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UNIT 1
INTRODUCTION TO PUBLIC FINANCE

1.1 MEANING AND SCOPE OF PUBLIC FINANCE

Public finance is a field of economics concerned with how a government raises money, how that money is spent and the effects of these activities on the economy and society. It studies how governments at all levels—national, state and local—provide the public with desired services and how they secure the financial resources to pay for these services.

Public finance deals with the finances of public bodies – national, State or Local – for the performance of their functions. The performance of these functions leads to expenditure. The expenditure is incurred from funds raised through taxes, fees, sale of goods and services and loans. The different sources constitute the revenue of the public authorities. Public finance studies the manner in which revenue is raised; the expenditure is incurred upon different items etc. Thus, public finance deals with the income and expenditure of public authorities and principles, problems and policies relating to these matters.

According to Professor Hugh Dalton,the term 'Public authorities' refers to the Government or State at all levels –National, State, and Local.

Harold Groves' definition outlines the types of governments whose finances are studied in Public finance.

According to Taylor, public finance studies the manner in which the state through its organ, the government, raises and spends the resources required. Public Finance is thus concerned with the operation and policies of the fisc - The State treasury.

The definition of public Finance by Mrs.Ursla Hicks highlights the satisfaction of collective wants which in turn leads to the need to secure necessary resources.

The definition of CS Shoup enlarges the scope of Public Finance for modern governments to include different types of expenditure and different sources of revenue.

All the definitions stated above illustrate the scope of Public Finance. From these definitions, we can conclude that Public Finance is an enquiry into the facts, techniques, principles, theories, rules and policies which shape, direct, influence and govern the use of scarce resources, with alternative uses, of the government.

1.2 IMPORTANCE OF PUBLIC FINANCE

1) Provision of public goods: -For providing public goods like roads, military services and street lightsetc. public finance is needed. Business firms will have no incentive to produce such goods, as they get no payment from private individuals.

2) Public finance enables governments to tackle or offset undesirable side effects of a market economy. The side effects are called spill overs or externalities. For example, pollution. The governments can introduce recycling programmes to lessen pollution or they can make laws to restrict pollution or impose pollution charges or taxes on activities that bring about pollution.

3) Public finance helps governments to redistribute income. To reduce the inequality in the economy, the governments can impose taxes on the richer people and provide goods and services for the needy ones.

4) Public finance provides many a programme for moderating the incomes of the rich and the poor. Such programmes include social security, welfare and other social programmes.

5) The acceptance of the principle of welfare state, the role of public finance has been increasing. Modern governments are no more police states as the classical economists viewed.

6) As the scope of state participation in the economic activity is widening, the scope of public finance has also been increasing. Generation of employment opportunities, control of economic fluctuations like boom and depression, maintaining economic stability etc. are some of the thrust areas of the governments through fiscal operations.

1.3 SUBJECT MATTERS OF PUBLIC FINANCE

The subject matters of Public Finance can be broadly classified in to five categories – a) Public revenue b) Public expenditure c) Public debt d) Financial administration e) Economic stabilization and f) Federal Finance.

Public Revenue:

The income of the states is referred to as Public Revenue. In this branch, we study the various ways of raising revenue by the public bodies. We also study the principles and effects of taxation and how the burden of taxation is shared among the various classes of society etc.

Public Expenditure

It deals with the principles and problems relating to the allocation of public spending. We study the fundamental principles governing the flow of public funds in to different channels, classification and justification of public expenditure; expenditure policies of governments and the measures adopted for welfare state etc.

Public Debt

The governments borrow when its revenue falls short of its expenditure.Public debts is a study of various principles and methods of raising debts and their economic effects. It also deals with the methods of repayments and managements of public debts.

Financial Administration

It deals with the methods of Budget preparation, various types of Budgets, war Finance, Development Finance etc. Thus, financial administration refers to the mechanism by which the financial functions are carried on. In other words, financial administration studies the organizing and disbursing of the finances of the State.

Economic stabilization and Growth

The use of Public revenue and Public expenditure to secure stability in levels of prices by controlling inflationary as well as deflationary pressures is studied. Similarly the income and expenditure policies adopted by the government so as to attain full employment, optimum use of resources, equitable distribution of income etc. are also studied.

1.3 FEDERAL FINANCE

Under federal finance we study the principles and policies governing the distribution of functions and funds among the public authorities in a federal set up. In a federal set up there are different levels of governments-centre, state and local.

Public Finance and Private Finance

The understanding and the study of public finance is facilitated by a comparison of the public or government finance with private or individual finance. Such a comparison will help us to know how the aims and objectives and methods of public Finance operation are similar or differed from the financial operations of the individual.

Similarities

1. Both the State as well as individual aim at the satisfaction of human wants through their financial operations. The individuals spend their income to satisfy their personal wants whereas the state spends for the satisfaction of communal or social wants.

2. Both the States and Individual at times have to depend on borrowing, when their expenditures are greater than incomes.

3. Both Public Finance and Private Finance have income and expenditure. The ultimate aim of both is to balance their income and expenditure.

4. For both kinds of finances, the guiding principle is rationality. Rationality is in the sense that maximization of personal benefits and social benefits through corresponding expenditure.

5. Both are concerned with the problem of economic choice, that is, they try to satisfy unlimited ends with scarce resources having alternative uses.

Dissimilarities

1) The private individual has to adjust his expenditure to his income. i.e., his expenditure is being determined by his income. But on the other hand the government first determines its expenditure and then the ways and means to raise the necessary revenue to meet the expenditure.

2) The government has large sources of revenue than private individuals. Thus at the time of financial difficulties the state can raise internal loans from its citizens as well as external loans from foreign countries. In the case of private individual, all borrowings are external in nature.

3) The state, when hard pressed, can resort to printing of currency, as an additional source of revenue. In fact, during emergencies like war, it meets its increased financial obligations by printing new currency. But an individual cannot raise income by creating money.

4) The state prepares its budget or estimates its income and expenditure annually. But there is no such limitation for an individual. It may be for weekly, monthly, or annually.

5) A surplus budget is always good for a private individual. But surplus budgets may not be good for the government. It implies two things. a) The government is levying more taxes on the people than is necessary and b) the government is not spending as much as the welfare of the people as it should.

6) The individual and state also differ in their motives regarding expenditure. The individuals hanker after profit. Their business operations are guided by private profit motive. But the states expenditure is guided by the welfare motive.

7) The private individual spends his income on various items in such a manner as to secure equi-marginal utilities from them. The government on the contrary does not give as much importance to this law as a private individual does. Modern government sometimes incur cretin types of expenditure from which there do not derive any advantage but they do incur this expenditure to satisfy cretin sections of the community.

8) Individuals always seek quick returns they save only a small amount for future and spend more to satisfy their current needs. Individual tend to think more on present as they are dead in the long run.Similarly they seldom spend if it does not yield any money income. On the other hand, State has a long term perspective of its expenditure. It does not care only for immediate benefit. State spends on projects having long gestation period. The burden of taxation is borne by the present generation in the interest of long run welfare of the community. Similarly sometimes government may have to spend on schemes which may not yield any money income at all (e.g. Public Health).

9) An individual's spending policy has very little impact on the society as a whole. But the state can change the nature of an economy through its fiscal policies.

10) The pattern of expenditure in the case of private finance is often influence by customs, habits social status etc. The pattern of government expenditures is guided by the general economic policy followed by the government.

11) Private Finance is always a secret affair. Individual need not reveal their financial transactions to anyone except for filing tax returns. But Public Finance is an open affair. Government budget is widely discussed in the parliament and out sides. Public accountability is an important feature of public finance.

12) Individuals can plan to postpone their private expenditure. But the state cannot afford to put off vital expenditure like defence, famine relief etc. Findlay Shiraz says that compulsory character is an important future of public finance.

1.4 NEED FOR PUBLIC SECTOR

Public sector plays a vital role in the development of any economy. Public sector being the monopoly in the hands of government is considered to be very important organization. It has following importance:-

In India, a public sector company is that company in which the Union Government or State Government or any Territorial Government owns a share of 51 % or more. Currently there are just three sectors left reserved only for the government i.e. Railways, Atomic energy and explosive material. Private sectors/players are not allowed to operate in these sectors.

Before the independence of India, there were only a few public sector companies in the country this includes, Indian Railways, the Port Trusts, the Posts and Telegraphs, All India Radio and the Ordinance Factory are some of the major examples of the country's public sector enterprises. However, post Indian independence, some policies for the development of the socio-economic status of the country were planned out by the then visionary leaders, where the public sector were used as a tool for the self-reliant growth of the nation's economy.

This was the reason that the second five year plan of India was solely based on the development of the different industries. Till 1990s major sectors of the economy were reserved only for the government, this caused the great loss of our precious natural resources and the whole country trapped into the great economic problem. From the very first five year plan till 1980s our country grows with the average rate of 3.5% per year (which is called Hindu rate of growth by Prof. Rajkrishna).

Objectives: The public sector aims at achieving the following objectives:

To promote rapid economic development through creation and expansion of infrastructure

1. To generate financial resources for development
2. To promote redistribution of income and wealth
3. To create employment opportunities
4. To promote balanced regional growth
5. To encourage the development of small-scale and ancillary industries, and
6. To accelerate export promotion and import substitution

1.4.1 ROLE OF PUBLIC SECTORS IN THE DEVELOPMENT OF THE COUNTRY IS EXPLAINED BELOW:

• **Public Sector and Capital Formation:** The role of public sector in collecting saving and investing them during the planning ear has been very important. During the first and second five year plan it was 54% of the total investment, which declined to 24.6 % in the 2010-11.

• **Employment Generation:** Public sector has created millions of jobs to tackle the unemployment problem in the country. The number of persons employed in the as on march 2011 was 150 lakh. Public sector has also contributed a lot towards the improvement of working and living conditions of workers by serving as a model employer.

• **Balanced Regional Development:** Public sector undertakings have located their plants in backward parts of the county. These areas lacked basic industrial and civic facilities like electricity, water supply, township and manpower. Public enterprises have developed these facilities thereby bringing about complete transformation in the socio-economic life of the people in these regions. Steel plants of Bhilai, Rourkela and Durgapur; fertilizer factory at Sindri, are few examples of the development of backward regions by the public sector.

• **Contribution to Public Exchequer:** Apart from generation of internal resources and payment of dividend, public enterprises have been making substantial contribution to the Government exchequer through payment of corporate taxes, excise duty, custom duty etc. gross internal resource generation in 1990- 2000 was 36000 cr which rose to 1, 11,000 cr in

2008-09, while net profit was 92,077 cr in 2010-11.

• **Export Promotion and Foreign Exchange Earnings:** Some public enterprises have done much to promote India's export. The State Trading Corporation (STC), the Minerals and Metals Trading Corporation (MMTC), Hindustan Steel Ltd., the Bharat Electronics Ltd., the Hindustan Machine Tools, etc., have done very well in export promotion.

• **Import Substitution:** Some public sector enterprises were started specifically to produce goods which were formerly imported and thus to save foreign exchange. The Hindustan Antibiotics Ltd., the Indian Drugs and Pharmaceuticals Ltd. (IDPL), the Oil and Natural Gas Commission (ONGC), the Indian Oil Corporation Ltd., the Bharat Electronics Ltd., etc., have saved foreign exchange by way of import substitution.

• **Promotion of Research and Development:** As most of the public enterprises are engaged in high technology and heavy industries, they have undertaken research and development programmes in a big way. Public sector has laid strong and wide base for self-reliance in the field of technical know-how, maintenance and operation of sophisticated industrial plants, machinery and equipment in the country. Expenditure on research and development reduces the cost of production.

1.5 MAJOR FISCAL FUNCTIONS

According to **Professor Musgrave** there are three major fiscal or budgetary functions of the governments. They are a) Allocation functions b) Distribution functions and c) Stabilization functions.

THE ALLOCATION FUNCTION

There are certain cases in which the wants of all individuals cannot be satisfied through market mechanism. In such cases the public sector or the governments have to provide goods and services. The allocation branch of public finance deals with the provision of social goods. Social goods are those goods and services produced to satisfy collective wants. Collective wants are those wants which are demanded by all members of the community in equal or more or less equal amounts. The allocation branch explains the process by which the resources in use are divided between private goods and social goods by which the mix of social good is chosen.

THE DISTRIBUTION FUNCTION

The very important feature of a market economy is the disparity in the distribution of income and wealth. The distribution function of public finance deals with the adjustment of the distribution of wealth and income to ensure "fair or just" state of distribution. That is, the distribution function of public finance deals with the determination of taxes and transfer payments policies of the governments.

THE STABILIZATION FUNCTION

The stabilization function explains the macroeconomic aspect of budgetary policy. In other words, the stabilization function deals with the use of budgetary policy as a means of maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth, with allowances for effects on trade and balance of payments. The major instruments of stabilization policy are monetary policy and fiscal policy. This function is otherwise known as compensatory finance.

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE One of the important principles of public finance is the so – calledPrinciple of Maximum Social Advantage explained by Professor Hugh Dalton. Just like an individual seeks to maximize his satisfaction or welfare by the use of his resources, the state ought to maximize social advantage or benefit from the resources at its command.

The principles of maximum social advantage are applied to determine whether the tax or the expenditure has proved to be of the optimum benefit. Hence, the principle is called the principle of public finance. According to Dalton, "This (Principle) lies àt the very root of public finance"

He again says "The best system of public finance is that which secures the maximum social advantage from the operations which it conducts." It may be also called the principle of maximum social benefit. A.C. Pigou has called it the principle of maximum aggregate welfare.

Public expenditure creates utility for those people on whom the amount is spent. When the volume of expenditure is small with a slighter increase in it, the additional utility is very high. As the total public expenditure goes on increasing in course of time, the law of diminishing marginal utility operates. People derive less of satisfaction from additional unit of public expenditure as the government spends more and more. That is, after a stage, every increase in public expenditure creates less and less benefit for the people. Taxation, on the other hand, imposes burden on the people. So, when the volume of taxation becomes high, every further increase in taxation increases the burden of it more and more. People under go greater scarifies for every additional unit of taxation. The best policy of the government is to balance both sides of fiscal operations by comparing "the burden of tax" and "the benefits of public expenditure". The State should balance the social burden of taxation and social benefits of Public expenditure in order to have maximum social advantage.

Attainment of maximum social advantage requires that;

a) Both public expenditure and taxation should be carried out up to certain limits and no more.

b) Public expenditure should be utilized among the various uses in an optimum manner, and

c) The different sources of taxation should be so tapped that the aggregate scarifies entailed is the minimum.

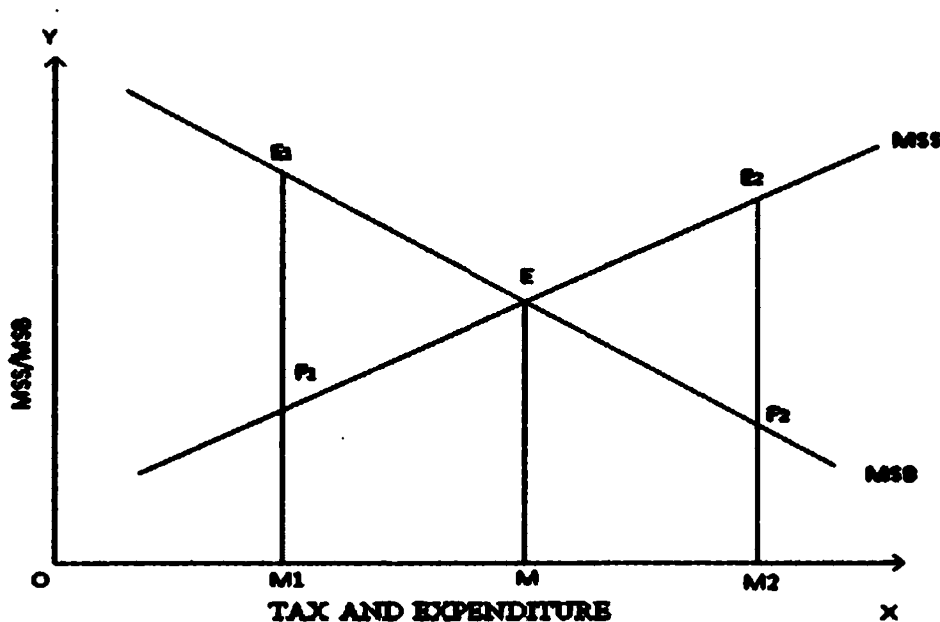
Assumptions of the Principle

- The public revenue consists of only taxes (and not of gifts, loans, fees etc.) and the state has no surplus or deficit budgets.
- Public expenditure is subject to diminishing marginal social benefits and the taxes are subject to increasing marginal cost or disutility.

According to Dalton, maximum social advantage is at a point where the Marginal Social Sacrifice (MSS) of taxation and Marginal Social Benefit (MSB) are equal. The point of equality between MSS and MSB is referred to as the point of maximum social advantage or least aggregate social sacrifice.

Musgrave calls Dalton's principle as "Maximum Welfare Principle of Budget Determination." He puts that the optimum size of the budget is determined at point where Net Social Benefit (NSB) of fiscal operations to the society becomes zero. The NSB is the difference between MSB and MSS. (NSB=MSB-MSS). Musgrave presented Dalton's principle of MSA with some slight differences.

Diagrammatic Representation



The curves MSS and MSB show the marginal social scarifies of taxation and marginal social benefit of public expenditure respectively. MSS curve slopes up words since taxation increases marginal social sacrifices. MSB curves slopes down wards showing that public benefit goes on declining with every increase in public expenditure. The ideal point of financial operations is where the governments collect OM taxation from the society and uses it for public expenditure. At this point , MSS is exactly equal to MSB (Point E) at OM 1 , MSS is M1 F1 which is less than MSB (M1 , E1) thus depicting a loss of welfare to the society (E1 F1). Similarly, the government is collecting OM2 taxation to finance larger public expenditure; The MSS is higher than MSB by E2 F2. So the ideal level of taxation and expenditure is at OM. According to Dalton "Public expenditure in every direction, should be carried just so far that the advantage to the community of a further small increase in any direction is just counter balanced by the disadvantage of a corresponding increase in taxation or in receipts from any other source of public income. This gives the ideal public expenditure and income".

1.5 CATEGORIES OF GOODS

PUBLIC GOODS

The indivisible goods, whose benefits cannot be priced, and therefore, to which the principle of exclusion does not apply are called public goods. The use of such goods by one individual does not reduce their availability to other individuals. For example, the national defence.

Characteristics of Public goods

1) **Non-rival in consumption:** - One person's consumption does not diminish the amount available to others. Once produced, public goods are available to all in equal amount. **Marginal cost of providing the public goods to additional consumers is ZERO.**

2) **Non-excludable:**- Once a public good is produced, the suppliers cannot easily deny it to those who fail to pay. That is, those who cannot (or do not agree to) pay its market price are not debarred or excluded from its use.

3) **Free-rider problem:** - People can enjoy the benefits of public goods whether pay for them or not, they are usually unwilling to pay for public goods. This act is the so-called free-rider problem.

PRIVATE GOODS

Private goods refer to all those goods and services consumed by private individuals to satisfy their wants. For example, food, clothing, car etc.

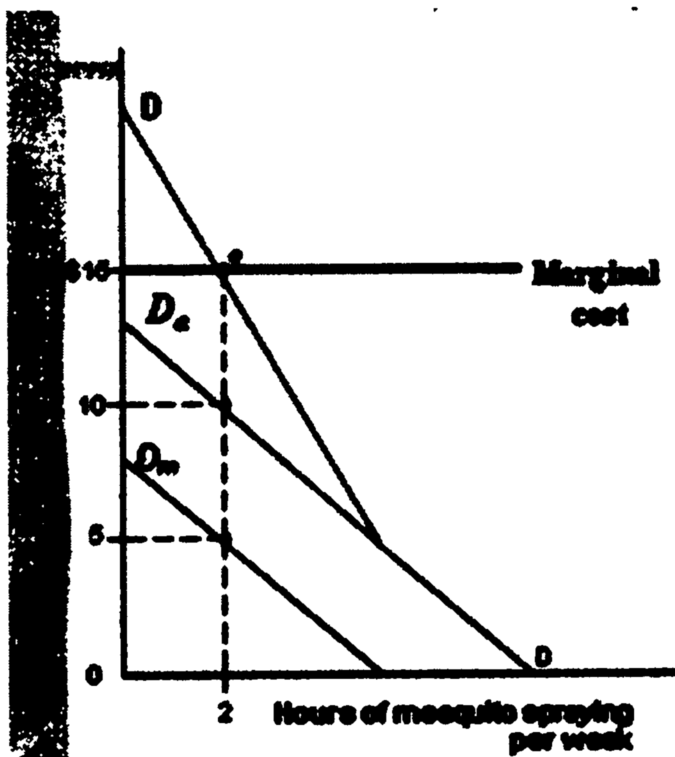
FEATURES

1) **Excludable:** - The suppliers of private goods can very well exclude those who are unwilling to pay.

2) **Rivalry in consumption:** - One person's consumption reduces the amount available to others. That is, the amount consumed by one person is unavailable for others to consume.

3) **Revealed Preference:** - The consumers reveal their preferences through effective demand and market price. These revealed preferences are the signals for the producers to produce the goods the individuals want.

Market demand for **private goods** is obtained by **horizontal summation** of individual demand curves and that of a **public good** is obtained by **vertical summation** of individual demand curves.



◆ D_a and D_m are the demand curves reflecting the marginal benefits that Alan and Maria, respectively, enjoy at each rate of output

◆ How much mosquito spraying should the government provide?

◆ Suppose the marginal cost of spraying is a constant $15 an hour; the efficient level of output is 2 hours per week, where the marginal benefit to the neighborhood equals the marginal cost

MIXED GOODS

Mixed goods are those goods having benefits which are wholly internalized (rival) and others, the benefits of which are wholly externalized (non-rival). The cost of producing such goods partly covered by private contributions and partly by government subsidy.

MERIT GOODS

Those goods whose consumption and use are to be encouraged are called merit goods (e.g.; education) and goods whose consumption and use are to be discouraged are called non-merit goods or demerit goods (e.g., liquor, narcotic etc.) drugs Merit goods are socially desirable goods which promote social welfare. **Merit goods are rival and excludable**. Governments provide merit goods in order to ensure distributional justice. These are goods which governments feel if people will under consume or produce and therefore should be subsidized or provided free. Examples of merit goods are education, mid-day meals in schools, essential food articles etc.

This concept was introduced by Prof.R.A.Musgrave in 1959.

1.5.1 CATEGORIES OF GOODS

CHARACTERISTICS	RIVAL	NON-RIVAL
EXCLUDABLE	PRIVATE GOODS CAR PIZZA FOOD	QUASI-PUBLIC CABLE TV UNCROWDED SWIMMING POOL
NON-EXCLUDABLE	OPEN ACCESS OCEAN FISH MIGRATORY BIRDS	PUBLIC GOODS NATIONAL DEFENCE SREET LIGHT

1.6 FACTORS PROPOSED BY URSULA K. HICKS

Hicks carries out a comparative analysis of essentially all successful and failed federations (though with emphasis on twentieth century experiences) with the aim of identifying general ingredients for success and failure among federations. By way of methodology Hicks states that:

In assessing factors influencing failure or success it is useful to distinguish between those that are essentially general, in line with world environmental changes (due for instance to new technological, physical or even political phenomena, which affected all countries) on the one side, and those which were peculiar to a particular federation (or felt there with particular intensity).

Hicks (1978, p. 172) organises her discussion under four heads, dealing respectively with the influence of:

(1) *initial endowments*, physical and human; (2) *constitutional and institutional organisations*; (3) the attitude of *other countries* in a world of fierce national rivalry, and (4) *incompatibilities and imbalances* between or within the federal States.

So far as initial physical endowments are concerned, Hicks cites the problems faced by the West Indies, Malaysia, Pakistan (comprising East and West Wings separated by India) and Australia (in relation to Western Australian isolation) and Tanzania, due to being too large and/or spread out and consequent problems of isolation and communication. Hicks further observes that:

There are many other ways in which the physical environment may affect the prospects of successful federation. An illustration of one such phenomenon is the discovery of mineral wealth in one part of a federation, as occurred when oil was found in the Eastern Region of Nigeria. This changed the whole relation between the different States of the Federation. When the Eastern Region realised that within the Federation she would not be permitted to retain the oil profits for her own use, she immediately sought to withdraw, and was only prevented from doing so as a result of civil war.

In relation to initial human endowments, Hicks states:

Differences in human endowment may mar the harmonious operation of a federation no less than differences in physical opportunities. These may take the form of religious disagreement, differences of culture, degree of education or sophistication and most of all race (especially of course where there is a question of colour). These may be present in various degrees, and while any of them alone might be insufficient to cause rupture, in combination they can easily lead to an impossible situation.

On the matter of constitutional and institutional arrangements, Hicks' study

highlights the importance of a carefully prepared and appropriate Constitution, an appropriately located federal capital city, and appropriately designed and sufficiently resourced (in terms of human and financial resources) legislatures, executives, judicial systems and administrations.

Regarding the attitude of *other countries*, Hicks observes that:

> *Foreign reactions are among the most important factors determining failure or success in federation. ... The most vital relation is that of the new nation to its immediate neighbours. There have been many instances where independent States got together for mutual protection from powerful neighbours (these in fact unintentionally promote federation if they do not swallow the infant nation). Canada and Switzerland are both striking examples of this phenomenon. Canada was so much afraid of being physically swallowed by the USA that the diverse (and possibly incompatible) elements of French (lower) and British (upper) Canada were prepared to make a nation together. There has long ceased to be any danger of physical acquisition of Canada by the USA. But increasing domination of Canadian investment by American firms (which mainly affects English Canada) may come near to binding her to her great neighbour as surely as political domination.*

Drawing further lessons from the Swiss example, Hicks notes that:

> *The history of the relation of Switzerland with her big neighbours is very revealing. Whenever there was a pressing external danger the cantons were strongly united. When there was no immediate threat intercantonal tensions and bickerings started up again. But gradually the cantons came firmly together in mutual respect, and the nation was secure.*

So far incompatibilities and imbalances are concerned, whilst differences in

language, culture and religion are often grounds for federation in the first place, the examples of Switzerland and the Indian subcontinent have highlighted how differences of religion, language and culture can affect the success of a federation.

According to Hicks (1978, p. 178), the Federation of Malaysia and Singapore broke up primarily because Singapore's wealth far exceeded that of the other member states, and because "Singapore is neutral as between races, religions and languages,

while Malaysia feels the need to assert her ego through religion and language". The Central African Federation is similarly said to have failed because of imbalances among "White-dominated Southern Rhodesia, wealthy and relatively advanced Northern Rhodesia (Zambia) and small and backward Nyasaland (Malawi)".

Religious incompatibilities have hampered the Swiss federation, but whereas these have been resolved in a generally satisfactory matter, similar incompatibilities prevented the union of India and Pakistan, although the divisive forces which led to the breakdown of the federation between Pakistan and Bangladesh were based on language and culture and "had nothing to do with religion".

Another incompatibility identified as being potentially problematic "is that between urban and rural interests", with Australia labelled as "a successful federation in which this incompatibility threatens to assume awkward proportions", because "the rapidly growing cities demand social services, constructional works and housing, matters which are of only secondary interest in the rural-dominated State Parliaments.

Finally, Hicks suggests that:

> *One of the most difficult of these is fiscal imbalance (between the central government and lower levels, or between individual states). ... If fiscal imbalance becomes serious enough it may cause the abandonment of a federal system. Even at the best it will be an obstacle to maximum efficiency of operation.*

In summary then, Hicks proposes that federal stability is enhanced if:

1. Physical geography is favourable to good communications so as to avoid problems of isolation, and of roughly equal economic value;
2. The population is at least compatible in terms of religion, culture, degree of education and especially race;
3. The federation is based on a carefully prepared and appropriate Constitution, and has an appropriately located federal capital city, and appropriately designed and sufficiently resourced (in terms of human and financial resources) legislatures, executives, judicial systems and administrations; and
4. Imbalances in wealth and fiscal relations, and as between urban and rural interests, are minimised.

QUESTIONS

1) What is public finance? Discuss the scope or subject matter of public finance.

2) Distinguish between public finance and private finance.

3) What is the role of public finance in the economic development of a country?

4) What are the fiscal functions of governments according to Professor Musgrave?

5) Explain the principle of maximum social advantage theory.

6) Write short notes on:

a) Public wants and private wants.

b) Merit goods and mixed goods.

c) Importance of public finance.

UNIT 2

PUBLIC REVENUE

2.1 PUBLIC REVENUE

This is one of the branches of public finance. It deals with the various sources from which the state might derive its income. These sources include incomes from taxes, commercial revenues in the form of prices of goods and services supplied by public enterprises, administrative revenues in the form of fees, fines etc. and gifts and grants.

The income of government through all sources is known as public revenue or public income. Prof. Dalton defined public revenue in two senses – Narrow sense and broader sense.

a) **Narrow sense:** In the narrow sense, it includes income from taxes, prices of goods and services supplied by public sector under takings, revenue from administrative activities, such as fees, fines etc.

b) **Wider sense:** It includes all the incomes of the governments during a given period of time, including public borrowing from individuals and banks and income from public enterprise it is known as public receipts.

Difference between Public revenue and Public receipts

Public revenue includes that income which is not subject to repayment by the government. Public receipts include all the income of the government including public borrowing and issue of new currency. In this way public revenue is a part of public receipts.

Public Receipts = Public revenue + Public borrowing + issue of new currency

2.2 SOURCES OF PUBLIC REVENUE

The sources of public revenue can be broadly classified in to two – Tax -source and non- tax source.

Taxes: Taxes are imposed by the government on the people and it is compulsory on the part of the citizens to pay taxes, without expecting a return.

Some Definitions

Tax is compulsory contribution from a person to the government to defray the expenses incurred in the common interests of all without reference to special benefits conferred - **Professor Seligman** Taxes are compulsory payments to the governments without expectation of direct return to or benefit to the tax payer - **Professor Taylor** Tax is compulsory contribution of the wealth of a person for the service of public power - **Prof. Charles F.Bastable**

The revenue from taxes came from three main sources. viz; a) **Taxes on income** b) **Taxes on wealth and property** and c) **Taxes on commodities.**

2.3 CHARACTERISTICS OF A TAX

1. It is compulsory payments to the government from the citizen. Each individual irrespective of caste, colour or creed, of age or sex has to pay it. Refusal to pay it or delay in payment brings punishment.
2. It is imposes a personal obligation: It means that it is duty of tax payer to pay it and he should in no case think to evade it.
3. Absence of direct benefit or quid pro quo between the State and people. The tax payer do get many advantages from the public authorities but no tax payer can claim direct benefit as a matter of right on the ground that he is paying a tax.
4. It is payments for meeting the expenses in the common interest of all citizens. The governments have to provide public utility goods. For this the governments have to incur huge amounts of expenditure. Therefore, taxes are imposed on all citizens so that all may share a common burden.
5. Certain taxes are imposed on specific objectives for example, tax on petrol to reduce consumption and tax on luxuries so as to divert resources for the production of essential commodities.
6. There is no tax without representation. This means that proposals regarding taxes are to be sanctioned in respective assembly of elected representatives.

Non - Tax Revenue

a) Commercial Revenue. (Income from public property and enterprises)

b) Administrative Revenue (Fee, Fine, Special assessment)

c) Gifts and grants and

d) Others

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

Administrative Revenue

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

Fees:"Fee is a payment to defray the cost of each recurring service under taken by the government in the public interest" – Prof.**Seligman.** Fees are payments imposed by the government. For Example, Court Fee, License Fee, Passport, Fee etc.

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

Special assessments: -According to Prof. Seligman "A special assessment is a compulsory contribution levied in proportion to the special benefit derived to defray the cost of specific improvement to property under taken in the public interest". For example, when the government constructs a highway, the prices of plots on either side of it will naturally go up. There for, the land owners may be required to bear a part of expenses incurred by the government. Such charges are called as special assessments.

Gifts and grants: - In general gifts and grants are the payments made by one government to another for some specific functions for example, central grant to state government. Gifts are voluntary contribution made by the people to the government for some special purposes.

Other sources of Revenue:-Other sources of revenue are Forfeitures, Escheat, Issuing of currency and Borrowings

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

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

Issue of Currency: - The printing of paper money yields income to the government.It is mean to create extra resources by the printing of paper money. It is normally avoided because if once this method of financing is started it becomes difficult to stop it. This further leads to inflation.

Borrowings: - This is another source of public revenue. That is through borrowings from the public in the shape of deposits bonds etc. It also includes external borrowings.

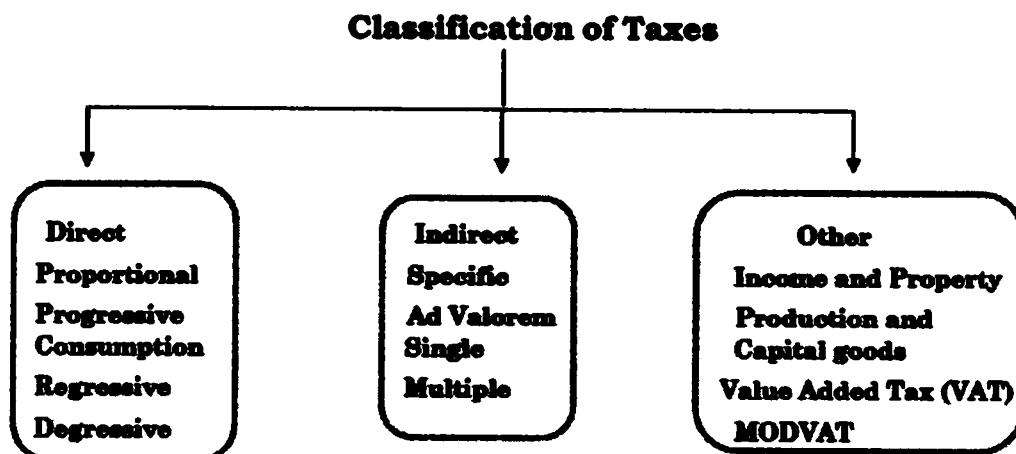
2.3.1 OBJECTIVES OF TAXES

- Raising Revenue
- Regulation of Consumption and Production
- Encouraging Domestic Industries
- Stimulating Investment
- Reducing Income Inequalities
- Promoting Economic Growth
- Development of Backward Regions
- Ensuring Price Stability

2.3.2 CLASSIFICATION OF TAXES

Taxes are classified on different bases. Different bases adopted by the economists to classify taxes are the forms, nature, aims and methods of taxation. The various taxes may be classified under following major heads.

Classification of Taxes



2.4 DIRECT TAXES AND INDIRECT TAXES

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

According to J S Mill, 'A direct tax is one, demanded from the very person who is intended or desired should pay it. Indirect taxes are those which are demanded from the one person in the expectation and intention that we shall identify him at the expenses of another'.

According to Prest, "The distinction between direct and indirect taxes is more commonly drawn by reference to the basis of assessment rather than the point of assessment."

Professor Antonio defines direct taxes as, "Direct taxes strikes a citizen's income at the moment of its production."

In the words of Gladstone, "The direct and indirect taxes are like two attractive sisters between whom an exchequer should be perfectly impartial."

According to P.E. Taylor, an authority on public finance, distinguished direct taxes and indirect taxes as follows," The terms direct and indirect taxes are finally distinguishable in meaning only in terms of shiftability. Direct taxes are not shifted while indirect taxes are."

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

That is, in the case ofdirect taxesboth impact and incidence fall upon the same person.

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

Examples of direct taxes are income tax, wealth tax, corporation tax, gift tax etc. And examples of Indirect taxes are Sales tax, excise duty, VAT etc.

MERITS OF DIRECT TAXES:

Following are the main merits of direct taxes.

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

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

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

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

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

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

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

DEMERITS OF DIRECT TAXES

The important demerits of the direct taxes are explained below.

1) Uncertainty: The precise degree on needed progression cannot be estimated on account of the difficulties of measuring the ability to pay and the subjective nature of the marginal utility of income.

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

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

4) Large scale evasion: direct tax is based on honesty. The tax is not evaded only when the tax payer is honest. It is a fact that the people in the higher income groups do not reveal their full income. It is remarked that "direct taxes are a premium on honesty."

MERITS OF INDIRECT TAXES

The following are the important merits of indirect taxes.

1) Convenience: Indirect taxes are more convenient to pay. It is paid at the time of purchase of a commodity. Hence, the tax payer does not feel the burden of tax. The tax is hidden in the price of the commodity bought. It is paid in small amount. The government can also collect it conveniently.

2) Indirect taxes lead to social welfare: indirect taxes on narcotics and intoxicants reduce the consumption of them which are harmful to health. Reduction in the consumption of such goods will indirectly increase the welfare of the people.

3) Indirect taxes are justified: indirect taxes are justifiable and equitable. They are paid by all the individuals and when they purchase goods and services.

4) Indirect taxes help production and investment: Another advantage of indirect taxes is that they perform as powerful tool in moulding the production and investment activities of the economy.

5) No evasion: Indirect taxes are generally difficult to be evaded as they are included in the price of the commodity. A person can evade an indirect tax only when he decides not to purchase the taxed commodity.

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

DEMERITS OF INDIRECT TAXES

1) Indirect taxes promote inequality: Indirect taxes are generally imposed on the consumption goods. The poor people have to pay as much by way of indirect taxes on commodities as the rich people. This is unjust and equitable. They are regressive in nature which will promote economic inequality in society by imposing larger burden of taxes on the poor people.

2) Uneconomical: Indirect taxes involve high costs of collecting them. To raise desired levels of public revenue, taxes should be collected from millions of people.

3) Element of uncertainty: Indirect taxes are extremely uncertain. The revenue accrued to the government from indirect taxes cannot be estimated accurately. As soon as the tax is imposed, the price of the commodity is raised. This will in turn reduce the demand for the commodity. It cannot be estimated with certainty as to what extent the demand falls.

4) Lack of civic consciousness: Indirect taxes do not create civicconsciousness as the tax payers in most cases do not feel the burden of the tax they pay.

5) Indirect taxes promote inflation: another demerit of indirect taxes is that it promotes inflationary tendency in the economy, as they would increase the prices of the taxed goods.

6) Discourage saving: Indirect taxes discourage savings because they are included in the prices of commodities. Therefore, people have to spend more on the purchase of commodities. This will reduces the disposable income of the people and hence the savings.

2.5 PROGRESSIVE, PROPORTIONAL, REGRESSIVE AND DEGRESSIVE TAXES

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

Progressive Tax:

A progressive tax is that in which the rate of the tax depends on change in income. That is, the rate of tax increases with the increase in the income. The higher the level of income, the higher the tax will be and vice- versa. (Table-1)

Table1. Progressive Tax Rates

Taxable income	Tax Rate%	Amount of tax
3000	10	300
4000	15	600
5000	20	1000
6000	25	1500

Proportional Taxes

A proportional tax is one in which the rate of tax remains the same irrespective of the level of income. Here, the same percentage of tax is levied on all income groups. The tax amount is simply calculated by multiplying the tax base with the tax rate. This is illustrated in Table 2.

Table 2 Proportional Tax Rates

Tax Base	Tax Rate %	Amount of tax
1000	10	100
2000	10	200
3000	10	300

Regressive Taxes

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

Table 3 Regressive Tax Rates

Tax Base in Rs.	Tax Rate %	Amount of tax in Rs.
1000	10	100
2000	8	160
3000	6	180

Degressive Taxes

Under this tax system, the tax is mildly progressive up to a certain limit. After that the tax may be charged at a flat rate. In other words, degressive tax system is a mixture of proportional as well as progressive tax system. In this, the higher income group people have to make little sacrifice in comparison with lower income group. (Table 4)

Table 4 Degressive Tax Rates

Tax Base in Rs.	Tax Rate %	Amount of Tax in Rs.
1000	10	100
2000	12	240
3000	13	390
4000	13	520

2.6 SINGLE AND MULTIPLE TAXATION

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

First of all, thephysiocrats during the 17th and 18th century strongly advocated a single tax on land, for according to them agriculture was the only productive sector

yielding surplus. Issac Sherman proposed a single tax on all real estates—on land—because it was convenient in administration and payments. Henry George also advocated a single tax on land mainly because he thought that it was not possible to shift the tax.

Merits of Single tax System

1) It is a very simple tax as it simplifies the work of the government.

2) It is less costly as lesser amount is spent to collect the revenue.

3) It is based social justice.

4) It does not discriminate against any particular work or industry.

Demerits

1) It cannot bring adequate revenue to meet the needs of the modern governments.

2) Single tax system violates the principle of ability to pay.

3) The burden of taxation is not equally distributed.

4) The tax system is not effective during the period of emergency or crisis.

5) Tax evasion is much possible.

6) It lacks elasticity.

2.7 MULTIPLE TAXATION

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

MERITS

1) It leads to equitable distribution of tax burden as it includes proportional, progressive, direct, and indirect taxes.

2) Tax evasion is very difficult under this system.

3) It is more flexible than single tax system.

4) It is based on the principle of equity.

5) It enhances the income of the governments.

DEMERITS

1) It is more complicated than single tax system.

2) Too much multiplicity leads to inconvenience to both the taxing authority and the tax payer.

3) It is not based on the principle of ability to pay.

4) It checks the productive process of the economy.

SPECIFIC AND AD VALOREM TAXES

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

Specific Tax

Taxes which are based on specific qualities or attributes of goods are called Specific tax. This tax is imposed on commodities according to their weights, size or volume. It is a per unit tax on commodity. For example, specific excise duty may be levied on the cloth in the length units and tax on sugar is based according to the units of weight.

Advantages

1) It is quite easy to calculate and administer.

2) The collection of the tax is very convenient.

3) It does not add to inflation, since it is fixed in amount.

4) It confirms to the canon of certainty.

5) It is difficult to evade as the tax is imposed on the basis of weight, size or measure.

Disadvantages

1) It is regressive in nature. It falls heavily on the cheaper varieties of products which the lower income groups consume.

2) It is less equitable as compared to the ad valorem tax.

3) They are less productive and less elastic.

4) They are also less economical during the period of inflation.

AD VALOREM TAX

When a tax is imposed on a commodity on the basis of its value, it is called ad valorem tax. This type of tax is levied after assessing the value of the taxable possession of a person. For example, several imported articles are taxed in terms of value and they have nothing to do with the weight, length, and size of the commodity.

Advantages

1) It imposes greater burden on the rich section of the society.

2) It is more equitable as it is imposed on the value of goods and thus the canon of ability to pay is fulfilled.

3) It is highly productive and elastic.

4) It is economical.

Disadvantages

1) It is quite difficult to administer as it is difficult to assess the value of commodities.

2) It increases inflationary pressures when there is rise in price level

3) There is wide scope for tax evasion as people may show smaller value of a particular commodity only for the sake of saving the tax amount.

2.8 PRINCIPLE OF NEUTRALITY IN TAXATION IN GST

Principle of Neutrality in Taxation is one of the key foundation principles along with the concept of destination based taxation upon which Goods and Services Tax has been implemented around the world.

The Report by Dr Amaresh Bagchi commonly referred to as Bagchi Report on "***Reform of Domestic Trade Taxes in India: Issues and Options***", published by National Institute of Public Finance and Policy in 1994 stated that

"If the ills of the present system are to be remedied, the problems have to be attacked at their roots and not by symptoms. The guiding principles should be neutrality, simplicity and equity."

If we observe the above comment, fact highlighted is that the evils of the system of taxation prevailing at that time could have been remedied by application of three principles, one out of which was principle of neutrality.

The report further went on to provide the negatives of not having principle of neutrality of taxation embedded in the taxation structure as follows:

"This lack of neutrality in the application of tax creates distortions in production and distribution channels, and creates inequities in the application of tax to competing firms. Such distortions and inequities force even otherwise honest dealers to resort to activities that are unethical or in contravention of the law."

A very interesting example was quoted in the report to showcase how unethical activities are resorted for the claim of exemption which results in inequalities:

"In the case of exemptions granted to new manufacturing units, the exempt units set up in one State move to another on the expiry of the tax holiday. As used machinery bought from outside the State is regarded as new investment for purposes of the exemption, they are able to extend the exemption period through relocation to another State."

The fact highlighted above was that the lack of neutrality in taxation provides distortions in production and distribution channels and creates inequalities amongst the competing firms which force them to adopt unethical practices.

Below are few of the hypothetical examples of inequalities being created amongst competing firms through taxation structure and tax having a primary influence on the decision of the both businessman and the consumer as well:

a) Supposedly, Tax on laptop is 5% and desktop computer is 14.5%. As both are very close substitutes of each other, it would be resulting in people preferring to purchase laptop than desktop computer and therefore as a result people would be more inclined towards investing in businesses engaged in producing laptops than desktop computers.

b) Supposedly, services obtained from a service provider in India is charged with tax at the rate of 14% and same services procured from a service provider outside India, is not chargeable to tax in India. It would then create a proposition wherein people would avail services from outside India rather than from a service provider in India.

c) Excise duty is leviable on Manufacture and is calculated as percentage of cost of manufacturing. It however does not include distribution margins of the distributors like Wholesaler, Retailer etc. Therefore products which have a high distribution margin have relatively low incidence of Excise Duty as percentage of selling price of the product as compared to the products wherein cost of production is high and distribution margin is low, thereby having higher incidence of Excise Duty as percentage of selling price of the product.

It has been further highlighted in the Bagchi Report on "***Reform of Domestic Trade Taxes in India: Issues and Options***", published by National Institute of Public Finance and Policy in 1994 as follows:

"As noted earlier, a tax that steps at intermediate stages of trade will not be uniform in its impact on different goods and services because of differences in their pattern of production and distribution."

This forms significant part of the cost and leads to distortion and inequality as excise duty paid by the distributor at the time of purchase of goods from the manufacturers is not allowed as credit against the tax liability arising at the time of selling of goods to the consumers and therefore higher the incidence of excise duty as percentage of the selling price more would be the inequality and distortion.

d) A transaction of sale of goods against C form, on principal to principal basis in the course of Inter- state trade or commerce would result in a levy of 2% Central Sales Tax each time the goods are sold in the course of Inter-State Trade or Commerce without any credit being available of the taxes paid earlier.

"***Reform of Domestic Trade Taxes in India: Issues and Options***", published by National Institute of Public Finance and Policy in 1994 provided that

"Since the CST is leviable on each inter-State sale of goods, regardless of the application of the tax at prior stages, when the goods go through a chain of purchase and resale in several States, the tax cascades in a manner similar to a multistage turnover tax. For example, if a Karnataka dealer imports paper from Maharashtra and then resells it to a dealer in Tamil Nadu, the CST would apply twice, for a total burden of 8 per cent. Obviously, this becomes a handicap for the Karnataka dealer, compared with one who can arrange a sale directly from Maharashtra to Tamil Nadu."

It has to be noted that the tax rate against C form in CST at that time was 4% as against present rate of 2%.

However, if the transaction is on principal to agent basis against F Form, then in such case there is no levy of Central Sales Tax. The dealers are therefore inclined towards integration of forward vertical chain and to shorten the distribution channel and open a direct outlet or branch of its own or appoint an agent to reduce the burden of taxes. Going one step ahead, such indifferent treatment results in dealers engaging themselves in dishonest practices and appointing agents on documents just to avoid the 2% Central Sales Tax.

"***Reform of Domestic Trade Taxes in India: Issues and Options***", published by National Institute of Public Finance and Policy in 1994 provides that

"A simple and widely practised way is to camouflage inter-State sale of goods as transfer on consignment, or a depot or branch transfer. While there is no firm estimate of how much of the products of one State goes out in the form of consignment, it is widely believed that the volume is sizeable and in some cases (like pharmaceutical products of Maharashtra) the proportion is said to be as high as 80 per cent. According to knowledgeable persons, on an average, not less than 50 per cent of the inter-State movements of goods go as "consignment" transfers some of which, of course, could be genuine intra-firm transfer."

Therefore such instances though not exhaustive and only illustrative lead to inconsistency in the taxation regime and thereby leading to a scenario where tax considerations affect the decision of the Investors in the business and also the consumers.

2.8.1 WHAT IS PRINCIPLE OF NEUTRALITY?

Principle of Neutrality in taxation is a scenario wherein decision of Investor and the consumer are both neutral and devoid of tax considerations creating inequalities and secondly price of the product does not include tax as part of cost thereby avoiding cascading effect until the product reaches the final consumer.

a) The Report by Dr Amaresh Bagchi commonly referred to as Bagchi Report on "***Reform of Domestic Trade Taxes in India: Issues and Options***", National Institute of Public Finance and Policy, New Delhi issued in the year 1994 stated

"The greatest virtue of VAT lies in its neutrality, that is, non-interference with the choices of decisions of economic agents and equal treatment of products, producers and consumers. Because of its anti-cascading effect, the number of times a product is traded before reaching the final consumer or how much of the value is added at what stage in the production-distribution process are of no consequence under a VAT. It is

also neutral regarding choice of production technique as well as business organisation. Other things remaining the same, the tax liability does not vary as between corporate and non-corporate entities, or between integrated or specialised units."

b) "Working Paper GST Reforms and Intergovernmental Considerations in India" for the Department of Economic Affairs Ministry of Finance, Government of India released in the month of March 2009 provided that

"The neutrality principle would suggest that:

- *the tax be a uniform percentage of the final retail price of a product, regardless of the supply-chain arrangements for its manufacturing and distribution;*
- *the tax on inputs be fully creditable to avoid tax cascading; and*
- *the tax be levied on the basis of the destination principle, with all of the tax on a given product/ service accruing in the jurisdiction of its final consumption."*

c) In the International VAT/GST Guidelines on neutrality issued by OECD (Organisation For Economic Co-Operation And Development) on 28 June 2011,

"The full right to deduct input tax through the supply chain, except by the final consumer, ensures the neutrality of the tax, whatever the nature of the product, the structure of the distribution chain and the technical means used for its delivery (retail stores, physical delivery, Internet)."

'& How does the Principle of Neutrality Works:

"Uniform percentage of Tax Rate on final retail price of the product and close substitutes should not be taxed at very different rates: There should be uniform percentage of Tax on final retail price of the product so that the complexities can be reduced for the taxpayers and it would also be easy to monitor for the government. This would also result in uniform incidence of tax on products and consumer choices not being influenced by the tax.

"Working Paper GST Reforms and Intergovernmental Considerations in India" for the Department of Economic Affairs Ministry of Finance, Government of India released in the month of March 2009 provided that

"In particular, it is important from an administrative perspective that close substitutes should not be taxed at very different rates—to avoid leakages and distortions."

At the outset, it has to be observed that the above reference is about close substitutes and not perfect substitutes. The term close substitutes covers broader category than perfect substitutes.

There should be similar taxability of close substitutes. Tax consideration should not distort the mind of the consumers. The decision of the consumer in a price sensitive market is motivated by the most competitive price amongst similar products. The price under unequal tax regime is in turn affected by tax policy measures. The government unless intending otherwise, unknowingly through non-uniform taxes on close substitutes create market condition in favour or against a particular product.

Therefore, the decision between two close substitutes by the consumer should be neutral of tax effect and should be based upon quality and other considerations. For eg. if two close substitutes are charged at different tax rates, there would be an inclination in the mind of the consumer for the product having lower tax rate.

" The definitions can also be understood with the help of the following three basic neutrality principles laid down in ***International VAT/GST Guidelines on neutrality issued by OECD (Organization For Economic Co-Operation And Development) on 28 June 2011:***

a) "The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation."

The report provides that

"In domestic trade, tax neutrality is achieved in principle by the multi-stage payment system: each business pays VAT to its providers on its inputs and receives VAT from its customers on its outputs. To ensure that the "right" amount of tax is remitted to tax authorities, input VAT incurred by each business is offset against its output VAT, resulting in a liability to pay the net amount or balance of those two. This means that VAT normally "flows through the business" to tax the final consumers. It is therefore important that at each stage, the supplier be entitled to a full right of deduction of input tax, so that the tax burden eventually rests on the final consumer rather than on the intermediaries in the supply chain.

This principle can be understood on the basis of following factors:

- ***There should be full right available to the taxable businesses to deduct Input Tax throughout the supply chain to avoid cascading effect of taxes***: To ensure neutrality of taxation, taxes should never form part of the cost and any taxes paid should be allowed as credit against the output liability during the course of entire supply chain until the product reaches the final consumer. Tax paid should be a complete pass through in the supply chain of taxable businesses unless specifically provided by law and except for the end customer.

In other words, taxable businesses should not burden their products with the cost of tax not allowed as credit. The right to claim credit of the input tax paid should be available to all taxable businesses unless specifically provided by the law and except to the end consumer.

- ***The right to deduct the input taxes should be available irrespective of the***

i. Nature of product

ii. Structure of distribution chain

iii. Technical means used for delivery (retail stores, physical delivery, Internet)

There should be no barrier in the right to avail credit of the taxes paid by the taxable businesses irrespective of Nature of Product (not being a product exempted from levy of tax), structure of distribution chain i.e. retailer, wholesaler or direct selling office of the company and technical means used for delivery i.e. physical or purchased from a retail store or purchased online.

- ***Due to the anti-cascading effect, the number of times a product is traded before reaching the final consumer or how much of the value is added at what stage in the production-distribution process are of no consequence under a VAT:***

The tax does not have a cascading effect, therefore each business whether producer or distributor pays tax in proportion to the value added by them after deducting the input tax paid by them from the tax collected by them and tax sticks as a cost to the product to the end consumer only.

In other words, tax is never added to the cost of the product even if the products are traded multiple times before reaching to the final consumer as all taxes paid in supply chain are allowed as credit and no taxes form part of the cost until it reaches to the final consumer thereby avoiding cascading effect i.e. tax on tax.

Therefore, inconsistency arising from lower incidence of Excise duty as percentage of selling price on products having high distribution margin as compared to products having lower distribution margin or levy of CST on multiple sale of same goods during the course of Inter-State Trade or Commerce without credit being available would not be a factor as all taxes paid would be allowed as credit to business other than final consumer.

- ***Other things remaining the same, the tax liability does not vary as between corporate and non-corporate entities, or between integrated or specialized units.***

The tax incidence in both scenarios i.e. wherein particular manufacturing process is outsourced to specialized unit or wherein there is backward vertical integration of the entire manufacturing process, would be tax neutral. Further, neutral would be the result of tax incidence in a scenario wherein the company may decide to open its own retail outlet resulting in forward vertical integration or may decide to sale the product to another person on principal to principal basis.

There would be no saving in terms of taxes other things remaining the same as there would be no cascading effect of taxes and all taxes levied at procurement stage are allowed as credit to the purchaser and tax only sticks to the cost to the end consumer only.

b) Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.

International VAT/GST Guidelines on neutrality issued by OECD (Organisation For Economic Co-Operation And Development) on 28 June 2011 provide that:

"Taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation;"

This provides that the tax administration should not discriminate between two similar businesses. Similar Businesses carrying out similar transactions in similar situations should be taxed similarly.

- ***Meaning of Similar Level of Taxation***: Businesses with similar levels of taxation means the final burden of tax taking into account all available refunds and credits.

- ***Meaning of Similar Business:*** The two business would be similar business on the basis of use of inputs for supporting the taxable activity and related right to deduct the input tax credit. The right to deduct input tax from output liability should be determined with reference to the right; two businesses have with regard to the availment of credit of the taxes paid by them on inputs used by them to support its taxable activities.

Similar Businesses would not be restricted only to similar Industries. The two businesses would not be similar businesses if one is carrying out taxable business activity and other one is carrying out exempted activity.

- ***Meaning of Similar Transaction:*** Similar Transactions would be based upon characterization of supply under the law. Once the characterization of the supply has been determined, then the source or terms of supply etc. should not be relevant.

- ***Example of the given Scenario:*** A simple example can be supposedly two Manufacturers are purchasing new machinery for manufacturing of taxable goods. One Business is a newly established entity and other business is an old business. The credit of the tax paid on machinery is allowed to the new entity and no credit is allowed to the old entity.

This would lead to similar business i.e. manufacturer of a taxable commodity carrying out similar transaction i.e. purchasing of capital goods not being taxed similarly i.e. newly established entity being allowed credit of the tax paid and old entity not being allowed credit of the tax paid on purchase of machinery.

Thereby, the entity established earlier would be facing higher incidence of tax and cascading effect on the taxes paid by them on the purchase of capital goods as compared to the entity newly established.

The Taxation structure should not discriminate between similar businesses carrying out similar transaction else it would lead to inclination of the investor to the business towards the business with lower tax incidence.

c) VAT rules should be framed in such a way that they are not the primary influence on business decisions.

The decision of the business should be primarily based upon economics rather than tax considerations. The decision whether to set up a permanent establishment, to open a branch, backward or forward vertical integration of the business etc. should be primarily based upon dynamics and economics of the business rather than the VAT Rules of the business.

A simple example has been provided in the report as follows:

"For example, in situations where foreign businesses are advantaged compared to domestic businesses in respect of the level of taxation (which is inconsistent with Guideline 2.4), a foreign business may change the decision it would otherwise make primarily in order to take advantage of this treatment. Thus, a business may decide to operate from offshore rather than in the domestic jurisdiction."

This would not be covering cases where decision of business are governed by taxation of two different products having different tax status or where the business decision opts to take advantage of simpler taxation provisions for small business firms etc.

Conclusion: How GST in India could follow the principal of Neutrality in Taxation:

With the Implementation of GST, Principle of Neutrality in Taxation should come into the framework and without the basic principles of Neutrality being incorporated in the statute; benefits of implementation of GST may not be reaped in fully by the stakeholders i.e. businesses, consumers and government.

If we have to summarize that how principal of neutrality should be incorporated in Implementation of GST in India as detailed provisions for Input Tax Credit and Levy of Taxes are yet to be brought in public domain, we can highlight following considerations:

a) Tax should be sought to be levied on the entire supply chain i.e. right from the starting to the end point of reaching to the consumer. It should not be a tax which is levied for the first time at an intermediary stage.

b) Tax Structure should contain minimum exemptions and should be broad based so that there is no cascading effect of tax being levied on tax again.

c) Tax levied should be a complete pass through during the entire supply chain and should not form part of the cost at any point until it reaches the final consumer.

d) Tax should be levied on a uniform basis without discriminating in any way i.e. between two close substitutes, businesses etc unless intended specifically.

e) Tax should be levied on the principle of destination based taxation wherein the tax revenue accrues to the jurisdiction wherein the goods or services are finally consumed. Any tax being levied or collected at origin or intermediary stage should be allowed as credit to the taxable business so that tax does not form part of the cost of the product until it reaches to the final consumer of the consumption state.

Levy of Additional Tax @ 1%:-How Far Neutral: The Levy of the proposed Additional Tax in GST at the rate of 1% on Inter State Supply of goods is against the very basis of principle of neutrality of taxation and should be avoided as it would lead to inheriting all the weaknesses of the present system as mentioned earlier in the article being caused due to the levy of Central Sales Tax.

2.8.2 THREE PRINCIPLES ON EQUITABLE DISTRIBUTION OF TAX BURDEN (FISCAL NEUTRALITY)

1. The Cost of Service Principle:

This principle suggest that the cost incurred by the government in providing public goods to satisfy social wants should be regarded as the basis of taxation. The expenses of government should be appor-tioned among the people according to the costs incurred in render-ing a particular service to the people.

The chief exponent of this principle was the Austrian economist Von Hock. The state is just like a producer of social goods and taxes are the prices for the same.

Von Hock considered the services provided by the state, falling in three categories. Firstly, there are certain services of the state which confer uniform benefit to all. For example, defence, law and order, maintenance of public health etc. These services are provided to rich and poor alike.

These should be made the basis of a personal tax. Secondly those who possess property and own industry get certain additional benefit under the protection of the state. Further the owners of property benefit by appreciation in the value of their property.

Protection of business and possession of property involve some cost, which should be recovered through a property tax.

Thirdly there are certain special services such as education, building of highways, the recording of mortgages etc. rendered to particular individuals who get a direct benefit out of these. Since these ser-vices are of special character, they should be made the basis of a special payment, according to cost of service approach.

This notion was prevalent in medieval times when everything was regarded as a payment for service rendered-justice, defence, administration etc. Hence the cost of service principle to taxation was applicable only to a feudal regime, where feudal payments were considered as the legitimate dues of the sovereign in return for the service of protection provided by them.

This principle has many shortcomings. It is not easy to esti-mate the cost of government service or social goods made available to each individual taxpayer. It is difficult to find out any precise mea-surement of the costs and sharing of such costs in most of the indivisible public service such as defence, police etc.

This principle is not In conformity with the definition of tax. A tax is not a price; tax has no quid-pro-quo.

It imposes undesirable limitation on the scope and scale of the public services. According to this principle, only those public ser-vices are justified for which the public is capable of bearing the cost.

Hence, in effect this theory does not justify many social welfare programmes of the government such as the relief works during fam-ine or floods, free general education, free medical facilities to the poor etc. the beneficiaries of these welfare measures are the poor who cannot bear the cost of providing the same.

It goes against the norms of welfare economics. If cost is the base of taxation, government cannot provide free education and medical care to the poor sections of community.

2. The Benefit Principle:

According to this approach dating back to Adam Smith and earlier writers an equitable tax system is one under which each taxpayer contributes in line with the benefits which he receives from public services.

The persons receiving equal benefits from the state should pay equal amount as taxes. Those who receive greater benefits should pay more as taxes. The benefit principle is very much similar to the cost of service principle.

The former approaches the problem from the side of the demand while the latter looks at it from the side of supply.

The benefit approach to taxation was accepted widely among the political theorists of the 17th century. Its modern formulation dates back to Adam Smith and leads up to Voluntary Exchange Theory of Lindahl.

(i) The Classical Version:

The mercantilist writer, Sir William Petty argues that "it is generally allowed by all that men should contribute to the public charge, but according to the share and interest they have in the public peace that is according to their estates and riches".

In the first sentence of his Maxim Smith introduced ability as well as benefit considerations in revenue rising. Smith observes **"the subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to the revenue which they respectively enjoy under the protection of the state".**

This raises some doubt whether Smith should be placed in the benefit camp. But towards the end of book No. V of Wealth of Nations there appears a clear cut rule that

the cost of public expenditure should be allocated according to benefit and that general contribution should be used only where expenditure cannot be allocated on a benefit basis.

According to Smith, everyone is benefited from public services and everyone should contribute to the cost of sustaining them. But the problem is how we can measure individual benefit and cost.

Since there is no practical way of doing this, a general rule of thumb is needed in place of individual imputation. This rule, according to Adam Smith, is provided by taxing individuals "in proportion to their respective abilities". That is the revenue which they respectively en-joy under the protection of the state. Musgrave argues that Smith shrewdly inserted an ability element into the weak link of the benefit rule.

A renaissance of the benefit approach took place in the hands of Pantaleoni, Mazzola and de Viti de Marco in Italy and Sax in Aus-tria. They joined in an effort to integrate the determination of taxes and expenditures with the allocation of resources in the market. Taxes came to be viewed as a price for public service in line with taxpayer demand.

The determination of the tax price in accordance with benefit received came to be looked upon as a condition of effi-cient allocation. Beyond this, it was regarded as a condition of equi-librium brought about by either a political or a market process.

Mazzola an Italian economist argues pricing of public services is entirely different from pricing of private services. Public services are equally consumed by all. Since the utility schedule for public services are different for different individuals, charging a single price for public services is not an efficient solution.

Hence for attaining equality between tax and marginal benefits, public service has to be supplied to individuals at different price, irrespective of the fact that they are consumed in equal amount by all.

The inference is that tax payment will be different for different individuals in accordance with the marginal benefit, which they expect from a particular quantity of public service.

Wicksell's justification is that benefit theory of taxation is just, because it is in conformity with democratic spirit of individual free-dom. Wicksell argues that since taxes are paid in accordance with the benefit received, no question of unjust compulsion of contribu-tion to public services arises.

The Italian economist de Viti de Marco in 1888, advocated that "citizens duty to pay taxes should be matched by the states duty to supply public services".

He advocates that every individual is a con-sumer of public services. As such income of the consumer reflects the index of demand for public service. Accordingly rich, person's capacity to pay for public service is comparatively higher than a poor person, even though both receive the same amount of public service.

He tried to introduce an element of progressive taxation in the benefit theory. When each citizen uses public service in propor-tion to his income, he concludes that taxation should be progres-sive.

(ii) Modern Views on Benefit Theory – Voluntary Exchange Approach:

(a) Lindahl Solution:

A modern approach to the benefit view of taxation comes from the famous Swedish economist Erik Lindahl in his voluntary exchange theory in 1919.

In its simplest form, the theory states that the cost of supplying public service should be covered by taxes voluntarily con-tributed by the beneficiaries, just as they pay voluntarily for any commodity purchased from private market.

Lindahl's theory simulta-neously tries to find out solution to allocation and distributive aspect of fiscal problem. Lindahl's soh lion involves taking three set of decisions simulta-neously. They are

(a) We must determine the total amount of public expenditure to be incurred and tax resources raised,

(b) The second decision relate to the allocation of total public expenditure among goods and services meant for the satisfaction of social wants and

(c) The allocation of total taxes among various individuals, who are ben-eficiaries of the provision of public service.

Lindahl states that these decisions are included in the allocation branch and are mutually interdependent and it must be rendered jointly. In a sense Lindahl applies the marshallian market principle of total cost allocation of two joint products to their respective supply prices.

Lindahl's solution can be explained with the following numerical example. Let us consider a community consisting of two tax payers 'A' and 'B' and one type of social goods. Both 'A' and 'B' consumes the total amount of social goods supplied. But they receives different amount of satisfaction from it.

Hence their benefit share may be considered as joint products. So cost of supplying social good is jointly contributed by A and B. Individually one will have to pay less as the other contributes more

The only way to allocate cost is to do it in accordance with the demand for two products. Thus if A' is willing to contribute 'X' percent of the total joint cost, then 'B' will be contributing the rest, that is (1 – X) percent of the total cost.

Thus joint contribution of both A and B covers the total cost of supplying the social good. It follows that A's offer to contribute certain percent-age of total cost may be looked upon as 'B's supply schedule of goods. Likewise 'B's offer may be similarly seen as the supply schedule for 'A'.

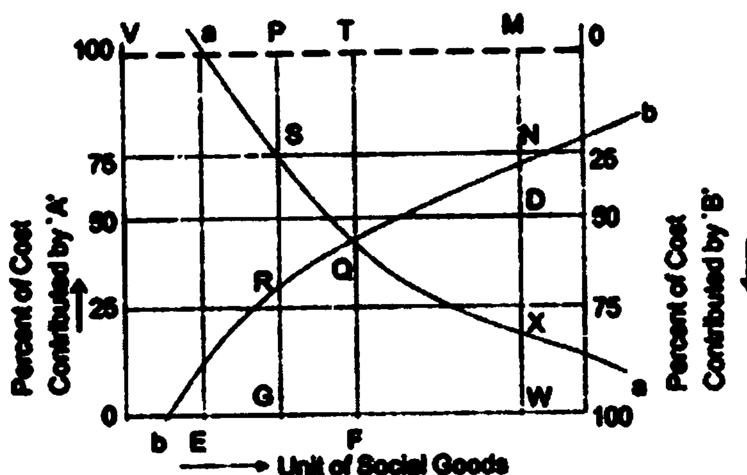


Fig. 4.1 : Lindahl's Model

Quantities of social goods are measured along the horizontal axis. Percentage of total cost contributed by A' along left vertical axis and percentage of total cost contributed by 'B' along right vertical axis.

Total unit cost of supplying social good is OV. The curve 'aa' is the demand schedule of individual A' and 'bb' corresponds to that of 'B'. Taxpayer A' will be willing to contribute 100 percent of cost for out-put OE, which will then be available free to 'B'. At the output level OG, taxpayer A' is willing to contribute GS percent of the cost.

Then the output is available to taxpayer 'B' at PS percent of cost. But taxpayer 'B' willing to contribute 'PR' percent of cost, because 'R' is the point on his demand schedule. Hence the total contribution of taxpayers 'A' and 'B' will exceed the cost of supplying social well by SR percent. This indicates that both taxpayers A and B prefer larger scale of social goods.

The optimum level of social good is given at OF, at which taxpayer 'A' contributes FQ percent of cost and taxpayer 'B' contributes TQ percent of cost. Their combined contribution covers the total cost of supplying OF level of social good.

It is not possible to extent the production of social good beyond the quality OF. The reason is that the combined contribution of both taxpayers will fall short of total cost of production.

Let us take the point OW level of output. At this output level, taxpayer 'A' will be willing to contribute WX percent of cost and taxpayer 'B' will be willing to contribute MN percent of cost, because 'N' is the point on his demand schedule. As a result 'NX' percent of cost will remain uncovered.

Suppose now taxpayer 'A' contributes 'WD' percent of cost, then 'OW' quantity of social good can be produced and sup-plied. But the taxpayers will be paying larger share of cost than the valuation they attach to the social good.

Hence both tax payers 'A' and 'B' will vote for small quantity of social good. Similarly it can be shown that both the taxpayers will reveal their preference for larger quantity of social goods, when the supply of social goods falls short of the optimum level at OF.

In this way, the budgetary process for the satisfaction of social wants is determined by a competitive solution, as in the case of a private goods market. Thus the voluntary exchange model of the benefit approach provides a tool by which the quantity of public goods and the contribution of tax share might be simultaneously deter-mined.

(b) Bowens Solution:

A better and simple model of benefit principle has been presented by Howard. R. Bowen in his book **"Towards Social Economy"** pub-lished in 1948. Prof. Musgrave favours Bowens approach, because it is more realistic and assumes increasing cost conditions in the provision of social goods.

Bowen's simple model is explained by as-suming one social good and two individual tax payers 'A' and 'B'. The figure 4.2 illustrates the model.

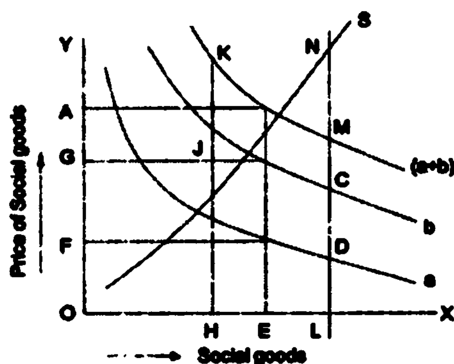


Fig.4.2 : Bowen's Model

Here we have one social good and tax payers 'A' and 'B'. The demand of taxpayer consumers A' and 'B', respectively for social good are presented by 'a' and 'b'. The total demand for social good is given by the schedule (a + b).

The supply curve of social good is represented by 'S'. It is upward rising, which indicates that social good is produced under conditions of increasing cost. OX axis repre-sent quality of social good and OY axis the price of social goods or tax to be paid by beneficiaries to meet the cost of social good.

The above figure simultaneously determines the amount of social goods and the tax share between consumers according to their own valua-tion of benefits.

The equilibrium quantity of social good is OE, and the total amount of tax revenue to be raised to cover the cost of supplying OE quantity is given by the area OEBA. ED and EC are the marginal benefits expected from OE quantity of social good, by tax paying consumers A and B respectively.

Hence A' will pay 'ED' and 'B' will pay 'EC' amount of tax per unit, so that the total amount of tax revenue raised comes to OEBA. The tax share of A and B will be OEDF and OECG respectively (OEDF + OECG = OEBA).

Any quan-tity of social good other than OE level will not be an optimum level of supply. For example, if the public good is at OH output level, the combined contribution of tax per unit will be HK, which is larger than the cost of supplying it that is HJ.

It reveals that more social good is demanded. At OL quantity of social good, the total contribution LM, per unit falls short of its cost, that is LN. Hence OE provides the optimum mix of social goods.

An Assessment of the Benefit Approach:

The benefit approach to tax burden distribution has some advan-tages. It co-ordinates the revenue and expenditure sides of the bud-get directly. It involves an approximation of market behavior in the Allocative procedure of the public sector.

Allocative efficiency and distributional equity considerations are reconciled in this approach. The theory suggests that the benefit conferred by public services jus-tify the imposition of taxes to pay for them. This theory is essentially a cost benefit approach which maintains a balance between income and expenditure of the government.

Moreover the theory links the provision of public services to the preference pattern of individuals. However this approach, though simple in application, has little practical use due to a number of limitations.

The theory is based on an unrealistic assumption that varied and complex activities of the public authorities are calculable and measurable.

According to this theory this can be assessed on the basis of personal benefit received. But in reality benefits from public services are indivisible. Moreover there is no standard yardstick to measure benefit conferred upon the people. How can we measure and divide the benefits of national defence or education which give rise to externalities.

The benefit approach limits the scope of government activities. Modern state is a welfare state. It provides certain services meant for the common benefit of the society and mostly targeted for the poorer sections of the community.

In this case, there is no quid-pro-quo basis in the exchange of social goods. Hence if this theory is truly followed, government will have to stop many of its welfare oriented expenditure policies targeted towards the socially vulnerable groups in the society. In this sense the theory seems obsolete.

The Lindahls' solution to benefit approach, assumes optimum distribution of income. However no precise meaning is given as to what constitute an optimum distribution of income.

At its core the theory assumes that each consumer reveals his preference for social goods. However in reality consumers cannot reveal their preferences because of ignorance or with deliberate in-tension. Hence authorities cannot judge and take prudent Allocative decisions.

Hence it can be concluded that benefit approach to distribution of tax burden has little operational significance. It is theoretically sound, and is an ideal approach, but lacks of practical applicability.

In practice, state cannot allocate tax burden on the basis of benefit conferred. Many of the budgetary operations of the state are beyond the lines of pure cost-benefit approach. However, it has some limited application, in the case of local authorities.

Local authorities if needed can apply some local taxes on benefit-cost basis. For example, limited application of this principle, in certain taxes such as vehicle tax, for financing improvements in road system is admitable and feasible.

3. Ability to Pay Theory:

The ability to pay approach or the faculty theory of taxation has been regarded as the ideal principle for the apportionment of tax burden. The principle of distribution of tax burden, which is in conformity with the popularly accepted notion of equity, is that of ability to pay.

By ability in the common parlance, we mean economic well-being or the overall level of living enjoyed by the tax payer. This principle fundamentally means that persons who have the same ability to pay should pay equal amounts of taxes and that the persons who have greater ability should pay more to the government, than those who are less well-off.

Those lacking any ability should be exempted from shouldering tax burden. Thus ability to pay theory was considered as the just and equitable theory of distribution.

According to J.S. Mill "equality in taxation means equality of sacrifice". Adam Smith, the chief exponent of ability to pay theory states "the subjects of every state ought to contribute towards the support of the government as nearly as possible, in proportion to their respective abilities, i.e. in proportion to the revenue which they respectively enjoying under the protection of the state". Musgrave states that "ability is the ideal, ethical basis of taxation".

Taxation according to ability to pay involves the realization of both horizontal equity and vertical equity. Horizontal equity is the concept that individuals with identical abilities to pay should be as-signed identical tax burdens.

The basis of the concept of vertical equity is that tax burden should rise with ability to pay. That is people with greater ability should pay more as tax, to shoulder the cost.

(i) Measurement of Ability to Pay:

It is very difficult to frame an ethical base to judge the ability of a person to pay taxes. An analysis of the concept of ability, involves framing the necessary conditions and qualification which must be observed in setting up the standard of ability, as the proper founda-tion of modern tax system.

Different interpretations have been given to the term 'ability to pay'. Basically there are two approaches - namely the subjective approach and objective approach to measure ability to pay. In the subjective approach, the sacrifice theory has been developed and in the objective approach, the faculty theory has been developed.

(ii) Index of Ability to Pay:

(a) Property:

The earlier economist considered property as the best index of a person's ability to pay. In earlier agrarian societies, the economic wellbeing of a person depends upon the property possessed by them.

Hence income from property was consid-ered as the suitable index of a person's ability to pay taxes. However, property as an index possesses a number of limitations in determining the ability of a person to pay taxes.

Firstly all kinds of property are not capable of generating income. Income from property is not a continuous flow. Depending upon location, climatic conditions, geography, and fertility etc. income from prop-erty varies considerably.

(b) Income:

With the advent of industrialization and emergence of industrial society, there occurred a shift in emphasis to income from property as the suitable index. The net income concept was considered as the best index to calculate tax paying ca-pacity of a person. Adam Smith observed that income is the best measure of the index of ability to pay. Taxable income was considered as income above subsistence.

(c) Size of Family:

In the modern world, size and composition of family influence and determine tax paying ability of a household. A large size of family with a fixed income, possess little tax paying capacity than a small family with the same level of in-come.

Given the same income, a bachelor has high tax paying capacity than a household with five members.

However, size and composition of family cannot be taken as the primary mea-sure of tax paying ability. But along with income, size of family also should be given due weightage in asserting the taxable capacity of a person.

(d) Consumption:

Consumption expenditure is also a good index of ability to pay taxes. An individual can evade taxes imposed to the basis of his income, by fraudulent practices. He can furnish false information regarding his earnings and evade pay-ment of taxes.

Hence professors J.S. Mill, Irving Fischer and Kaldor, advocate the consumption expenditure as an index of taxable capacity. To quote Kaldor **"consumption rather than in-come should be the basis of taxation".**

Consumption reveals the resources that an individual actually withdraws from the economy for his personal use. Hence, consumption expenditure was sug-gested as the suitable criterion to ascertain the taxable capac-ity of a person.

2.9 IMPACT, INCIDENCE, AND SHIFTING OF TAXATION

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

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

IMPACT

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

SHIFTING

The process of transferring the burden of a tax from one person to another is called shifting. The producer may shift the tax burden to the wholesaler, the wholesaler to the retailers, and the retailers to the consumers etc. This is done through the changes in prices. This is a case of forward shifting. Forward shifting may be multi point or single point. The case explained above is an example of multi point shifting. When the tax burden is shifted by a producer to consumers directly it is a case of single point shifting. Shifting may also be backward. Backward shifting refers to shifting of tax burden to sellers by buyers. **Tax capitalization** is a particular case of backward shifting.

INCIDENCE

The final or ultimate money burden of a tax is called incidence. It is the money burden of a tax which is borne by the last person. That is, the incidence of a tax is the final resting place of it (De Facto tax payer- Di viti).

DISTINCTION BETWEEN IMPACT AND INCIDENCE

1) Impact refers to the initial burden of the tax, while the incidence is the ultimate burden of the tax.
2) Impact is at the point of imposition, while incidence is at the point of settlement.
3) The impact of a tax falls upon the person from whom the tax is collected and the incidence rests on the person who pays it eventually.
4) The impact may be shifted but the incidence cannot be shifted.

Effects and Incidence of Taxation

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

CONCEPTS OF TAX INCIDENCE

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

1) Dalton's Concept (Traditional Concept)
2) Mrs. Hicks' Concepts of Formal and Effective Incidence and
3) Musgrave's Concept of Incidence.

Dalton's Concept of Incidence

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

is the reduction of consumption or a fall in savings. The direct real burden and indirect real burden together constitute the effects of taxation.

Hence, the incidence of taxation is the direct money burden of a tax. That is, the actual initial payments of tax which may either fall upon a person on whom it is initially imposed or if shifting is possible, upon some other persons by whom the tax money is finally paid.

Mrs. Hicks' Concept of Incidence

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

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

Musgrave's Concept of Incidence

According to Musgrave "A change in the distribution of income available for private use which arises as a result of changes in budget policy is called incidence." That is, the distributional change caused by changes in budgetary policies that involve resource transfer is incidence. The budgetary policy may either be tax policy or expenditure policy bringing about distributional changes. According to him there are five forms of incidence viz., (i) Specific tax incidence (ii) Differential tax incidence (iii) Specific expenditure incidence (iv)Differential expenditure incidence and (v) Balanced budget incidence.

Specific tax incidence:

The distributional change in income brought about by a change in tax policy, when there is no change in expenditure policy is called specific tax incidence.

Differential tax incidence:

Here also expenditure policy is kept unchanged. One tax is substituted for another, money income (yield) is the same, the resulting distributional change is called differential tax incidence. Musgrave says, "Thedifference in the distributional results of two tax policies that provided for equal yield in real terms" is called differential tax incidence.

Specific expenditure incidence:

The distributional effects as a result of a change in public expenditure, the tax policy remaining the same, are called specific expenditure incidence. The specific expenditure incidence is associated with the effects of inflation and deflation.

Differential expenditure incidence:

Differential expenditure incidence refers to the resultant change in the distribution of income when public expenditure policy is changed under conditions of balanced budget so as to avoid inflation and deflation. When the budget is balanced, an increase in public expenditure in one direction is compensated by a decrease in public expenditure in another direction.

Balanced budget incidence:

The resulting change in distribution when tax-expenditure policy is changed under conditions of balanced budget is referred to as balanced budget Incidence. For example, if the government wants to increase its expenditure, its tax function should be changed to obtain additional revenue. This will bring about changes in distribution.

THEORIES OF TAX SHIFTING AND INCIDENCE

There are different theories to explain the shifting and incidence of taxation. They are classified into three categories viz. (i) The concentration theory (ii) The diffusion theory, and (iii) The modern theory.

The concentration theory:

This theory was developed by the Physiocrats in the 18th century. They believed that all taxes ultimately concentrate on a particular kind of people. They regarded agriculture as the only productive activity which alone yielded a surplus. They advocated a single tax on the net income of land. According to them diversity of taxes should be avoided. The major criticism against the theory is that all activities are productive and a single tax on land is not suitable for modern welfare states. Similarly the burden

should not be concentrated on a single section of the society but instead there should be equal distribution of tax burden on the entire society. The major advantage of the theory is that it stresses that all taxes are paid out of surplus. If there is no surplus the burden of the tax is shifted to others.

The diffusion theory:

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

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

Limitations of the Diffusion theory

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

(2) The theory is based on perfect competition. It is unrealistic.

(3) The principle of equity is neglected in the theory.

THE MODERN THEORY OF INCIDENCE (Demand & Supply Theory)

The modern theory of tax incidence was developed byProfessor Dalton and was supported by modern economists like Seligman and Edgeworth. The theory possesses all the virtues of the earlier theories. It states that tax should be imposed on surplus. It also believes that tax is a part of cost of production and therefore, it enters into price. Shifting of tax burden is thus done through price changes. If there is no price transaction, shifting of tax burden is impossible. So shifting is common in commodity taxation. In short, shifting and incidence depend on pricing. Pricing in turn depends

on the interaction of the market forces of demand and supply.The factors influencing the demand and supply are therefore having paramount importance in understanding the nature of tax shifting and as well as to determine the incidence of a tax. The most important factors which affect demand and supply are the elasticity of demand, the elasticity of supply, the laws of returns, and market structure- perfect competition, monopoly, monopolistic competition, and oligopoly.

Elasticity of Demand and Elasticity of Supply

According to Prof.Dalton, "Incidence of a tax is divided between buyers and sellers in the ratio of the elasticity of supply to elasticity of demand." That is, Es/Ed where Es=elasticity of supply and Ed= elasticity of demand. The important propositions of the modern theory of incidence may be summarized as follows:

1) When Ed = or Es=0, the whole incidence is on the sellers. (figure i&ii)
2) When Es= or Ed=0, the whole incidence is on the buyers. (figure iii &iv)
3) When Ed=Es, the burden is equally divided between the buyers and sellers. (figure v)
4) When Es> Ed, more incidence is on the buyers (figure vi) and
5) When Ed>Es, more incidence is on the sellers (figure vii).

Types of Elasticity	Burden on Buyers	Burden on Sellers
Perfectly elastic demand	Zero	Entire
Perfectly inelastic supply	Zero	Entire
Perfectly inelastic demand	Entire	Zero
Perfectly elastic supply	Entire	Zero
Elasticity of demand = Elasticity of supply	Equal	Equal
Es> Ed Ed>Es	Higher Lower	Lower Higher

Cost Conditions (Laws of Returns) and Tax Shifting

Different cost conditions will divide tax incidence between buyers and sellers differently.

a) Increasing cost (Diminishing returns)

This is a case where per unit cost rises as more output is produced. That is, supply can be increased only at a higher per unit cost. Here, incidence is partly on the seller and partly on the buyer. If demand is less elastic, incidence will be more on the buyer. Similarly, when demand is more elastic, larger incidence is on the seller.

b) Constant Cost (Constant Returns)

Under constant cost conditions, since per unit cost remains the same even if the supply is reduced, the seller will shift the entire incidence to the buyers.

c) Decreasing Cost (Increasing Returns)

Under decreasing cost conditions, per unit cost falls as more output is produced.

The price will increase more than the amount of the tax.

Incidence of tax under various market conditions Perfect Competition

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

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

Monopoly Market and Tax Shifting

Monopoly is a market situation where a single seller is controlling the entire supply of a commodity which has no close substitutes. The seller is a price maker and he maximises profit where MC=MR. A tax increases the cost of production. Monopoly

taxes are of two types-lumpsum tax and ad valorem or specific. In the former case, the monopolist would bear the whole incidence and in the latter case, the monopolist will shift the tax burden partly to the buyer depending on the elasticity of demand for the good.

Monopolistic Competition and Tax Shifting

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

Factors Influencing the Process of Shifting of a Tax

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

1) Form of quoting the price
2) Rate of tax and Type of the market
3) Availability of substitutes
4) Geographical coverage
5) Time allowed for tax shifting
6) General economic conditions
7) Familiarity of consumers with a particular set of prices
8) Public policy etc.

2.10 VALUE ADDED TAX (VAT)

VAT is a multi-point tax levied at each stage of value addition chain with a provision to allow input tax credit on tax paid at an earlier stage. It is a general consumption tax assessed on the value added to goods. In the case of sales tax, there are problems of double taxation of commodities and multiplicity of taxes, resulting in cascading of tax burden. This results in double taxation with cascading effects. Under VAT set off is given for input tax as well as tax paid on previous purchases. Multiplicity of taxes with overlapping nature like the turn over taxes, Octroi, the CST and surcharges is

another feature of the present indirect tax regime. VAT is unanimously acknowledged to be a major reform in the indirect taxation system.

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

STATE LEVEL VAT

Following the June 18, 2004 decision of the Empowered Committee (convenor: Asim Das Gupta) of state finance ministers to implement State-level VAT from April 1,2005, all 28 states and Union Territories had introduced VAT. The first state to introduce VAT was Haryana in 2003 and the last state was Utter Pradesh in 2008.

FEATURES OF VAT

- It eliminates the cascading effects of taxes.
- It promotes competitiveness of exports.
- This is tax one pays when they buy goods or services.
- The shopkeeper or service provider adds it to the cost of the goods or services.
- This is a known as a consumer tax in some countries.
- In some countries, goods are priced in the shop minus this type of tax, but when the customer comes to the checkout they will be asked for the cost price plus the consumer tax.
- The shop collects this tax on behalf of the government.
- The difference between the amount of VAT the producer, wholesaler or retailer charged the shopkeeper and the amount the shopkeeper charged the customer must be paid to the government.
- If the amount of VAT paid by the business exceeds the VAT charged by business, the government will repay the excess.
- This ensures that VAT is paid by the ultimate customer, not by the business.

- A value-added tax is an indirect national tax levied on the value added in production of a good or service.
- In many European and Latin American countries the VAT has become a major source of taxation on private citizens.
- Many economists prefer a VAT to an income tax because the incentive effects of the two taxes differ sharply.

2.11 GOODS AND SERVICES TAX (GST)

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

The Finance Minister P.Chidambaram in his Budgetspeech in 2006 had said: "It is my sense that there is a large consensusthat the country should move towards a NationalLevel Goods and Service Tax (GST) that shouldbe shared between the Centre and the states. Ipropose that we set April 1, 2010 as the date ofintroducing GST. World over, Goods and Services attract the same rate of Tax. This is the foundationof GST. People must get used to the idea of a GST.We must converge progressively the service tax rate and CENVAT rate. I propose to take one stepthis year and increase the service tax rate from10 per cent to 12 per cent. Let me hasten to add that since service tax paid can be credited againstservice tax payable or excise duty payable, the ne impact will be very small."

The GST can be divided into followingsections to understand it better:

1. Charging Tax: The dealers registered under GST (Manufacturers, Wholesalers and Retailers and Service Providers) are requiredto charge GST at the specified rate of taxon goods and services that they supply tocustomers. The GST payable is included inthe price paid by the recipient of the goodsand services. The supplier must deposit this amount of GST with the Government.

2. Getting Credit of GST: If the recipient ofgoods or services is a registered dealer(Manufacturers, Wholesalers and Retailers and Service Providers), he will normally beable to claim a credit for the amount of GSThe has paid, provided he holds a proper tax invoice. This "input tax credit" is setoffagainst any GST (Out Put), which the dealercharges on goods and services, which he supplies, to his customers.

3. Ultimate Burden of Tax on Last Customer:

The net effect is that dealers charge GST but do not keep it, and pay GST but get a credit for it. This means that they act essentially as collecting agents for the Government. The ultimate burden of the tax falls on the last and final consumer of the goods and services, as this person gets no credit for the GST paid by him to his sellers or service providers.

4. Registration: Dealers will have to register for GST. These dealers will include the suppliers, manufacturers, service providers wholesalers and retailers. If a dealer is not registered, he normally cannot charge GST and cannot claim credit for the GST he pays and further cannot issue a tax invoice.

5. Tax Period: The tax period will have to be decided by the respective law and normally it is monthly and/or quarterly. On a particular tax period, which is applicable to the dealer concerned, the dealer has to deposit the tax if his output credit is more than the input credit after considering the opening balance, if any, of the input credit.

6. Refunds: If for a tax period the input credit of a dealer is more than the output credit then he is eligible for refund subject to the provisions of law applicable in this respect. The excess may be carried forward to next period or may be refunded immediately depending upon the provision of law.

7. Exempted Goods and Services: Certain goods and services may be declared as exempted goods and services and in that case the input credit cannot be claimed on the GST paid for purchasing the raw material in this respect or GST paid on services used for providing such goods and services.

8. Zero Rated Goods and Services: Generally, export of goods and services are zero-rated and in that case the GST paid by the exporters of these goods and services is refunded. Thisis the basic difference between Zero ratedgoods and services and exempted goods and services.

9. Tax Invoice: Tax invoice is the basic and important document in the GST and a dealer registered under GST can issue a tax invoice and on the basis of this invoice the credit (Input) can be claimed. Normally a tax invoice must bear the name of supplying dealer, his tax identification nos., address and tax invoice nos. coupled with the name and address of the purchasing dealer, his tax identification nos., address and description of goods sold or service provided.

The idea of GST was first proposed in the budget speech of 2006-07 which had set out the deadline of 2010 for its introduction in the country. To implement such a tax regime a constitutional amendment would be needed as the Centre as well as States is involved in this issue. To operationalize the GST, the Constitution (115th Amendment) Bill 2011 was introduced in the Parliament. The Finance Minister has expressed the hope that the two tax reforms the GST and the Direct Tax Code (DTC) will be implemented soon.

GST paid on the procurement of goods and services can be set off against that payable on the supply of goods or services. But being the last person in the supply chain, the end consumer has to bear this tax and so, in many respects, GST is like a last-point retail tax. The proposed rate of GST in India is **16%.** The GST will subsume most indirect taxes like Value Added Tax, Service Tax, Central Excise, Entertainment Tax, Luxury Tax, Octroi, Lottery tax etc. India will have a **'dual GST'** system where states and Centre both would have powers to levy taxes on goods and services. In short, the **GST** is:

- An indirect tax on final consumption of goods and services.
- Levied on businesses and recovered by them on supplies.
- Collected at each stage in the commercial and production chain by producers and suppliers.
- GST is typically charged on registered businesses.
- Input GST incurred in relation to taxable output of goods and services is available as an offset.
- GST thus operates as a pure Value Added Tax (VAT).

Objectives of GST

- To lower tax rates due to broadening of the tax base and minimizing exemptions & exclusions.
- Creation of a common market across the country.
- Redistribution of the burden of taxation equitably between manufacturing and services.
- Reduction in transaction and compliance costs.
- Facilitation of business decisions on purely economic considerations.
- Enhanced efficiencies & productivity through the supply chain.

Recommendations of Thirteenth Finance Commission on GST

1. Single 12% rate on all goods and services. (5% for Central GST and 7% for State GST).
2. All indirect taxes and cess to be subsumed in GST.
3. Railways fares and freight, electricity to attract GST.
4. Only possible services by governments, service transactions between employer and employee and health and education should be exempted from GST.
5. Petrol, diesel, alcohol, tobacco may be changed to GST with additional levies by centre and states.
6. Exports to be zero rated.

MAJOR ISSUES TO BE SOLVED

- Agreement on GST rates among states and Centre.;
- Constitutional amendments empowering states to levy tax on services & empowering Centre to levy tax on sales;
- Compensation to be given by the Centre to States incurring revenue losses on implementation of GST;
- Drafting & implementation of Centre GST and State GST laws are lagging behind;
- Final approval and support of industry is a must;
- It is also a formidable challenge that we have only limited time left for GST to become a reality and
- Success of GST would depend upon implementation of IT resources in every nook and corner of the country.

QUESTIONS :

1. Define Public Revenue. What are the sources of Public Revenue?
2. Explain the objectives and characteristics of tax?
3. Explain Fiscal Neutrality or Principles of Equal Distribution of Tax Burden.
4. Explain the theories of tax shifting and incidence.
5. Explain the features of GST.

UNIT 3

PUBLIC EXPENDITURE AND PUBLIC DEBT

3.1 PUBLIC EXPENDITURE: MEANING AND IMPORTANCE

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

The two major reasons for the same are: a) the economic activities of the state has increased manifold and b) nature and volume of public expenditure have greatly affected the economic life of the country in a different manner. i.e., it has affected production and distribution and general level of economic activities.

In the laissez-faire era the state was assigned a very limited role to play. The functions assigned to the state where based on the principle of least interference or **'that government is the best which spends the least.'** According to the classical school led by Adam Smith restricted the functions of the state to **'Justice, Police and Arms.'** They considered government expenditure wasteful and that money could be used much well by private persons than by the government. Adam Smith in his magnum opus **'TheWealth of Nations'** published **in 1776** observed that the sovereign has three main duties to perform as a) to protect the society from violence and invasion of other independent societies b) to protect against injustice and c) erecting and maintaining certain public works.

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

In recent time, public expenditure has been increased enormously. The main reason is that the functions of governments have been increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, a German economist, presented his famous **'Law of Increase of State Activities.'** He states

that 'comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments.' This increase is both intensive and extensive.

Prof. RA Musgrave, the twentieth century economist, advocated public expenditure since a government is forced to do many activities such as 1) activities to secure a reallocation of resources 2) redistribution activities, 3) stabilizing activities and 4) commercial activities.

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

3.2 CAUSES FOR THE INCREASE IN PUBLIC EXPENDITURE:

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

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

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

3) Growth of democracy: The form of democratic government is highly expensive. Theconduct of elections, maintenance of democratic institutions like legislatures etc. cause great expenditure.

4) Growth of population: tremendous growth of population necessitates enormous spending on the part of the modern governments. For meeting the needs of the growing population more educational institutions, food materials, hospitals, roads and other amenities of life are to be provided.

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

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

7) Development expenditure: for implementing developmental programs like Five Year Plans, Modern governments are incurring huge expenditure.

8) Public debt: Along with debt rises the problem like payment of interest and repayment of the principal amount. This results in an increase in public expenditure.

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

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

3.3 CLASSIFICATION OF PUBLIC EXPENDITURE:

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

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

Revenue Receipts include

- receipts from taxation
- profits of enterprise
- other non-tax receipts like administrative revenue (fees, fines, special assessment etc.)
- gifts grants etc.

Revenue expenditure includes

- interest-payments
- defence expenditure
- major subsidies
- pensions etc.

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

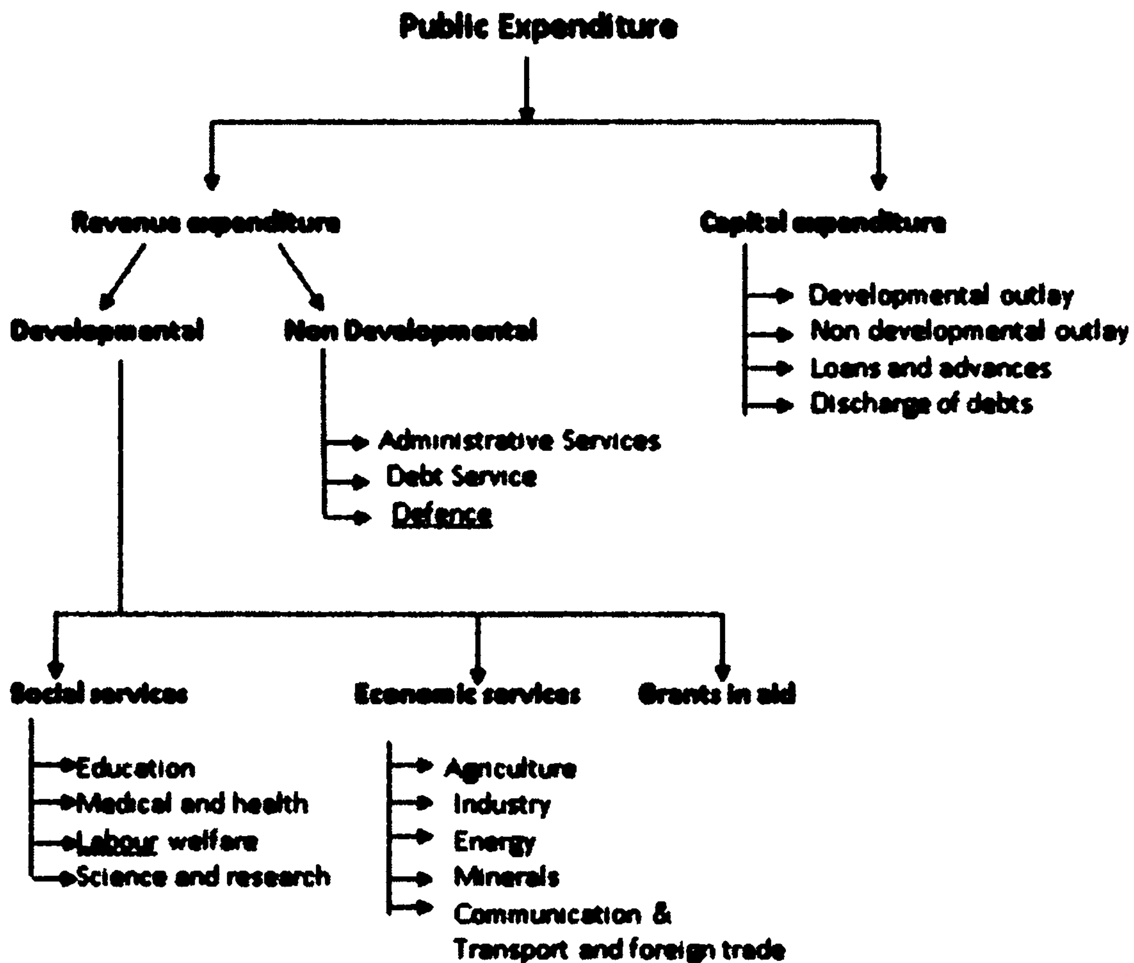
Capital Receipts include

- Borrowings
- Recovery of loans and advances
- Disinvestments and d) Small savings.

Capital Expenditure includes

- Developmental Outlay
- Non-developmental outlay
- Loans and advances and
- Discharge of debts.

This can be explained as follows:



3.4 THEORIES OF GROWTH OF PUBLIC EXPENDITURE

As we know in modern times all the countries of the world have witnessed an enormous increase in public expenditure. The three important theories of the growth public expenditure are the following:

1. Adolph Wagner's hypothesis
2. Wiseman – Peacock hypothesis and
3. Colin Clark's Critical Limit Hypothesis.

3.4.1 Adolph Wagner's Hypothesis:

Adolph Wagner (1835-1917) believed that there was a cause-effect relationship between economic growth and public expenditure. His hypothesis of"Law of Increasing State Activity"lays that as a percapita income and output increase in industrialized

counties, the public expenditure of those counties necessarily grows as a proportion to total economic activity. He explained that 'comprehensive comparisons of different countries and different times shows that among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments. The increase is both extensive and intensive, the central and local governments. Constantly undertake new functions, while they perform both old and new functions more effectively and completely.'He explained the trend of public expenditure.

Conclusions:-

1) As the national income increases in amount, the percentage of outlayfor government supplied goods is greater.
2) Increased public expenditure was the natural result of economic growth and continued pressure for social progress.

3.4.2 Wiseman – Peacock hypothesis:

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

1) Displacement effect 2) Inspection effect and 3) concentration effect.

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

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

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

3.4.3 Critical Limit Hypothesis: (Colin Clark):

The hypothesis was developed by Colin Clark immediately after the Second World War. It is concerned with the tolerance level of taxation. By maximum limit of the tolerance level is 25% of GNP. When the share of government expenditure exceeds 25% in the GNP, inflation occurs even in balanced budget.

3.5 CANONS OF PUBLIC EXPENDITURE

The canons or principles of public expenditure are the fundamental rules which govern the public expenditure policy of the governments. The method and direction in which the public expenditure utilized is of paramount importance

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

a) Public expenditure should promote the welfare of the society.

b) Careful judgement should be exercised by the public authority and the electorate to ensure that the advantages of the public expenditure should exceed the costs and that the fund utilized by the governments will be more conducive to social welfare than the same funds would, if privately utilized.

c) Public expenditure should be utilized in the order of priority of welfare. That is, the services which will bring about maximum welfare should be undertaken first.

Prof. Findlay Shirras has explained four canons of public expenditure. They are canon of benefit, canon of sanction, canon of economy and canon of surplus.

CANON OF BENEFIT

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

CANON OF ECONOMY

This implies that the state should be economical in spending money.It should not spend more than the necessary amount on items of expenditure. The sole aim is to avoid extravagance and corruption. Social benefit can be maximised when resources are not wasted. While incurring public expenditure social costs are to be minimised. To satisfy this canon Project Appraisal and Cost Benefit Analysis are to be adopted. **"Economy means protecting the interests of the tax payers not merely in effecting economies in expenditure, but in developing revenue."—Shirras.**

CANON OF SANCTION

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

CANON OF SURPLUS

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

3.5.1 OTHER CANONS OF PUBLIC EXPENDITURE CANON OF PRODUCTIVITY

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

CANON OF ELASTICITY

There should be flexibility in government expenditure. That is, the government may be able to change its public expenditure policy with changing conditions. It means

that public expenditure should increase during periods of emergency and reduce during normalcy.

CANON OF EQUALITY

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

CANON OF NEUTRALITY

Public expenditure should not worsen the production-distribution -exchange relationship instead of improving it. Public expenditure should result in increased production and productivity, reduced inequality of income and wealth and increased economic activity and exchange relationship.

CANON OF CERTAINTY

The public authorities should clearly know the purposes and extent of public expenditure to be incurred. This anon explains the preparation of public budgets.

3.6 EFFECTS OF PUBLIC EXPENDITURE

The traditional economists held the view that the state should least interfere in economic activities and the government is merely an agent for the people to keep political organization intact. During the time of Adam Smith the government that interfered least in the economic activities of the state was considered the bestgovernment. Till the beginning of the 20th century, state performed only limited functions-the maintenance of law and order and protection of the country from the external attack. Therefore, the state had to collect only small revenue andspend little. Recently, in almost all countries of the world there has been a phenomenal increase in the magnitude and the variety of governmental activities. The acceptance the principle of welfare state, the necessity of maintaining full employment and economic development etc. the significant role of the government has been increased. All these show the need for an ever increasing public expenditure. In the following few paragraphs we can explain the important effects of public expenditure.

EFFECTS OF PUBLIC EXPENDITURE ON PRODUCTION

"Just as taxation, other things being equal, should reduce production as little as possible so the public expenditure should increase it as much as possible."— Prof.Dalton. The effects of public expenditure on production can be evaluated by examining its effects on the following.

a) Effects upon ability to work, save and invest.

b) Effects upon willingness to work, save and invest.

c) Effects upon diversion of economic resources as between different uses and localities.

Ability to work, save and invest

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

B) WILLINGNESS TO WORK SAVE AND INVEST

Public expenditure may tend to affect the willingness of the people to work, save and invest which is described as 'incentive effect'.As far as the will to, save and invest is concerned, it depends to great extent on the character of public expenditure and public policy of the governments. For example, old age pension, provident fund benefit, insurance against sickness and unemployment allowances etc., have an adverse effect on the willingness of the people to work, save and invest. This is because people will have a feeling that the governments will look after them, when they are unable to earn an income. Therefore, public expenditure should be incurred in such a way that it may not adversely affect the incentive to work of the people. If, however, the benefit increases with the increase in work and the volume of savings, the willingness to work, save and invest will increase and vice-versa. Similarly, the willingness to work can be increased by making the benefits conditional, i.e., the people may be required to contribute something in order to avail the benefits of social security measures. In brief, public expenditure should be incurred systematically and in a planned manner

in order to provide social security measures to the maximum extent. Public expenditure should also provide opportunities under which savings and investments are properly rewarded and do not enlarge inequalities.

DIVERSION OF RESOURCES BETWEEN DIFFERENT USES AND AREAS

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

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

The forms of public expenditure which increase the productive power and are socially very much desirable for the transfer of resources are generally of the following nature. a) Debt redemption b) Developmental projects like irrigation, power and transport, roads, railways etc. c) Promotion of education, research, inventions training etc. d) Provision of public health and e) Social security etc.

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

In short, the public expenditure does have many favourable effects on production. To conclude the effect of public expenditure on production we can quote Dalton once again.Whereas taxation, taken alone, may check production, public expenditure, taken alone, should almost certainly increase it.

EFFECTS OF PUBLIC EXPENDITURE ON DISTRIBUTION

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

3.7 PUBLIC EXPENDITURE AND STABILITY

Economic stability refers to a fairly stable level of national income, employment, prices, savings and investments in the economy. The economy may face cyclical fluctuations on account of imperfections in the market (Depression and Inflation). Public expenditure can be used to check the fluctuations. According to Lord J.M.Keynes economic instability implies departure from full employment at stable price level. It is the deficiency of the effective demand caused by a low marginal propensity to consume coupled with low marginal efficiency of investment in developed countries. (**"The General Theory of Employment, Interest and Money-1936"**)

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

Similarly, during the time of inflation-rising prices - the public expenditure has an entirely different role to play. The government has to adopt **Surplus Budgeting** policy. That is, the government should spend less than its revenue.During inflation that part of the public expenditure which reduces the funds going to the people with higher propensity to consume is reduces. After full employment, public expenditure is likely to add to inflationary pressure, for public expenditure will further increase the purchasing power of the people without any corresponding increase in production.

3.8 PUBLIC DEBT

Among the non-tax sources, the major source of revenue of the government is public debt. That is, borrowing. It may either be internal or external debts. When the government raises revenue by borrowing from within the country, it is called internal debt. Similarly, if the government is borrowing from the rest of the world, it is a case of external debt. According to Philip E. Taylor, **"The debt is the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on the principal. Borrowing is resorted to provide funds for financing a current deficit."**

3.9 CAUSES FOR PUBLIC DEBT

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

3.10 OBJECTIVES OF PUBLIC DEBT: The objectives of public debt are the following.

1) To bridge the budget deficit (Deficit Financing)
2) To fight against depression.
3) To check inflation.
4) To finance economic development.
5) To meet unforeseen contingencies.
6) An alternate source of income when taxable capacity is reached.
7) To finance wars.
8) To finance public enterprises.
9) To carry out welfare programmes.
10) To create infrastructure.
11) For creation of productive assets.
12) For creation of essential non-income yielding assets (provision of public goods) etc.

3.11 IMPORTANT SOURCES OF PUBLIC DEBT

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

1) Borrowing from individuals.
2) Borrowing from Non-Banking Financial Institutions (Insurance companies, investment trusts, mutual funds etc.)
3) Borrowing from commercial banks.
4) Borrowing from central banks.
5) Borrowing from External sources (IMF, IBRD, ADB, Foreign Governments or countries)

3.12 CLASSIFICATION OF PUBLIC DEBT

1) Voluntary and compulsory (On the basis of legal enhancement): Voluntary debt is the debt which is paid any legal enforcement. Whereas compulsory debt is legally forced in nature. Here people have no option but repay the debt.

2) Funded and unfunded debt (Provision for repayment): Funded debt is long term or 'definite period' debt. A proper agreement and terms and conditions of repayment with the percentage of interest payable are declared. They are used for creation of permanent assets. Unfunded debt is for a short term and for indefinite period. It is paid through the income received from other sources. These are used for meeting current needs.

3) Internal and external debt: When the government raises revenue by borrowing from within the country, it is call internal debt. Whereas if the government is borrowing from the rest of the world, it is case of external debt.

4) Productive and Unproductive(Purpose of loans): Loans on Projects yielding income (Construction of plants, railways, power schemes etc.) are called productive debt. Loans on loan non income yielding projects are called unproductive loans (war, famine relief etc.)

5) Redeemable and Irredeemable loans (Promise to repay): Redeemable debts refers to the loan which the government promises to pay off at some future date. (principal

plus interest) Irredeemable debts are those, principal amount of which are never returned by the government but pays interest regularly.

6) Short / Medium/ Long term loans (Time duration): Short term loans are usually incurred for a period varying from three months to one year. Usually governments get such loans from the central bank by using treasury bills. These loans are calls **'ways and means advances.'**

Medium Term loans are those which are obtain for more than one year but less than ten years.

Long term loans are those which are obtain for more than ten years. These are used to finance developmental activities.

3.13 REDEMPTION OF PUBLIC DEBT

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

Advantages of debt redemption

1) It saves the government from going into bankruptcy.
2) It checks extravagance on the part of the governments.
3) It preserves the confidence of the lenders.
4) It makes easy for the government to float future loans.
5) It reduces the cost of management of public debt.
6) It saves the future generations from the pressure of public debt.
7) The resources obtained after redemption of the debt would be diverted towards private investments and therefore a favorable climate for investment could be created.
8) Redemption of debt may act as a useful tool to curb deflation.

3.14 METHODS OF REPAYMENT OF DEBT

1) Repudiation: It means refusal to pay a debt by governments. This method was followed by the USA after the civil war and by the USSR after the 1917 Revolution. This method is undesirable and has not been used recently anywhere in the world.

Repudiation shakes the confidence of the people in public debt and many provoke retaliation from creditor countries.

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

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

4) Sinking Fund: Sinking fund is a special fund created for the repayment of public debt. There is a theoretical justification for creating this fund because it imposes a requirement on the government to pay the old debts regularly. According to this method, the government sets aside a certain amount out of the budget every year for this fund. The balances in the funds are also invested and the interest accruing on them is also credited in the fund.

Sinking fund is of two types: (i) certain sinking fund—here, the governments credit a fixed sum of money annually. (ii)Uncertain sinking fund— the amount is credited when government secures a surplus in the budget.The one danger of this method is that the government may not wait till the end of the period of maturity and utilize the fund for some other purpose than the one for which the fund was created originally. The practice of sinking fund inspires confidence among the lenders and the enhancement of the creditworthiness of governments.

5) Capital levy: Capital levy is a special type of **"once for all"** tax on capital imposed to repay war debts. All capital goods are taxed above a minimum level of assets

possessed by residents of the country. Simply, capital levy refers to a very heavy tax on property and wealth. This tax was levied immediately after the First World War. This method has been advocated by economists like David Ricardo, Pigou and Dalton.Professor Dalton has suggested that capital levy as a method of debt redemption with least real burden on the society. It is useful on account of its deflationary character.

6) Surplus budget: Quite often, surplus budget may be used to clear public debt. But in recent times due to the ever increasing public expenditure, surplus budget is a rare phenomenon.

7) Buying up of Loans: Governments redeems debt through buying up loans from the market.

MODEL QUESTIONS

1) What is the importance of public expenditure?
2) Explain developmental and non-developmental expenditure.
3) What are the canons of public expenditure?
4) Explain Wagner's hypothesis of public expenditure.
5) Explain Peacock-Wiseman hypothesis of public expenditure.
6) How does public expenditure affect the economy?
7) What are the causes for increasing public expenditure?
8) Distinguish between revenue expenditure and capital expenditure.
9) What is public debt? What are the reasons for incurring public debt?
10) What are the types of public debt?
11) What are the methods of redemption of public debt?
12) What do you mean by a budget? Explain the objectives of budget.
13) Explain different concepts of budget deficits? What are the implications different deficits?

UNIT - 4

CENTRE STATE FINANCIAL RELATIONS

4.1 FEDERAL FINANCE: CONCEPT, PRINCIPLES AND PROBLEMS

4.1.1 THE CONCEPT OF FEDERAL FINANCE:

In usual parlance federation is defined as an association of two or more states. The federal setup is characterized by the existence of a union government (Central government) on the one hand and state government for different constituent units.

It is a form of political association in which two or more states constitute a political unity with a common government, but in which the member states retain a measures of internal autonomy. Encyclopedia Britannica defines fed-eration **"as a form of government in which the essential principle is that there is a union of two or more States under the central body for certain permanent objectives."**

Sir Robert Garran defined federation as a foam of government in which Sovereignty or political power is divided between the central and the local governments, so that each of them within its own sphere is independent of the other.

As far as functions and resources are concerned the two sets of government are independent. Actual federations are however of different forms. For example India is more a unitary than federal type, where there is large concentration of power in the hands of central government.

Whereas USA is more of a federal than unitary type Country, Where there is lesser concentration of power with centre and larger exer-cise of power by provincial and local governments.

Thus depending on the type of federation fiscal responsibilities is shared between central, state and local governments. Therefore federal finance means divisions and coordination of different items of income and expenditure between central, state and local govern-ments. This multilevel decentralized fiscal system is known as fiscal federalism.

In this context Dr. R. N. Bhargava opines **"federal finance refers to the finance of the federal as well as of the state governments and the relationship between the two."** However the concept and definition of federal principles is still a controversial issue.

Prof. K. C. Wheare states:

"by the federal principle I mean the method of divid-ing power so that the general and regional governments are each, within a sphere, Co- ordinate and independent."

Therefore federation is characterized by certain basic principles like:

(a) Division of power and functions,

(b) Supremacy of the constitutions,

(c) Constitutional independence of the constituent units, and

(d) Federal predominance.

4.1.2 PRINCIPLES OF FEDERAL FINANCE:

In a federation functions are distributed among different layers of government. Since each government is responsible for its own sphere of activity there should be adequate provision for source of revenue and its efficient administration for discharging the assigned func-tions independently and satisfactory.

Therefore the pool of total rev-enue source should be divided between the centre, state and local governments scientifically and reasonably. This warrants some mu-tually beneficial and sound principles, for the division of revenue source.

What should be the guiding principle regarding the division of functions and resources among different layers of government.

A host of economist provided an array of guiding principles in determining the resource allocation. Prof. Seligman prescribed three principles on the basis of which revenue sources i.e., taxes should be divided between the different layers of government.

These fundamental principles governing resource allocation are:

(a) Efficiency,

(b) Suitability, and

(c) Adequacy.

Efficiency norms insist that tax allocation among different layers of government should be decided by the capacity of feasibility to administer the tax effectively. There will be taxes, which can be best administered by the centre. Such taxes should be assigned to the central government. For example income tax in India.

Likewise there are some taxes which can be administered by the state government. Such taxes should be assigned to the state government. Best example is agricultural income tax. Suitability criterion insists that the nature of tax is an important aspect determining allocation.

Taxes will possess wider or narrow jurisdiction. Taxes with narrow jurisdiction should be allocated to regional or local governments rather than central government. The adequacy norms insist that revenue assigned to a particular layer of government should be sufficient to carry out the functions and responsibilities assigned to them.

The non-coordination between functions of government and revenue allocated to discharge the functions generate crucial problem in federal finance. Prof. Seligman in his Essays in Taxation observes" no matter how well intentioned a scheme may be or how completely it may harmonies with the abstract principles of Justice, if the tax does not work administratively, it is doomed to failure".

Therefore as a matter of fact there are no uniform principles which determine the resource allocation in federal finance.

Prof. B.P Adarkar in his master piece "Principles and Problems of Federal Finance." laid down three principles governing the working of Federal Finance. Later economists added a few more principles based on certain practical situations.

These principles are briefly explained below:

1. Independence and Responsibilities:

The success of fiscal federalism is conditioned by the two funda-mental requisites- Financial independence and financial responsibil-ity. It means that the central and state government must be finan-cially independent within their own spheres.

Each government should possess separate and independent sources of revenue. Government at different layers should have full power to tax, to incur expenditure and to borrow to perform the assigned functions effectively.

Prof. Adarkar observes, "Taxing autonomy and spending autonomy should go hand in hand. In the broader interest of the nation the centraliza-tion of revenue in the hands of the central government seems to be good. However too much dependence of state government on cen-tral government for resources is not a healthy practice in federal finance."

Prof. Adaekar Says, "full freedom of financial operations must be extended to both federal as well as state governments in-order that they may not suffer from a feeling

of Cramp in the discharge of their normal activities and in the achievements of their legitimate aspirations for the promotion of social and economic advancement."

Therefore the centre and state government should be financially in-dependent and autonomous in respect of taxing with in their own spheres.

2. Adequacy and Elasticity:

Adequacy implies that allocation of resources should be based on distribution of functions. The sources of revenue assigned to each layer of government, should be sufficient enough to discharge the functions efficiently and effectively.

For achieving this financial structure should be elastic, flexible and adaptable to the changing conditions of economy. The resources should be capable of expres-sion in response to the rapidly growing needs and responsibilities of government otherwise the federal finance system will create rigidi-ties during times of economic stress and strain.

As John Athan Says "if a federal system with real independence in the states is to continue, the state must have financial resources under their own control reasonably adequate to meet their responsibilities." Justify-ing the principle of adequacy and elasticity.

Dr. R. N. Bhargawa observes "the scheme of resources must be set up on elastic system because no scheme, howsoever good, can be final for all times to come; under changing conditions, any argument is bound to be-come out of date in course of time. The scheme of division must, therefore, incorporate provisions for such changes when they be-come necessary in the national interest."

3. Administrative Efficiency and Economy:

Tax resources should be assigned to different layers of government considering efficiency and economy in administration. The adminis-trative Cost should be minimized. There should be no scope for fraud and evasion.

While allocating resources the administrative efficiency should be adhered. For example it is better and economical to allo-cate land tax to local bodies, excise tax on alcohol to state govern-ment and income tax to central government.

Here each layer of gov-ernment is assigned such sources of revenue which it can adminis-ter efficiently. As point out by prof. Seligman, the nature of tax and character of administration determine the effectiveness of different taxes. This will ensure optimum utilization of revenue potential and help to prevent corruption and evasion in revenue mobilization and realization.

4. Other Important Principles:

1. Principle of Uniformity and Equity:

In a federation there may be regional variation in the level of eco-nomic development, owing to a number of economic and non-economic factors. Therefore contribution of each state in federal resources structure should be based according to its ability or economic con-dition.

Hence the principles of equality in the distribution of tax bur-den are another guiding principle of federal finance. Principles of uni-formity insist that there should be no discrimination between citi-zens of different states in a federation.

Adequate provision should be there to protect the interest of backward regions and states and even weaker sections of the community, under conditions of differ-ence in resource endowments, tax burden should be distributed on the basis of marginal sacrifice principle.

For the success of fiscal federalism there should be proper integra-tion and co-ordinations of the financial system of different layers of government. Judicious uses of scarce resources are affected by well co-ordinated and integrated intergovernmental fiscal policy.

3. Principles of Accountability:

In a federal form of political set up federation and democracy are considered as sister institutions. So in a federation each layer of government should be accountable to its own legislature for its tax-ing and spending decisions.

Utmost transparency should be retained in all financial and administrative matters. Each government spend-ing and taxing decisions should be done with regard to their effect on other governments.

4. Principle of Financial Access:

This principle implies that there should be no bar on centre and state governments in exploring new source of resources, to meet the grow-ing financial requirements. In a sense resource should grow along with growth in responsibilities.

Moreover in order to develop healthy financial relation between different units in a federation each government unit will have to work under certain self-imposed discipline. Moreover division of resources should be subject to flexibility.

It is a reality that a number of problems arises and exist in federal finance. We should not try to overshadow these problems by putting certain rigid norms and principles.

A pragmatic approach towards finding solutions to problem is needed. Since socio-eco-nomic conditions differ from time to time and from state to state the division of resources should be subjected to flexibility and adaptabil-ity. In a federal fiscal system, there is only scope for adjustment in the light of changing circumstances

4.1.3 PROBLEMS OF FEDERAL FINANCE:

Federalism whereby two or more sovereign units of government Co-exist within the same political environment, provides the primary basis for the intergovernmental fiscal problems. It is very difficult to decide which level of government will perform the specific functions as per community preference.

In addition the revenue sources nec-essary to finance these expenditure functions must be allocated among the various levels of government in a specified manner. A considerable divergence exist between the sources of revenue and functional expenditure obligations among the government of a fed-eration.

Therefore some government may find it easier to than others to meet their expenditure responsibilities from their own revenue source. This situation is a form of imbalance between revenue and expenditure, that too between different levels of government.

The problems of a decentralized fiscal system in fiscal federal-ism, as it is called, have received much attention, in public finance literatures during the past 3 decades. This is partly due to the fact that there are different sovereign levels in the political system and because of the extension of the theory of public goods, at the na-tional, state and local levels.

It has also been partly due to certain development in federal fiscal structure including the imbalance in the distribution of resources and needs among different levels of govern-ment. This has called forth a reconsideration of the fiscal rules to be performed by various levels of government and there relations to one another. In this context it is worth to analyses some of the important problems in federal fiscal system.

For the smooth functioning of a federation division of functions and resources is imperative. However for the last several years, there is a growing conflict between centre and state in matters regarding the distribution of financial resources, between the units in a federa-tion, owing to political and ideological grounds.

There is multiplicity of taxing and spending activities in a federation. The allocation of functions between the centre and the state government differ from country to country. Generally the functions which are of national im-portance like defence, foreign affairs interstate activities etc. is usu-ally shouldered by the central government.

Whereas matters which are of regional interest remain in the hands of regional government. Performance efficiency is the basis criteria for allocating functions among different constituent units in a federation.

As such functions like defence, foreign trade foreign affairs, post and telegraph etc. are put under the jurisdiction of central government. Subjects of regional interest like education, health service, public works, internal law and order etc. are assigned to the local government. This necessitates a proper co-ordination of the policies and activities of the centre and state governments.

Vertical Fiscal Imbalance:

In many democratic countries a large divergence exists between the revenue source and expenditure obligations among the governments of a federation. Some constituent governments in a federation many find it easier than others to manage their expenditure responsibilities from their own revenue source.

Whereas some others find it difficult to manage the revenue-expenditure programme in a balanced manner. Nowadays there is a continuous and persistent increase in the expenditure programmes of the state and local governments due to increasing welfare oriented programmes.

Expenditures on activities like education public health, social welfare, urban management, welfare schemes for weaker sections rural development activities etc. are on a continuous increase.

Whereas majority of revenue source under the control of state and local governments is inelastic in nature. This creates a situation of imbalance between growing expenditure requirements and poor yield of revenue source for state and local governments.

Contrary to this, the central government always possesses surplus revenue owing to control over more elastic sources of revenue. There occurs a situation of greater expansion of financial resources of central government, and shrinking of resources bases of state and local governments, coupled with increasing responsibilities of state and local governments due to growth of welfare activities.

This type of resource gap between the centre states is called vertical fiscal imbalance. The situation of imbalance of revenue and expenditures vertically between levels of government is referred to as the problem of non-correspondence or vertical fiscal imbalance.

Fiscal federalism tries to bridge this gap and attain a balance through vertical co-ordinations between the centre, state and local level public expenditure and resources needed to finance them.

The important methods adopted to achieve vertical fiscal equality be-tween the centre and regional governments in a federation are:

1. Tax sharing,

2. Tax credit,

3. Tax deductibility,

4. Tax denial,

5. General grants-in-add, and

6. Selective grants-in-aid.

Under tax sharing arrangement a tax is levied and collected by single administration. But the proceeds are shared either wholly or partly with two or more units.

The allocation of the share to constitu-ent units require some criteria which may be either within in the constitution or left to be determined by the national government or it may be determined by periodical agreement between the centre gov-ernment and constituent units.

Under the tax credit, a superior government unit allows a credit against its tax to anyone who pays the same kind of tax to subor-dinate units. This method eliminates tax competition problem and thereby increases the capacity of the subordinate units.

Tax deductibility is another method to correct vertical imbalance. Under the method permission is granted by one government to de-duct tax paid from the tax payers upon which another government levies taxes.

Under the tax denial the government may put restrictions on state and local government taxing powers. It includes denial of power to subordinate jurisdictions to levy certain taxes, putting a ceiling on the tax rule used by the lower level governmental units; Any upward change in the tax rate requires the approval of the central

legislature. These methods of tax co-ordination are known as tax denial or tax restrictions.

In order to avoid overlapping of taxes and duplication of adminis-tration and to ensure uniformity of the base of taxation, the method of tax supplement must be used. The higher level government collects the tax with an additional duty imposed by the lower level gov-ernments.

Another method of collecting vertical imbalance in fiscal re-sources transfer is grants-in-aid. Three types of grants are used to transfer revenue to lower level of government viz. General (Block or unconditional) grant, or selective grant (restrictive or conditional grant and matching or non-matching grants.

Horizontal Fiscal Imbalance:

Horizontal imbalance exists between units at the same level of sover-eignty. When fiscal imbalance occurs between different units of gov-ernment at the same level of government in a federation, it is known as problem of equalization or horizontal fiscal imbalance.

In a federation differences exist in the per capita distribution of income and wealth and the volume of trade among different states. Regional difference in resource endowment among different commu-nities leads to variation in per capita revenue potential among com-munities.

Horizontal fiscal imbalance is corrected and the principle of fiscal equity is achieved through equalization of fiscal residue. Prof. J. M. Buchanan defines fiscal residue as **"net benefits from tax-expenditure programme i.e., benefit from expenditures minus disutility from tax payment."**

Due to difference in resource endowment, level of development and variation in the implementation of tax expenditure programmes among different states in a federation, the central and state taxes generate unequal fiscal residue for their citizens. Thus a gap in fiscal residue arises and the some must be equalized to achieve, what is called horizontal fiscal balance.

This gap in fiscal residue can be filled by interstate transfer of resources. That is there should be a federal arrangement for transferring resources from richer states to poor states.

This will help to reduce interpersonal fiscal inequality. Musgrave put it as realization of horizontal equality however it is unlikely that rich states within a country will

voluntarily agree to transfer adequate resources to the resource deficient poor states. Foe affecting such a transfer a strong political set up at the centre is needed.

Another problem in federal set up is the tax competition, In order to attract more capital and trade from other parts of the country, one state government may reduce or abolish certain type of taxes, this policy may sometimes benefit backward states. However this type of competitive tax reduction may hinder the smooth flow of interstate trade.

It may again generate regional disparities in development, and income endowments among communities. This is a practical prob-lem in federal fiscal system in modern period.

4.2 DIVISION OF FUNCTIONS AND RESOURCES UNDER THE CONSTITUTION

Federation or Union

The basic feature of a federation is that the powers are so divided that the central and state governments are each within its sphere coordinate and independent. India is a federation ot States. The Constitution of India which came into force in 1950 provided for a clear-cut division of functions and revenue resources between Union and States. The Seventh Schedule of the Constitution contains a detailed distribution of functions between the central and state governments in the form of three lists i.e., union, state and concurrent lists. The functions of the central government are specified in the Union list which includes defence, atomic energy, foreign affairs, railways, national highways, posts and telegraphs, currency and coinage, foreign exchange, inter-state trade and heavy and basic industries.

The functions assigned to the states as enumerated in the state list include law and order, police, administration of justice, education, medical and public health, agriculture, irrigation, power, forests, fisheries, cooperatives, rural and community development and slum clearance.

Apart from the union and state lists, there is a third list known as the concurrent list. Functions of an inter-state nature, such as commercial and industrial monopolies, labour disputes, social legislation, social security and. economic and social planning have been placed under the concurrent legislative powers of the central and state governments. In the event of a clash between. the laws of the central and state governments over a concurrent area, the former i.e. the central law prevails.

The Constitution describes India as a 'Union of States'. A motion to designate India as a 'Federation of States' was rejected by the Constituent Assembly. Dr. **B.R.** Ambedkar put it very succinctly thus;

". . . though India was to be a federation, the federation was not the result of an . agreement by the States to join in a federation and that the federation not the result of an agreement. no State has the right to secede from it. The federation is a Union because it is indestructible. Though the country and the people may be divided into different States for convenience of administration, the country is one integral whole, its people a single people living under a single imperium derived from a single source. The Americans had to wage a civil war to establish that the States have no right of secession and that their federation was indestructible ."

The Drafting Committee thought that it was better to make it clear at the outset rather than to leave to speculation or to dispute.

Financial Powers

In effecting a division of resources, the Constitution provides for a strong centre. The Constitution ensures the supremacy of the action of the Union Government over the fairly comprehensive Union list as also over concurrent jurisdiction. Allocation of the heads of taxation between the union and the states is based on ;he broad principle that taxes which are location-specific and relate to subjects of local consumption have been assigned to the states. . Those taxes like for example Income tax which are of inter-state significance and where the place of residence is not a correct guide to the true incidence of tax have been vested in the union. This clear-cut division of heads of taxation between the union and the states has minimised the scope for conflicts and litigation between them.

The taxes over which the union has legislative jurisdiction can be classified as follows :

a) Taxes which are to be levied and collected by the Union and the entire proceeds therefrom are to be retained by it. These include corporation tax and customs duties.

b) Taxes which are levied and collected by the Union but proceeds are shared with the States. These are income tax, and excise duties.

c) Taxes which are levied by the Union but collected and retained by the States. These are estate duties and terminal taxes on goods and services.

d) Taxes which are levied by the Union but collected and retained by the States.

These are excise duties on medicinal and toilet preparations (containing alcohol), opium, etc.

In addition, there are exclusively state taxes, i.e., taxes levied and collected by the states and appropriated by them. This category includes

i) Duty on succession to agricultural land

(ii) Estate duty on agricultural land.

(iii) Land revenue.

(iv) Tax on agricultural income.

(v) Tax on land and buildings

(vi) Capitation taxes.

(vii) Tax on mineral rights.

(viii) Tax on the consumption or sale of electricity.

(ix) Tax on vehicles.

(x) Tax on the sales and purchase of goods (other than newspaper) for e.g. Sales tax.

(xi) Tolls

(xii) Tax on professions, trades and employment.

Article 286 of the Constitution forbids taxation by states of

a) imports into or exports from the territory of India;

b) Inter-state trade; and

c) sale of goods dec1ared.b~th e Parliament by law to be essential for the life of the community.

The property of the union is exempt from state taxation. The property and income of the states are exempt from the union taxation.

In addition to the provisions for tax-sharing, Article 275 of the Constitution provides for both general purpose and specific grants. However, it has been left to the Parliament to decide which states are in need of grant assistance and to what extent subject to the recommendations of the Finance Commission.

The borrowing powers of the central and state governments are regulated by Articles 292 and 293 of the Constitution. The central government can borrow on the security of the Consolidated Fund of' India within and outside the country subject to the

limits, if any, specified by the Parliament. The state governments can borrow generally only within the territory of India with the consent of the central government. The central government may also give loans to the state governments, subject to such conditions as are laid down in a law of Parliament.

If the President of India is satisfied that a situation has arisen where the financial stability or credit of India or any part of the territory thereof is threatened, the President may declare financial emergency under Article 360 of the Constitution. In these abnormal and emergent circumstances, both collection and distribution of revenues in state governments are made by the central government or state governments as decided by the Parliament.

Allocation of financial powers, and resources between the centre and the states, is indeed the most vital and yet the most difficult task. The revenues of the federations have undoubtedly. been growing. In some federations like the United States of America, where the federation and the states have concurrent taxation powers, there has been a lot of litigation which is inherent in the exercise of overlapping powers.

In Australia and Canada, negotiations and agreements played an important part in determining the shares in the proceeds of' taxes. In such situations, it is political expediency rather than time-honoured conventions which come handy in resolving conflicts. With regard to allocation of financial resources between the centre and the states as said earlier there are constitutional provisions that :

i) the states are entitled to a significant share in federal taxes;

ii) the proceeds of certain taxes levied by the centre are totally assigned to the states; and

iii) there is a system of grants-in-aid to the states.

One criticism that is often voiced regarding the allocation of financial resources between the centre and the states in India is that elastic and substantial sources of revenue have been assigned to the centre whereas the states, which have been entrusted with important developmental and welfare functions, have been entrusted with inelastic and inadequate sources of revenue.

4.3 THE FINANCE COMMISSION

Finance Commission and Planning Commission are the two important bodies through which fiscal transfers between the centre and states are effected. As we have said earlier, in the allocation of resources between the centre and the states, major elastic

sources of revenue have been assigned to the centre. The fact that the Constitution provides for obligatory sharing of income tax receipts and permissive sharing of Union Excise Duties, is an implicit acknowledgement of the inadequacy of 'States' sources of revenue. The Constitution, however, did not specify the share of the state or its inter se distribution. The Constitution, therefore, provides for the setting up of

a Finance Commission periodically for this purpose. The functions of the Finance Commission are to make recommendations to the President in respect of :

1) the distribution of net proceeds of taxes to be shared between the Union and the. States and the allocation of shares of such proceeds among the States

2) the principles which should govern the payment of the Union grants-in-aid of the revenue of the States; and

3) any other matter concerning financial relations between the Union and the States.

The Finance Commission is a quasi-judicial body and it acts independent of the centre and the states. The specific terms of reference of each Finance Commission are drafted by the Ministry of Finance at the Centre. The state governments are not consulted in the matter. Practical difficulties in working out a consensus approach, amongst different states at times ruled by different political parties with different viewpoints, seem to have discouraged consultations with the state governments.

In the absence of a clearly specified and constitutionally recognised institutional mechanism for revenue-sharing between .the federal and state governments in some of the important federations, numerous adjustments had to be resorted to. In the first place, because of concurrent taxation powers in federations like USA, Australia and Canada, "which level uses what kind of tax and what extent has been decided more by custom and negotiation, included in statute, or agreement, than by Constitutional provision". In USA, at least, the tax system which dame to be developed over the years is described to be uncoordinated and overlapping. The other federations have faced similar or worse problems.

The Finance Commission in India on the other hand, because of its constitutional status constitutes a unique arrangement. Because of this status and the fact of being an expert body, the devolution of resources i.e. tax-sharing and grants-in-aid has been removed from the arena of political bargaining. Even though the Commission is an advisory body, its recommendations, along with the action taken thereon, have to be placed before the Parliament.

According to the Constitution, the Finance Commission should consist of a Chairman and four other members. According to the Finance Act, 1951, the Chairman shall be a person with experience in public affairs. The four members should have been or be qualified to be appointed as Judge! of the High Court, or should have specialised knowledge of economics, financial matters or finance and accounts of the government.

The constitutional status accorded to it. and its functioning as a semi-judicial expert body has earned for the Finance Commission high regard of the Union and the States.

The Approach

In India, so far ten Finance Commissions have been set up and they adopted a common approach with regard to fiscal transfers from centre to states. Some uniform principles or considerations have been kept in view by the Finance Commissions in making their recommendations. The first Finance Commission laid down certain principles as follows :

Firstly, the additional transfer of resources from the centre must be such as the centre should bear without undue strain on its resources taking into account its responsibility for such vital matters as the defence of the country and the stability of the economy.

Secondly, the principles of distribution of resources between !he states and the determination of grants-in-aid must be uniformly applied to all.

Thirdly, the scheme of distribution should attempt to lessen the inequalities between the states (First Finance Commission Report).

The First Finance Commission further observed: "It is not the purpose of any system of grants-in-aid to diminish the responsibilities of the State governments to balance their own budgets. The method of extending financial assistance should be such as to avoid any suggestion that the Central Government had taken upon themselves the responsibility for helping the states to balance their budgets from year to year." The Eighth Finance Commission gave primacy to national interest as a whole. Their paramount consideration was reconciling the need to accelerate the development of! backward states without hindering the further development of the more advanced ones. The commission, therefore, took steps to reduce the regional imbalances between the states in addition to covering revenue gaps.

The Ninth Finance Commission (Second Report) also observed :

"The manner of transfer of resources should be such as to preserve fiscal autonomy of the states and to promote fiscal responsibility on the part of both the centre and the states. Central transfers invariably involve questions of inter-state equity and such equity can be attained in a system of federal ,transfers only if fiscal prudence, tax effort and growth impulses are not penalised."

Resource Transfers

Share of Income Tax : Article 270(1) of the Constitution provides for distribution of taxes on income between the union and the states, in such manner as may be prescribed by the President after considering the recommendations of the Finance Commission.

The First Finance Commission fixed the state's share of the divisible pool at 55 per cent which earlier was 50 per cent..This was progressively raised to 60 per cent, 66 per cent, 75 per cent by the second, third and fourth Commission respectively. The sixth and seventh commissions raised it further to 80 per cent and 85 per d n t respectively. m e eighth and ninth Finance Commissions have retained it at that level.

Share of Excise Duties : This is another tax whose proceeds are shared by the union with the states. Under Article 272 of the Constitution, union duties on excise other than that on medicinal and toilet preparations as mentioned in the union list are levied and collected by the centre, but if Parliament provides by law may be shared between the centre and the states. The states' share has been successively increased.

The growth is mainly due to :

a) increase in the number of commodities taxed

b) increase in rates

c) rise in prices; and

d) increase in the output of taxable commodities.

The states' share in divisible pool of excise duties was 40 per cent of only three commodities. The share was raised by the second and third commissions and fourth commission raised the share to 20 per cent of all commodities. The fifth and sixth finance commissions maintained the level, seventh commission raised it to 40 percent of all commodities, eighth raised it to 45 per cent of all commodities. Ninth Commission retained it at that level.

Grants-in-aid : Under Article 280 of the Constitution, the Finance Commissions have been given the right of making recommendations regarding the payment of grants-in-aid of the revenues of the states out of the Consolidated Fund of India.

Article 275 provides for the payment of such funds to the states which are actually in need of assistance. But the controversies that arise with regard to grants-in-aid is because the term 'need' has not been clearly defined in the Constitution. The first Finance Commission listed six principles of grants-in-aid which have been followed by later Finance Commissions also with varying degrees of emphasis. These are :

1) budgetary needs;

2) tax efforts;

3) economy in expenditure

4) standard of social services.

5) special obligations; and

6) broad purpose of national importance.

The first Finance Commission recommended specific grants for jute producing states, special grants to eight states for promoting primary education. The second Finance Commission did not recommend the grants for primary education.

The third Finance Commission tried to widen the scope of the grants-in-aid by including grants for plan outlays also. It was of the view that total impact of s grants-in-aid should be of an order which would enable the states, along with the surplus out of devolution, to cover 75 per cent of the revenue requirements of their plans. Quite contrary to this, the fourth Finance Commission confined itself to non-plan revenue expenditure and thus limited the scope of Article 275 to cover only the non-plan grants. Similar views were expressed by the fifth commission.

The sixth Finance commission identified certain administrative services such as general administration, administration of justice, jail, police and social services such as primary education, medical and public health, welfare of scheduled castes, scheduled tribes and other backward classes as to be of crucial importance. It recommended that those states whose expenditure on these items in per capita terms was below the all states average should be enabled to come up to such an average by the last year of the award. Such additional provisions were taken into account for determining quantum of overall plan revenue gap.

The seventh Finance Commission took the view that grants-in-aid should only be a residuary means of assistance and should be used not merely to fill in the uncovered revenue gaps but should be used to narrow down the disparities in the standards of administrative and social services of the states. The eighth Finance Commission broadly agreed with the views of the seventh Finance Commission. The successive Finance Commissions have, therefore, broadly followed the residuary financial assistance approach in recommending the grants-in-aid.

The basic objectives underlying the ninth Finance Commission's approach and methodology were :

a) phasing out the revenue deficit of the Centre and States in such a manner that the deficit is reduced to zero or a relatively small figure by 31st March, 1995;

b) equity in the distribution of fiscal resources both vertically and horizontally; and

c) promotion of fiscal discipline and efficiency in the utilisation of resources.

The Finance Commissions, have played a very important role in the field of federal finance, in spite of certain limitations under which, they had to function. Some of these limitations include :

I. Constitutional limitations =.it has to function under the given framework.

II. Constraints imposed by the Union on the Finance Commission by prescribing certain terms of reference.

III. Non-implementation of important recommendations of the Finance Commission by the union government.

IV. Problems arising out of the methodologies followed by the Finance Commission.

Some of the states have made suggestions for improving the working of the Finance Commission. These have been Summarised by the Sarkaria Commission as follows:

a) The functions of the Finance Commission be enlarged. It should also consider plan and other transfers and/or undertake comprehensive annual periodical reviews of the financial performance of the Union and State Governments.

b) The Finance Commission should be made a permanent or standing body to cope with enlarged responsibilities.

c) The coordination between the Finance Commission and the Planning

d) Commission should be improved so that an integrated view of the flow of Central assistance to the States becomes possible.

e) It should be provided with a permanent and well-equipped secretariat to carry out studies and maintain operational continuity for the benefit of the subsequent Finance Commissions.

As regards the terms of reference being given by the centre, it has already been pointed out earlier that differences of opinion between the states themselves do not allow a consensus to emerge. The union government, however, initiated steps to secures the representation of states on an official level committee set up to finalise the terms of reference. This arrangement is considered adequate for the purpose.

On the non-implementation of the recommendations of the Finance Commission, the Sarkaria Commission has listed three such occasions upto Seventh Finance Commission which the central government could not implement for various reasons. However, the criticism that the union government did not implement the report of the eighth Finance Commission in the first year itself, has been found to be valid and the Sarkaria Commission calls it rather unfortunate. It hopes such occasions will not arise in future.

There has been a long-standing suggestion that the Finance Commission should consider plan and other transfers in addition to non-plan revenue transfers. While conceding that plan transfers could be considered by them, the fourth Finance Commission observed that "the importance of planned development is so great that there should not be any division of responsibility in regard to any element of plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Government in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the State's new plan expenditure"

The suggestion regarding a permanent Finance Commission did not find favour with the Sarkaria Commission which felt an active involvement of the Finance Commission in determination of annual transfers would be at the cost of objectivity.

There is no denying the fact that the Finance Commissions have done an impressive amount of work in the field of federal finance, which has been better known as the Indian Finance Commission's approach to federal finance. Inspite of the several limitations in their approach and methods, they have on the whole succeeded in maintaining the basic equilibrium in the finances of the state governments.

4.4 THE PLANNING COMMISSION

As said earlier the Planning Commission is another important body which has an important place in Centre-State financial relations. The genesis of economic planning in India necessitated the introduction of plan assistance to states to enable them to undertake various developmental programmes envisaged in the five year plans. The responsibility for taking decisions and implementing them rests with the union and the state governments. The resolution emphasised the need for "adequate coordination" between the development schemes initiated by the union and the states and for comprehensive planning based on a careful appraisal of resources and essential conditions of progress.

The broad functions of the Planning Commission include :

- assessment of material, capital and human resources;
- formulation of a plan for their most effective and balanced utilisation;
- determination of priorities and allocation of resources for completing each stage of the plan;
- determination of machinery for securing successful implementation of the plan;
- appraisal of progress and recommending adjustments in policies and measures during the execution of the plan; and
- making of interim and ancillary recommendations on current development policies, measures, etc..

From the very beginning, the Prime Minister has been the Chairman of the

Commission. The Deputy Chairman is an eminent person, usually a politician, holding the rank of a Cabinet Minister. There are two types of members of the

Planning Commission in addition to the Minister for Planning. There are a few full-time members who are eminent public persons, economists, social scientists, technical experts or administrators. In addition, the Commission has as its members, a few Cabinet Ministers like the Finance Minister, Defence minister etc., who attend only very important meetings of the Commission. A large secretariat has been established to assist the Planning Commission in its work.

The Planning Commission has Advisers (State Plan) who perform a very important role vis-a-vis the States. On the one hand, they assist the Planning Commission in finalising the state and on the other, In monitoring the progress of various development

programmes in the states. They also interact with the state governments and assist them in resolving these in implementation of the plan. They are thus expected to function as an active link between the Planning Commission and the state governments.

National Development Council

The setting up of the National Development Council in August **1952** on the

suggestion of the Planning Commission itself, may be regarded as the most significant step for promoting understanding and consultation between the Union and the state governments on planning and common economic policies. It was assigned the three important functions of (i) reviewing the working of the National plan from time to time; (ii) considering important questions of social and economic policy affecting national development, and (iii) to recommend measures for the achievement of the aims and targets of the national plan. Presently, besides the Prime Minister who is the Chairman, its members include the Chief ministers of all the States and Union Territories, Ministers of the Union Cabinet. The Council can meet "as often as may be necessary and at least twice in each year". Although the NDC is not a statutory body, its very composition gives it a unique character and its recommendations are treated with respect by the union and the state governments. It imparts a national character to the entire process of planning.

Devolution of Resources

Devolution of resources Worn the union to the states may be placed under three categories:

(a) transfers based on the recommendations of the Finance Commission;

(b) transfers by way of assistance for execution of the plans recommended by the

(c) Planning Commission, including centrally sponsored schemes; and

(d) others consisting of small savings, loans, assistance for natural calamities, etc., canalised through the Union Finance Ministry.

As already stated, the transfers effected on the recommendations of the Finance Commission (also called statutory transfers) are normally determined for a period of five years. Bulk of these transfers are unconditional and have a built-in buoyancy with respect to the growth of the concerned tax receipts. These transfers accounted for about 40 per cent of the total transfers during the period 1951-85.

A substantial part of the transfers in the second category are by way of assistance for the execution of the state plans. These accounted for **31** per cent of the total transfers from the union to the states during the period **1951-85.** If to these transfers are added those on account of central and centrally sponsored plan-scheme, the totality of the plan transfers during the period 1951-83, works out to about 41 per cent of the total transfers. The central assistance for the plans is based on the recommendations of the Planning Commission. It includes loans and grants.

The third category of transfers are given for various purposes by the union

government. These are in the form of grants and loans for relief of natural calamities, improvement of roads, upgrading salaries of teachers, etc. During 1951-85, such transfers amounted to 19 per cent of the transfers.

Central assistance is an important instrument for reducing regional inequalities and augmenting finances particularly of less developed states for meeting their developmental needs. Plan assistance has always been crucially important for state plans and presently about 50 to 60 per cent of state plan outlays are met from central assistance. The amounts given as plan assistance in the form of grants (30 per cent) and loans (70 per cent) has always been determined on the basis of prescribed criteria.

Nevertheless; in actual practice stronger states could get away with a larger slice than what was their due.

It is often alleged that in as much as only 40 per cent of the total transfers from the Union have been effected on the recommendations of the Finance Commission, the transfers through the Planning Commission and the Union Ministries (for Centrally Sponsored Schemes) have been discretionary in character (implying subjectively arbitrary). Firstly, the Plan assistance is not mandatory on the union government. Secondly, allocation of Central assistance is subject to the approval of the National Development Council on which all Chief Ministers are represented. Thirdly, bulk of central assistance (grants And loans) is decided according to prescribed criteria, population being a major criterion, backwardness of the states, other special problems also being other important criteria. This is done under what is known as the Gadgil Formula or modified Gadgil Formula. Fourthly, in the case of centrally sponsored schemes, the pattern of financing, viz. Central assistance vis-a-vis States own contribution for various schemes is determined and known well in advance. As Sarkaria Commission has observed: "It is not humanly possible to derive foolproof formula which would make the totality of central transfers confirm fully to the ideal of automatic and free-from interference devolution. Some amount of flexibility and room for

subjective judgment will have to be left to the concerned institutions to deal with the specific situations as they arise. What is really important is that the institutions involved should function in a fair and non-partisan manner and take decision with due discernment and expertise which are implicitly acceptable to the states".

4.5 CENTRE-STATE FINANCIAL RELATIONS - A CRITICAL APPRAISAL

The centre-state relations in a new federation like India are quite complex. In older federations like USA, Canada and Australia, a general acceptance of the financial relations between the federal governments and the states makes for a far more smooth relationship. The general complaint against the financial relations between the union and the states concerns the division of resources.

(a) The states have a grievance that by and large the taxes with the Union are quite elastic whereas those left with the states are inelastic and their tax base is also narrow. Of the various taxes levied by them, only Sales Tax and to some extent the State Excise Duties have shown a degree of elasticity. Land Revenue has lost its importance. In 1951-52, it yielded Rs. 49 crore, comprising 21 per cent of their own tax revenue. In 1984-85, it was about Rs. 300 crore, constituting only 2.6 per cent of their own tax revenue. The states and some of the critics maintain that the Constitution has assigned to them the responsibility for development works, rural and social uplift, building of social overheads. Additionally, the responsibility for the maintenance of law and order, the expenditure on general administration has also gone up by leaps and bounds. Thus there are gaps between the revenue and expenditure.

(b) Extending the above criticism, it is held that there is inadequate devolution of taxes levied and collected by the central government, thereby reducing the finances available for state activities, within their sphere of responsibility.

(c) The heavy dependence of the states on the union for financial resources has resulted in progressive erosion of the jurisdiction, authority and initiative of the states in their own constitutionally defined spheres.

(d) The states have also to depend on the union for their share of the enormous financial resources. These includes the banking sector and other financial institutions, foreign a.id and in the last resort deficit financing supported by the Reserve Bank.

(e) The states are obligated to submit their five year plans, including the items within the sphere of their own responsibility to the Planning Commission created

by the central government -and there is interference and control by the letter over the plans of individual States. There is also a gradual decline in the relative share of State's Plan outlay in the total, growing outlay of the union on state subjects, and proliferation of centrally sponsored schemes. Thus, the intrusive planning process along with inadequate and inelastic tax base leading to resource constraints and dependence on the Union, constitute the bulk of the criticism by the states of actual operation of fiscal federalism in India.

It is not correct to say that the foregoing criticism is representative of the, perceptions of all the states. In fact, according to Sarkaria Commission, most of the states are of the view that the existing constitutional arrangements are basically sound and there is no need to make any changes in the division of the areas of taxation envisaged in the Constitution. In fact, one state has pointed out that any transfer of taxation areas now with the union to the states would make the rich states richer and the poor states poorer.

The finances of the Union Government are in none too happy a position. There is no balance from current revenues (surplus on revenue account). The Union finances have been reeling under massive deficits leading to desperate remedies in the year **1990-91** and **1991-92**. More than **100** public sector enterprises are incurring losses every year. Similarly, over the years, most of the states have given exemptions on Land Revenue, etc., whereas the gross volume and value of agricultural production have increased manifold during this period. Only a few states are levying a nominal Agricultural Income Tax and that too to an insignificant extent. Agricultural Income Tax is not easy to administer. Large commercial losses have also been incurred by the public sector enterprises year after year.

The difference between the states own resources and their revenue expenditures over a period of years is not an infallible measure of the extent of their dependence on the resource transfers from the Union. The main snag is that the quantum of revenue expenditure of a state carries a substantial component relatable to revenue received by transfer from the union. This component is a variable factor which has an incremental effect on the level of the state's revenue expenditure. The so-called narrow tax-base of the states, therefore, cannot be related quantitatively to the level of their revenue expenditure as the latter itself depends upon their total revenue resources including revenue transfers from the Union. A state government has in fact conceded after a quantitative analysis that the state's indirect taxes (Sales Tax on Passengers and Goods, Electricity Duty and Stamp Duties and Registration Fees) are fairly elastic to prices and income, but their direct taxes such as Land Revenue and .Profession Tax, are highly inelastic.

If one takes note of the broad trends of revenue centralisation and expenditure decentralisation in other federations, one can say that generally all over the world, the federal governments have a large and increasing control over revenues. This is particularly true of Australia and to a large extent of the United States of America. A more balanced situation, however, exists in Canada. A comparative study conducted under the auspices of National Institute of Public Finance and Policy has observed.

"We may conclude that there is a slightly higher degree of centralisation of revenues in India than is generally found in the economically developed federations. But the expenditure decentralisation in India is greater than in those federations. As a result, the degree of dependence on the centre, in terms of the share of federal transfers in State's revenue is higher. However, in so far as the transfers take place in the form of Constitutionally assigned taxes the high share of federal transfers cannot be said to be an indication of dependence"

Indebtedness of States : One of the major problem areas in Centre-State financial relations pertains to the mounting central loans. As per the Ninth Finance commission Report (second Report), total debt of states is estimated to be Rs. **899461** crore, as on **31.3.89** of which liabilities to the central government form about **63** per cent. Provident funds, reserve funds and deposits are the next largest source of debt financing, amounting to 23 per cent of the state's total debt. Market loans constitute almost **12** per cent of the debt and the residual is negotiated loans from public financial institutions and others. About 11 per cent of the debt is short-term.

The major cause for the rapid rise in state's indebtedness is due to investment under the plans, but more recently to the states resort to cover part of revenue expenditure.

As far as market borrowings are concerned,-under each five year plan, each state is allocated a share on a net basis, i.e. of repayments due in the year. The states find that their repayment obligations to the centre are absorbing a large and ever-increasing proportion of fresh loans. These cut into plan resources to a substantial extent.

The states' representation to the Ninth Finance Commission, among others, was in regard to reduction of repayment burden, write-off loans used- for social infrastructure, the pattern of central plan assistance to be changed to have a higher proportion of grants, e.g. **50:70** proportion of grants to loans, etc.

In channeling market loans, allocation of capital funds by the centre favour the weaker states. Had the moneys been borrowed by all the states directly from the market, the richer states would have gained in competition. The Ninth Finance Commission points out that if the centre is asked to bear the cost of borrowing funds, the amounts

available for direct transfers to the states would be reduced. The "Central Government is not acting merely as a financial agent on behalf of the States in order to reap economies of scale in obtaining funds from me market, but also aims to fulfil certain national purposes such as promoting development and helping weaker States". It felt that the solution to the government debt problem lay in using borrowed funds efficiently and productively for capital expenditure instead of revenue expenditure. It held that, in future, scheduling of loans should be avoided and that the terms on which the funds were lent by the centre to the states must be reasonable and equitable. It recommended certain debt relief measures for the states.

According to Sarkaria Commission :

"The present division of fields of taxation between the Union and the States is based on economic and administrative rationale. Levying of taxes with inter-state base and where uniformity in rates is desirable, are with the Union Government. Taxes that are location-specific are with the States. Consensus of efficiency and equity in administration of taxes and the imperative need for the Union to have adequate resources, inter alia, to help the States with lower level of socio-economic development and tax-potential leave hardly any scope for shifting any major sources of revenue of the States from the present allocation of areas of taxation to the Union". We may note here the views of the Administrative Reforms Commission Study Team that "if at all, a review of taxation power is carried out, economic considerations would most probably compel a shift in favour of the Union and not the other way"

4.6 THE CONSTITUTION (EIGHTIETH AMENDMENT) ACT, 2000

An Act further to amend the Constitution of India.

BE it enacted by Parliament in the Fifty-First Year of the Republic of India as follows:-

1. Short title: This Act may be called the Constitution (Eightieth Amendment) Act, 2000.

2. Amendment of article 269: In article 269 of the Constitution, for clauses (1) and (2), the following clauses shall be substituted, namely:- '(1) Taxes on the sale or purchase of goods and taxes on the consignment of goods shall be levied and collected by the Government of India but shall be assigned and shall be deemed to have been assigned to the States on or after the 1st day of April, 1996 in the manner provided in clause

(2). Explanation.-For the purposes of this clause; - (a) the expression "taxes on the sale or purchase of goods" shall mean taxes on sale or purchase of goods other than

newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce; (b) the expression "taxes on the consignment of goods" shall mean taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place takes place in the course of inter-State trade or commerce; (2) The net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the State within which that tax is leviable in that year, and shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law'.

3. Substitution of new article for article 270:

For article 270 of the Constitution, the following article shall be substituted and shall be deemed to have been substituted with effect from the 1st day of April, 1996, namely:-

Taxes levied and distributed between the Union and the States: 270. (1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in articles 268 and 269, respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2). (2) Such percentage, as may be prescribed, of the net proceeds of any such tax or duty in any financial year shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax or duty is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed in the manner provided in clause (3).

(3) In this article, "Prescribed" means - (i) until a Finance Commission has been constituted, prescribed by the President by order, and (ii) after a Finance Commission has been constituted, prescribed by the President by order after considering the recommendations of the Finance Commission.'

4. (1) Omission of article 272 : Article 272 of the Constitution shall be omitted.

(2) Notwithstanding anything contained in sub-section (1), where any sum equivalent to the whole or any part of the net proceeds of the Union duties of excise including additional duties of excise which are levied and collected by the Government of India and which has been distributed as grants-in-aid to the States after the 1st day of

April, 1996, but before the commencement of this Act, such sum shall be deemed to have been distributed in accordance with the provisions of article 270, as if article 272 had been omitted with effect from the 1st day of April, 1996.

(3) Any sum equivalent to the whole or any part of the net proceeds of any other tax or duty that has been distributed as grants-in-aid to the States after the 1st day of April, 1996 but before the commencement of this Act shall be deemed to have been distributed in accordance with the provisions of article 270.

4.7 TYPES OF TAXES IN INDIA

Direct Taxes:-

These types of taxes are directly imposed & paid to Government of India. There has been a steady rise in the net Direct Tax collections in India over the years, which is healthy signal. Direct taxes, which are imposed by the Government of India, are:

(1) Income Tax:-

Income tax, this tax is mostly known to everyone. Every individual whose total income exceeds taxable limit has to pay income tax based on prevailing rates applicable time to time.

By doing investment in certain scheme you can save Income Tax.

(2) Capital Gains Tax:-

Capital Gain tax as name suggests it is tax on gain in capital. If you sale property, shares, bonds & precious material etc. and earn profit on it within predefined time frame you are supposed to pay capital gain tax. The capital gain is the difference between the money received from selling the asset and the price paid for it.

Capital gain tax is categorized into short-term gains and long-term gains. The Long-term Capital Gains Tax is charged if the capital assets are kept for more than certain period 1 year in case of share and 3 years in case of property. Short-term Capital Gains Tax is applicable if these assets are held for less than the above-mentioned period.

Rate at which this tax is applied varies based on investment class.

Example:-

If you purchase share at say 1000 Rs/- (per share) and after two months this price increased to 1200 Rs/-(per share) you decide to sale this stock and earn profit of 200

Rs/- per share. If you do so you have to pay Short term CGT (capital gain tax) @ 10% +Education cess on profit as it is short term capital gain. If you hold same share for 1 year or above it is considered as long term capital gain and you need not to pay capital gain tax.it is considered as tax free.

Similarly if you purchase property after two year if you find that property price in which you invested has increased and you decide to sale it you need to pay short term capital gain tax.

For property it is considered as long term capital gain if you hold property for 3 years or above.

(3) Securities Transaction Tax:-

A lot of people do not declare their profit and avoid paying capital gain tax, as government can only tax those profits, which have been declared by people. To fight with this situation Government has introduced STT (Securities Transaction Tax) which is applicable on every transaction done at stock exchange. That means if you buy or sell equity shares, derivative instruments, equity oriented Mutual Funds this tax is applicable.

This tax is added to the price of security during the transaction itself, hence you cannot avoid (save) it. As this tax amount is very low people do not notice it much.

Current STT Rates are:-

Securities Transaction Tax

Market Type	Current Rate
Futures & Options	0.017%
Capital Market (Delivery)	0.125%
Capital Market (Intra-Day)	0.025%

(4) Perquisite Tax:-

Earlier to Perquisite Tax we had tax called FBT (Fringe Benefit Tax) which was abolished in 2009, this tax is on benefit given by employer to employee. E.g If your company provides you non-monetary benefits like car with driver, club membership, ESOP etc. All this benefit is taxable under perquisite Tax.

In case of ESOP The employee will have to pay tax on the difference between the Fair Market Value (FMV) of the shares on the date of exercise and the price paid by him/ her.

(5) Corporate Tax:-

Corporate Taxes are annual taxes payable on the income of a corporate operating in India. For the purpose of taxation companies in India are broadly classified into domestic companies and foreign companies.

Corporate Tax India

[illegible]	[illegible]	[illegible]
Domestic Company	30% + Surcharge + Education Cess	30%+ Education Cess
Foreign Company	40% + Surcharge + Education Cess	40%++ Education Cess

In addition to above other taxes are also applicable on corporates.

Indirect Taxes:-

(6) Sales Tax :-

Sales tax charged on the sales of movable goods. Sale tax on Inter State sale is charged by Union Government, while sales tax on intra-State sale (sale within State) (now termed as VAT) is charged by State Government.

Sales can be broadly classified in three categories. (a) Inter-State Sale (b) Sale during import/export (c) Intra-State (i.e. within the State) sale. State Government can impose sales tax only on sale within the State.

CST is payable on inter-State sales is @ 2%, if C form is obtained. Even if CST is charged by Union Government, the revenue goes to State Government. State from which movement of goods commences gets revenue. CST Act is administered by State Government.

(7) Service Tax:-

Most of the paid services you take you have to pay service tax on those services. This tax is called service tax. Over the past few years, service tax been expanded to cover new services.

Few of the major service which comes under vicinity of service tax are telephone, tour operator, architect, interior decorator, advertising, beauty parlor, health center, banking and financial service, event management, maintenance service, consultancy service

Current rate of interest on service tax is 14.5%. This tax is passed on to us by service provider.

(8) Value Added Tax:-

The Sales Tax is the most important source of revenue of the state governments; every state has their respective Sales Tax Act. The tax rates are also different for respective states.

Tax imposed by Central government on sale of goods is called as Sales tax same is called as Value added tax by state government.VAT is additional to the price of goods and passed on to us as buyer (end user). Around 220+ Items are covered with VAT.VAT rates vary based on nature of item and state.

Government is planning to merge service tax and sales tax in form of Goods service tax (GST).

Also Read:- Download new 15G/15H Forms

(9) Custom duty & Octroi (On Goods):-

Custom Duty is a type of indirect tax charged on goods imported into India. One has to pay this duty , on goods that are imported from a foreign country into India. This duty is often payable at the port of entry (like the airport). This duty rate varies based on nature of items.

Octroi is tax applicable on goods entering in to municipality or any other jurisdiction for use, consumption or sale. In simple terms one can call it as Entry Tax.

(10) Excise Duty:-

An excise or excise duty is a type of tax charged on goods produced within the country. This is opposite to custom duty which is charged on bringing goods from outside of country. Another name of this tax is CENVAT (Central Value Added Tax).

If you are producer / manufacturer of goods or you hire labor to manufacture goods you are liable to pay excise duty.

(11) Anti Dumping Duty:-

Dumping is said to occur when the goods are exported by a country to another country at a price lower than its normal value. This is an unfair trade practice which can have a distortive effect on international trade. In order to rectify this situation Central Govt. imposes an anti dumping duty not exceeding the margin of dumping in relation to such goods.

Other Taxes:-

(12) Professional Tax :-

If you are earning professional you need to pay professional tax. Professional tax is imposed by respective Municipal Corporations. Most of the States in India charge this tax.

This tax is paid by every employee working in Private organizations. The tax is deducted by the Employer every month and remitted to the Municipal Corporation and it is mandatory like income tax.

The rate on which this tax is applicable is not same in all states.

(13) Dividend distribution Tax:-

Dividend distribution tax is the tax imposed by the Indian Government on companies according to the dividend paid to a company's investors. Dividend amount to investor is tax free. At present dividend distribution tax is 15%.

(14) Municipal Tax:-

Municipal Corporation in every city imposed tax in terms of property tax. Owner of every property has to pay this tax. This tax rate varies in every city.

(15) Entertainment Tax:-

Tax is also applicable on Entertainment; this tax is imposed by state government on every financial transaction that is related to entertainment such as movie tickets, major commercial shows exhibition, broadcasting service, DTH service and cable service.

(16) Stamp Duty, Registration Fees, Transfer Tax:-

If you decide to purchase property than in addition to cost paid to seller. You must consider additional cost to transfer that property on your name.

That cost include registration fees, stamp duty and transfer tax. This is required for preparing legal document of property.

In simple sense this tax is imposed on the handing over of the title of property ownership by one person to another. It incorporates a legal transaction fee & stamp duty. This amount varies from property to property based on cost.

(17) Education Cess , Surcharge:-

Education cess is deducted and used for Education of poor people in INDIA. All taxes in India are subject to an education cess, which is 3% of the total tax payable. The education cess is mainly applicable on Income tax, excise duty and service tax.

Surcharge is an extra tax or fees that added to your existing tax calculation. This tax is applied on tax amount.

(18) Gift Tax:-

If you receive gift from someone it is clubbed with your income and you need to pay tax on it. This tax is called as gift tax.

This tax is applicable if gift amount or value is more than 50000 Rs/- in a year.

(19) Wealth Tax:-

Wealth tax is a direct tax, which is charged on the net wealth of the assessee. Wealth tax is chargeable in respect of Net wealth corresponding to Valuation date.Net wealth means all assets less loans taken to acquire those assets. Wealth tax is 1% on net wealth exceeding 30 Lakhs (Rs 3,000,000). So if you have more money, assets you are liable to pay tax.

Note:- Wealth tax is abolished by government in budget 2015.Now onwards surcharge of 12% is applicable on individual earning 1 crore and above.

(20) Toll Tax:-

At some of places you need to pay tax in order to use infrastructure (road, bridge etc.) build from your money given to government as Tax. This tax is called as toll tax. This tax amount is very small amount but, to be paid for maintenance work and good up keeping.

(21) Swachh Bharat Cess:-

Swacch Bharat Cess is recently being imposed by the government of India. This tax is applicable on all taxable services from 15thNovemeber, 2015. The effective rate of Swachh Bharat Cess is 0.5%. After this tax we need to pay 14.5% service tax.

(22) Krishi Kalyan Cess:-

In budget 2016 finance minister has introduced new tax namely Krishi Kalyan Cess. This cess is introduced in order to extend welfare to the farmers. The effective rate of Krishi Kalyan Cess is 0.5%. This tax will be imposed on all taxable services. Krishi

Kalyan Cess would come in force with effect from June, 1, 2016. Once this cess is applied we need to pay service tax @ 15%.

(23) Dividend Tax:-

In budget 2016 finance minister has introduced a new tax on the dividend amount. It is proposed that 10% additional tax will be imposed on dividend income above 10 Lac from 1st April 2016 onwards.

(24) Infrastructure Cess:-

New Infrastructure cess on car and utility vehicle imposed recently in budget 2016. 1% infrastructure cess is applicable on petrol/LPG/CNG-driven motor vehicles of length not exceeding 4 meters and engine capacity not exceeding 1200cc. 2.5% cess on diesel motor vehicles of length not exceeding 4 meters and engine capacity not exceeding 1500cc and 4% cess is applicable on big sedans and SUVs.

(25) Entry Tax:-

This entry tax is imposed by Gujarat, Madhya Pradesh, Assam, Delhi and Uttarakhand state government recently. The tax rate is variable 5.5-10% depending upon the state. All items entering in the state boundaries ordered via E-commerce are under this tax boundary.

So in total you pay 25 different taxes in direct or indirect way. At the end in order to make you laugh i will tell you one small joke on tax.

Update –

By Introduction of GST on 1st July,2017 all indirect taxes are subsumed in GST. Total 15 different taxes are abolished by introduction of single tax GST (Goods and Service Tax). Taxes removed by introduction of GST are Central Excise Duty, Service Tax, Value Added Tax, Countervailing duty, Custom Duty, Entertainment Tax, Luxury Tax, Lottery Tax, State Surcharge, Sales Tax, Antidumping duty, Swacch Bharat Cess, Krishi Kalyan Cess, Infrastrcutre Cess & Education Cess.

So, total number of tax in India is reduced from 25 to 10.

QUESTIONS :

1. State the broad functions of the Planning Commission.
2. What are the functions of the National Development Council?
3. What are the major sources of devolution of resources from the union to the states?
4. Point out the areas of conflict in federal finance between the centre and states.
5. Comment on the limitations of the functioning of the Finance Commission. What suggestions have been made by the Sarkaria Commission for improving the functioning of the Finance Commission?
6. Describe the functions of the Finance Commission.
7. Broadly indicate the classification of taxes over which the union has legislative jurisdiction.
8. What are the taxes collected by state government?
9. What are the taxes collected by the central government?
10. Explain the features of GST in India.

UNIT - 5

UNION BUDGET AND FISCAL POLICY

5.1 INDIAN UNION BUDGET

5.1.1 MEANING AND DEFINITION OF THE BUDGET

Throughout the world, the processes for determining how to raise, allocate and spend public resources constitute one of the foundations of government. The way public resources are used is a major determinant of the achievement of public policy objectives. The annual budget is a key policy document, setting out a government's intentions for raising revenues and using resources during the year.

According to Aaron Wildavsky, Budget is:

- A record of the past,
- A plan, a statement about the future,
- A mechanism for allocating resources,
- An instrument for pursuing efficiency,
- A means for securing economic growth,
- An engine of income distribution,
- A precedent,
- The result of political bargaining,
- The most operational expression of national policies in the public sector.

The word budget originated from bougette or 'small bag' in middle French. The use of the word spread to England, where it came to designate the leather bag in which ministers of the crown carried financial plans to parliament, and eventually it became synonymous with its contents. The use of the word in the United Kingdom now refers to the spring financial statement, which focuses on taxation measures. In most countries, the term refers to the annual expenditure and revenue plans tabled in the legislature.

The first traceable legal definition of the budget is contained in a French decree of 1862:

'The budget is a document which forecasts and authorizes the annual receipts and expenditures of the State...' (Stourm 1917: p. 2[10]). In most countries, the government budget is drafted at regular intervals by the executive and tabled in the legislature for review and approval before the beginning of the fiscal year to which it applies.

The budget is the life-blood of the government; the financial reflection of what the government does or intends to do. A theory which contains criteria for determining what ought to be in the budget is nothing less than a theory stating what the government ought to do.

5.1.2 BUDGETING IN INDIA

Budgeting in ancient and medieval India was known not only in its essentials but in fairly great detail, modern budgetary practices started taking shape with the governance of the country being taken over directly by the British Crown. Broadly, the evolution of budgeting has passed through three stages. Firstly, the budgeting system was a sub-system of the British administration. The financial objectives were subordinate to the limited objectives of the colonial power. Control of expenditure and accountability were the hallmarks of this period. Secondly, with the attainment of Independence, the developmental priorities of the nation superseded the limited objectives of the British Raj. In the third phase, a planning orientation has been sought to be imparted to the budgetary exercises. These three phases correspond to the systems known as incremental budgeting, performance budgeting and zero base budgeting respectively.

5.1.3 EVOLUTION OF BUDGETING SYSTEM IN INDIA

"Kautilya's Arthashastra, which describes the administration during Mauryan period makes reference to an excellent budget system with very detailed, minute rules about the maintenance, preparation, submission and scrutiny of accounts. Every year, the Finance Minister made a note of the opening balance in the Treasury, of all current expenditure, including capital projects in hand (Karaniya) as well as those which had been completed (Siddham). Along with this there was a detailed statement of receipts from all sources; and also a statement of the closing balance anticipated at the end of the year. Full and precise accounts were kept of all receipts and outgoings, on Revenue and Capital accounts; plans were also prepared and included in the budget of all proposed new and profitable expenditure for investment.

The accounts included estimates for the coming year, and the actual results of the year just ended. The entire Cabinet sat in a conclave, so to say, to scrutinize them and to pronounce upon their accuracy, fullness and satisfactory nature in all respects. And their business was not only to verify the actual figures, to tally expenditure with outlay by vouchers and receipts, they also had to see that full value was received for every pie spent; that the clerks, officers and departmental heads has done their duty honestly and efficiently. A system of fines or rewards helped to make the system very effective. The rewards as well as punishments fell as much upon clerks as upon the superior officers, inspectors or even the Auditor-General.

The rulers of the Delhi Sultanate and the Mughal Empire also continued a financial system not very different from the Mauryan system.

With the advent of the British rule, the Indian Financial Administration came effectively under the control of the East India Company. Till 1833, the presidencies of Bengal, Bombay and Madras were quite independent in finance and there was hardly any centralized financial system. This position changed with the Charter Act of 1833 which vested the superintendence, direction and control of all the revenues in the Governor General of India-in-Council.

The main activity of the East India Company being territorial expansion, expenditure on costly wars mounted. Huge sums were remitted to England on account of interest payable on Indian debt, interest on investment on Railways, civil and military charges supposed to have been incurred in England on behalf of India, including the expenses on the maintenance of the Office of East India Company in India. That the Governors of the three presidencies hardly had any powers can be seen from the fact that no governor could create a permanent post carrying a princely salary of more than Rs. ten per month.

Following the first war of Independence, in 1857, there was chaos in financial administration. With the takeover of the Indian administration by the Crown, the financial system came to be fashioned on the lines of the system prevailing in England. Imperial objectives dictated a highly centralised system of financial and administrative control. The first budget was formally introduced in India in 1860 by Sir James Wilson, the then Finance Member of the Governor-General-in-Council. There was at that time no elected legislature in India. The budget was also not presented to the British Parliament. The budget, however, made the **Viceroy/Governor-General-in-Council** accountable to the Secretary-of-State-in-Council in London who, as a member of the British Cabinet, looked after Indian affairs. The Secretary of State became the

fountainhead of all authority. He delegated powers to the Governor-General of India. The powers had to be exercised within the ambit of rules and regulations which had to be strictly followed.

The basic features of the financial system in India during the period 1858- 1935 were:

1. The Secretary-of-State-in-Council was the chief regulator of the financial system;
2. Governor-General-in-Council exercised delegated financial authority;
3. Finance Department was the custodian of Indian finance and
4. Controller General had combined responsibility for Indian Audit and Accounts.

The Secretary of State controlled Indian finances through:

a) Acceptance of the Indian budget;

b) Regulation and control of expenditure through voluminous rules, regulations and codes; and

c) Through numerous executive orders.

The budgetary system, more or less, retained these features in spite of the reforms introduced by Lord Mayo in 1870, Lord Lytton in 1877, Lord Rippon's Quinquennial Settlements of 1882 and Lord Curzon's Reforms, 1904. The scene, however, changed significantly following Montague-Chelmsford Reforms of 1919. From 1921 onwards, the Central Legislative Assembly, with a non-official majority, was for the first time given the right to discuss and pass the annual budget of the Government of India in respect of 'non-reserved' subjects, as also to pass the Finance Bill embodying taxation proposals. The Governor-General was, however, empowered to "certify" the financial proposals in the event of their rejection by the legislature.

Before these reforms were introduced, the provincial governments had to seek the Approval of the Central Government for every rupee spent. The Montague-Chelmsford Reforms for the first time introduced realistic provincial autonomy. Central and provincial heads of revenue were clearly demarcated. Consequently, the importance of the supervisory role of Finance Member over the provincial finance departments declined considerably and vanished altogether after 1935. The Secretary of State, however, did not suffer any diminution in his supreme authority after the 1919 reforms. Nothing of significance could happen without his knowledge. But he intervened only when the imperial interests were in jeopardy.

The Government of India Act, 1935, delivered a body blow to his powers. Except for the control over the services, the Secretary of State gave up direct exercise of most of his powers. The Governor General and the Governors exercised special powers and prerogatives over what were called reserved subjects which together with charged items were outside the purview of legislative financial control. They could also restore a demand rejected or reduced by the legislatures. Again, no expenditure could be incurred even if it was duly authorized by the legislature unless it was included in a schedule of expenditure authenticated by the Governor-General or the Governor.

Thus the system of financial control, both at the time of budget formulation and approval for incurring expenditure, turned out to be very rigid, rule-oriented and complex. This system naturally inhibited and suppressed any popular initiative towards change and development. Understandably, the control over financial administration was a necessary adjunct of the fundamental imperial objectives. It was never meant to facilitating solutions to national problems. It was this system, with all its distortions and rigidities, which India inherited from the British."

5.1.4 PRINCIPLES OF BUDGETING

The essential principles generally observed in government budgeting in India are:

i) Principle of **annuality**. The budget should be on an annual basis; this leads to another rule "the rule of lapse". The operation of this rule leads to a rush of expenditure towards the end of the year. However it has the merit of enforcing parliamentary sanction-which is always for an amount for a specific period after which it must be obtained again. This implies that if the funds voted are not used by the end of the financial year, the unspent balance lapses.

ii) The government budgets are **on cash basis**.

iii) There should be **one budget** for all financial transactions of the government. In the absence of one common budget it would be difficult to assess the true financial position of the government. Railways and other public enterprises, however, have separate budgets. In the case of railways, total receipts and expenditure are incorporated in the Central Government Budget. The estimates of capital and loan disbursement and also the extra budgetary resources for financing the plans of public enterprises are also shown in the Central Budget.

iv) The budgeting should be **gross** and not net. Gross transactions, both in the case of receipts and expenditure of each department, should be shown. It is not permissible to deduct any receipt accruing to the department from the charges

of collection or any other expenditure. This is intended to ensure that the parliamentary control over expenditure is meaningful. In the absence of this provision, the budget coming up before the Parliament would be reduced only to the net deficit, if any.

iv) Budgeting should be **close.** It should not be guess work or guess estimates which result in wide fluctuations and can lead to improper allocation of funds, supplementary grants.

v) The form of estimates should correspond to the **accounting heads** since the system-I estimates eventually get converted into actual accounts of receipts and expenditure.

5.1.5 FINANCIAL YEAR

In early budgeting, there was a clear link to the crop cycle. Once the harvest was in, one could make plans for the next year. Many developing countries have maintained this connection by clinging to the broken budget year. In India, the revenue for the subsequent year can only be assessed after the Monsoon season in May, June and July. But agriculture is not the only source of income to be taken into account in the Third World. Papua New Guinea changed its budget year to fit that of the donor countries, since their contributions were so decisive for the government's economic planning. In other parts of Asia, governments hesitate between the lunar and the solar calendars. Over time, there has been a tendency to converge on the calendar year as the most convenient basis for budgeting. While the United Kingdom has held out with a budget year beginning in April, Sweden gave up the broken budget year to adopt the calendar year model in 1995. In the long discussion preceding this decision, it was claimed that a harmonization both upwards (towards the European Union) and downwards (towards private enterprises, communes and regions which had long practiced calendar year budgeting) would bring about greater transparency and facilitate coordination between different levels.

When the first modern budget was presented in 1860 in India, the financial year adopted by the government was from 1st May to 30th April. Beginning with the year 1866, however, the financial year was changed to April-March, in conformity with the practice in England. This practice has been the subject of debate and various committees and commissions which examined the issue have been critical of it. The Administrative Reforms Commission in its Report on Finance, Accounts and Audit observed:

"The financial year starting from the 1st of April is not based on custom and needs of our nation. Our economy is still predominantly agricultural and is dependent on the behaviour of the principal monsoon. A realistic financial year should enable a correct assessment of revenue, should also synchronise with a maximum continuous spell of working season and facilitate an even spread of expenditure. For centuries, people in India have become accustomed to commence their financial year on the Diwali day. This practice has its roots in their way of life. The business community and other sections of society start the Diwali day with the feeling that they have finished with the old period of activity and have embarked upon a new one. It is, therefore, appropriate that the commencement of the financial year should be related to Diwali and in order to prescribe it in terms of a date, we have recommended that the 1st November should be the beginning of financial year."

The commission also thought that a budget year commencing on the 1st November would be better suited for the transaction of Parliamentary business. It is normally argued that the effect of south-west monsoon, which is responsible for over 90 per cent of the total annual rainfall in India, would be known by September, and the likely agricultural production during the year can be estimated fairly accurately. The commercial and industrial activities are also largely dependent on the performance in the agricultural sector. Besides, the monsoon months can be utilised for budget formulation and the critical fiscal parameters can be decided upon in the light of anticipated level of economic activity in the ensuing year.

Under the present arrangements, soon after the expenditure sanctions reach the executing agencies, the onset of monsoon renders it difficult to start construction of the budgeted works. These works have to wait till the rains are over. The speed of works is affected because of the intervention of monsoons when barely the preparatory work of projects has been completed. The delayed execution of works results in the rush of expenditure towards the end of the year leading to surrender of funds at the close of the financial year.

Essentially a budget year should help in performing the following functions:

i) Making a fairly accurate estimate of revenue;

ii) Making a fairly accurate estimate of expenditure;

iii) It should facilitate an efficient execution of projects; and

iv) The budget calendar should be convenient to the legislators and administrators.

Different dates have been suggested by the various experts who have examined the question of financial year. These are 1st July, 1st October, 1st November or 1st January. While there is a merit in each one of these suggestions, none of these can reconcile the conflicting criteria proposed. Considering only the criterion of better predictability of revenues, no single budget year provides enough scope for the various states to make a realistic assessment for both Kharif and Rabi crops. Rabi crops are very important for some of the states. The estimation of total agricultural production would, therefore, remain a guess work.

It has, therefore, been argued that the balance of advantage lies in not disturbing the present fiscal year. The database of the economy relates to the existing financial year and any dislocation in this year will lead to statistical, accounting and **Indian Budgetary System** administrative problems. One has to weigh the advantages of changing over to a different fiscal year against the disadvantages inherent in such a switchover. And one has to remember that there is no general agreement on the alternative fiscal year. The only practical approach, therefore, is to continue with the present financial year.

5.1.6 KINDS OF BUDGET

In modern times public budget occupies a very significant place in the economic and financial system of the country. Public Budgets have been of different types, varying in form, manner of presentation of information and data, objectives, their impact on the economy and so on. Following can be different types of budget:

Multiple and Unified Budget: In USA the Government budget used to be divided into parts in such a way that each part would enable to highlight the specialized functions of the Government. Subsequently it was felt that a unified Budget would be more useful for knowing the total effect on the economy which is more important. So the need for a unified budget arose.

Functional and Cash Budget: In USA, distinction made between the functional and cash budgets. The main difference between them is the mentioning of revenue and expenditure figures on accrual basis and excluding those receipts and expenditure which do not belong to the government. Functional Budget always presents an inadequate picture of the government activities. On the other hand, in the Cash Budget, all the flow of funds to and from the government of actual basis is shown, inclusive of funds which are not owned by the government. Therefore, cash budget is invariably larger than the functional budget and a better representative of reality.

Legislative and Executive Budget: A legislative budget is one which is prepared and adopted by the legislature directly or with the help of committees. An executive budget is also passed by the legislature but it is prepared by the executive branch of the government. It is generally believed that an executive budget is more preferable than a legislative budget.

Revenue and Capital Budget: The general practice adopted by many countries is to divide the public budget into Revenue and Capital Accounts; the former covering those items which are of recurring nature while the latter includes items which are of non-recurring nature i.e., which are concerned with the acquisition and sale of capital assets.

Indian Situation: According to the constitution of India, the Budget must distinguish between expenditure on Revenue Account from other expenditures. Hence the budgets of the central and state governments are divided into two parts, namely, Revenue Budget and Capital Budget; the former comprising revenue receipts and the expenditure met out of these receipts. Revenue receipts such as collected from Taxes – Direct and Indirect Tax and Non Tax receipts, collected from currency, coinage and mint, interest payments, dividends, profits, revenue from general services, revenue from social and community services and revenue from economic services. On the other hand, capital receipts include market loans, borrowing from the Reserve Bank of India, receipts of the sale of treasury bills and loans from foreign governments and others to the central government. Disbursement of capital accounts include expenditure on acquisition of physical assets like land, buildings, machinery and equipment, shares and debentures and loans to state Governments and other organizations.

Till mid -1980s the Plan Budget was also prepared along with the main budget. The Plan Budget showed the budgetary provisions for important projects and schemes included in the Central Plan. Now this practice has been changed. The budget of the Government of India is now first divided into two parts: Plan and Non-plan and then each part are further divided into Revenue and Capital Accounts.

Economic and Functional Classification: Economic classification of the budget implies the classification of expenditure and the manner of its financing in terms of economic categories. By doing so, one is able to gather valuable information about the generation of savings, investment, consumption, financial assets and liabilities etc. on the other hand, functional classification refers to the types of functions, which the government undertakes, or the services which it provides.

Balanced and Unbalanced Budget: A budget can be balanced and unbalanced. A government Budget is said to be balanced when its tax revenue and its expenditure are equal. And when Government income and expenditure are not equal, it is said to be unbalanced budget. The imbalances may be due to an excess of expenditure over income or an excess of income over expenditure. In the former case, it is called a deficit budget and in the latter, a surplus budget.

Performance and Programmed Budget: Performance and programmed budgeting is the most recent technique of the formation and execution of government budgets. In this system, government budget is first divided into the major functions of the government, then each major function is further divided into specific programmes, activities and projects and then funds are allocated according to the achievement expected from a department or ministry over a specific period from the proposed expenditure. The emphasis is, therefore, on the size of the programme, its implementation, and the cost involved.

The performance budgeting involves the sequence of steps to be taken for executing a programme along with the expenditure required at each stage and results expected to be achieved. The emphasis of performance budgeting is on efficient internal management in the light of results to be achieved and their cost.

Indian situation: In India the suggestion for adopting the PPB system was made by twentieth estimates committee. It considered this technique ideal for a proper appreciation of the schemes and outlays included in the budget. But, it preferred its use for "large development activities". Subsequently, the Study Team of the Administrative Reforms Commission on financial administration recommended the use of performance budgeting for linking the financial and fiscal aspects of economic development. The Study Team observed that the prevailing budgetary system was good from the point of view of financial and legal accountability but from the viewpoint of effectiveness of expenditure it did not give adequate information and did not help the people and the parliament to have a complete knowledge of the operation and activities of the government. According to the Study Team the use of performance budgeting in India will confer the following advantages:

i) The presentation of the purpose and objectives of seeking fund would be clearer and the progress and accomplishments would be expressed in financial terms.

ii) It would help the legislature to have a better understanding of the budget and to review it more effectively.

iii) It will improve budget formation and the decision making process at all levels in the government.

iv) It will increase the accountability of the executive for the control of financial operations.

v) It will make performance audit more effective and meaningful.

The Study Team recommended the introduction of PPB system in India in a phased manner with priority assigned to those departments and organizations, which handle programmes which involved large expenditure. In India, all the ministries and departments had started preparing performance budget from the year 1975-76. These budgets contain main projects, programmes and activities with reference to the specific objectives, an assessment of the previous year's budget and achievements.

5.1.7 SIGNIFICANCE OF PUBLIC BUDGET

In olden days, Public Budget was considered only as a simple statement of receipts and expenditures of the Government. Then it had only two objectives: Firstly, how little money a government can take out of the pockets of the tax-payers, which is just inadequate to maintain its essential activities at a proper level of efficiency; and secondly, since parliament had to vote funds it was necessary for it to know the plan of expenditure of the government. That was the position of the public budget in a laissez-faire economy but, since the development of the concept of welfare state the activities of the government have expanded at a very rapid rate and now they encompass almost every aspect of the socio-economic life of the community. As compared to the olden days-

(a) The size of the Budget has swollen enormously. Its capacity to affect the national economy has greatly increased.

(b) The government activities are reflected through public budgets and they affect the production and distribution of national income and the utilization of the resources of the country.

(c) The government with the help of the budget can produce a powerful impact on the level of economic activity through its policies on taxation, expenditure and borrowing.

(d) The borrowing policy of the government may lead to an increase in the rate of savings and mobilization of resources for economic development of the country.

(e) That is why Van Philips remarked, "The superiority of the Budget is due to its more firm and direct hold on the economy, the results of the budgetary policies are more direct."

5.1.8 STRUCTURE OF GOVERNMENT ACCOUNTS

Annual Financial Statement

"With the attainment of Independence, the objectives, the policy framework and the environment of financial administration underwent a radical change. The conflict between popular will and aspirations and the policy and procedures which had characterized financial administration in the country disappeared overnight. Even though the basic features of the Government of India Act, 1935, with regard to financial administration, were retained, there was no fundamental disharmony between these instruments and the national priorities. These instruments could be and were refashioned according to the changed objectives.

The budgetary processes in India follow the procedure laid down in Articles **112 to 117** of the Constitution. Accordingly, Annual Budget of the Union, called the Annual Financial Statement of estimated receipts and expenditure, is to be laid before both Houses of the Parliament in respect of every financial year.

The Budget shows the receipts and payments of government under three parts in which government accounts are kept:

(a) Consolidated Fund,

(b) Contingency Fund, and

(c) Public Account

Consolidated Fund of India

All revenues received by government, loans raised by it, and also its receipts from recoveries of loans granted by it form the Consolidated Fund. All expenditure of government is incurred from the Consolidated Fund and no amount 'can be withdrawn from the fund without authorisation from the Parliament.

Contingency Fund

Occasions may arise when government may have to meet urgent unforeseen expenditure pending authorization from the Parliament. The Contingency Fund is an Imprest placed at the disposal of the President to incur such expenditure. Parliamentary approval for such expenditure and for withdrawal of an equivalent amount from the Consolidated Fund is subsequently obtained and the amount spent from Contingency Fund is recouped to the fund."

Public Account

Besides the normal receipts and expenditure of government which relate to the Consolidated Fund, certain other transactions enter government accounts, in respect of which government acts more as a banker; for example, transactions relating to Provident Funds, Small Savings Collections, other deposits etc. The money thus received is kept in the Public Account and the connected disbursements are also made there from. Generally speaking, Public Account funds do not belong to government and have to be paid back some time or the other to the persons and authorities who deposited them. Parliamentary authorization for payments from the Public Account is, therefore, not required.

Charged Expenditure

Under the Constitution, certain items of expenditure like emoluments of the President, salaries and allowances of the Chairman and the Deputy Chairman of the Rajya Sabha and the Speaker and Deputy Speaker of the Lok Sabha, salaries, allowances and pensions of Judges of the Supreme Court and the Comptroller and Auditor-General of India, interest on and repayment of loans raised by government and payments made to satisfy decrees of courts etc; are charged on the Consolidated Fund. These are not subject to the vote of Parliament. The budget shows the charged expenditure separately in the Consolidated Fund.

Government budget comprises:

- Revenue budget; and
- Capital budget

Revenue Budget

It consists of the revenue receipts of government (tax and non-tax revenues) and the expenditure met from these revenues. The estimates of revenue receipts shown in the budget take into account the effect of the 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.

Capital Budget

It consists of capital receipts and payments. The main items of capital receipts are loans raised by government from public which are called Market Loans, borrowings by government from Reserve Bank and other parties through sale of Treasury Bills,

Loans received from Foreign Governments and Bodies and Recoveries of loans granted by Central Government to 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. Capital budget also incorporates transactions in the Public Account.

Demands for Grants

"The estimates of expenditure from the Consolidated Fund included in the budget and required to be voted by the Lok Sabha are submitted in the form of Demands for Grants. Generally, one Demand for Grant is presented in respect of each ministry or department. However, in respect of large ministries or departments, more than one demand is presented. 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, 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 Parliament. 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.

Plan expenditure forms a sizeable proportion of the total expenditure of the central government. The Demands for Grants of the various ministries show the plan expenditure under each head separately from the non-plan expenditure. The document also gives the total plan provisions for each of the ministries arranged under the various heads of development and highlights the budget provisions for the more important plan programmes and schemes.

A large part of the plan expenditure incurred by the central government is through public sector enterprises. Budgetary support for financing outlays of these enterprises is provided by government either through investment in sharecapital or through loans. The budget shows the estimates of capital and loan disbursements to public sector enterprises in the current and the budget years for plan and non-plan purposes and also the extra-budgetary resources available for financing their plans.

The Railways and Telecommunication services are the principal departmentally-run commercial undertakings of government. The budget of the Railways and the demands for grants relating to Railway expenditure are presented to parliament separately. However, the total receipts and expenditure of the Railways are incorporated in the Central Budget. The demands for grants of the Department of Telecommunications are presented along with other demands of the central government."

5.1.9 THE BUDGETARY PROCESS

Functions

The national budget is a document that, once approved by the legislature, authorises the government to raise revenues, incur debts and effect expenditures in order to achieve certain goals. Since the budget determines the origin and application of public financial resources, it plays a central role in the process of government, fulfilling economic, political, social, legal and administrative functions:

Economic

The budget is the state's financial plan. As a tool of economic policy, the budget is the means by which the government seeks to achieve three key economic policy goals: firstly, fiscal discipline, by controlling aggregate expenditure in line with macroeconomic constraints; secondly, the allocation of resources in line with the government's policy priorities; and thirdly, the economic, efficient and effective use of resources in achieving its policy goals.

Political

The budget process ensures the people's representatives scrutinise and approve the raising of taxes, the contracting of debts and the application of public funds by government. This is achieved through a formal separation of powers: government proposes the budget, which is approved by parliament, then executed by government, and finally subject to monitoring and appraisal by parliament to ensure compliance.

Legal

Enactment of the budget in law by parliament limits the powers of government, since the government may not raise taxes that have not been approved by parliament and may not exceed parliament's expenditure appropriations. An auditor, usually accountable to parliament, scrutinises the budget to ensure compliance with parliamentary authorisations. Institutions and individual managers, who fail to comply by, for instance, spending in excess of parliamentary appropriations, are accountable before the law.

Managerial

The budget communicates government policy to public institutions by informing them how much may be spent for what purpose, thereby guiding policy implementation. In some budgeting systems, this function may be reinforced by the inclusion of specific service performance targets within the budget document.

These functions are interdependent: the government is unlikely to implement successful economic policies (economic function) as approved by parliament (political function) if the budget does not effectively communicate its policies to public agencies (managerial function) and compliance with approved policy is not verified (legal function).

5.2 ZERO BASE BUDGETING

The budgeting process is a tool for setting goals and objectives to recognize weaknesses or inadequacies in organizations, and for controlling and integrating the diverse activities performed by many agencies within large organizations, both public and federal. Budgeting requires inspection of the organizational resources that have been used in the past, evaluation of, and planning for what is to be accomplished, and programming a course for the future by allocating new resources for the coming budget period. Zero Based Budgeting (ZBB), an analytical technique was developed in 1969 in a private organization, Texas Instruments. It was first applied to government by Governor Jimmy Carter in the preparation of his fiscal year 1973 budget. After that in 1977 President Carter mandated its use in the federal government. Major aim of this mechanism is to achieve an optimal allocation of resources that incremental and other budgeting systems cannot achieve. Managers are asked to identify and justify their areas of work in terms of decision packages prior to starting the work. A zero-base budget necessitates managers to rationalise all of their budgeted expenditures, instead of the more common approach of only requiring justification for incremental changes to the budget or the actual results from the previous year. Therefore, a manager is supposedly presumed to have an expenditure base line of zero. Zero-base budgeting is an actual management tool which is extensively used in business, non-profits and government organizations. This system provides more scrutiny and transparency in the budgeting process. Though it is initially introduced for government use but small businesses can also get advantage from the use of zero-based budgeting to find ways to reduce costs, invest limited resources more intentionally, and evaluate the benefits of budgeted tasks or projects. It is a system of planning and decision-making that opposites of the working process of traditional budgeting. In traditional incremental budgeting, departmental managers explain only variances versus past years, based on the assumption that the "baseline" is robotically

approved. In zero-based budgeting, every line item of the budget must be accepted, rather than only changes. Zero-based budgeting needs the budget request be reassess systematically, starting from the zero-base. This process is autonomous of whether the total budget or specific line items are increasing or decreasing.

5.2.1 Concept of Zero Base Budget

Zero-Base-Budgeting was developed in the decade of 60s at Texas Instruments by Peter Phyrr. Zero-Base-Budgeting is a financial and management approach which help policymakers accomplish more cost- effective delivery of public services. In actual situation, a manager is expected to have a lowest amount of funding for basic departmental operations, above which additional funding must be reasonable.

The main objective of the process is to constantly refocus finance on business objectives, and dismiss or scale back any activities no longer related to those objectives. Sarant stated that, Zero-Base-Budgeting is a technique which complements and links to existing planning, budgeting and review processes. It identifies alternative and efficient methods of utilizing limited resources. It is a bendable management approach which offers a trustworthy justification to reallocate resources through systematic appraisal and explanation of the funding and performance levels of current programs. Zero-base budgeting was also initiated in the federal government by President Jimmy Carter in 1977 to control program costs. After that, this process was improved in various governments.

Studies indicated that Zero-base budgeting is more suitable for private businesses. In some cases, private businesses have been more prosperous through this exciting process than governments.

Traditional vs zero base budgeting

[illegible]	Traditional Budgeting	Zero base budgeting
Emphasis	It is accounting oriented, emphasis on "How much"	It is more decision oriented, emphasis on "Why"
Approach	It is monitoring towards the expenditures	It is towards the achievement of objectives
Focus	To study the changes in the expenditures	To study the cost benefit analysis
Communication	It operates only vertical communication	It operates in both directions horizontally and vertically
Method	It is based on the extrapolation i.e. from the yester figures future projections are carried out	Its decision package is totally based on the cost benefit analysis.

5.2.2 The basic steps under Zero Base Budgeting

There are two steps to the process of zero based budgeting. The first step is to develop what is called as "decision packages". The second is to rank the decision packages. The decision package is a document that identifies and explains the specific and goals and objectives, measurement of performance, costs, benefits and alternative courses of action. Ranking of decision packages is then accomplished at each management level until a comprehensive agency wide ranking is obtained. Conceptually, zero-base budgeting is a system approach to allocating resources where they will do the most good. The extent of application must be decided in next phase of zero-base budgeting. Next stage is to prioritize the activities. The important phase is cost benefit analysis. Last step is to select, approve the decision package and finalize the budget.

Argyris studied the impact of budgeting on organizations in the 1950s. Many studies have shown that budget processes used in organizations have some behavioural effects. It has been observed that the particular process used could lead to dysfunctional behaviour in subordinates, irrespective of the degree of technical modification of the budgetary system. In the decade of 1970, Hopwood's studies investigated the effects of budgets on human behaviour and results found that the use by seniors of a budget-constrained style of assessment increased significant levels of job-related tension, had adverse effects on peer and subordinate-boss relationships, and was implicated in manipulative behaviour on subordinates. Zero-based budgeting may necessitate more time, money, and paper work, but it offers a systematic method of addressing an organization's financial issues and enable an organization to better allocate its resources. A blend of zero-based budgets with rolling budgets or some other form of budgeting that spreads the work of justifying new budgets each cycle is way to integrate zero-based budgeting without undue stress at the same time for all managers with budgetary accountability.

5.2.3 Advantages of Zero Base Budgeting

Organizations who adopt zero-base budgeting get numerous advantages. Zero-base budgeting needs that managers recognise alternative ways to implement each activity, as well as the effects of different levels of spending. With these alternatives, the process makes managers consider other ways to operate the business.

Budget inflation is another benefit. Since managers must link expenditures to activities, it becomes less expected that they can artificially expand their budget. The change should be easily to spot. The zero-base budget should trigger a significant

debate among the management team about the corporate mission and the way it can be accomplished. A zero-base budget review process compel managers to decide which operation is appropriate to the company. Such force enable managers to target non-key activities for elimination or outsourcing. Since the zero-base budgeting conception force managers to define the various missions of their departments. The evaluation may disclose that the same activities are being conducted by numerous departments, leading to the elimination of the activity outside of the area where management wants it to be centred. Companies who implement zero-base budgeting on a regular basis can examine various aspects periodically. It can be established that zero-base budgeting is microeconomic tools to change objectives into efficient operating plans.

5.2.4 Disadvantages of Zero Based Budgeting

With advantages, there are some drawbacks of using zero base budgeting. The main disadvantage of zero-base budgeting is the very high level of effort needed to examine and document department activities. This is a difficult task even once a year, which causes some entities to only use the procedure once every few years, or when there are noteworthy changes within the organization. Another substitute is to require the use of zero-base budgeting on a rolling basis through different parts of a company over several years, so that management can deal with fewer such reviews per year. Zero base budgeting needs an enormous amount of analysis, meetings, and reports, all of which requires extra staff to manage the process. Some managers may try to manipulate their budget reports to concentrate expenditures under the most important activities, thus ensuring that their budgets will not be reduced. It can be problematic to control or validate expenditure levels for areas of a business that do not produce "concrete," tangible results. The operational evaluation authorized by zero-base budgeting requires a significant amount of management time. Managers need special training in the zero-base budgeting process, which further increases the time required each year.

5.2.5 Modified Zero Based Budgeting

Service-level budgeting is a modified zero-base budget approach. This matches spending levels with services to be accomplished. Under zero-base, there is an attempt to document personnel and expense requirements that are readily accepted as necessary. Modified zero-base can evade this by developing a base that is higher than zero. The term service level budgeting is sometimes better account of this process.

To summarize, Zero-Based Budgeting is effectual cost alteration effort that successfully implement resource planning. Zero based budgeting is explained by theorists as

'budgeting from the ground up, as though the budget is being prepared for the first time with every proposed expenditure coming under review'. (Horngren et al, 1996) Zero-based budgeting is a management process to budgeting, in which the budget for every activity begins with zero for each new budget period. An analysis of this practice in a non-profit setting is important because Zero-Based Budgeting is applied in local and government organisations where predominant costs are of a flexible nature (Drury, 2004). It differs from traditional budgeting processes through investigating all expenses for each new period, not just incremental expenditures in obvious areas. Zero-Based Budgeting forces managers to analyse all spending and requires justifying every expense item that should be kept. It facilitates companies to profoundly reshape their cost structures and increase competitiveness. Zero-Based Budgeting analyses which activity should be executed at what level and frequency and scrutinises the way these could be better performed through streamlining, standardization, Outsourcing, offshoring or automation. The process is supportive to align resource allocations with strategic goals, though it can be time-consuming and challenging to measure the returns on some expenditures.

5.3 BUDGET DEFICIT

5.3.1 BUDGET DEFICIT - MEANING

When the government expenditure exceeds revenues, the government is having 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 it's receipts.

The government finances its deficit mainly by borrowing from the public, through selling bonds, it is also financed by borrowing from the Central Bank.

5.3.2 TYPES OF BUDGETARY DEFICIT

The different types of budgetary deficit are explained in following points :-

1. 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 & subsidies.

Table below indicate revenue deficit of the central government of India.

Revenue Deficit - Central Government of India

Year	Rs. Crore	% of GDP
1990-91	18,562	3.3
2005-06	94,644	2.7

From the above table it is clear that revenue deficit was Rs. 18,562 crores in 1990-91 and Rs. 94,644 crores in 2005-06. As proportion of GDP, revenue deficit increased from 1.5% in 1980-81 to 3.3% in 1990-91 and declined to 2.7% in 2005-06. The decline is due to the passing of the Fiscal Responsibility and Budget Management Act in 2002.

2. 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.

Budgetary Deficit of central government of India was Rs. 2,576 crores in 1980-81, it went up to Rs. 11,347 crores in 1990-91 to Rs. 13,184 crores in 1996-97.

The concept of budgetary deficit has lost its significance after the presentation of the 1997-98 Budget. In this budget, the practice of ad hoc treasury bills as source of finance for government was discontinued. Ad hoc 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.

3. Fiscal Deficit

Fiscal Deficit is a difference between total expenditure (both revenue and capital) and revenue receipts plus certain non-debt capital receipts like recovery of loans, proceeds from disinvestment.

In other words, fiscal deficit is equal to budgetary deficit plus governments market borrowings and liabilities. This concept fully reflects the indebtedness of the

government and throws light on the extent to which the government has gone beyond its means and the ways in which it has done so. in 1980-81, fiscal deficit was Rs. 7,733 crores. Between 1980-81 and 1990-91 it increased 5 times to Rs. 37,606 crores. Since the introduction of economic reforms in 1991-92, the government has tried to restrict the growth of fiscal deficit. As percentage of GDP fiscal deficit declined from 6.2% in 2001-02 to 4.1% in 2005-06.

4. 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 loans taken in the past.

Table below indicate primary deficit as a Percentage of GDP.

Primary Deficit as % of GDP

Year	% of GDP
1990-91	2.8
2005-06	0.4

Primary deficit of the central governent of India was 16,108 crores in 1990-91, it reduced to 14,591 crores in 2005-06.

5. Monetised Deficit

Monetised Deficit is the sum of the net increase in holdings of treasury bills of the RBI and its contributions to the market borrowing of the government. It shows the increase in net RBI credit to the government. It creates equivalent increase in high powered money or reserve money in the economy.

All these budgetary deficit reveal fiscal imbalance. Fiscal imbalance & budget deficit result in harmful consequences like mounting inflation, deficit in balance of payment, etc. It has also adversely affect the growth of the economy. The government must introduce fiscal correction policies to overcome the deficit budget and fiscal crisis.

5.4 DEFICIT FINANCING

5.4.1 MEANING

Deficit financing is defined as financing the budgetary deficit through public loans and creation of new money. Deficit financing in India means the expenditure which in excess of current revenue and public borrowing. the government may cover the deficit in the following ways.

1. By running down its accumulated cash reserve from RBI.

2. Issue of new currency by government itself.

3. Borrowing from reserve bank of India and RBI gives the loans by printing more currency notes.

5.4.2 OBJECTIVES OF DEFICIT FINANCING :

1. To finance war:- Deficit financing has generally being used as a method of financing war expenditure. During the war time through normal methods of raising resources. It becomes difficult to mobilize adequate resources. Therefore government has to adopt deficit financing.

2. Remedy for depression :- In developed countries deficit financing is used as on instrument of economic policy for removing the conditions of depression. Prof. Keynes has also advocated for deficit financing as a remedy for depression and unemployment.

3. Economic development:- The main objective of deficit financing in an under developed country like India is to promote economic development. The use of deficit financing in fact becomes essential for financing the development plan especially in underdeveloped countries.

4. Mobilization of Resources :- deficit financing is also used for the mobilization of surplus, ideal and unutilized resources in the country.

5. For granting subsidies :- In a country like India government grants subsidies to the producers to encourage them to produce a particular type of commodity, granting subsidies is a very costly affair which we cannot meet with the regular income this deficit financing becomes must for it.

6. Increase in aggregate demand :- Deficit financing loads to increase in aggregate demand through increased public expenditure. This increase the income and purchasing power of the people as a consequence there is an increase availability of goods and services and the production and employment level also increase.

7. For payment of interest:- Loan which are taken by the govt. are supposed to be repaid with their interest for that government needs money deficit financing is an important tool to get the income for the repayment of loan along with the interest.

8. To overcome low tax receipts.

9. To overcome the losses of public sector enterprises

10. For implementing anti poverty programme.

5.4.3 ADVERSE EFFECTS OF DEFICIT FINANCING

Deficit financing is not free from its diffects. It has its adverse effect on economy. Important evil effects of deficit financing are given below.

1. Leads to inflation :- Deficit financing may lead to inflation. due to deficit financing money supply increases & the purchasing power of the people also increase which increases the aggregate demand and the prices also increase.

2. Adverse effect on saving:- Deficit financing leads to inflation and inflation affects the habit of voluntary saving adversely. Infect it is not possible for the people to maintain the previous rate of saving in the state of rising prices.

3. Adverse effect on Investment ;- deficit financing effects investment adversely when there is inflation in the economy trade unions make demand for higher wages for that they go for strikes and lock outs which decreases the efficiency of Labour and creates uncertainty in the business which a decreases the level of investment of the country.

4. Inequality :- in case of deficit financing income distribution becomes unequal. During deficit financing deflationary pressure can be seen on the economy which make the rich richer and the poor, poorer. The fix wage earners are badly effected and their standard of living detoriates thus no gap b/w rich & poor increases.

5. Problem of balance of payment :- Deficit financing leads to inflation. A high price level as compared to other countries will make the exports more expensive and thus they start declining. On the other hand rise in domestic income and price may encourage people to import more commodities from abroad. This will create a deficit in balance of payment and the balance of payment will become unfavorable.

6. Increase in the cost of production :- When deficit financing leads to the rise in the price level the cost of development projects also rises this means a larger dose of deficit financing is required on the port of government for completion of these projects.

7. Change in the pattern of investment:- Deficit financing leads to inflation. During inflation prices rise and reach to a very high level in that case people instead of indulging into productive activities they start doing speculative activities.

5.4.4 IS DEFICIT FINANCING INFLATIONARY?

Deficit financing may not necessarily be inflationary there are certain conditions under which deficit financing may not lead to inflation. With increase in money supply due to deficit financing prices do rise but rise in price will only be temporary for about a period. As flow of goods and services increase prices will began to fall. deficit financing is an important device for financing development plans for underdeveloped countries and accelerate their rate of economic development. But If deficit financing is not kept within limits. it may give rise to prices, distorted investment and unequal and unjust distribution of income. therefore it is essential that deficit financing is kept within limits and its impact on prices and costs are softened through various controls.

5.4.5 FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT

The Fiscal Responsibility and Budget Management (FRBM) Act was legislated by the Parliament in the year 2003.

Its objectives can be identified as:

- To institutionalise fiscal discipline;
- Reduce Fiscal Deficit;
- Improve Macroeconomic Management.
- The law aims at promoting Fiscal Stability for the country on a long-term basis.
- It emphasises a Transparent Fiscal Management System and a more equitable distribution of debts over the years.
- This law also gives flexibility tothe Reserve Bank of India to undertake monetary policy to tackle inflation and take corrective measures in order to give an impetus to the economic environment.

As the Government needs resources for funding various kinds of developmental schemes androutine expenditures. Resources are raised through taxes and borrowing. The government can raise funds by borrowing from the Reserve Bank of India, financial institutions or from the public by floating bonds.

Fiscal deficit

It is the Total Expenditure minus the Revenue Receipt, Loan Recoveries and Receipts from Disinvestment etc. It is a measure of the government borrowing ina year.

However, uncontrolled Fiscal Deficit is harmful not only for the health of economy but also for the Growth of the economic indicators and finally the development prospects in the road towards Inclusive Growth.

- FRBM Act was notified in 2004 in response to the need felt to curb broadening Fiscal Deficit.
- The FRBM rules specify annual reduction targets for fiscal indicators.
- Originally, the act envisaged Revenue Deficit to be reduced to nil in five years beginning 2004-05.
- Fiscal deficit was required to be reduced to3 percent of GDP by 2008-09.
- The Act also provides exception to the government in case of Natural Calamity and whenever there is a threat to National Security.

The implantation of the act was put on hold in 2007-08 due to Global Financial Crisis and the aggravating demand for Fiscal Stimulus.

There was a need for increased government expenditure to create demand to fight off the financial downturn and hence the government moved away from the path of Fiscal Consolidation for this period.

- This law also prohibits borrowing by government from the Reserve Bank of India and purchase of primary issues of central government securities after2006.
- The Act asked the Central government to lay in Parliament three statements in one financial year about the fiscal policy.
- To enforce fiscal discipline at the state level, the Twelfth finance commission provided for incentives to states through conditional debt restructuring and interest rate relief.

In 2012, the FRBM Act was amended and it was decided that the FRBM Act would target *Effective Revenue Deficit* in place of *Revenue Deficit*.

- *Effective Revenue Deficit* excludes Capital Expenditure from Revenue Deficit and thus provides space to the government to spend on formation of Capital Assets.

The critics of this Act usually point of out the demerits that it would put a curb on the government's social sector spending, but no one can deny the fact that there is a rising need for Fiscal Sustainability in order to put the economic indicators back on the path of Growth as well as Development.

5.5 FISCAL POLICY

"The role of fiscal policy for economic growth relates to the stabilization of the rate of growth of an advanced country. Fiscal policy through variations in government expenditure and taxation profoundly affects national income, employment, output and prices".

5.5.1 Meaning of Fiscal policy

Fiscal policy means the use of taxation and public expenditure by the government for stabilisation or growth. According to Culbarston, "By fiscal policy we refer to government actions affecting its receipts and expenditures which we ordinarily taken as measured by the government's receipts, its surplus or deficit." The government may offset undesirable variations in private consumption and investment by compensatory variations of public expenditures and taxes.

Arthur Smithies defines fiscal policy as "a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment." Though the ultimate aim of fiscal policy in the long-run stabilisation of the economy, yet it can be achieved by moderating short-run economic fluctuations. In this context, Otto Eckstein defines fiscal policy as "changes in taxes and expenditures which aim at short-run goals of full employment and price-level stability."

5.5.2 Objectives of Fiscal Policy

In developing countries, taxation, Government expenditure and borrowing have to play a very important role in accelerating economic development. In fact, fiscal policy is a powerful instru-ment in the hands of the Government by means of which it can achieve the objectives of develop-ment.

There are several peculiar characteristics of a developing country which necessitate the adop-tion of a special fiscal policy which ensures a rapid economic growth. There are vast and diverse resources, human and material, which are lying underutilised.

Such countries have weak infra-structure, i.e, they lack adequate means of transport and communications, roads, ports, highways, irrigation and power. They also lack

technical know-how. Their population is increasing at an explosive rate which necessitates rapid economic development to meet the requirements of the rapidly growing population. Above all, these countries suffer from deficiency of capital. They are caught up in a vicious circle of poverty. In order to overcome these handicaps, a suitable fiscal and taxation policy is called for.

The principal objectives of fiscal policy in a developing economy are:

1. To mobilise resources for economic growth, especially for the public sector;
2. To promote economic growth in the private sector by providing incentives to save and invest;
3. To restrain inflationary forces in the economy in order to ensure price stability; and
4. To ensure equitable distribution of income and wealth so that fruits of economic growth are fairly distributed.

5.5.3 Fiscal Policy for Economic Growth

The role of fiscal policy for economic growth relates to the stabilisation of the rate of growth of an advanced country. Fiscal policy through variations in government expenditure and taxation profoundly affects national income, employment, output and prices. An increase in public expenditure during depression adds to the aggregate demand for goods and services and leads to a large increase in income via the multiplier process; while a reduction in taxes has the effect of raising disposable income thereby increasing consumption and investment expenditure of the people.

On the other hand, a reduction of public expenditure during inflation reduces aggregate demand, national income, employment, output and prices; while an increase in taxes tends to reduce disposable income and thereby reduces consumption and investment expenditures. Thus the government can control deflationary and inflationary pressures in the economy by a judicious combination of expenditure and taxation programmes. For this, the government follows compensatory fiscal policy.

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 stabilise the economy at the full employment level.

The compensatory fiscal policy has two approaches:

(1) Built-in stabilisers; and

(2) Discretionary fiscal policy.

(1) Built-in Stabilisers:

The technique of built-in flexibility or stabilisers 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 also known as one of automatic stabilisation.

The various automatic stabilisers are corporate profits tax, income tax, excise taxes, old age, survivors and unemployment insurance and unemployment relief payments. As instruments of automatic stabilisation, 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.

It's Merits:

Built-in stabilisers have certain advantages as a fiscal device:

1. The built-in stabilisers 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 stabilisers minimise the errors of wrong forecasting and timing of fiscal measures.
5. They integrate short-run and long-run fiscal policies.

Limitations:

1. The effectiveness of built-in stabilisers 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 stabilisers in controlling inflationary and deflationary tendencies. But the elasticity of tax receipts is not so high as to act as an automatic stabiliser 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 stabiliser doing a downswing.
3. The built-in stabilisers do not consider the secondary effects of stabilisers 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 unfavourable. Economists, therefore, suggest that built-in stabilisers should be supplemented by discretionary fiscal policy.

(2) 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. But 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 businessmen with little incentive to invest, tax reductions are temporary. This policy will again be less effective. So 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.

It's Limitations:

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 after 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.

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 stabilisers, as has been' the experience of developed countries like the USA.

5.5.4 Budgetary Policy—Contra-cyclical Fiscal Policy

The budget is the principal instrument of fiscal policy. Budgetary policy exercises control over size and relationship of government receipts and expenditures. We discuss below the common budgetary policies that can be adopted for stabilising the economy.

(1) Budget Deficit—Fiscal Policy during Depression:

Deficit budgeting is an important method of overcoming depression. When government expenditures exceed receipts, larger amounts are put into the stream of national income than they are withdrawn. The deficit represents the net expenditure of the government which increases national income by the multiplier times the increase in net expenditure. If the MPC is 2/3, the multiplier will be 3; and if the net increase in government expenditure is Rs.-100 crores it will increase national income to Rs. 300 crores (= 100 x 3).

Thus the budget deficit has an expansionary effect on aggregate demand whether the fiscal process leaves marginal propensities unchanged or whether a redistribution of disposable receipts occurs. The E expansionary effect of a budget deficit is shown diagrammatically in Figure 1. C is the consumption function. C + I+G represent

consumption, investment and government expenditure (the total spending function) before the budget is introduced. Suppose government expenditure of ΔG is injected into the economy.

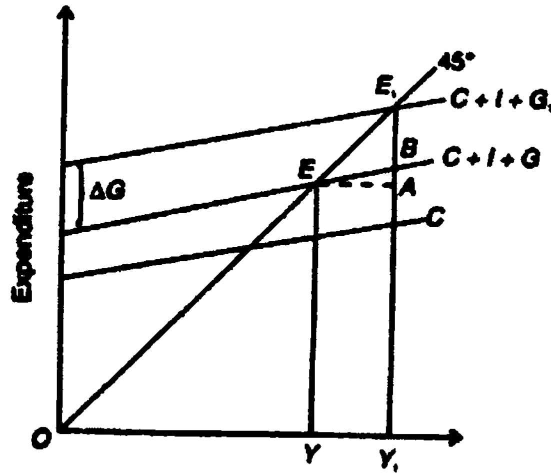


FIG. 1

As a result, the total spending function shifts upward to C +1 + G_1. Income increases OY from OF to OF, when the equilibrium position moves Income from E_1 to E_1 .The increase in income YY_1 (= EA = MiE_1A) is greater than the increase in government expenditure E_1B (=ΔG). BA (E_1A – E_1B) represents increase in consumption. Thus the budget deficit is always expansionary, the rise in national income being (YY_1) greater than the actual amount of government spending (ΔG = E_1B). In this method of budget deficit, taxes are kept intact.

Budget deficit may also be secured by reduction in taxes and without government spending. Reduction in taxes tends to leave larger disposable income in the hands of the people and thus stimulates increase in consumption expenditure. This, in turn, would lead to increase in aggregate demand output, income and employment. This is illustrated in Figure 2, where C is the original consumption function. Suppose tax is reduced by ET, it will shift the consumption function upward to C_1. Income will increase from OY to OY_1.

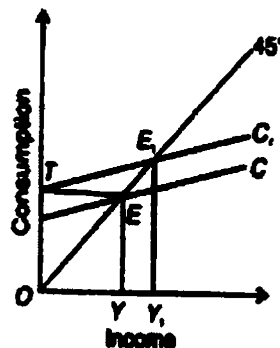


FIG. 2

However, reduction in taxes is not so expansionary via increased consumption expenditure because the tax relief may be saved and not spent on consumption. Businessmen may not also invest more if the business expectations are low. Therefore, to safeguard against such eventualities the government should follow the policy of reduction in taxes with increased government spending and its multiplier effect will be much higher in case we also assume that some consumption and investment expenditures increase due to tax relief.

(2) Surplus Budget—Fiscal Policy during Boom:

Surplus in the budget occurs when the government revenues exceed expenditures. The policy of surplus budget is followed to control inflationary pressures within the economy. It may be through increase in taxation or reduction in government expenditure or both. This will tend to reduce income and aggregate demand by the multiplier times the reduction in government or/and private consumption expenditure (as a result of increased taxes).

This is explained with the aid of Figure 1, where the economy is at the initial equilibrium position E_1. Suppose the government expenditure is reduced by $-\Delta G$ so that the total spending function C + I + G shifts downward to C + I + G. Now E is the new equilibrium position which shows that the income has declined to OY from OY_1 as a result of reduction in government expenditure by E_1B. The fall in income $Y_1 Y_1$(= AE) > $E_1 B$ the reduction in expenditure because consumption has also been reduced by BA.

There may be budget surplus without government spending when taxes are raised. Enhanced taxes reduce the disposable income with the people and encourage reduction in consumption expenditure. The result is fall in aggregate demand, output income and employment. This is illustrated in Figure 3. C is the consumption function before the imposition of the tax. Suppose a tax equal to ET is introduced. The consumption function shifts downward to C_1. The new equilibrium position is E_1. As a result, income falls from OY to OY_1.

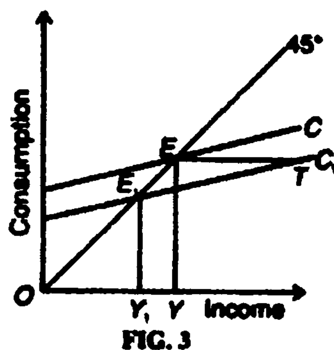


FIG. 3

(3) Balanced Budget:

Another expansionist fiscal policy is the balanced budget. In this policy the increase in taxes ($\triangle T$) and in government expenditure ($\triangle G$) are of an equal amount. This has the impact of increasing net national income. This is because the reduction in consumption resulting from the tax is not equal to the government expenditure.

The basis for the expansionary effect of this kind of balanced budget is that a tax merely tends to reduce the level of disposable income. Therefore, when only a portion of an economy's disposable income is used for consumption purposes, the economy's consumption expenditure will not fall by the full amount of the tax. On the other hand, government expenditure increases by the full amount of the tax. Thus the government expenditure rises more than the fall in consumption expenditure due to the tax and there is net increase in national income.

The balanced budget theorem is based on the combined operation of the tax multiplier and the government-expenditure multiplier. In this, the tax multiplier is smaller than the government-expenditure multiplier. The government-expenditure multiplier is

$$\text{Or } \triangle Y = 1/1\text{-}c \ \triangle G$$

$$\triangle Y/\triangle G = 1/1\text{-}c$$

Which indicates that the change in income ($\triangle Y$) will equal the multiplier ($1/1-c$) times the change in autonomous government expenditure?

The tax multiplier is

$$\triangle Y = -c\triangle \ \ T/1\text{-}c$$

$$\triangle Y/\triangle T = \text{-}c/1\text{-}c$$

Which shows that the change in income ($\triangle Y$) will equal multiplier ($1/1-c$) times the product of the marginal propensity to consume (c) and the change in taxes ($\triangle T$).

A simultaneous change in public expenditure and taxes may be expressed as a combination of equations (1) and (2). Thus the balanced budget multiplier

$$k_b = \triangle Y/\triangle G + \triangle Y/\triangle T = 1/1\text{-}c + \text{-}c/1\text{-}c = 1\text{-}c/1\text{-}c = 1 \text{ or } k_b = 1$$

Since $\triangle G = \triangle T$, income will change by an amount equal to the change in government expenditure and taxes.

2

To understand it, it is explained numerically. Suppose the value of c- 2/3 and the increase in government expenditure ΔG = Rs 10 crores. Since $\Delta G = \Delta T$, therefore the increase in taxes (lumpsum) ΔT = Rs. 10 crores.

We first calculate the government-expenditure multiplier,

$$k_g = \Delta Y/\Delta G = 1/1\text{-}c = 1/1\text{-}2/3 = 3$$

The tax multiplier is $k_T = \Delta Y/\Delta T = -c/1\text{-}c = -2/3/1\text{-}2/3 = -2$

To arrive at the increase in income as a result of the combined operation of the government expenditure multiplier and the tax multiplier, we write the balanced budget multiplier equation as

$$k_b = \Delta Y = 1/1\text{-}c\ \Delta G + c/1\text{-}c\ \Delta T$$

and fit in the above values of c, ΔG and ΔT so that

$$k_b = \Delta Y = 3\ \Delta G - 2\ \Delta T$$

$$= 3 \times 10 - 2 \times 10 = \text{Rs. } 10 \text{ crores}$$

Thus the increase in income (ΔY) exactly equals the increase in government expenditure (ΔG) and the lumpsum tax (ΔT) i.e., Rs. 10 crores. Hence k_b= 1.

This balanced budget multiplier or unit multiplier is explained with the help of Figure 4. C is the consumption function before the imposition of the tax with income at OY_0 level. Tax of AG amount is imposed. As a result, the consumption function shifts downward to C_1.Now g government expenditure of GE amount is injected into the è ø economy which is equal to the tax yield AG.

The new government expenditure line is C_1+ G which determines OY income at point E. The increase in income Y_0Y equals the tax yield A G and the increase in government expenditure GE. This C proves that income has risen by 1 (one) times the amount of increase in government expenditure which is a balanced budget expansion.

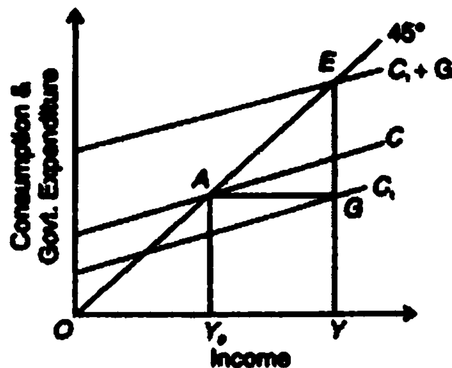


FIG. 4

5.6 ROLE OF FISCAL POLICY FOR MOBILIZATION OF RESOURCES IN DEVELOPING COUNTRIES

In developing economies, the Government has to play a very active role in promoting eco-nomic development and fiscal policy is the instrument that the state must use. Hence the great importance of public finance in underdeveloped countries desirous of rapid economic develop-ment. In a democratic society, there is an inherent dislike for direct (physical) controls and regula-tion by the state. The entrepreneurs would not like to be ordered about to produce this or that, how much to produce or where to produce.

Fiscal incentives in the form of tax concessions, rebates or subsidies are, therefore, preferable. Similarly, the consumers would not like to be told directly to curtail their consumption or to consume this and not to consume that. Taxation of articles whose consumption is to be discouraged is therefore preferable.

Hence, a democratic state must rely on indirect methods of control and regulation and this is done through fiscal and monetary policies. Thus, in democratic countries, fiscal policy is a powerful and least undesirable weapon on which the states can rely for promoting economic development. Capital formation is of strategic importance in the matter of rapid economic development and the developing economies suffer from capital deficiency. It is, therefore, necessary to achieve a higher ratio of savings to national income.

In early days of capitalism, payment of low wages and the existence of inequalities of income helped capital formation in the present-day developed countries. But no democratic country can adopt this method in modern times; the effort rather is to raise wages and reduce inequalities of income and wealth.

Under a regime of socialist dictatorship, capital for-mation is brought about by ruthlessly curtailing consumption and keeping down the standards of living. But in modern democracies with every adult person having a right to cast vote very low levels of living for a long time is not feasible.

Hence the state must rely on instruments of fiscal policy to mobilise resources for economic development. Taxation can be used to raise collective savings for public investment and also at the same time to promote private investment.

A well-conceived scheme of taxation is an important way of raising ratio of savings to national income which is one of the crucial determinants of the rate of economic growth. As Nurkse says, "public finance assumes a new significance in the face of the problem of capital formation in underdeveloped countries."

On the expenditure side, there is positive need for public investment, especially in those branches of economic activity where the private investments are not easily attracted, for example, the devel-opment of infrastructure such as power resources, means of transport and communications, basic heavy industries, education and research. Such investments are very often the very foundations of rapid economic advance. Thus, fiscal policy is of crucial importance in accelerating the pace of development in developing countries.

We explain below in detail how fiscal policy measures can be used to achieve the objectives of economic growth, more equal distribution of income and price stability in the developing countries.

Promoting Private Saving:

Capital formation is an important determinant of economic growth. For accelerating the rate of capital formation, savings and investment rate in the economy has to be stepped up. For this purpose savings have to be mobilised and channelled into productive invest-ment.

The alternative means other than fiscal policy available to promote savings and investment in the developing countries are not very effective in mobilising enough resources for investment and capital formation. The propensity to consume is very high in these countries.

There exist large in-equalities of income in these countries and this should ensure a large voluntary savings by the richer sections of the society. But the richer sections in them indulge in conspicuous consumption such as building of luxury houses, indulging in five star cultures, buying air-conditioners and such other things and, therefore, the volume of their voluntary savings is meagre.

This propensity to indulge in conspicuous consumption is reinforced by demonstration effect which is operating strongly these days due to the development of electronic media and superior means of advertisement.

Further, rich people tend to invest their rising incomes on unproductive investment such as gold and jewellery, real estate etc., which yield high profits due to their appreciation. In view of these, sufficient volun-tary savings cannot be made available for raising significantly the rate of capital formation.

The alternative to taxation and Government borrowing to finance capital formation is to obtain forced savings through creation of excessive creation of new money, often called money financing (i.e. monetisation of budget deficit) and resultant price inflation.

But this is not a desirable, equitable and efficient way of obtaining the needed funds for development.

First, the inflation tends to direct private investment into unproductive types of investment such as inventory holdings, purchase of real estates, gold and jewellery etc.

Secondly, inflation raises the cost of public sector investment projects which lowers the rate of real investment.

Thirdly, inflation reduces the volun-tary savings of the people. This is because inflation reduces the real value of money which ad-versely affects willingness to save money.

Fourthly, since inflation raises the incomes of the indus-trialists and traders on the one hand and reduces the real incomes of the general public on the other, it increases disparities of income in a society which runs counter to the objective of social justice.

Therefore, most economists do not favour financing development through forced savings gener-ated by deliberate inflation caused by excessive deficit financing. Due to the severe limitations of alternative ways of mobilising resources for capital formation, the role of fiscal policy in performing this task assumes greater importance. Fiscal policy, if prop-erly designed, is an efficient and equitable way of mobilising resources for augmenting public investment.

Through it not only collective public savings can be raised for financing public investment but also at the same time private savings and investment can be encouraged. "In fact" taxa-tion is one of the effective means of increasing the total volume of savings and investments in an economy where the propensity to consume is normally high.

Further, the fiscal policy can be so devised that not only the objective of rapid capital accumulation or growth, but also other objec-tives of economic policy such as equitable distribution of income and wealth, price stability and promotion of employment opportunities can be achieved. In what follows we shall explain how the various instruments of fiscal policy such as taxation and Government borrowing can be used to mobilise resources for economic development.

5.7 FUNCTIONS GOVERNING THE DEVOLUTION OF FISCAL POWERS UNDER A FEDERAL STRUCTURE

The theory and practice of the devolution of powers and function among the different tiers of government involved in the fiscal operation is what is called as 'fiscal federalism'.

In other words, fiscal federalism provides a framework for the devolution of function between the national and the sub-national government along with a framework for sharing the revenue collected among the different tiers of government.

Allocation Function:

The task of ensuring the welfare of its people requires a government to devise a system by which the allocation of public goods and services are efficiently made. An important question in this context is-which tier of government should provide which type of services.

A widely followed principle, in this respect, is that of 'benefit incidence'. Benefit incidence is a method of computing the distribution of public expenditure across different demographic group, such as women and men.

The procedure involves allocating per unit public subsidies (for example, expenditure per student for the education sector) according to the individual utilisation rate of public services. Further, according to the benefit incidence principle if there is a function whose benefit is nation-wide, such a function is to be entrusted to the national government, while if the benefit of a function is regional or sub- regional in character such a function should be entrusted to the State or local governments.

Thus, services like defence, scientific exploration, etc. whose benefit incidence reaches the whole nation, should be provided by the Central government. On the other hand, public goods like law and order, supply of water, electricity, sanitation, etc. state and local level governments.

Distribution Function:

Distribution of services, and therefore the resources to be raised by levying taxes for providing the services to the people, is another important fiscal function. The function of distribution is assigned to the Central government. If this function is to be carried out by the sub-central governments, it may lead to distortions in the mobility of labour leading to increase in inequality.

The distribution process by the State and local level governments becoming a failure is that these tiers may choose to implement the distribution process for reasons of politico-administrative factors. However, this does not mean that the sub-Central governments cannot altogether render the distribution function.

It also does not mean that the Central government is always more capable and effective in discharging the distribution function. It only means that the Central government may have a greater reach and act in the national interest than the sub-Central government in many cases.

Stabilisation Function:

The process of aiding macro-economic adjustment is known as 'stabilisation'. Stabilisation function cannot, however, be entirely entrusted to sub-central government as they do not have adequate instruments to deal with such macro-economic issues without giving scope for economic distortion. Moreover, in most of the federations, it is the exclusive prerogative of the Central governments to deal with the 'external sector'.

In view of this, in almost all the federations the Central government performs the function of stabilisation by using the tools of monetary and fiscal policies. Thus, while the Central government has an absolute advantage in rendering the redistribution and stabilisation functions, lower layers of government can render the function of delivery of goods and services more effectively.

In the light of these, while functional responsibilities have been distributed between different layers of government on the basis of the principle of benefit incidence, functions like defence, space, exploration, navigation railways etc. have been entrusted to the central government. Functions like law and order, water supply, education, health, sanitation, agriculture, etc. are entrusted to the lower tiers of governments.

Once the functional division takes place, each tier of government needs financial resources to discharge their respective functions. So what is equally important is the distribution of revenue or tax powers.

5.8 FISCAL IMBALANCES: DIFFERENT TYPES OF OF FISCAL IMBALANCES

Fiscal imbalance is a mismatch in the revenue powers and expenditure responsibilities of a government. When the revenue powers are divided between two or more tiers of government in a federation, in general, the Central government is entrusted with more financial resources. This is because due to its functional responsibilities like defence, space research, etc. there is always a greater demand for its expenditure requirement vis-a-vis its revenue resources.

This is to say some of its functions are required to be discharged more in the national interest than the interest of a regional dimension, which warrants greater revenue powers for it.

Thus, the fiscal imbalance among the states would arise because of inadequate revenue resources in comparison to their respective expenditure commitments. Such non-correspondence between the revenue resources and expenditure requirements among the states in a federation is known as fiscal imbalance.

In the literature on fiscal federalism, two types of fiscal imbalances are measured:

Vertical Fiscal Imbalance:

Non-correspondence between revenue and expenditure commitments of the central governments vis-a-vis the non-correspondence between revenue and expenditure commitments of the federating units put together is known as Vertical Fiscal Imbalance. It is natural that the federal governments of any country have vertical fiscal imbalance irrespective of their development status.

Horizontal Fiscal Imbalance:

Non-correspondence between revenue and expenditure commitments across state governments in a federation is known as Horizontal Fiscal Imbalance. This type of fiscal imbalances arises due to the differences in the endowment of natural resources, given the uniform revenue powers and expenditure responsibilities. Thus, horizontal fiscal imbalance also exists in federations across the countries irrespective of their state of development.

5.9 DIFFERENT METHODS USED FOR FISCAL ADJUSTMENTS!

In order to reduce the fiscal imbalance of both vertical and horizontal types, fiscal adjustment is made through fiscal transfers, from the Central government to State and local governments. Fiscal transfers are also used as instruments to reduce regional inequalities of income and wealth in the federation.

The important types of fiscal transfers or methods of fiscal adjustment are briefly explained below:

Divisible Pool Method:

As per this method, either a fixed percentage of net revenue from all the taxes or identified select taxes are pooled for the purpose of distribution across the federating states on the basis of a criterion. In view of this, this method of fiscal transfer is also known as distributive pool or shared tax revenue method.

Certain issues like:

(i) Which taxes are to be shared,

(ii) What percentage of each of the pooled taxes should be shared, and

(iii) How to distribute the pooled revenue across the competing states, etc. are decided separately.

There is a uniform practice in all the countries with regard to these issues. In some countries these are mentioned either in the Constitution of the country, while in others, these are decided by independent agencies.

If the shareable taxes, the percentage of shares and the criteria for inter se distribution are written in the Constitution, it leads to fiscal rigidity. So, in several federations, including India, these are decided by an independent agency. The agency in India, which discharges this function, is known as the Finance Commission.

The most important advantages of the divisible pool method are the following:

i. It keeps the supremacy of the Central Government while upholding the fiscal autonomy of the States;

ii. Simple to administer, it enables the distribution of the financial resources equitably and efficiently among the States; and

iii. It expands the resources of the States as the revenues from the sharable taxes expand.

However, logical and rational distribution of the percentage of shareable taxes and the criteria of distribution are often difficult to arrive at. Any arbitrariness will lessen the importance of this fiscal device.

Supplementary Levies:

This is a levy imposed by a tier of government over and above the basic rate of the same tier or that of the other tier. The financial resources thus mobilised will be used either for a specific or general purpose of the state. This device is also simple, administratively efficient and carries all the advantage of the divisible pool method.

Federal Grants:

An important fiscal adjustment method is the grant-in-aid. As these are mostly provided by the federal government to the states to reduce both the vertical and horizontal fiscal imbalances, these are also known as 'federal grants'.

Federal grants are broadly categories as (i) conditional grants and (ii) unconditional grants. Conditional grants are further divided into conditional matching grants and conditional non-matching grants.

i. Conditional Grants:

If the 'grantor' insists on any conditions while providing the grant to the 'grantee', either with reference to its eligibility or in it use, the grant is known as a-'conditional grant'. For instance, the granter could insist upon the grantee to contribute a lump sum or a fixed percentage of the total grant amount. Such a grant is known as conditional matching grant. If the grant is made with conditions for its use but without any contribution, it is known as conditional non-matching grant.

ii. Unconditional Grants:

If the grantor provides grants to the grantee without stipulating any conditions, either with reference to its eligibility or its use, the grant is known as unconditional grant. These are also known as general purpose grants. These grants are as good as revenue from and -non-tax source to the States.

In almost all federations, fiscal transfers from the Central government to the State or local governments are made in the form of shared tax revenue or grants or both. In India also, powers of revenue collection and functions have been distributed between the Center and the States right from the adoption of the Constitution.

Fiscal adjustments have been made in the form of shared tax revenue, and grants and loans have been transferred from the Centre to States and Union Territories. The two agencies responsible for fiscal transfers from Center to States are the Union Finance Commission and the Planning Commission.

5.10 MAIN ASPECTS OF FISCAL FEDERALISM IN INDIA

The five main aspects of fiscals federalism are as follows:

(1) Division of Functions:

The fiscal powers and functional responsibilities in India have been divided between the Central and State government following the principles of federal finance. The division of functions is specified in the Seventh Schedule of the Constitution in three lists vis. the Union List, the State List and the Concurrent List.

The Union List contains 97 subjects of national importance, such as defence, railways, national highways, navigation, atomic energy, and posts and telegraphs. 66 items of State and local interest, such as law and order, public health, agriculture, irrigation, power, rural and community development, etc. have been entrusted to the State governments.

47 items such as industrial and commercial monopolies, economic and social planning, labour welfare and justice, etc. have been enumerated in the Concurrent List. The concurrent list is one in which both state and the centre can make legislations. However, in case of a conflict or tie, federal laws prevail.

(2) Revenue Powers of the Center:

The Central government has been given powers in respect of taxes on income other than agricultural income, customs duties, and. excise duties on tobacco and other goods manufactured or produced in India, corporation, tax, taxes on capital values, estate duty in respect of property other than agricultural land, terminal taxes on goods or railway passengers carried by railway, sea or air, taxes other than stamp duties on transactions in stock exchanges and futures, markets, stamps duty in respect of land, etc.; taxes on sale or purchase of news papers and on advertisements published therein; and sale, purchase and consignment of goods involving inter-State trade or commerce. In fact, the Central government does not get revenue from all the above taxes.

These revenues can be divided into four categories on the basis of levy, administration and the accrual of revenue as follows:

(a) Taxes that are levied collected and retained by the Central government: e.g. Corporation Tax, Customs Duties;

(b) Taxes that are levied and collected by the Centre but shared with the states: e.g. the net proceeds from Union Excise Duties under Article 270 and the net proceeds from Union Excise Duties under Article 272, respectively;

(c) Taxes that are levied and collected by the centre but whose net proceeds are assigned to the states: e.g. all the eight items under Article 269 of the constitution such as Estate duty. Taxes on Railway Passenger Fares and Freights and Consignment Tax, etc.; and

(c) Tax levied by the Centre but allocated and appropriated by states, such as exercise duties on medicinal and toilet preparations, etc.

(3) Revenue Powers of the State:

The State governments have been given exclusive tax powers in respect of land revenue; taxes on agricultural income; duties in respect of succession to agricultural land; estate duty in respect of agricultural land; taxes on land and buildings; excise duties on goods containing alcoholic liquors for human consumption; opium, Indian hemp

and other narcotic drugs; taxes on the entry of goods into local areas; taxes on the sale or purchase of goods other than newspapers; taxes on vehicles, tolls; taxes on professions, trades, callings and employment; capitation taxes, taxes on luxuries including taxes on entertainment, amusements, betting and gambling.

(4) Division of Borrowing Powers:

The borrowing powers have also been clearly mentioned in the Constitution. Under Article 292, the central government is empowered to borrow funds from within and outside the country as per the limits imposed by the Parliament. According to Article 293(3), the States can borrow funds within the Country. Article 293(2) empowers the Centre to provide loans to State subject to conditions laid down by Parliament.

(5) Fiscal Imbalances in India:

The Constitutional fiscal arrangement shows that fiscal imbalances were deemed inevitable as most of the powers for elastic taxes are given to the Central government. Further, the division of powers and functions itself leads to vertical federal fiscal imbalance while the differences in the endowment position of natural resources across States cause horizontal federal fiscal imbalance.

Visualising the fiscal imbalances, the Constitutional makers provided a mechanism of fiscal adjustment by way of fiscal transfers from the Central to the State Governments. This provision in the Constitution was made under Article 280 by way of setting up of a Finance Commission for every five years or earlier, if the President of India feels it necessary.

QUESTIONS :

1. Discuss the evolution of budgeting system in India.
2. Explain the principles of budgeting.
3. What are the kinds of budget?
4. What is zero based budgeting? Explain its process.
5. What are the advantages and disadvantages of zero based budgeting?
6. What is budget deficit? Explain its types.
7. What are the objectives of deficit financing?
8. Explain the provisions of Fiscal Responsibility and Budget Management Act.
9. What are the principal objectives of fiscal policy in a developing economy?
10. Explain the role of fiscal policy for mobilization of resources in developing countries.
11. Explain the main aspects of fiscals federalism in India.

PUBLIC FINANCE AND IT LAW

HC6B

VI Semester B.B.A.LL.B.

Model Question Paper

Time: 3 Hours Maximum Marks – 100 Marks

PART – A (2 X 12 = 24 marks)

Answer TWO of the following in about each

1) Explain the features of GST in India.

2) Comment on the limitations of the functioning of the Finance Commission. What suggestions have been made by the Sarkaria Commission for improving the functioning of the Finance Commission?

3) Explain the Constitutional Provisions of Federal Finance.

PART – B (2 X 7 = 14 marks)

Answer TWO of the following in about 100 words each

4) Explain the provisions of Fiscal Responsibility and Budget Management Act.

5) Explain the objectives and characteristics of tax?

6) What is budget deficit? Explain its types.

PART – C (5 X 4 = 20 marks)

Answer FIVE of the following

7)

a) State the broad functions of the Planning Commission.

b) What are the taxes collected by state government?

c) Distinguish between public finance and private finance.

d) Explain the theories of tax shifting and incidence.

e) What are the major sources of devolution of resources from the union to the states?

f) Describe the functions of the Finance Commission.

g) Point out the areas of conflict in federal finance between the centre and states.

PART – D (6 X 2 = 12 marks)

Answer SIX of the following

8)

a) What are the sources of Public Revenue?

b) What are the functions of the National Development Council?

c) What are the objectives of deficit financing?

d) What are the methods of repayment of public debt?

e) What is 80th Amendment of Constitutional Act?

f) What is Resource Mobilization?

g) Explain Wagners Law.

h) What is VAT?

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