by the poor and the middle-class people.

(2) **Inadequate and Inelastic Revenue :** It is said that the State Government sources of revenue are inadequate, static and inelastic. Most of the sources of revenue of State Governments are not productive, such as, stamps and registration fees.

(3) **Conservative Policy :** The State Governments are charged with adopting conservative policy. They have not taken adequate interest in increasing and developing new sources of income.

(4) **Excessive Non-plan Expenditure :** The state governments are charged with incurring excessive expenditure on security services like police, jails and courts, whereas the law and order situation in almost every state is deteriorating every day. There has been a rapid increase in crimes, such as, murder, theft etc.

(5) **Lack of Uniformity :** There is total lack of uniformity in the tax structure of the State Governments. There is no co-ordination in various taxes and their rates differ from state to state, such as, sales tax. Similarly, some commodities are exempted from sales tax in some states but not in others.

8.8 SUGGESTIONS FOR REFORMS :

Prof G. Thimmaiah in his article on State Finances : "How to improve them", which appeared in Economic Times on 11th March, 1993 has suggested that the states should reduce their revenue deficits and generate surplus on revenue account to be utilised for plan purposes. For this, the subsidies at the state level should be phased and there should be reduction in other non-plan expenditure. As a matter of fact, a number of suggestions may be given for improving State Finances in India. The important ones are as follows :

(1) Emphasis should be laid on increasing tax revenues of the State Governments by better collections of the taxes.

(2) The regressive character of the state taxes should be toned down.

(3) Uniformity in the tax system should be ensured in the different states. For example, there should be uniformity in the rates of sales tax in all the states.

(4) A better co-ordination between the finances of the State Governments and local bodies should be established.

(5) There should be economy in wasteful expenditure at the state level.

(6) The states should reduce their revenue deficits. It can be done by oving the efficiency of the staff.

(7) There should be reorganisation of the state-level public enterprises. Emphasis should be laid on increasing their productive efficiency. It should be clearly notified that the state is not going to bear the burden of state enterprises running in losses any more. They should be asked either to increase their productive efficiency or should be closed down or handed over to private sector.

(8) Emphasis should be laid on improving the law and order situation in the states. The law and order situation, particularly in U.P. and Bihar is terrible.

(9) Emphasis should be laid on improving the efficiency of the State Government employees. Corrupt and inefficient employees should be punished severely. It should be clearly stated that they are State Government employees and not of political leaders. Short-time refresher courses should be introduced at regular intervals.

(10) State Government ministers should be refrained from making announcements involving huge funds for achieving their own political objectives and gaining cheap mass popularity.

(11) Code of conduct for State Government ministers should be introduced. They should be asked to follow it strictly, failing which they should cease to be ministers.

8.9 CONCLUSION :

The situation, really, is so alarming that it needs immediate correction. While, increase in the rate of growth of revenues, no doubt, can be a solution but if the rate of growth of expenditure continues to be higher than that of revenues, then the only reasonable step would be to curtail expenditure. We have already discussed the various measures which the governments should take and no useful purpose would be served to repeat them. The governments should select such measures which may not only produce immediate result but also have a long run effect of regulating the growth of total expenditure in such a way that the debt/GDP ratio will stabilise at a reasonable level.

8.10 MODEL QUESTIONS :

1. Write a brief note on classification of expenditure of state governments.
2. Write about Fiscal performance of the states and also briefly explain about state level Fiscal reforms.
3. Critically examine state finances. Suggest remedies.

8.11 SUGGESTED READINGS :

Government of India	:	Economic Surveys
S.S. Bagai	:	Black Money in India
D.N. Gadhok	:	Parliamentary Control Over Government Expenditure, 1976
R.C. Agarwal	:	Public Finance : Theory and Practice
T.N. Hajela	:	Public Finance

MODULE-3

LESSON -1

RESOURCE MOBILIZATION AND REVENUE ALLOCATION- FINANCE COMMISSION

9.14: references

9.0: Introduction

In this unit, the resource mobilization and revenue allocation under different finance commission is discussed. Resource obligation and revenue allocation is an important aspect of centre state financial relations. There are many resources at the centre and the at present the centre has taken responsibilities maintaining the social security such as food security in addition to the defense and other responsibilities, In this contest the judiously and equity is needed with regarding to the distribution of resources at the disposable of the centre. After reading this unit you will know that the background and the distribution of the resources by different finance commissions since independence

9.1: Constitutional Provision of the finance commission

A Finance Commission is to be set up under Article 280 of the Constitution, by the President of India for every five years or earlier if the president of India feels it necessary Unlike in the USA. Canada and Australia, the Indian Finance Commission was given Constitutional status.

Table 9.- I: Central Finance Commission - Chairmen

Finance Commission	Name of the Chairman	Year of Appointment
First Finance Commission	Sri K. C. Neogy	1951
Second Finance Commission	Sri K. Santhanam	1656
third Finance Commission	Dr. A.K, Chanda	1960
Fourth Finance Commission	Sri P.V. Rajamannar	1964
Fifth Finance Commission	Sri Mahavir Thyagi	1968
Sixth ‘Finance Commission	Sri Kasu Brahmananda Reddy	1972
Seven Finance Commission	SriJ.M. Shelath	1977
Eight Finance Commission	SriY.B. Chavan	1982
Ninth Finance Commission	SriN.K.P. Salve	1987
Tenth Finance Commission	Sri K.C. Panth	1992
Eleventh Finance Commission	Dr. A.M. Khusro	1998
Twelfth Finance Commission	Dr. C. Rangarajan	2002
Thirteenth Finance Commission	Vijay Kelkar	2007
Fourteenth finance commission	Dr. Y.V.Reddy	2014

Constitutional provisions are made the unbiased, legal and statutory Finance... Commission by which the financial autonomy of the states and financial stake of the Center can be preserved . so afar 14 Finance Commissions have been appointed since 1951.The finance commission consists of five members including the chair appointed for a term. According to the. Constitution, the Finance Commission is required to make Recommendations relating to fiscal transfers. Moreover, the president of India may refer any item to the Finance Commission for its recommendations in the interest of sound finance. The following table can know details of the finance commissions and its chairs.

According to Table -9.1, it may be noted that so far fourteen Finance Commissions have been recommendations relating to fiscal transfers between the Centre and States and are by the Government. The government two years ago under the chair of Dr. Y.V.Reddy has appointed the fourteenth Finance Commission, former Governor of RBI, which is, submitted its report on March 2014 to the president.

9.2. Finance commission- functions

The Finance Commission has to make recommendations to the President of India relating to the following aspects under Article 280 (3) of the constitution. a) To determine the States' share of the shareable taxes, both of obligatory sharing and optional sharing taxes, and the principles that govern the inter-state distribution of the net process set apart of states' purpose' b) To determine the Quantum of grants-in-aid to be made from the Consolidated Fund of India under Article 275(l) to those States which are in need of revenues and to evolve the principles that govern the eligibility of states to get grants-in-aid. c) Any other matter referred to the commission by the president of India in the interest in sound finance.

The functions detailed above can be divided into three categories. To distribute the tax revenue from the shareable taxes, 2) to recommend grants in -aid to the states in need of revenues. 3) Other recommendations. It has been customary to accept the recommendation the parliament, except in few cases, though the constitution has not specified anywhere that the commission's recommendations would be accepted in toto. The fiscal transfers through the Finance Commission, the Planning Commission and through the Central Ministries of the Union Government. The first category is the share from the net proceeds from shareable taxes: while the second is the grants-in-aid (Plan and Non-plan) and the third being loans for different purposes. The fiscal transfers from the Centre to States between First Five Year Plan and 2009-2010 may be seen in Table-9.2.

The relative shares of Finance Commission transfers and other channels of revenue transfers to State Governments are presented in Table 9.2.The trends show that Finance Commission transfers, comprising tax devolution and grants to the States, have remained the major source of transfers to the States. These transfers increased from 60.1 per cent of total transfers in the award period of the FC-VIII to 68.6 per cent in the award period of the FC-X and remained stable till the award period of the FC-XII. In 2014-15, direct transfers have been brought within the ambit of the non-statutory Plan transfers to State Governments.

Table -9.2: revenue Transfers from the Centre to States

	FINANCE COMMISSION TRANSFERS			Other transfers				
COMMISSIONS	Share in central taxes	Grants	Total transfers	Plan grants	Non plan grants	Total other transfers	Total transfers	% in GDP
FCVIII	53.48	6.65	60.13	32.8	4.07	39.87	100	4.83
FCIX	52.98	8.48	61.46	35.91	2.63	38.54	100	4.89
FCX	62.06	6.55	68.61	29.52	1.87	31.39	100	4.09
FCXI	58.38	11	69.38	28.65	1.97	30.62	100	4.16
FCXII	56.79	12.12	68.91	28.34	2.75	31.09	100	4.86
FCXII	57.49	9.51	67.44	31.14	1.42	32.56	100	4.95
2010-11FC	58.6	8.42	67.02	28.32	4.66	32.98	100	4.81
2011-12	59.29	10.42	69.5	28.96	1.54	30.5	100	4.78
2012-13	62.46	9.7	72.16	27.44	0.4	27.74	100	4.62
2013-14(RE)	61.91	10.76	72.67	26.27	1.06	27.33	100	4.53
2014-15 (BE)	51.25	8.67	59.92	39.49	0.59	40.08	100	5.79

The Finance Commission transfers are predominantly in the form of tax devolution and, to a lesser extent, grants. The grants include non-Plan revenue deficit grants, grants to local bodies, grants for disaster management, sector-specific grants and state-specific grants. The Finance Commission Grants accounted for 11 per cent of revenue transfers in the FC-XI period and the FC-XII raised the share to over 12 per cent. However, it declined to 9.5 per cent in the FC-XIII award period. 5.6 The share of Plan grants in total transfers to the States has shown an increasing trend in recent years, particularly since 2006-07. However, within Plan grants, the share of normal Plan assistance distributed under the Gadgil-Mukherjee formula has shown a declining trend, particularly after the practice of the Union Government giving Plan loans to State Governments was stopped following the recommendations of the FC-XII. Only the North-eastern States as well as the hill states of Himachal Pradesh, Jammu and Kashmir and Uttarakhand continue to receive substantial portion of Plan grants by way of normal assistance for state Plans. The decline in the share of formula-based grants also reflects the faster expansion of discretionary grants for Central Sponsored Schemes(CSS). In fact, when the grants given directly to implementing agencies for CSS are taken into account, the decline in the formula-based transfers is even sharper. In 2014-15, with these grants being channeled through the State budgets, the share of both Finance Commission transfers and the overall formula-based transfers will show a further decline.

Grants other than Finance Commission and Plan grants are insignificant. In the FC-XIII period, these were estimated at 1.4 per cent of total revenue transfers to the States. Though their share increased briefly in 2010-11 because of grants released by way of compensation to States for phasing out of Central sales tax (CST), it declined overall in the FC-XIII award period. It may be noted that the fiscal transfers have increased from Rs. 1431 crores during First Five Year Plan to Rs. 3, 23,561 crores during the Eighth Five Year Plan. These transfers were estimated to be Rs. 1,13,801 crores in 2000-2001.There is a favorable trend to the States in allocating the resources. The proportion of grants in the total fiscal transfers has been declining

between First and Eighth Five Year Plan period, which is good to the States. However, not all these transfers are made through the statutory Finance Commission. So let us know the role of the Finance Commission more elaborately in resource mobilization. Shared tax revenue is the most important fiscal transfers among the fiscal transfers made through it Finance Commission
9.3: shared tax revenue

Provisions have been made in the constitution to transfer a share from the central taxes to states. According to Article 270 of the Constitution, the centre has to give a share from income Tax net proceeds. Similarly, a share from the net proceeds from Union Excise Duties under Article 272 may be given to the States if the Parliament thus decides. Therefore, it means while a share from the net proceeds from Income Tax shall be given compulsorily to states, share from Union Excise Duties may be given to the states. However, almost alt the Finance Commissions recommended share from these two shareable taxes and the government accepted the recommendations. It may be noted that the above constitutional arrangement has been in practice until the 80th Amendment. According to the 80th Constitutional Amendment share from all the taxes of the Central

9:3 : Finance Commissions - income Tax and Union Excise Duty Revenue States' Share

Finance Commission	States 'Share in Income Tax	States' share in Union Excise Duties
Finance Commission	50-55	40 From Tobacco, Matches and Vig. products
2nd Finance Commission	55-60	25 8 goods (tobacco, matches, veg. Products, sugar, coffee, tea, paper and veg. Products)
3rd Finance Commission	60-66 2/3	20 All commodities
4th Finance Commission	66 2/3-75	20 All commodities
5th Finance Commission	75-no change	20 All commodities
6th Finance Commission	75-80	20 All commodities
7th Finance Commission	80-85	40 All commodities
8th Finance Commission	85-no change	45 All commodities (5% for deficit states only)
9th Finance Commission	85-no change	45 All commodities
10th Finance Commission	85-77.5	47.5 All commodities s (7.5 %for deficit states only)
11th Finance commission	85	all commodities
12th Finance commission	78	all commodities
13th Finance commission	80	All commodities

Government instead of only from Income Tax and Union Excise Duty. This arrangement is known as Global Sharing. According to the 10th and 11th finance Commissions recommendations 29 per cent and 29.5 per cent of the net proceeds from all the taxes (including Additional Excise Duty).

Table – 9.3 explains the percentage shares of Income Tax and Union Excise Duty net proceeds as recommended by successive Finance Commissions. For instance, the Income Tax share has increased to 85 per cent by the Eighth Finance Commission. The ninth finance commission retained the States' share while it was reduced to 77 .5 per cent by the 10th finance Commission. It may be noted that the Finance Commission for the first time has reduced the existing share from income Tax. The Government through a constitutional amendment implemented the alterative scheme recommended by the 10th finance commission, which was subsequently accepted by the 11th fiancé commission. Therefore, the earth while sharing of Income Tax and Union Excise Duties net proceeds lost its importance. The First Finance Commission recommended 40 per cent of Union Excise Duties on three commodities Of tobacco, matches and vegetable products while the Second Finance Commission extended the sharing to 8 commodities such as sugar, coffee, tea, paper, vegetable oils including the above three commodities reducing the States' share to 25 per cent. The Third Finance Commission reduced the States' share to 20 per cent extended the coverage of excise duty lo all commodities which was, more or less, continued till the Seventh Finance Commission . The Seventh Finance Commission recommended States' share to 40 per cent with a view to increase the resources at the States level. The Eight Finance Commission increased the states share to 45 per cent. However, it recommended that the increased 5 per cent age revenue should be distributed only among those states having budgetary deficits on their non-plan revenue account. While the State' share was rationed by the Ninth Finance Commission the 45 per cent the 10th Finance Commission recommended 47.5 per cent with the condition that the 7,5 percentage share be distributed among States with revenue deficits. It may be noted that the revenue from tax sharing chandelled through the Finance Commission has increased substantially. For example, the revenue from shared tax revenue has increased from Rs. 344. 10 crores during First Five Year Plan to Rs. 1,3 1,150 crores during 8th Five Year Plan.

9.4.: additional excise duties

The states withdrew their sales tax on tobacco. sugar and mill-made textiles since 1957-58 onwards. Instead. the centre has been levying Additional Excise Duties on these commodities and the revenue thus accrued 'has been distributed among the states" The successive Finance Commissions have been entrusted the responsibility to evolve principles to distribute the net proceeds from these duties and determine the percentage share to each state. But the 10th and 11th Finance Commission in their alternative scheme If devolution recommended 3 per cent and 1.5 per cent respectively from the centre's tax revenue in lien of Additional Excise Duties where Sales Tax on these three is not imposed.

9.4.1: Transfers from the union to states as percentage of gross revenue receipts

The FC-XIII had noted that the trends in revenue transfers had exceeded the indicative ceiling of 38 per cent of the gross revenues of the Union Government set by the FC-XII for its award period. Keeping in view the increase in the tax devolution, the FC-XIII recommended raising the indicative ceiling to 39.5 per cent. The shares of revenue transfers from the Union Government to State Governments are shown in Table 9.4. The estimated 41 per cent total revenue transfers in the entire FC-XIII period have already exceeded the indicative ceiling. This can be attributed mainly to revenue transfers increasing to 47.3 per cent in 2014-15 (BE), with direct transfers included as part of the Plan transfer to States. However, when the direct transfer component is added, the level of transfers go up from 48.9 per cent in 2010-11 to 53.7 per cent in 2011-12 before declining to 49 per cent in 2012-13 (Table 5.2). It is estimated that the level of Union transfers to the States in 2014-15 will remain at about 47 per cent. The indicative ceiling prescribed by the previous Finance Commissions, therefore, has not restrained the Union Government from making larger transfers to States under the CSS.

Table 9.4: Transfers from the union to states as percentage of gross revenue receipts (%)

	FINANCE COMMISSION TRANSFERS			Other transfers			
COMMISSIONS	Share in central taxes	Grants	Total transfers	Plan grants	Non plan grants	Total other transfers	Total transfers
FCVIII(1984-89)	20.25	2.52	22.57	13.586	1.54	15.1	37.86
FCIX(1989-95)	21.37	3.42	24.79	14.49	1.06	15.55	40.33
FCX(1995-00)	22.22	2.34	24.56	10.57	0.67	11.24	35.79
FCXI(2000-05)	20.59	3.88	24.47	10.1	0.70	10.80	35.27
FCXII(2005-10)	22.03	4.70	26.73	10.99	1.07	12.06	38.79
FCXII(2010-15)	23.95	3.93	27.87	12.87	0.59	13.45	41.33
2010-11	21.68	3.12	24.79	10.48	1.72	12.20	36.99
2011-12	25.27	4.35	29.62	12.34	0.66	13.00	42.61
2012-13	24.84	3.86	28.70	10.91	0.16	11.07	39.77
2013-14(RE)	23.54	4.09	27.62	9.99	0.40	10.39	38.02
2014-15 (BE)	24.24	4.10	28.34	18.67	0.28	18.95	47.29

9.4.2 Principles or criteria of distribution

The shared tax received from Income Tax and Union Excise Duties set apart for States' purpose have been distributed on different criteria or principles. The net proceeds from income Tax until the seventh Finance Commission have been distributed 80 or 90 per cent based on population and 20 or 10 percent of the basis of collection or assessment in those states. Since the 8th Finance Commission onwards, the weight age given to population has been declining and the importance of a 'criteria of backwardness' is determined by several socio-economic factors. Therefore, the-states, which are backward, are benefited by such a criteria. The criteria adopted by the 11th Finance Commission n are really in favour of the backward states. This is mainly because of the high importance accorded to per capita Income to see that the state with the lowest per capita income gets the highest share.

With regard to the shared tax revenue from Union Excise Duties, the first two commissions accorded high importance to population factor while taking into account collector/assessment of the tax for inter-state distribution of the net proceeds. The third Finance

Commission adopted a 'criteria of backwardness' on the basis of several factors like the road length, rail mileage, geographical area, scheduled castes and tribes population as a proportion of total population of the State, per capita Income of the State etc, With regard to Additional Excise Duties, the States were given initially, compensatory grant which is equivalent to the loss of revenue from Sales.

The second Finance Commission, recommended an amount of Rs. 32.50 crores for distribution among all the states- In the subsequently Excise Duties over and above the guarantied amounts have been distributed union the States of the basis of a criteria as recommended by the successive Finance Commission. The Finance commissions have taken factors such as the consumption of these three goods, sales tax collection, dispatches of these goods in the respective states while determining the States' share.

9.4.3: Relative share of union and state in combined Revenue receipts

The proportion of transfers from the Union to the States in the combined revenues is shown in Table 9.5. The share of the Union, taking into account its resources net of statutory and non-statutory transfers, has been in the range of 35 per cent to 39 per cent, with the exception of the FC-XI period. The transfers have varied in a narrow range of 24 per cent to 26

Table 9.5: Relative share of union and state in combined Revenue receipts (%)

	UNION			states		
	Revenue receipts before transfers	Transfers (statutory +non statutory	Revenue receipts after transfers	Revenue receipts before transfers	Transfers (statutory +non statutory	Revenue receipts after transfers
FCVIII	65.4	26.7	38.7	34.60	26.7	61.3
FCIX	62.8	27.5	35.3	37.2	27.5	64.7
FCX	60.8	24.5	36.3	39.2	24.5	63.7
FCXI	58.50	25.2	33.3	41.5	25.2	66.7
FCXII	63.81	25.36	38.45	36.19	25.36	61.55
FCXII	61.08	24.64	36.44	38.91	24.54	63.55
2010-11	64.36	24.17	40.19	35.64	24.17	59.81
2011-12	60.62	26.09	34.53	39.38	26.09	65.47
2012-13	58.89	23.8	35.09	41.11	23.8	64.91

percent of the combined revenue receipts of the Union and States. However, when the direct transfers are taken to account, the proportion of transfers in the combined revenues increases to 30.5 per cent in the initial three years of the FC-XIII period.

9.4.4: GRANTS IN LIEU OF RAILWAY PASSENGER FARES TAX

The Article 269 of the constitution empowers the Central Government to levy a tax on railway passenger fares and to collect the same but the entire net revenue goes to the State .This tax was imposed for the first time in 1957. However, the tax was wound up in 1961 due to administrative reason and agreed to compensate the toss by providing a grant of Rs' 12.50 Crores per year for the period 61-65. This compensatory grant has been increased to Rs' 9.12 crores in 1980-81 to 95 crores by the Eighth Finance commission and to Rs. 150 crores. The Ninth finance Commission for the period 1990-95. The annual amount of grant has been increased to Rs. 380 crores for the period 1995-2000. Successive Finance Commission recommended that the. grant amount be .distributed among States based on average collection of non-suburban rail charges' route mileage etc'

Table 9.6 indicates the relative share of the Union Government and State Governments in the combined revenue and total expenditure. The share of Union Government expenditure in total expenditure has been increasing since the FC-XII period, but remains lower than the share of States' expenditure. However, if expenditure by States' implementing agencies is taken as expenditure having been incurred in the States, then the skew in the relative balance of the respective shares of the Union and the States is set right.

Table 9.6: Relative share of union and state in Revenue and total expenditure (%)

	Total expenditure		Revenue expenditure	
Finance commission periods	Union	State	Union	State
FCI	43.83	56.17	40.77	59.23
FCII	49.47	50.53	41.83	58.17
FCIII	50.51	49.49	46.10	53.90
FCIV	47.69	52.31	41.77	58.23
FCV	43.14	56.86	40.00	60.00
FCXVI	47.35	52.65	44.19	55.81
FCXVII	44.79	55.21	41.98	58.02
FCVIII	47.86	52.14	44.22	55.78
FCIX	45.58	54.42	43.45	56.55
FCX	43.35	56.65	43.18	56.82
FCXI	43.77	56.23	44.03	55.97
FCXII	46.08	53.92	47.59	52.41
FCXII	46.64	53.36	47.16	52.84

9.4.5:Current Status

The fiscal imbalance of the Union Government has widened since 2008-09 due to the increasing revenue deficits. The 2014-15 budget estimates (BE) indicate that the ratio of revenue and fiscal deficits to GDP are 2.9 per cent and 4.1 per cent, respectively. The outstanding debt for the year is estimated at 45.4 per cent of GDP. These deficit levels are above the targets in the original FRBM Act of 2003. The rules of the original Act required the Union Government to eliminate revenue deficits and restrict the fiscal deficit to 3 per cent of GDP by 31 March 2009. In addition, the Act required the Union Government to, starting from 2004-05, cap guarantees issued in a year to 0.5 per cent of GDP and to limit additional liabilities including external debt at the current exchange rate to 9 per cent of GDP every year, reduced progressively by 1 per cent of GDP every year. A temporary deviation from the FRBM Act targets was allowed in 2008-09 and 2009-10 to enable a fiscal stimulus to mitigate the adverse impact of the global financial crisis on the Indian economy.

In 2012-13, the fiscal targets were revised in line with the fiscal consolidation path recommended by the FC-XIII for 2010-15. In the Finance Act 2012-13, the FRBM Act was amended to allow the Medium-Term Expenditure Framework Statement to be laid before both Houses of Parliament after the session in which the Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement were presented. The MTFP is expected to indicate three-year rolling targets for prescribed expenditure indicators, specifying the underlying risks and assumptions. The amendments also shifted the targets in the original Act from 31 March 2009 to 31 March 2015. Along with these amendments, the FRBM Act introduced the concept of an effective revenue deficit, defined as the difference between the revenue deficit and grants for the creation of capital assets. The FRBM targets were reset to eliminate the effective revenue deficit by 31 March 2015, and to achieve a revenue deficit of not more than 2 per cent of the GDP by that date. The amendment also requires the Union Government to mandate the Comptroller and Auditor General (C&AG) to periodically review compliance of the provisions of the Act and for these reviews to be presented in both Houses of Parliament.

9.5: central grants-in-aid

The Central Government (with the approval of the Parliament) can award grants-in-aid under Article 275(1) to those States which are in need of revenues. The First Finance Commission recommended an annual grant of Rs. 14.43 crores for the period 1952-57 to those states, which were estimated to be having revenue deficits. The Second Finance Commission Recommended total amount of Rs. 187.75 crores for the period 1955-60 while an annual grant of Rs. 52 crores and Rs. 121.89 crores respectively were recommended by the Third and Fourth Commission. It may be noted that the Fifth. Sixth. Seventh, Eighth and Ninth Commission recommended respectively Rs. 367.85 crores. Rs. 2509.61 crores, Rs. 1173 Crores, Rs. 1513 crores and Rs. 15017 crores to those states having deficits on their non-plan revenue accounts. The Tenth Finance Commission recommitted an amount of Rs' 20300 Crores for different purposes for the period 1995-2000. Of this, Rs. 7582 crores were given for filling the non-plan 'deficit, Rs. 1362 crores for the development of services, Rs. 1246 crores for Special problems. Rs. 5380 crores for Local Bodies and Rs. 4728 crores for financing Relief expenditure that arises due to natural calamities'

The 11th Finance Commission recommended a huge amount of Rs. 58.857 crores as Grants-in-aid for different purposes. Out of this an amount of Rs.35359 crores. Are given for the'' non-plan expenditure gap of the States. The commission has provided Rs. 4972 crores for the up gradation of non-developmental administrative-and social services, Rs. 10,000 crores for the Local Bodies and Rs. 5045 crores for financing relief expenditure. As a whole, it has recommended total amount of Rs. 4, 34,945 crores to the States for the five-year period. Besides, several Finance Commission has provided financial relief. To States which are having outstanding debts. It is pertinent to note that almost alt Finance Commission s have taken .Budgetary needs' as the basis for awarding the revenue-gap grants to fill the deficits on the non plan revenue account.

Previous Finance Commissions recommended both tax devolution and grants-in-aid to the States. The grants have varied from 7 per cent of Finance Commission transfers (FC-VII) to 26 per cent (FC-VI) 1. On the relative roles of tax devolution and grants-in-aid, the FC-XI observed that the dominance of tax devolution weakens the equalizing capacity of Finance Commission transfers, even though successive Commissions have tried to redress this shortcoming by introducing redistributive elements in the devolution formula. The FC-XII observed that State Governments generally favored a large proportion of Finance Commission transfers as tax devolution rather than as grants-in-aid and that, they viewed tax devolution as a matter of entitlement and, by its very nature, unconditional. However, despite this marked preference for tax devolution on the part of States, the FC-XII relied on grants-in-aid as an important instrument in its overall scheme of transfers. It held that grants-in-aid had unique characteristics, as they could take better account of cost disabilities and redistributive considerations that were not adequately captured in the tax devolution formula. The FC-XIII observed that grants-in-aid are an important instrument of financing that enabled more comprehensive transfers, especially to address various issues spelt out in its ToR. The FC-XIII also observed that grants allowed it to make corrections for cost disabilities faced by many States; this was possible only to a limited extent in the tax devolution formula. Previous Finance Commissions have enunciated four main considerations governing grants-in-aid. First, grants-in-aid may be given to the States to meet their residuary budgetary needs after taking the devolution of taxes into account. Second, grants-in-aid have been recommended to facilitate the upgradation of standards of administrative and social services and to ensure minimum expenditures on such services across the country. Third, they have been recommended to meet the special needs, burdens and obligations of the States and to address the specific sectors of national importance. Finally, grants-in-aid have been recommended for augmenting expenditures, rather than for substituting what a State Government is already spending.

9.6: grants for up gradation of services

Finance Commissions awarded grants-in-aid for the upgradation of administrative and social services (both non-developmental and developmental) to those states, which are falling below. The national average. Tire First Finance Commission 'recommended 9 crores to those states', which requires to upgrade primary education. The Government of Andhra Pradesh got Rs' 12 " crores for the purpose. Similarly, the Third Finance Commission awarded Rs. 36 crores for the development of road communications .successive Finance Commission from 6th to 11th (except 9th Finance Commission) awarded grants-in-aid for different purposes like police' education, medical, treasury, training social and administrative services etc. as shown in

Table -9.7: Financial Commissions - Grants for Upgradation of Administrative system

Financial Commission	Grants-in-Aid	Share of Andhra Pradesh
1st Finance Commission	I	1.2
3rd Finance Commission	36	2
6th Finance Commission	838	5.3
7th Finance Commission	437	20
8th Finance Commission	915	80
10th Finance Commission	2648	154
11th Finance Commission	4973	285
12th finance commission	6830	450
13th Finance Commission	14600	575

Source: Reports of the Finance Commission

9. 7: grants for financing of relief expenditure

The state governments should undertake relief operations whenever natural calamity (floods, cyclones, earthquakes, fire accidents and drought occur. The centre extends its help and assistance in order to enable the states to withstand this calamitous situation. The Ninth Finance Commission took a verify important decision in this regard. Until then, the Central Team, which used to visit the state on request, used to recommend central assistance to state after assessing the loss sustained due to the natural calamities. Such assistance used to given after inordinate delays and was attributed to be discriminatory. So the Ninth Finance Commission recommended for the establishment of Calamity Relief Fund (CRF) each state which is to be operated under the purview of the Chief Secretary of the State" I total fund amount is to be decided on the basis of certain approved norms which are applied uniformly to all states. Out of the total fund amount, 75 per cent is to be contributed by the center while the state contributes 25 per cent from its own revenues. This innovate arrangement facilitates immediate relief' by the states wherever a natural calamity occurs.

Ninth Finance Commission recommended a total amount of Rs.4000 crores towards the for all states and recommended Rs. 3000 crores as its share of the 75 per cent of the Fund. The remaining amount contributed by the states from their own revenues. The Tenth Finance Commission recommended an amount of- Rs. 4728 crores while the Eleventh Finance Commission recommended Rs 8250 crores as its 75 percent share. Moreover, the earlier Finance Commission recommended the setting up of National Calamity Contingency Fund provide relief to a state whenever there is National Calamity occurs. , According to Commission, a special levy may be imposed for the purpose of the Fund, the resources that are to [: e spent at times of natural calamities. This facilitates relief operations to continue aid on permanent basis.

The financing of disaster relief has been an important aspect of federal fiscal relations. Successive Finance Commissions since the FC-II have provided 'margin money' for such contingencies. From the time of the FC-VI, the terms of reference (ToR) have specifically entrusted each Commission with the task of considering the arrangements between the Union Government and State Governments relating to financing disaster management and making recommendations on the subject. When earlier Commissions examined the issues, there was no specific law relating to disaster management. By the time the FC-XIII was constituted, Parliament had enacted the Disaster Management Act, 2005. However, the various funds envisaged under the Act had not been constituted. Some of the funds prescribed under the law have since been constituted, and arrangements for their operations put in place. Our mandate, under Para 9 of the Tore , requires us to "review the present arrangements on financing of Disaster Management with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005) and make appropriate recommendations thereon".

Table 9.8: Collection of NCCD and Release from NICE / NERVE (2002-03 to 2011-12)

(Rs. crores)

Year	National Calamity Contingent Duty (NCCD) Collected	Release from NCCF/NDRF)
2002-03	1648.45	1600.00
2003-04	1740.13	1587.42
2004-05	1484.44	2583.12
2005-06	1274.67	3061.44
2006-07	1727.88	1962.05
2007-08	2268.36	373.38
2008-09	2319.73	2279.92
2009-10	2619.56	3261.52
2010-11	2966.51	4179.25
2011-12	3246.16	2458.12

The Disaster Management Act provides for the effective management of disasters and all related matters, including the mechanisms for funding disaster relief and response. The Act defines disaster in very broad terms to include both natural and fabricated disasters. It envisages the constitution of two types of funds, one for disaster response and the other for mitigation. These are to be set up at the national, state and district levels. Thus, for disaster response, the Act envisages a National Disaster Response Fund (NDRF), a State Disaster Response Fund (SDRF) in each State and, within the States, a District Disaster Response Fund (DDRF) in each district. Similarly, the Act envisages a National Disaster Mitigation Fund (NDMF), State Disaster Mitigation Funds (SDMF) and District Disaster Mitigation Funds (DDMF) for disaster mitigation. So far, at the national level, only the NDRF has been constituted. All

State Governments have constituted an SDRF, but only a few have constituted an SDMF. Very few State Governments have constituted District Disaster Response Funds (DDRFs). During a disaster, relief activities at the district level are generally carried out through transfers from the SDRF.

9.8: debt relief of the states

The President of India has been asking the successive Finance Commission. To solve the problems of debt relief. The Finance Commission recommended cancelation of debts. Rescheduling of debt by waiving of interest payments and grants-in-aid for debt relief taking into account huge of debt burden, interest payments. Financial situation of the State and. fiscal discipline etc. However, the Finance Commissions used to provide grants-in-aid or relief measures only after assessing the non-plan capital gap of the states. The Sixth Financial Commission recommended Rs. 1969.62 crores as grants-in-aid for debt relief while Rs. 2155.80 crores, Rs. 2285.39 crores and Rs. 2000 crores respectively were awarded by the Seventh, Eighth and Ninth Finance Commission The Tenth Finance Commissions recommended special relief measures to stares with fiscal distress and also to special category states taking into account the fiscal discipline of the States. The Eleventh Finance Commission also adopted, more or less the debt relief scheme as recommended by the 10th 'Finance Commission while observing that any scheme of debt relief needs to encourage fiscal prudence and fiscal discipline.

9.9: grants to local bodies

The Finance Commission can make recommendations to augment resources of the local bodies according to 73rd and 74th Constitutional Amendment. The Tenth Finance Commission, taking advantage of the provisions of the 73rd and 74th ' Amendment Acts, for the first time recommended an amount of Rs. 5381 crores for both Rural Local Bodies and Urban Local Bodies for the period 1996-97 and 1999-2000. The Eleventh Finance Commission also recommended Rs. 10,000 crores for the local bodies for the period 2000-05. However, the grant amount has to be spent by the local bodies for the development of basic amenities. This recommendation may be considered as a milestone and an important event in the history of Local bodies.

9.10: plan assistance

The Central Government makes central assistance for State Plan Schemes based on the Planning Commission Funds are made available for plan purposes based on Article 282. Moreover, the Centre provides assistance through the Central Ministries for central sector and Centrally Sponsored Schemes. The Centre used to provide assistance to the State plan schemes. according to its discretion to the State Plan Schemes according to its discretion until 1968-69. But in the light of States 'demand, central assistance for State Plan Schemes since the Fourth Plan period has been distributed among the States on the basis of an objective and uniform formula known as' Godgil Formula as shown in Table -9.5. Several changes have been made to the Gadgil Formula subsequently. The main aim of Gadgil Formula was to reduce the bias arid discretion of the government in provision and distribution of central assistance among the states. According to Gadgil Formula, the Loan-grant ratio of the Central Plan assistance to states, both developed and developing. is 70:30. Currently the plan assistance is being distributed by a formula as shown in the following Table. Apart from this assistance, the Centre has been providing assistance through the central sector and centrally sponsored schemes. It is estimated that at the time of lunching the 10^{th} 'Five Year plan, there are about 200 schemes. Several States have Been demanding that these schemes do not

9.11. Goods and service tax

The FC-XIII appointed a task force on GST and recommended a single rate of 5 per cent for Central GST and 7 per cent for State GST, based on the report of this task force. It also recommended a uniform threshold of Rs 10 lakh for goods and services under both the levies and uniform treatment for both goods and services to avoid classification disputes. The GST design proposed by the FC-XIII limited the exemption from the tax to public services of the government, unprocessed food under the public distribution scheme, health and education services. The design also included motor spirit, alcohol and tobacco under GST as a creditable levy. It also recommended a compensation amount of Rs. 50,000 crore, in case of revenue loss to the States, for five years from 2010-11 to 2014-15.

9.11.a:Views of the Union Government

the Union Government in its memorandum to the 14th Finance Commission, mentioned that it had envisaged progress in the implementation of GST during the award period of the FC-XIII. It explained that this did not happen owing to the long process of building consensus between the Union and the States, along with the time required in undertaking the necessary Constitutional amendments. The Union Government, in its subsequent submission on GST to the Commission, stated that key aspects like tax base and rate, exemption limit and place of supply rule for services, are still evolving. It said that in the absence of clarity on these issues, it is not possible to assess the likely impact of GST. The Union Government also emphasized that GST rates should be as close to the Revenue Neutral Rate (RNR) as possible, so that revenue loss is minimized.

9.11.b:Views of the State Governments

The States, in their submissions to the 14^{th} finance commission and earlier finance commissions, have generally favored the implementation of GST and focused their stand on five critical issues: (i) revenue compensation, including the issue of pending CST compensation; (ii) goods and services that should come under the purview of GST; (iii) state-specific issues with regard to inclusion/exclusion of specific taxes having implication on the GST design; (iv) issues related to RNR; and (v) capacity building.. in spite of the agreement the FFC has made a policy with the below points.

1.The Finance Commission are unable to estimate revenue implications and quantify the amount of compensation in case of revenue loss to the States due to the introduction of GST.

2. The Finance Commission also believe that GST compensation can be accommodated in the overall fiscal space available with the Union Government.

3. It is suggested that 100 per cent compensation be paid to the States in the first, second and third years, 75 per cent compensation in the fourth year and 50 per cent compensation in the fifth and final year.

4. The Finance Commission recommend creation of an autonomous and independent GST Compensation Fund

5. Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term

9.12: summary

Almost all the finance commissions in our country were excelled in their aspect except 11th finance Commission. AM Khusro a renowned economist of India.Later it was proved that it had done a commendable work headed it. The concerned union governments accepted all the finance commission's recommendations.

9.13: questions

1. Explain the constitutional provision of establishing the finance commission s ? What are its functions?

2. Explain the principle of t criteria followed by the earlier finance commission except fourteenth finance commission

3. discuss the role of grant in aid in allocations of finance Commission. How the finance commissions allocated the fund

4. Explain the allocation of the Fourteenth Finance commission

5. How the finance commissions allocated to Natural Calamity fund?

6. Explain the goods and Service Tax ?

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MODULE-3

LESSON-2

RECOMMENDATIONS OF VARIOUS FINANCE COMMISSIONS

10.0:Introduction

The Finance Commission is a unique arrangement envisaged by the framers of the Constitution to redress the imbalances in the revenues and expenditure of the Union and the State Governments arising out of a mismatch between the powers to raise revenues and the functional responsibilities of the governments. The Finance Commission is mandated to 'achieve this through approximate tax sharing between the Centre and the States and through grants-in-aid the States which are in need of such assistance. The Finance Commission is also required to recommend the inter-state allocation among States of their share in the Central taxes.

During 1990s has been a witness to Constitutional amendments effected with a view to strengthen the finances of the Municipalities and panchayats, the third tier of the Government at the local level. The State Finance Commissions (SFCs) are the instrumentality to achieve this objective and the Finance Commission is required to suggest measures to augment the States' revenues to implement the recommendations of the SFCs. A Constitutional amendment was also necessitated when the vertical devolution process was sought to be simplified by making all taxes and duties in the Union List sharable with the States.

The Finance Commissions in India have stood the test of time and contributed richly to the cause of fiscal federalism. Despite the obvious handicap of lack of continuity, successive Commissions have been able to draw upon the immense experience of the experts in the field besides their own and come up with recommendations acceptable to the Centre as well as the States. In view of its credibility, issues beyond its constitutional mandate such as restructuring of public finances, sustainability of debt, calamity relief etc. is also referred to the Finance Commission.

10.1:Awards of Finance Commissions

10.A.Pre Liberalisation

10. A .1:Ist Finance Commission

(a) 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 States specified in Part C of the First Schedule to the Constitution or to taxes payable in respect of Union emoluments, to be assigned to the States, should be fifty five;

(b) the percentage of the net proceeds of taxes on income which shall be deemed to represent proceeds attributable to States specified in Part C of the First Schedule to the Constitution should be 2.75; and

(c) the percentage share of the net proceeds of taxes on income assigned to the States should be distributed among the States as follows-

Under Article 272 of the Constitution forty per cent of the net proceeds of the Union duties of excise on tobacco (including cigars, cigarettes, etc.), matches and vegetable products should be distributed among the States in Part A and Part B of the First Schedule, except the State of Jammu and Kashmir, in proportion to their population according to the 1951 census. The shares of the States will on this basis be-

(3) Separate funds to be earmarked to the states under Article 273 of the Constitution as grants-in-aid of the revenues each year of the States of Assam, Bihar, Orissa and West Bengal in lieu of assignment of any share of the export duty on jute and jute products-

(6) The grants now being paid to the States of Bombay, Madhya Pradesh and Madras for refraining from the taxation of tobacco should be discontinued with effect from the 1st April 1953.

(7) The 'revenue gap grants' now being paid to the States of Bihar, Bombay, Madhya Pradesh and West Bengal in respect of the 'merged areas' should be discontinued with effect from the 1st April 1952.

10. A .2:IInd FINANCE COMMISSION

Major recommendations of the commission-

(a) the percentage of the net proceeds in any financial year of taxes on income other than agricultural income, except in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, to be assigned to the States be 60 (sixty);

(b) the percentage of the net proceeds of taxes on income which shall be deemed to represent proceeds attributable to Union territories be l(one); and

(1) out of the net proceeds in each financial year of estate duty in respect of property other than agricultural land, a sum equal to 1(one) per cent be retained by the Union as proceeds attributable to Union territories;

(2) The balance of the net proceeds is apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year;

(3) The sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State; and

(4) The sum apportioned to property other than immovable property be distributed among the States as follows-

State Andhra Pradesh Assam Bihar Bombay Kerala Madhya Pradesh Madras Mysore Orissa Punjab Rajasthan Uttar Pradesh West Bengal Jammu and Kashmir

(B) In respect of the period prior to 1st April 1957, the distribution already made is legally ratified.

In regard to the loans made by the Government of India to the States between 15th August, 1947 and 31st March, 1956-

(a) with effect from 1st April, 1957, in respect of loans made to the States for the rehabilitation of displaced persons and relent by them, the States be allowed to pay to the Union only the amounts of principal and interest collected, including arrears, if any;

(b) No modification be made in the rate of interest or terms of repayment of interest- free loans; and

(i) the balances on 31st March 1957 of all loans carrying interest at three per cent or more per annum and repayable on or after 1st April 1977, be consolidated into one single loan at 3(three) per cent per annum repayable on 31st March 1987;

(ii) The balances on 31st March 1957 of all loans carrying interest at 3 (three) per cent or more per annum and repayable on or before 31st March 1977 be consolidated into one single loan at 3 (three) per cent per annum repayable on 31st March 1972;

(iii) the balances on 31st March 1957 of all loans carrying interest at less than three per cent per annum and repayable on or after 1st April 1977 be consolidated into one single loan at 21/z (two and a half) per cent per annum repayable on 31st March 1987; and

(iv) the balances on 31st March 1957 of all loans carrying interest at less than 3 (three) per cent per annum repayable on or before 31st March 1977 be consolidated into one single loan at 21/2 (two and a half) per cent per annum repayable on 31st March 1972.

VII. Out of the net proceeds of the additional duties of excise levied in replacement of sales taxes on mill-made textiles, sugar and tobacco (including manufactured tobacco)-

(A) If each of the additional duties is to be distributed separately-

(1) A sum equal to 1 (one) per cent of the net proceeds of each additional duty be retained by the Union in respect of Union territories;

(2) A sum equal to 11/4 (one and one quarter) per cent of the net proceeds of each additional duty be paid to the State of Jammu and Kashmir; and

(3) a sum equal to the balance of the net proceeds of each additional duty, i.e., after deduction of the sums mentioned in sub-paragraphs (1) and (2) above, be distributed as follows-

(a) The sums mentioned below representing the present income of the States because of sales taxes, by whatever name called, on the three commodities be first paid to them.

10. A .3: IIIrd FINANCE COMMISSION

For a period of four years with effect from April 1, 1962-

(a) Out of the net proceeds in each financial year of estate duty in respect of property other than agricultural land, a sum equal to 1 (one) per cent be retained by the Union as proceeds attributable to Union territories;

(b) The balance of the net proceeds is apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year;

(c) The sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State; and

(a) A sum equal to 1 (one) per cent of the net proceeds be retained by the Union as attributable to Union territories;

(b) A sum equal to 11/2 (one and a half) per cent of the net proceeds be paid to the State of Jammu and Kashmir; and

(c) a sum equal to the balance of the net proceeds of the duties, i.e., after the deduction of the amounts mentioned in sub-paragraphs (a) and (b) above, be distributed as follows-

10. A .4: IVth FINANCE COMMISSION

In each of the five years commencing from 1st April, 1966-

(i) 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;

(ii) The balance is apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year;

(iii) The sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State; and

(iv) The sum apportioned to property other than immovable property be distributed among the States as follow

In each of the five years commencing from 1st April, 1966-

(i) 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 (Seventy Five) per cent;

(ii) 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

In each of the five years commencing from 1st April, 1966, a sum equal to 20 (twenty) per cent of the net proceeds of the Union duties of excises on all articles levied and collected in that particular year, excepting regulatory duties, special excises and duties and cusses earmarked for specific purposes be paid out of the Consolidated Fund of India to the States and

In each of the five years commencing from 1st April, 1966, out of the total net proceeds of the additional duties of excise on cotton fabrics, silk fabrics, rayon or artificial silk fabrics, woolen fabrics, sugar and tobacco including manufactured tobacco:-

(i) A sum equal to 1.00 (one) per cent of the net proceeds be retained by the Union as proceeds attributable to Union territories;

(ii) A sum equal to 1.50 (one and a half) per cent of the net proceeds be paid to the State of Jammu and Kashmir;

(iii) A sum equal to 0.05 (one twentieth) per cent of the net proceeds be paid to the State of Nagaland; and

(iv) out of the balance (i.e. 97.45 per cent) of the net proceeds of the duties, i.e., after the deduction of the amounts mentioned in sub-paragraphs (i) to (iii) above, the following sums representing the revenue realized in 1956-57 by each State on account of Sales Taxes on the six commodities, be first paid to the following 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 below be charged on the Consolidated Fund of India as grants-in-aid of the revenues of the States mentioned against them-

10. A .5: Vth FINANCE COMMISSION

In respect of distribution between the Union and the States of the net proceeds of income-tax in the years 1967-68 and 1968-69, there should be no change in the distribution as prescribed in the Constitution (Distribution of Revenues) Order, 1965, in the event of the said net proceeds being certified by the Comptroller and Auditor General of India on the revised basis;

(i) Out of the net proceeds of taxes on income in each financial year, a sum equal to 2.6 per cent thereof be deemed to be the portion which represents the proceeds attributable to Union territories;

a) The percentage of the net proceeds of taxes on income, except the portion which represents proceeds attributable to Union territories, to be assigned to the States should be 75 (seventy-five) per cent; and during each of the years 1969-70 to 1971- 72 a sum equivalent to 20 (twenty) per cent of the net proceeds of Union duties of excise on all articles levied and collected in that year, excluding special excises, regulatory duties and duties and cesses levied under special Acts and earmarked for special purposes, should be paid out of the Consolidated Fund of India to the States;

(b) During the years 1972-73 and 1973-74, a sum equivalent to 20 (twenty) per cent of the net proceeds of Union duties of excise on all articles levied and collected in the respective year, including special excises, but excluding regulatory duties and duties and cusses levied under special Acts and earmarked for special purposes, should be paid out of the Consolidated Fund of India to the States; and

(a) It would not be desirable to maintain the existing arrangements in regard to the levy of additional duties of excise on textiles, sugar and tobacco, unless the Government of India, after discussing the matter further with the State Governments, can arrive at a general agreement for the continuance of the present scheme with suitable modifications;

(b) while the arrangements are continued, the rates of duties may be made ad valorem as far as possible, and may be revised periodically so as to secure reasonable incidence having regard to the prevailing prices and the general level of sales taxes on similar items levied by the States;

(2) There is no scope at present for extending such arrangements to other items or commodities;

(3) The net proceeds of the additional excise duties during each financial year in which the existing arrangements continue, should be distributed on the following basis-

(a) A sum equal to 2.05 per cent of such net proceeds is retained by the Union as attributable to Union territories;

(b) A sum equal to 0.83 per cent of such net proceeds is paid to the State of Jammu and Kashmir as its share;

(c) A sum equal to 0.09 per cent of such net proceeds is paid to the State of Nagaland as its share;

(d) Out of the remaining balance of 97.03 per cent of such net proceeds the sums specified below, representing the revenue realized in the financial year 1956-57 by each respective State from the levy of sales taxes on the commodities subject to additional excise duties, be first paid as guaranteed amounts to the following

In case the existing arrangements are discontinued during the course of a financial year, the sums specified in clause (d) above, be reduced pro rata to the period for which the

10. A .6: VIth FINANCE COMMISSION

The recommendations of the Finance commission on devolution of taxes and grants-in-aid of the revenues of the States are set out below

In respect of distribution of the net proceeds of income tax in each of the financial years from 1974-75 to 1978-79

(1) Out of the net proceeds of taxes on income in each financial year, a sum equal to 1.79 per cent thereof be deemed to represent the proceeds attributable to Union Territories;

(2) The percentage of the net proceeds of taxes on income, except the portion representing the proceeds attributable to Union Territories, to be assigned to the States, should be eighty;

(3) The distribution among the States inter-se of the share assigned to the States in respect of each financial year should be based on the following percentages-

During each of the years 1974-75 and 1975-76 a sum equivalent to 20 (twenty) per cent of the net proceeds of Union duties of excise on all articles levied and collected in that year, excluding auxiliary duties of excise and cusses levied under special Acts and earmarked for special purposes, should be paid out of the Consolidated Fund of India to the States;

(b) During the year 1976-77, 1977-78 and 1978-79 a sum equivalent to 20 (twenty) per cent of the net proceeds of Union duties of excise on all articles levied and collected in the respective year, including auxiliary duties of excise, but excluding cesses levied under special Acts and earmarked for special purposes, should be paid out of the Consolidated Fund of India to the Sates; and

(c) The distribution among the States of the sum payable to the States in respect of each financial year should be made based on the following percentages-

There is no need to set apart any guaranteed amounts to the States as in our opinion there is no risk of the share of any State in the net proceeds of additional excise duties falling short of the revenue realized from the levy of the sales tax on the commodities subject to additional duties of excise in lieu of sales tax for the financial year 1956-57 in that State;

(2) The net proceeds of the additional excise duties during each financial year be distributed on the following basis-

(a) A sum equal to 1.41 per cent of such net proceeds is retained by the Union as attributable to Union Territories;

The balance of 98.59 per cent of such net proceeds be distributed among the States in accordance with their respective percentage shares of such balance as under-

10.A.6a:Financing relief expenditure

In the light of our analysis of the advantages and disadvantages of the establishment of a National Fund, and the views expressed by the State Governments The Finance commission have concluded that the establishment of a National Fund, fed by Central and State contributions, is neither feasible nor desirable. At the same time, the present arrangements for assisting the States for meeting expenditure on relief operations need to be completely overhauled. Detailed programmes of both medium and long-term significance for permanent improvement of the areas liable to drought and flood should be drawn up with the utmost urgency and these programmes fully integrated with the Plan.

The commission strongly urges that instead of incurring expenditure on relief on ad hoc basis on schemes of dubious value, provision should be made on a much larger scale for development of drought and flood prone areas in the Fifth Plan in both the State and Central sectors. Any assistance, which is provided to the States for purposes of relief in this manner, would be subject to the overall ceiling of Central assistance for the plan period as a whole. At the same time the Finance commission, feel that the provision of a reasonable margin in the forecasts of State Expenditure should be considered as a legitimate charge on the revenue accounts of the States.

10. A .7:VIIth FINANCE COMMISSION

10. A .7a: Estate duty

The recommendations of the seventh Finance Commission on devolution of taxes and grants-in-aid of the revenue of the States for the period 1980-84 are below-

(1) 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.

(2) 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 located in the State where it is brought to assessment.

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 realized 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.

(2) Sikkim should have a share in the net proceeds of these duties except the duties on textiles on which the State levies sales tax.

(3) 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 in the percentages shown below-

4.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.

5. 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

6. 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 State-wise percentage shares would then be as shown below-

In respect of distribution of the net proceeds of income tax in each of the financial years from 1979-80 to 1983-84.

(1) Out of the net proceeds of taxes on income in each financial year a sum equal to 2.19 per cent thereof should be deemed to represent the proceeds attributable to
(2) (2) the percentage of the net proceeds of taxes on income, except the portion representing the proceeds attributable to Union territories, to be assigned to the States, should be eighty-five; and
(3) (3) The distribution among the States inter-se of the share assigned to the States in respect of each financial year should be on the basis of the following percentages-
The following States be paid the sums specified against each of them as Grants-in-aid of their revenues in the respective years indicated in the Table below under the substantive part of Clause I of Article 275 of the Constitution-

10. A .7b: Financing relief expenditure

In the light of review of the existing policy and arrangements about the financing of relief expenditure and after considering the expenditure incurred by the State Governments in providing gratuitous relief and on repair and restoration works of public properties after natural disasters. The Finance Commission the following annual provisions (margins) under the head of account 289 - Relief on account of natural calamities for different States-

10. A .7c:Short-term loans

Short-term loans, if any, by the Central Government to the States that may remain outstanding at the end of 1978-79 may be recovered according to the existing terms applicable to such loans;

(iii) Central loans advanced to State Governments by way of share out of net collections of small savings, and outstanding at the end of 1978-79, may be converted into loans in perpetuity, in respect of which the States need make no repayment of principal from 1979-80 but should continue to pay interest at the existing rate;

10. A .8:VIIIth FINANCE COMMISSION

The commission starts from the financial years 1984-85 to 1988-89. The major recommendations are

(1) Out of the net proceeds, a sum equal to 1.792 per cent thereof shall be deemed to represent the proceeds attributable to Union territories;

(2) The share of net income tax proceeds, except the portion representing the proceeds attributable to Union territories and Union emoluments, to be assigned to the States should be 85 per cent; and
(3) The distribution amongst the States inter- se of the share assigned to the States in respect of each financial year should be on the basis of the percentages contribution to the divisible pool.-

10. A .8a:Union excise duties

States should be paid a share out of the net proceeds of all excise duties, except the duties collected under the provisions of Additional Excise Duties (Textiles and Textile Articles) Act, 1978, and cesses earmarked by law for special purposes.

(2) The net proceeds of the entire excise duty on generation of electricity should be distributed among the States in an amount equal to the collections in or attributable to that State.

(3) The States' share in the net proceeds of shareable excise duties, excluding that on electricity, should be 45 per cent.

(4) 40 per cent of the net proceeds of shareable excise duties, excluding that on electricity, should be distributed among all the States based on the percentages they calculated.

10. A .8b:Grants in aid

To cover the deficits on revenue account, the following States be paid the sums specified against each of them as grants-in- aid of their revenues in the respective years indicated in the table below under the substantive part of clause (1) of Article 275 of the Constitution.-

To meet the margin money requirements of States they shall be entitled to the sums specified against each of them as grants-in- aid of their revenues in each of the five years commencing from 1st April, 1984, under the substantive portion of clause (1) of Article 275 of the Constitution, provided that these amounts shall be

Grants-in-aid under Article 275 of the Constitution to cover net additional interest liability on account of fresh borrowings and lending's in the period 1984-89 may be paid to the deficit States in each of the four years commencing from 1st April, 1985, as indicated in paragraph 13.16 of the Report. Grants-in-aid, if any, may also be paid to the deficit States during the years 1985-86 to 1988-89 to cover the additional burden because of Measures to deal with non-Plan Capital Gap.

(1) For purposes of debt relief, non-Plan capital gap has been computed after excluding repayments of overdraft loans and small savings loans.

(2) No relief is recommended in respect of overdraft loans given to States in 1982-83 and 1983-84.

(3) No relief is recommended in respect of repayment of small savings loans, except that in 1984-85, no repayment shall be made

(4) Loans for relief and rehabilitation of displaced persons etc. should be written off.

10. A .9:IX FINANCE COMMISSION

The Finance Commission major recommendations for the period 1989-90- to 1995 are as follows.

(1) Out of the net proceeds, a sum equal to 1.044 per cent thereof shall be deemed to represent the proceeds attributable to Union Territories,

(2) the share of net income tax proceeds, except the portion representing the proceeds attributable to Union Territories and Union emoluments, to be assigned to the States should be 85 per cent, and

(3) The distribution amongst the States inter-se of the share assigned to the States in respect of the financial year 1989-90 should be on the b

4. The apportionment of cost of collection between income tax and corporation tax should be re-examined.

10. A .9a:Union excise duties

If the purpose of revising administered prices is to raise resources for the government it should be done through increases in excise duties so that the States also get a share of the proceeds thereof notwithstanding the fact that the extent of increase would be higher in such cases.

(2) The existing arrangement under which 45 per cent of the net proceeds of shareable excise duties are distributed among States should continue for the year 1989-90)

(3) 40 per cent of the net proceeds of shareable excise duties should be distributed amongst all the States based on percentages shown in the table below-

4. The remaining 5 per cent of the net proceeds of shareable excise duties may be distributed amongst the deficit States on the basis of the

10. A .9b:Additional Duties of Excise in Lieu of Sales Tax-

(1) The net proceeds of the additional duties of excise on textiles, sugar and tobacco should be determined on the following basis-

(a) A sum equal to 2.023 per cent of such net proceeds is retained by the Central Government as attributable to the Union Territories;

(b) The balance should be distributed amongst the States in accordance with the percentages indicated below-

(1) The scheme of financing of relief expenditure as recommended by the eighth Finance Commission should continue.

(2) The following amounts of margin money may be fixed for each State-

Moratorium on the interest payments and the repayment of Principal due in 1989-90 should be granted in respect of the Central loans given to the States in 1986-87 and 1987 -88 by way of additional Plan assistance towards approved relief expenditure over and above 5 per cent of the annual Plan outlay on account of unprecedented drought during those years.

(2) Moratorium on the interest payment and repayment of principal due in 1989-90 in respect of special loans given to Punjab during 1984-89 should be continued during 1989-90 also

(3) The loans already advanced and those proposed to be advanced to Madhya Pradesh in connection with the Bhopal Gas Tragedy should be converted into interest-free loans to be set off against the compensation as and when received from the Union Carbide Limited. There should also be moratorium on the repayment of the principal as well as interest falling due in 1989-90 in respect of those loans.

10.B.: Post liberalization

There are sea changes in the post liberalization period both in economic administration and in fiscal policy of the government. There is liberalization and more that that privatization of government assets in the economy. The financial administration has also changed**.** In the circumstance the role and allocation of Finance Commissions has also changed. New methods also introduced in tax policy.

10.B.1: Xth FINANCE COMMISSION

The Finance Commission that for each financial year in the period 1995-96 to 1999-2000-

(a) Out of the net distributable proceeds of income tax, a sum equal to 0.927 per cent shall be deemed to represent the proceeds attributable to Union Territories.

(b) The share of the net proceeds of income tax assigned to the States shall be 77.5 per cent.

(c) The distribution among States of the share assigned to them in each financial year should be based on the percentages shown in the table below

10.B.1a:Union excise duties

The Finance Commission that 40 per cent of the net proceeds of Union excise duties during each financial year in the period 1995-96 to 1999- 2000 should be distributed as per the shares in the Table below-

The Finance Commission also recommend that the remaining 7.5 per cent of the net proceeds of Union excise duties be distributed among the States in accordance with the shares specified by us for each financial year in the period 1995-96 to 1999-2000 as given in the Table below-

Having regard to the share of States in income tax, Union excise duties, and grant-in-lieu of tax on railway passenger fare in total central tax revenues (including additional excise duties), and the fact that The Finance Commissionaire recommending inclusion of some taxes under article 269 in the central pool, The Finance Commission that the share of States in the gross receipts of central taxes shall be 26 per cent. The Finance Commission further recommends that the tax rental arrangement should be terminated, and additional excise duties merged with basic excise duties. These three commodities should not be subject to States sales tax. Having done so The Finance Commission further share of three per cent in the gross tax receipts of the Centre for the States in lieu of additional excise duties. These shares of twenty-six and three per cent respectively should be suitably provided for in

The Constitution and reviewed once in 15 years.

10.B.1b:Financing of local bodies

The amount worked out for all the States for the period of our Report is Rs.6304.27 crores. Out of this, the Centre will be required to contribute Rs.4728.l9 crores (75 per cent) and the States Rs.1576.08 crores (25 per cent). The Finance Commission recommended the continuation of the current scheme of the Calamity Relief Fund with modifications suggested by us. (Para 9.15)

The size of the National Fund for Calamity Relief would be Rs.700 crores, to be built up over the period 1995-2000, with an initial corpus of Rs.200 crores to which the Centre would contribute Rs.150 crores and the States Rs.50 crores in the proportion of 75:25.

The finance Commission recommended that in case the actual realization of the concerned States from royalty is higher than that assumed in our estimates, it would be open to the central Government to make suitable adjustments in the grants-in-aid under Article 275 recommended by us for meeting their non-plan revenue deficits.

The Finance Commission also recommended that the State Governments should ensure that the provisions for maintenance are made in accordance with our recommendations. The Finance Commission further recommend that a high-powered committee chaired by the Chief Secretary and with Secretaries of the State Governments concerned in the departments of

Finance, Planning, Irrigation and Public Works and the concerned Chief Engineers of the works departments should review every quarter the allocation and utilization of funds provided for maintenance.

10. B.2.:XIth FINANCE COMMISSION

In the overall scheme of the transfer, 37.5 per cent of the gross revenue receipts of the Centre are suggested to be transferred to the States

In assessing the revenue gaps of the States, a normative approach has been followed as far as possible.

For an enduring solution to the problem of budget deficits, attention needs to be paid to the system of budgeting and budgetary control. The newly constituted Expenditure Reforms Commission is expected to go into the system of budgetary practices and controls and make recommendations for reforms in this direction.

There should be regular revision of the royalties on minerals. In case, the process of revision is not completed by the due date, the States should be entitled to compensation. The task of making recommendations on royalty rates should be entrusted to an independent body.

There is no need to appoint Pay Commissions as a routine at the intervals of ten years. As the recommendations of the Central Pay Commission have a bearing on the States, its terms of reference, when appointed, should be

Determined in consultation with the States. The level of salaries and allowances should bear a relationship with the revenue expenditure of the States to be laid down by an Expert Committee.

Government may examine the feasibility of introducing a multi-year budgeting process, and stipulate the time by which the reports of the Comptroller and Auditor General of India should be scrutinized by the Public Accounts Committee and the Parliament or the Legislature, as the case may be.

The revenue gaps of the special category States should be met out of the Finance Commission grants. The responsibility for the development of infrastructure of vital importance to the region requiring large investment should be that of the Centre.

The States should show greater commitment for timely and qualitative implementation of the project undertaken through the upgradation and special problem grants. The physical and financial monitoring of the projects should be done by the SLEC. The States should send quarterly report to the Ministry of Finance of the Government of India, to facilitate release of grants

The composition of government expenditure should be restructured in favour of priority areas like elementary education, primary health care, water supply, sanitation and infrastructure like roads and bridges. Expenditure on salaries, pensions, interest payments and subsidies requires a tight rein.

The share of the States is fixed at 28 per cent of the net proceeds of all shareable Union taxes and duties for each of the five years starting from 2000-01 and ending in 2004-05. The recommendations made in the interim report of the Commission for the sharing of income tax and Union excise duties consequently stand modified.

The criteria and relative weights for deterring inter-se share of States are population 00 per cent), distance (62.5 per cent), area (7.5 per cent), index of infrastructure (7.5 per cent), tax effort (5 per cent) and fiscal discipline (7.5 per cent).

The States should show greater commitment for timely and qualitative implementation of the project undertaken through the upgradation and special problem grants. The physical and financial monitoring of the projects should be done by the SLEC.

The commission recommended that Article 243.1. Should be amended to enable the States to set up the State Finance Commissions (SFC) at the expiration of every fifth year or earlier, akin to the provision that already exists under article 280 for constituting the Finance Commission. The synchronization of availability of the SFC reports may also be ensured through either a Central legislation or an appropriate provision in the Constitution.

The commission was also in view that Local bodies, which do not have trained accounts staff, might contract out the upkeep of accounts to outside agencies/persons. The C&AG may lay down the qualification and experience required for this purpose. The Director, Local Fund Audit, or his equivalent authority, may do the registration of such agencies/persons.

The roles of the three tiers of the panchayats have generally not been delineated in the State legislations and the matter has usually been left to be decided by way of executive instructions. Legislative arrangements should be made to clearly indicate the role that these bodies have to play in the system of governance in the rural areas of a district.

Administrative reorganization of panchayats is necessary to ensure their development as viable institutions of self-government.

Treating the borrowings of the States relating to small saving, as loans in perpetuity is neither desirable nor viable.

There is a need for setting up of a sinking fund in each State for the amortization of debt.

Development of a stronger database on public finances is very necessary at the State level. This may start with the recasting of budget documents on the lines of the Central budget.

10. B.3:XII FINANCE COMMISSION

10. B.3a:Total Transfers recommended

The 12th Finance Commission has recommended a total transfer of Rs.7,55,751.62 crore (share in central taxes and duties Rs.6,13,112.02 Crore + Grants-in-aid Rs. 1,42,639.60 crore) to States during 2005-10 as against Rs.4,40,209.26 crore (Rs. 3,76,318.01 crore as share in central taxes and duties + Rs. 58,587.39 crore as grant-in-aid + Rs.5,303.86 crore as Centre's share of Incentive Fund) by 11th Finance Commission for the five years period 2000-05, showing an increase of 71.68% over TFC award period.

10. B.3b.Grant in aid of state revenues

The Non-plan grants under Article 275 of the constitution as per 12th Finance Commission are significantly higher when compared with the corresponding grants for the period of 11th Finance Commission 2000-05 as shown below:

Table 10.1 : allocation of grants by the 11th Finance Commission

Purpose of Grant	**During 2000-05 (11th FC)**
1. Local Bodies grants	10,000.00
2. Centre's share in Calamity Relief	8,255.69
3. Non-Plan revenue deficit grants	35,359.07
4. Grant for education	Nil
5. Grant for heath	Nil
6. Grant for maintenance of roads and bridges	Nil
7. Grant for maintenance of public buildings	Nil
8. Grant for maintenance of forest.	Nil
9. Grant for heritage conservation.	Nil
10. Grant for State-specific needs	Nil
11. Upgradation and special problem grants.	4,972.63
12. Centre's share of Incentive Fund	5303.86
Total Non Plan Grants	**63891.25**

10.3c.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.

10.3d.Distribution of Union Tax

The total share of states in the total sharable 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 and tobacco.

10.3e.Grants to local bodies

The total grant that will have to be given to the states for panchayati raj institutions and local urban bodies for the period of 2005-09 will be Rs 20000 crores and Rs 5000 crores respectively.

10.3f.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 21333 crore for the period of 2005-10.

10.3g.Grant in aids to the states

For the period of 2005-10, the total non-plan revenue deficit grant of Rs 56856 crores is recommended to 15 states and the total grant of Rs 10172 is recommended for 8 educationally backward states. A grant of Rs 15000 crores is recommended for building roads and bridges which is in addition to the normal expenditure of the states while the grants that are recommended to the states for maintenance of public buildings, forests, heritage conservation and specific needs of states are Rs 500 crore, Rs 100 crore, Rs 625 crore and Rs 7100 crore.

The policy regarding use of proceeds from disinvestment needs to be liberalized to also include capital expenditure on critical infrastructure and the environment.

10. B.4:XIIIth FINANCE COMMISSION

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

1.The policy regarding use of proceeds from disinvestment needs to be liberalised to also include capital expenditure on critical infrastructure and the environment.

2.Both the Centre and the states should conclude a ‘Grand Bargain’ to implement the Model GST. The Grand Bargain comprises six elements:

3.Public expenditure through creation of funds outside the consolidated fund of the states needs to be discouraged.

4.The share of states in net proceeds of shareable central taxes shall be 32 per cent in each of the financial year

5.The Central Government should review the levy of cess and surcharges with a view to reducing their share in its gross tax revenue.

6.The revenue deficit of the Centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15.

7.A target of 68 per cent of GDP for the combined debt of the Centre and states should be achieved by 2014-15.

8.Detailed breakup of grants to states under the overall category of non-plan and plan grants.

9.An independent review mechanism should be set-up by the Centre to evaluate its fiscal reform process.

10.State Governments should ensure that the recommendations of State Finance Commissions (SFCs) are implemented immediately and that the Action Taken Report (ATR) is promptly placed before the legislature.

11.The National Calamity Contingency Fund (NCCF) should be merged into the National Disaster Response Fund (NDRF) and the Calamity Relief Fund (CRF) into the State Disaster Response Funds (SDRFs) of the respective states. Contribution to the SDRFs should be shared between the Centre and states in the ratio of 75:25 for general category states and 90:10 for special category states.

10. B.5: XIVth FINANCE COMMISSION

10B.5a:SHARING OF UNION TAXES

i. Considering all factors, in our view, increasing the share of tax devolution to 42 per cent of the divisible pool would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out specific purpose transfers to the States.

ii. The Finance Commission have not consented to the submission of States on minimum guaranteed devolution. (Para 8.14)

iii. Though The Finance Commission are of the view that the use of dated population data is unfair, The Finance Commission are bound by our ToR and have assigned a 17.5 per cent weight to the 1971 population. Based on the exercises conducted, The Finance Commission concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. We, therefore, assigned a 10 per cent weight to the 2011 population.

iv. For area, The Finance Commission have followed the method adopted by the FC-XII and put the floor limit at 2 per cent for smaller States and assigned 15 per cent weight.

v. The Finance Commission believe that a large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. The Finance Commission has assigned 7.5 per cent weight to the forest cover.

vi. The Finance Commission have decided to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50 per cent weight. The Finance Commission has calculated the income distance following the method adopted by FC-XII.

vii. Table 8.1 shows the criteria and weights assigned for inter-se determination of the shares of taxes to the States.

viii. As service tax is not levied in the State of Jammu & Kashmir, proceeds cannot be assigned to this State. The Finance Commission have worked out the share of each of the remaining twenty-eight States in the net proceeds of service taxes

10.B.5b:Grants to Local bodies

The Finance Commission recommended that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations

The Finance Commission recommended distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each State will be divided into two - a grant to duly constituted gram panchayats and a grant to duly constituted municipalities, based on urban and rural population of that State using the data of Census 2011.

The Finance Commission recommended that the grants should go to gram panchayats, which are directly responsible for the delivery of basic services, without any share for other levels. The Finance Commission expect that the State Governments will take care of the needs of the other levels.

The Finance Commission are providing performance grants to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues.

The Finance Commission recommended that either the Union or the State Governments for the release of funds should impose no further conditions or directions other than those indicated by us.

The Finance Commission recommended that the States should review the position and prepare a clear framework of rules for the levy of betterment tax. . The Finance Commission suggest that States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source. The Finance Commission recommended that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment... The Finance Commission recommended arising the ceiling of professions tax from Rs. 2,500 to Rs. 12,000 per annum. The Finance Commission further recommended that States might amend Article 276(2) of the Constitution to increase the limits on the imposition of professions tax

The finance Commission recommended that the Union and State Governments examine in depth the issue of properly compensating local bodies for the civic services provided by them to government properties and take necessary action, including enacting suitable legislation, in this regard.

10.B.5c: GRANTS-IN-AID TO STATES

, Table 10.4: Grants-in-Aid to States	(Rs. crore)
1 Local Government :	287436
2 Disaster Management:	55097
3 Post-devolution Revenue Deficit:	194821
Total	537354

10.B.5d: Other Recommendations

i. A total revenue deficit grant of Rs. 1,94,821 crore is recommended during the award period for eleven States

ii. There is a case for transfers from the Union Government to the States to augment expenditure in specific sectors with a high degree of externalities in order to ensure desired minimum level of expenditures in every State. However, past experience shows that achieving this through the mechanism of Finance Commission grants may not be appropriate. Further, The Finance Commissions are informed that Finance Commission grants on this account often operate in parallel with other transfers. The commission concluded that all such transfers, in whichever sectors are considered necessary, should be addressed through a different institutional arrangement .

iii. The Finance Commission endorses the proposal made by the Department of Justice to strengthen the judicial systems in the States and urge State Governments to use the additional fiscal space provided by us in the tax devolution to meet such requirements

iv. Our assessment of the expenditure needs of the States has taken into account the high base of expenditure for both general administration and police. Therefore, in our view, the States have the appropriate fiscal space to provide for the additional expenditure needs as per their requirements. This should help them address the problems and facilitate them to build capacity and bridge the existing gaps about general administration and police.

v. The Finance Commission has provided appropriate fiscal space for maintenance expenditures and this should enable the States to meet the additional expenditure needs according to their requirements. The Finance Commission also urges the States to enhance expenditure on maintenance of capital assets to the appropriate levels.

vi. The Finance Commission considers health, education, drinking water and sanitation as public services of national importance, having significant inter-state externalities. However, in our view, the grants to these sectors should be carefully designed and implemented and an effective monitoring mechanism put in place with the involvement of the Union Government, State Governments and domain expertise. Therefore, The Finance Commission have desisted from recommending specific-purpose grants and have suggested that a separate institutional arrangement be introduced for the purpose

10.B.5e: GOODS AND SERVICE TAX

The Finance Commission recommended creation of an autonomous and independent GST Compensation Fund through legislative actions in a manner that it gives reasonable comfort to States, while limiting the period of operation appropriately

The finance Commission recommended that the Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term, while making necessary provisions for smooth transition through temporary arrangements.

The finance Commission recommended creation of an autonomous and independent GST Compensation Fund through legislative actions in a manner that it gives reasonable comfort to States, while limiting the period of operation appropriately. We, therefore, recommend that the Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term, while making necessary provisions for smooth transition through temporary

The fiscal deficit targets and annual borrowing limits for the States during the award period are enunciated as follows:

i. Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP. The States will be eligible for flexibility of 0.25

ii. It has recommended an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules.
iii. There should be 100 per cent metering be achieved in a time-bound manner for all electricity consumers as already prescribed statutorily.
iv. There should be an independent regulators for the passenger road sector,
v. It suggested that States (and urban and rural bodies) should progressively move towards 100 per cent metering of individual drinking water connections to households, commercial establishments as well as institutions.

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10.2: summary

In the above discussion the recommendations of the different Finance Commission were given in detail. This module is concentrated on the working and allocation of the revenues by the Finance Commissions, the next chapter is concentrated on the centre state financial relations.

10.3: Questions

1. Explain the awards of the different Finance Commissions in brief?

2. What are differences in Finance Commission awards pre liberalization and post liberalization periods?

3. |explain the financing the relief expenditure of 6^{th} and 7^{th} Finance Commission? How it makes the way to allocate in its award by 14^{th} Finance Commission.

4. Explain briefly the sharing of union taxes awarded by the 14^{th} Finance Commission ?

5. Explain the role of Grant in aid in state Revenues?

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MODULE-3

LESSON-3

CENTRE STATE FINANCIAL RELATIONS

11.1: introduction

India is a country with federal structure; center-state fiscal relations are recognized as very important in almost all the federations. 'it may be noted that the central government plays an important and key role in achieving economic development in countries with federal, structure" in modem times. India was formed in to a federation after its independence. Provisions for economic and social development, thus necessary were incorporated in the Indian constitution. The division of revenues and functions, winch is;-inevitable in a federation, -is provided in the constitution. The centre-state financial relations, which are federal fiscal relations, govern necessary for the existence of a federation. it is pertinent to note that provisions are made in the Indian constitution to set up “finance commission to channelize and also to monitor fiscal transfers, but it may be noted that planning commission, which was established with the initiative of the government, besides the statutory finance commission have been playing a significant role with, regard to centre-state financial relations. Therefore, it is necessary to know-elaborately the financial relations, which make fiscal adjustment between the centre and states.

11.2 constitutional division of powers and functions

The powers and functions between the centre and states are not very clear and unambiguous. However, in this division while more revenue powers are given to the centre. States have been given more expensive and expansive functional responsibilities. Let us known about those aspects in more detail below.

11.2.1 The union list

the constitution contains 3 lists with regard to division of various subjects - the" union list - 97 subjects, (2) state list containing subjects and the 46 subjects included in the concurrent list, which are included in the seventh schedule of the constitution. As per the constitutional division, the following are the tax powers of the union government.

1. income tax on non-agriculture income

2. corporation tax

3. Excise duties on tobacco and other goods manufactured or produced in India except alcoholic liquids for human consumption, opium. Indian hemp and other narcotic - drug-s and narcotics.

4. estate duty on non-agriculture lands.

5. Taxes on capital values.

6. Taxes other than stamp duties on transactions in stock exchanges and future markets.

7. rates of stamp duty in respect of bills of exchange, cheques. Promissory notes, bills of.

landing etc.

8. taxes on sale or purchase of newspapers and on advertisements therein. .

9. Terminal taxes on goods or passengers carried by railway, sea, or air; taxes on railway

Passenger fares and freights.

10. Taxes on the sale and purchase of goods other than news papers, where such sale or

Purchase takes place in course of interstate trade or commerce.

11. Taxes on the consignment of goods where such consignment takes place in course of

Inter-state trade and commerce.

12. Customs duty.

11.2.2: functions of the centre: the functional responsibilities are also divided between the center and states just like the revenue powers. These are functions, which have an inter-state character was entrusted to the center while functions having regional or local interests are allocated to the states. Following are the important functions to the center as follows:

I. defense
2. External affairs
3. Commerce
4. Posts and telegraphs'
5. Railways
6. Shipping
7. Internal communications

The tax powers which are not enumerated either in the union list or state list or to be in the imposed by the centre according to the Indian constitution. This shows supremacy of the central government.

11.2.3: functions of the state government:

I. education

2. Medical

3. Public health

4. Irrigation

5. Road transport

6. State electricity boards

7. Social welfare schemes

8. Agriculture

11.3: states list of tax powers

1. Land revenue

2. Taxes on sale and purchase of goods excluding news papers

3. Agriculture income tax

4. Taxes on property and buildings

5. Estate duty on agricultural lands

6. Excise duties on goods containing alcoholic liquors for human consumption, opium Indian hemp and other narcotic drugs and narcotics

7. 'Taxes on the entry of goods into local area

8. Taxes on mineral rights

9. Taxes on consumption or sale of electricity

10. Taxes on animals and boats and vehicles

11. Rates of stamp duty in respect of documents other than those specified in the union list.

12. Terminal taxes on goods or passengers carried by railway, sea, or air; taxes on railway passenger fares and freights.

13. Taxes on luxuries including taxes on entertainments. Amusements, betting and gambling

14. Tolls

15. Taxes on professionals, trades, callings and employment

16. Capitation taxes

17. taxes on advertisements other than advertisements published in newspapers and advertisements broadcast by radio and television recommended by the planning commission.

It is necessary to know the type and volume of fiscal transfers channeled through these institutions in order to analyze, understand, and analyze the centre state financial relations in India. Let us know first the fiscal transfers made trough the finance commission.

Some subjects who are not included either in the union list and state list is included in the concurrent list. The powers and functions, which are not, included in any of these three lists, are known as residuary powers on which central government legislative powers have. As consequences the division of powers and functions, imbalances emerged, which are very common in a federation and which did the constitutional makers visualize? This is mainly because most of the productive and elastic and productive resources or revenue powers to the centre while in elastic and unproductive tax powers besides, the states are provided with expensive and expansive functions. As a result, both vertical and horizontal federal fiscal imbalances exist in Indian federation.

for example in 1950-51 out of the combined revenues of centre and stales, while the center accounts for 65 per cent the states are left with 35 per cent. More or less similar trend is continued now. The constitution made several provisions to make fiscal adjustment through fiscal transfers in order to ensure healthy financial relation between the centre and state in India. This is because fiscal imbalances are not only quite normal as opined by Maxwell; there can be no final solutions to fiscal problems in a federalization. So fiscal balance is to be attained by making fiscal transfers.

This is because it is not rational to make fresh division of powers and functions in order to reduce fiscal imbalance. Through the division of powers and functions are divided between the centre and states in India adopting scientific and economic principles of B.P. Adarkar... in order, to reduce these fiscal the centre has made imbalances' fiscal transfers to states, right from 1950 on words, through the following channels.

11.4: central finance commission

As explained above, fiscal transfers are being made by the finance commission, planning commission and various union central ministries for several schemes. The president of India appoints the finance commission for every 5 years.

Article 280. Provides for a finance commission as, quasi-judicial body. It is constituted by the president every fifth year or even earlier. It is required to make recommendations to the president on the following matters:

The distribution of the net proceeds of taxes to be shared between the centre and the states, and the allocation between the states, respective shares of such proceeds.

1. The principles, which should govern the in-aid to the states by the centre (i.e., the consolidated fund of India).

2. The measures needed to augment the dated fund of a state to supplement the panchayats and the municipalities the state based on the recommendations made by the state finance commission.

3. Any other matter referred to it by the in the interests of sound finance.

The constitution envisages the finance commission's ion as the balancing wheel of fiscal federalism of India. However, the planning commission, a non-constitutional non-statutory body, has undermined its role in the centre-state relations.

11.5: important problems in centre – state financial relations

There should be healthy financial relations between the centre and states to ensure prolonged existence of a federation. There has been difference of opinion and problems between the centre and the states right from the implementation of the constitution. The states strongly believe that the divisions of powers and functions are in favour of the centre. Moreover, several states objected the increasing and important role of the planning commission in transferring the resources compared to the finance commission, which is a statutory body. The state argues vehemently that the finance commission should be made a permanent body.

Moreover, the redefinition of income tax by the central government excluded the states of a share from company income tax. the states have been demanding that the surcharge imposed by the centre from time to time should be abolished, the sales tax power of the states on sugar, tobacco and textiles be restored, to expedite the collection of tax revenue from taxes under article 268 and 269, to change the loan: grant ratio relating to central assistance for state plan schemes in favour of backward states.

It has also been demanded to reduce the size of central sector and centrally sponsored schemes and to increase the assistance provided for relief expenditure that arise due to natural calamities. The states also criticize that the non-statutory fiscal transfers are relatively larger than the statutory fiscal transfers are. However, most of the above-mentioned problems are automatically solved due to the 'alterative scheme' of fiscal transfers as recommended by the 10th commission and paved the way for new fiscal relations. It is pertinent to note that the states feel that the following issues are very important to improve the centre-state fiscal relations in India. The issue is:

11.5 a: allocation of taxing powers

The constitution divides the taxing powers between n the centre and the states in the following way:

1. The parliament has exclusive power to levy taxes on subjects enumerated in the union list

(Which are 15 in number).

2. The state legislature has exclusive power to levy taxes on subjects enumerated in the state

List (which are 20 in number).

3. Both the parliament and the state legislature can levy taxes on subjects enumerated in the

Concurrent list (which are three in number)

4. The residuary power of taxation (that is, the power to impose taxes not enumerated in any

Of the three lists) is vested in the parliament. Under this provision, the parliament has imposed gift tax, wealth tax and expenditure tax.

5. The constitution also draws a distinction between the power to levy and collect a tax and the power to appropriate the proceeds of the tax so levied and collected. For example, the income tax is levied and collected by the centre but its proceeds are distributed between the centre and the states.

11.5.B: further, the constitution has placed the following restrictions on the taxing powers of the states:

(i) A state legislature can impose taxes on professions, trades, callings and employments. However, the total amount of such taxes payable by any person should not exceed Rs. 2,500 per annuam

(ii) A state legislature can impose taxes on the sale or purchase of goods (other than newspapers).

However, this power of the states to impose sales tax is subjected to the four restrictions:

(a) No - tax can be imposed on the sale or purchase taking place outside the states;

(b) No tax can be imposed on the sale or purchase taking place in the course of import or export;

(c) No tax can be imposed on the sale or purchase taking place in the course of inter-state trade and commerce; and

(d) A tax imposed on the sale or purchase of goods declared by parliament to be of special importance in inter-state trade and commerce is subject to the restrictions and conditions specified by the parliament.

(iii) A state legislature can impose tax on the consumption or sale of electricity. but, no tax can be imposed on the consumption or sale of electricity which is a) consumed by the centre or sold to the centre or b) consumed by the construction and maintenance or operation or any railway by the centre or by the concerned railway company or sold to the centre or to the railway company for the same purpose

iv) A state legislature can impose a tax in respect of any water or electricity stored, generated, consumed, distributed or sold by any authority established by parliament for regulating ad developing any interstate river or river valley. However, such law, to effective, should be reserved for the president's consideration and receive his consent.

11.6: distribution of tax revenues

The 80th amendment of 2000 and 88th amendment of 2003 have introduced major changes in the scheme of the distribution of tax revenues between the centre and the states. The 80th amendment was enacted to give effect to the recommendations of the 10th finance commission. The commission recommended that or to the total income obtained from the certain central taxes and duties, 29% should go to the states. This is known as the alternative scheme of devolution and came into effect retrospect from April 1996. this amendment has brought several central taxes and duties like corporation and customs duties at par with income tax (tax on income other than agricultural income) a s their constantly mandated sharing with stets is concerned.

The 88th amendment has added a new article 269 dealing with service tax. It also added a new subject in the union – entry 92-c (taxes and services). The centre collected by the centre, collected, and appropriated by both the centre and states levies service tax.

After these two amendments, the present position in this regard is as follows.

11.6a. **taxes levied by the centre but collected and appropriated by the states** (article 268)

This category includes the following taxes and duties:

i. stamp duties on bill of exchange. cheques, promissory notes, policies of insurance transfer of shares and others

(ii) Excise duties on medicinal and tablet preparations containing alcohol and narcotics.

The proceeds of these duties levied within any state not form a part of the consolidated fund of India, but are assigned to that state.

11.6b: **service tax levied by the centre but collected and appropriated by the centre and the states (article 268-a):**

The centre levies taxes on services. However, their proceeds are collected as well as appropriated by both the centre and the states. The principles of their collection and appropriation are formulated by the parliament.

11.6. c. **taxes levied and collected by the centre but assigned to the states (article 269):**

The following taxes fall under this category:

(i) Taxes on the sale or purchase of goods (other than newspapers) in the course of inter-state

Trade or commerce.

(ii) Taxes on the consignment of goods in the course of inter-state trade or commerce.

The net proceeds of these taxes do not form a part of the consolidated fund of India. They are

Assigned to the concerned states in accordance with the principles laid down by the parliament.

11.6. d. taxes levied and collected by the centre but distributed between the centre and the states (article 270):

This category includes all taxes and duties referred to in the union list except the following:

(i) duties and taxes referred to in articles 268, 268-a and 269 (mentioned above):

(ii) Surcharge on taxes and duties referred to in article 271 (mentioned below'): and

(iii) Any cuss levied for specific purposes. 'The president on the recommendation of the finance commission prescribes the manner of distribution of the net proceeds of these taxes and duties.

11.6. e. surcharge on certain taxes and duties for purposes of the centre (article 271):

The parliament can at any time levy the surcharges on taxes and duties referred to in articles 269 and 270 (mentioned above). The proceeds of such surcharges go to the centre exclusively. In other words, the states have no share in these surcharges.

11.6.f. taxes levied and collected and pertained by states

These are tire taxes belonging to the states exclusively. They are enumerated in the state list and are 20 in number. These are: (i) land revenue; (ii) taxes on agricultural income, succession and estate duties in respect of agricultural land;

(iii) Taxes on lands and buildings, on mineral rights, on animals and boats, on road vehicles, on luxuries, on entertainments, and on gambling; (iv) excise du-ties on alcoholic liquors for human consumption and narcotics

iv) Excise duties on alcoholic liquors for human consumption and narcotics

v) Taxes on entry of goods into a local area on advertisements on consumption or sale of electricity and on goods and passengers carried y road or on inland waterways

vi) Taxes on profession trades callings ad employments not exceeding 2500 per annum

vii) Capitation taxes viii) tolls ix) stamp duty on documents x) sales tax

xi) Fees on the matters enumerated in the state list

11.7: distribution of non-tax revenues

11.7a: the centre

the receipts from the following form the major sources on non tax revenues of the centre i) post and telegraphs ii) railways iii) banking iv) broadcasting v) coinage and currency vii) central public sector enterprises vii) and vii) escheat and lapse

11.7.b. the states

The receipts from the following form the major sources of non-tax revenues of the states i) irrigation ii) forests. iii) Fisheries iv) state public sector enterprises v) escheat and lapse

11.7c.grants in aid to the states

Besides sharing of taxes between the center and the states, the constitution provides for grants in aid to the states from the central resources. There are two types of grants in aid statutory grants and discretionary grants

11.8: statutory grants

Article 275 empowers the parliament to make grants to the states, which are in need of financial assistance, and not to every state. In addition, different sums may be fixed for different states. These sums are charged on the consolidated fund of India every year.

Apart from the general provision, the constitution also provides for specific grants for promoting the welfare of the scheduled tribes in a state. The statutory grants under article 275(both general and specific) are given to the states on the recommendation of the finance commission.

11.9: discretionary grants:

Article 282 of the constitution both the centre and state to make any grants for any public purpose, even if it is not within their respective legislative competence. Under this provision, the centre makes grants to the state on the recommendations of the planning commission.

These grants are also known as discretionary grants, the reason being that the centre is under, no obligation to give these grants and the matter lies within its discretion. These grants have two-fold purpose to help the state financially to fulfill the targets; and to give some advantage and to influence and coordinate state action to make the national plan.

Notably, the discretionary grants from the larger part of the central grants to the states (when com-pared with that of the statutory grants). Hence, the planning commission has assumed greater significance than the finance commission in centre state financial relations.

11.10: other grants

The constitution also provided for a third type of grant in aid, but for a temporary period. thus, a provision was made for grants in lieu of export duties on jute products to the states of Assam, Bihar and west Bengal these grants were to be given for a period ten years from the commencement of the constitution. These sums were charge on the consolidated fund of India and were made to the states, on the recommendation of the finance commission.

11.11: protection of the states interest

To protect the interest of states in the financial meters, the constitution lays down that the bills can be introduced in the parliament only with the recommendation of the president:

1. A bill which imposes or varies any tax or in which states are interested;

2. A bill, which varies the meaning of the section ‘agricultural income’ as, defined for purposes of the enactments relating to income tax;

3. A bill which affects the principles on moneys are or may be distributable to and

4. A bill, which imposes any surcharge on specified tax or duty for the purpose centre.

The expression "tax or duty in which states interested" means: (a) a tax or duty the whole or part of the net proceeds were of are assigned to any or (b) a tax or duty by reference to the net proceeds of sums are for the time being payable, out the consolidated fund of India to any state.

the phrase 'net proceeds' means the proceeds of a tax or a duty minus the cost of collection the net proceeds of a tax or a duty in any' area is to be ascertained and certified by the comptroller and auditor-general of India. His certificate is final.

11.12: borrowing by the centre and the states

The constitution makes the following provisions with regard to the borrowing and the states:

1. The central government can borrow either within India or outside upon the security of the consolidated fund of India or can give guarantees, but both within the limits fixed by the parliament. So far, no such law has been enacted by the parliament.

2. Similarly, a state government can borrow within India (and not abroad) upon the security of the consolidated fund of the state or can give guarantees, but both within the limits fixed by the legislature of that state.

3. The central government can make loans to ' any state or give guarantees in respect of loans raised by any state. Any sums required for making such loans are to be charged on the consolidated fund of India.

4. A state cannot raise any loan without the consent of the center, if there is still out-standing any part of a loan made to the state by the centre or in respect of which the centre has given a guarantee.

11.13: inter-governmental tax immunities

Like any other federal constitution, the Indian constitution also contains the rule of immunity from mutual taxation and makes the following provisions in this regard:

11.13a: exemption of central property from state taxation

The property of centre is exempted from all taxes imposed by a state or any authority within a state like municipalities, district boards, and panchayats and so on. However, the parliament is empowered to remove this ban. the word 'property' includes lands, buildings, chattels, shares, debts, everything that has a money value, and every kind of property,-movable or immovable and tangible or intangible... further, The property tax may used for sovereign (like armed forces) or commercial for purposes. The corporations of the companies created by the central government are not immune from state taxation or local taxation. The reason is that a corporation or a company is a separate legal entity.

11.13b: exemption of state property tax or income from central taxation

The property tax and income of a state is exempted from, central taxation. Such income may be derived from sovereign function or commercial function. However, the centre can tax the commercial operations of a state if parliament so provides. however , the parliament can declare any particular trade of business as incidental to the ordinary function of the government notably the property and income of local authorities stated within a state are not exempted from the central taxation . Similarly, the centre can tax the property or income of corporations and companies owned by u a state.

The Supreme Court, in an advisory opinion (1963) held that the immunity granted to a state in respect central taxation does not extend to the duties of customs or duties of excise s. In other words, the centre can impose customs duty on goods imported or exported by a state, or an excise duty on goods produced or manufactured by a state.

11.13c: effects of emergencies

The centre –state financial relations in normal times (described above) undergo changes during emergencies. \these is as follows:

11.13d: national emergency

While the proclamation of national emergency (under article 352) is in operation, the president can modify the constitutional distribution of revenues between the centre and the states. This means that the president can either reduce or cancel the transfer of finances (both tax sharing and grants in aid) from the centre to the states. Such modification continues until the end of the financial year in which the emergency ceases to operate.

11.13c: financial emergency

While the proclamation of financial emergency (under article 360) is in operation, the centre can give directions to the states. To observe the specified cannons of financial provision should be abandoned and its placed should be taken by a states

11.13e: performance of the states

In select below fields

a) Tax effort

b) Fiscal management

c) Progress in some sectors of national priorities

1. To make the central finance commission a permanent body'

2. To make the loan: grant or plan assistance as '50:50'

3. To empower the states to impose service tax on specified services.

4. To augment more revenues from taxes enumerate e under article 268 and 269'

5. To abolish the upper ceiling imposed by the 11th finance commission on the total fiscal transfers from the centre.

6. To increase the volume of fiscal transfers in view of the expensive and expansive states' responsibilities'

7. To reduce the size or number of centrally sponsored schemes.

the states demand the above issues to be solved in their favour, the center holds that states depend on the center for fiscal resources without exploiting their own resources allotted that both the centre and the states need to solve the fiscal problems with mutual and better understanding, cooperating each other without suspecting each other' then only it would be possible to have a cooperative federalism in India.

The Sarkaria commission is in the view that flow of direct assistance and re-finance through cooperatives and the other institutions to agriculture and private enterprises in other sectors does not generally fall within the ambit of union-state financial relations. However, given the overall development and equity considerations, it is too important to be ignored. Undesirable politicization of the cooperative system, thus leaving untapped substantial institutional finance, which could be available for development, has been noted by expert studies. In the context of consideration of institutional finance to the private sector, two aspects become pertinent. One is that scarce capital resources in our country carry a high opportunity-cost. Therefore, their optimum use is necessary. The second aspect is that notwithstanding the preferential and concessional finance facility offered, people in the less-developed states have not been able to avail of the institutional finance to the desired extent. It is necessary to develop organizational capabilities and enterprise urgently in such states.

Given mutual trust, confidence and under-standing between the two tiers of the polity, our recommendations—it is hoped—, if implemented, will go a long way to ensure smooth and harmonious working of the union-state arrangements on principles of cooperative federalism. However, it is not claimed that they foreclose the need for a countrywide debate in political, academic and other forums as to their merits, utility and viability.

11.2: summary

The centre-state fiscal relations are very important in the Indian federation. We have fulfilled constitutional division of powers and functions are in favour of the center and other reasons for the emergence of fiscal imbalances. We have also learnt the various methods of fiscal adjustment_incorporated in the constitution, the role of the finance and planning control and various types of fiscal transfers from the centre. There have been several fiscal problems between the centre and the states even though the fiscal transfers have increased by so many times in the last six decades. The issues or measures, as viewed by the states, to improve the centre-state fiscal relations are also explained. There is a need for evolving cooperative federalism by initiating necessary measures in India by the present government.

11.3: Questions

1. Explain the constitutional division of powers in India

2. What are the functions of the center?

3. What are the functions of the state?

4. \what are the problems of centre state relations.

5. What are the taxes levied and shared by the centre

6. Explain the different taxes levied by the state and appreciated by the state?

7. Discuss the role of non-tax revenues in the centre state financial relations?

8. What arte the provisions for financial emergency?

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MODULE-3

LESSON-4

SARKARIA COMMISSION REPORT

12.0: introduction

In the year 1983, the then central government appointed a three-member commission on centre state relations under the chair ship of R.S.Sarkaria, a retired judge of the Supreme Court. The commission was asked to examine and review the working of existing arrangements between the centre and states in all spheres and recommend appropriate changes and measures. It was initially given one year to complete its work but its term was extended four times. The final report was submitted in October 1987, and the summary was later officially released in January 1988.

12.1: recommendations

12.1. A: financial

Union government should, in consultation with the state governments, periodically consider and explore the revision or imposition of these duties. The revenue raised from these duties should be separately specified in the budget and other relevant publications.

Taxation of agricultural income is a sensitive matter. In view of its potential, the question of raising resources from this source by forging political consensus and the modalities of levying the tax and collection of proceeds, etc., would require an in-depth and comprehensive consideration in the national economic and development council.

By an appropriate amendment of the constitution, the net proceeds of corporation tax may be made permissibly sharable with the states, if and as parliament may by law so provide. This would have the advantage of enlarging the base of devolution so that in the revenues of the states there would be greater stability and predictability, if future. Further, being an elastic resource, the states would benefit from its growth consequent on inclusion of corporation tax in the divisible pool; adjustments will have to be carried out by suitably bringing down the shares of states in income tax and union excise duties.

The union government except for a specific purpose and for a strictly limited period only should not levy the surcharge on income tax.

Both the union and the state governments on schemes, which have come to be known as populist measures, incur substantial expenditure. It will be in the best interests of the concerned governments to take explicitly into account the high opportunity-cost of such schemes and to examine whether any important programmes of development are compromised due to such diversion of scarce resources.

It is necessary that a comprehensive paper on direct, indirect and cross-subsidies, covering both union and state governments, is prepared by the planning commission every year and brought up before NCDC for discussion, since the increasing burden of subsidies has a direct relevance to the availability of resources for the execution of the plan.

There needs to further strengthen the finance commission division? It would result in much closer coordination between the planning commission and the finance commission if this division were to work under the general supervision of the member in charge of financial resources in the planning commission. Such an arrangement will also make available to the planning commission data and analysis on various parameters relevant for resource discussions for the plan and reviewing of the finances of the union and the states.

The step taken by the union government to initiate a process of consultation with the states in finalizing the terms of reference of the finance commission is in the right direction. Any consultation to be meaningful should be adequate. However, there is no advantage in formalizing the same through a change in the constitutional provisions, which would introduce undue rigidity. Nonetheless, it is desirable that this healthy practice of informal consultation with the states in this matter should co

There are complaints that the yield from certain cusses levied along with union excise duties under special acts of parliament has remained outside the divisible pool of resources. While it may become necessary for the union government to levy such cusses in view of the special needs, their application should be for limited durations and for specific purposes only.

The constitution should be suitably amended to add the subject of taxation of 'advertisement broadcast by radio or television' to the present entry 92, list i and article 269(1)(f)

The finance commissions take into account the expenditure liability of the states with respect to dearness allowance, etc., and make a provision for the same. However, inflation increases both outlays and revenues. The permanent secretariat of the finance commission should make an annual review of the situation. If in any year the net burden of the states seems unduly heavy, the planning commission and the union ministry of finance should jointly evolve appropriate relief measures.

His rationality of transfers from the union to the states would involve more of revenue transfers to the less-developed states with the lower repayment capacity and weak financial base. In contrast, keeping in view the needs of development in the advanced states, a suitable mix of budgetary and non-budgetary access to capital resources may be allowed to them. The logic is that such states are in a better position to service commercial borrowings.

The union government should give its consent freely to states for borrowing from banks and financial institutions for periods less than one year under clause (4) of article 293.

The seasonal range of weekly ways and means "demand" compared to the prescribed limits should be carefully studied every year for the preceding triennium in the light of price-trends, separately for each state, by the reserve bank and taken into account in re-fixing quarterly ways and means limits for the state. The period for overdrafts should be extended from seven to 14 days in view of the prevailing time lag in collecting relevant information from various treasuries. Simultaneously, steps should be taken to modernize the treasury system.

Importance of decentralization of power in India, because of the diversities in relation, language, caste, race, etc. there are a large number of groups, seeking to establish their identity and promote their sectional interests. the issue of devolution of powers and responsibilities between the top two tiers of government, union and states, needs, therefore, to be considered in the context of the broader issue of decentralization between these and other tiers of government on the one hand, and the functional agencies within each of these tiers, on the other. The interests and aspirations of most people are concentrated in the localities in which they live and carry on their avocations of life. Normally, they would be content to compete at the level of the local self-governing bodies, making way for persons interested in larger issues of regional or national significance, to opt for higher elective forums. decentralization of real power to these local institutions would thus help defuse the threat of centrifugal forces, increase popular involvement all along the line, broaden the base of our democratic polity, promote administrative efficiency and improve the health and stability of inter-governmental relations. Unfortunately, there was not only inadequacy

The commission has drawn attention in the chapter on economic and social planning to the need for decentralization of the planning process. The objectives of decentralized planning cannot be achieved unless the panchayati raj and other local bodies are allowed full scope to play their role. The commission was of the view that for this purpose, it is necessary that elections are held regularly and adequate finances are devolved on these institutions. To rectify this dysfunctioning of the local self-governing bodies it is necessary to ensure, by legal provisions analogous to those in articles 172 and 174 of the constitution, that elections to and sessions of Zilla Parishads, municipal corporations are held regularly, and these institutions do not remain superseded for long periods. The power of enacting such a law vests under entry 5, list ii exclusively in the state legislatures. Nevertheless, uniformity in these aspects of the law throughout the territory of India is essential. This uniformity can be secured by adopting, in the following order of preference, any of the alternatives given below:—

Effective participation by citizens is an integral part of democracy. Large parts of the programmes, projects and services initiated by the union are executed in the states. Many of the programmes undertaken by the states also have wider implications for the union as well as local governments. There is at present no forum where a citizen can present his views on all these matters. No doubt, the inter-governmental council recommended by us would discuss various issues of national importance. However, it will necessarily be in camera.

12.1.b: non-financial recommendations

The commission made 247 recommendations. To improve centre state relations. The important recommendations are mentioned below

1. A permanent interstate council called the inter governmental council should be set up under article 263

2...article 356 (president rule) should be used very sparingly, in extreme cases as last resort when the entire available alternative fail.

3. The institution of all India services should be further strengthened and some ore such services should be created.

4. The residuary powers of taxation should continue to remain with the parliament, while the other residuary powers should be placed in the concurrent list.

5. When the president withholds his assent to the state bills, the reasons should be communicated to the state government.

6. The national development council (NDC) should be renamed and reconstituted as the national economic and development council (NCDC).

7. The zonal councils should be constituted / afresh and reactivated to promote the spirit of federalism-

8. The centre should have powers to deploy its armed forces, even without the consent of states. However, it is desirable that the states should be consulted.

9. The centre should consult the states before making a law on a subject of the concurrent list.

10. The procedure of consulting the chief minister in the appointment of the state governor should be prescribed in the constitution itself.

11. The net proceeds of the corporation tax may be made permissibly shareable with the states.

12. The governor cannot dismiss the council of ministers so long as it commands a majority in the assembly.

13. The governor's term of five years in a state '/ should not be disturbed except for some extremely compelling reasons.

14. No commission of enquiry should be set up against a state minister unless a demand is made by the parliament.

15. The surcharge on income tax should not be levied by the centre except for a specific purpose and for a strictly limited period.

16. The present division of functions between the finance commission and the planning commission is reasonable and should continue.

17. Steps should be taken to uniformly implement the three-language formula in its true spirit.
18. No autonomy for radio and television but decentralization in their operations.

19. No change in the role of Rajya Sabha and centre's power to reorganize the states.

20. The commissioner for linguistic minorities, should be activated until December 2011, the central government has implemented 180 (out of 247) recommendations of, the Sarkaria commission.

21. The last important is " the establishment of the inter-state council in 1990

12.2: summary

In the above chapter the establishment of the Sarmatia commission and it s recommendation were discussed. The commission did not favour structural changes and regarded the existing constitutional arrangements and principles relating to the institutions sound. However, emphasized on the need for changes in the functional arrangement for cooperative action than static institutional concept. it out rightly rejected the demand for curtailing the powers of the center and stated that a strong centre is essentially to safeguard the national unity and integrity which is being threatened by the fissiparous tendencies in the nobody politic . However, it did not equate strong centre with centralization of powers. It is observed that over centralizations leads to bloods pressure at the centre and anemia at the periphery. It has changed the course of center state relations.

12.3: Questions

1. Explain in detail the about the Sarkaria commission

2. What are the financial recommendations of the Sarkaria Commission?

3. What are the non - recommendations of the Sarkartia commission

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MODULE-5

LESSON-1

INSTRUMENTS OF FISCAL POLICY AND LONG TERM FISCAL POLICY

18.0:Introduction

Fiscal policy deals with the taxation and expenditure decisions of the government. Monetary policy, deals with the supply of money in the economy and the rate of interest. These are the main policy approaches used by policy experts to steer the broad aspects of the economy. In most modern economies, the government deals with fiscal policy while the central bank is responsible for monetary policy. In this chapter the instruments of fiscal policy and the long-term fiscal policy is discussed.

18. 1: Fiscal Policy

Fiscal policy is composed of several parts. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy. Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends, more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. This tends to influence other economic variables.

On a broad generalization, excessive printing of money leads to inflation. If the government borrows, too much from abroad it leads to a debt crisis. If it draws down on its foreign exchange reserves, a balance of payments crisis may arise. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds. Sometimes a combination of these can occur. In any case, the impact of a large deficit on long run growth and economic well-being is negative. Therefore, there is broad agreement that it is not prudent for a government to run an unduly large deficit.

However, in case of developing countries, where the need for infrastructure and social investments may be substantial, it sometimes argued that running surpluses at the cost of long-term growth might also not be wise (Fischer and Easterly, 1990). The challenge then for most developing country governments is to meet infrastructure and social needs while managing the government's finances in a way that the deficit or the accumulating debt burden is not too great strategy.

18.2. Objectives of Fiscal Policy

The following are the objectives of fiscal policy:

1. To maintain and achieve full employment.

2. To stabilize the price level.

3. To stabilize the growth rate of the economy.

4. To maintain equilibrium in the balance of payments.

5. To promote the economic development of underdeveloped countries.

18.3: Implications of the Functional Finance:

i) Government finances be dealt on a 'functional'. Basis, and revenue and expenditure should not be considered 'solely by the requirements of securing Collective consumption

ii) The budget need not always be balanced. It is, in fact, less desirable (to balance the Budget) under conditions economic recession.

iii) Similarly, public expenditure (or for that matter, taxation) should not be considered for its direct benefits, but for, the sake of indirect impact it produces in the form of raising effective demand.

With some knowledge of macroeconomic analysis, it is not difficult to comprehend as to how such a fiscal policy functions. Returning to the equation: Y =C+ I+G allowing for nation’s exports and imports, y, or I: C+I+G+X-M, the public spending can be directly controlled by the government, while other variable can be indirectly affected through taxation and other fiscal measures. The Keynesian analysis thus brings the fiscal policy into the mainstream of economic analysis.

18.4: fiscal policy for growth and development

Ms. U.K. Hicks rightly observes, "Now that fiscal policy has been developed as an established economic function of the government, every country is anxious to gear its public finances in pursuit of the twin aims of stability and growth; but their relative importance is very differently regarded from one country to another. A poor and backward country will strive to put most of the emphasis on growth, especially if. - its population is expanding rapidly". In the context of this statement, the main aim of the fiscal policy is to encourage growth and development

18.4a: Evolution of Indian fiscal policy until 1991

India commenced on the path of planned development with the setting up of the Planning Commission in 1950. In terms of tax policy, this meant that both direct and indirect taxes were focused on extracting revenues from the private sector to fund the public sector and achieve redistributive goals. The government authorized a comprehensive review of the tax system culminating in the Taxation Enquiry Commission Report of 1953.

British economist Nicholas Kaldor examined the possibility of reforming the tax system. Kaldor found the system inefficient and inequitable given the narrow tax base and inadequate reporting of property income and taxation. The Indirect Tax Enquiry Report of 1977 recommended introduction of input tax credits to convert the cascading manufacturing tax into a manufacturing value added tax (MANVAT). It was later changed as modified value added tax (MODVAT) was introduced in a phased manner from 1986 covering only selected commodities.

. India, has adopted the strategy of planned development wherein public sector had been assigned a key role. As much as 60 per cent of our has been allocated to the public sector. Other Development outlays of the plan also significantly contribute to the national development. In order to finance this large volume of public sector outlays as well as to promote private sector' investment' especially in a democratic society, there is no alternative to fiscal policy. According to Prof. R'J' Chelliah, an eminent economist, Fiscal policy “is the most powerful and the least undesirable weapon of control which the state can employ, to promote growth and employment”. Fiscal policy, for a developing economy should aim at raising the incremental saving ratio".

18.5: fiscal instruments and their tasks in a developing country

Various fiscal instruments and fiscal choices can be used to achieve objectives’ in this regard, fiscal instruments or areas of activity and their tasks'

18.5.1. Public Expenditure

a) Direct spending on public sector capital formation. especially on social overheads'

b) Indirect expenditure on promoting private investment, including R & D

c) Priority to anti-poverty programmers and desirable welfare expenditure (for instance family welfare, literacy, and public wealth)'

18.5.2. Taxes and Subsidies

a) Heavy taxes on undesirable consumption

B) Special tax concession/subsidies for (i) promoting savings. (ii) Affecting changes in sectoral/regional distribution of investment

c) Progressive taxation to curb concentration of income and wealth.

18.5.3. Choice of Revenue adjustment

Source of government finance varying consequential effects on price stability and other object. For instance. an increase in general or overall prices would different in terms of its magnitude 'social implication and time-path of change while the same amount of revenue is raised by indirect taxes-deficit finance' or - upward price-revision of public sector produced input goods (energy, steel. etc). Hence, a 'least cost' solution has to be strived for in terms of resource mobilization through the alternative revenue sources

18.5.4. Loan Finance and Debt Management

a) Public borrowing- primarily- at technique for transferring savings from private to the public sector.

b) Minimum, use of borrowing from the central banks and commercial banks.

C) Debt management related to the needs of developing the financial infrastructure and the regulation of overall liquidity conditions.

18.5.5. Fiscal Co-ordination

A) Economic planning and fiscal policy coordination

B) Need for coordination budgetary policies of the Central and State governments. Coordination among the various aspects of fiscal policy.

18.6. Long Term fiscal policy (LTFP)

This Long-Term Fiscal Policy Framework includes three goals: (1) structural balance; (2) sustainable spending growth; and (3) disciplined management of long-term liabilities.

1) Structural balance is achieved when budgetary spending is based on sustainable levels of revenue.

2) Sustainable spending growth is targeted to maintain structural balance throughout a five-year 3) Disciplined management of long-term liabilities is.

In 1985-86, the government presented its Long-Term Fiscal Policy stressing on the need to reduce tariffs, have fewer rates and eventually remove quantitative limits on imports.

18.7: Liberalization, growth, inclusion and fiscal consolidation (1991-2014)

Following the balance of payments crisis of 1991, the government commenced on a path of economic liberalization whereby the economy was opened up to foreign investment and trade, the private sector was encouraged and the system of quotas and licenses was dismantled. Fiscal policy was re-oriented to cohere with these changes.

The Tax Reforms Committee provided a blue print for reforming both direct and indirect taxes. Its main strategy was to reduce the proportion of trade taxes in total tax revenue, increase the share of domestic consumption taxes by converting the excise into a VAT and enhance the contribution of direct taxes to total revenue. It recommended reducing the rates of all major taxes, minimizing exemptions and deductions, simplifying laws and procedures, improving tax administration and increasing computerization and information system modernization

In indirect taxes, the MODVAT credit system for excise was expanded to cover most commodities and provide a comprehensive credit system by 1996-97. The eleven rates were merged into three with a few luxury items subject to additional non-rebatable tax in 1999-2000. In 2000-01, the three rates were merged in to a single rate and renamed as central VAT (CENVAT).

Despite the reforms in central taxes, even after the economic reforms of 1991, state government tax reforms were inadequate and sporadic. A major move in this direction was the coordinated simplification of the state sales tax system in 1999. This eventually led to the introduction of a VAT in 21 states in 2005.

Table 18.1:Composition of central government revenues (1995-12)

	1995-96	2000-01	2005-06	2009-10	2011-12	2013-14 RE)
Direct Tax	20	26	35	48	47	49
Indirect tax	54	45	43	32	37	37
Non-tax Revenue	26	29	22	20	16	14

Data source: Database on the Indian Economy, (Reserve Bank of India, 2014)

Recent developments indicate that policymakers have come to accept strict budgetary constraints, while attempting to maximise resources for developmental activities. The Planning Commission abundantly reveals this in its preparatory reports for the 12th Five Year Plan (2012-17) Rather than rely on revenue performance alone, expenditure reforms with effective targeting of subsidies appears to be a major policy strategy.

The main approach in the Fiscal policy after liberalization is on 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. 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 is another aspect. Unification of tax rates on closely held as well as widely held domestic companies. There is a 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.

18.8: Fiscal Policy for 2015-16

The fiscal policy of 2015-16 has been calibrated with two fold objectives – first, to aid economy in growth revival; and second, to institutionalize the co-operative federal structure in light of emerging views on the Centre-State fiscal relations. While, allocations in the social and welfare sectors have been protected, it is expected that the States' will be bringing in greater share to give fillip to government spending in these sectors. Under the Central Plan, which falls under the exclusive domain of the Centre, allocation has been increased in the Capital spending. Similarly, higher allocations have been made to core sectors of infrastructure, which have the potential to give impetus to manufacturing and job creation.

Key initiatives taken in the current financial year include rationalization of administered pricing policies in petroleum and natural gas, removing bottlenecks in the land acquisition and to ensure adequate availability of key inputs like coal and power

Given the resource constraint explained above on the revenue side, only option to raise additional resources remains through borrowing. The debate on easing fiscal deficit roadmap had been argued to give boost to public spending in the core sectors of the economy.

18.8a: Tax Policy

During the fiscal consolidation period, the tax- GDP ratio improved significantly from 9.2 per cent in 2003-04 to 11.9 per cent in 2007-08 and 12.1 in the year 2014-15. This has been achieved through rationalization of the tax structure (moderate levels and a few rates), widening of the tax base, and reduction in compliance costs through improvement in tax administration. The extensive adoption of information technology solutions and re- engineering of business processes has also fostered a less intrusive tax system and encouraged voluntary compliance. These measures resulted in increased buoyancy in tax revenues until 2007-08 and helped in achieving fiscal consolidation through revenue measures alone by 2015-16.

18.8b: Direct Taxes:

The Government policy on direct taxes has been to achieve growth in direct taxes by broadening the tax base while maintaining a regime of moderate tax rates. Tax collection is the product of two factors- tax rates and tax base. There will be no change in the rate of personal income tax and the rate of tax for companies in respect of income earned in the financial year 2015-16.

18.8c: Government Borrowings, Lending and Investments

The governments of developing countries have used the measure of public borrowing also for resources. This measure has its limitations because the level of income of the people is s low and a small number of people are able to save.

In addition to these measures, the governments cause-the surpluses of public utilities and public enterprises for investment However, this is possible only are charged for their products/services' Frequently public enterprises, railways, ports, postal and telegraph systems, irrigation works, etc" not only fail to cover depreciation and interest but also run with deficits.

18.8c :Debt management

Recently published Status Paper on Government Debt is to improve transparency in dissemination of information related to public debt. In recent document(December, 2014) the government mentioned Prudent debt management is necessary to face international shocks. In poor country, debt policy is driven by the principle of gradual reduction of public debt to GDP ratio . The debt policy in India emphasizes maintaining a stable, sustainable, low cost and prudent debt structure.The government is in process of introducing necessary legislation and setting up its own Public Debt Management Agency (PUMA).

The commitment to carry on with the fiscal consolidation measures, the fiscal deficit for 2015-16 is budgeted to decline to 3.9 per cent of GDP. Total borrowings requirement for 2015-16 has been budgeted at ` 5,55,649 crores. Net market borrowings (adjusted for repurchases/ switches in (2015-16) of ` 4,56,405 crore has been budgeted to finance 82.1 per cent of gross fiscal deficit.

18.8d: Public Expenditure Management Commission:

Public expenditure in India assumed significance in the context of the mixed economy model adopted since Independence The primary responsibility of building the capital and infrastructural base rested with the Government. The concerns regarding equity and poverty alleviation, particularly since the 1970s, added another important dimension to public expenditure in terms of redistribution of resources. The inadequate returns on the huge capital outlays over the years as well as the macroeconomic crisis of 1991 stemming from high fiscal imbalances led to a shift in the focus from mere size to efficiency in public expenditure management so as to facilitate adequate returns and restore macroeconomic stability.

The cutbacks in capital outlay undertaken as part of the expenditure management in the first half of the 1990s. It raised concerns over the inadequate infrastructural investment and the repercussions on the long-term growth potential. The upward movement in Government's revenue expenditure was partly responsible for fiscal deterioration which set in during the latter half of 1990s.

With a renewed commitment towards fiscal consolidation since 2003-04, re-prioritization of expenditure and emphasis of outcomes rather than outlays are the guiding principles of public expenditure management in our country.

Apart from the emphasis on undertaking large-scale capital outlay, expenditure policy was also geared towards promotion of equity and social justice through public expenditure on social welfare and poverty alleviation schemes. Rural development received special attention in terms of larger outlays and directed lending by the newly nationalized banks. Several employment schemes were inaugurated and small-scale industry, which was touted to promote employment, was given special privileges. Exchange control and industrial licensing were tightened during this period

While Government has managed to control the expenditure through rationalization in the fiscal consolidation phase, and has been successful in taming the fiscal deficit; however the public finance on the revenue side requires attention. This entails structural changes in the Plan spending and definitive measures to contain Non-Plan spending within sustainable limits. In recent times, there are initiatives from the government side to establish the public expenditure management commission. The RBI opposed this idea.

18.9: Conclusion

India's fiscal policy in the phase of planned development commencing from the 1950s to economic liberalization in 1991 was largely characterized by a strategy of using the tax system to transfer private resources to the massive investments in the public sector industries and achieve greater income equality. The result was high maximum marginal income tax rates and the consequent tendency of tax evasion. The public sector investments and social expenditures were also not efficient. In the post liberalization the fiscal policy is concentrated on the reducing the revenue deficits and fiscal deficits. In addition to these the fiscal policy was concentrated on attracting the FDIs. Post liberalization the fiscal policy is aimed to create the capital intensity and reducing fiscal deficit and liberalizing the tax structure.

Later years in the context of liberalization and privatization there are drastic changes in the tax rate and import duties.

18.10: Questions

1. What are the objectives of the fiscal Policy?

2. How fiscal policy which influence Growth and development

3. Explain the Evolution of the Indian fiscal Policy?

4. What are the fiscal instruments in implementing the fiscal Policy?

5. What is the fiscal policy that is initiated in the budge year of 2015-16?

6. Discuss on the debt management and public expenditure Management?

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MODULE-5

LESSON-2

COMPENSATORY FISCAL POLICY AND INFLATION

19.0: Introduction

The compensatory fiscal policy is a deliberate budgetary action taken by the government to compensate for the deficiency in, and to reduce the excess of, aggregate demand. The compensatory action is taken by the government in the form of surplus budgeting of deficit budgeting.

The policy of surplus budgeting is adopted by the governments during the period of high rate of inflation, especially when inflation is caused by excessive demand. Surplus budgeting is a powerful tool to control the aggregate demand. Under this policy, the government keeps its expenditure lower than its revenue. If necessary, the government may resort to a higher rate of taxation and cut its expenditure further down. Taxation reduces disposable income. As a result, the aggregate demand decreases at the rate of tax multiplier. On the expenditure side a cut in the government expenditure reduces the aggregate demand at the rate of expenditure multiple. The two-prong attack on the aggregate demand hips reducing the demand pressure and, thereby, the inflation.

Most of the classical economists favored balanced budgets. It is implied that, the governments, like individuals, should live 'within their means' and their expenditures should not exceed the, revenue. This philosophy of balanced budgets grew out of the conviction that the State should pay a minimum role in economic activity. However, luring the period of the Great Depression in 1930s, it was recognized that the State could push up the productive activity and usher the economy intro the phase of economic recovery if it extended its expenditures much beyond its revenues. It was argued that such an expansion 'would generate additional demand and this, in turn, would give a boost to industrial production and business activity' Therefore, deliberate 'unbalancing' of the budget in such a way that government expenditure exceeded government revenue was advocated as a measure to overcome depression and set the economy on the path of economic recovery.

19.1: The objective of compensatory fiscal policy:

19.1a: Increasing the Rate of Investment

since the level of employment and income are low in developing countries and there is a huge mass of underemployed people, the fiscal policy must aim at increasing the employment. This implies that the rate of investment has to be pushed up to a high degree. This can be done by pushing up the incremental saving ratio and by restricting actual and potential consumption.

As far as the latter is concerned, the governments of developing countries shall have to exercise direct physical controls on the availability and use of certain consumption goods (especially non-essential goods) and control the demonstration effect of advanced countries operating on the consumption level of developing countries' As far as raising the incremental saving ratio is concerned, the most effective measure is raising the governmental income through taxation and public spending. Income from taxes can be increased either by raising the rates of the existing taxes or by imposing new taxes.

The difficulty in raising additional resources through taxation in developing countries is that the levels of income are very low and only a small number of the people have the ability to pay taxes. Therefore, the scope of imposing direct taxes (like income tax) is not much. As the government continues to increase the rates of these taxes, the limit of the ability to pay soon. It is not possible to go beyond this limit without causing hardships to the tax-payers and without adversely affecting the level of private investment' Therefore of necessity, the governments of the developing countries have to resort increasingly to indirect taxes' As long as these taxes are imposed on Luxury goods, they do not cause much hardships as such goods are purchased by the elite class, However, luxury goods have an elastic demand and if their prices continuously increase, their demand is likely to fall considerably.

If the government is interested to get tax revenue, it must tax essential consumer goods since their demand is inelastic. However, the priority is likely to impinge hard on the poor classes of people. since they must purchase these goods whatever the price. This shows that raising additional resources through taxation is not easy task and many difficult choices have to be selected.

19.2: major objectives of compensatory fiscal policy

19.2a: Reducing Inequalities in income

There are extreme inequalities in income and wealth-in developing countries. While the majority of the people struggle hard to make both ends meet, a small number of people possess huge money and financial resources and control the reins of the economy. For instance, in India, about one-third of the population is below the poverty line which is defined as a line ensure subsistence lever while some 20 to 25 large business houses exercise effective controls on-the industrial economy of the country' A welfare state committed to social equality and economic justice

In this regard, fiscal policy can play an important can be designed in such a way that the overall tax structure is highly progressive. Sections of the population should be compelled to contribute substantially more in the form of taxes than the poorer sections. The lowest stratum of the society should not be taxed. As far as public expenditure is concerned, the government can undertake programmers of medical-care for poor, ensure free education to poor children, provide free housing Laborers, etc. Thus, by a judicious mixing of tax policies and public expenditure policies, the governments of developing countries succeed in reducing the economic inequalities. However, existence corruption, tax evasion and political conveniences of joining hands with the rich. There are economic limits also on making the tax structure too progressive as such; a tax structure is likely to affect adversely the ability and willingness of the private sector to invest.

19.2b. Reducing Unemployment and Underemployment

Fiscal policy can be used as a measure to tackle the problem of unemployment and under-employment in developing countries. Public expenditure programme can play a specific role in this regard. For example, it is a known fact that a large number of rural people remain unemployed and/or under- employed during off seasons (i.e., when there is no work on land). A public works programme of constructing school buildings, hospital buildings, roads, earthen dams, irrigation canals, etc., can be undertaken during these periods to give employment to such people. A number of developing countries have initiated public works programmes. The Government of India made a start in this direction by adopting the Rural Works Programme (RWP) in the Third Plan.

This was followed by a number of similar programmes like the Crash Scheme for Rural Employment, Employment Guarantee Scheme, Pilot Intensive Rural Employment Project, Food for Work Programme, National Rural Employment Programme (NREP), Jawahar Rozgar Yojana (JRY), Employment Assurance Scheme (EAS), Jawahar Gram Samridhi Yojana (JGSY), Swamajayanti Gram Swarojgar Yojana (SGSY), Swarna JayantiShahri Rozgar Yojana (SJSRY) etc. The latest and the most ambitious programme for creation of employment opportunities in the rural areas is the National Rural Employment Guarantee Scheme (NREGS).

The objective of these programmes has been to generate additional gainful employment for the unemployed and under-employed persons in the rural areas, to create productive community assets for direct and continuing benefits to the poverty groups and for strengthening the rural, economic and social infrastructure and bring about a general improvement in the overall quality of life in the rural areas. The overriding objective, of course, has been provision of wage employment to rural poor.

19.2c: Controlling inflationary Tendencies

Because of the need to implement large-scale industrialization programmes in the face of paucity of resources, the developing countries are often led to depend more and more on deficit financing. This creates inflationary conditions as supply of goods fails to increase sufficiently to nullify the increase in demand. Consequently, it becomes necessary to implement fiscal measures to control (or reduce) the level of demand and encourage the production of goods (especially mass consumption goods). The level of demand can be reduced by raising the level of taxation. For increasing the supply of goods, incentives to industries can be granted and, if necessary, protection to essential consumer goods industries can be given.

19.2d: interrelated monetary and fiscal policy.

Even since the 1930s when the role of fiscal policy was first recognized in a right perspective it has been given increasing importance in both, the developed and the developing countries. In the context of the depression conditions of the 1930s, it was found that cheap money policy had proved ineffective to induce private investment. It was suggested that private investment could ‘be stimulated by creating new community income through deficit spending. Later on, the role of deficit spending ‘in checking chronic tendencies towards over-saving and under-investment was duly emphasized. After the Second World War, the developing countries have found in this instrument an easy way to raise resources for economic development. Therefore, though originally conceived to supplement monetary' policy, fiscal policy has tended to supplant it. The consequent neglect of monetary policy has had various harmful effects on the economies of the developing countries, the most important being the reckless monetary expansion accompanied by inflationary rise in prices.

High and ever ‘increasing prices in many developing countries have encouraged speculative activities and undermined the confidence of the people in their currencies besides creating numerous problems in the planning process. These points to the necessity of evolving a judicious mix of monetary and fiscal policies. As noted by Robert B. Bangs, perhaps a judicious mix in the context of a developing economy will involve a tight fiscal policy combined with an easy credit policy. A tight fiscal policy ensures that an ample volume of resources is generated to finance public expenditure programmes while an easy credit policy ensures that private investment is not allowed to suffer because of inadequacy of loans. Such a policy has an additional benefit that it is less inflationary as compared to alternative mix of policies since private investment generally adds to output more quickly than public investment.

19.2e: compensatory fiscal policy as anti-depression measure- difficulties:

1. There has to be a proper timing of public investment. However, it is difficult to forecast the advent of depression.

2. The required magnitude of public investment is to be determined in relation to the duration and amplitude of the depression, along with the multiplier effect causing income propagation. It is, however, difficult to measure the amplitude of the contractionary phase and the severity of the depression at the time of recession.

3. The advent of depression cannot be checked so soon by the immediate enforcement of compensatory public spending.

4. When compensatory public spending is financed through public loans it adds to the burden of public debt.

5. Any public work project when undertaken has to be completed. In addition, if it does not coincide with the contraction phase and if it is prolonged, further even when depression is overcome, it will generate inflation.

19.3: approaches Compensatory Fiscal Policy:

The compensatory fiscal policy aims at continuously compensating the economy against chronic tendencies towards inflation and deflation by manipulating public expenditures and taxes. It, therefore, necessitates the adoption of fiscal measures over the long run rather than once-for-all measures it a point of time.

When there are deflationary tendencies in the economy, the government should increase its expenditures through deficit budgeting and reduction in taxes. This is essential to compensate for the lack in private investment and to raise effective demand, employment, output and income within the economy.

On the other hand, when there are inflationary tendencies, the government should reduce its expenditures by having a surplus budget and raising taxes in order to stabilize the economy at the full employment level.

19.3a :Built-in stabilizers; and

19.3b: Discretionary fiscal policy.

19.3a .1: Built-in Stabilizers:

The technique of built-in flexibility or stabilizers involves the automatic adjustment of the expenditures and taxes in relation to cyclical upswings and downswings within the economy without deliberate action on the part of the government. Under this system, changes in the budget are automatic and hence this technique is known as one of automatic stabilization.

The various automatic stabilizers are corporate profits tax, income tax, excise taxes, old age, survivors, unemployment insurance, and unemployment relief payments. As instruments of automatic stabilization, taxes and expenditures are related to national income. Given an unchanged structure of tax rates, tax yields vary directly with movements in national income, while government expenditures vary inversely with variations in national income.

In the downward phase of the business cycle when national income is declining, taxes, which are based on a percentage of national income automatically, decline, thereby reducing the tax yield. At the same time, government expenditures on unemployment relief and social security benefits automatically increase. Thus, there would be an automatic budget deficit, which would counteract deflationary tendencies.

On the other hand, in the upward phase of the business cycle when national income is rising rapidly, the tax yield would automatically increase with the rise in tax rates. Simultaneously, government expenditures on unemployment relief and social security benefits automatically decline. These two forces would automatically create a budget surplus and thus inflationary tendencies would be controlled automatically.

19.3a.2: It's Merits:

Built-in stabilizers have certain advantages as a fiscal device:

1. The built-in stabilizers serve as a cushion for private purchasing power when it falls and lessen the hardships on the people during deflationary period.

2. They prevent national income and consumption spending from falling at a low level.

3. There are automatic budgetary changes in this device and the delay in taking administrative decisions is avoided.

4. Automatic stabilizers minimize the errors of wrong forecasting and timing of fiscal measures.

5. They integrate short-run and long run fiscal policies.

19.3a.3: limitations:

1. The effectiveness of built-in stabilizers as an automatic compensatory device depends on the elasticity of tax receipt, the level of taxes and flexibility of public expenditures. The greater the elasticity of tax receipts, the greater will be the effectiveness of automatic stabilizers in controlling inflationary and deflationary tendencies. However, the elasticity of tax receipts is not so high as to act as an automatic stabilizer even in advanced countries like America.

2. With low level of taxes even a high elasticity of tax receipts would not be very significant as an automatic stabilizer doing a downswing.

3. The built-in stabilizers do not consider the secondary effects of stabilizers on after-tax business incomes and of consumption spending on business expectations.

4. This device keeps silent about the stabilising influence of local bodies, state governments and of the private sector economy.

5. They cannot eliminate the business cycles. At the most, they can reduce its severity.

6. Their effects during recovery from recession are unfavorable. Economists, therefore, suggest that built-in stabilizers should be supplemented by discretionary fiscal policy.

19.3b: Discretionary Fiscal Policy:

Discretionary fiscal policy requires deliberate change in the budget by such actions as changing tax rates or government expenditures or both.

It may generally take three forms:

(i) Changing taxes with government expenditure constant,

(ii) changing government expenditure with taxes constant, and

(iii) variations in both expenditures and tax simultaneously.

(i) When taxes are reduced, while keeping government expenditure unchanged, they increase the disposable income of households and businesses. This increase private spending. However, the amount of increase will depend on whom the taxes are cut, to what extent, and on whether the taxpayers regard the cut temporary or permanent.

If the beneficiaries of tax cut are in the higher middle income group, the aggregate demand will increase much. If they are businesspersons with little incentive to invest, tax reductions are temporary. This policy will again be less effective. Therefore, this is more effective in controlling inflation by raising taxes because high rates of taxation will reduce disposable income of individuals and businesses thereby curtailing aggregate demand.

(ii) The second method is more useful in controlling deflationary tendencies. When the government increases its expenditure on goods and services, keeping taxes constant, aggregate demand goes up by the full amount of the increase in government spending. On the hand, reducing government expenditure during inflation is not so effective because of high business expectations in the economy, which are not likely to reduce aggregate demand.

(iii) The third method is more effective and superior to the other two methods in controlling inflationary and deflationary tendencies. To control inflation, taxes may be increased and government expenditure be raised to fight depression.

19.3b.1: Limitations of discretionary policy:

19.3b.2: The discretionary fiscal policy depends upon proper timing and accurate forecasting:

1. Accurate forecasting is essential to judge the stage of cycle through which the economy is passing. It is only then that appropriate fiscal action can be taken. Wrong forecasting may accentuate rather than moderate the cyclical swings. Economics is not an exact science in correct forecasting. As a result, fiscal action always follows the turning points in the business cycles.

2. There are delays in proper timing of public spending. In fact, discretionary fiscal policy is subject to three time lags.

(i) There is the “decision lag,” the time required in studying the problem and taking the decision. The lag involved in this process may be too long.

(ii) Once the decision is taken, is an “execution lag.” It involves expenditure, which is to be allocated for the execution of the programme. In a country like the USA, it may take two years and less than a year in the U.K.

(iii) Certain public work projects are so cumbersome that it is not possible to accelerate or slow them down for the purpose of raising or reducing spending on them.

The experience of many developing countries is that resources generated in all the above ways frequently fall short of the requirements for investment. Accordingly, the governments have to indulge in deficit financing (which means .creation of money).

19.3b.3: Encouraging a socially optimum pattern of Investment

The developing countries can use fiscal policy measurers to direct investments in those fields, which are most desirable from the point of view of the society. Priority of the governments will differ from country to country and developing countries. The priority of the governments in developing countries is transportation and communications system. Railway tracts air connectivity power plants, electricity generation, etc". These facilities are very insufficient and as long as these are not provided on a large scale' the economy cannot be put on the path of economic development. It is observed that, from the point of view of these countries, the socially optimum investment should be in the economic and social overheads.

Large developing countries like India that have vast potentialities of industrial development, must also undertake large-scale investments in basic and capital goods* accordingly, these industries must also come under the category of socially optimum investment. This is so because basic and capital- goods industries form the basis of large-scale industrialization programme.

19.4: Conclusion:

compensatory' fiscal policy has little relevance for present-day developing countries. Compensatory finance was evolved in the context of cyclical fluctuations and is primarily suited to the conditions of advanced capitalist economies. In a developing country, the actual constraint to a steady growth and output is certainly lack of effective demand, but the structural bottlenecks (on supply side) reflected in the form of paucity of resources (social overhead capital, in particular) and the low levels of productivity of the available resources.

Despite the higher multiplier effect of government spending as against changes in tax rates, the latter can be operated more promptly than the former. Emphasis has thus shifted to taxation as the best fiscal device for controlling cyclical fluctuations. Thus when the turning point of a business cycle is already underway, discretionary fiscal action tends to strengthen the built-in stabilizers, as has been' the experience of developed countries like the USA during 1960s. The compensatory policy has little relevance at present public finance. However, every economic student must know the system and methods of compensatory Fiscal policy.

19.5: questions

1. What are the objectives of compensatory Fiscal Policy?

2. What is the approach s of compensatory fiscal policy?

3. Explain the Built in stabilizers?

4. explain the discretionary fiscal Policy?

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MODULE-5

LESSON-3

EFFECTIVENESS OF FISCAL POLICY AND FISCAL POLICY IN INDIA

20.0:Introduction

Fiscal Policy is essentially concerned with the "overall" effects of government's fiscal operations, namely, its total expenditure and taxation on macroeconomic aggregates of national income, output, price stability, etc. What distinguishes fiscal policy from other aspects? Of public finance is its central concern, as stated above with the aggregate variables such as an individual tax or an item of government expenditure has, generally speaking, a specific and narrow objective such as raising government revenue or reduction or increase in consumption.

In this unit the effectiveness of the fiscal policy is discussed. By this unit the students will be familiarized about the fiscal policy particularly with the reference of India . they also know about the different stages that the fiscal policy is implemented in our economy. In addition to the above the students will also familiarized with the classical and Keynesian views on the fiscal policy by reading this unit.

20.1: meaning of fiscal policy

. The boundary between fiscal policy and other policies of public finance, no doubt is rather than and, in ultimate analysis, remains arbitrary''. In fact, decisions about the "over-all" variables are made up of decisions about particulars. In addition, decision that has over-all effects will exercise particular effects on particular individuals' enterprises or sectors of the economy. It is also useful to make a distinction between fiscal policy and monetary policy, the policies that are inter-connected in several ways: Monetary policy is generally defined as a policy with respect to quantity of money, while fiscal policy is a policy with respect to all government financial sources and uses of funds and their composition. Arthur Smithies defines fiscal policy as "a policy, under which the government uses its expenditure .and revenue which produce desirable effects and avoid undesirable effects on the national income' production and employment'"

In other words, fiscal policy denotes the use of budgetary instruments (taxation' public borrowing and credit creation and public spending for advancement of the socio-economic goals of a country. Thus seen, Dirk. Wolfsan aptly describes fiscal policy as comprising "all resources". To increase the general welfare through the public control of resources by means of public spending ". Mobilization, public and semipublic Enterprises".

20.2: evolution of fiscal policy

20.2a:Classical' View,

The modern-day concept of fiscal policy as an active instrument to promote overall economic objectives, is only a little half-a-century old. Prior to 1930s (classical) economists " believed that the scope of fiscal activities of the government was very restricted except to the extent that certain collective wants, such as maintenance of law and order, national defense and provision for some essential services, have to be satisfied through public spending. Such economists argue, government ought not to interfere with of economy. Maintaining high level of employment and stabilizing the rate of growth of total national output: it was believed that in tire long run the economy would tend to produce at a rate determined by "real" factors. The supply of labour and capital and the state of technology prices and wage rates, under this system, would adjust to changes in total expenditure for goods and-services and thus would leave real output unchanged. Thus, if any adjustment were needed, they could be effectively carried out through monetary policy, following the famous quantity theory of money.

However, it will be misleading to conclude that for the classical economists, there was no concern for fiscal policy there has been governments; there has been a fiscal policy. The need to provide for collective want satisfaction, through what came to be known as public goods, was well recognized. For instance, Adam smith, apart from emphasizing external security as "primary" tasks for any government, advocated certain economic and social ends: "erecting and maintaining those public institutions and works, which though they may be in the highest degree advantageous to a great society, could never repay the expense to any individual". In modern idioms, this statement could be regarded as an advocacy for social capital formation by the state. However, it remains true that the earlier economists' justification for resource allocation to satisfy, certain collective wants and the burden distribution of its financing (namely. taxation) was primarily based on moral and humanitarian groups and not on economic ground. If we were to sum-up the basic principles of classical (and largely, neoclassical also) fiscal policy. The following would emerge as its key-stones.

20.3:Keynesian view

The above thinking about the nature and role of fiscal policy underwent a radical and fundamental change with the advent of Keynesian economic analysis in the 1930s. John Maynard Keynes effectively argued that the government finances could be manipulated to inference the level off effective demand. For achieving full employment, it is crucial that available resources are to be considered as fixed in -short-run) ought to be matched probable demand or aggregate (money) expenditure. Arranged in terms of integrated national income accounts, one can estimate: (A) total resources available and B) probable demand (consumption and investment spending of both the public and private sectors. If A>B. there is a 'gap' which must be filled- in by fiscal/public policy, measures"... Such a gap may also arise if A.B. which should also be adjusted by fiscal measures.

This is infect, the well-known Keynesian equation: Y = C+I+G. The question of filling this gap with fiscal instrument government spending, taxation, and deficit financing) has been conceptualized under the term, contemporary, finance. (Associated with the contribution of A.H. Hansen).

20.4:Basic Principles or Classical Fiscal policy

i) Government expenditure beyond what is required to maintain essential services- including public works, should be avoided.

ii) Government should not in any case, undertake spending beyond the revenues that can be raised through taxation. 'Balanced budget' must guide the Fiscal policy as a "fundamental article of financial faith". Any budgetary deficit would lead only to inflationist price increase under the classical assumption of full employment

iii) As a corollary to the above. Public borrowing should be avoided, as it will withdraw resources from productive employment

iv) Taxes should be kept as low as possible. The distribution of tax burden should be .fair, and just'. Hence, 'public expenditure was required only to secure the collective consumption of certain goods and service and that taxation was a contribution, to defray the costs incurred for this purposes". It was premised that the government should pay its way just like an individual or firm.

20.5: objectives of fiscal policy of developing countries

Fiscal policy has different objectives in developed countries and underdeveloped countries as the problems differ in different countries. Fiscal Policy and Developed Countries

The following are the objectives of fiscal policy in the developed countries.
I. To maintain economic stability
2 To maintain full employment
3. To control inflation and deflation
4. To maintain a high rate of economic growth.

20.6: fiscal policy and developing countries

Keynesian analysis of fiscal policy is applicable to advanced economies. Fiscal policy in a developing country both in' respect of objectives and content. In a developing economy, the government has to play an increasing role in promoting economic development, which is the primary aim of its economic policy. Fiscal policy becomes an important instrument for achieving the above aim. There are four essential objectives of fiscal policy in a developing country.

a) Promotion and acceleration of capital formation in the public and the private sector.

b) Mobilization of financial resource for the public sector without hampering the expansion of resources for the private sector.

c) Promotion and maintenance of reasonable degree of stability in the economy in keeping with the requirement of economic development

d) Accelerating economic growth by suitable fiscal policy measures.

e) Redistribution of national income, to promote distributive justice

Sometimes, there may be a clash between one aim and the other. Efficient management of finance, therefore, involves affecting a suitable harmony among all these aims.

20:6a. Capital Formation

Fiscal policy can be used as an instrument of capital formation in two ways.

a) By expanding investment in public and private sectors.

b) By directing the flow of resources from socially less desirable to more desirable investment channels

.Increases in public sector investment on overheads such as transport, communication, power etc is very important for development. Private sector does not come forward in these areas.

Fiscal policy can stimulate investment in private sector by giving concession in taxation, provision of finance. Subsidies. Fiscal incentives are also used to divert productive resources from socially less desirable to more desirable direction. It may also be used for large-scale investment expenditure on public health and education, which leads to human capital Formation.

20.6b: Mobilization of Resources

In developing countries, the propensity to consume is high and the propensity to save is Low mainly because of low levels of income. Even when incomes rise, people spend a large part of their incomes on luxury consumption. Fiscal policy plays an important role in mobilizing resources for development. The following methods can be used to mobilize resources.

l. Fiscal policy can used to stimulate private savings,

2. Taxation may be used as a source of development funds,

3. Profits from public enterprises may be used as surplus for reinvestment.

4. Utilization of surplus labour for development by providing suitable employment.

5. Deficit financing can be used as instrument of development'

20.6c: Economic stability

Economic instability in developing countries normally caused by instability in developed countries. The exports of the developing countries usually consist of primary products, which are particularly sensitive to fluctuations of demand abroad. These fluctuations are more in prices than in output. Therefore, there will be fluctuations in foreign exchange earnings. Fiscal policies can help largely in maintaining stability in prices etc.

20.6.d. Accelerating Economic growth

Achieving higher rate of economic growth is one of the important objectives of economic policy in under developed countries. Ln accelerating the rate of growth through public spending and taxation policies, fiscal policy plays an important role... Fiscal policy also helps in improving the savings and investment, which in turn would lead to rapid economic growth.

20.6e: Achievement of distributive Justice'

Developing countries suffer from inequalities in incomers and welfare . Increase in per capita income does not necessarily lead to an increase in the welfare of all- sections of the people, equitable distribution o f the rising national Product is assured' It has been righty pointed out by some economists that expansion in inequalities in income and wealth are determinants to under development in future they reduce the nutritional' health and living standards of the people, create excessive demand for imported luxury consumer goods., Besides, these conditions , in realities create political arid social discontent which lead to economic flexibility. Through redistributive public expenditure and tax policy. We can reduce inequalities in income and wealth'

20.7: Fiscal Policy of India

The Indian government fiscal policy aimed at to reduce inequalities in the incomes, encourage spending by lowering the taxes and reduce the fiscal deficit by encouraging the exports and less depending on borrowing. The main approach of the fiscal policy of India is

20.7a: 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 Matthai Commission brought out the first major official study on the incidence of direct and indirect taxation. 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

20.7b: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

20.7c: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 to reduce 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 behavioral 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

20.7d: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 (Box 1). 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.

20.8:Recent approach

20.8a:Tax Policy

. During the fiscal consolidation period, the tax- GDP ratio improved significantly from 9.2 per cent in 2003-04 to 11.9 per cent in 2007-08. This has been achieved through rationalization of the tax structure (moderate levels and a few rates), widening of the tax base, and reduction in compliance costs through improvement in tax administration. The extensive adoption of information technology solutions and re- engineering of business processes has also fostered a less intrusive tax system and encouraged voluntary compliance. These measures resulted in increased buoyancy in tax revenues till 2007-08 and helped in achieving fiscal consolidation through revenue measures alone. Due to the stimulus measures undertaken largely on the tax side during the global economic crisis in 2008-09 and 2009-10, as a measure to insulate Indian economy from the adverse impacts of global economic crisis and slowdown in domestic growth, the gross tax revenue as percentage of GDP declined sharply to 9.6 per cent in 2009-10.

Further, due to high international prices and as a measure to insulate consumers and to reduce under recoveries government had to further reduce taxes, duty on petroleum products in 2011-12. As a result the gross tax receipts as percentage of GDP in 2011- 12 declined to 10.1 per cent from 10.2 per cent in 2010- 11. With partial roll back of stimulus measures in indirect taxes and additional revenue measures, it was estimated that tax receipt, as percentage of GDP would improve to 10.9 per cent in 2013-14.

However, global uncertainties and exchange rate volatility and growth rate lower than expectations in 2013-14, the actual tax-GDP ratio stood at 10.0 per cent. Tax buoyancy has come down to below one, implying thereby that tax collection has failed to keep pace with the growth in GDP. This is more pronounced in case of Indirect taxes than in Direct tax collection.

Continuing forward on the path of fiscal consolidation with a view to narrow the gap in government spending and resources, the tax-GDP ratio was targeted at 10.6 per cent in the BE 2014-15 with a growth rate of 19.8 per cent over provisional actual of 2013-14. In RE 2014-15, after realistic assessment, tax-GDP ratio has been revised at 9.9 per cent which indicates a growth of 9.9 per cent in gross tax receipts over 2013-14. For FY 2015- 16 gross tax, revenues are estimated to grow at 15.8 per cent over the gross-tax revenues during 2013-14 taking tax-GDP ratios at 10.3 per cent.

20.8b: **Indirect Taxes** .

The performance of key industrial sectors based on the Index of Industrial Production (IIP) reveals the reversal in trends of industrial production in 2014-15, which had slowed down since 2011-12. The revival of manufacturing sector has been unleashed in the “Make-in-India” initiative accompanied with several other initiatives of the Government. The growth momentum is likely to be continued in FY 2015-16 as well. Turnaround in economic activity expected in FY 2015-16 with the improvement in industrial, manufacturing and service industry, growth in exports and expectation of recovery of growth rate will provide a scope for achieving the budget targets in FY 2015-16 14.

In the medium term, the most significant step from the point of view of broadening the tax base and improving revenue efficiency through better compliance is the introduction of Goods and Services Tax (GST). As far as Central taxes viz. Central Excise duties and Service Tax are concerned, a fair amount of integration has already been achieved, especially through the cross-flow of credits across the two taxes. It would be possible to realize full integration of the taxation of goods and services only when the State VAT is also subsumed and a full-fledged GST is launched. As a preparation for introduction of Goods and Service Tax (GST), Government has been taking consistent policy steps to expand the scope of service tax.

To broaden the tax base, negative list approach to taxation of services was introduced with effect from 1st July 2012. Negative List of Services and service tax exemptions were reviewed for broadening the tax base and as a preparation for introduction of GST, in the following manner:

(i) The Following services have been brought under the tax net,- • Online and mobile advertising; • Services provided by radio taxis or radio cabs.

(ii) The service tax exemption on the following services has been withdrawn,- • Clinical research on human participants; • Services provided by air-conditioned contract carriages

(iii) Scope of some of the existing exemption was rationalized.

There are several specific proposals in the Budget 2015-16 to recalibrate the tax effort on indirect taxes so that fiscal consolidation may be achieved in the short term. The important and revenue significant proposals

The underlying theme of the indirect tax policy during the year is to boost domestic manufacture, to bring about clarity in tax laws, stability in duty rates & rationalization of duty structure. Direct Taxes:

These factors of inflation do not affect wages, which mainly contribute to personal income tax collection.

20.8c: Contingent and other Liabilities .

In terms of Article 292 of the Constitution, Central Government gives guarantees for the repayment of borrowings upon the security of the Consolidated Fund of India. The FRBM Act mandates the Central Government to specify the annual target for assuming contingent liabilities in the form of guarantees.

. In addition to providing a greater maneuverability for cash management, treasury bills also provide benchmark and momentum to trading activity in the money market therefore facilitating the financial and corporate sector in meeting their short-term cash requirements. In addition, Small Savings, State Provident Fund and other receipts from Public Account would finance remaining portion of the deficit. There was no balance estimated at the end of financial year 2014-15 under Market Stabilization Scheme (MSS).

Continuing further with this debt management strategy, `50,000 crore was budgeted in FY 2014-15. Thus far in the current financial year `30,602 crore worth of dated securities have been switched and `6,283 crores have been bought back.

To prematurely redeem the Government Stocks by utilizing surplus cash balances, repurchases (buyback) of government securities (G-Sec) worth `18,805 crore were carried out during September 2014 for securities maturing in FY 2014-15 and FY 2015-16. . Therefore, in FY 2015-16 further provision of `50,000 crores has been made to undertake buyback

Switch operation of shorter tenor G-securities with longer tenors G-securities. 33. Cash management framework is an essential ingredient of the overall debt management strategy. Government is moving toward a market based cash framework with reduced dependence on the central bank. With the introduction of Cash Management Bills in 2010-11, cash deficit requirements are now largely managed through the market.

20.9:. Policy Evaluation

. Government has adopted active policy stance to revive the economic growth in recent years. Apart from slew of policy interventions in critical sectors such as manufacturing, infrastructure etc., Government has also adopted institutional reforms such as ‘minimum government, maximum governance’, . the present t government has replaced Planning Commission with NITI Ayog. The thrust of these reforms have been to streamline the government structure to meet the aspirations of a new, vibrant nation in the modern age. There has been definite and decisive move towards co-operative federalism where Centre-State relationship is put on a new footing as partners in development. Central theme of the government has been to re-define the manner of engagement between the centre and states on the development agenda. The present government has accepted the recommendations of Fourteenth Finance Commission (FACE) and Government’s decision to implement the award in letter and spirit, despite its far reaching implications on range of issues.

Budget 2015-16 is landmark budget in many ways. It has altered fundamental approach to development. Building on the FACE award, Government has integrated it with its drive towards co-operative federalism and re-designing of the Planning Commission. NITI Ayog provides the ready platform for building upon the institutional framework recommended by the FFC.. As a result, Central Plan outlays have been provided adequately for the Centre to carry out its mandate on the Union list.

. However, keeping in mind that many of these schemes are national priorities, and some are legal obligations (such as MGNREGA) and in order to underline the Central Government’s most of these are proposed to be continued. .

Further, and more importantly it is proposed that the Union Government may continue to support certain programmes which are for the benefit of socially disadvantaged in an unaltered manner from its own resources.. Public discourse has centered around the fact that the process of growth revival can be hastened with higher public spending on infrastructure. The argument of pro-cyclical, structurally adjusted fiscal targets

20.11: For less developed countries such as India, the following main objectives of fiscal policy may be restated as:

(i) To increase the rate of investment and capital formation, so as to accelerate the rate of economic growth.

(ii) To increase the rate of savings and discourage actual and potential consumption.

(iii) To diversify the flow of investments and spendings from unproductive uses to socially most desirable channels.

(iv) To check sectoral imbalances.

(v) To reduce widespread inequalities of income and wealth.

(vi) To improve the standard of living of the masses by providing social goods on a large scale.

For the purpose of development, not only an expansionary budget but also a deficit is desirable too in a developing country. The government expenditure on developmental planning projects must be increased.

It may be financed even by means of deficit financing. Deficit financing, here, refers to the creation of new money by printing additional notes by the government or by borrowing from the central bank, which ultimately means creation of additional money supply. However, the government must use the technique of deficit financing cautiously. An excessive dose of deficit financing may lead to inflation, which may endanger economic growth.

Public borrowing also is an important means of getting resources for development of the public sector. External loans are useful to some extent when the country has to import machines, capital goods, etc., from a foreign country and the country has a scarcity of foreign exchange.

Anyway, the effectiveness of fiscal measures in promoting development in a poor country depends on the incentives administered to the strategic points in the productive set up by virtue of the consequences of taxation and public spending.

It must be noted that fiscal policy in a developing economy has to operate within a framework influenced by social, cultural and political conditions and institutions, which may inhibit the formulation and implementation of good economic policies.

Further, fiscal policy in a poor country may be used to reduce inequalities in income and wealth distribution by means of taxes and government expenditure. Taxation has to be progressive and government spending must be welfare-oriented.

In short, for promoting economic growth, the fiscal policy must be first formulated in such a way that it will increase the rate of volume of investment in the public and private sectors. The tax policies must discourage unproductive and speculative investment. Second, fiscal policy must mobilize more and more resources for capital formation. Hence, taxation must be used to curb excessive consumption. Third, it must encourage an inflow of foreign capital.

Fiscal policy, however, cannot be effective when there are loopholes in the taxation laws and the tax administration is corrupt so that there is large-scale tax evasion. Again, if the government is extravagant in spending on non-developmental items, then a technique such as deficit financing may prove to be inflationary. Again, market imperfections, bottlenecks, shortages of raw materials, and lack of entrepreneurial skills, do not allow fiscal policy to be effective.

A high population growth, and an orthodox society also come in the way of development and without a coordinated, sound, physical plan and its proper implementation, fiscal policy cannot be very effective in reaching its goal of rapid economic development with stability.

Nonetheless, of all economic policies, fiscal policy today assumes unique importance in realizing general economic goals, depending on the size of the fiscal measures adopted and their timing. The exact change effected in the national economy will depend on the form and the magnitude of public revenue, especially, the rates and structure of taxation and the mode of public spending by the government.

Further, when prices are rising, government has to adopt a surplus budget at an appropriate time in order to avoid secular inflation. However, there is practical difficulty in knowing the changing conditions or appearance of price stability; hence, it is very difficult to forecast perfect timing.

Political and administrative delays tend to aggravate the problem and the desired effect of fiscal programme may not be realised. Sometimes, even if the fiscal action is taken at a right time, in quantitative or qualitative terms, it may not be adequate or appropriate.

20.10: Fiscal Policy and Objectives of Indian Government!

The budgetary provisions made in the budgets when read together, bring out the guiding philosophy of the new fiscal policy and the objectives that the government intends to achieve.

20 .10a: Restoring Fiscal Equilibrium:

A very important feature of the government’s efforts is to attain a match between the revenue receipts and revenue expenditure with the ultimate aim of securing surpluses on revenue account for capital expenditure.

Towards this end, three types of measures have been taken. The first concerns expenditure. This has been to slow-down the growth-rate in it despite increase in the absolute amounts. Second concerns tax-revenues.

The aim is to increase it, but unlike in the past when high taxes prevailed the policy now is to seek larger tax receipts through moderately low rates of taxes on a wider base. Third, the government has made efforts to raise profits of the public sector undertakings.

20.10b:Reforming Tax-structure:

The approach towards the tax system is to design it in such a manner that it becomes growth elastic and gets in line with the tax-systems of other fast-growing and developed countries. To ensure better compliance and less incentive for tax evasion, the government has lowered the tax rates in respect of both direct taxes and indirect taxes.

At the same time, schemes have been introduced to widen the base of the tax. These together with lower tax and a wider base are very likely to raise the yield of taxes. In addition, with growth in the activities and income of the economy, the tax receipts will increase.

This approach is totally different from the one pursued so far on the premise of a high tax-rate on a narrow base. The new tax-regime will reduce and if pursued further eliminate the difference between the domestic tax-rates and the tax rates in the foreign country.

This will help in integrating the Indian economy with the world economy. The benefits to the country will be an increase in exports and a larger inflow of foreign direct investment. The competitive strength and efficiency of the Indian economy will also improve.

20.10c: Promoting Socially Desirable Activities:

The Government in the new fiscal policy has also provided larger expenditure, tax concessions and other incentives for the expansion of socially important sectors. These are the sectors, which are normally the responsibility of the government. The development of infrastructure is one such field of key significance for the economy.

While most of it is to be undertaken by the Government, several incentives have been extended to seek private sector's involvement in some areas like power to ensure that the supply of infrastructural services becomes adequate.

Tax concessions in the form of tax holiday have been given to encourage the private sector to set up industries in the backward regions. Similar incentives have also been given to industries producing pollution-control equipment.

Provision has also been made for the development of R&D (Research and Development) to upgrade the technological base of the economy. Besides public expenditure, tax concessions have been given to the private sector for this purpose.

20.10d: Market-Oriented Development:

The new fiscal policy in line with the new economic policy aims at promoting allocation of resources largely in terms of the market prices. The government has already dismantled a significant part of state- intervention and enlarged the field for the private sector. The fiscal policy has carried this process further by offering money incentives through lower tax-rates and tax-concession to the private sector.

Supply constraints in the market have also been caused by several fiscal measures. Reduction in custom duties on the import of capital goods to modernize domestic production is one such measure to step-up the supply of goods and services.

The lowering of the rates of indirect taxes on the consumer goods including luxury items like electronics goods, cars, etc., will encourage a growth-pattern largely based on the expansion of consumer goods industries.

The market orientation of development is also sought to be promoted by providing a demand stimulus to the economy. How direct taxes will mean larger disposable income with the people. Low indirect taxes will result in lower prices. Both of these will increase demand.

Some of the major ways to control deflation are as follow: 1. Monetary Policy 2. Fiscal Policy!

Deflation can be controlled by adopting monetary and fiscal measures in just the opposite manner to control inflation

20.11 :problems of Indian fiscal policy

Let us now discuss some of the areas of Indian fiscal policy, of late, especially since the mid-70s. the government fiscal operations have shown continuity. Below are brief summary of such issues.

20.11a: disequilibrium between revenue and expenditure

There has been a tendency towards persistent disequilibrium between the government revenues and current expenditure. As observed from the combined revenue budgets of central-state governments over the period, it was found that disequilibrium between revenue and expenditure has be-en showing an increasing trend, thus eroded the capacity of government to generate the surplus that are necessary to expand the essential management.

20.11b: not so buoyant and responsive

The tendency of non-plan current outlay to expand much faster than the tax revenues. It is a situation "Expenditures are more responsive to inflation than as revenues". This means that the Indian tax structure has not been sufficiently buoyant and responsive to growth in income.

20.11c: black or unaccounted money

It is a fact that the share of direct taxes (on income and wealth) in the total tax revenue, as well as percentage of GNP has declined in the recent years, despite economic expansion. This obviously, a serious failure of the tax structure in terms of both tapping additional income as well as to reduce concentration of income and wealth. Perhaps a major part of the problem arises because of the existence and growth of black or unaccounted money incomes, which escape the tax net. The tax evasion remains the major menace to India's fiscal policy.

20.11d: low returns on public investment

Added to the problem of lack of buoyancy of the tax system, there is the question of low returns of public investment. However, it is well known that a vast majority of these enterprises have incurred huge losses and the overall rectum on public investment has been quite low. This means that no surplus funds could be available from the public sector for further expansion. In addition, growth. The argument that public enterprises have been established certain 'social' achievement and not for profits. has an obvious limit too.

20.11e: deficit financing

Government had to resort to deficit financing on an increasing scale leading to serious inflationary prices increase along with concomitant socio-economic repercussions. This constitutes a serious fiscal hazard to economic stability,. Furthermore, governmental fiscal management of budgetary deficits (overall) has been hardly efficient. Over the recent years, the Central and State Government have preferred to resort to hikes all administered price (of input goods produced or controlled by the public sector) as against additional taxation and direct deficit financing. The choice has not been made in terms of any strict economic rationality :,(such as least inflationary impact) but largely as a matter of political convenience. This further aggravated the inflationary situation. Resulting in a variety of distortions in resource use.

20.11f: lack of effective public expenditure policy

Yet another area of critical importance to fiscal policy relates to lack of effective public expenditure policy. The existing procedures for scrutiny' of public expenditure. Especially of non-development nature, lack any meaningful orientation in terms of cost-effective analysis.

20.11g: lack of fiscal discipline

There is an overall lack of fiscal discipline in the country. Whether it is a question of tax procedures. Deficit financing or expenditure control.

The above is certainly not a fully exhaustive list of fiscal problems facing our country. But it provides gainful insight into various dimensions relating to economic growth. Stability' and social justice.

20.12:Summary:

In this unit, effectiveness of fiscal policy and fiscal policy in India is discussed . Evolution and basic principles of fiscal policy is also discussed. In addition to objective of fiscal policy, fiscal policy at different stages is also discussed. In the case of Indian the fiscal policy’s objectives and hurdles also discussed.

20.13:Questions

1. Explain the meaning and evolution of fiscal policy
2. Discuss the classical and Keynesian view of fiscal policy

3. Explain the basic objectives of fiscal policy?
4. Explain the role of fiscal policy in developing countries?
5 .Explain the different phases of ?fiscal policy in briefs
6. what is the recent approach of fiscal policy
7. What are the problems of Indian fiscal policy

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MODULE-5

LESSON-4

IMPACT OF FISCAL REFORMS AND ECONOMIC DEVELOPMENT

21.0:Introduction

Fiscal Policy is one of the most important policies followed by the governments. This policy has great iompact on the income and employment of the economy. In this unit fiscal reforms and economic development is discussed. While implementing the poliey thee will be some lags . those are also discussed in this unit.

21: Fiscal Policy in Developing countries.

In developing countries, the requirements of fiscal policy are just the opposite that is needed in developed economies. In these countries, because of the general poverty of the masses, the macro propensity to consume is very high. Therefore, the ratio of saving .is because of the volume of savings in these countries that the rate of investment also remains low and there is a huge amount of under-employment...There is not only disguised unemployment, but also conditions of chronic secular inflation.

Obviously, under such circumstances, the government must direct its efforts to solving the twin problems of under-employment and inflation. as noted by Prof. Raja Chelliah, the goal of fiscal policy in a developing country may be said to be the promotion of the highest possible rate-of capital formation without inflation.

21.1: Some of the major limitations of fiscal policy are as follows:

Although fiscal policy gained prominence during world depression of 1930's, yet its practical application has a number of problems or limitations. In view of such a situation, let us understand fully problems and limitations, which are associated with a fiscal policy.

21.1b. Policy Lags:

During the recent times, there is not much argument about the desirability or otherwise of a discretionary fiscal policy. The provocative question in this context is related with the timing of the fiscal measures. Unless the variations in taxes and public expenditure are neatly timed, the desired counter-cyclical effects cannot be realized.

There is generally some interval between the time when a particular action is needed and the time when a fiscal measure has its impact felt. The duration of this interval determines the extent to which a specific fiscal measure can be effective. This time interval comprises of three types of lags-recognition lag, administrative lag and operational lag.

21.1c: Recognition Lag:

This is the interval between the time when action is needed and when it is recognized that action is needed. This lag may exist when a change in the economy and a report concerning the change do not coincide. Such a lag has duration of 3 months. It can be reduced if the forecasting is satisfactory.

21.1.d: Administrative Lag:

This is the interval between the time when need of an action is recognized and the time when the action is actually taken. This is perhaps the most difficult lag to deal with. Even when the need of action has been recognized, the sanction from legislature and executive must take some time and that may involve about 1 to 15 months of time.

In order to reduce such a lag and to minimize the legislative and executive red-taps, it is important to keep a shelf of public works in readiness. The recognition and administrative lags together determine the inside lag of the fiscal policy and its length, according to Willes, is 4 to 18 months.

21.1e: Operational Lag:

The time interval between when action is taken and when it has its impact on income and employment is known as the operational or the outside lag. Albert Ando and E.C. Brown have pointed out that the change in personal income taxes produce significant changes in disposable money income and consumption within a month or two; changes in the corporate tax structure produce changes in corporate spending in about 3 or 4 months. Willes was of the view that the outside lag of fiscal policy has a short duration of 1 to 3 months only. J.G. Ranlett, however, considers that these estimates need modification.

Based on U.S. income tax data of 1960's, he emphasized that the valuation in income tax rates affected changes on consumption spending with a lag of about 3 to 9 months. Even this estimate of outside lag of fiscal policy is much lower than that of the monetary policy.

21:2. Forecasting:

Another most serious limitation of fiscal policy is the practical difficulty of observing the coming events of economic instability. Unless they are correctly observed the amount of revenue to be raised, the amount of expenditure to be incurred or the nature and extent of budget balance to be framed cannot be suitably planned. In fact, success of fiscal measures depends on the accurate predictions of various economic activities. In its absence, it proves to be a little bit erratic.

21:3. Correct Size and Nature of Fiscal Policy:

The most important necessity on which the success of fiscal policy will depend is the ability of public authority to frame the correct size and nature of fiscal policy on the one hand and to foresee the correct timing of its application on the other. It is, however, too much to expect that the government would be able to correctly determine the size, nature of composition and appropriate execution time of fiscal policy.

21:4. Fiscal Selectivity:

When monetary policy is general in nature and impersonal in impact, the fiscal policy, in contrast, is selective. The former permits the market mechanism to operate smoothly. The latter, on the contrary, encroaches directly upon the market mechanism and gives rise to an allocation of resources which may be construed as good or bad depending upon one's value judgments. A particular set of fiscal measures may have an excessively harsh impact upon certain sectors, while leaving others almost unaffected.

21:5. Inadequacy of Fiscal Measures:

In anti-depression fiscal policy, the expansion of public spending and reduction on taxes are always important elements. The question arises naturally, whether a specific variation in public spending or taxes will bear the desired results or not. In case the injections or withdrawals from the circular flow are more or less, than what are required, the system will fail to move in the desired direction. This results in exaggeration of instability in the economy.

21:6. Adverse Effect on Redistribution of Income:

It is felt that fiscal policy measures redistribute income, the actual effect will be uncertain. If income is redistributed in favour of the low-income classes whose marginal propensity to consume is high, the effect will be increase in total demand. However, the fiscal action will be contractionary if larger part of the additional income goes to people having higher marginal propensity to save.

21:7. Self-offsetting Effect:

The compensatory fiscal policies of the government may discourage private investment, since the private entrepreneurs have to face a competition from public enterprises in securing labour, raw materials and finances. Moreover, increased involvement of the government in economic activity at the onset of recession strengthens the pessimistic expectations of the private entrepreneurs. The expansion of public spending may be associated with a curtailment of private spending. Consequently, the fiscal measures may be self-offsetting.

21:8. Reduction in National Income:

Balanced budget multiplier as a fiscal weapon can be gainfully applied during depression is conditioned by the fact of marginal propensity to spend of the recipients of public expenditure being larger than or, at least, equal to that of the taxpayers. In case it becomes smaller than the taxpayers do, the fiscal programmes under balanced budget will bring about reduction in the national income.

21:9. Solution for Unemployment:

The purpose of fiscal policy will be defeated if the policy cannot maintain a rising supply level of work effort. The money national income will rise with increase in productive efficiency and increased supply of work effort. However, if the tax measures are stringent and too high, they will certainly affect the incentive to work. This is an important limitation of fiscal policy.

21:10. Adverse Effect on debt Management:

The use of fiscal instruments during unemployment and depression is often associated with the subsequent problem of debt management. Because deficit budgeting is the normal fiscal cure, public debt is made for financing it. In addition, if the process of recovery from depression is long, the creation of budget deficit year after year will create a huge problem of debt repayment and debt management.

21:11. Adverse Psychological Reaction:

Large deficit programmes financed by borrowings bring about adverse psychological reactions. Rumors of government bankruptcy discourage investors and often flight of capital takes place.

21:12. Hardships in U.D.Cs:

The creation of additional income through compensatory fiscal measures is not easily possible in underdeveloped countries as in advanced economies. This is mainly because a stagnating agricultural sector dominates the largest part of their economy where marginal propensity to consume is so high that most of the additional income is consumed and the marketable surplus is the least.

21.13: Administrative Problems in Democratic Countries:

In a democracy, fiscal policy measures must be a time-consuming process. Legislative actions, administrative tasks and the executive process are often delayed and the original estimates of revenue earnings and government expenditures often become irrelevant. The operational lag relating to fiscal measures results in a considerable erosion of effect and the gap between expected achievement and the real attainment often becomes vast.

Fiscal Policy assumes a central place in the overall macroeconomic framework. As government sector and private sector compete for resources and for consumption in the economy, fiscal policy needs to be designed in a framework where an increase in government activity would result in net gains to the economy even when it may negatively affect in private sector activity, or reduce foreign exchange reserves or increase the monetary base.

Fiscal reforms have initiated a right kind of approach to maintain fiscal discipline in the Indian economy and the Indian economy has met it successfully at the national level however there has been some problems at the state level. Fiscal reforms have brought a new vision and mission for the government both central and state towards competitiveness and efficient mode for managing the economy

The research work has analyzed the work of specialized institutions and organizations of the govt. of India and RBI. The data are mostly sourced from budget documents of govt. of India , articles on central govt. finance published by RBI, finance accounts of govt. of India, handbook of statistics on the Indian economy published by RBI Compared the performance of the fiscal variables in the post reform decade to the extent possible subject of availability of data & put them in simple tabular form The policy simulation results revealed that fiscal deficit, in general, resulted in widening the current account deficit if it is money- financed. In this case, the price and income effects reinforce each other, leading to the deterioration in the external balance both in the short-run and in the end.

Thus, the recourse to deficit financing to promote public investment and growth involves a loss of control on inflation the study will have an important implication in development programmes and public policies

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.

Fiscal Policy during the Great Recession Despite the small employment effect stipulated by Okun’s law, the general agreement across the theoretical spectrum is that boosting aggregate demand is the proper objective. There is some disagreement on the exact method by which aggregate demand can be expanded, but generally, the policy response would include an automatic and a discretionary component. Government spending expands automatically in recessions with the increase in unemployment insurance, welfare benefits, and other transfers to the jobless and the poor. In addition, tax revenues decline with the fall in economic activity, thus boosting the countercyclical government deficit. Furthermore, a number of discretionary moves can be undertaken to hasten the recovery. These normally include additional tax cuts to households and businesses, as well as direct aid to states and firms in the form of grants, contracts, and loans for the purposes of new investment

Over the years, various instruments of fiscal policy viz., taxation, public expenditure and public borrowings have been employed, with varying degrees of importance, to achieve higher economic growth and stability, efficient resource allocation and equitable distribution of income. Furthermore, in India, as in many developing countries, fiscal policy does not operate in isolation as it has close macroeconomic linkages with real, monetary and external sectors. Thus, the macroeconomic impact of fiscal policy is critical for achieving the broader economic goals. Indian public finance today has reached a turning point. The future course of public finance would critically hinge upon the following developments. First, fiscal policy can be a powerful tool for accelerating growth, provided resources be raised efficiently without causing distortions and utilized for delivering public goods and services, including physical and social infrastructure and helping the underprivileged. Total government expenditure as proportion of GDP needs to be maintained, and raised at the State level, in order to ensure the maintenance of existing infrastructural facilities and create new ones. This calls for a change in the composition of expenditure. Second, adherence to fiscal legislation, both at Centre and State level, is critical for macroeconomic, financial, external sector and budgetary sustainability. Third, fiscal empowerment i.e, expanding the scope and size of revenue flows into the budget, through tax reforms appropriate user charges and restructuring of public sector undertakings assumes critical importance. Fourth, as the Indian economy becomes more open and integrated with the rest of the world, fiscal policy would have to face greater challenges. Fifth, the approach to fiscal federalism, both in terms of addressing the vertical and horizontal imbalances, would have to focus on institutional reforms, which align needs with revenue capacities. Sixth, the changing demographic profile would make designing an appropriate fiscal policy

21.14: Side Effects

Just like monetary policy, fiscal policy can be used to influence both expansion and contraction of GDP as a measure of economic growth. When the government is exercising its powers by lowering taxes and increasing their expenditures, they are practicing expansionary fiscal policy. While on the surface, expansionary efforts may seem to lead to only positive effects by stimulating the economy, a domino effect is much broader reaching. When the government is spending at a pace faster than tax revenues can be collected, the government can accumulate excess debt as it issues interest bearing bonds to finance the spending, thus leading to an increase in the national debt.

When the government increases the amount of debt it issues during expansionary fiscal policy, issuing bonds in the open market will end up competing with the private sector that may also need to issue bonds at the same time. This effect, known as crowding out, can raise rates indirectly because of the increased competition for borrowed funds. Even if the stimulus created by the increased government spending has some initial short-term positive effects, a portion of this economic expansion could be mitigated by the drag caused by higher interest expenses for borrowers, including the government.

Another indirect effect of fiscal policy often overlooked, is the potential for foreign investors to bid up the U.S. currency in their efforts to invest in the now higher yielding U.S. bonds trading in the open market. While a stronger home currency sounds positive on the surface, depending on the magnitude of the change in rates, it can actually make American goods more expensive to export and foreign made goods cheaper to import. Since most consumers tend to use price as a determining factor in their purchasing practices, a shift to buying more foreign goods and a slowing demand for domestic products could lead to a temporary trade imbalance. These are all possible scenarios that have to be considered and anticipated. There is no way to predict which outcome will emerge and by how much, because there are so many other moving targets, market influences, natural disasters, wars and any other large scale event that can move markets.

Fiscal policy measures also suffer from a natural lag or the delay in time from when they are determined to be needed, and the time their measures pass through congress and ultimately the president. From a forecasting perspective, in a perfect world where economists have a 100% accuracy rating for predicting the future, fiscal measures could be summoned up as needed. Unfortunately, given the inherent unpredictability and dynamics of the economy, most economists run into challenges in accurately predicting short-term economic changes

21.15:Summary:

In this unit fiscal policy and reforms are discussed . Students will kmnow about the impact of fiscal policy in the economy. You also know the obstacles of fiscal policy and the lags is also familiarized with this unit

21.16:Questions

1. What are the limitations of the fiscal Policy?
2. What is the positive impact of the fiscal policy?
3. What is negative impact of the fiscal policy?

21.17: Bibliography

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