M.A. [Economics]
II - Semester
362 23

FISCAL ECONOMICS
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Units (1-6, 7.2.1, 8, 9.2-9.2.1, 10, 11.3, 12, 14.2-14.4)

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INTRODUCTION

Public finance studies the role of the government in the economy. It is the definitive branch of Economics which assesses the Government revenue and Government expenditure of the Public Authorities and the adjustment of one or the other to achieve desirable effects and avoid undesirable ones. Public Finance is a subject which has the distinction of intimate interaction between theory and practice. As such it acquires a meaning and usefulness only in the context of institutional framework of the economy with reference to which it is being studied. The theoretical concepts and policy applications in public finance feed upon and grow out of each other. No single theoretical model can adequately fit in the framework of every economy since its institutional framework is a thing unique to itself. It is important, therefore, that the discussion of public finance should be in the context of a single economy. A very crucial part of public economics comprises of fiscal economics, which studies the manner in which the government receipts and expenditure affects the economy and its performance. It also discusses concepts related to polity and laws which have a bearing on economics. As a field, the fiscal economics deals with several important issues including the theories of public finance, expenditure and revenues sources, the system of taxation, the types of taxation, the principles and practice of fiscal federalism its affect on the economy.

This book, Fiscal Economics, is written with the distance learning student in mind. It is presented in a user-friendly format using a clear, lucid language. Each unit contains an Introduction and a list of Objectives to prepare the student for what to expect in the text. At the end of each unit are a Summary and a list of Key Words, to aid in recollection of concepts learnt. All units contain Self-Assessment Questions and Exercises, and strategically placed Check Your Progress questions so the student can keep track of what has been discussed.
INTRODUCTION TO FISCAL ECONOMICS

UNIT 1 PUBLIC FINANCE

Structure
1.0 Introduction
1.1 Objectives
1.2 Public Finance and Its Meaning
1.2.1 Nature of Public Finance
1.3 Scope and Uses of Public Finance
1.4 Answers to Check Your Progress Questions
1.5 Summary
1.6 Key Words
1.7 Self Assessment Questions and Exercises
1.8 Further Readings

1.0 INTRODUCTION

The study of government’s role in the economy is known as public finance. As an important branch of economics, it assesses the government revenue and government expenditure of the public authorities which could impact the economy of a country. The revenue collection and public expenditure are the two main components of the public/State finance. The collection of revenue by a State comes in the form of taxes, fees, special assessments, fines and duties. On specific occasions, State supplements its budgetary deficit by external borrowing in the form of loans. The expenditure incurred by a State on the developmental and non-developmental activities is known as public expenditure. Besides spending on various social, economic and developmental activities like education, health, etc. the State also mobilizes finance for its administrative expenses. Hence public finance plays a key role in a modern State for the well-being of the people. It is for this reason that concept of public finance is said to be as old as the State. A sound government must have a sound finance. The more efficient the administration, the more sound would be the financial management.

This unit aims at analysing the meaning, scope and uses of public finance.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning of public finance
- Enumerate the nature of public finance
1.2 PUBLIC FINANCE AND ITS MEANING

The main difference between public and private goods as well as the concept of the public sector leads us to explore the vast field of public finance. Public finance is clearly related to the financing of State activities, and can be defined as a subject that discusses the financial operations of the public treasury of a nation. Earlier, writers on the subject defined public finance in a much narrower context than the writers of today. Public finance helps us study the financial aspects of the government. It helps us study the government policy, especially the expenditure and tax policy, which impacts the economy and the welfare of the country’s citizens.

1.2.1 Nature of Public Finance

To understand the meaning of public finance, it is important to understand the meaning of the words ‘public’ and ‘finance’. The word ‘public’ stands for a collection of individuals, whereas the word ‘finance’ means money resources or revenues. Therefore, ‘public finance’ means the resources of a public body.

Areas of the subject of public finance have undergone repeated revisions in line with developments in State activities and corresponding economic philosophy. Accordingly, over the years, the definition of public finance has expanded to cover ever-widening areas. In the early days of capitalism, it was widely believed that the private sector was always more efficient than the public sector. It, therefore, provided a theoretical basis for laissez faire (doctrine of individualism). By implication, almost all economic decisions were to be guided by the market forces of demand and supply. The role of the government was not to interfere with the working of market forces but to limit its own activities to the bare minimum, including the following:

- Protecting the society against internal disruption, and ensuring that effective law and order situation prevailed. For this, the State was to maintain itself and create the needed administrative, judicial and police set-ups.
- Protecting the society against any foreign aggression that might take place. The State was to maintain armed forces to meet this objective.
- Stepping forth and assuming the responsibility of creating and maintaining social overheads, where the private sector found itself unable to create and run social overheads or infrastructural facilities for reasons of their commercial non-viability but was otherwise essential for efficient working of the economy. The argument for stepping in of the State was not that the public sector was more efficient than the private sector. The basic argument was that in the absence of the public sector, essential social
overheads would not come into existence. In their case, the social marginal overheads usually exceed their social marginal cost. It, therefore, pays for the society to expand social overheads. Their private marginal benefit, however, is much less compared to the private marginal cost. As a result, the private sector is not ready to develop them. Accordingly, the State is expected to finance social overheads out of public funds and run them, if need be, at a commercial loss.

It must be noted that the State, according to the laissez-faire philosophy, was considered as something extraneous to the economy, which was more or less equated with its private sector only. It was, therefore, considered best that the public sector should help and supplement the private sector but never replace it. It was not thought desirable to have a planned economy even for tackling the problems of capital formation and economic growth.

Since activities of the State were to be tolerated only as a necessary evil and were to be reduced to the minimum possible scale, the real question was not to decide the basic allocation of economic activities between public and private sectors and to deal with the associated financial and allied problems, but rather to analyse the way the treasury should operate. With this philosophy in the background, the theory of public finance was obviously assigned a limited field. It was mainly considered a description of the way in which operations of the treasury interfere with the working of the private sector of the economy and the way in which it could keep such interference to the minimum.

Similarly, Carl C. Plehn, author of Introduction to Public Finance, says that the term public finance 'has come, by accepted usage, to be confined to a study of funds raised by governments to meet the costs of government.'

**Check Your Progress**

1. What do you mean by public finance?
2. Why has the nature of public finance undergone a notable transformation?

### 1.3 SCOPE AND USES OF PUBLIC FINANCE

The scope of public finance involves a complete discussion of the influence of fiscal operations of the government at the level of overall activity, employment, prices and the growth process of the economic system as a whole.

Economist Philip E Taylor says, 'Public finance deals with the finance of the public as an organized group under the institution of the government. It thus deals only with the finances of the government. The finances of the government include the raising and disbursement of government funds. Public finance is concerned with the operation of the fisc, or public treasury. Hence, to the degree that it is a science, it is the fiscal science; its policies are fiscal policies, its problems are fiscal problems.'
These days, the need of interaction and interdependence between state and private sectors is duly recognized and therefore, in a modern economy, the public sector is assigned a significant role, both in theory and in practice. This has meant a corresponding widening of the scope of public finance which includes the following:

(a) Measures for social security
(b) Checking trade cycles
(c) Reducing unemployment
(d) Bringing about distributive justice
(e) Helping capital accumulation and economic growth
(f) Removing regional disparities

Many governments also resort to formal planning and an extensive use of the public sector. Therefore, in line with this new approach we come across much wider definitions of public finance. Richard Abel Musgrave, author of The Theory of Public Finance, for example, says, ‘The complex of problems that centre around the revenue expenditure process of government is referred to traditionally as Public finance ... While operations of the public household involve money flows of receipt and expenditure, the basic problems are not issues of finance (emphasis supplied) ... we must think of our task as an investigation ... into those aspects of economic policy that arise in the operation of the public budget.’

Thus, the subject matter of public finance is logically, though not solely, concerned with the financial aspects of the business of government. Similarly, American economist, James M. Buchanan says, ‘The government, considered as a unit, may be defined as the subject of the study of public finance. More specifically, public finance studies the economic activity of government as a unit.’

The subject matter of public finance, thus deals with not only the way in which public treasury operates, it also deals with the repercussions of alternative policies which the treasury might adopt and accordingly deals with the question of choice of these policies and operations. Musgrave has advocated an approach in which the state sector is viewed as a public household. Such a public household has certain objectives which can be grouped into categories of:

(i) Allocation of resources
(ii) Adjustments in the distribution of income and wealth
(iii) Stabilization of prices and employment

These refer to the three objectives of budget policy, namely, the use of physical instruments:

(a) To secure adjustments in the allocation of resources
(b) To secure adjustments in the distribution of income and wealth
(c) To secure economic stabilization
We may add that the objectives covering capital formation, economic growth and the like should also be there. In any case, a detailed study of public finance brings in various aspects connected with the formulation and execution of budgetary policies such as the effects of taxation. Relevant conclusions in the theory of public finance can be drawn by bringing in the detailed discussion of not only the way in which public household should itself operate (such as in the field of public sector undertakings) but also the way in which private sector would react to alternative fiscal measures. Such fiscal measures would include, for example, those of taxation, expenditure and public debt. Accordingly, it may be emphasized that Musgrave’s approach, though very useful in focussing our attention upon basic objectives of the public household and normative aspects of its working, cannot help us much unless we are equipped with detailed knowledge of the various components of fiscal policy and operations and unless our analysis takes into account the relevant institutional factors.

Since a modern government often operates at several levels (federal, state and local), the subject matter of public finance looks into the financial problems and policies of the government at different levels and also studies the inter-governmental financial relations.

The subject matter of public finance admits to alternative subgrouping with unavoidable areas of overlapping and interdependence. Moreover, each group or sub-group admits further details. It should also be kept in mind that the socioeconomic dynamism of a typical modern economy, supplemented with exponential growth of the financial system and globalization, has added to the responsibilities of a modern state and its activities. Fresh issues and problems keep coming up and demanding attention. In the process, the resource needs of the State keep increasing. It also discovers new avenues of its disbursements as also additional policy weapons. All these developments have enriched and continue to rapidly enrich the discipline of public finance.

The scope of public finance may be divided into the following:

1. **Theory of public revenue**: The theory of public finance deals with alternative sources of State income. It discusses and analyses comparative advantages and disadvantages of various forms of revenue and the principles which should govern the choice between them. Of various sources of public revenue, taxation, non-tax revenues, public debt and creation of additional currency get special attention.

   (a) In the study of taxation, we cover various principles governing the choice of tax measures, the problems of incidence of taxation, and the effects of taxation on the working of the economy.

   (b) Non-tax revenue includes dividends and profits from public undertakings, grants, fees, fines, and interest receipts, etc. Each of them is of significant importance in overall policies of the government in general and of fiscal policies in particular.
(c) In modern times, it is helpful to study public debt problems separately.
(d) Resorting to the printing press by the authorities has its own advantages and disadvantages, dangers and limitations and deserves special attention.
(e) In some economies public sector undertakings provide a crucial policy and regulatory instruments in the hands of authorities. In such a case, it is imperative to ensure that they happen to be a source of strength rather than a weakness.
(f) With modern governments, public debt has become an important source of revenue, but that is not all. Its servicing causes disbursement of public funds and belongs to the side of public expenditure. Moreover, public debt has assumed the role of an important instrument for regulating the working of the economy.

2. **Theory of public expenditure**: Through public expenditure, the government participates in and contributes to financial flows of the economy and influences its demand and supply patterns. It is also a major tool for implementing welfare, growth stabilization and other policies of the Government.

3. **Financial administration**: All financial activities involve issues of financial administration including public budget, its passing, implementation, auditing and similar other matters. Without a study of relevant dimensions of financial administration, the subject of public finance remains incomplete.

4. **Stabilization, growth and distributive justice**: These have become leading issues in economic policies of modern governments and therefore their financial implications deserve a separate treatment in the discussion of public finance theory.

5. **Federal finance**: Existence of a multilayer (or multi-level) system of government necessitates a corresponding division of functions and resources between different layers as also issues and problems relating to intergovernmental financial flows, financial imbalances and their rectification. Federal finance has, therefore, been an integral part of modern public finance.

6. **Issues of public policy**: A modern government is expected to deal with a host of socio-economic issues that keep cropping up continuously. Such issues are of diverse nature and financial implications. They may be treated on a standalone basis, or integral parts of other issues.
Check Your Progress

3. Why is the public sector assigned a significant role today?
4. What does theory of public revenue deal with?
5. Why is federal finance important?

1.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. ‘Public finance’ means the resources of a public body. Public finance helps us study the financial aspects of the government. It helps us study the government policy, especially the expenditure and tax policy, which impacts the economy and the welfare of the country’s citizens.

2. Areas of the subject of public finance have undergone repeated revisions in line with developments in state activities and corresponding economic philosophy. Accordingly, over the years, the definition of public finance has expanded to cover ever-widening areas.

3. These days, the need of interaction and interdependence between state and private sectors is duly recognized and therefore, in a modern economy, the public sector is assigned a significant role, both in theory and in practice.

4. The theory of public finance deals with alternative sources of state income. It discusses and analyses comparative advantages and disadvantages of various forms of revenue and the principles which should govern the choice between them. Of various sources of public revenue, taxation, non-tax revenues, public debt and creation of additional currency get special attention.

5. Existence of a multilayer (or multi-level) system of government necessitates a corresponding division of functions and resources between different layers as also issues and problems relating to intergovernmental financial flows, financial imbalances and their rectification. Federal finance has, therefore, been an integral part of modern public finance.

1.5 SUMMARY

- The main difference between public and private goods as well as the concept of the public sector leads us to explore the vast field of public finance. Public finance is clearly related to the financing of state activities, and can be defined as a subject that discusses the financial operations of the public treasury of a nation.
To understand the meaning of public finance, it is important to understand the meaning of the words ‘public’ and ‘finance’. The word ‘public’ stands for a collection of individuals, whereas the word ‘finance’ means money resources or revenues. Therefore, ‘public finance’ means the resources of a public body.

The basic argument was that in the absence of the public sector, essential social overheads would not come into existence. In their case, the social marginal overheads usually exceed their social marginal cost.

State, according to the laissez-faire philosophy, was considered as something extraneous to the economy, which was more or less equated with its private sector only. It was, therefore, considered best that the public sector should help and supplement the private sector but never replace it.

Since activities of the State were to be tolerated only as a necessary evil and were to be reduced to the minimum possible scale, the real question was not to decide the basic allocation of economic activities between public and private sectors and to deal with the associated financial and allied problems, but rather to analyse the way the treasury should operate.

Carl C. Plehn, author of *Introduction to Public Finance*, says that the term public finance ‘has come, by accepted usage, to be confined to a study of funds raised by governments to meet the costs of government.’

The scope of public finance involves a complete discussion of the influence of fiscal operations of the government at the level of overall activity, employment, prices and the growth process of the economic system as a whole.

The subject matter of public finance is logically, though not solely, concerned with the financial aspects of the business of government. Similarly, American economist, James M. Buchanan says, ‘The government, considered as a unit, may be defined as the subject of the study of public finance. More specifically, public finance studies the economic activity of government as a unit.’

The theory of public finance deals with alternative sources of State income. It discusses and analyses comparative advantages and disadvantages of various forms of revenue and the principles which should govern the choice between them. Of various sources of public revenue, taxation, non-tax revenues, public debt and creation of additional currency get special attention.

With modern governments, public debt has become an important source of revenue, but that is not all. Its servicing causes disbursement of public funds and belongs to the side of public expenditure. Moreover, public debt has assumed the role of an important instrument for regulating the working of the economy.
• All financial activities involve issues of financial administration including public budget, its passing, implementation, auditing and similar other matters. Without a study of relevant dimensions of financial administration, the subject of public finance remains incomplete.

• A modern government is expected to deal with a host of socio-economic issues that keep cropping up continuously. Such issues are of diverse nature and financial implications. They may be treated on a standalone basis, or integral parts of other issues.

1.6 KEY WORDS

• Laissez-faire: This is an economic system in which transactions between private parties are free from government intervention such as regulation, privileges, tariffs and subsidies.

• The public sector: This is the part of the economy composed of both public services and public enterprises.

• Fiscal policy: In economics and political science, fiscal policy is the use of government revenue collection and expenditure to influence the economy.

• Public revenue: It is an important tool of the fiscal policy of the government and is the opposite factor of government spending.

• Distributive justice: This concerns the nature of a socially just allocation of goods. A society in which inequalities in outcome do not arise would be considered a society guided by the principles of distributive justice.

• Public policy: Public policy is the principled guide to action taken by the administrative executive branches of the state with regard to a class of issues, in a manner consistent with law and institutional customs.

1.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the definition of public finance as given by Carl C. Plehn.
2. Write a short note on the nature of public finance.
3. What are the main components of public finance?
4. Explain some of fiscal measures which are needed in public finance.
5. What is the role of stabilization, growth and distributive justice in public finance?
Long Answer Questions

1. Discuss the study of public finance as an important branch of economics.
2. Analyse the role of public finance in State’s various activities.
3. Discuss how the subject matter of public finance is concerned with the financial aspects of the business of government.

1.8 Further Readings

UNIT 2 ROLE OF PUBLIC FINANCE IN THE ECONOMY

Structure
2.0 Introduction
2.1 Objectives
2.2 Public Finance and the Economic System
2.3 Public Finance and Private Finance
   2.3.1 Private vs Public Finance
   2.3.2 Public Goods vs Private Goods
2.4 Answers to Check Your Progress Questions
2.5 Summary
2.6 Key Words
2.7 Self Assessment Questions and Exercises
2.8 Further Readings

2.0 INTRODUCTION

Although economists are divided over their preference for public or private finance, both play a key role in improving the performance of the economy. There is a common refrain that because private sector is more efficient, all economic activities should be entrusted to it. However, there are those who are in favour of making public sector more effective so that it can be an alternative to private sector. It is often found that governments resort to surplus or deficit budget and bring in 'undue' interference with the working of the economy, creating an atmosphere of financial indiscipline and imprudence. It is important that public debt has an important and indispensable place in any sound financial system. Market mechanism, which guides the working of the private sector, also leads to certain undesirable result. Emphasis should be given on the relevance of the aggregate effective demand created by both public and private sectors instead of surplus or a deficit budget.

For any analytic assessment of finance, one needs to look into the various similarities and differences between public finance and private finance as both are involved in activities like lending, borrowing, receiving/making payments, etc.

This unit aims at analysing the role of public and private finance in the performance of economy.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the role of public finance in the economy
- Explain the role of public debt as an instrument of economic policy
- Analyse similarities and differences between public and private finance
2.2 PUBLIC FINANCE AND THE ECONOMIC SYSTEM

The state/public sector is described by many economists as a necessary evil. However, it can be designed and operated as an effective set of tools for improving the performance of the economy in several ways.

The classical approach to the study of public finance did not accept this viewpoint. It assumed that private sector was always more efficient than the public one, implying that to the extent possible, the economic activities should be entrusted to the private sector only. It was argued, accordingly, that the ‘sound budgetary policy’ of the government was that of balancing the budget. Running into deficits and creating public debt cause a financial burden upon the future public budgets and an ‘undue’ interference with the working of the economy. Therefore, any unavoidable deficit such as during a war should be redeemed as quickly as possible. There is another danger in the practice of budgetary deficits. It creates an atmosphere of financial indiscipline and imprudence within the government itself leading to irresponsible spending and inflationary pressures. Similarly, one can argue against surplus budgets. A surplus budget implies a heavier than needed taxation, reduces effective demand in the market and results in unemployment and depression.

It was realized, in due course, that the market mechanism, which guides the working of the private sector, is not an unmixed blessing. It leads to certain undesirable results also. These considerations strengthen the case for the public sector as an effective alternative to the private sector in many ways. Accordingly, the old dictum that the government must try to balance its budget as a sound budgetary policy stands discredited. It has given place to what is called the functional finance. According to it, what is needed is not a balanced or unbalanced budget as such, but stability and growth of income and employment in the economy. For this purpose, it may be necessary to add or subtract from the effective demand created by the private sector. If a particular tendency, such as a deficiency of effective demand, persists in the private sector, there would be no harm if the State sector repeatedly incurs a deficit. The emphasis here is on the relevance of the aggregate effective demand created by both public and private sectors instead of surplus or a deficit budget. The concept of a balanced budget, in whatever way defined, becomes irrelevant in a policy of using financial operations of the government exclusively as instruments of economic and public policy.

This view is further strengthened by the recognition of the fact that public debt can be an important and effective instrument of economic policy, especially in stabilization. This view was emphasized by the Radcliffe Committee in England and is now well recognized in both academic and policy circles. The precise way in which public debt may be used as a stabilizing instrument is debatable, but its importance is beyond doubt.
Gurley and Shaw, in their famous book *Money in a Theory of Finance*, have provided a theoretical basis for creating public debt. According to this view, an economy can have a healthy growth only if it has a sound financial system in which public debt has an important and indispensable place, since the health of the financial system is dependent upon the provision and soundness of public debt (including currency supply).

### Check Your Progress

1. Why should the practice of budgetary deficits be avoided?
2. When does the concept of a balanced budget become irrelevant?

## 2.3 PUBLIC FINANCE AND PRIVATE FINANCE

Private finance, refers to the financial problems and policies of an individual economic unit (which does not form a part of State organs) as compared with those of the public authorities. It is a convention to look into similarities and dissimilarities between the two so as to provide an analytical foundation for the decision-making aspects of public finance.

### 2.3.1 Private vs Public Finance

In this section, let’s compare the concept of public and private finance by discussing the similarities and dissimilarities between them.

#### Similarities

Modern economies are monetized. That is to say, most of their economic activities have financial counterparts involving creation and use of financial claims. Both private and public sectors are engaged in activities that involve purchases, sales and other transactions. Similarly, they are engaged in production, exchange, saving, capital accumulation, investment, and so on. In order to finance these operations, the government, amongst other things, creates money (which is also a financial asset), raises loans, and makes payments. Similarly, a private economic unit lends, borrows, receives payments, makes payments, and so on. In this respect, therefore, both the public and private finances are quite similar to each other.

One may also point out that both sectors are engaged in satisfying the wants of the society by sharing economic activities. Both have limited resources at their disposal and try to make their best by taking decisions such that the ‘most important’ wants are satisfied first. In that sense, their problems and decisions are similar. But the similarities between the two types of finances almost end here. In contrast, the differences between the two are quite sharp.
Dissimilarities

The dissimilarities between private and public finance may be summarized as follows:

1. To begin with, it may be stated that a private economic unit has to live within its means. Its deficit budgeting (that is spending more than the income) can be only for a limited period and only up to a limit. Given its economic standing, it can accumulate outstanding debt liabilities up to a limit and no more. But this constraint hardly applies to the State. It can plan to add to its outstanding debt with every budget, and may also succeed in doing so. A number of governments are virtually doing this. The result is that the public debt in many countries has become a high proportion of national income.

2. The distinction between private and public borrowings does not end with only amounts of possible borrowings, but extends to their forms, rates of interest and other terms and conditions. A private firm cannot raise non-repayable loans, but the State may and sometimes does. The state can borrow both internally and externally, that is, it can borrow from those who are subject to its authority and from those who are not. But a private economic unit (such as a firm) cannot raise an internal loan; all its loans have to be ‘external’. Furthermore, high creditworthiness of the State enables it to borrow at rates much lower than the private economic units have to pay. It has the support of the central bank of the country as an agent and as an underwriter when its loans are floated in the market. It can draw upon the facilities of the banking and other financial institutions more liberally. In some cases, it may adopt indirect coercive methods to borrow at lower rates, as was done in India till the early 1990s.

3. The government or a competent authority on its behalf can create legal tender currency, that is, money which the creditors cannot refuse to accept in discharge of their claims upon their debtors. With the introduction of paper currency, the authorities in many countries have acquired an unbridled discretionary power to add to currency supply. Often the formal technical restrictions can be waived if the government so wants. Such types of restrictions mainly indicate procedural handicaps and not essential checks. The upshot of the argument is that the government can just create purchasing power and add to the demand side of the market and take away a part of the national produce. It can leave the rest of the economy with more money and a smaller supply of goods than before. A private economic unit cannot do so. Its obligations can never become legal tender. A private economic unit is always expected to pay back its obligations. In contrast, obligations of public authorities via issue of currency need not be redeemed at all.

4. It is claimed that private finance follows the ‘market principle’, or the principle of economic rationality; but public finance follows the budget principle.” It means that private economic units are guided by market signals and of market mechanism and their own economic interest. In contrast, the essence
of the budget principle is that the services in this sphere are determined not by profit expectations and the willingness of the individuals to spend their money for the purchase of such services, but by decisions reached through political and administrative procedures and based on common social objectives. The State does not go by the principle of quid pro quo.

5. Quite often, in private finance, the view taken is a short term one. In contrast, the State is expected to take a long-term view of the interests of the economy as a whole and be ready to suffer commercial losses for that purpose, both in the short run and in the long run. Also the State would keep in mind the fact that the society is a perpetual entity and for its welfare, many activities are needed which have no immediate economic return, even to the society. An example in case is the investment of the State in removing untouchability.

6. It is generally pointed out that while a private economic unit proceeds by first ascertaining its income and then determining its expenditure, the government first decides about its expenditure and then goes round to seek revenue for it. But, it is an erroneous idea based upon the outmoded thinking that the activities of the state would be confined to the minimum possible and that the State would then find out the best ways of financing them. However, these days, it is not so. It is realized that the activities of the State are not fixed ones. They are ever-widening and with the increasing complexity and growth of the society, the need to increase State activities is also going up. The government, therefore, has to expand its activities through such expansion is restricted, amongst other things, by financial considerations also. Though the State, theoretically speaking, has complete powers of raising additional receipts through taxation, confiscation, borrowing, and printing notes, it would use these powers only within limits so that the fabric of the economy is not overstretched. For example, over-borrowing by the State could starve the capital market and private investment. Too much of note printing would lead to inflationary pressures and other problems in the economy. Excessive taxation may discourage saving and investment and productive activities, and so on. Therefore, in practice, the government does not use these powers indiscriminately. For example, most governments follow a system of progressive tax in which poorer sections of society are taxed lightly. All said and done, the expenditure programme of the government is, to a great extent, conditioned by the revenue considerations.

In the same manner, a private economic unit does not mechanically go about deciding how much to spend. The wants of a private economic unit would also be generally too many and within limits it has to work out the possible ways of increasing its income.

Thus, we note that in spite of some similarities between the public and private finance, there are some very important fundamental differences between them. In order to study public finance, we have to keep these basic
differences in mind, since it is obvious that on their account a number of principles of private finance will not apply to public finance. Differences like the very objective of private finance and public finance, or the ability of the authorities to create money, to borrow, to tax, and so on cannot be ignored.

But in order to appreciate the basic nature of public finance, it is equally essential to remember that the public sector is a part and parcel of the totality of the economy. The activities of the public and private sectors are interrelated and interdependent and involve a good deal of mutual transferring of resources. The policies adopted by the authorities have to be analysed in the light of these observations.

In order to understand the nature of public finance and its principles, one has to be equipped with the knowledge of the way the economy as a whole works, the way various financial flows take place in the economy and the corresponding economic activities that are there. The activities of the State bring about changes in these financial flows in their own ways and the subject matter of public finance has to be discussed in the light of all these implications.

2.3.2 Public Goods vs Private Goods

There are certain goods the availability of which to users can be decided in a discriminatory manner. Such a good may be subjected to principle of exclusion by making it a priced product. Those who cannot (or do not agree to) pay its market price are debarred from its use. In this sense, it becomes indivisible so far as its use is concerned. Thus, the ability to price a good, its divisibility and the exclusion principle, all go together. Its indivisibility characteristic may also imply that each individual has an access to its entire amount so that his use of it does not reduce its availability to others. For example, any number of persons can tune in a radio or TV programme without depriving others of the facility. Alternatively, it may be that if some persons are allowed access to its use, other members of the society cannot be prevented from its use. A typical example is that of defence service. Once the country is protected against foreign aggression, no section of the society can be excluded from enjoying its benefits. The defence service in other words, is indivisible. It cannot be priced in the market in order to deprive some members of the society from its benefits. Similarly, in some cases a consumer cannot surrender the use of a service even if he wants to. An individual cannot ask to be left un-defined by the defence arrangements of the state, or refuse the benefit of a reduction in air pollution or that of street lighting etc.

The question of financing the supply of a specific good or service is closely linked with its being a social good or a private good. A private good is subject to the principle of exclusion. It can be priced and those who do not pay for can be deprived of it. In contrast, a public good is indivisible and principle of exclusion does not apply to it. Consequently, there is a risk of beneficiaries not paying for it voluntarily. For example, in the case of defence service, every individual may
argue that the supply of defence service would not be affected by his not paying for it. Consequently, very few or even none may pay for it voluntarily hoping that through the contributions and efforts of others the supply of the service will be maintained. This is referred to as the problem of free riders, that is, the problem of financing the supply of a good on a voluntary basis. Therefore, the provision of such a good or service has to be financed through compulsory contributions (like taxation) by the members of the society. Their financing cannot be left to market mechanism.

The indivisible goods, whose benefits cannot be priced, and therefore, to which the principle of exclusion does not apply, are called pure public goods. Pure private goods, on the other hand, are completely divisible and to them the principle of exclusion applies in full measure. Only those can get these goods who are both willing and able to pay their market prices.

It must be noted that the indivisibility of a good does not necessarily imply that every citizen of the society has actually an equal share in its benefits. In case of a war, protection against enemy attack may, to some extent, depend upon one’s places of residence and work. Similarly, people living near political boundaries of the country may, for obvious reasons, be relatively less protected. People living near public parks derive more benefit from them even when all members of society are equally entitled to their use. Thus, the main criterion of indivisibility is that the good in question should be equally available to all members of the society (or a section thereof) irrespective of their ability or willingness to pay for it. The financing of the concerned activity has to be through public expenditure and not through market pricing. This implies that pure public goods must be in the hands of the public sector only.

It, however, does not prove as to which sector (public or private) should provide pure private goods. In order to get an answer to this question, we have to consider the following additional factors:

(i) The level of efficiency at which the public and private sectors may be expected to operate;
(ii) Political and social objectives of the society;
(iii) Additional characteristics of pure public and private goods (described below).

**Externalities**

Pure public goods are characterized by the existence of externalities, that is, economic effects which flow from their production or use to other parties or economic units. Such economic effects may also be called spill-over effects, neighbourhood effects or third party effects. They arise on account of interdependence of economic units via input/output relationships and may be in the form of gains or losses. It may be pecuniary (that is, directly monetary) or technological. An externality affects the prices in the economy, which in turn, transmit
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their effects to production and consumption decisions of other economic units. This causes a divergence between the internal (or private) and social marginal costs (or benefits) of the good in question. Thus, for example, pollution caused by factories, power houses, railways and transport vehicles is a cost to the society but not to the individual undertakings. Similarly, beneficial externalities of social overheads like roads cause a divergence between private and social marginal benefits.

These externalities are of two types.

(i) Market external effects; and

(ii) Non-market external effects.

In the case of non-market external effects, individual economic units cannot be identified and compensated for loss, nor can they be identified and charged for economic gains. In contrast, in the case of market-external effects, the losers (beneficiaries) can be identified and compensated (charged) for the same.

By implication, provision of public goods with non-market external effects should be preferably in the hands of the public authorities since they can do so irrespective of their commercial profitability. In contrast, pure public goods with market external effects may be left in the hands of the private sector (though even here their characteristic of indivisibility demands that they should be in the hands of the public sector only).

A pure private good is not supposed to have any externalities. In its case, there is no difference between private and social marginal costs of supply. And therefore its market price represents its social supply cost also. By implication, even in the hands of private sector, its supply would be at the socially optimum level. Ordinarily, therefore, the provision of pure private goods should be entrusted to the private sector. But on account of various reasons this may not be adhered to in every case. The government might decide to step in where merit wants (to be discussed later in this chapter) are concerned or for other relevant considerations like the cost conditions (discussed below), resource availability, social and political philosophy, and so on.

Marginal Cost

A likely characteristic of a pure public good is that its marginal cost is zero or close to zero. It means that an additional member of the society can be benefited by its use without appreciably adding to its total cost. To put it differently, the use of a pure public good by one more member of the society does not reduce its availability to the others. A good example of it is the tuning in of your radio set. Still another example is that of a bridge, over which an additional vehicle may pass without any additional cost to the society. Note, however, that mostly this principle applies, in reality, only to a limited extent. We cannot keep adding to the number of vehicles that may use the same bridge; we cannot have the same defence budget if our population keeps increasing, and so on. Also it may be added that a large number
of members of the society may not be able to enjoy the benefits of a public good without adding to the cost of its supply. Similarly, the provision of a public good may be increased or decreased for budgetary reasons or due to extraneous factors. Pure public goods which possess this characteristic have a strong case for inclusion in the public sector since public goods are indivisible also. In the case of private goods, on the other hand, the argument is basically in favour of largescale production for which either the society should agree to monopolistic type of private enterprise or should go in for public sector.

**Decreasing Average Cost**

Another likely characteristic of a pure public good is its decreasing costs. Being lumpy, it would be subject to the economies of scale. If the public good is provided in small units, then the average cost is likely to be much more. For example, the average cost of operating a sewerage system is much smaller if it serves a wide area than when it serves only a portion of the city. When it comes to the choice between public and private sectors for the provision of goods possessing this characteristic, considerations similar to the ones mentioned above in the case of marginal cost apply.

**Impure Public goods**

It would be noticed that it is highly difficult to come across goods which fully satisfy all the characteristics of pure public goods. Similarly, it is highly difficult to come across pure private goods. In general, most goods possess elements of both publicness and privateness. The difference between goods is mostly of degree and not of kind. Such goods which are neither pure public goods nor pure private goods are called impure public goods (also called quasi-public goods or quasi-private goods). If the elements of publicness are predominant in the mixture of characteristics of a good, then it may be termed a public good; and in the opposite case, a private good.

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### Check Your Progress

3. What are the similarities between public and private finance?
4. How does externality impact the economy?
5. Which goods are called impure public goods?

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### 2.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Running into deficits and creating public debt cause a financial burden upon the future public budgets and an ‘undue’ interference with the working of the economy. Therefore, any unavoidable deficit such as during a war should be redeemed as quickly as possible. There is another danger in the practice...
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2. The concept of a balanced budget, in whatever way defined, becomes irrelevant in a policy of using financial operations of the government exclusively as instruments of economic and public policy.

3. Both private and public sectors are engaged in activities that involve purchases, sales and other transactions. Similarly, they are engaged in production, exchange, saving, capital accumulation, investment, and so on. In order to finance these operations, the government, amongst other things, creates money (which is also a financial asset), raises loans, and makes payments. Similarly, a private economic unit lends, borrows, receives payments, and makes payments, and so on. In this respect, therefore, both the public and private finances are quite similar to each other.

4. An externality affects the prices in the economy, which in turn, transmit their effects to production and consumption decisions of other economic units. This causes a divergence between the internal (or private) and social marginal costs (or benefits) of the good in question.

5. The difference between goods is mostly of degree and not of kind. Such goods which are neither pure public goods nor pure private goods are called impure public goods (also called quasi-public goods or quasi-private goods). If the elements of publicness are predominant in the mixture of characteristics of a good, then it may be termed a public good; and in the opposite case, a private good.

2.5 SUMMARY

- The state sector is described by many economists as a necessary evil. However, it can be designed and operated as an effective set of tools for improving the performance of the economy in several ways.

- As per the classical view, running into deficits and creating public debt cause financial burden upon future public budgets. There is danger in the practice of budgetary deficits. It creates an atmosphere of financial indiscipline and imprudence within the government itself leading to irresponsible spending and inflationary pressures. Similarly, one can argue against surplus budgets. A surplus budget implies a heavier than needed taxation, reduces effective demand in the market and results in unemployment and depression.

- Gurley and Shaw, in their famous book *Money in a Theory of Finance*, have provided a theoretical basis for creating public debt. According to this view, an economy can have a healthy growth only if it has a sound financial system in which public debt has an important and indispensable place, since
the health of the financial system is dependent upon the provision and soundness of public debt (including currency supply).

- By private finance, we mean the financial problems and policies of an individual economic unit (which does not form a part of State organs) as compared with those of the public authorities. It is a convention to look into similarities and dissimilarities between the two so as to provide an analytical foundation for the decision-making aspects of public finance.

- Modern economies are monetized. That is to say, most of their economic activities have financial counterparts involving creation and use of financial claims. Both private and public sectors are engaged in activities that involve purchases, sales and other transactions.

- One may also point out that both sectors are engaged in satisfying the wants of the society by sharing economic activities. Both have limited resources at their disposal and try to make their best by taking decisions such that the ‘most important’ wants are satisfied first. In that sense, their problems and decisions are similar.

- A private firm cannot raise non-repayable loans, but the State may and sometimes does. The state can borrow both internally and externally, that is, it can borrow from those who are subject to its authority and from those who are not. But a private economic unit (such as a firm) cannot raise an internal loan; all its loans have to be ‘external’.

- With the introduction of paper currency, the authorities in many countries have acquired an unbridled discretionary power to add to currency supply. Often the formal technical restrictions can be waived if the government so wants. Such types of restrictions mainly indicate procedural handicaps and not essential checks.

- The State would keep in mind the fact that the society is a perpetual entity and for its welfare, many activities are needed which have no immediate economic return, even to the society. An example in case is the investment of the State in removing untouchability.

- Though the State, theoretically speaking, has complete powers of raising additional receipts through taxation, confiscation, borrowing, and printing notes, it would use these powers only within limits so that the fabric of the economy is not overstretched.

- In spite of some similarities between the public and private finance, there are some very important fundamental differences between them. In order to study public finance, we have to keep these basic differences in mind, since it is obvious that on their account a number of principles of private finance will not apply to public finance.

- In order to understand the nature of public finance and its principles, one has to be equipped with the knowledge of the way the economy as a whole

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works, the way various financial flows take place in the economy and the corresponding economic activities that are there.

- The question of financing the supply of a specific good or service is closely linked with its being a social good or a private good. A private good is subject to the principle of exclusion. It can be priced and those who do not pay for can be deprived of it. In contrast, a public good is indivisible and principle of exclusion does not apply to it.

- It must be noted that the indivisibility of a good does not necessarily imply that every citizen of the society has actually an equal share in its benefits. In case of a war, protection against enemy attack may, to some extent, depend upon one’s places of residence and work.

- In the case of non-market external effects, individual economic units cannot be identified and compensated for loss, nor can they be identified and charged for economic gains. In contrast, in the case of market-external effects, the losers (beneficiaries) can be identified and compensated (charged) for the same.

- A pure private good is not supposed to have any externalities. In its case, there is no difference between private and social marginal costs of supply. And therefore its market price represents its social supply cost also.

- Pure public goods which possess this characteristic have a strong case for inclusion in the public sector since public goods are indivisible also. In the case of private goods, on the other hand, the argument is basically in favour of largescale production for which either the society should agree to monopolistic type of private enterprise or should go in for public sector.

- Such goods which are neither pure public goods nor pure private goods are called impure public goods (also called quasi-public goods or quasi-private goods). If the elements of publicness are predominant in the mixture of characteristics of a good, then it may be termed a public good; and in the opposite case, a private good.

2.6 KEY WORDS

- **Quid pro quo**: This is a Latin phrase used in English to mean an exchange of goods or services, in which one transfer is contingent upon the other; “a favour for a favour”.

- **Legal tender**: Legal tender is a medium of payment recognized by a legal system to be valid for meeting a financial obligation. Paper currency and coins are common forms of legal tender in many countries. Legal tender is variously defined in different jurisdictions.

- **Indivisible goods**: A good is indivisible when the utility one derives from it depends on the number of users or individuals using it.
• **Externality**: In economics, an externality is the cost or benefit that affects a party who did not choose to incur that cost or benefit. Externalities often occur when a product or service's price equilibrium cannot reflect the true costs and benefits of that product or service. Externalities can be both positive and negative.

• **Marginal cost**: In economics, marginal cost is the change in the total cost that arises when the quantity produced is incremented by one unit; that is, it is the cost of producing one more unit of a good.

• **Quasi-public goods**: These have characteristics of both private and public goods.

### 2.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

#### Short Answer Questions

1. What is the concept of "sound budgetary policy"?
2. When, according to Gurley and Shaw, an economy can have a healthy growth?
3. Explain the activities wherein the public and private finances are quite similar to each other.
5. Write in a brief note on public goods vs private goods.
6. What are the two types of externalities in pure public goods?

#### Long Answer Questions

1. Discuss the impact of the practice of budgetary deficits in the performance of economy.
2. Analyse the common features of public and private finance.
3. Discuss why provision of public goods with non-market external effects should be preferably in the hands of the public authorities.
4. Analyse the various characteristics of a pure public good.

### 2.8 FURTHER READINGS

UNIT 3 THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

Structure
3.0 Introduction
3.1 Objectives
3.2 The Principle of Maximum Social Advantage in Public Finance
   3.2.1 The Point of Maximum Social Advantage
   3.2.2 Limitations of the Principle of Maximum Social Advantage
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3.3 Answers to Check Your Progress Questions
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3.5 Key Words
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3.0 INTRODUCTION

Introduced by British economist Hugh Dalton, the Principle of Maximum Social Advantage (MSA) is the fundamental principle of public finance. One of the main assumptions of this principle is that all public expenditure leads to the well-being of the public at large. Dalton says that all taxes result in greater amount of impact and sacrifice on the society. The benefit that society gets after additional taxations is known as Marginal Social Benefit (MSB). Social advantage is considered to be maximized at the point where marginal social sacrifice cuts the marginal social benefits curve. However, the principle of MSA has some limitations as it follows that the benefits from the very existence of the State exceed the cost of its own maintenance. But the State cannot remain indifferent to the working of the economy as more often than not market mechanism creates income and wealth inequalities.

This unit aims at analysing the principle of maximum social advantage in public finance and explains the role of state in determining the economy for the benefit of the society.

3.1 OBJECTIVES

After going through this unit, you will be able to:
- Understand the principle of maximum social advantage in public finance
- Enumerate the various assumptions of the principle of maximum social advantage
3.2 THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE IN PUBLIC FINANCE

The Principle of Maximum Social Advantage was introduced by British economist Hugh Dalton. According to him, public finance is concerned with income and expenditure of public authorities and with the adjustment of one with the other.

Budgetary activities of the government result in transfer of purchasing power from some individuals to others. Taxation causes transfer of purchasing power from taxpayers to the public authorities, while public expenditure results in transfers back from the public authorities to some individuals, therefore financial operations of the government cause ‘Sacrifice or Disutility’ on one hand and ‘Benefits or Utility’ on the other. This results in changes in pattern of production, consumption and distribution of income and wealth. Therefore, it is important to know whether those changes are socially advantageous or not. If they are socially advantageous, then the financial operations are justified otherwise not. According to Hugh Dalton, ‘The best system of public finance is that which secures the maximum social advantage from the operations which it conducts.’

The Principle of Maximum Social Advantage (MSA) is the fundamental principle of Public Finance. It states that public finance leads to economic welfare when public expenditure and taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.

Hugh Dalton explains the principle of maximum social advantage with reference to:

1. Marginal Social Sacrifice
2. Marginal Social Benefits

This principle is, however, based on the following assumptions:

1. All taxes result in sacrifice and all public expenditure lead to benefits.
2. Public revenue consists of only taxes and no other sources of income to the government.
3. The government has no surplus or deficit budget but only balanced budget.
4. Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

Marginal Social Sacrifice (MSS)

Marginal Social Sacrifice (MSS) refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax.
Every unit of tax imposed by the government taxes result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing i.e. the total social sacrifice increases at an increasing rate. This is because, when taxes are imposed, the stock of money with the community diminishes. As a result of diminishing stock of money, the marginal utility of money goes on increasing. Eventually every additional unit of taxation creates greater amount of impact and greater amount of sacrifice on the society. That is why the marginal social sacrifice goes on increasing.

The Marginal Social Sacrifice is illustrated in the following diagram:

![Fig. 3.1 Increasing Marginal Social Sacrifice Curve](image)

The above diagram indicates that the Marginal Social Sacrifice (MSS) curve rises upwards from left to right. This indicates that with each additional unit of taxation, the level of sacrifice also increases. When the unit of taxation was $OM_1$, the marginal social sacrifice was $OS_1$, and with the increase in taxation at $OM_2$, the marginal social sacrifice rises to $OS_2$.

**Marginal Social Benefit (MSB)**

While imposition of tax puts burden on the people, public expenditure confers benefits. The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal Social Benefit (MSB).

Just as the marginal utility from a commodity to a consumer declines as more and more units of the commodity are made available to him, the social benefit from each additional unit of public expenditure declines as more and more units of public expenditure are spent. In the beginning, the units of public expenditure are spent on the most essential social activities. Subsequent doses of public expenditure are spent on less and less important social activities. As a result, the curve of marginal social benefits slopes downward from left to right as shown in figure 3.2.
The Principle of Maximum Social Advantage

3.2 The Principle of Maximum Social Advantage

3.2.1 The Point of Maximum Social Advantage

Social advantage is maximized at the point where marginal social sacrifice cuts the marginal social benefits curve.

This is at the point P. At this point, the marginal disutility or social sacrifice is equal to the marginal utility or social benefit. Beyond this point, the marginal disutility or social sacrifice will be higher, and the marginal utility or social benefit will be lower.

Fig. 3.2 Diminishing Marginal Social Benefit Curve

In the above diagram, the marginal social benefit (MSB) curve slopes downward from left to right. This indicates that the social benefit derived out of public expenditure is reducing at a diminishing rate. When the public expenditure was $OM_1$, the marginal social benefit was $OB_1$, and when the public expenditure is $OM_2$, the marginal social benefit is reduced at $OB_2$.

3.2.2 Units of Taxation and Expenditure

This is due to the reason that additional unit of revenue raised and spent by the public expenditure...
The Principle of Maximum Social Advantage

government leads to increase in the net social advantage. This situation of increasing taxation and public expenditure continues, as long as the levels of taxation and expenditure are towards the left of the point P.

At point P, the level of taxation and public expenditure moves up to OQ. At this point, the marginal utility or social benefit becomes equal to marginal disutility or social sacrifice. Therefore at this point, the maximum social advantage is achieved.

At point P, the marginal social sacrifice $S_{Q_2}$ is greater than marginal social benefit $P_{Q_2}$. Therefore, beyond the point P, any further increase in the level of taxation and public expenditure may bring down the social advantage. This is because each subsequent unit of additional taxation will increase the marginal disutility or social sacrifice, which will be more than marginal utility or social benefit. This shows that maximum social advantage is attained only at point P and this is the point where marginal social benefit of public expenditure is equal to the marginal social sacrifice of taxation.

Maximum Social Advantage is achieved at the point where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equated, i.e., where $MSB = MSS$.

This shows that to obtain maximum social advantage, the public expenditure should be carried up to the point where the marginal social benefit of the last rupee or dollar spent becomes equal to the marginal social sacrifice of the last unit of rupee or dollar taxed.

3.2.2 Limitations of the Principle of Maximum Social Advantage

The simple exposition of the principle of maximum social advantage as described above suffers from some obvious limitations.

1. The principle wrongly assumes that the State is something external to the economy.

2. The principle can be refuted even on the assumption that the State is a superimposed entity upon the economy. So long as it is essential to have certain basic State functions like that of protecting the society both from internal disaster and external aggression, it follows that the benefits from the very existence of the State exceed the cost of its own maintenance. Actually, without these basic functions of the State, the very existence of the society cannot be guaranteed. Also, the availability of State protection to the society invisibly adds to its productive efficiency.

3. As Dalton points out, there is no basis for a generalization that every tax is a burden upon the society and that every State expenditure is a benefit for it. We can explain this point with a real life example. A tax on the consumption of narcotics and other harmful drugs cannot be called a burden upon the society, though a similar tax on education or sanitation would be. Similarly, if the State undertakes the provision of social overheads and other public
utilities, it leads to the emergence of external economies. Through them the cost of production falls, efficiency in production goes up and the economy benefits. The State, through its activities, may succeed in breaking the vicious circle of poverty in an underdeveloped country and in this way it may return to the economy (in the form of economic growth) more than it gets from it.

4. Moreover, the benefits and ill-effects of a public budget to the economy generally spill over beyond the period covered by a given budget. Accordingly it is a defective logic to argue in terms of a single budget only.

5. If we assume that all taxes are harmful and all public expenditure is beneficial, we arrive at some absurd results. For example, it will follow that the best course for the State would be not to levy any tax at all and finance all its activities through deficit financing only. It is very easy to demonstrate the absurdity of this conclusion. We must remember that by themselves taxes or public expenditure do not destroy or create any resources. They only provide a means of transferring resources between private and public sectors of the economy. Any variation in overall resource availability is only an indirect result of budgetary operations.

6. Non-tax revenue includes fines, fees, profits from public undertakings, dividends from investments, use of the printing press, market borrowings, and so on. These sources of revenue cannot be dismissed as unimportant either quantitatively or as irrelevant to the welfare and working of the economy.

7. Every State is committed to certain expenses - a liability from which it cannot free itself easily. These expenses include maintenance of the State itself, defence of the country, maintenance of law and order in the society, imparting justice to the people, certain welfare measures, servicing of the existing debt, and so on.

8. The effects of public finance operations are complex, widespread, and often indirect. They are not quantifiable in simple and direct terms as is done in the Principle of Maximum Social Advantage. An imbalanced budget is often an effective weapon affecting various remedial and welfare measures, and thereby maximising aggregate social advantage. For example, indirect taxes often change relative prices of commodities leading to changes in demand, consumption, production and investment patterns of the society. Thus, it is not possible to link welfare and growth effects of public finance operations with the amounts of taxation and public expenditure and ignore other aspects of budgetary measures and policies.

9. To assume that the government budget should always be a balanced one is a highly unrealistic restriction. If the objective of the budgetary policy is to be of maximum advantage to the society, such a restriction is most likely to hinder its attainment. Contra-cyclical budgetary measures to offset fluctuations in demand generated by the private sector are often suggested.
Similarly, in an underdeveloped country, a deliberate deficit budgeting may be needed to stimulate savings and capital accumulation.

10. Logically, it is incomplete to determine an optimum level of State activities in terms of budgetary aggregates only. Full potential of budgetary operations is revealed only through their detailed study and associated policies. This fact brings in a host of relevant questions regarding institutional and economic framework of the country such as income and wealth inequalities, regional imbalances, and the like. To put it differently, the question of determining an optimum level of State activities leads us to consider in details the effects of alternative budgetary policies at different levels and in all their details; and without such an analysis no meaningful answer is possible.

The Principle in Practice

The question arises that since the Principle of Maximum Social Advantage suffers from so many limitations, should we not discard it totally to which the reply is an emphatic no. Instead, we should try to make it more realistic and capable of yielding policy conclusions. For this purpose, we first show that it is highly undesirable to limit the State’s budgetary activities to the minimum possible. And then we try to find out the tests which should tell us as to whether the budgetary activities of the State are of net advantage to the society or not.

The Case for State Activities

The case for confining State activities to the minimum rests on the assumption of superiority of market mechanism. It assumes that the market is able to generate full employment, and is always more efficient than the public sector. Therefore, within its narrow sphere, the State should only make a judicious choice between alternative taxes and items of expenditure. But we note that these assumptions are highly unrealistic. In reality, market mechanism fails to generate full employment, leads to cyclical fluctuations and creates income and wealth inequalities. It need not succeed in realising high enough rates of capital accumulation and economic growth. Therefore, it is a duty of the State to remove these drawbacks.

Furthermore, we must remember that though competition is supposed to guide the economy according to consumer’s sovereignty, in reality it is not so for two reasons.

Firstly, on account of inequalities of income and wealth, the demand pattern generated in the market does not really display true needs of the society. Quite a number of luxuries are demanded at the cost of necessities which the poor people cannot afford to buy for want of purchasing power. There is also a shortage of merit goods due to their non-profitability.

Secondly, the market competition, in practice, tends to degenerate into a monopolistic competition in which there is a lot of wastage on account of selling expenses, unutilised productive capacity, hoarding, speculation, and so on.
3.2.3 The Tests of Maximum Social Advantage

Assuming, therefore, that the State cannot remain indifferent to the working of the economy, we proceed to look for the tests of maximum social advantage. To make these tests realistic we treat the State as a part and parcel of the economy. This being so, the sweeping statements like the ones asserting that all taxes are leakages from the economy’s resources and that all public expenditures are additions to them, lose their meaning. Instead, it becomes relevant to analyse the net effects of budgetary activities, covering not only the budgetary aggregates as such, but also their detailed composition and associated budgetary policies.

However, this is not an easy task. The effects of many State activities cannot be quantified. As examples, we can mention the removal of untouchability, spreading of education, improvement in health and sanitation, and so on. Almost every State activity has widespread effects and it is nearly impossible to estimate all of them. In other words, it is very difficult to devise objective tests of benefits and losses to the society and thereby determine (estimate) the quantum of social advantage generated by State activities.

1. Dalton’s tests

Even under difficult (but realistic) conditions, Professor Dalton gives us certain objective tests according to which it can be ascertained whether public finance operations are adding to the social advantage or not. These tests are formulated by assuming that there are certain generally accepted desirable objectives which the society should try to achieve, namely the following:

1. **Preserving the society**: If it is agreed that the society, as it exists, is worth preserving, then a system of public finance which ensures adequate protection to the society against both foreign aggression and internal disruption certainly adds to social advantage and is worth pursuing.

2. **Economic Welfare of the Community**: This welfare involves two aspects:

   - (a) an improvement in production, and
   - (b) an improvement in the distribution of national income.

   An improvement in production should not be taken to mean an increase in current output as such, but basically an increase in the productive capacity of the economy on a sustainable basis. An increase in current output through capital consumption cannot be termed an “improvement in production” because it is not sustainable in the long run. Improved productive capacity implies capital accumulation, better utilisation of productive resources, and an increase in productivity of workers with a corresponding addition to the social advantage.

   An improvement in the distribution of national income covers both “efficiency” and “equity” dimensions thereof. Efficiency in distribution relates to aggregate of satisfaction only, while equity relates to the sharing of aggregate satisfaction between members of the society. Normally, the two aspects are so intermixed and interdependent that a decision involving efficiency also affects equity and vice versa.
The welfare aspect of distribution of national income, therefore, does not lend itself to an easy treatment. Quite often, we are not even able to find out whether certain decisions would add to the efficiency of distribution or not. In other cases, the efficiency and equity tests might clash, so that improvement in one leads to a deterioration in the other. It is not, therefore, possible to lay down full-fledged objective criteria of social advantage. But we can recommend some common-sense steps about which, on general grounds, there is not much chance of a difference of opinion. We can, for example, advocate reduction in inequalities of income and wealth, reduction in unemployment, uplifting the standards of living of the people, bringing about a higher rate of economic growth, bringing about economic stability in the economy and so on.

2. Hicks’ Tests

Mrs Hicks has also suggested two sets of criteria for judging whether a particular public finance operation or policy adds to the net social benefit or not. The first is called the production optimum and the second is the utility optimum.

According to Mrs. Hicks, an optimum in production is achieved if through reallocation of productive resources it is not possible to increase production of any given commodity without reducing that of some other. Obviously, this criterion is not only ambiguous but may also be misleading. Increasing production of one commodity may necessitate reducing that of the other, but the total output may increase. Mrs. Hicks’ production optimum may apply in a situation of full employment and complete utilisation of existing productive capacity. However, it must be noted that budgetary operations and policies are not always successful in achieving even these conditions. If they could, many of the economic ills of the world of today would not have been there. Again, this test of production optimum applies in short-term only. In the long run, it is always possible to augment productive potential of the economy such as through creation and expansion of social overheads, capital goods sector and investment in human capital.

Utility optimum of Mrs Hicks is related to the composition of the national output and relative importance of its components. A variation in this composition would automatically lead to a variation in the utility derived from it. When a stage is reached whereby such a variation in the utility derived from GDP cannot be increased, the utility optimum is said to have been achieved. The difficulty with this criterion arises out of the fact that utility, and therefore, the relative importance of various goods and services cannot be quantified. Furthermore, such measures of relative utility are always subject to revision over time and place and as also between individuals.

All said and done, we find that the basic idea contained in this principle is useful even when it is not possible to adopt it in strict quantitative terms. In line with the reasoning of this idea, we can proceed with the aim of increasing the usefulness of overall budgetary policy of the government for the society. To this end, we first equip ourselves with adequate theoretical knowledge and empirical
evidence relating to the immediate and long-term repercussions of various budgetary measures. We have then to choose between various alternatives which budgetary policy may offer including, for example, the level of State activities, the composition of tax and non-tax revenues, tax rates, and similar other considerations regarding the expenditure side of the budget. All these decisions have to be taken in the light of our objectives and the extent to which they can be achieved in practice. The optimum size of the government budget is not a fixed quantity. It depends upon several relevant considerations, e.g., the objectives, their practicability, their relative costs and benefits, the administrative capability of the government including the accounting system and programme and performance budgeting, the institutional and economic framework of the society and the like.

Check Your Progress
1. What is the principle of maximum social advantage (MSA)?
2. List some of assumptions of the principle of MSA.
3. When is Maximum Social Advantage achieved?
4. Why the assumption that State activities should be confined to the minimum is unrealistic?
5. What do you mean by Dalton’s tests?

3.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The Principle of Maximum Social Advantage (MSA) is the fundamental principle of Public Finance. It states that public finance leads to economic welfare when public expenditure and taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.

2. The principle of MSA is based on the following assumptions:
   i. All taxes result in sacrifice and all public expenditure lead to benefits.
   ii. Public revenue consists of only taxes and no other sources of income to the government.
   iii. The government has no surplus or deficit budget but only balanced budget.
   iv. Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

3. Maximum Social Advantage is achieved at the point where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equated, i.e., where MSB = MSS.
The Principle of Maximum Social Advantage

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4. The case for confining State activities to the minimum rests on the assumption of superiority of market mechanism. But these assumptions are highly unrealistic because in reality, market mechanism fails to generate full employment, leads to cyclical fluctuations and creates income and wealth inequalities.

5. Professor Dalton gives us certain objective tests according to which it can be ascertained whether public finance operations are adding to the social advantage or not. These tests are formulated by assuming that there are certain generally accepted desirable objectives which the society should try to achieve.

3.4 SUMMARY

- The Principle of Maximum Social Advantage was introduced by British economist Hugh Dalton. According to him, public finance is concerned with income and expenditure of public authorities and with the adjustment of one with the other.

- The Principle of Maximum Social Advantage (MSA) is the fundamental principle of Public Finance. It states that public finance leads to economic welfare when public expenditure and taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.

- Marginal Social Sacrifice (MSS) refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax. Every unit of tax imposed by the government taxes result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing i.e. the total social sacrifice increases at an increasing rate.

- While imposition of tax puts burden on the people, public expenditure confers benefits. The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal Social Benefit (MSB).

- Maximum Social Advantage is achieved at the point where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equated, i.e., where MSB = MSS.

- The State, through its activities, may succeed in breaking the vicious circle of poverty in an underdeveloped country and in this way it may return to the economy (in the form of economic growth) more than it gets from it.

- The effects of public finance operations are complex, widespread, and often indirect. They are not quantifiable in simple and direct terms as is done in the Principle of Maximum Social Advantage.
The case for confining State activities to the minimum rests on the assumption of superiority of market mechanism. It assumes that the market is able to generate full employment, and is always more efficient than the public sector. Therefore, within its narrow sphere, the State should only make a judicious choice between alternative taxes and items of expenditure.

Even under difficult (but realistic) conditions, Professor Dalton gives us certain objective tests according to which it can be ascertained whether public finance operations are adding to the social advantage or not. These tests are formulated by assuming that there are certain generally accepted desirable objectives which the society should try to achieve.

Mrs Hicks has suggested two sets of criteria for judging whether a particular public finance operation or policy adds to the net social benefit or not. The first is called the production optimum and the second is the utility optimum.

Utility optimum of Mrs Hicks is related to the composition of the national output and relative importance of its components. A variation in this composition would automatically lead to a variation in the utility derived from it. When a stage is reached whereby such a variation in the utility derived from GDP cannot be increased, the utility optimum is said to have been achieved.

The basic idea contained in the principle maximum social benefit is useful even when it is not possible to adopt it in strict quantitative terms. In line with the reasoning of this idea, we can proceed with the aim of increasing the usefulness of overall budgetary policy of the government for the society.

3.5 KEY WORDS

- **Marginal Social Sacrifice (MSS):** This refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax.
- **Marginal Social Benefit (MSB):** The benefits experienced by the individual consumers of a particular good, plus or minus any social or environmental benefits or costs.
- **Tax on consumption:** A consumption tax is a tax levied on consumption spending on goods and services. The tax base of such a tax is the money spent on consumption.
- **Merit good:** The concept of a merit good introduced in economics by Richard Musgrave is a commodity which is judged that an individual or society should have on the basis of some concept of need, rather than ability and willingness to pay.
- **Non-tax revenue:** Non-tax revenue or non-tax receipts are government revenue not generated from taxes.
3.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions
1. Why do financial operations of the government cause ‘Sacrifice or Disutility’ and ‘Benefits or Utility’?
2. Write a short note on the significance of the principle of maximum social advantage in public finance.
3. What is the role of the public expenditure in obtaining maximum social advantage?
4. How is an optimum in production achieved according to Mrs. Hicks?

Long Answer Questions
1. Discuss the evolution of the principle of maximum social advantage in public finance.
2. Illustrate with diagram how maximum social advantage (MSA) is achieved.
3. Discuss the role of State activities in obtaining maximum social advantage in public finance.
4. Analyse Mrs. Hick’s view on utility optimum in public finance operation.
5. Explain some of limitations of the principle of maximum social advantage.

3.7 FURTHER READINGS

UNIT 4 PRINCIPLES OF PUBLIC EXPENDITURE

Structure
4.0 Introduction
4.1 Objectives
4.2 Public Expenditure: An Introduction
  4.2.1 Theories of Increasing Public Expenditure
  4.2.2 Comparison between Private and Public Expenditure
4.3 Classification of Public Expenditure
  4.3.1 Productive and Unproductive Expenditures
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  4.3.3 Plan and Non-Plan Expenditure
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  4.3.5 Canons of Expenditure
4.4 Causes and Effects of Public Expenditure with Reference to India
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4.0 INTRODUCTION

Expenditure incurred by public authorities for promoting economic and social welfare of their people is known as public expenditure. Broadly, it is classified into two types: developmental and non-developmental expenditure. Since 1930’s after the onset of the great depression, as the functions and responsibilities of the countries have undergone a sea change, the role of public budget received wider attention. Governments of the various countries had to cope with the challenges to meet the development programmes. As a result, the budget became a powerful fiscal instrument to invest in economic indicators as production, prices and employment. Many countries needed the public expenditure to bring in plan outlays for fulfilling various objectives such as eradication of poverty, generation of employment and sustained pace of development.

However, the purpose of public expenditure differs in the context of developed and developing economies. For decades, public expenditure in a developing economy has been playing a greater role in raising the rate of growth, employment and productivity as also to improve income distribution. While the main objective of public expenditure is to optimize society’s consumption and maximize social and economic welfare, economists are of the view that public spending should be designed to optimize the level of investment in such a way as...
to maintain full employment with growth. According to Keynes, public spending in a backward economy should accelerate the tempo of economic development by constructing the infrastructure of the economy and increasing capital formation for augmenting industrial activity and allied production of goods and services. Countries, under democratic set up, are called upon to play an active role to promoting economic development.

The role of the public expenditure in so many development activities can’t be underestimated but at the same time we should also look into the fact that it is also responsible for many economic problems. Researchers and economists need to study more vigorously on the actual impact that public expenditure creates in transforming the lives of people.

The unit aims at analysing the role of public expenditure by bringing out a comprehensive analysis of various principles and types of public spending for the development of the people especially in countries like India

### 4.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the principles public expenditure
- Examine the meaning and nature of public expenditure
- Explain the similarities and differences between private and public expenditure
- Analyse the classification of public expenditure
- Explain cause and effect of public expenditure with reference to India

### 4.2 PUBLIC EXPENDITURE: AN INTRODUCTION

Public expenditure refers to the expenses which a government incurs for (i) its own maintenance, (ii) the society and the economy, and (iii) helping other countries. In practice, however, with expanding State activities, it is becoming increasingly difficult to separate the portion of public expenditure meant for the maintenance of the government itself from the total.

Historically, public expenditure has recorded a continuous increase over time in almost every country. However, traditional thinking and philosophy did not favour this trend because it rated market mechanism as a better guide for the working of the economy and allocation of its resources. It was argued that each economic unit was the best judge of its own economic interests and the government should not try to decide on behalf of others. Furthermore, while a private economic unit was guided by its own economic interests, the public sector had no such motivation. Accordingly, its efficiency was bound to be very low. If this philosophy had been practised in its entirety, public expenditure would not have grown as
rapidly as it did. In reality, however, the state could not ignore problems of economic growth and social injustice. It could not remain a silent spectator of the miseries of the people. This resulted in the acceptance of several versions of socialist and welfare philosophy.

However, in spite of the fact that public expenditure has increased rapidly during the last two centuries or so in almost every State, and in spite of its growing role and importance in national economies, the area of public expenditure remains relatively unexplored. As Lowell Harris says, “the economists have generally concentrated their attention on the theory of taxation. The theory of public expenditure has been more of less confined to that of generalities in terms of the effects of public expenditure on employment and prices etc.” Of course, it may be pointed out that lately this deficiency is being removed by various studies in the field of public expenditure.

4.2.1 Theories of Increasing Public Expenditure

There are two important and well known theories of increasing public expenditure which we shall be discussing below. The first one is connected with Wagner and the other with Wiseman and Peacock. These are as follows:

1. Wagner’s Law of Increasing State Activities

Adolph Wagner (1835–1917) was a German economist who based his Law of Increasing State Activities on historical facts, primarily of Germany. According to Wagner, there are inherent tendencies for the activities of different layers of a government (such as central and state governments) to increase both intensively and extensively. There is a functional relationship between the growth of an economy and government activities with the result that the governmental sector grows faster than the economy. From the original version of this theory it is not clear whether Wagner was referring to this increase in the following ways:

(a) Absolute level of public expenditure
(b) The ratio of government expenditure to GNP
(c) Proportion of public sector in the total economy

Musgrave believes that Wagner was thinking of (c) above. F. S. Nitti not only supported Wagner’s thesis but also concluded with empirical evidence that it was equally applicable to several other governments which differed widely from each other. All kinds of governments, irrespective of their levels (say, the central or state governments), intentions (peaceful or warlike), and size, etc., had exhibited the same tendency of increasing public expenditure.

A number of reasons can be enumerated for this inherent long-term tendency recorded in history. These are:

(i) An expansion in the traditional functions of the State. Defence became increasingly more expensive over time. Within the country,
administrative set kept increasing both in coverage and intensity. The government machinery had to be manned by experts in their fields. With the progress of society, administration of the government, and its services had to become increasingly more extensive, cumbersome and expensive so as to retain efficiency.

(ii) State activities were increasing in coverage. Traditionally they were limited to only defence, justice, law and order, maintenance of the State and social overheads. But with growing awareness of its responsibilities to the society, the government started expanding its activities in hitherto unexplored field of socio-economic welfare. These measures included efforts to enrich cultural life of the society and provision of social security to the people (such as old age pensions and so on). Subsidies for and direct provision of various merit goods also registered an increase. Most governments also took active steps to ensure distributive justice by reducing income and wealth inequalities.

(iii) The need to provide and expand the sphere of public goods received an increasing attention. The State tried to shift the composition of national produce in favour of public goods, and this, in turn, necessitated an expansion of investment activity of the government.

Wagner’s Law was based upon historical facts. It did not reveal the inner compulsions under which a government has to increase its activities and public expenditure as time passes. It was applicable only to modern progressive governments which were interested in expanding public sector of the economy for its overall benefit. This general tendency of expanding State activities had a definite long-term trend, though in the short-run, financial difficulties could come in its way. “But in the long-run the desire for development of a progressive people will always overcome these financial difficulties.”

Thus, Wagner was emphasising long-term trend rather than short-term changes in public expenditure. Moreover, he was not concerned with the mechanism of increase in public expenditure. Since his study is based on the historical experience, the precise quantitative relationship between the extent of increase in public expenditure and time taken by it was not fixed in any logical or functional manner. His contention that public expenditure had been increasing over time, could not be used to predict its rate of increase in future. Actually, it is consistent with Wagner’s law to state that in future the State expenditure would increase at a rate slower than the national income though, factually speaking, it had increased at a faster rate in the past. Thus in the initial stages of economic growth, the State finds that it has to expand its activities quite fast in several fields like education, health, civic amenities, transport, communications, and so on. But when the initial deficiency is removed, then the increase in State activities may be slowed down.
Additional factors which contribute to the tendency of increasing public expenditure relate to a growing role of the State in ever-increasing socio-economic complexities of modern society. These are:

(i) Many societies are experiencing a growing population which becomes a major contributory factor in the growth of public expenditure. The sheer scale of state services has to increase to keep pace with population growth, including, for example, more schools, hospitals, and police, etc.

(ii) Most countries have registered increasing urbanisation. Existing cities grow and new ones come up. Urbanisation implies a much larger per capita expenditure on civic amenities. It necessitates a much larger supply of incidental services like those connected with traffic, roads, and so.

(iii) Prices have a secular tendency to go up. This also adds to public expenditure even if the scale of state services remains unchanged.

(iv) The size and nature of public services necessitates an ever-increasing specialisation. The quality of the services improves, both as a historical fact as also due to circumstantial compulsions. Better quality services and higher qualified administrators, technicians, etc., imply a higher cost of providing public services. Also, the government has to purchase a number of goods and services for its own maintenance. With rising prices, expenditure on them also goes up.
A modern government considers it a part of its duty to protect the economy from the “failures” of market mechanism. Accordingly, anti-cyclical and other regulatory measures are adopted. Efforts are made to reduce the income and wealth inequalities and bring about social and economic justice which, in turn, add to public expenditure.

Modern governments have shown a tendency to run into debt and this leads to a subsequent increase in public expenditure in the form of increasing cost of debt servicing and repayment of the loans.

Popularity of the philosophy of planning and economic growth as also increasing government activities in the areas of capital accumulation and economic growth have also contributed to the growth of public sector.

Musgrave and Musgrave emphasise a growing complementarity between public and private consumer and capital goods so that with an increase in per capita income, demand for public services also increases with a corresponding growth in public expenditure.

There is an inherent tendency of vested interests to develop which demand an increase in public expenditure for their own benefit. For this reason, a variety of subsidies and other avoidable expenditures inflate the public budget.

It is claimed that government bureaucracy has an inherent tendency to expand irrespective of the size and nature of public services provided by it.

Recent investigations have brought into focus productivity and efficiency dimensions of government organs and public undertakings as also the manner in which these dimensions push up public expenditure. Specific mention may be made of the concepts of “productivity lag” advanced by Allan Peacock and Baumol’s Disease. According to these concepts, public sector is less efficient and productive than the private one, and tends to be more labour intensive (or overstaffed). Similarly, an element of avoidable inefficiency and therefore cost (termed X-inefficiency) creeps in due to poor supervision, non-fixation of responsibility, non-check on output of individual employees and non-quantification of government services.

At the same time, there is a myth that the individuals can voluntarily get together to resolve market deficiencies without government intervention. It is known as Coase Fallacy. The myth is explained by Fundamental Non-Decentralizability Theorem expounded by B. Greenland and J. Stiglitz.

Wagner’s model has an important analytical limitation which can be removed in an expanded version. A government is not a monolithic entity. It comprises a number of organs and associated institutions. Households and business units in the
private sector also do not observe government activities passively. Instead, they respond to them more actively. Thus, the government decision-making has become a complex phenomenon and has multifarious tendencies to increase public expenditure.

Buchanan and Tullock, in the context of US experience, have viewed Wagner’s theory in terms of increasing discrepancy between growth of government expenditure and government output and termed the phenomenon as “Wagner Squared” hypothesis. They base their argument on two facts. Firstly, in contrast with the situation prevailing in the private sector, expenditure on civil servants grows faster than the corresponding increase in their output. Secondly, with increasing social security and other measures, the proportion of population receiving transfer payments from authorities keeps increasing. This way, public expenditure increases both in absolute terms and as a proportion of national income. It may be noted that even if the expenditure on civil services as a proportion of expenditure on employees in the private sector does not increase, and even if the proportion of population receiving transfer payments remains stable, the Wagner Squared hypothesis would hold. The major limitation of this hypothesis is that output of public servants cannot be measured with any degree of accuracy.

Alan Tait Peacock does not agree with this explanation of Buchanan and Tullock. He says that a typical individual does not relate his tax payments with the receipt of government services. He considers his tax liabilities as they are and strives for additional public services; that is, he fights for additional opportunities for milking government services and not for reducing taxes. The politicians, to win their votes, try to expand government services and therefore impose more taxes. The government expenditure keeps on increasing without any reference to productivity/cost ratio of government services.

We may add that modern governments have found new weapons whereby to increase their expenditure even without collecting more taxes. They now own public undertakings which can be a source of revenue to them. But more important than that is their capacity and willingness to resort to deficit financing. Even in advanced countries deficit financing has become a common occurrence. The public opinion is not strong enough to check this sort of policy even though it has disastrous inflationary effects.

2. Wiseman–Peacock Hypothesis

The second thesis dealing with the growth of public expenditure was put forth by Wiseman and Peacock in their study of public expenditure in the UK for the period 1890-1955. The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner, but in jerks or step like fashion. At times some social or other disturbance takes place, creating a need for increased public expenditure which the existing public revenue cannot meet. While earlier, due to an insufficient pressure for public expenditure, the revenue constraint was dominating and restraining an expansion in public expenditure, now under changed...
requirements such a restraint gives way. The public expenditure increases and makes the inadequacy of the present revenue quite clear to everyone. The movement from the older level of expenditure and taxation to a new and higher level is the displacement effect. The inadequacy of the revenue as compared with the required public expenditure creates an inspection effect. The government and the people review the revenue position and the need to find a solution of the important problems that have come up and agree to the required adjustments to finance the increased expenditure. They attain a new level of tax tolerance. They are now ready to tolerate a greater burden of taxation and as a result the general level of expenditure and revenue goes up. In this way, the public expenditure and revenue get stabilised at a new level till another disturbance occurs to cause a displacement effect. Thus each major disturbance leads to the government assuming a larger proportion of the total national economic activity. In other words, there is a concentration effect.

The concentration effect also refers to the apparent tendency for central government economic activity to grow faster than that of the state and local level governments. British data are consistent with this hypothesis, but its application to other countries needs verification. Moreover, this aspect of concentration effect is also closely connected with the political set up of the country.

On the face of it, Wiseman-Peacock hypothesis looks quite convincing. But we must remember that they are emphasising the recurrence of abnormal situations which cause sizeable jumps in public expenditure and revenue. In all fairness to the historical facts, we must not forget that on account of advancement of the economy and the structural changes therein, there are constant and regular increments in public expenditure and revenue. Public expenditure has a tendency to grow on account of a systematic expansion of the public activities as also an increase in their intensity and quality. Increasing population, urbanisation and an ever-increasing awareness of the civic rights on the part of the public, coupled with an increasing awareness of its duties on the part of the State, leads to an upward movement of public expenditure. To an extent public expenditure gets financed by ever increasing revenue which is made possible through the expansion and structural changes in the economy. These days, in underdeveloped countries like India, the State is deliberately trying to increase its activities and makes an effort to finance those activities through various tax efforts. Even in developed countries, the State finds that it has to perform an increasing regulatory duty to protect the economy against instability and excessive inequalities of income and wealth. Thus, Wiseman Peacock hypothesis is still a description of a particular tendency and does not isolate all the relevant causes at work.

It must be emphasized that apart from various factors like population growth, defence expenditure, urbanisation, rising prices etc., which by themselves push up public expenditure, an important additional contributory force is the failure of market mechanism in achieving various socio-economic objectives of the country. Inherent deficiencies of market mechanism make the economy a prey of economic instability, income and wealth inequalities, defective patterns of consumption,
employment and investment and so on. In a number of cases the market mechanism is not able to pull the economy out of its vicious circle of poverty and launch it on a path of secular and rapid economic growth. Therefore, the government is forced to increase its field of activities with a corresponding increase in public expenditure.

4.2.2 Comparison between Private and Public Expenditure

With regard to similarities between the public and private expenditures, we can hypothesise that both private units and public authorities try to maximize returns per unit of expenditure (the returns being the objectives to be achieved). Any shortfall on this front will be on account of inefficiency, uncertainty, lack of foresight and similar other causes. Another point of similarity between private and public expenditure is an element of flexibility, though it is generally more in the case of public expenditure. Both private economic units and public authorities take a collective view of the income, expenditure and the possibilities of adjustments in each. While an individual chooses between an effort to earn and leisure, and a firm thinks of the cost of earning more and spending more, the public authorities compare effects of additional revenue with those of extra expenditure. It must also be remembered that in each case there can be more than one way of raising additional income. The authorities, for example, can plan to raise the additional tax or non-tax revenue, or borrowing or even raising taxation in various forms. There are, therefore, problems of overall efficient and integrated management of finances. They are related to the alternative ways in which finances can be raised, the efforts needed to raise them, the effects of such revenue efforts and the corresponding benefits of the expenditure which are to be incurred. It is also obvious that depending upon circumstances prevailing at the time, the net equilibrating solution will differ. While in some cases a larger tax and expenditure level would be desirable, in others the amount indicated will be smaller. Similarly, in the case of private finance, we have different levels at which the solutions will be found.

However, while private and public expenditures are similar in their overall and complex ramifications, the dissimilarities between them are also quite glaring. The first such dissimilarity is the objective with which the expenditure is incurred. In the case of an individual economic unit, generally an exchange relationship determines the mode, pattern and volume of expenditure. As a consumer, an individual equates the marginal utility of the good (or service) purchased with the disutility of expenditure. A commercial economic unit compares private marginal returns from an expenditure with the amount spent. Public authorities however cannot and do not always adopt a commercial attitude towards their expenditure plans. They have to consider social benefits generated in the process of their expenditure activities. And in quite a few cases these benefits are vague and immeasurable. The State has to impute social valuation to these benefits and decide whether it is worthwhile undertaking these expenditures or not. Also, certain State expenditures are directed at bringing about social and economic justice. The benefits of such State expenditures cannot be evaluated directly.
Keeping in view the fact that the State is the guardian of the social welfare and economic and social health of the society, provision for many public services is not decided on the basis of their cost-effectiveness. Moreover, an individual has a limited horizon covering only a foreseeable future. The State, on the other hand, takes a much longer view. For this reason, the State may adopt even a policy of permanent budgetary deficit. A private economic unit cannot do so. The objectives of public expenditure are now far wider than imagined earlier.

**Check Your Progress**

1. What do you mean by the public expenditure?
2. What does Wagner’s *Law of Increasing State Activities* state?
3. What is the main thesis of Wiseman and Peacock in their study of public expenditure?

### 4.3 CLASSIFICATION OF PUBLIC EXPENDITURE

It is conventional to classify public expenditure into various economic categories. Accounting classification has been there for centuries because it enables the State executive to maintain an effective control and check over public expenditure and possible leakages and wastage, diversions and misappropriations. It may be departmental classification or classification according to heads of expenditure. Such a classification is good for auditing and for safeguarding against misappropriations, etc., but it does not help us in understanding its effects. It is, therefore, difficult to formulate an appropriate expenditure policy on this basis. In the same way, a distinction between obligatory (or legally committed) expenditure and optional expenditure can only highlight the constraints under which the government’s budgetary policy has to work. It cannot bring out fully the possible effects of different expenditure policies. These days, however, an increasing need for useful and effective classification of public expenditure is felt. It is only through such classification that the economic effects of various State activities can be gauged and proper policies formulated. A fuller discussion of the economic classification of the government budgets will be taken up in a later portion of the book. Here, however, we can take up two classifications of public expenditure, each of them indicating an area of possible effects on the economy.

![Fig. 4.2 Classification of Public Expenditure](image-url)
4.3.1 Productive and Unproductive Expenditures

This distinction emphasises that while some expenditures are in the nature of consumption, others are in the nature of investment and help the economy in improving its productive capacity. Under the *laissez-faire* philosophy, the only productive public expenditures are those which are incurred to create and maintain social overheads. Expenditures on administration, defence, justice, law and order, and maintenance of the State are unproductive. Adam Smith believed that an economy added to its productive capacity in the long run only through additions to its capital stock and production of tangible goods. If we extend this logic to public expenditure, it will follow that only those public expenditures are productive which create some tangible assets in the economy and enable it to produce more in future. Some people would like to adhere to the usual classical thinking in which the government sector is considered as something foreign and alien to the economy proper. In this case, only those public expenditures are productive which add to the tangible assets of the government, or more precisely income yielding tangible assets of the government including public enterprises of commercial type. The government would be charging for the services of those enterprises to pay for them. Depending upon the pricing policies and other factors, such public expenditures may be, partially or fully, self-liquidating. They could even be a source of profit for the authorities.

It is obvious that the foregoing analytical framework is totally unrealistic. Basically the government sector is a part and parcel of the economy as a whole and must be considered as such. Accordingly, whether an asset is added to the ownership of the government or to that of the private sector should not be the determining factor in deciding about the productiveness or otherwise of any public expenditure.

Secondly, it would also follow that there are many assets which do not yield an income to the government, but which would be really necessary for the productive efficiency of the economy. Such assets ought to be termed productive even though on normal commercial considerations they are not. Parks, waterworks and similar goods and services which add to the productive efficiency of the economy must be viewed as productive assets, and expenditure on their creation and maintenance as the productive expenditure. Such public expenditure is, therefore, also self-liquidating in an indirect manner. There will be an increase in the national product and the authorities will be able to collect, even without raising the tax rates or their coverage, an additional revenue.

Thirdly, it is not necessary that the so called productive assets must be in some tangible form only such as buildings, machinery and the like. The productive power of the society can reside in the form of human wealth also. It can manifest itself in different forms. If through education, training, health, better living conditions, better labour relations, etc., the working population of the country can add to its productive power, the expenditure on such items should certainly be termed
productive. Even if some of these expenditures do not add to the productive effort and rational income, they will be adding to the enjoyment of the people. Of course, just as some tangible assets can be useless, so can be some expenditures on particular types of education and training, etc. But that is a question of choosing proper forms of education and training which would be useful for the economy.

Fourthly, there are certain public expenditures without which the economy cannot live and cannot maintain its productivity. Rather in many cases such expenditures indirectly help the economy in attaining higher levels of productivity. Examples are those of defence expenditure, expenditure on research, and so on. Even efficient administration, communication, and other infrastructural facilities indirectly add to the health and efficiency of the economy. Similarly, some institutions and work culture enhance the economy’s productivity while others retard it. Therefore, a precise distinction between productive and unproductive public expenditure is not an easy task. Each case has to be judged on its own merits. Basically, we may take the position that any wasteful and avoidable expenditure is unproductive, while all the necessary and relevant expenditure is productive.

4.3.2 Transfer and Non-Transfer Expenditures

This classification was favoured by Pigou. A transfer expenditure is a payment without corresponding receipt of goods and services by the State. Examples are interest payments, old-age pensions and unemployment benefits. In these cases, the government is simply transferring the right or claim to use the goods and services to certain sections of the society. In contrast, non-transfer expenditure is that by which the State pays for its purchases or use of goods and services. While in the case of transfer expenditure, the beneficiaries are to decide about the use of real resources, in the case of non-transfer expenditure, it is the State which uses the resources straightaway. Such a use of resources by the State, of course, may be for consumption purposes or for investment purposes. Expenditure on defence, education and such like things are all of non-transfer or real expenditure type as are the investment expenditures. It must, of course, be remembered that when the government incurs a real expenditure, it is not implied that the government will necessarily purchase at the market rates. For one reason or the other, the government may be purchasing at concessional rates or at non-economic rates.

4.3.3 Plan and Non-Plan Expenditure

Plan expenditure in the Government, generally, signifies expenditure taken up under development schemes during a particular Five Year Plan. However, some of these schemes can be continued from a previous plan or some may be ‘spill-overs’. At the initial stages of the exercise of preparation of a Five Year Plan, Planning Commission issues detailed instructions directing what should be classified as ‘Plan Expenditure’. The plan schemes are mostly expected to be limited to a Five Year Plan period. But they may have implications that may extend beyond the plan period.
Major issues relating to plan/non-plan expenditure

Due to the complex nature of Government, the policy regarding what should get classified as plan expenditure and what should get classified as Non-Plan expenditure has been losing clarity. Besides, a notion has widely gained ground among the policy makers and officials across all levels that plan expenditure is good and Non-Plan is bad. This bias in favour of Plan expenditure and against Non-Plan expenditure has led to a situation in which essential Non-Plan expenditure like maintenance of assets is neglected. This has also led to a motivation for showing higher plan expenditure and higher plan sizes both at Central and State levels. Further, several factors such as shift of plan focus from capital to revenue expenditure and the process of transferring expenditure of old schemes to Non-Plan at the end of each Five Year Plan mean that correspondence cannot be drawn between plan and development expenditure.

The Plan/Non-Plan bifurcation of expenditure has contributed to a fragmented view of resource allocation to various programmes/ schemes. With fragmented view, it is difficult not only to ascertain cost of delivering a service but also to link outlays to outcomes. Outcomes and outputs of programmes depend on total expenditure, Plan and Non-Plan put together and not merely on Plan expenditure which constitutes about 30% of the total expenditure only. To conclude, Plan and Non-Plan distinction in the budget is neither able to provide a satisfactory classification of developmental and non-developmental dimensions of Government expenditure nor an appropriate budgetary framework. It has, therefore, become dysfunctional.

Thus, it is recommended that Plan and Non-Plan distinction in the budget should be removed. At the Central Government level, Planning Commission may be responsible, for the sake of convenience and domain knowledge, for guiding the overall development priorities of the Government, setting of outcome targets and review of performance of Ministries/Departments. Ministry of Finance may be responsible for guiding the fiscal policy, preparation of budget and financial decisions. Planning Commission may be responsible for consolidation of the Five Year Plan covering all Services based on the inputs from the Ministry of Finance. The annual budgeting process may need to be revised to facilitate output and outcome-based budgeting within a multi-year framework.

4.3.4 Classification of Public Expenditure in India

The expenditure of the Government is classified into functional heads. The functional classification signifies broadly the function of Government for which the expenditure has been incurred and the activity on which the expenditure has been incurred. The functional classification being followed, as of now, is a six tier structure with a hierarchy of major, sub-major, minor, sub-head, detailed heads and object head. The first tier of the functional classification, called the major head denotes the functions of the Government that are discharged through the expenditure. The second tier of functional
classification provides the description of sub functions. The third tier, denoted by the
minor head, indicates the objective of the Government being achieved through that
particular expenditure. Below the minor head are the two tiers of sub heads (fourth
tier) and detailed heads (fifth tier). The Sub-head indicates specific schemes or activities
of the Government under which the expenditure has been incurred and the detailed
head indicates various components of the schemes or sub-schemes. The sixth tier of
object head provides details about the object of expenditure. Thus, this forms a two
dimensional classification where the expenditure is classified into object heads for
each functional head. The division provided by Plan/Non-Plan classification is laid
over the functional and object classification. This division cuts across the entire
classification hierarchy into two columns.

4.3.5 Canons of Expenditure

Like canons of taxation, people have propounded canons of public expenditure
also which should govern the public expenditure decisions. They reflect the
philosophy of a judicious use of public funds with associated legal propriety. Some
of these canons are in the nature of administrative safeguards while others are
expected to help the economy and society in achieving their diverse objectives. It,
of course, goes without saying that these canons are only broad generalisations
and detailed guidelines have to be worked out in each specific case.

1. Canon of Economy: The resources of the economy are always scarce
compared with its needs. No wastage should, therefore, be permitted. Public
expenditure is the financial counterpart of the resources which the government
uses up directly or places at the disposal of certain sections of the society
for this purpose. It is therefore, essential that the process of public expenditure
should not involve the use of resources more than what are just necessary.
Utmost care must be taken to avoid wasteful usage of public funds. And as
the sphere of government activities increases both in coverage and quality,
it becomes all the more difficult to judge the exact type and extent of wasteful
expenditure. Therefore, still greater care and a scientific approach towards
the assessment of the required expenditure is needed. Techniques like those
of programme and performance budgeting and zero base budgeting have
been developed to meet these objectives.

One form of wastage of public expenditure is the delay that often
accompanies in formulating the plans of public expenditure, their sanction
and their execution. On account of the faulty planning and execution and
the delays involved, some benefits are lost; or to put it differently, for given
benefits the authorities pay more. Furthermore, on account of delays, when
prices are rising, costs themselves go up. These days, various costing methods
have been evolved for continuous check on various cost elements of projects,
especially the manufacturing ones. The authorities also use these methods
in a number of such projects. In quite a few projects, the cost benefit
approach is adopted in which the social cost and social benefits of a project
are estimated (including an imputed valuation of the intangible social costs and benefits) and then the worthwhileness of the project is decided. It must, however, be noted that the techniques of costing and cost benefit analysis are not applied to all the items of public expenditure. And there are certain expenditures which are contractual. The authorities are under obligation to incur them (such as interest on public loans) and the question of economy in their use just does not arise.

2. **Canon of Sanction**: This canon asserts that no public funds should be used without proper authorisation and further that funds must be used only for the purpose for which they have been sanctioned. In a democratic set up, it is the legislature which sanctions the expenditure on demand by the executive authorities. The idea is that such a restriction would avoid unscrupulous and unwanted expenditure and will also be a check against misappropriation of funds. Given the authority by the legislature, detailed authorisations are worked out and at each stage the spending unit has to have the sanction and approval of the appropriate authorities. Since, however, there can always be emergencies and delays in getting the sanction of the legislature for additional funds, a certain flexibility is granted in a number of cases up to a margin.

3. **Canon of Benefit**: This is clearly related to the canon of economy. Actually economy of expenditure is a relative term and not an absolute one. Any expenditure is to be viewed against the benefits that will accrue from it. Canon of benefit also says that the public expenditure should be incurred only if it is beneficial to the society.

Now the beneficial nature of public expenditure can manifest itself also in the form of various effects on income and wealth distribution, effects on production, and so on. In the final analysis this canon leads the authorities to observe the principle of maximum social advantage. The additional consideration here would be that it may be possible to reallocate the same public expenditure between different items in a manner which increases social benefit. The authorities should, therefore, try to choose that combination of items for public expenditure which collectively maximize the social benefit.

4. **Canon of Surplus**: This canon should actually be interpreted to mean that the government should avoid deficit budgeting, at least a persistent one. It should always try to be prudent and should aim at meeting its current expenditure needs out of its current revenue. It should not overspend and run into a debt. Since it may not be possible to avoid some deficits, it would be better if the general effort is directed at achieving a moderate surplus. Such moderate surpluses during some years will take care of reasonable but unavoidable deficits during other years. If on account of war, etc., a large deficit has to be incurred, then the government should try to pay off its debts as soon as possible.
This canon, however, no longer finds favour with the fiscal authorities or with economists in general. This canon was an offshoot of the *laissez faire* philosophy. These days, however, the regulatory role of the government is recognized in an increasing measure and therefore the choice of a surplus or a deficit budget is left to be decided on the merits of the case. Thus during depression in a developed country, the government would do well to run into a deficit to stimulate demand and production. Objectives of stabilisation and economic growth may necessitate even recurring deficits. Resource mobilisation efforts in an underdeveloped country often necessitate deficit financing. It is a concealed taxation through which the government appropriates additional resources of the economy which can be used for capital formation. In the growth process, the barter sector of an underdeveloped economy gets increasingly monetised while the economy itself grows in complexities. In order to help and sustain this process, the financial and credit structure of the economy must also develop along healthy and efficient lines. To this end, deficit financing through resultant increase in money supply and public debt, provides the necessary credit base.

In recent years, some academicians have added to the canons of expenditure. A brief description of these canons is as follows:

1. **Canon of Maximum Social Benefit.** Ideally, each component of public expenditure should aim at maximizing aggregate social benefit, that is, satisfying one fundamental principle of Maximum Social Advantage. In practice, application of this criterion poses several difficulties including the identification and quantification of the expected benefit, the efficiency with which public expenditure is incurred, the alternative ways in which it could be spent, the conflicting interests of different social groups, and so on. In general, a good deal of subjectivity (discretion) is involved in deciding the best way of spending public money.

2. **Canon of Elasticity:** This means that there should not be any rigidity in spending public funds. It should be possible to bring about necessary changes in it in response to changing circumstances and situation. This objective, however, comes in conflict with the fact that there has to be an overall and tight control over each piece of public expenditure and functionaries of the government cannot be given complete discretionary powers to use public funds as per their personal judgement and preference.

3. **Canon of Balanced Budget:** This principle does not command universal acceptability. In a way, it says that the government should allow the market forces to work without intervention. In contrast, some thinkers recommend that the government should take active part in modifying the working of demand and supply forces and thereby aim at facilitating the achievement of some of the socio-economic objectives like accelerating economic growth, improving income and
wealth distribution, stimulating employment, helping some specific economic sectors, and so on. To this end, therefore, if the government requires a surplus or a deficit budget, it should proceed with it. However, it is also recognized that persistent high surplus or high deficit budgets go against the objectives for which they are adopted. It should be remembered that even a balanced budget is not neutral and can interfere in the working of market forces because of (i) the size and manner of collecting revenue and (ii) the size and manner of public expenditure.

4. **Canon of Optimizing Production and Distribution:** It is claimed that public expenditure must work out a proper control on both production and distribution of income and wealth in the society.

It is noteworthy that several of the canons of public expenditure conflict with each other. The starting point for formulating these canons is to decide whether the government should pursue a policy of total non-intervention and let the ill-effects of ‘market failures’ go unchecked, or whether it should adopt a specific set of objectives of public expenditure. Even in the latter case, it is not necessary that the public expenditure policy should always aim at a balanced, a surplus or a deficit budget and the size and composition of this imbalance. Every government would, therefore, take decisions in the context of various detailed objectives, legal provisions, and its own capacity.

**Check Your Progress**

4. Give some examples of expenditure which are labelled as unproductive.
5. What is a transfer expenditure?

### 4.4 Causes and Effects of Public Expenditure with Reference to India

The objective of contemporary public expenditure is to focus on improving institutional arrangements and management practices to create incentives for better resource allocation, resource use and financial management. These objectives are based on both traditional fiscal policy and newly introduced institutional development. The objectives of public expenditure are as follows:

- Fiscal discipline
- Resource allocation according to strategic priority (Allocative Efficiency)
- Effective and efficient usage of resource according to strategic priority (Operational Efficiency)

The role of public expenditure in the fiscal policy goals of growth, equity and stability, has varied across different phases of economic development in India. The historical importance of public expenditure lies in the mixed economy model.
adopted after Independence in India whereby the government assumed the primary responsibility of building the capital and infrastructure base to promote economic growth. The concerns regarding equity and poverty alleviation after two decades of Independence added another important dimension to public expenditure in terms of redistribution of resources. The inadequate returns on capital outlays and the macroeconomic crisis of early-nineties arising out of high fiscal deficit shifted the focus of public expenditure to efficiency in its management for facilitating adequate returns and restoring macroeconomic stability. While the fiscal policy goal of stability could be achieved, the modus operandi of public expenditure management through curtailing capital expenditure raised concerns about infrastructure investment and its impact on the long-term growth potential of the economy. Furthermore, stagnating revenue mobilization in particular and some upward movements in expenditures led to a reversal of the fiscal stabilization process since the second half of the Nineties. An improved fiscal performance during 2003-04 engendered by containment of the non-plan expenditures and supported by high revenue mobilization on the back of buoyant real activity paved the way for renewed commitment towards fiscal consolidation in India.

Study of management of public expenditure by State Governments in India is highly relevant as:

- The Indian economy is in a decelerating mode according to the Planning Commission marked by deterioration of the fiscal situation—with high fiscal and revenue deficits at both Centre and the States especially in the 1990’s.
- Economic Survey (2000-01) of the Ministry of Finance recognizes gaps in the reform process clouding the long term prospects of the economy and recommends credible medium term programme of fiscal improvement.
- International Monetary Fund’s Report (April 2000) categorizes India among the fastest growing economies of the world needing deft handling of monetary policy to combat the challenge of fiscal deficit.
- Approaches to public expenditure management during the Eighth Plan have been, directed towards reducing budgetary deficits and have concentrated on compression of public investment affecting development investments.
- There is need for appreciation of the fact that the character of expenditure, rather than the size of the deficit is more important and that the composition of the budget and direction of expenditure influence the growth of GDP and that the level and patterns of expenditure as well as the means through which resources are raised directly affect the income and expenditure streams.
- Analysis of transactions on revenue and capital accounts, at the centre reveals that, revenue surplus covered to a significant extent the capital deficit till the eighties but the trend reversed in the nineties with the emergence of capital surpluses and revenue deficits, reduction in capital expenditure and increasing borrowings and debt liabilities in the latter years.
Recent Changes in Public Expenditure in India

As part of the Public Financial Management System, the Department of Expenditure, Ministry of Finance has brought in a lot of changes (As of 2017), some of which are:

- The distinction between plan and non-plan expenditure has been done away with.
- A General Financial Rules (GFRs), 2017 was released to provide a framework for financial management.
- The Government also accepted the recommendation of the FRBM Committee to use Fiscal Deficit target as the key operational parameter.

Ideas regarding the need and the effects of public expenditure have varied over time. The earlier approach was closely linked with the philosophy of laissez-faire, according to which the best government was the one which governed the least. It was argued that everyone was the best judge of his own interests and that the government could not be expected to take any decision which was basically superior to the private ones. The only sphere where the government could legitimately operate was the preservation of the society and undertaking those activities which were needed by the economy but were commercially unprofitable. It was this logic which delimited the State’s legitimate sphere of activities to defence, law and order, justice, administration and social overheads.

However, the fact that the market mechanism failed in many respects to bring about the desired results in the economy, forced an increasing intervention on the part of the State. This not only led to a rapid growth in the government sector and public expenditure but also fed various analytical hypotheses concerning public expenditure. However, we find that on account of the basic differences in the approaches adopted by various writers, we have no general agreement as to the way in which public expenditure can be used and the way it would affect the working of an economy. Thus, we find that some authors have characterised public expenditure as a potent tool for bringing about income and employment stability in the economy. Others are sceptical about the very possibility of using public expenditure usefully. To them public expenditure is a sheer waste and, therefore, a burden upon the economy. Still others would look at public expenditure as a major weapon for bringing about an egalitarian society through various welfare measures and so on.

Let us, however, proceed with the recognition of the fact that the government sector is a part of the economy and that it should be treated as such. It is a different thing, of course, that just as different sectors of the economy are interdependent and influence each other, similarly, the government sector also is inter-linked with the rest of the economy. But there is one major difference. It is that the private sector of the economy is guided by the market mechanism while the government sector can be used by the authorities to bring certain changes in the economy. Within limits, the government sector can float the laws of the market.
It is also an important means of directing the working of the rest of the economy. It is this intricate relationship between the government sector and the rest of the economy which spells out different possible effects of public expenditure.

**Expenditure Policy**

Public expenditure can deeply affect the working of an economy through its sheer size. In India, it assumes a special significance because the Government explicitly claims to use it for various policy objectives including reduction in income and wealth inequalities, decentralization of economic power, removal of regional disparities, and acceleration of economic growth. Till recently, it also considered public sector as a pre-condition for achieving all these objectives.

One way of assessing the impact of expenditure of the Government is that of studying its break up into consumption and capital formation components.

The total expenditure of GOI is split up into four components, namely (i) gross fixed capital formation by the GOI itself, (ii) financial investments and loans to the rest of the economy, (iii) consumption expenditure of GOI, and (iv) transfer payments to the rest of the economy. Of these, the first two components are taken to represent capital formation by GOI. In India, it has been seen that the sum of these two components registered an increase in absolute terms. However, as a proportion of total expenditure, it increased only till the end of Second Plan. From Third Plan onwards, this proportion kept on declining and, in Eleventh Plan, had fallen to only 10.4%.

Similarly, consumption expenditure as a proportion of total expenditure declined from a high of 33.9% in the First Plan to only 20.2% in the Eleventh Plan. But its rate of increase was much faster than that of gross fixed capital formation. This is something which goes against praiseworthy growth-oriented fiscal management. The underlying causes for this phenomenon include persistent inflationary pressures and inability of the GOI in containing growth in its own consumption expenditure.

The most disturbing increase has been in the component ‘transfer payments to the rest of the economy’. Starting from a mere 23% (₹117 crore) in 1950–51, it was budgeted at ₹34,45,402 crore or 69.5% of total expenditure in 2012–13. Added to the consumption expenditure, it accounted for 89.7% of total expenditure of GOI.

In the context of expenditure policy of GOI, the following additional points are also noteworthy.

- GCF does not represent an equivalent addition to the productive capacity of the economy. GCF figures are inclusive of variations in stocks of foodgrains, fertilizers, stores and inventories as also maintenance of capital assets.
- What matters for economic growth is not just the rate of capital formation but also its optimum allocation and effective utilisation. Analysts hold
the view that the authorities frequently follow wrong priorities in resource allocation and that procedural and bureaucratic delays lead to high capital-output ratio and under-utilisation of productive capacity. There have been attempts at reducing/containing unproductive expenditure (particularly the transfers) but without any success. All the proclaimed measures aiming at fiscal discipline and downsizing of government, cutting down of subsidies, interest payments, and the like have been of little avail.

4.4.1 Economic Stability and Development

It is a well-known fact that the market forces by themselves leave much to be desired in the field of economic results. The more advanced and free the market mechanism, the more prone the economy is to fluctuations in income, employment, and prices. It is for this reason that with the development of capitalism, free enterprise economies came to experience ever stronger trade cycles. Accordingly, the need to use some effective anti-cyclical measures was recognized more so since the havoc which the Great Depression of the 1930s caused. Keynesian diagnosis of the basic cause of the ills of a developed market economy was the deficiency of effective demand which was caused on account of a low marginal propensity to consume coupled with a low marginal efficiency of investment. He therefore advocated a continuous injection of additional purchasing power in the market through stimulation of investment and consumption activities and through direct public investment. This direct investment was a part of the public expenditure. Such a public expenditure was meant to directly add to the effective demand in the market and generate a high-value multiplier by distributing income to those sections of the population which had a high marginal propensity to consume. The addition to demand by such sections would also stimulate investment activity and thus through an all-round increased demand, the depression could be overcome. Keynesian prescription was basically directed towards curing a state of depression, but the logic of the argument can also be extended to that of curing an inflationary situation. To put it differently, Keynesian policy prescription can be developed into a scheme of compensatory finance - correcting the deficiency or excess of demand by the private sector of the economy. During a depression the State was expected to increase total spending in the economy. And this could be done, if need be, through deficit financing. Public borrowings, to the extent they came out of savings of the people, would help in the stimulation of overall demand when they were spent. This would be more so when the savings of the people were not finding an investment outlet, due to an all-round deficiency of demand.

Similarly, if deficit financing was being met through creation of additional money, the stimulating effect of additional public expenditure would again be felt. In either case there would be a net increase in total expenditure and demand flows in the economy. During a boom, on the other hand, the need is to curb extra demand. This may be done through reducing public expenditure while maintaining
the same amount of taxation and/or borrowings. Here taxation would drain away some of the purchasing power from the hands of the people and public borrowings would in the same way cut into market investment (since market savings are not likely to go un-invested on account of good investment opportunities). Thus a curtailment of public expenditure would restrain the inflationary pressures.

It must be remembered that the use of public expenditure as an anti-cyclical weapon implies the existence of a well-knit and sensitive market mechanism where, through the free working of the input-output relationships between different industries, any change starting in one industry spreads to the rest of the economy. It is necessary that such spreading out of effects should be even enough and without undue time lags. And if a depression is to be cured through stepping up of demand, then there must be adequate unutilized excess capacity in the economy. If these assumptions are satisfied, then the authorities have to concern themselves only with the aggregate demand and not with the particular directions in which it is flowing, since through the interaction between demand and supply flows an automatic adjustment takes place. In a market, where there are technical and other rigidities, the effect created in one sector may not evenly spread to the others. It must be noted that such rigidities are not absent even in developed countries. As a result, under such circumstances, public expenditure no longer remains a simple and easy tool.

The authorities have to regulate not only the total magnitude of demand in the economy, they have also to ensure that the subdivisions of the demand flows match the supply flows. Public expenditure as an anti-cyclical tool will have to be devised in a detailed manner. If this care is not taken, and if the authorities use public expenditure just to stimulate demand in general, then such a stimulating effect will be felt only for certain items while many other industries and areas would remain unaffected, or would be affected only partially. Actually, it is quite possible that while some sectors of the economy are suffering from lack of demand some others might be groaning under inflationary pressures on account of too much demand. Similarly, it is also possible that when the government reduces its expenditure to curtail over-all demand, the effect is more or less concentrated in the industries for which the government reduces the expenditure directly.

As is well-known, an underdeveloped country suffers from far greater rigidities than do the developed countries. Shortages of particular materials, are common. There are gaps in the form of absence of certain industries or adequate productive capacity therein. Various kinds of institutional and legal restrictions prevent a proper and quick market response on the part of different sectors of the economy; and it may be the case even with those sectors to which public expenditure is applied directly. As a result, the problem of bringing about economic stability is far more complex in this case.

Another factor which contributes to the complexity of the problem is the fact that an underdeveloped economy is having, generally speaking, inelastic
demand for essential maintenance imports while demand for its exports is quite weak. The result is that if the world prices for its exports fall, it is forced to distress sales; while if its import prices increase, its cost price level is pushed up. Ordinarily an underdeveloped country does not have much defence against this type of instability. Public expenditure cannot remedy the situation to a sufficient degree. Normally, through export and import duties, it should be possible to bring about desired changes in exports and imports; but under unfavourable conditions, this is generally not effective enough. And for some countries, recurring balance of payments problems add to their difficulties.

In summary, we may say that in underdeveloped countries, public expenditure as a general weapon against economic instability has only a limited use; a very detailed programme has to be worked out to meet the specific problems on hand and even then public expenditure alone may not be adequate to overcome the difficulties. A careful and judicious combination of the import and export subsidies, duties and other steps has to be used for achieving effective results.

The factors discussed above help us in assessing the role of public expenditure in economic growth also. In a developed country, through economic stabilisation, stimulation of investment activity and so on, public expenditure maintains a rate of growth which is a smooth one. In an underdeveloped country, public expenditure has an active role to play in reducing regional disparities, developing social overheads, creation of infrastructure of economic growth in the form of transport and communication facilities, education and training, growth of capital goods industries, basic and key industries, research and development and so on. Public expenditure has a great role to play in the form of stimulating saving and capital accumulation.

One way in which public expenditure is expected to affect the pace of economic growth is the will and capacity of the people to work, save and invest. In this connection, the exact effect depends largely upon the precise form and magnitude of public expenditure as seen in the context of accompanying circumstances. Now when public expenditure is incurred, by itself it may be directed to particular investments or may be able to bring about re-allocation of the investible resources in the private sector of the economy. This effect, therefore, is basically in the nature of re-allocation of resources from less to more desirable lines of investment. But whether or not there will be an addition to the total investment activity, depends upon a number of additional factors. It partly depends upon the will of the people to work.

There are conflicting views as to whether public expenditure increases the will to work or dampens it. Some welfare expenditures might lead to an effect in either direction. Similarly, the net effect also depends upon economic activity and investment. An important way in which public expenditure can accelerate the pace of economic growth is by narrowing down the difference between social and private marginal productivity of certain investments. Here public expenditure can be used to provide subsidies for those investments which are commercially non-
viable but which are very helpful for economic growth. Such a system of subsidies, for example, may be for agricultural inputs if agricultural production is to be stimulated, or for investment in backward areas to reduce regional disparities and unemployment. Subsidies can also be used to promote import substitution and, at the same time, to keep the prices of necessary imports of capital goods etc., low.

As far as savings are concerned, it may be presumed that public expenditure would be designed in such a way as to increase the over-all savings in the country, though of course not necessarily so. Some public expenditure may be in the form of education, various social services and so on in which case it will lead to an increase in consumption rather than savings. On the other hand, to the extent public expenditure helps the people in attaining higher efficiency and productivity, their capacity to work and save increases. But above all, we must recognize the lead which public expenditure, if used in a judicious way and with a purpose, can give to the economy. It has a capacity to open up vast opportunities and it can create an awakening and desire in the minds of the people to improve their lot.

It must be recognized, however, that public expenditure is only a part of the over-all economic policy that a country may be adopting. Taxation, licensing and various policy instruments may aid public expenditure in achieving different objectives. Of course, if the things are ill-planned, different institutions may even work at cross-purposes. When therefore, the probable effects of public expenditure are mentioned, it is always understood that these effects have to be considered in the context of taxation and other measures being pursued by the government and that there is a co-ordination between different objectives and institutions.

**Economic Distribution**

An important aspect of the market mechanism is the inequalities of income and wealth that arise on account of it and which through the institutions of private property and inheritance get widened with the passage of time. Furthermore, such income and wealth disparities not only spell a social and economic injustice, they also distort production and employment patterns.

Lesser inequalities of income and wealth, it may be claimed, contribute towards economic stability. It is generally recognized that marginal propensity to consume falls as income rises. As a result, during the expansionary phase of a trade cycle, consumption demand tends to lag behind and causes a check on further expansion of demand in the economy. Without such a check the upward movement of the trade cycle might develop into a real inflation. Similarly, during a depression, consumption refuses to dip below a certain level and as a result the economy is provided a firm base below which on account of a minimum demand it would not go. Furthermore, such a stability in the economy itself is helpful to economic growth. Private investment is affected, amongst other things, by safety and expected rates of return. With economic stability and expectation thereof, the risk of loss is reduced and this has, therefore, a healthy effect on the investment climate.
Welfare considerations also favour an equitable distribution of income and wealth. The purpose of an economic policy should be to contribute towards achieving the maximum social benefits. Though we cannot prove objectively that marginal utility of income falls as income increases, such a statement may be accepted on common-sense basis. If that is agreed, it follows that any movement towards equitable distribution of income and wealth would increase the aggregate satisfaction in the community. Lerner has shown that even if we do not know the exact way in which marginal utility of income falls with a rise in income and even if we cannot have inter-personal comparisons of utility, still a shift towards equality would probably add to the aggregate satisfaction of the community.

Such a shift towards equality, of course, may be achieved through various forms of public expenditure especially those which are meant to help the poorer sections of the society. A number of welfare measures like free education, health, water and other facilities can be given a top priority. Numerous social security schemes can be adopted whereby people are entitled to old-age pensions, unemployment relief, and sickness allowance and so on. Articles of common consumption like food can be subsidised, and the production of those which are in short supply can be taken up in the public sector. Left to market mechanism, the supply of ‘merit goods’ is likely to be insufficient. Public expenditure, through direct purchases, public production or subsidies can ensure that their supply is augmented to the desired extent. Similarly public expenditure, through appropriate subsidies and other ‘purchase and stores’ policy can encourage labour-intensive techniques of production which reduce unemployment and improve income distribution.

However, while proceeding with the programme of bringing about income and wealth equalities, certain aspects of possible interaction between distributive justice and other dimensions of the economy must be kept in mind. To begin with, poorer people may not be able to enjoy fully the additional income because of ignorance, etc. But this argument is applicable only if suddenly large amounts of income start flowing to the poorer sections of the community. In an underdeveloped country (to whose poor people this argument could be directed); this argument does not apply because there is not enough to significantly improve the lot of everyone. Through income redistribution the poor masses can only feel a marginal relief. Even if there was a lot of income to redistribute, the desirability of reducing inequalities would not be disproved. It would only point towards the need for going slow in this direction, so that the poorer sections also get accustomed to higher standards of living.

The second consideration is that of the effect of equalities on production through the will and capacity to work, save and invest. This is a controversial field, and clear-cut and widely acceptable generalisations are difficult to make. In a poor country, where the need to reduce inequalities is the greatest, saving potential is only with the higher income groups. With a big shift towards equalities, such a saving potential is much reduced especially because the poorer sections of the
Community are bound to consume away a major portion of their newly acquired incomes. The objective of economic equality, therefore comes into conflict with that of economic growth. In other words, both will and capacity to save on the part of the members of the society are likely to suffer when a shift towards income and wealth equalities is made. An underdeveloped country, therefore, is faced with a difficult choice.

Thirdly, the distributive effects of public expenditure must be viewed in the context of its method of financing. For example, if the tax system of the country is regressive, it would militate against the distributive effects of public expenditure. Similarly, if public expenditure is financed through deficit financing, or through such borrowings as are inflationary in character, inequalities would widen. However, deficit financing to a limited extent need not generate inflationary pressures. Similarly, public borrowings out of genuine savings of the economy are expected to be only mildly inflationary. While the long-term solution of its economic difficulties cannot be had without economic growth, the problems of income distribution also cannot be postponed indefinitely. This, therefore, has to be worked out wherein both these objectives are pursued concurrently in a balanced manner. And to the extent the hitherto un-exploited resources can be tapped, or foreign aid is received, the task of pursuing both the goals (of equitable distribution and growth) become less difficult.

Check Your Progress
6. What are the objectives of public expenditure in India?
7. What is the flip side of economic distribution through the market mechanism?

4.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Public expenditure refers to the expenses which a government incurs for (i) its own maintenance, (ii) the society and the economy, and (iii) helping other countries.

2. Adolph Wagner’s Law of Increasing State Activities states that there are inherent tendencies for the activities of different layers of a government (such as central and state governments) to increase both intensively and extensively. There is a functional relationship between the growth of an economy and government activities with the result that the governmental sector grows faster than the economy.

3. The main thesis of the Wiseman and Peacock’s study of public expenditure is that public expenditure does not increase in a smooth and continuous manner, but in jerks or step like fashion. At times some social or other disturbance takes place, creating a need for increased public expenditure which the existing public revenue cannot meet.
4. Expenditures on administration, defence, justice, law and order, and maintenance of the State are unproductive.

5. A transfer expenditure is a payment without corresponding receipt of goods and services by the State. Examples are interest payments, old-age pensions and unemployment benefits.

6. The objective of contemporary public expenditure is to focus on improving institutional arrangements and management practices to create incentives for better resource allocation, resource use and financial management. These objectives are based on both traditional fiscal policy and newly introduced institutional development. The objectives of public expenditure are as follows:
   - Fiscal discipline
   - Resource allocation according to strategic priority (Allocative Efficiency)
   - Effective and efficient usage of resource according to strategic priority (Operational Efficiency)

7. An important aspect of the market mechanism is the inequalities of income and wealth that arise on account of it and which through the institutions of private property and inheritance get widened with the passage of time. Furthermore, such income and wealth disparities not only spell a social and economic injustice, they also distort production and employment patterns.

4.6 SUMMARY

- Historically, public expenditure has recorded a continuous increase over time in almost every country. However, traditional thinking and philosophy did not favour this trend because it rated market mechanism as a better guide for the working of the economy and allocation of its resources.

- Adolph Wagner (1835–1917) was a German economist who based his Law of Increasing State Activities on historical facts, primarily of Germany. According to Wagner, there are inherent tendencies for the activities of different layers of a government (such as central and state governments) to increase both intensively and extensively.

- Wagner’s Law was based upon historical facts. It did not reveal the inner compulsions under which a government has to increase its activities and public expenditure as time passes. It was applicable only to modern progressive governments which were interested in expanding public sector of the economy for its overall benefit.

- Buchanan and Tullock, in the context of US experience, have viewed Wagner’s theory in terms of increasing discrepancy between growth of government expenditure and government output and termed the phenomenon as “Wagner Squared” hypothesis.
The second thesis dealing with the growth of public expenditure was put forth by Wiseman and Peacock in their study of public expenditure in the UK for the period 1890-1955. The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner, but in jerks or step like fashion.

On the face of it, Wiseman-Peacock hypothesis looks quite convincing. But we must remember that they are emphasising the recurrence of abnormal situations which cause sizeable jumps in public expenditure and revenue.

While private and public expenditures are similar in their overall and complex ramifications, the dissimilarities between them are also quite glaring. The first such dissimilarity is the objective with which the expenditure is incurred.

Keeping in view the fact that the State is the guardian of the social welfare and economic and social health of the society, provision for many public services is not decided on the basis of their cost-effectiveness.

These days, however, an increasing need for useful and effective classification of public expenditure is felt. It is only through such classification that the economic effects of various State activities can be gauged and proper policies formulated.

Under the laissez-faire philosophy, the only productive public expenditures are those which are incurred to create and maintain social overheads. Expenditures on administration, defence, justice, law and order, and maintenance of the State are unproductive.

A transfer expenditure is a payment without corresponding receipt of goods and services by the State. Examples are interest payments, old-age pensions and unemployment benefits. In these cases, the government is simply transferring the right or claim to use the goods and services to certain sections of the society. In contrast, non-transfer expenditure is that by which the State pays for its purchases or use of goods and services.

Due to the complex nature of Government, the policy regarding what should get classified as plan expenditure and what should get classified as Non-Plan expenditure has been losing clarity. Besides, a notion has widely gained ground among the policy makers and officials across all levels that plan expenditure is good and Non-Plan is bad.

The expenditure of the Government in India is classified into functional heads. The functional classification signifies broadly the function of Government for which the expenditure has been incurred and the activity on which the expenditure has been incurred.

It is noteworthy that several of the canons of public expenditure conflict with each other. The starting point for formulating these canons is to decide whether the government should pursue a policy of total non-intervention and let the ill-effects of ‘market failures’ go unchecked, or whether it should adopt a specific set of objectives of public expenditure.
The role of public expenditure in the fiscal policy goals of growth, equity and stability, has varied across different phases of economic development in India. The historical importance of public expenditure lies in the mixed economy model adopted after Independence in India whereby the government assumed the primary responsibility of building the capital and infrastructure base to promote economic growth.

The fact that the market mechanism failed in many respects to bring about the desired results in the economy, forced an increasing intervention on the part of the State. This not only led to a rapid growth in the government sector and public expenditure but also fed various analytical hypotheses concerning public expenditure.

It is a well-known fact that the market forces by themselves leave much to be desired in the field of economic results. The more advanced and free the market mechanism, the more prone the economy is to fluctuations in income, employment, and prices. It is for this reason that with the development of capitalism, free enterprise economies came to experience ever stronger trade cycles.

It must be remembered that the use of public expenditure as an anti-cyclical weapon implies the existence of a well-knit and sensitive market mechanism where, through the free working of the input-output relationships between different industries, any change starting in one industry spreads to the rest of the economy.

Public expenditure can be used to provide subsidies for those investments which are commercially non-viable but which are very helpful for economic growth. Such a system of subsidies, for example, may be for agricultural inputs if agricultural production is to be stimulated, or for investment in backward areas to reduce regional disparities and unemployment.

An important aspect of the market mechanism is the inequalities of income and wealth that arise on account of it and which through the institutions of private property and inheritance get widened with the passage of time. Furthermore, such income and wealth disparities not only spell a social and economic injustice, they also distort production and employment patterns.

Welfare considerations also favour an equitable distribution of income and wealth. The purpose of an economic policy should be to contribute towards achieving the maximum social benefits. Though we cannot prove objectively that marginal utility of income falls as income increases, such a statement may be accepted on common-sense basis.

In a poor country, where the need to reduce inequalities is the greatest, saving potential is only with the higher income groups. With a big shift towards equalities, such a saving potential is much reduced especially because the poorer sections of the community are bound to consume away a major portion of their newly acquired incomes.
• While the long-term solution of its economic difficulties cannot be had without economic growth, the problems of income distribution also cannot be postponed indefinitely.

4.7 KEY WORDS

- **Wiseman-Peacock Hypothesis**: This focused on the pattern of public expenditure and stated that public expenditure does not follow a smooth or continuous trend but the increase in public expenditure takes place in jerks or steps.

- **Tolerance tax**: Tolerance tax was a tax that was levied against Jews of Hungary, then part of the Austrian Empire, between 1747 and 1797. The tax was based on the German statute that a Jew was obliged to pay a certain tax to be “tolerated”

- **Laissez-faire**: Laissé-faire is an economic system in which transactions between private parties are free from government intervention such as regulation, privileges, tariffs and subsidies.

- **Non-plan expenditure**: This is accounted for by interest payments, subsidies (mainly on food and fertilisers), wage and salary payments to government employees, grants to States and Union Territories governments, pensions, police, economic services in various sectors, other general services, etc.

- **Market failure**: In economics, market failure is a situation in which the allocation of goods and services by a free market is not efficient, often leading to a net social welfare loss.

- **Deficit financing**: This is the budgetary situation where expenditure is higher than the revenue. It is a practice adopted for financing the excess expenditure with outside resources.

- **Fiscal Discipline**: This refers to a state of an ideal balance between revenues and expenditure of government, in an economy. If the fiscal discipline is not maintained, then the government expenditure exceeds government receipts.

- **The Great Depression**: This was a severe worldwide economic depression that took place mostly during the 1930s, beginning in the United States. The timing of the Great Depression varied across nations; in most countries it started in 1929 and lasted until the late-1930s.

4.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short Answer Questions**

1. Why is public expenditure historically significant?
2. Write a short note on the theories of increasing public expenditure.
3. What is “Wagner Squared” hypothesis?
4. What are major issues relating to plan/non-plan expenditure?
5. Explain the role of accounting classification in public expenditure.
6. How is public expenditure by State Governments in India managed?
7. What are the distributive effects of public expenditure?

**Long Answer Questions**

1. Discuss the impact of various principles of public expenditure.
2. Analyse, in detail, the various classification of public expenditure.
3. Discuss the various canons of expenditure.
4. Analyse the role of public expenditure on economic stability and development of a country.
5. Discuss how economic equality can be achieved through various forms of public expenditure.

**4.9 FURTHER READINGS**

UNIT 5 PUBLIC REVENUE SOURCES

5.0 INTRODUCTION

In mobilizing sources for public revenue, taxes play the most important role and also contribute handsomely to government’s exchequer. Taxes are compulsory payments to government without expecting direct benefit or return by the tax payer. Taxes collected by Government are spent to provide benefits to the people in form of various public welfare services. Their significance can be gauged from the fact that refusal to pay the tax is a punishable offence. The government collect tax revenue by way of direct and indirect taxes. Corporate tax, personal income tax, capital gain tax and wealth tax form the part of direct tax whereas custom duty, central excise duty, VAT and service tax come under indirect tax. Tax Revenue forms part of the Receipt Budget.

Non-Tax Revenue is obtained by the government from sources other than tax. This includes fees, fines or penalties, Surplus from Public Enterprises, Special assessment of betterment levy, Grants and Gifts and Deficit financing, etc.

This unit aims at getting an insight into various sources of public revenue and analysing the distinction between tax and non-tax revenue.

5.1 OBJECTIVES

After going through this unit, you will be able to:
- Understand the various sources of public revenue
- Describe the distinction between public receipts and public revenue
- Discuss the classification of public revenue
- Analyse the distinction between tax revenue and non-tax revenue
5.2 SOURCES OF PUBLIC REVENUE

Every government needs funds to finance its activities. Such funds are raised from various sources. It is difficult to give a complete list of all the sources of public receipts. But the important ones include taxes, income from currency, market borrowings, sale of public assets, income from public undertakings, fees, fines, gifts and donations, etc. Professor Dalton makes a distinction between public receipts and public revenue. While public receipts include receipts from all sources, public revenue is a narrower concept and excludes public borrowings, income from the sale of public assets, or receipts from the use of “printing press”.

It is a normal practice with a government to divide its receipts into “revenue” and “capital” categories. Broadly speaking, revenue receipts include “routine” and “earned” ones. For this reason, they do not include borrowings and recovery of loans from other parties, but they do include tax receipts, donations, grants, fees, and fines etc. Capital receipts, on the other hand, cover those items which are basically of non-repetitive and non-routine variety and change government’s financial liabilities/assets.

Classification of Public Revenue

The following are the main classifications of public revenue given by different economists:

- **Adam Smith’s classification:** Adam Smith classified public revenues into two categories, namely revenue from the public and revenue from state property. This classification is very narrow; it does not serve the purpose of modern finance.

- **Bastable’s classification:** Professor Bastable also classified public revenues into two categories, namely income received by the government from various functions and income received by the government in the capacity of the ‘state’.

- **Seligman’s classification:** Seligman classified public revenues into two categories: (i) gratuitous revenue, (ii) compulsory revenue and (iii) contractual revenue. A major drawback of this classification is that it fails to describe unambiguously the differences between fees, prices and taxes.

- **Lutz’s classification:** Lutz has classified public revenue into six categories: commercial revenue, administrative revenue, taxation, public debts, grants and bookkeeping revenue. Of these six categories, the last three are no longer included in the category of public revenue.

- **Dalton’s classification:** According to Dalton, there are two main sources of public revenue: taxes and prices. He has identified twelve categories of public finance: taxes, gifts and reparations, compulsory loans, fines in courts,
5.2.1 Distinction between Tax Revenue and Non-Tax Revenue

All the aforementioned classifications of public revenue have some type of lacuna in them. But Findlay Shirras’ classification of revenue into tax and non-tax categories is accepted as most convincing classification of public revenue.

Tax revenue itself is divided into three sections. These are:

(a) Taxes on income and expenditure: This section covers all those taxes which are levied on receipts of income and expenditures such as corporation tax, income tax, expenditure tax, interest tax, and similar other taxes, if any, in force.

(b) Taxes on property and capital transactions: This section covers taxes on specific forms of wealth and its transfers such as estate duty, wealth tax, gift tax, house tax, land revenue and stamps and registration fees, etc.

(c) Taxes on commodities and services: This section includes taxes on production, sale, purchase, transport, storage, and consumption of goods and services.

Non-tax revenue of the government is divided into three sections. These are:

(a) Currency, coinage and mint: This category covers the receipts of Currency Note Press at Nasik, Security Paper Mill at Hoshangabad, Bank Note Press at Dewas and of the Mints. Profit from circulation of small coins is also included here.

(b) Interest receipts, dividends and profits: This section comprises, apart from interest receipts on loans by the Government to other parties, dividends and profits from public sector undertakings run by or as government departments including other income generating departments. Examples are: contributions from railways and posts and telecommunications, and surplus profits of the Reserve Bank of India transferred to the Government.

(c) Other non-tax revenue: This section covers revenue from various government activities and services such as from administrative services, public service commission, police, jails, agriculture and allied services, industry and minerals, water and power development services, transport and communications, supplies and disposal, public works, education, housing, information and publicity, broadcasting, grants-in-aid and contributions etc. It is to be noted that income and profit from the creation of currency by the government, i.e., the excess of face value of currency over its cost of creation are also included in this group of revenue.
### 5.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Professor Dalton makes a distinction between public receipts and public revenue. While public receipts include receipts from all sources, public revenue is a narrower concept and excludes public borrowings, income from the sale of public assets, or receipts from the use of “printing press”.

2. Seligman classified public revenues into two categories: (i) gratuitous revenue, (ii) compulsory revenue and (iii) contractual revenue.

3. Taxes on income and expenditure covers all those taxes which are levied on receipts of income and expenditures such as corporation tax, income tax, expenditure tax, interest tax, and similar other taxes, if any, in force.

4. Non-tax revenue of the government is divided into three sections. These are:
   (a) Currency, coinage and mint
   (b) Interest receipts, dividends and profits
   (c) Other non-tax revenue

### 5.4 SUMMARY

- Every government needs funds to finance its activities. Such funds are raised from various sources. It is difficult to give a complete list of all the sources of public receipts. But the important ones include taxes, income from currency, market borrowings, sale of public assets, income from public undertakings, fees, fines, gifts and donations, etc.

- Broadly speaking, revenue receipts include “routine” and “earned” ones. For this reason, they do not include borrowings and recovery of loans from other parties, but they do include tax receipts, donations, grants, fees, and fines etc.
Adam Smith classified public revenues into two categories, namely revenue from the public and revenue from state property. This classification is very narrow; it does not serve the purpose of modern finance.

According to Dalton, there are two main sources of public revenue: taxes and prices. He has identified twelve categories of public finance: taxes, gifts and reparations, compulsory loans, fines in courts, public enterprises, public property and fees in other payments, public monopolies (monopoly profits), duties, special assessment, voluntary gifts and mint.

Taxes on income and expenditure cover all those taxes which are levied on receipts of income and expenditures such as corporation tax, income tax, expenditure tax, interest tax, and similar other taxes, if any, in force.

Taxes on property and capital transactions cover taxes on specific forms of wealth and its transfers such as estate duty, wealth tax, gift tax, house tax, land revenue and stamps and registration fees, etc.

Taxes on commodities and services include taxes on production, sale, purchase, transport, storage, and consumption of goods and services.

Interest receipts, dividends and profits comprise, apart from interest receipts on loans by the Government to other parties, dividends and profits from public sector undertakings run by or as government departments including other income generating departments.

Income and profit from the creation of currency by the government, i.e., the excess of face value of currency over its cost of creation are also included under the section of other non-tax revenue.

5.5 KEY WORDS

- **Public receipts**: These include receipts from all sources.
- **Revenue receipts**: Revenue receipts are money received by a business as a result of its normal business operations. In this way, revenue receipts affect the profit or loss of a business.
- **Capital receipts**: Capital receipts refer to those receipts which either create a liability or cause a reduction in the assets of the government. They are non-recurring and non-routine in nature.
- **Tax revenue**: This is the income that is gained by governments through taxation. Taxation is the primary source of income for a state. Revenue may be extracted from sources such as individuals, public enterprises, trade, and royalties on natural resources and/or foreign aid.
- **Non-tax revenue**: Non-tax revenue or non-tax receipts are government revenue not generated from taxes.
5.6  SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short Answer Questions**

1. How does government raise resources to finance its activities for the common benefits?
2. Write a short note on the significance of capital receipts in public revenue.
3. How does Adam Smith classify public revenue?
4. Which taxes are covered under tax revenue?
5. Briefly explain the contribution of non-tax revenue in public revenue.

**Long Answer Questions**

1. Discuss the various sources of public revenue.
2. Discuss the distinction between tax revenue and non-tax revenue.

5.7  FURTHER READINGS

INTRODUCTION

To put it simply, tax is compulsory contribution levied by the government on individuals’ income and business profits. It is often added to the cost of some goods, services, and transactions. Taxpayers are not entitled to receive any direct quid pro quo from the state or government for paying taxes. Taxes which are levied directly on entities are direct taxes, and taxes levied on goods, services, activities, etc. are indirect taxes. Income tax comes under direct tax because a tax payer is determined on the basis of his ‘taxable income’. Corporate taxes or taxes on ‘professions’ are also direct tax as these are levied against the legal entities. Taxes such as excise duties, customs duties, sale/purchase taxes, VAT, service tax, entertainment tax, motor vehicle tax are indirect tax. Also indirect taxes may be specific or ad valorem.

Economists often refer to terms like the average and marginal rates of taxation. Some of them also advocate that the rates used should not be just nominal but effective ones. Although there is the economic effect of taxation on production, distribution, employment generation, etc., the major objective of taxation is to maintain economic stability. However, the level of impact also depends upon the nature of tax.

This unit aims at analysing the meaning, sources and impact of taxation.
6.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning of taxation
- Enumerate the sources of taxation
- Discuss the classification of taxes
- Analyse the impact of taxation

6.2 MEANING OF TAXATION

Tax is a compulsory levy payable by a legal entity to the government without any corresponding entitlement to receive any specified and direct quid pro quo from the government. Note the word direct here. Tax is not a price paid by the taxpayer for any specified service rendered or a commodity supplied by the government. The benefits received by taxpayers from the government are not related to or based upon their being taxpayers. Tax is a generalized exaction, which may be levied on one or more criteria upon individuals, groups of individuals, or other legal entities.

It may be noted that every compulsory payment to the government need not be a tax. For that, absence of a quid pro quo is also a must. However, we frequently come across complex and hazy cases which do not satisfy these criteria unambiguously. Given below are some examples to illustrate this observation. These are:

1. Authorities may supply some priced goods and services to the public. The ‘user charges’ recovered from the public for such a good or service may be higher than its cost of supply and the supply cost itself may contain a component of inefficiency. Furthermore, consumers may have no alternative source of acquiring such a good/service. In such cases, the price/user charge paid by the public contains an element of taxation.

2. A ‘special assessment’ (or a betterment levy) is a kind of a special charge levied on those members of the society who are beneficiaries of certain government activities or public goods. For example, provision of parks and other facilities may push up land values in the neighbourhood. Irrigation facilities often increase the productivity of irrigated lands and, therefore, land prices. Such benefits are ‘unearned increment’ for property owners which the authorities may choose to tax away. Being a compulsory payment, a betterment levy is like a tax. But since there is a quid pro quo (some people get the benefit out of a project and they pay for it), it is also like a price.
3. Fines (such as court fines) are also compulsory payments without any *quid pro quo* but they are different from taxes because they are imposed to curb certain offences and not for raising public revenue. Therefore, fines should not be classified as taxes. Similarly, import and export duties may be imposed with different intentions in mind. If the intention is to get some revenue for the public treasury, they are taxes. But if the intention is to regulate the flow of imports and exports, then they change their character and they are no longer taxes in strict sense of the term.

4. The authorities also may charge fees for certain services such as registration of legal documents, marriages, births and deaths. However, quite often such fees are far in excess of their cost of provision (except, probably, in the case of health services). The extent of excess charges is in the nature of a tax.

5. Profits from creation and issue of government currency are also like compulsory levies upon the public. The actual cost of creating this currency is much less than its face value. The Government, therefore, makes a profit out of this. But this profit is not like the usual profits from other public undertakings. The public has no choice but to use this currency at its face value.

6. Take the case of deficit financing. Ordinarily, it means an excess of public expenditure over public revenue. This excess may be financed by borrowings from the market, borrowings from abroad, or the use of the printing press (creation of currency). The latter two avenues are open to GOI only. In the case of borrowings from abroad, there is no compulsion for the lenders; but in the case of internal borrowings there can be. The government may force various individuals, firms, corporations and other institutions to lend to it at rates much lower than would be the case otherwise. This amounts to a kind of taxation in the sense that the government does not pay as much to the lenders as they could get otherwise. On the other hand, instead of borrowing, the government may choose to use the printing press. When the government spends the additional funds so created, the aggregate demand in the market increases and prices are pushed up. The government purchases away a part of resources and the market is left with smaller supplies. In other words, the government, through the use of the printing press, taxes away some resources of the market just as it could tax them away directly.

7. Voluntary gifts to the government cannot be termed either taxes or prices.

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**Check Your Progress**

1. What do you mean by the term ‘tax’?
2. How do fines differ from tax?
6.3 SOURCES OF TAXATION

Taxes are frequently classified on the basis of the degree of their progressivity. This may be elaborated with reference to taxation of income.

1. If, with increasing income, tax liability of a tax payer increases not only in absolute terms, but also as a proportion of his income, then it is termed a progressive tax.

2. If, on the other hand, the tax liability of a taxpayer increases in the same proportion as the increase in his income, then it is termed a proportional tax.

3. It is termed as a regressive tax if the tax liability of the taxpayer, as a proportion of his income, falls with an increase in his income. The absolute tax liability, however, may increase even in this case.

The foregoing terminology is applicable in the case of every tax base. The base of a tax is the legal description of the taxed object such as, net income or wealth or consumption expenditure of the taxpayer. The term tax rate is used to denote the amount of a tax per unit of the tax base. Accordingly, therefore, when the tax rate does not change with a change in the tax base, it is termed a proportional tax. If, on the other hand, the tax rate and tax base move in the same direction, that is, either both increase or both fall together, we have a progressive tax and the tax is regressive if the tax rate falls as the base increases and vice versa (that is, the tax rate and tax base move in the opposite directions).

It should be specifically noted that the afore-mentioned terminology assumes that every tax base represents a corresponding paying capacity of the taxpayer so that a larger tax base denotes a higher paying capacity.

It will be noted that the presence of proportionality or progressiveness gives rise to a corresponding relationship between average and marginal tax rates. Average tax rate is computed by dividing total tax liability by the total tax base. The marginal tax rate, on the other hand, is estimated by dividing change in the total tax liability by the change in the total tax base. For example, if for an income of ₹ 10,000, the tax liability is ₹ 1,000 and for an income of ₹ 11,000, the tax liability is ₹ 1,320, then the average tax rate for the two income levels are 10% and 12% respectively. The marginal tax rate is the additional tax liability (viz., ₹ 320) divided by additional tax base (namely ₹ 1,000) i.e. 32%. In the case of proportional taxation, since by definition the average tax rate remains unchanged, the marginal rate always remains equal to the average rate. If the tax rate structure is progressive, then the marginal rate increases along with an increase in tax base and lies above the average rate of tax. In the case of regressive tax rates, both average and marginal tax rates fall as the tax base increases and accordingly marginal tax rate lies below the average tax rate.
If rate of progression declines with an increase in tax base, it is termed regressive taxation. It has two forms. In the first case, the entire taxable base is divided into two slabs. No tax is levied on the lower slab, while the entire upper slab is taxed at a given rate. For this reason, the average tax rate falls as the size of taxed base increases. In the second case, the rate of tax does not rise fast enough as the tax base increases (more precisely where the degree of progression is not constant throughout), so that the increase in tax rate becomes slower as the tax base increases. This sort of regression is often found in practice in the case of income tax.

It must be remembered that the concept of progressiveness as stated above is with reference to only the money (or money equivalent) burden of a tax. It need not correspond to the real burden on the taxpayer, that is, the sacrifice which the taxpayer undergoes. In terms of sacrifice, for example, a proportional income tax is progressive because it entails a proportionately greater sacrifice of utility on the part of the lower income taxpayers. Actually, depending upon the rate at which marginal utility of income falls, even some degree of progressiveness in money terms might turn out to be regressive in its real burden.

An assessment of the arguments for and against progressive, proportional and regressive taxes should be conducted at two levels, namely, the impact on an individual tax payer and the impact on the entire society in terms of economic growth, saving, investment, regional disparities, and so on.

When we argue in subjective terms, that is, in terms of the sacrifice which individual tax payers undergo in paying the taxes, we come in contact with the ability to pay and benefits received approaches. These approaches are intimately associated with the subjective formulation of the degree of progressiveness of a tax. Economists have often viewed progressivity of taxation in terms of relationship between the average and marginal rates of taxation. Some advocate that the rates used here should not be just nominal (as in law) but effective ones, since actual collections differ from nominal rates on account of various exemptions, rebates and even evasion. Empirically, these rates should be estimated on the basis of actual tax collections from various income classes of tax payers. It is also possible to devise a measure of tax progressivity by making use of measures of inequality of income distribution. Amongst others, the inequality may be measured by means of Lorenz Curve or in terms of Gini coefficient (G). For example, if we estimate Gini coefficient for pre-tax distribution (G) and for post-tax distribution (G*), then the ratio G*/G would give the overall progressivity of the tax. The tax would be progressive, neutral, or regressive if (G*/G) is greater than, equal to or less than unity. The ratio (G* – G) / G, on the other hand, would give a measure of the effect of taxation on the distribution of income. A larger distributive effect would be reflected in a bigger value of the ratio.
6.3.1 Direct and Indirect Taxes

A valid and acceptable economic criterion for distinguishing between direct and indirect taxes is as follows:

The authorities may levy a tax directly on legal entities (that is, tax payers like individuals, families, business firms, institutions, etc.), or they may levy a tax indirectly on legal entities by first levying it on some good, service or activity and then making associated legal entities like sellers, buyers, transporters, service providers, tourists, and so on to pay them. Therefore, a tax levied in the former manner is a direct tax, while a tax of the latter variety is an indirect one. To reiterate in simple words, taxes levied directly on legal entities are direct taxes; and taxes levied on goods, services, activities etc. are indirect ones.

In the case of a direct tax, liability of a tax payer is assessed on the basis of some indicator/measure of his paying capacity. For example, income tax is one such direct tax because in this case, the liability of a tax payer is determined on the basis of his 'taxable income', which is taken as a measure of his capacity to pay. Same is the case with several other taxes like wealth tax, expenditure tax, gift tax, capital gains tax, interest tax, and so on. Corporate taxes, such as taxes on profits, sales proceeds or assets of firms and corporations are also direct taxes because they are directly levied on these legal entities. A tax on 'professions' is also a direct tax because it is levied on all those legal entities who pursue any of the identified professions and, therefore, in the judgement of the authorities, need to be taxed. Similarly, a poll tax is also a direct tax because it is directly levied on "targeted" individuals (though irrespective of their capacity to bear it).

As stated above, indirect taxes are those which are 'levied' on identified goods, services and activities, though collected from individual legal entities on the basis of some specified nature of their 'association' with the taxed items. Examples of such taxes include excise duties, customs duties, sale/purchase taxes, VAT, service tax, entertainment tax, motor vehicle tax, and so on. Thus, an excise duty is levied on the production of a good and collected from those who produce it (who, in turn, may collect it from its buyers). Customs duties are levied on imported/exported goods and services and collected from those who import/export them.

Thus, the classification of taxes into direct and indirect categories is not based upon shifting of their incidence. Such shifting depends upon the relevant demand and supply elasticities which themselves may change over time. It is a different matter, however, that the authorities mostly assume that the incidence of an indirect tax would be shifted forward. In contrast, in the case of a direct tax, they normally assume that its incidence would not be shifted.

Indirect taxes may be specific or ad valorem. When they are imposed on per item or per unit basis, they are called specific. On the other hand, when the tax on an item is assessed on the basis of its value, it is ad valorem one. Sales
taxes are mostly *ad valorem*. Excise duties, on the other hand, are sometimes specific, sometimes *ad valorem* and sometimes a combination of both. Taxes on rail and bus passenger fares are usually *ad valorem*, but they can be specific also. The advantage of an *ad valorem* tax is that its receipts automatically increase with an increase in the value of the taxed item. In some cases, like a percentage tax on rail passenger fares, an *ad valorem* tax is more just and equitable. However, being *ad valorem*, it also feeds inflationary pressures and is therefore, regressive in nature.

**Check Your Progress**

3. What is a progressive tax?
4. How is liability of a tax payer assessed in direct tax?
5. When does indirect tax become *ad valorem*?

### 6.4 IMPACT OF TAXES

The effects of taxation, as we know, cover all the changes in the economy resulting from the imposition of a tax system (or a variation in it). One may say that without taxation, a market economy would attain certain production, consumption, investment, employment and similar other levels and patterns. The presence of taxation modifies these levels and patterns for good or for bad and such modifications may collectively be called the effects of taxation.

There was a time when under the influence of the *laissez faire* philosophy, it was advocated that the State should have a neutral tax policy. In other words, revenue raised by the State should cause none or minimum possible variation in economic parameters generated by the market forces. Such a policy is also referred to as ‘general fiscal rationality.’ It implies that the fiscal action of the government should, to the extent possible, disturb the resource allocation in the economy or affect relative position of its parameters. This view implies that in a free market mechanism, the patterns of resource allocation and production conform to the social marginal rates of substitution between different goods and services. Obviously this claim rests on two fundamental assumptions. These are as follows:

- Economic parameters generated by the free market are optimum are the best possible attainable by the economy.
- The State can raise adequate tax revenue without undue interference in the working of the economy.

Both these assumptions are unrealistic. It is now well recognized that the market forces by themselves seldom lead to an optimal outcome. A free market mechanism breeds trade cycles, inequalities of income and wealth, imbalanced growth and similar other ills. Actually it is able to move closer to an optimum allocation of resources and other desirable results only when certain strict conditions...
are satisfied. It is assumed, for example, that the market is perfectly competitive, while in reality there are all sorts of imperfections caused by irrational consumer behaviour, monopolistic practices of the suppliers, technical rigidities, imperfect knowledge of the market, and so on. Similarly, another stringent condition is that of the absence of externalities of goods—a condition which is not satisfied in the case of public goods.

A modern State needs quite a sizeable revenue which forms a significant proportion of the total national income. Its sheer size rules out neutrality. It is next to impossible to have such a tax system. Moreover, there is a need to rectify deficiencies of the market mechanism and tax system provides a fertile ground for devising various policy tools for this purpose. Therefore, tax tools may be devised with the aim of restructuring market decisions for maximizing aggregate social benefits. These tools should help in bringing about equality between social marginal rates of substitution and technical rates of substitution between pairs of goods and services. The same idea may be extended to the economy as a whole in choosing between public and private goods. This is illustrated in Figure 6.1.

Let the production possibility curve, showing the possible combinations of public and private goods which can be produced from the use of the economy’s resources be given by $AB$. Let $I_1, I_2, I_3, \ldots$ be the social indifference curves showing different combinations of private and public goods which are equally preferable to the society. Then, the optimum allocation between the public and private goods should be as shown by point $E$. Any fiscal action which brings the economy nearer it would be contributing towards the allocative efficiency and any fiscal action pushing the economy away from point $E$ will likewise be harmful to it.

![Fig. 6.1 Optimum Allocation between Public and Private Goods](image_url)

We should remember that the use of taxation in the type of economy we are considering is not to be directed at destroying the market mechanism, but for guiding and regulating its working. Therefore, all tax measures would work through their influence on the demand and supply forces in the market.
The tax measures either reduce the disposable income of buyers (individuals, firms, and so on) thereby affecting their demand, or they have an important bearing upon the economy through their supply effects. In both cases, relevant demand and supply elasticities also play their role.

On account of the shifting of incidence, both demand and supply reactions get mixed up and breed fresh rounds of effects. Distortions in market behaviour caused by imposition of taxes are called their announcement effects by Pigou.

Effects of a tax system are generally a multi-stage phenomenon admitting a corresponding stage-wise examination thereof. For example, the first stage covers the fact of tax imposition itself which reduces the disposable income of those upon whom the statutory responsibility of paying the tax rests. The final stage of effects is associated with the fact of incidence. A number of stages exist in between these two extremes. The effects of taxation may be studied at different levels of aggregation. The choice depends upon the purpose of our analysis and/or comparing the effects of different taxes on the working of the economy.

We shall confine our discussion of the effects to more or less aggregative level. The likely behaviour of a typical economic unit will be considered mainly to arrive at some aggregative level of the economy as a whole. It is also noteworthy that several effects of tax measures may be counterbalanced by those of public expenditure. For example, if public taxation reduces the savings of the private sector, the government sector may save to counteract that to some extent. Such counterbalancing effects, moreover, can be there even in the private sector of the economy. For example, the government might be neutralizing its profit-tax by giving subsidies to a particular industry. We shall, however, abstract from these effects of public expenditure and concentrate only upon the effects of taxation and that also only in the private sector. Four important categories of effects will be chosen by us for discussion, namely, those on (a) production and growth, (b) distribution, (c) economic stabilization, and (d) inflationary pressures.

6.4.1 Effects of Taxation on Production and Growth

In line with Dalton, the effect of taxation on production and growth may be analysed with reference to

(i) Capacity to work, save and invest; and
(ii) The will to work, save and invest.

An alternative way of analysing these effects would be to split them up into

(a) Shift in the allocation of existing productive resources, and
(b) A change in the supply of these productive resources and use them as manifestations of the capacity (and will) to work, save and invest.

The analysis of the effect of a tax on the supply of a factor of production should cover its total supply offered in the market as also its utilisation. The response of different productive resources in this context would vary from factor to factor.
Moreover, a number of non-tax forces are known to have a strong determining influence here. For example, the response of supply of land to a tax is likely to be near zero, while its response in terms of utilisation can be quite significant. Similarly, in the case of labour, a number of long term forces come into play to determine the total labour supply and its productive efficiency. It would be therefore more meaningful to discuss the effect of taxation on the supply of labour in the restricted sense of its utilisation. In the case of capital, annual accretions through supply of savings and investment appear to be as important as the shifts in its utilisation. But here also a number of non-economic forces exhibit their strength. For example, given the institutions of private property and inheritance, most people would like to save for old age and emergencies as also for their children. Similarly, in some societies, building up property might bring a social prestige in which case people will save in spite of taxes.

A. Effect on Savings and Investment

Here, we should think of not only the will to save of the taxpayers, but also their capacity to save and invest. With the extent of inequalities of income and wealth which we usually come across in the market economies, the saving potential is significantly concentrated in the hands of upper income groups. This phenomenon is particularly strong in underdeveloped countries. This implies that in order to create and maintain a capacity to save, we should leave out the richer sections. This prescription, however, militates against the distributive objective of a modern welfare State and creates a lot of social and political unrest as well. A tax system, therefore, can accommodate regressive elements only to a limited extent. Their use may be necessary, especially in underdeveloped countries where the total saving potential is limited as compared with the needs for economic growth and capital accumulation. But they certainly cannot be relied upon as an exclusive source of State revenue. Moreover, any excessive use of regressive taxes reduces even the capacity to work. In an underdeveloped country, where total voluntary saving potential is very small, the State might decide to step in and save on behalf of the community. In that case it will have to tax the poorer sections also. In other words, in an underdeveloped country, there can be a conflict between equity and growth objectives which, viewed from a different angle, becomes a choice between immediate consumption and future consumption (through capital accumulation and growth). The State has to resolve this conflict as best as it can. To the extent, however, some foreign aid becomes available, or certain untapped resources can be exploited, solution of this problem becomes easier.

This brings us to the question of capacity to invest which is clearly connected with the capacity to save though the two are not identical. As an individual economic unit, a person or a firm may be able to save but not able to invest for various reasons. Similarly, it may not be able to save but still may be able to invest. For example, an economic unit may be able to save, say, through tax evasion and may not be able to invest the savings openly. Similarly, it may be able to save in a normal way, but opportunities to invest may be blocked through fiscal and administrative hurdles.
While referring to the capacity to invest, therefore, we assume, for the sake of simplicity, that the economic unit will not be debarred from investment on account of any non-economic causes, such as non-availability of permits and licenses, and so on. Such like measures, in conjunction with taxes, may be designed to push investment from one line into the other, but not more than that.

For an individual economic unit, as noted above, saving may not be essential for investment. It might borrow from banks and other financial institutions to finance its investment operations. But this option is not open to the economy as a whole. There, the financial institutions will be basically channelling the savings of the community into the hands of investors and thereby enabling them to invest. If through credit creation etc., an extra investment is attempted, it will force extra savings upon the community through an increase in prices and a reduction in consumption. This is the technique which lies behind financing of various projects through deficit financing by the government. However, a policy of forced saving may be desirable up to a certain limit but not beyond, because it creates inflationary pressures in the economy with its attendant ills.

Given the existence of financial institutions and mechanism for collecting the community’s savings and bringing them to investors, the level and pattern of investment will be greatly influenced by the taxation in the country. This is because the investors are basically interested in making profits and the profitability of investment can be affected through various tax measures.

Firstly, we note the possibility of taxing savings themselves. If that happens, the investors are left with smaller volume of savings and the overall level of investment in the country declines (unless this is counterbalanced by other forces, such as an increase in community’s capacity to save, or the savings on the part of the government).

Secondly, the authorities might tax investment earnings so heavily that the firms fail to raise adequate resources for investment in the market. The capital market might dry up.

Thirdly, taxation of retained profits of the firms eats into their capacity to generate internal resources for investment. They are forced into borrowings for investment. And this, in turn, necessitates interest payments out of operating profits. The net result is that non-business economic units would have to save more if aggregate flow of capital is to be maintained.

Increasing taxation level on business units leads to two effects. Firstly, the pre-tax rate of profit from investment will have to go up for maintaining their commercial viability. This is likely to result in an all-round downward pressure on investment. Secondly, business units find that they can increase their expenses with less than proportionate reduction in their profits. For example, if the marginal rate of tax is 60% on the profits of a firm, it will find that an additional expenditure of ₹ 100 (and so a reduction of pre-tax profit by ₹ 100) reduces its tax liability by ₹ 60 so that its after tax profit is reduced only by ₹ 40. Because of this, therefore,
under heavy taxation the firms tend to spend lavishly on office buildings, air conditioning, furniture, cars, phones, allowance to the officers, and so on.

Other tax ingredients also affect the capacity to invest. For example, if the firms are allowed to carry on losses from one year to the other, then over a number of years their average tax liability may be reduced and they may be left with more resources for investment. In contrast, if losses cannot be carried over, then though during the year of loss, a tax is not paid, in the year of profit full tax payment falls due. Similarly, in the case of VAT, a firm pays a tax on the value added without reference to the profits earned. This reduces its capacity to invest during years of no profit. Likewise, if the firms are subjected to wealth and property taxes, their total assets will decrease and their expansion capacity and borrowing ability will suffer.

For an underdeveloped country, all these considerations have a special bearing. Such a country needs a rapid and balanced (both inter-sectoral and inter-regional) growth. Accordingly, such a country should seek tax instruments which do not eat into the sources of capital accumulation as such and which permit the use of funds for expansion and creation of new assets. Furthermore, tax instruments should discriminate between different types of industries by favouring the high-priority ones. Such tax instruments may take the form of tax holidays, exemptions, rebates, higher depreciation allowance, and so on. These measures have the effect of allowing them to retain more funds for investment out of their earnings and increase the profitability of their investment. The same policy can be extended with respect to industries in relatively underdeveloped areas.

Check Your Progress

6. Why does State rule out a neutral tax policy?
7. What’s the impact of excessive use of regressive tax in an underdeveloped country?

6.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Tax is a compulsory levy payable by a legal entity to the government without any corresponding entitlement to receive any specified and direct quid pro quo from the government.
2. Fines (such as court fines) are also compulsory payments without any quid pro quo but they are different from taxes because they are imposed to curb certain offences and not for raising public revenue. Therefore, fines should not be classified as taxes.
3. If, with increasing income, tax liability of a tax payer increases not only in absolute terms, but also as a proportion of his income, then it is termed a progressive tax.
4. In the case of a direct tax, liability of a tax payer is assessed on the basis of some indicator/measure of his paying capacity. For example, income tax is one such direct tax because in this case, the liability of a tax payer is determined on the basis of his ‘taxable income’, which is taken as a measure of his capacity to pay.

5. When the tax on an item is assessed on the basis of its value, it is *ad valorem* one. The advantage of an *ad valorem* tax is that its receipts automatically increase with an increase in the value of the taxed item. In some cases, like a percentage tax on rail passenger fares, an *ad valorem* tax is more just and equitable. However, being *ad valorem*, it also feeds inflationary pressures and is therefore, regressive in nature.

6. A modern State needs quite a sizeable revenue which forms a significant proportion of the total national income. Its sheer size rules out neutrality. It is next to impossible to have such a tax system. Moreover, there is a need to rectify deficiencies of the market mechanism and tax system provides a fertile ground for devising various policy tools for this purpose. Therefore, tax tools may be devised with the aim of restructuring market decisions for maximizing aggregate social benefits.

7. Any excessive use of regressive taxes reduces even the capacity to work. In an underdeveloped country, where total voluntary saving potential is very small, the State might decide to step in and save on behalf of the community. In that case it will have to tax the poorer sections also.

### 6.6 SUMMARY

- Tax is a compulsory levy payable by a legal entity to the government without any corresponding entitlement to receive any specified and direct *quid pro quo* from the government.
- Tax is not a price paid by the taxpayer for any specified service rendered or a commodity supplied by the government. The benefits received by taxpayers from the government are not related to or based upon their being taxpayers.
- It is termed as a regressive tax if the tax liability of the taxpayer, as a proportion of his income, falls with an increase in his income. The absolute tax liability, however, may increase even in this case.
- The base of a tax is the legal description of the taxed object such as, net income or wealth or consumption expenditure of the taxpayer. The term tax rate is used to denote the amount of a tax per unit of the tax base. Accordingly, therefore, when the tax rate does not change with a change in the tax base, it is termed a proportional tax.
- If rate of progression declines with an increase in tax base, it is termed regressive taxation. It has two forms. In the first case, the entire taxable
base is divided into two slabs. No tax is levied on the lower slab, while the entire upper slab is taxed at a given rate.

- It must be remembered that the concept of progressiveness as stated above is with reference to only the money (or money equivalent) burden of a tax. It need not correspond to the real burden on the taxpayer, that is, the sacrifice which the taxpayer undergoes.

- The authorities may levy a tax directly on legal entities (that is, tax payers like individuals, families, business firms, institutions, etc.), or they may levy a tax indirectly on legal entities by first levying it on some good, service or activity and then making associated legal entities like sellers, buyers, transporters, service providers, tourists, and so on to pay them. Therefore, a tax levied in the former manner is a direct tax, while a tax of the latter variety is an indirect one.

- In the case of a direct tax, liability of a tax payer is assessed on the basis of some indicator/measure of his paying capacity. For example, income tax is one such direct tax because in this case, the liability of a tax payer is determined on the basis of his ‘taxable income’, which is taken as a measure of his capacity to pay.

- Indirect taxes are those which are ‘levied’ on identified goods, services and activities, though collected from individual legal entities on the basis of some specified nature of their ‘association’ with the taxed items. Examples of such taxes include excise duties, customs duties, sale/purchase taxes, VAT, service tax, entertainment tax, motor vehicle tax, and so on.

- The classification of taxes into direct and indirect categories is not based upon shifting of their incidence. Such shifting depends upon the relevant demand and supply elasticities which themselves may change over time. It is a different matter, however, that the authorities mostly assume that the incidence of an indirect tax would be shifted forward.

- The advantage of an ad valorem tax is that its receipts automatically increase with an increase in the value of the taxed item. In some cases, like a percentage tax on rail passenger fares, an ad valorem tax is more just and equitable. However, being ad valorem, it also feeds inflationary pressures and is therefore, regressive in nature.

- There was a time when under the influence of the laissez-faire philosophy, it was advocated that the State should have a neutral tax policy. In other words, revenue raised by the State should cause none or minimum possible variation in economic parameters generated by the market forces. Such a policy is also referred to as ‘general fiscal rationality.’

- A free market mechanism breeds trade cycles, inequalities of income and wealth, imbalanced growth and similar other ills. Actually it is able to move closer to an optimum allocation of resources and other desirable results only when certain strict conditions are satisfied.
A modern State needs quite a sizeable revenue which forms a significant proportion of the total national income. Its sheer size rules out neutrality. It is next to impossible to have such a tax system. Moreover, there is a need to rectify deficiencies of the market mechanism and tax system provides a fertile ground for devising various policy tools for this purpose.

The tax measures either reduce the disposable income of buyers (individuals, firms, and so on) thereby affecting their demand, or they have an important bearing upon the economy through their supply effects. In both cases, relevant demand and supply elasticities also play their role.

Effects of a tax system are generally a multi-stage phenomenon admitting a corresponding stage-wise examination thereof. For example, the first stage covers the fact of tax imposition itself which reduces the disposable income of those upon whom the statutory responsibility of paying the tax rests. The final stage of effects is associated with the fact of incidence.

The analysis of the effect of a tax on the supply of a factor of production should cover its total supply offered in the market as also its utilisation. The response of different productive resources in this context would vary from factor to factor. Moreover, a number of non-tax forces are known to have a strong determining influence here.

Given the existence of financial institutions and mechanism for collecting the community’s savings and bringing them to investors, the level and pattern of investment will be greatly influenced by the taxation in the country.

6.7 KEY WORDS

- Betterment levies: These are a form of tax or a fee levied on land that has gained in value because of public infrastructure investments.

- *Ad valorem* tax: An *ad valorem* tax is a tax whose amount is based on the value of a transaction or of property. It is typically imposed at the time of a transaction, as in the case of a sales tax or value-added tax.

- Regressive tax: A regressive tax is a tax imposed in such a manner that the average tax rate decreases as the amount subject to taxation increases.

- The Pigou effect: In economics, the Pigou effect is the stimulation of output and employment caused by increasing consumption due to a rise in real balances of wealth, particularly during deflation.

- VAT: A value-added tax (VAT), known in some countries as a goods and services tax (GST), is a type of tax that is assessed incrementally, based on the increase in value of a product or service at each stage of production or distribution. VAT essentially compensates for the shared services and infrastructure provided in a certain locality by a state.
### 6.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short Answer Questions**
1. Mention the situation wherein export and import duties are not treated as taxes.
2. What is a proportional tax?
3. What is the difference between the average tax rate and the marginal tax rate?
4. How do we measure the overall progressivity of the tax?
5. Write a short note on Dalton’s analysis on the effect of taxation on production and growth.

**Long Answer Questions**
1. Illustrate with examples a few of situations where levies or user charges are not treated as taxes.
2. Analyse the functioning and impact of progressive, proportional and regressive taxes on individuals.
3. “Indirect taxes may be specific or ad valorem.” Justify this statement.
4. Discuss the effect of taxation on savings and investment in underdeveloped countries.

### 6.9 FURTHER READINGS

UNIT 7 FISCAL POLICY: MEANING

7.0 INTRODUCTION

A collective term for the taxing and spending actions of governments is called as fiscal policy. The two tools — fiscal policy and monetary policy — are used by the government to achieve its macroeconomic objectives. The main objective of fiscal policy is to increase the aggregate output of the economy. The purpose of the monetary policies is to control the interest and inflation rates and it allows the central bank to control the availability of credit which is needed to achieve the objective of government’s economic policy. Even as fiscal policy and monetary policy is run by separate bodies, they are dependent on each other. Central bank often takes step to control fiscal deficits when fiscal policy goes expansionary and creates inflationary pressure on the economy. Also the relationship between monetary and fiscal policy depends on the development of financial markets. In recent times, central banks in some countries have brought in such rules, which can help fiscal authorities better withstand pressures for higher spending and slower fiscal consolidation.

When it comes to include all expenses involved in collecting, budgeting, appropriating and expending public money, financial administration plays a critical role. It plays an important role in the socio-economic welfare of the people. The Finance Ministry is the leading state institution in the field of finances. The primary concerns of this ministry are taxation, financial legislation, financial institutions, capital markets, centre and state finances, and the Union Budget.

This unit gives a detailed analysis of fiscal and monetary policy in developing countries. It also discusses the role of financial administration and principles of budgeting.
7.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning of fiscal policy
- Describe fiscal policy in developing countries
- Discuss the impact of fiscal expansion
- Analyse the role of financial administration
- Explain the principles of budgeting

7.2 RELATION BETWEEN FISCAL, MONETARY AND EXCHANGE RATE POLICIES

Fiscal policy generally refers to the government’s choice regarding the use of taxation and government spending to regulate the aggregate level of economic activity. In the same vein, the use of fiscal policy entails changes in the level or composition of government spending or taxation, and hence in the government’s financial position. Key variables that policy makers focus on include government deficits and debt, as well as tax and expenditure levels.

Monetary policy refers to the central bank’s control of the availability of credit in the economy to achieve the broad objectives of economic policy. Control can be exerted through the monetary system by operating on such aggregates as the money supply, the level and structure of interest rates, and other conditions affecting credit in the economy. The most important objective of central bankers is price stability, but there can be others such as promoting economic development and growth, exchange rate stability and safeguarding the balance of external payments, and maintaining financial stability. Key variables in this policy area include interest rates, money and credit supply, and the exchange rate.

While monetary and fiscal policy are implemented by two different bodies, these policies are far from independent. A change in one will influence the effectiveness of the other and thereby the overall impact of any policy change. Tensions can arise between what each will do to help smooth economic cycles and achieve macroeconomic stability and growth. That is why it is crucial to pursue a consistent monetary-fiscal policy mix and coordinate these (and other) policies as much as possible to avoid tensions or inconsistencies. This policy mix is a key component of the IMF’s macroeconomic policy advice and of IMF–supported economic adjustment programmes, together with external, structural, and financial sector policies. In practice, imbalances in the budgetary position have in many cases proven to be a key element in both macroeconomic problems and their solution. For this reason, the IMF was sometimes jokingly said to stand for ‘It’s Mostly Fiscal’, although in reality the macroeconomic problems countries are faced...
Fiscal Policy: Meaning

with generally consist of a broader mix of imbalances and require a broader set of policy responses.

How does fiscal policy affect monetary policy and thus the central banks? There are both direct and indirect channels. Starting with the first category, there are a number of ways in which fiscal policy may impinge on monetary policy. First and foremost, an expansionary fiscal policy may result in excessive fiscal deficits, which may create a strong temptation for governments to resort to the printing press (i.e., monetary financing by the central bank) to finance the deficits. An expansionary fiscal policy, then, leads to an expansionary monetary policy, fuelling inflationary pressures, causing a possible real appreciation of the currency and hence balance of payments difficulties, potentially even resulting in a currency (and/or banking) crisis.

But even if governments finance their deficits in a non-monetary way, that is, through the markets, there may be cause for concern, specifically about crowding out: If governments take up (too) much funding in the markets, the result may be too little or too expensive credit for the private sector. This may harm economic development and growth, which would certainly be a concern of central bankers. On the external side, there is the risk that too much dependence on foreign funding of domestic debt results in exchange rate and/or balance-of-payments risks, which again would be worrying to central banks.

There is another, more direct channel of fiscal policy affecting central bankers and that is the impact of indirect taxes on the price level and thus on inflation. If governments feel forced to resort to substantial increases in indirect taxes—sales taxes, value added taxes—rather than taxes on various forms of income, this will have a direct impact on prices. The key concern here is that a one-off increase leads to a wage-price spiral and therefore permanent (higher) inflation and inflationary expectations.

In addition to these direct relationships between fiscal and monetary policy, there is the more indirect channel through expectations. Perceptions and expectations of large and on-going budget deficits and resulting large borrowing requirements may trigger a lack of confidence in the economic prospects. This may become a risk to the stability in financial markets. Such a lack of confidence in the sustainability of the financial position of the government may become a potential destabilizing factor on bond and foreign exchange markets, eventually even leading to the collapse of the monetary regime.

Impact of Fiscal Expansion

Conceivably, expansionary fiscal policy may at some stage become ineffective as a means to stimulate demand and, similarly, fiscal contractions may turn out to be expansionary. When economic agents realize that the government is borrowing too much for its own good, they will conclude that this can only lead to higher taxation levels in the future, and they may decide to compensate for that already
now by saving more and consuming less. This so-called ‘Ricardian equivalence’ means that the financial behaviour of economic agents—on which central banks base their monetary policy decisions—depends on their perception of fiscal sustainability. It is, therefore, another example of how fiscal policy can (indirectly) affect the effectiveness of monetary policy.

It should be noted that the impact of fiscal policy on central bank objectives is not automatically avoided when the central bank is independent. Even when the central bank has independence, and hence is not submitted to the fiscal needs of the government, the need to offset the impact of expansionary fiscal policy on aggregate demand and inflation in the economy could prompt the central bank to tighten monetary policy, by raising interest rates or reducing credit in the financial system. The resulting high interest rates could depress economic activity, attract short-term and easily reversible capital inflows—thereby adding to inflation and appreciation pressures on the currency, and eventually damaging macroeconomic and financial stability.

Severe budgetary problems may even lead to crises. There have been a number of examples of such severe tensions in the past, in which large and growing fiscal deficits—in the absence of needed public sector reforms—led to high real interest rates. This intensified the government’s debt-servicing costs, causing a build-up of short-term and foreign currency-linked public debt, thus increasing the sensitivity to interest rate, exchange rate, and rollover risks, which materialized as foreign capital inflows that had helped to finance the debt were suddenly reversed. Examples of this set of circumstances were apparent in the run up to the crises in Turkey (1994, 2001), Mexico (1994), Russia (1998), Brazil (1999), and Argentina (2001).

Even in countries where such extreme conditions did not materialize, the sustainability of the monetary regimes can be challenged by fiscal policies that are too accommodating. This has happened in the past, for example, Israel and Poland where expansionary fiscal policy caused an overheating of the economy, reviving inflationary pressures and worsening the current account. High interest rates—required to contain inflation—attracted capital inflows that complicated the implementation of monetary policy. Sterilization of capital inflows to keep inflation under check became increasingly difficult and costly for the central bank.

One of the channels of fiscal policy constraining the conduct of monetary policy include the impact of fiscal deficits on interest rates and interest spreads, particularly, for emerging markets. While the conventional theory argued that higher fiscal deficits raise intermediate and long-term interest rates, empirical studies revealed mixed results. Some studies established the impact of fiscal variables on country premiums, while other showed that the fiscal policy could constrain monetary policy through its impact on exchange rates. Under a high capital mobility and flexible exchange rate situation, deterioration in the fiscal situation could lead to a temporary appreciation of the exchange rate. In contrast, under low capital mobility...
mobility, the exchange rate may depreciate, following higher imports and widening of the current account deficit on account of fiscal expansion (Zoli, 2005).

Financial Markets

Another area where monetary and fiscal policy come together is the development of financial markets. Both finance ministries and central banks have a strong interest in financial market development because: (i) it is indispensable for economic development and growth; (ii) it facilitates funding of deficits and debt; and (iii) it enables market-based operations by central banks. As part of financial market development, it is important for the authorities to engage in a discussion with (potential) market participants on market practices, conditions, and possible impediments.

The relationship between monetary and fiscal policy depends strongly on the development of financial markets. The transition from a rudimentary financial system to a fully developed system can be divided into four stages. In the undeveloped stage, there is no government debt outside the central bank, and fiscal deficits are essentially accommodated by money creation. In the next stage, marketable securities are introduced, but there is no secondary market and interest rates are inflexible. In the transitional stage, a secondary market for government debt instruments exists, interest rates have become more flexible, and central banks conduct more active and independent liquidity management. In the final developed stage, medium-term debt instruments are offered through auctions, interest rates are fully flexible, and central banks control liquidity in the markets through indirect and market-based instruments (e.g., repos). In particular, in the latter two stages, good coordination between the government’s financial management (issuance of treasury bills, etc.) and the central bank’s monetary policy operations is required.

The Role of Central Bankers

What can central banks do about fiscal policy? First of all, coordination is very important. Even if central banks act on the short end and governments on the long end of the market, their financial activities should be coordinated. Second, communication is key as well. Central bankers expressing views on budgetary policies have become regular features in the international financial press, often in the context of presentations in Parliament and at presentation of reports on the economy. Of course, timing and frequency are important elements, and governors are not expected to issue statements each day. The effectiveness of the message will be affected by the stature and image of the governor and his or her institution.

In their messages, central bankers tend to focus on the medium-term sustainability of fiscal policy more than the short-term policies. This includes a focus on a solid and realistic budgetary process that (i) does not require frequent adjustments during the year (which tend to make markets nervous); (ii) is based on ‘conservative’ macroeconomic assumptions in particular with regard to economic growth (a key variable in any budget), but also with respect to interest
rates, exchange rates, and exogenous variables such as energy prices; (iii) does not include too many one-off measures and open-ended commitments; and (iv) does not imply too many and too frequent fundamental changes in the tax regime (which might create uncertainty and inefficiencies). At the same time, they will focus on the bottom-line (i.e., deficits and debt) rather than on the specific line-items, to avoid being dragged into a very specific political debate. Last but not least, there appears to be a certain tendency among central bankers to ‘lean against the wind’, that is, to not to be too optimistic when things go well, and not too pessimistic when things take a turn for the worse, but rather to be realistic.

Medium-term Fiscal Frameworks

In recent years, an increasing number of countries have adopted formal fiscal rules. Central bankers are generally among the proponents of such rules, which can help fiscal authorities better withstand pressures for higher spending and slower fiscal consolidation. The rules, which are often focused on targets for deficits and debt, or on a multi-year spending timeline, are to be embedded in a medium-term fiscal framework based on balanced assumptions for macroeconomic developments.

Fiscal rules can be particularly helpful in cases in which there is no unique counterpart for the central bank, as is the case, for example, in the euro-zone, which is also faced with the issue of a new currency that has a limited track record. In order to enforce fiscal discipline and to ensure that national fiscal policies support the stability-oriented monetary policies by the European Central Bank (ECB), member countries adopted the Stability and Growth Pact (SGP) as a tool for fiscal policy coordination. The rules of the SGP aim at fiscal sustainability by strengthening fiscal discipline through requirements for budget deficits and debts and medium-term fiscal policy objectives.

Transparency

Finally, incorporating transparency into monetary and fiscal policy is key to their effectiveness. In this context, the IMF has developed two important international standards: the Code of Good Practices on Transparency in Monetary and Financial Policies for central banks and supervisors, and the Code of Good Practices on Fiscal Transparency for governments. These codes are important instruments to support clarity in discussions on the necessary coordination between monetary and fiscal policy.

Exchange Rate and Monetary Policy

The exchange rate plays an important part in considerations of monetary policy in all countries. More generally, the exchange rate serves to buffer the economy from external shocks, such that monetary policy can be directed towards achieving domestic price stability and growth.
Under inflation targeting, monetary policy no longer targets any particular level of the exchange rate. Various measures suggest that exchange rate volatility has been higher in the post-float period. However, exchange rate flexibility, together with a number of other economic reforms—including in product and labour markets as well as reforms to the policy frameworks for both fiscal and monetary policy—has likely contributed to a decline in output volatility. In particular, exchange rate fluctuations have played a particularly important role in smoothing the influence of terms of trade shocks.

Both through counterbalancing the influence of external shocks, and more directly, through its influence on domestic incomes and therefore demand, the exchange rate has been an important influence on inflation. Under the previous fixed exchange rate regimes, the Australian economy ‘imported’ inflation from the country (or countries) to which the exchange rate was pegged. However, the floating of the exchange rate meant that changes in world prices no longer had a direct effect on domestic prices: Not only did it break the mechanical link between domestic and foreign prices, but it meant that the Reserve Bank was now able to implement independent monetary policy. Instead, under the floating exchange rate regime, movements in the exchange rate have a direct influence on inflation through changes in the price of tradable goods and services—a process commonly referred to as ‘exchange rate pass-through’. The extent of this influence has changed since the float, and since the introduction of inflation targeting. In particular, exchange rate pass-through has become more protracted in aggregate, but is faster and larger for manufactured goods, which are often imported.

7.2.1 Fiscal Policy in Developing Countries

In underdeveloped countries, however, the aggregative role of fiscal policy is rather limited since such economies lack adequate flexibility and tend to develop pockets of inflationary pressures. Therefore, the government has to devise more specific measures of taxation and expenditure, coupled with additional selective credit controls, etc., to help the economy. In the field of foreign trade also, its exports and imports are likely to suffer from low elasticities and, therefore, the use of customs duties and subsidies has to be supplemented with that of physical quotas, licences, and so on.

It should be remembered that fiscal policy aims at bringing about stability in the economy by counteracting ‘market failures’. It, however, is likely to have only a limited success in this endeavour because of innumerable rigidities, technical specificities and institutional and other imperfections from which a modern market suffers. Therefore, the response of the market to measures taken by the authorities is bound to be incomplete and slow. In addition, formulation and implementation of fiscal policy itself suffers from various ‘government failures’. These manifest themselves in non-merit subsidies and tax concessions, favouring vested interests and so on.
Performance in India

In India, fiscal policy cannot be said to be a success in regard to ensuring economic stability. It has succeeded in keeping trade cycles under control, but has not been able to ensure price stability. Amongst various factors contributing to inflationary price rise, we may count government’s persistent deficit financing and therefore, a rapid increase in the supply of currency and credit. Inefficient working of public undertakings with price hikes to cover their deficits has also added to inflationary forces. Our dependence on crucial imports and world wide inflation (particularly of oil prices) has also added to our cost of production and prices. The fact that public sector controls commanding heights of the economy, coupled with frequent price hikes of basic goods and services, has added to cost and prices all round. This in turn increases the budgetary expenditure of the government itself and forces it to rely all the more on indirect taxes on the one hand and deficit financing on the other. It may be noted that increasing reliance on indirect taxes as indicated by a rapid increase in revenue from excise duties and sales tax, has fed the cost and price cascading process. In terms of price stability, therefore, our fiscal policy cannot be termed a success.

Fiscal Policy and Economic Growth

Budgetary flows form an important portion of the flow of funds of an economy and, therefore, have a profound role in directing its working. Even a developed country cannot afford to stagnate or decay. For it also, a steady increase in national income and employment is very desirable. Stability of the economy helps it in achieving this objective because investment decisions are affected more favourably under conditions of stability (an investor is interested in not only the rate of return but also in safety and stability of investment). With stability the consumption expenditure does not fall below a certain minimum level and forms a cushion against economic contraction.

Though essentially stability encourages growth, it need not necessarily be so. This is because, to a large extent, long run growth rate depends upon the rates of capital accumulation and development of the capital goods sector. For example, a high level of stable employment may be achieved and sustained through encouragement of unproductive investment and expenditure on the part of the government. Such stability at a high level of employment, however, may eat into economic growth because of a long run reduction in economy’s capital stock.

The conflict between stability and growth becomes clearer in the case of underdeveloped countries. Here, there is an express need to accelerate the process of capital accumulation for which, therefore, it is the capital goods sector and the social overheads which are to be given priority. Furthermore, capital goods industries are generally capital intensive and generate proportionately lower employment. On the other hand, if labour intensive industries are encouraged so as to create more employment, there will be an increase in consumption demand.
Fiscal Policy: Meaning

Market mechanism of an underdeveloped economy is not likely to be able to generate adequate savings and investment needed for a rapid economic growth. Consequently, the government has to assume a leading role in effecting savings in the economy. Whether or not foreign capital can play a significant role in supplementing budgetary savings of an underdeveloped country, depends upon the specific attending circumstances of the situation. But in general, foreign capital can be relied upon only up to a limited extent. Budgets have a more direct role to play in capital accumulation and economic growth in an underdeveloped country than in a developed one. As it is, saving potential in an underdeveloped economy is very limited partly because of the shortage of several specific resources, partly due to lack of adequate demand (especially for capital goods), and partly because of high cost of production. This vicious circle can be broken by the government with the help of investment-oriented budgets. Such budgets should also be designed so as to yield a surplus in the hands of the authorities which may then be directed towards the creation of social overheads and basic and key industries, and so on.

It should be noted that the government need not confine its efforts at economic growth to only the public sector. So long as market mechanism and private enterprise are allowed to exist, they can also be induced to contribute their share to the development process. More specifically, the authorities should have a definite policy of encouraging the growth of particular industries and in particular areas (so as to reduce regional imbalances). For this purpose, specific tax concessions and subsidies such as tax holidays, higher depreciation allowances, etc. can be designed and incorporated in the budgetary policy.

Recently, a new line of thinking is gaining popularity in recognition of the constraints from which government administration suffers. It is admitted that a developing country needs a rapid addition to its infrastructure which is also run efficiently. Availability of adequate and efficient infrastructure adds to the total factor productivity (TFP) of the economy. However, due to the financial, managerial and other limitations from which public sector suffers, it is now advocated that the government should go in for projects jointly with the private sector. This reasoning is referred to as Public Private Partnership (PPP) in which both sectors pool their resources and expertise etc. In other words, the scope of fiscal policy has been broadened under this new form of thinking and philosophy. It is claimed that the presence of private sector ensures higher productive and managerial efficiency and capacity utilization of a project while the participation of the public sector prevents its undue commercial exploitation.

It is essential to note that the development of capital goods sector adds to the inflationary pressures. This is because while investment in capital goods simultaneously adds to aggregate demand through generation of additional money incomes, additions to supply flows are delayed on account of long gestation periods of capital goods industries. This problem is further aggravated when there is deficit without a corresponding increase in capital formation and the result would be a deceleration of the growth rate.
financing. Therefore, additional measures are needed to contain inflationary forces. Since direct saving capacity of the people is limited, therefore, the authorities find it easier to resort to deficit financing for purpose of financing the growth of public sector. There are two forms of deficit financing here and both may be resorted to in combination.

Firstly, the government may borrow from the market. This procedure is equivalent to transferring the resources straight from the private hands into those of the government. Normally, the scope for pure market borrowings is somewhat limited in an underdeveloped country. People do not have enough to spare for investing in government loans. The market borrowings, therefore, generally amount to loans from various institutions and this generally means a diversion of investable funds from the private sector to the public sector. In other words, the market borrowings are not likely to add to the total investment in the country. However, a shift in investment would be there if the government investment plans are different from those of the private ones (and this is most likely to be so).

Secondly, the deficit financing, namely, resorting to the printing press, amounts to taking away a portion of the private sector’s resources and leaving it with extra money. This technique can be used for re-allocating of the economy’s resources and thus accelerating the pace of economic growth.

However, market borrowings and currency creation by themselves do not guarantee that capital accumulation process will be strengthened or that inflation will be avoided. Actually, if government uses the market borrowings or currency creation for financing welfare and other consumption-oriented expenditure programmes, the result can be a retardation of the growth process. Growth oriented programmes may be divided into two portions. Some of them will be those which yield quick results such as minor irrigation schemes, reclamation of land and the like. There will be others like training and education of the working classes and development of capital goods sector. Investment in latter types of programmes may add to inflationary forces in the short run and it is necessary that a proper corrective policy be adopted to counteract that. In brief, we may emphasize that the budgetary investment policies have both a multiplier effect which influence the aggregate demand and the capacity effect (which add to the production stream) in varying forms and with varying lags. It is, therefore, essential that the budgetary policy directed towards growth must incorporate elements of fiscal policy adjustments to avoid inflation or deflation. Thus, the investment programmes of the government designed to ensure growth would imply additional measures to bring about necessary adjustments between demand and supply of important goods and keeping the balance of payments on an even keel. This highlights the basic usefulness as also the limitations of fiscal policy for economic development. The effective range of choice for policy makers in the form of fiscal instruments may be much narrower than we might believe in the first instance. Furthermore, the budgetary measures designed for growth come up against problems of implementation, especially if there are various authorities participating in the task such as the ministry.
Fiscal Policy: Meaning

of finance, the planning commission and the local authorities. The conflicts and
difficulties are further heightened when we think of the fact that a policy of economic
growth is usually accompanied by additional objectives of social development and
egalitarian ends.

Check Your Progress

1. Define fiscal policy and monetary policy.
2. How does expansionary fiscal policy affect monetary policy?
3. Why have many countries adopted formal fiscal rules?
4. What role does exchange rate play?

7.3 FINANCIAL ADMINISTRATION

Administration and finance are two inseparable items. All administrative activities
involve expenditure of some kind. Without finance, administrative machinery
becomes inoperative. On the other hand, finance too has to depend on
administration. To be specific, all financial transactions and expenditure, in order
to be documented properly, should be administered or executed by efficient means.
The term financial administration is used in a broad sense to include all expenses
involved in collecting, budgeting, appropriating and expending public money. It
also includes auditing income, expenditures, receipts and disbursements and
accounting for funds needed to be expended on public services. Thus, financial
administration touches the very basic of socio-economic welfare of the people.

Financial administration is a dynamic process that consists in a chain of
operations, performed by the following agencies:

(i) The Executive (primarily the Finance Ministry) which needs funds
(ii) The Legislature, which alone can grant funds
(iii) The Finance Commission
(iv) The Indian Audit and Accounts Department
(v) The Parliamentary Committees

Administration and finance are mutually dependent on each other. For
performing administrative activities, we need finance, whereas, for proper
documentation of all financial transactions and expenditures we need proper
administration. So we use the term financial administration, when we talk about all
expenses related to collecting, budgeting, appropriating and expending public
money. It is also responsible for auditing income, expenditure, receipts and accounts
of funds that are need to be expended on public services.

The Executive: Role of the President and Finance Ministry

Being the chief executive of the Indian union, the executive powers of the central
government have been vested in the President, to be exercised by him or her
either directly or through officers subordinate to him or her, in accordance with the Constitution (Article 53).

- The President has control over the purse of the nation. It is President who causes the national budget to be laid before each house of Parliament.
- The President has been authorized by Article 280 to appoint a Finance Commission consisting of a chairman and other members every fifth year, or earlier if necessary.
- The President has also been given control over the Contingency Fund of India. He or she can advance money from this fund to the Government of India for meeting unexpected expenditures.
- Certain money bills (Article 110) and bills affecting the taxation in which states are interested (Article 274) are to be reserved by the state Governors for the approval by the President.

The Cabinet controls the financial policy of the Union executive. It is the Finance Minister who submits the budget to the Parliament. The Parliament approves the budget—expenditure and revenue items in its original form with the support of a majority.

**Finance Ministry**

The Finance Ministry is an important ministry within the Government of India. It is the leading institution in the field of finances. It develops financial policy, coordinates and organizes its implementation, as well as performs other functions stated in the external regulatory enactments.

Taxation, financial legislation, financial institutions, capital markets, centre and state finances, and the Union Budget are the primary concerns of this ministry.

The functions of the Finance Ministry may be summarized as follows:

1. It develops and implements the following policies:
   i. State budget and finance management policy;
   ii. Customs policy;
   iii. Tax and duties system policy;
   iv. State and local governments’ procurements policy;
   v. State aid control policy;
   vi. Internal audit policy;
   vii. Policy of remuneration for public sector employees;
   viii. Policies in accountancy fields.
   ix. Ensures observance of common principles in budget administration;

2. It provides methodological assistance regarding budget preparation and implementation issues;
3. At the state budget planning stage, it:
   i. Prepares the state budget sections on subsidies and earmarked grants for local governments;
   ii. Evaluates correspondence of the approved budgets to the regulatory requirements;
   iii. Analyses performance indicators of local governments;
   iv. Performs calculations regarding equalization of local government finances;
   v. Prepares draft protocol of agreements and disputes between the Cabinet of Ministers and Latvian Association of Local and Regional Governments.

4. It provides control numbers regarding State Investment Program, total state budget investment amount and agrees them with the Ministry of Economics, evaluates financially economic justification of these projects, as well as monitors utilization of state budget resources during the implementation of the projects;

5. It develops long-term, short-term and medium-term macroeconomic development scenarios and provides fiscal policy justification for the state budget forecasts;

6. It reviews, adds and specifies customs tariff objects, arranges and updates the Harmonized Commodity Description and Coding System, Latvian Combined Nomenclature and TARIC Classificatory;

7. It develops, implements, coordinates, maintains and updates unified accounting system of remunerations for employees of institutions financed from the state budget;

8. It coordinates attraction of foreign financial assistance resources and monitors their utilization.

The Legislature

India has a parliamentary form of government. Our Parliament or the Union Legislature, the supreme legislative body in the country, comprises two Houses—Lok Sabha (House of the People) and Rajya Sabha (Council of States). The main function of both the Houses is to pass laws. The law proposal originates in the Parliament in the form of a bill. There are four types of bills that come up before the Parliament, namely ordinary or non-money bill, money bill, constitution amendment bill and budget. Of these four types of bills, money bill and budget pertain to financial administration.

Article 110 clearly defines what constitutes a ‘money bill’. The Speaker of the Lok Sabha certifies whether a bill is a ‘money bill’ or a non-money bill. Money bill can be introduced, only along with the prior recommendation of the President, in the Lok Sabha and not in the Rajya Sabha. The Rajya Sabha cannot reject the money bill. It can only make recommendations.
Every year, the budget is presented before the Lok Sabha. The Finance Ministry prepares the budget. The budget is presented in two parts: (a) Railway Budget and (b) General Budget. Railway budget is presented by the Railway Minister while the general budget is presented by the Finance Minister. The budget passes through various stages.

The discussion on budget in Parliament is done through two stages: (a) General discussion and (b) demands for grants for each ministry. In the ‘general discussion’, the general economic policy is discussed and there is no detailed discussion on taxation and expenditures in both the Houses of the Parliament. In these discussions, both Houses express their opinion regarding the economic policy of the government and a general appraisal of the economic policy is made. Here, it should be noted that the Rajya Sabha also discusses the budget; however, it cannot go beyond general discussion.

The next stage is the appropriation bill, which incorporates all the demands for grants voted by the Lok Sabha and the expenditures charged on the Consolidated Fund of India. The bill seeks the legal authority to be given to government to appropriate expenditure from and out of the Consolidated Fund of India.

**Finance Bill**

It contains government proposals for raising revenues. The move for leave to introduce a finance bill cannot be opposed and it is forthwith put to vote. This bill has to be considered and passed by the Parliament and assented to by the President within 75 days after it is introduced. Passing of the finance bill is the final act of Parliament’s financial procedure.

**Vote on Account**

Sometimes, the Lok Sabha passes the Vote on Account. Vote on Account is passed normally for 2 months, when the passage of budget is delayed for some reason. During an election year, it may be passed for 3–4 months. As a convention, vote on account is treated as a formal matter and passed by the Lok Sabha without discussion. Thus, the House is able to consider the Budget at a convenient time.

### 7.3.1 Principles of Budgeting

Some of the principles of budgeting are as follows:

- Budgets should be managed within clear, credible and predictable limits for fiscal policy.
- Budgets should be thoroughly aligned with governmental priorities.
- The capital budgeting framework should be designed in order to meet national development needs in a cost-effective and lucid manner.
- One should make sure that budget documents and data are open, transparent and accessible.
The debate on budgeting choices should be all-encompassing, participative and realistic.

During the presentation of a budget, a reliable account of public finances should be presented.

The execution of the budget should be actively planned, managed and monitored.

It should be ensured that performance, evaluation and value for money are integral to the budget process.

Check Your Progress

5. What is the role of financial administration?

6. What does a finance bill contain?

7.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Fiscal policy generally refers to the government’s choice regarding the use of taxation and government spending to regulate the aggregate level of economic activity.

2. An expansionary fiscal policy may result in excessive fiscal deficits, which may create a strong temptation for governments to resort to the printing press (i.e., monetary financing by the central bank) to finance the deficits. An expansionary fiscal policy, then, leads to an expansionary monetary policy, fuelling inflationary pressures, causing a possible real appreciation of the currency and hence balance of payments difficulties, potentially even resulting in a currency (and/or banking) crisis.

3. In recent years, an increasing number of countries have adopted formal fiscal rules. Central bankers are generally among the proponents of such rules, which can help fiscal authorities better withstand pressures for higher spending and slower fiscal consolidation.

4. The exchange rate plays an important part in considerations of monetary policy in all countries. More generally, the exchange rate serves to buffer the economy from external shocks, such that monetary policy can be directed towards achieving domestic price stability and growth.

5. The term financial administration is used in a broad sense to include all expenses involved in collecting, budgeting, appropriating and expending public money. It also includes auditing income, expenditures, receipts and disbursements and accounting for funds needed to be expended on public services. Thus, financial administration touches the very basic of socioeconomic welfare of the people. Financial administration is a dynamic process that consists in a chain of operations.
6. Finance Bill contains government proposals for raising revenues. The move for leave to introduce a finance bill cannot be opposed and it is forthwith put to vote. This bill has to be considered and passed by the Parliament and assented to by the President within 75 days after it is introduced. Passing of the finance bill is the final act of Parliament’s financial procedure.

7.5 SUMMARY

- Fiscal policy generally refers to the government’s choice regarding the use of taxation and government spending to regulate the aggregate level of economic activity. In the same vein, the use of fiscal policy entails changes in the level or composition of government spending or taxation, and hence in the government’s financial position.

- Monetary policy refers to the central bank’s control of the availability of credit in the economy to achieve the broad objectives of economic policy. Control can be exerted through the monetary system by operating on such aggregates as the money supply, the level and structure of interest rates, and other conditions affecting credit in the economy.

- While monetary and fiscal policy are implemented by two different bodies, these policies are far from independent. A change in one will influence the effectiveness of the other and thereby the overall impact of any policy change.

- The relationship between monetary and fiscal policy depends strongly on the development of financial markets. The transition from a rudimentary financial system to a fully developed system can be divided into four stages. In the undeveloped stage, there is no government debt outside the central bank, and fiscal deficits are essentially accommodated by money creation. In the next stage, marketable securities are introduced, but there is no secondary market and interest rates are inflexible.

- Central bankers expressing views on budgetary policies have become regular features in the international financial press, often in the context of presentations in Parliament and at presentation of reports on the economy. Of course, timing and frequency are important elements, and governors are not expected to issue statements each day.

- Administration and finance are two inseparable items. All administrative activities involve expenditure of some kind. Without finance, administrative machinery becomes inoperative.

- Being the chief executive of the Indian union, the executive powers of the central government have been vested in the President, to be exercised by him or her either directly or through officers subordinate to him or her, in accordance with the Constitution (Article 53).
The Cabinet controls the financial policy of the Union executive. It is the Finance Minister who submits the budget to the Parliament. The Parliament approves the budget—expenditure and revenue items in its original form with the support of a majority.

Taxation, financial legislation, financial institutions, capital markets, centre and state finances, and the Union Budget are the primary concerns of Finance Ministry.

7.6 KEY WORDS

- **IMF**: The International Monetary Fund (IMF), an international organization headquartered in Washington, D.C., aims to promote global financial stability, encourage international trade, and reduce poverty.
- **Finance Commission**: The First Finance Commission was established by the President of India in 1951 under Article 280 of the Indian Constitution. It was formed to define the financial relations between the central government of India and the individual state governments.
- **Money bill**: This is a bill that solely concerns taxation or government spending, as opposed to changes in public law.
- **Appropriation bill**: Also known as supply bill or spending bill, this is a proposed law that authorizes the expenditure of government funds. It is a bill that sets money aside for specific spending.

7.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short Answer Questions**

1. Which are the key variables of fiscal policy?
2. How are fiscal and monetary policies dependent on each other?
3. What can central banks do about fiscal policy?
4. Which are the main agencies that perform financial administration?
5. What constitutes a ‘money bill’?

**Long Answer Questions**

1. Discuss the role of central bank’s monetary policy in achieving macroeconomic stability and growth.
2. Analyse how does the exchange rate influence the inflation?
3. Discuss the role of the Finance Ministry in formulating and developing financial policy in the State.

4. Analyse the significance of principles of budgeting.

7.8 FURTHER READINGS

UNIT 8 BUDGET

8.0 INTRODUCTION

A budget is a financial plan and in the case of a public budget as presented by various governments in modern times, it serves as a statement of expenditure and revenue for a specific period of time, normally a fiscal year. In India, a budget is referred to as the annual financial statement of the estimated receipts and expenditure of the government for a financial year. It contains estimates of anticipated revenues and proposed expenditures for the budget period. Various activities that the government undertakes and the means of their financing are derived from these estimates. For the government, budget becomes an instrument through which it controls the entire economy. As the budget reflects policy and purpose of the government, greater importance is now being given to budgetary proposals that become the basis for deciding the financial health of a nation. Budgetary documents play a key role in today’s highly complex economies.

Though budget can be of different types, emphasis is given to make it productive and meaningful, leaving no scope of inadequacies. After all, it is through the budget that the government fixes targets for its socio-economic and institutional duties towards the society. As a financial plan and policy statement, government prepares the budget containing details of estimated receipts and proposed expenditures under various heads. In India, Constitution of India has provision under Article 112 which states that an annual financial statement shall be placed before both Lok Sabha, and Rajya Sabha. Similar provision for each State is given under Article 202 where an annual financial statement shall be placed before the Legislature of that State.
This unit presents a detailed analysis of various characteristics of a good budget with special emphasis on preparation of budget and budgeting in India.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the characteristics of a good budget
- Describe the different kinds of budget
- Discuss the preparation of budget
- Analyse the budgeting in India

8.2 CHARACTERISTICS OF A GOOD BUDGET

A good budget is one which satisfies criteria identified for this purpose and is prepared on the basis of well-recognized principles. One such principle is that the budget should be accompanied by an account of the performance of the fiscal policies and programmes of the government during the previous year. This provides a necessary basis for deciding as to what was to be done, what has been accomplished and what more should be aimed at and in what manner. It is noteworthy that several governments have experimented along these lines, and have drawn heavily upon the techniques used by the corporate sector. The Government of India has also undertaken such exercises (though partially and imperfectly) including the programme and performance budgeting and outcome budgeting.

The budgetary proposals should also be accompanied by an analytical description of the current economic situation of the country as also the financial health of the Treasury. The budgetary proposals become far more meaningful in the light of the above mentioned accounts and descriptions. And they enable the legislature and the public to see the relevance or otherwise of the budgetary proposals and help the legislature in taking a more objective and rational stand in this connection. In India, as in several other countries, this need is fulfilled by bringing out an economic survey highlighting the health and current problems of the economy and identifying the lines along which fiscal policy should proceed. The budgetary proposals should be as unambiguous and transparent as possible. They should be easy to understand so that correct judgement can be formed as to the way in which the budget is expected to function in the coming year. Accordingly, details must accompany the proposals under major heads of receipts and expenditure. There should also be various statements which highlight the particular aspects of the budget.

Though complete accuracy cannot be expected, financial estimates of a budget should not be wide off the mark. They should be fairly close to the realized
figures under normal circumstances. A budget should reflect the overall policy and purpose of the government and should be so designed as to help the society move nearer to its chosen goals.

Modern economies have become highly complex and budgetary flows and policies exert a significant impact on their working. Analysts find that the conventional accounting format used in public budgets is not able to provide the extent of information needed these days. Accordingly, in recent years, various suggestions have been made to improve the usefulness of the budgetary documents.

Government of India has always been keen on experimenting with innovative ideas for improving the informative and analytical usefulness of its Budget. It was one of the first countries in the world to prepare and publish an Economic Classification of its budget in mid 1950s and adding to it an Economic and Functional Classification in mid 1960s. In later years, the government experimented with Programme and Performance Budgeting, Zero-based Budgeting. These days, it is prepares and publishes an Outcome Budget and a Gender Budget. The budget documents also contain Budget Provision for Schemes for the Welfare of Children, Medium Term Fiscal Policy Statement, Fiscal Policy Strategy Statement, Revenue Foregone Statement, Revenue Foregone under Central Tax System, Arrears of Non-tax Revenues, and Tax Revenues Raised But Not Realized, etc.

It would be instructive to have a closer look at the Revenue Foregone under the Central Tax System. When the government takes upon itself the task of helping the society in its socio-economic and institutional development and promote its equity parameters, then several policy measures commend themselves for inclusion in the budgetary provisions as well. Measures relating to the tax system include special tax rates, exemptions, deductions, rebates, deferrals and credits, and the like. These measures are collectively known as ‘tax preferences’ or ‘tax expenditures’ and result in a revenue ‘loss’. The first revenue foregone statement laid before Parliament covered fiscal year 2006-07, and the practice has continued since then. The estimates of revenue foregone are based upon short term impact of specific tax preferences and other simplifying assumptions. It is noteworthy that according to this statement, the revenue foregone was about 68.95% of the aggregate tax collections in 2008-09.

8.2.1 Kinds of Budget

In pursuit of trying to understand the different kinds of budgets, we shall deal with two questions, namely,

- Who should prepare the budget and formulate the budgetary proposals?
- What should be the accounting basis of the budget?

Both these questions pertain to the effectiveness of the administrative/legislative control over budgetary policy and operations. During the heyday of laissez-faire philosophy, a public budget was primarily considered a statement of the projected financial receipts and disbursements of the government. These days,
the philosophy of *laissez-faire* stands replaced by the view that the State has to play an all-pervasive and multi-dimensional role in preserving and promoting the socio-economic fabric of the country. In this viewpoint, the impact of government’s budgetary policies and financial flows generated by its budget is accorded a prominent place. However, the contents and nature of a public budget are believed to be closely related to several factors like the agency entrusted with the responsibility of preparing it, the system of accounting used, and so on. It would, therefore, be helpful to note different kinds of a public budget and their formats.

I. Executive versus Legislative Budgets

This distinction is based upon the type of agency entrusted with the preparation of the public budget. A legislative budget is the one which is prepared and adopted by the legislature directly or through its committees. An executive budget, on the other hand, is the one which is prepared by the executive wing of the government. Such a budget is also normally passed and adopted by the legislature but the initiative lies with the executive wing. It is generally believed that an executive budget is preferable to the legislative one for the following reasons:

- The executive wing of the government is better equipped to estimate probable receipts and required expenditures than the legislature. While the executive wing can have a staff of professionally trained persons, the legislative wing is not expected to be so equipped.
- The responsibility for the execution of the budget always lies with the executive. It is not desirable to just thrust certain estimates and figures upon the executive and ask it to realize the targets especially if these estimates happen to be highly unrealistic.
- When the budget is prepared by the executive, it is easier to fix responsibility for any shortcomings and lapses.

II. Multiple versus Unified Budgets

A unified budget is one in which all the financial flows generated by the government activities are recorded in a systematic manner as one piece and presented to the authority for its passage. The financial flows are suitably classified and grouped in alternative ways, such as ministries and departments, as also under other various functional categories, and in revenue and capital components etc. In contrast, a multiple budget is meant to be prepared and submitted for passage in parts without a cross reference. The idea is that this method facilitates a better evaluation of the functions of the government. It is obvious that the concept of a multiple budget is a misleading one. Its relevance is limited only to the extent of requiring each ministry/department to formulate its budgetary proposals for incorporation in the unified budget. Of course, the selection of such budgetary proposals for inclusion in the unified budget should be subject to a proper scrutiny and assessment and should be subject to rejection or inclusion after revision. And when the unified budget is presented to the legislature for its passage, each of its proposals and corresponding
financial components should be subjected to scrutiny and approval. Such a unified budget not only permits a proper evaluation of its each component, but also that of the budget as a whole.

III. Cash-flow-Based versus Accrual-Based Budgeting

Conventional accounting system used in the public budgets is cash-flow based. A search for improving informative and analytical policy prescriptive usefulness of public budgets has led thinkers to look into the possibility of shifting to accrual-based accounting. In cash-flow based accounting, receipts and disbursements are recorded with reference to the timing of their occurrence, while generation of claims to receive cash or liabilities to pay cash in the future are ignored. In contrast, in accrual-based accounting, entitlements to cash receipts or liabilities to pay cash are recorded with reference to the time of their occurrence irrespective of the timing of their actual receipts or payments.

A large number of countries have switched over to accrual based budgeting, either fully or partially and some more are weighing the benefits of switching over. However, whether accrual budgeting is better than cash flow budgeting or not is still a controversial and inconclusive issue for various reasons.

Case for Accrual-Based Accounting

- Advocates of accrual based accounting emphasize the inability of cash-flow based system in meeting the needs of a modern government, particularly because the information provided by it is inadequate for chalking out a long term fiscal policy in line with the socio-economic developments and the chosen goals.
- It is a well-recognized fact that a modern market economy is a victim of what is termed the ‘market failures’. This fact necessitates remedial measures on behalf of the State including fiscal measures. A cash-flow based budget is unable to meet stringent requirements needed for this purpose.
- The size of the budget of a modern government has an inherent tendency to increase for several reasons. Budgetary flows and policy measures have all-pervasive spill-over effects which often cover a multi-budget time period. The government needs to be equipped with relevant information to optimize the beneficial spill-over effects. But cash-flow based budgets are ill-equipped to perform this task. Such budgeting does not enable us to evaluate the long-term desirability or otherwise of the overall long term fiscal strategy.
- Cash-flow based budgeting does not provide information relating to future receipts and payments or building up of assets and liabilities and is, therefore, silent about the sustainability or otherwise of the government’s fiscal health. It means, for example, that a government may be indulging in huge fiscal deficits and accumulating debt liabilities without realizing the potential danger of mounting cost of debt servicing and other associated ill effects of this phenomenon. Advocates of accrual-based budgeting claim that it permits a
better evaluation of the government’s fiscal policies. It is also more transparent and provides a better basis for the accountability of the government.

- Cash-flow based budgeting does not reveal whether the current budgetary transactions are result-oriented, efficient and productive or result in resource wastage.
- In a federal setup, some undesirable trends (like the indebtedness of States to the Centre in India) tend to remain obscure and may end up as difficult situations.
- Cash-flow based budgeting does not reveal if future commitments are going to be sustainable or bearable.

However, inadequacies of cash-flow based budgeting should not lead us to discard it totally particularly when its recommended substitute, namely, accrual based budgeting has its own limitations. Some of the reasons for retaining cash-flow based budgeting include the following.

- To prevent wastage of public resources, each sum of expenditure must be backed by specific authorization and subject to auditing. It is difficult to set audit standards for projections made in an accrual based budget.
- Government is a custodian of the economy’s resources and has the duty to protect and strengthen the socio-economic fabric of the society. It has to have a system to prevent any unauthorized receipt or expenditure. Financial reporting must also conform to this requirement. Cash-flow based budgeting satisfies these criteria.
- Cash disbursement cannot be effected unless there are corresponding cash receipts, including borrowings, if need be.
- Accrual based budgeting is a complex system, expensive and can be managed efficiently only by experts. Several less developed countries are not equipped to switch over to this system.
- Government is a custodian of the economy’s resources and has the duty to protect and strengthen the socio-economic fabric of the society. It has to have a system to prevent any unauthorized receipt or expenditure. Financial reporting must also conform to this requirement. Cash-flow based budgeting satisfies these criteria. Choice of assumptions needed for projected estimates of several budgetary components is bound to be subjective and therefore open to manipulation.
- It is claimed that the legislators are generally ill-equipped to understand the faulty choice of assumptions used in projections and understand the implications of the projections themselves.
- Disbursements of budgetary resources cannot be left to the discretion of disbursing authorities. To avoid wastage, unproductive, and low priority expenditure, each budgetary expenditure must be within specifically
sanctioned amount and with appropriate procedures and propriety. It means that it is a reckless policy to totally discard cash-flow based system in favour of an accrual based one.

- Opponents of accrual based system claim that its efficiency benefits are unduly exaggerated.

To conclude, it would be more productive and meaningful if cash-flow based budgeting is supplemented with all the relevant memo items. Instead of portraying cash-flow based and accrual-based budgeting as opposites of each other, they should be considered as complimentary to each other.

8.2.2 Preparation of a Budget

A public budget is a policy statement of the government with its financial implications. A typical modern government wants to undertake several economic and non-economic activities and pursue a set of policies which have their financial counterparts in the form of receipts, borrowings, and expenditures. Accordingly, the government describes its intentions and policies which it would like to pursue during the forthcoming period (usually a year) and draws up a financial plan corresponding to this scheme of things. Such a financial plan contains details of estimated receipts as also proposed expenditures and other disbursements under various heads.

Therefore, a budget enables the government to decide about each individual item of revenue and expenditure in the overall context of its policies.

No government can afford to take taxation, borrowings, expenditure and other fiscal decisions at random. On account of their interdependence, all decisions and policies must be in harmony with its overall set of objectives. The whole approach has to be quite systematic if chaos and wastage are to be avoided.

Check Your Progress

1. Name the kind of documents India was one of the first countries to publish in relation to innovation in Budget.

2. What is the relevance of multiple budget limited to?

8.3 BUDGETING IN INDIA: AN OVERVIEW

In India, the actual financial statement of the Government of India incorporating item-wise proposed disbursements and estimated receipts for a specified period (normally a year) is termed its Budget Statement. Article 112 of the Constitution of India states that an annual financial statement shall be placed before both Lok Sabha, and Rajya Sabha, while Article 202 of the Constitution states that a similar financial statement for each State shall be placed before the Legislature of that State.

In India, all Government accounts (of both the Centre and the States) are grouped into three parts, viz., (i) Consolidated Fund, (ii) Public Account and (iii) Contingency Fund.
All sums of money received by and belonging to Government of India or States are credited to the Consolidated Fund of India or those of the respective States. For example, all revenues received by the Government of India, all loans raised by it through the issue of treasury bills, loans or ways and means advances and recoveries of loans are credited (with the exception of sums credited to the Contingency Fund of India) to the Consolidated Fund of India. No amount can be spent from this Fund without Parliamentary sanction, except for certain expenditure items specified in the Constitution and 'charged' upon the Fund (such as the salaries of the Judges of the Supreme Court and Comptroller and Auditor General of India). These expenses are included in the Budget but are not put to vote in Parliament. Corresponding provisions govern the replenishments of the Consolidated Fund of a State and expenditure from it.

All sums of money received by the Centre or a State, but not belonging to it and held in trust, are credited to the Public Account of India or that of the concerned State. No legislative sanction is needed to make payments out of the Public Account.

The contingency fund consists of the money put at the disposal of the governments to meet unforeseen emergent expenses. A prior sanction of the Parliament (for spending an amount out of the Contingency Fund of India) or of a State Legislature (for spending an amount out of the State Contingency Fund) is not needed. However, any such expenditure has to be approved later by the Parliament or the State Legislature as the case be, and the Contingency Fund is to be replenished accordingly.

8.3.1 Contents of the Budget

In India, both the Central and State Budget Statements show the receipts and payments under the above mentioned three Accounts separately.

In India, a budget (whether central or State) shows financial accounts of the previous year, the budget and revised estimates of the current year, and the budget estimates for the forthcoming year. The estimates for the forthcoming year are in two parts: those based upon the assumption that existing taxes and their rates would continue, and those based upon the proposed changes therein. A budget, in this sense, becomes both a description of the fiscal policies of the government and the financial plans corresponding to them.

It is quite possible that some revenues happen to be earmarked for certain specific expenditure heads, such as betterment levies, special assessments and the like. Similarly, some expenditure heads of the budget may be contractual in nature with the government legally bound to honour them. Examples of such expenditure heads include interest payments on loans, repayment of loans, payments arising out of satisfaction of court decrees, amounts falling due for payment on account of salaries, pensions, provident funds, and so on.
8.3.2 Budget Presentation in Parts

In India, a budget may be presented in parts. For example, each layer of the
government (national and sub-national) has its own budget. In addition, there are
bound to be some intergovernmental transactions and, depending upon the legal
and accounting procedures. They may form a part of the budget of one layer or
the other. The net effect of the fiscal policy of any one government is conditioned
by the collective budgeting of all the layers of the government. Similarly, while
railway finances form a part of the Central Government Finances, the railway
budget is presented separately from the main budget of the Central Government.

There are two other reasons also on account of which the main budget of
the year may be split up. The first is a political one. When, technically, the existing
executive government may or may not continue for the full year on account of the
fact that elections are due, then a lame duck budget is presented that is, a budget
which covers only a part of the year. Such a practice enables the next executive to
formulate its own budget for the rest of the year. The second cause is an economic
one which may result in a supplementary budget. It is not always possible to foresee
and provide for all emergencies (such as a war, or natural calamities) which may
necessitate an extra expenditure. Similarly, for some reason or other, the revenue
receipts may fall short of the expected ones. Or, it may become necessary to
revise some tax rates, provide subsidies, or take some other mid-course corrective
action. In such circumstances, the authorities may find it fit to have a supplementary
budget.

8.3.3 Periodicity of Budget in India

The periodicity of the public budget in India has also been a subject of debate on
two counts. These are as follows:

- In India, fiscal year runs from 1st of April to 31st March of next year. It has
  been a long-standing argument that a significant portion of our GDP from
  agricultural sector which is prone to vagaries of nature. It has, therefore,
  been a long standing suggestion that the beginning of our fiscal year should
  coincide with the beginning of the busy season of the economy (which starts
  with the kharif crop) in October/November. This way the budget would
  cease to be a gamble in the monsoon. However, this reasoning has lost
  much of its weight. This is because Indian economy, on account of its (i)
  overall growth in the recent past, (ii) increased exposure to the global forces,
  and (iii) increased commercialization and diversification of agricultural sector,
  has gained in resiliency. Now a change in revenue receipts from agricultural
  sector are not able to cause a major swing in aggregate revenue receipts of
  the government. Public budget, for these reasons, is no longer a gamble in
  the monsoon.
It is argued that the annual practice of preparation, presentation and passage of the budget is a wasteful one. Expenditure against sanctioned amounts starts with a time lag, while preparation for the next annual budget starts soon after. In other words, the budget has become a continuous and time consuming activity of the government. It is claimed that this practice allows the authorities to revise the tax structure more frequently. But this argument holds no weight. Even now the authorities are in a position to vary those taxes where such a need may arise (such as in customs duties). In respect of most other taxes, however, frequent changes do not allow a judicious assessment of the effects of tax measures. Accordingly, it is suggested that the broad features of the tax structure should be left unaltered for a few years at a time and only minor changes should be allowed from year to year. This, however, does not prevent the authorities from introducing major changes in times of national emergencies.

8.3.4 Secrecy in Budget Presentation

Secrecy surrounding budget proposals is also a debatable issue. It is asserted that budgetary proposals are unnecessarily kept secret till their actual presentation to the legislature. This practice causes a lot of uncertainty and speculation and obstructs efficient planning of economic activities by everyone. In India, this uncertainty affects even the State budgets because of large scale transfer of resources from the Centre to the State. Till the passage of the Central budget, the States cannot assess the size of these transfers. The State budgets are also indirectly affected by the inflationary impact of the Central budget.

Critics maintain that there is absolutely no reason to be secretive about proposals concerning direct taxes. Rather, they should be widely discussed to assess their impact on savings, capital formation and other parameters of the economy. An open discussion of proposals concerning even indirect taxes would cause less speculation than is the case at present. Moreover, such a discussion would enable the public to participate in the budget deliberations in a more constructive manner. For the authorities also it would be a more flexible position as against the existing one in which they think it necessary to defend every proposal presented to the legislature. Under the new system, they will be better placed to modify the proposals to suit the needs of the economy.

Check Your Progress

3. Which Articles in the Indian Constitution have provision for budget in the Centre and the States?
4. Which are the three parts into which all government accounts in India are grouped?
8.4 ANSWERS TO CHECK YOUR PROGRESS
QUESTIONS

1. Government of India has always been keen on experimenting with innovative ideas for its Budget. It was one of the first countries in the world to prepare and publish an Economic Classification of its budget in mid 1950s and adding to it an Economic and Functional Classification in mid 1960s.

2. The relevance of multiple budget is limited only to the extent of requiring each ministry/department to formulate its budgetary proposals for incorporation in the unified budget.

3. Article 112 of the Constitution of India states that an annual financial statement shall be placed before both Lok Sabha, and Rajya Sabha, while Article 202 of the Constitution states that a similar financial statement for each State shall be placed before the Legislature of that State.

4. In India, all Government accounts (of both the Centre and the States) are grouped into three parts, viz., (i) Consolidated Fund, (ii) Public Account and (iii) Contingency Fund.

8.5 SUMMARY

- A good budget is one which satisfies criteria identified for this purpose and is prepared on the basis of well-recognized principles. One such principle is that the budget should be accompanied by an account of the performance of the fiscal policies and programmes of the government during the previous year.

- Government of India has always been keen on experimenting with innovative ideas for improving the informative and analytical usefulness of its Budget. It was one of the first countries in the world to prepare and publish an Economic Classification of its budget in mid 1950s and adding to it an Economic and Functional Classification in mid 1960s.

- A unified budget is one in which all the financial flows generated by the government activities are recorded in a systematic manner as one piece and presented to the authority for its passage. The financial flows are suitably classified and grouped in alternative ways, such as ministries and departments, as also under other various functional categories, and in revenue and capital components etc.

- A multiple budget is meant to be prepared and submitted for passage in parts without a cross reference. The idea is that this method facilitates a better evaluation of the functions of the government. It is obvious that the concept of a multiple budget is a misleading one.
Conventional accounting system used in the public budgets is cash-flow based. A search for improving informative and analytical policy prescriptive usefulness of public budgets has led thinkers to look into the possibility of shifting to accrual-based accounting.

Advocates of accrual based accounting emphasize the inability of cash-flow based system in meeting the needs of a modern government, particularly because the information provided by it is inadequate for chalking out a long term fiscal policy in line with the socio-economic developments and the chosen goals.

Cash-flow based budgeting does not provide information relating to future receipts and payments or building up of assets and liabilities and is, therefore, silent about the sustainability or otherwise of the government’s fiscal health.

It would be more productive and meaningful if cash-flow based budgeting is supplemented with all the relevant memo items. Instead of portraying cash-flow based and accrual-based budgeting as opposites of each other, they should be considered as complimentary to each other.

A public budget is a policy statement of the government with its financial implications. A typical modern government wants to undertake several economic and non-economic activities and pursue a set of policies which have their financial counterparts in the form of receipts, borrowings, and expenditures.

In India, the actual financial statement of the Government of India incorporating item-wise proposed disbursements and estimated receipts for a specified period (normally a year) is termed its Budget Statement.

In India, all Government accounts (of both the Centre and the States) are grouped into three parts, viz., (i) Consolidated Fund, (ii) Public Account and (iii) Contingency Fund.

In India, a budget (whether central or State) shows financial accounts of the previous year, the budget and revised estimates of the current year, and the budget estimates for the forthcoming year.

In India, a budget may be presented in parts. For example, each layer of the government (national and sub-national) has its own budget. In addition, there are bound to be some intergovernmental transactions and, depending upon the legal and accounting procedures. They may form a part of the budget of one layer or the other.

Secrecy surrounding budget proposals is also a debatable issue. It is asserted that budgetary proposals are unnecessarily kept secret till their actual presentation to the legislature. This practice causes a lot of uncertainty and speculation and obstructs efficient planning of economic activities by everyone.
Critics maintain that there is absolutely no reason to be secretive about proposals concerning direct taxes. Rather, they should be widely discussed to assess their impact on savings, capital formation and other parameters of the economy.

8.6 KEY WORDS

- **Zero-based budgeting**: Zero-based budgeting is a method of budgeting in which all expenses must be justified and approved for each new period.
- **Gender budgeting**: Gender budgeting means preparing budgets or analysing them from a gender perspective. Also referred to as gender-sensitive budgeting, this practice does not entail dividing budgets for women.
- **Consolidated Fund**: Revenues received by the government and expenses made by it, excluding the exceptional items, are part of the Consolidated Fund.
- **The Public Account of India**: This was constituted by Article 266(2) of the Indian Constitution. It deals with the money received by the government, i.e. state provident funds, various pre-deposits under income tax, depreciation and reserve funds of departmental undertakings are paid into public accounts.
- **A contingency fund**: This is a fund for emergencies or unexpected outflows, mainly economic crises.

8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is the significance of the budgetary proposals?
2. Which measures are known as tax expenditures?
3. Write a short note on different kinds of budget.
4. Is accrual budgeting better than cash flow budgeting?
5. What role does Consolidated Fund of India play?

Long Answer Questions

1. Discuss the role of public budget as government’s financial planning and policy statement.
2. Analyse the various characteristics of a good budget.
3. Discuss the difference between Executive and Legislative Budgets.
4. Analyse the constitutional provisions for a budget in India.
8.8 FURTHER READINGS

UNIT 9 DEFICIT FINANCING

9.0 INTRODUCTION

In the common parlance, deficit spending refers to the amount by which spending exceeds revenue over a particular period of time. It is the practice a government resorts to when it spends more money than it receives as revenue, the difference being made up by borrowing or minting new funds. While there could be numerous causes for deficit financing, on several occasions, government relies on the deficit financing to stimulate the economy. Some economists have also pointed out that deficit financing also results from government inefficiency, widespread tax evasion or wasteful spending rather than the operation of a planned policy. In India, as the deficit exists due to the gap between expenditure and its receipts, government uses this tool when it fails to meet deficits through external borrowings.

This unit discusses the objective, effect and limitation of deficit financing and explains how it works in India.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the provision of deficit financing
- Enumerate the objectives, need and effects of deficit financing
- Discuss the limitations of deficit financing
- Analyse deficit financing in India
9.2 NEEDS AND OBJECTIVES OF DEFICIT FINANCING

An important source of public income is deficit financing. Ordinarily, deficit financing means an excess of public expenditure over public revenue. This excess may be met by borrowings from the market, borrowings from abroad, or the use of the printing press (creation of currency). In the case of borrowings from abroad, there cannot be any compulsion for the lenders; but in the case of internal borrowings there can be. The government may force various individuals, firms, corporations and other institutions to lend to it at rates much lower than would be the case otherwise. This amounts to a kind of taxation in the sense that the government does not pay as much to the lenders as they could get otherwise. On the other hand, instead of borrowing, the government may choose to use the printing press. When the government spends the additional funds so created, the aggregate demand increases and prices are pushed up. The government purchases away a part of resources and the market is left with smaller supplies. In other words, the government, through the use of the printing press, taxes away some resources of the market just as it could tax them away directly.

The objective in seeking deficit financing is to finance the shortfall between government expenditures and tax receipts. Tax increases are not politically palatable. Governments often resort to deficit financing when other components of GDP such as private consumption decline during recessionary periods. Such deficits, if undertaken for a short period with an action plan to create equivalent surplus in near future, could reverse decline in real GDP and stimulate growth in real GDP for the benefit of citizens of the nation. Structural deficits are indicative of inability to reduce entrenched government expenses.

9.2.1 Causes, Effects and Limitations of Deficit Financing

The sustainable level of accumulated deficits can also be determined with reference to both the deficit servicing requirements and deficit servicing sources. This analysis will entail identification of cause and effect relationships that determine the factors influencing each of these two areas. As shown by other researchers, the explanatory variables leading to deficits include domestic budgetary receipts; tax structure; budgetary endowments; budgetary discretionary expenses; trade deficit; growth in real GDP; private consumption; domestic capital formation; and foreign direct investment flows. Deficit servicing requirements analysis takes into account accumulated deficit; expected additions to deficit; deficit held by Government Accounts, by Federal Reserve System, by public–domestic entities, by overseas public and governments, maturity term; and cost of debt.

From a theoretical point of view, the causes of sovereign deficits are equally diverse. Primary cause of deficit is that some components of government spending have a built-in growth multiplier that is much higher than the rate of growth of tax receipts. Government expenses can be broken down into discretionary and non-
Deficit Financing

NOTES

Deficit financing is discretionary. Over time, the non-discretionary component grows as a percentage of total budgetary expenses, thereby reducing government's ability to reduce expenses without disenfranchising the electorate. Deficits incurred to meet national emergencies present a special case where the expenditure is incurred without any considerations for fiscal sacrifices. Secondary causes of deficits include shifts in government spending, changes in the competitive environment, globalization, presence of shadow economies, and fraud in government programs, role of multinationals, and income distribution that affects private consumption expenditures.

During periods of economic downturn, governments often tend to stimulate demand through either direct expenditure on specific projects or through reduction in direct taxes. Stimulation through direct expense is intended to increase employment or save jobs, while stimulation through reduction in direct taxes is aimed at increasing disposable income and, therefore, consumption as well as investments. Reduction in taxes does not necessarily lead to increased consumption and its impact on increasing employment has a longer lag than that of direct expenses. Reduction in taxes on higher income groups and corporations has not always increased investment since higher savings could be hoarded in bank accounts or in retained earnings by corporations. It should be noted that once taxes are reduced, it is difficult to raise them for reducing the budget gap at a later date.

The role of competitive forces in allocation of resources and setting prices, especially in free market economies, has been diminishing. Competition has been replaced in reality by oligopoly where a few firms dominate a business sector. Although the number of buyers is large, product is not necessarily homogeneous; information is asymmetric; and the seller has considerable control in setting prices and output level. Oligopolistic firms influence elections and issues to their own benefit by funding elections and lobbying on issues. This often leads to either unintended direct government expenses or increased tax expenditures contributing to deficits. Similarly, increased globalization tends to reduce the effect of domestic multipliers for income and employment due to leakages beyond the borders of a country. Thus growth of a business in a country does not necessarily mean increase in employment in the country as anticipated by historical income and employment multipliers. Presence of shadow economy also accounts for some problems as this unaccounted portion of GDP outside the reach of fiscal measures increases deficit by reducing potential tax revenue.

Another factor that might influence deficits is fraud in government-run programs that often leads to unintended excess government expenditure. Government bureaucracies can also be included in the list of factors that affect deficits. Bureaucracy often leads to redundant government agencies that essentially perform the same tasks resulting in an increase in government expenses without providing any additional benefits or services. Income distribution impacts both consumption and investments in a country. A summary measure of inequality of income is Gini index. The more unequal a country's income distribution, the farther its Lorenz curve from the 45 degree line and the higher its Gini index. If income
was distributed with perfect equality, the Lorenz curve would coincide with the 45 degree line and the index would be zero; if income was distributed with perfect inequality, the index would be 100.

9.2.2 Deficit Financing in India

In India, deficit financing is a way of meeting government deficits through borrowings. The deficit exists due to the gap because of excess government expenditure over its receipts. Government expenditure encompasses disbursement on revenue as well as on capital account. Similarly, receipts consists of revenues on current account as well as capital account. In the past, excess government spending was met through the creation of new money. However, now, it is met through a scheme called Ways and Means Advances (WMA). Under this, the government can get only temporary loans to overcome the mismatch between its receipts and expenditures.

**Purpose of Deficit Financing in India**

Deficit financing is primarily resorted to in India to ensure that the government has the required resources to meet its plans. This is because the levels of outlay laid down are of an order which cannot be met only by taxation and borrowing from the public. The gap is usually made up through external borrowing, but when that is not enough, deficit financing is used.

**Check Your Progress**

1. What does the term ‘deficit financing’ mean?
2. What is the objective of deficit financing?
3. How does deficit financing work in India?

**9.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

1. Ordinarily, deficit financing means an excess of public expenditure over public revenue. This excess may be met by borrowings from the market, borrowings from abroad, or the use of the printing press.
2. The objective in seeking deficit financing is to finance the shortfall between government expenditures and tax receipts.
3. In India, deficit financing is a way of meeting government deficits through borrowings. The deficit exists due to the gap because of excess government expenditure over its receipts. Deficit financing is primarily resorted to in India to ensure that the government has the required resources to meet its plans. This is because the levels of outlay laid down are of an order which cannot be met only by taxation and borrowing from the public.
9.4 SUMMARY

- Ordinarily, deficit financing means an excess of public expenditure over public revenue. This excess may be met by borrowings from the market, borrowings from abroad, or the use of the printing press [creation of currency]. In the case of borrowings from abroad, there cannot be any compulsion for the lenders; but in the case of internal borrowings there can be.

- The objective in seeking deficit financing is to finance the shortfall between government expenditures and tax receipts. Tax increases are not politically palatable. Governments often resort to deficit financing when other components of GDP such as private consumption decline during recessionary periods.

- Deficit servicing requirements analysis takes into account accumulated deficit; expected additions to deficit; deficit held by Government Accounts, by Federal Reserve System, by public–domestic entities, by overseas public and governments, maturity term; and cost of debt.

- From a theoretical point of view, the causes of sovereign deficits are equally diverse. Primary cause of deficit is that some components of government spending have a built-in growth multiplier that is much higher than the rate of growth of tax receipts.

- During periods of economic downturn, governments often tend to stimulate demand through either direct expenditure on specific projects or through reduction in direct taxes. Stimulation through direct expense is intended to increase employment or save jobs, while stimulation through reduction in direct taxes is aimed at increasing disposable income and, therefore, consumption as well as investments.

- Growth of a business in a country does not necessarily mean increase in employment in the country as anticipated by historical income and employment multipliers. Presence of shadow economy also accounts for some problems as this unaccounted portion of GDP outside the reach of fiscal measures increases deficit by reducing potential tax revenue.

- A factor that might influence deficits is fraud in government-run programs that often leads to unintended excess government expenditure. Government bureaucracies can also be included in the list of factors that affect deficits. Bureaucracy often leads to redundant government agencies that essentially perform the same tasks resulting in an increase in government expenses without providing any additional benefits or services.

- In India, in the past the excess government spending was met through the creation of new money. However, now, it is met through a scheme called
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Means Advances. Under this, the government can get only temporary loans to overcome the mismatch between its receipts and expenditures.

- Deficit financing is primarily resorted to in India to ensure that the government has the required resources to meet its plans. This is because the levels of outlay laid down are of an order which cannot be met only by taxation and borrowing from the public. The gap is usually made up through external borrowing, but when that is not enough, deficit financing is used.

9.5 KEY WORDS

- **Oligopolistic**: An oligopoly is a market form wherein a market or industry is dominated by a small number of large sellers.

- **Lorenz curve**: In economics, the Lorenz curve is a graphical representation of the distribution of income or of wealth. It was developed by Max O. Lorenz in 1905 for representing inequality of the wealth distribution.

- **Gini index**: In economics, the Gini coefficient, sometimes called Gini index, or Gini ratio, is a measure of statistical dispersion intended to represent the income or wealth distribution of a nation’s residents, and is the most commonly used measurement of inequality.

- **Ways and means advances (WMA)**: This is a mechanism used by Reserve Bank of India (RBI) under its credit policy to provide to States to help them tide over temporary mismatches in the cash flow of their receipts and payments.

- **External borrowing**: This is the portion of a country’s debt that was borrowed from foreign lenders including commercial banks, governments or international financial institutions.

9.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short Answer Questions**

1. Why does the government need deficit financing?
2. What are the effects of deficit financing?
3. Write a short note on the purpose of deficit financing in India.

**Long Answer Questions**

1. Discuss the factors and causes of deficit financing.
2. Analyse the limitation of deficit financing.
9.7 FURTHER READINGS

INTRODUCTION TO FISCAL FEDERALISM

Structure
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10.1 Objectives
10.2 Theory of Fiscal Federalism
   10.2.1 Rationale for Fiscal Federation
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10.0 INTRODUCTION

As a part of public finance, the term fiscal federalism came to be used in the late 1950s and refers to the division of governmental functions and financial relations among different levels of government. Today, one can see federal set ups in the various countries which comprise governments at the national and state levels through the decentralization and devolution of powers. In most of the larger countries, their constitutions have provisions for a range of subjects which would be under the jurisdiction of federal government and various States. In countries like India with diverse ethnic, cultural and linguistic groups, this arrangement has been quite successful. In India, the Constitution, in Union List and the State List, has made provision for the functions and powers of the Central and State governments, respectively. In addition, there is the Concurrent List which contains those functions which should be carried by both the Central and State governments.

However, the balance between these two levels are maintained in such way that subjects that could impact the entire country gravitate towards the Centre and those with regional nature comes under the State. Subjects like defence, currency and foreign relations come under the federal or central governments. According to the theory of fiscal federalism, a federal system of government can be effective at solving problems such as distribution of income, efficient allocation of resources, and economic stability which many governments face today.
This unit analyses the evolution of federalism in various countries and offers an insight into the theory of fiscal federalism.

### 10.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the system of federations
- Describe the theory of fiscal federalism
- Discuss the rationale of fiscal federation
- Analyse various issues involved in the functioning of federalism

### 10.2 THEORY OF FISCAL FEDERALISM

Historical evolution of a federal set up normally follows one of the two alternative paths, namely, ‘centralization’ or ‘unification’ and ‘decentralization’. In the former case, some States decide to form a union and have a ‘national government’. To this end, they surrender some specified powers to it and retain the freedom of action and sovereignty in respect of remaining matters. For example, the State governments may surrender to the federal government subjects like defence, currency and foreign relations only, while retaining the remaining subjects. In this case, the federation is a creature of the States and, depending upon the constitutional set up, individual States may have the right of even breaking away from the federation.

In the second case, the national government of a country decides to create one more tier of sub-national governments for reasons of administrative efficiency and economy and shares some of its subjects with them and/or delegates some functions to them. The formation of such a federation reflects fissiparous forces in the country and a lack of harmony between interests of different regions. This tendency is more likely to be found in a geographically big country with a strong presence of regional differences. Federations are also suitable for those countries in which different ethnic and cultural groups occupy reasonably distinct geographical areas. This system of political organization enables these groups to maintain their identity and progress in their own ways, while still co-operating with each other.

**Framework of federal set ups**

Federal set ups are characterized by a variety of structural and other features. To an extent, they depend upon their evolutionary background, and the evolution of inter-governmental relationships. Generally, the constitution of a federation demands that that inter-governmental allocation of subjects and other related matters may be revised only with mutual consent of the parties involved.

One form of limiting the powers of one layer of government and assigning the balance to the other layer has been noted above where the federating States
allow the Centre to deal with only some specified subjects. In another variety, the Centre delegates certain powers specifically to the States. In still other forms of federalism, the functions of both the States and the Centre may be specifically laid down. In this arrangement, both layers of government may have some concurrent powers as well, such as, the concurrency of levying and collecting certain taxes. In India, for example, the functions and powers and the Central and State governments are as given in the Union List and the State List of the Constitution. In addition, the Concurrent List contains functions which overlap between the Central and State governments. However, Indian Constitution did not allow both the Centre and the States to tax the same base. Similarly, in some constitutions, as in India, the Centre may have the authority to abolish, create or re-define the boundaries of a State.

Converging tendency

Thus, we have a wide variety of federal structures in the world. However, they have collectively exhibited a tendency to converge to a set of core features. In most federations, functions covering the entire country have gravitated towards the Centre with functions with regional character going to States. In this way, even the unitary types of governments have moved along the path of ‘decentralization’, while the ‘decentralized’ federations have exhibited a tendency to strengthen their unitary features in certain spheres. Consequently no government, Central or State, remains completely sovereign and this is the basis and spirit of any federation. In other words, every federal set up is faced with the task of assignment problem, the exact contents of which keep changing over time. This problem concerns assigning both the functions and financial resources to each stratum or layer of the government on the basis of certain principles and/or historical reasons. In some cases, even political factors come to play their role in these decisions. The efficiency of a federal set up, however, does not depend upon the formal constitutional provisions only. Far more important is the way the system is operated, the conventions followed, and the spirit in which the intentions of the constitutional provisions are honoured.

10.2.1 Rationale for Fiscal Federation

Fiscal federalism recognizes the fact that modern governments are stratified and therefore, the problems arising therefrom must be studied and solved. However, a question arises as to whether there should at all be a federal set up in a country? Are there any theoretical underpinnings for it? Let us see the justifications for having such a set up.

1. Efficiency

One answer to this question lies in the complexities of a modern life in its various ramifications—political, economic, and social. And it is found that there are various duties and functions which can be more efficiently performed only at a federal level, while there are others which are best tackled at the State or even local level.
In the extreme, there are some services which approach very closely the pure public goods and which have a good deal of externalities such as defence, currency, measures for economic stability and the like. The provision of such services should ideally be in the hands of the federal government rather than the State governments or local authorities. Similarly, those services which cover more than one State, such as inter-state transportation, communication, trade and commerce, are subjects which are better suited for the federal government. These public services are meant to be consumed by the entire population of the country, or the population belonging to more than one State, and to put these under the jurisdiction of any one State, or divide them between States is likely to create unnecessary complications. The reason is that, in such cases, the costs and/or benefits of the service in question obviously spill over the boundaries of a single State. It becomes difficult to have a proper cost benefit analysis of such a service, to have a unified decision making process and bring in a harmony between the cost recovery and the paying out of benefits. On the other hand, there are some public services, the exact need for which is most likely to differ from area to area such as sanitation, provision of drinking water, medical aid and the like. From the administrative and other viewpoints, such services should be left in the hands of the States and local governments.

In between the two extremes are those functions which pose a problem, and make it difficult to have a clear cut division between the Central and the State governments. These are those functions which can probably be handled efficiently by both layers of government. Moreover, with the passage of time, it is possible that a function which was left to the States (or Centre) is now found better suited for the other layer of the government. Such difficult cases would probably include education. Any division of such functions can be debated and questioned. In India, we have the Concurrent List of functions for both the Central and the State governments. In such cases, however, care must also be taken that there is no duplication of efforts and no serious gap is left.

2. Nature of Problems and their Solutions

In a big country, there is likely to be a lack of uniformity in the problems faced by different regions. The nature of their problems may defy a common solution. For example, each region has its own economic resources and potentialities as also the limitations which it faces. The problems of regional disparities assume particular importance in an underdeveloped country and need an immediate attention. And an ideal solution would be the one which is in harmony with the cultural, social and political values of the people. In a big country, or in a country populated by different social and economic groups, therefore, the ideal economic, political and other solutions will differ. It would be best, therefore, to have a diversified pattern to suit the regional and other requirements. A federal set up provides better scope for aspirations—social and economic—of different regions of the people to be translated into practice through the diversity that it permits in the set up.
10.2.2 Financial Issues and Public Services

Government activities have their financial counterparts, generating financial receipts and disbursements. Therefore, in a federation, along with the political problem of division of functions between different layers of the government, the issues connected with financial arrangements have also to be sorted out. In other words, a federal set up is confronted with the twin issues of diversity and equivalence in the context of provision of public services and their financing.

1. Provision of Public Services

In the context of provision of public services, the former issue concerns the objective that in a federal set up, regional and local needs and aspirations should be satisfied to the extent possible. It implies that the level and composition of provision of public services in different regions should vary. Equivalence, on the other hand, means that no region or locality is to be discriminated against; that is, by itself the policy of the government should be to treat all regions on a parallel footing and variation in public services should reflect only their respective needs and aspirations. More particularly, it means that public services may be categorized on the basis of their national, regional and local applicability and provided accordingly. Defence, for example, is a nation-wide service, maintenance of law and order is a regional one, and provision of street lighting, a local one.

2. Financing of public services

As regards the financing of a public service, it is generally stated that the power to spend should go along with the obligations and power to raise the necessary resources. This is considered more so because expenditure is a relatively pleasant duty of administration as compared with that of raising the revenue. It implies that a sound solution of the financial issues will ensure that the governments in a federal set up have clear cut tax bases which do not overlap. Between the federal government and the State governments, the tax power should be divided according to the identification of the tax bases while across the State governments, even the same bases may be taxed but only within their respective territorial jurisdictions. Thus, for example, if the federal government is imposing income tax, the State governments should not do the same. However, taxes like land tax may be imposed by all the State governments since here the territorial boundaries of one tax-levying authority can be distinguished from those of the others.

In practice, however, it is not always possible to avoid taxing the same base by two or more governments. And sometimes, another problem may arise in the form of what is termed as a tax competition. One State government may reduce or abolish certain taxes (such as sales tax) in order to attract trade and manufacture from other parts of the country. This type of competition is not always bad. A backward State might find it a useful incentive to attract capital and thereby help in bringing about economic growth. Therefore, whether or not tax competition in any
particular situation is unhealthy, will depend upon the merits of the case and no a priori generalization can be made in this connection. Economists who ignore the problem of regional disparities advocate the principle of locational neutrality according to which no region should be allowed to compete capital away from others. But as Stated above, this principle cannot always be justified. Within a country, poorer regions should be permitted to attract capital through fiscal concessions but the richer regions should not be allowed to do so. While assigning the functions and resources, the question of economic stabilization dictates that some heads should be reserved for the Central governments. These include, for example, regulation of the economy as a whole to protect it against fluctuations in income, employment, and output, correction of balance of payment deficits and surpluses, and regulation of international capital flows.

By implication, subjects like money and banking as also credit regulation should be with the Central government. Similarly, there is the question of spill-overs. Any function or resource which covers more than one region should be with the federal government rather than with those of individual regions. Connected with the above is the principle of fiscal equalization. Allocation of the heads of functions and resources on the basis of above mentioned criteria and principles gives rise to the problem of fiscal imbalance between the federal government and regional governments on the one hand and between different regions on the other. These versions of imbalances become issues of vertical financial imbalance/inequity and horizontal financial imbalance/inequity. This imbalance has to be solved by appropriate mechanism of resource transfers.

Another aspect of the problem of federal financial relations concerning financial discipline may be stated as follows: To allow and expect a government to perform certain functions means expecting it to spend the necessary amounts. If the government is not able to raise the needed funds, it obviously cannot perform these functions. A limitation on the available resources is a limitation on its power to spend and hence perform that function. But to let it have resources without any legitimate controls and discipline is also not desirable. If, for example, the Central government agrees to finance all the specified activities of the State governments irrespective of the extent of expenditure involved, the State governments would tend to over spend. There would also be wastage and inefficiency. This leads us to look for a need for rules and guidelines for allocating financial powers as between different government units.

It may be added that the above issues generally do not yield a harmonious solution. The objectives connected with these issues come in conflict with each other and the authorities have to choose an optimum feasible path.

10.2.3 Principles of Division of Financial Resources in a Federation

Principles for efficient inter-government division of financial resources are as follows:
1. Efficient handling of resources

Different sources of public revenue can best be handled at different levels. Some sources of revenue are, by their very nature, national in character, while some are of regional or even of local character. For example, if we take the case of income tax, we find that to let this source of revenue be in the hands of State governments would create many anomalies and complications.

First, income tax rates and exemptions are likely to differ, if different States are given authority to fix their own schedules and exemptions.

Secondly, in a large number of cases, it will be difficult to demarcate the jurisdiction of various States in a clear cut manner. One can easily see the problems encountered in the use of direct taxes like income tax, gift tax, expenditure tax, etc. It is, therefore, thought best to assign such direct taxes to the federal government.

There are similar other taxes which, because of their multiple association with different States, cannot be left in the hands of the States such as taxation of wealth, gifts, and inter-State trade transactions. Similar observations apply to custom duties.

Similarly, in a modern economy, a number of regulatory and protective financial powers have to be left with the federal government. One may mention here the currency and coinage, international capital flows, foreign aid, and the like. These things are assuming ever-increasing importance with expanding international economic relations.

In contrast, certain financial sources are better left with the State governments for efficient scheduling and collection. Examples may be given of land revenue, small scale and cottage industries, dairy farming, road transport, etc. Some sources of revenue should preferably be left in local hands; for example, the income from water rates, house taxes, city transport and the like.

2. Economy

Like the canon of economy for the selection of the taxes, the assignment of various financial powers to different governments should also be with reference to the economy in the cost of collection. A non-economical and expensive way of collecting a revenue would be wasteful for the economy, and no economy is rich enough to waste its resources.

3. Desired Effects

Again it is found that a number of collective and other actions have to be taken which are of local nature and which vary significantly over different areas. The rates of house taxes, for example, need not be uniform in all cities. They are best decided by the municipal authorities themselves. In contrast, fiscal measures designed to bring about stabilization in the economy will be more effective if designed and implemented at the federal level. To protect the economy from a balance of payments disequilibrium and the like, a policy of customs duties can be helpful at
the national level. Regarding the industrial policy designed to help the overall growth of the economy, it is the national action that is needed; but to reduce the regional disparities, State actions can also be employed. Thus, fiscal efficiency in terms of collections, and variations of coverage and schedules often point the way in which financial powers should be divided between different governments.

4. Adequacy

American economist Edwin R.A. Seligman emphasized the criterion of adequacy when he said that ‘the three principles that should guide in the allocation of revenue as among various tax jurisdictions are: the extent of the base of the system, the efficiency of administration and the adequacy of the revenue.’ However, the adequacy of revenue should obviously refer to the adequacy of the total revenue availability to a government. And in a federal set up, even that may come in conflict with the criteria on the basis of which functions are assigned to different governments. Of the two, these days, the efficient allocation of functions is given a priority and the financial adequacy is sought to be adjusted through inter-governmental transfer of resources.

Basic Criteria of Resource Division

As a general rule, however, we can mention a few basic criteria which should form the basis of dividing the financial resources between the federal and the State governments, as also between the State governments themselves.

- The tax coverage and tax schedules should avoid being discriminatory as between citizens of the same country residing in different States, unless of course, the overall national policy dictates so, say, on welfare grounds whereby resources ought to be transferred from the more advanced to the less advanced States.

- Assuming that there is no specific problem of regional imbalance, the tax structure should be as uniform as possible as between different States. The States should avoid unhealthy tax competition and should therefore not come into conflict with each other.

10.2.4 Financial Imbalance: Vertical and Horizontal Inequity

The discussion relating to inter-governmental allocation of functions and resources reveals the problem of imbalance at the aggregative level, as between the Centre and the State, and as between the States themselves. It is a complex case of imbalance at both vertical and horizontal levels, where the latter refers to imbalance between authorities at the same level of government. The details of this double-edged manifestation of vertical and horizontal financial inequity vary from case to case and thus defy any standard solution. In India, this double-edged problem gains further complexity because of a large variety of local bodies with widely divergent sets of functions to perform.
Let us first look at the imbalance at the aggregative level. It is highly unlikely that the duties (responsibilities) and financial powers would be in harmony at different levels of government. To begin with, it must be noted, that even for the economy as a whole, it is very unlikely that the needs and the availability of resources will match.

First, as Wagner and Wiseman Peacock hypotheses show, there will be an upward trend in public expenditure. The balance between the expenditure and revenue, even if it is attained once, is not likely to stay for ever. And Wiseman Peacock thesis supports this possibility in a much stronger manner.

Secondly, cyclical fluctuations and other disturbances in prices, income and employment, natural calamities and other emergencies etc., would cause an imbalance between the two.

Even if there is an overall matching of the resources with the needs, there is no reason to believe that such will be the case at local, State and federal levels separately as well. ‘It so happens that the distribution of functions by performance criteria and of powers by economic allegiance tests do not lead to even a roughly satisfactory balance between own revenue and expenditure of most of the federations.’ The nature of revenue resources best suited for one level of the government need not conform to the nature of the requirements of that level of the government. Similarly, even with similar financial powers, one State government may find them inadequate while the other may not. Actually, as we shall see below, there are chances that there will be quite a good deal of discrepancy, at least on welfare grounds. The discrepancy between the resources available to the Centre and the States increases due to the fact that on account of efficiency, economy and other criteria, the Centre gets those resources which are relatively more elastic and buoyant in nature, while the States are mostly saddled with relatively inelastic and less buoyant revenues.

Between the States also, various factors contribute to the discrepancy between their revenue resources. The level and composition of income in different States may vary widely. Those of them which have industries and services would be able to collect larger revenues, while those depending mainly upon agriculture will not be so fortunate. Similarly, the extent and intensity of trade, commerce, and allied services differ from area to area. Bigger commercial Centres are obviously able to lay their hands on more revenue than the areas which are backward in this respect. And peculiarly enough, the revenue needs of the economically advanced States are comparatively (as a proportion of the income of the State/region) lower. In less developed areas, there is an all-round need for improving social services, providing social overheads, improving health, establishing industries and the like. To put it differently, the marginal utility of each rupee spent by way of public expenditure in less developed States exceeds that in more advanced States. On the other hand, the marginal disutility of each rupee raised by way of public revenue is higher in the backward States.
Distributive justice is as much called for between regions of the same country, as between different members of the society. This justice implies that whatever be the level of governmental activity, the marginal disutility of taxation should be the same for different regions. And, similarly, the marginal utility or benefit of government expenditure should be the same. Since a backward region needs much larger amount of State services than it has at present, its marginal social utility from governmental services is far greater. In a backward region, therefore, the public expenditure should increase if need be, even by transferring the resources from the more advanced regions. Similarly, when it comes to collecting the tax revenue, it is relatively better off regions which should pay more because of the lower social marginal disutility or sacrifice of tax. Eventually, inter-regional justice demands that the richer regions should be taxed more and the tax collections should be transferred (partly) to and spent in the poorer regions. Though we are not able to measure the social disutility and social utility of taxation and public expenditure, still a reduction in glaring regional inequalities will certainly be helpful.

It is very unlikely that the advanced States within a country will voluntarily agree to transfer adequate resources to the poorer States. For such a transfer, we should have a strong federal government with resources much larger than its own requirements (and a larger share of these resources should be coming from the more advanced regions of the country) so that it can transfer them to the poorer regions for their levelling up. A strong Centre is also needed for political integrity of the country, which again implies larger resource availability to the Central government.

Check Your Progress

1. What are the two alternative paths which federal set ups mostly follow?
2. List the subjects the federal governments retain in any arrangement of federal set up.
3. What are the constitutional provisions in India for power and functions of Central and State governments?
4. Why is there discrepancy between the resources available to the Centre and the States?

10.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Historical evolution of a federal set up normally follows one of the two alternative paths, namely, ‘centralization’ or ‘unification’ and ‘decentralization’.
2. The federal government retain subjects like defence, currency and foreign relations only, while States retain the remaining subjects. There is a consensus
that subjects like money and banking as also credit regulation should be
with the Central government. Similarly, there is the question of spill-overs.
Any function or resource which covers more than one region should be
with the federal government rather than with those of individual regions.
Connected with the above is the principle of fiscal equalization.

3. In India, the functions and powers and the Central and State governments
are as given in the Union List and the State List of the Constitution. In
addition, the Concurrent List contains functions which overlap between the
Central and State governments. However, Indian Constitution did not allow
both the Centre and the States to tax the same base. Similarly, in some
constitutions, as in India, the Centre may have the authority to abolish, create
or re-define the boundaries of a State.

4. The discrepancy between the resources available to the Centre and the
States increases due to the fact that on account of efficiency, economy and
other criteria, the Centre gets those resources which are relatively more
elastic and buoyant in nature, while the States are mostly saddled with
relatively inelastic and less buoyant revenues.

10.4 SUMMARY

- Historical evolution of a federal set up normally follows one of the two
  alternative paths, namely, ‘centralization’ or ‘unification’ and
  ‘decentralization’.

- Federal set ups are characterized by a variety of structural and other features.
  To an extent, they depend upon their evolutionary background, and the
  evolution of inter-governmental relationships. Generally, the constitution of
  a federation demands that that inter-governmental allocation of subjects
  and other related matters may be revised only with mutual consent of the
  parties involved.

- We have a wide variety of federal structures in the world. However, they
  have collectively exhibited a tendency to converge to a set of core features.
  In most federations, functions covering the entire country have gravitated
  towards the Centre with functions with regional character going to States.

- Fiscal federalism recognizes the fact that modern governments are stratified
  and therefore, the problems arising therefrom must be studied and solved.
  However, a question arises as to whether there should at all be a federal set
  up in a country?

- In a big country, there is likely to be a lack of uniformity in the problems
  faced by different regions. The nature of their problems may defy a common
  solution. For example, each region has its own economic resources and
  potentialities as also the limitations which it faces.
Government activities have their financial counterparts, generating financial receipts and disbursements. Therefore, in a federation, along with the political problem of division of functions between different layers of the government, the issues connected with financial arrangements have also to be sorted out. In other words, a federal set up is confronted with the twin issues of diversity and equivalence in the context of provision of public services and their financing.

Between the federal government and the State governments, the tax power should be divided according to the identification of the tax bases while across the State governments, even the same bases may be taxed but only within their respective territorial jurisdictions. Thus, for example, if the federal government is imposing income tax, the State governments should not do the same.

While assigning the functions and resources, the question of economic stabilization dictates that some heads should be reserved for the Central governments. These include, for example, regulation of the economy as a whole to protect it against fluctuations in income, employment, and output, correction of balance of payment deficits and surpluses, and regulation of international capital flows.

Different sources of public revenue can best be handled at different levels. Some sources of revenue are, by their very nature, national in character, while some are of regional or even of local character. For example, if we take the case of income tax, we find that to let this source of revenue be in the hands of State governments would create many anomalies and complications.

In a large number of cases, it will be difficult to demarcate the jurisdiction of various States in a clear cut manner. One can easily see the problems encountered in the use of direct taxes like income tax, gift tax, expenditure tax, etc. It is, therefore, thought best to assign such direct taxes to the federal government.

Certain financial sources are better left with the State governments for efficient scheduling and collection. Examples may be given of land revenue, small scale and cottage industries, dairy farming, road transport, etc.

The tax coverage and tax schedules should avoid being discriminatory as between citizens of the same country residing in different States, unless of course, the overall national policy dictates so, say, on welfare grounds whereby resources ought to be transferred from the more advanced to the less advanced States.

The nature of revenue resources best suited for one level of the government need not conform to the nature of the requirements of that level of the government. Similarly, even with similar financial powers, one State government may find them inadequate while the other may not.
Between the States also, various factors contribute to the discrepancy between their revenue resources. The level and composition of income in different States may vary widely. Those of them which have industries and services would be able to collect larger revenues, while those depending mainly upon agriculture will not be so fortunate.

Distributive justice is as much called for between regions of the same country, as between different members of the society. This justice implies that whatever be the level of governmental activity, the marginal disutility of taxation should be the same for different regions.

When it comes to collecting the tax revenue, it is relatively better off regions which should pay more because of the lower social marginal disutility or sacrifice of tax. Eventually, inter-regional justice demands that the richer regions should be taxed more and the tax collections should be transferred (partly) to and spent in the poorer regions.

It is very unlikely that the advanced States within a country will voluntarily agree to transfer adequate resources to the poorer States. For such a transfer, we should have a strong federal government with resources much larger than its own requirements so that it can transfer them to the poorer regions.

10.5 KEY WORDS

- **The Union List**: It has a range of subjects under which the Parliament may make laws. This includes defence, foreign affairs, railways, banking, among others.

- **Economic stabilization**: This is the result of the governmental use of direct and indirect controls to maintain and stabilize the nation’s economy during emergency conditions.

- **Fiscal equalisation**: This is a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity or public service cost.

- **Gift tax**: In economics, a gift tax is the tax on money or property that one living person gives to another. Items received upon the death of another are considered separately under the inheritance tax. Many gifts are not subject to taxation because of exemptions given in tax laws.

- **Cyclic fluctuations**: Fluctuations are periodic lows and highs in measures of economic activity, such as unemployment and inflation. These fluctuations affect wages, consumer demand, and the prices of raw materials. Seasonal fluctuations are short-term, but cyclical fluctuations could last for years.

- **Marginal utility**: In economics, utility is the satisfaction or benefit derived by consuming a product; thus the marginal utility of a good or service is the change in the utility from an increase in the consumption of that good or service.
10.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. When does a country need a federal set up?
2. What are the main problems which emerge during the process of federalism?
4. What are the basic principles which work in the division of resources in federalism?
5. Why, in a federal set up, subjects like money and banking should be with the Central government?

Long Answer Questions

1. Discuss the evolution of federalism in various countries in the world.
2. Analyse the various features of a federalism.
3. Discuss how theory of federalism is applied in India where there is a central and state government.
4. “In India, despite federalism, there is discrepancy between the resources available to the Centre and the States.” Justify this statement.

10.7 FURTHER READINGS

UNIT 11 CENTRE AND STATE FINANCIAL RELATIONS

Structure
11.0 Introduction
11.1 Objectives
11.2 Problems of Centre and State Financial Relations in India
   11.2.1 Goals of Inter-governmental Fund Allocation
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   11.2.3 Criticism of the Federal Finance Structure of India
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11.0 INTRODUCTION

Keeping in view the federal economy and the Centre-State relations, the Constitution of India has given both the layers of government specific powers to share, raise and spend the resources. In the normal course, the arrangement looks hassle-free but when it comes to raising or sharing the revenue in the form of taxation and excise duties, more often than not, it leads to confrontation between the two as the power is tilted towards the central government. The Constitution clearly mandates that the Central government needs to transfer resources to the State as the latter has higher responsibility for expenditure. Needless to say, transfer of resources helps the State to bridge the gap which props up when they are not able to raise resources to meet the requirements and fulfill the responsibilities. Through the channel of the Planning Commission, the Finance Commission and of numerous agencies, the Centre transfers the various funds to the States. Then there is the fact that States have limited power of enforcing taxes even as they are dependent on the Central government for resources which cover a major portion of their revenue.

Role of Finance Commission (FC) becomes all the more important because its recommendation to the central government, though not legally binding, plays a key role in fund allocation for non-plan expenditure to the States. Reports and recommendations from the successive Finance Commissions indicate the critical role that FC plays in balancing the financial relations between the Centre and the States.

NOTES
This unit aims at analysing the problems of Centre and State financial relations and explains the role of Financial Commissions in the allocation of resources to the States.

### 11.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand Centre and State Financial Relations
- Examine Problems of Centre and State Financial Relations
- Discuss the role of Finance Commission in India
- Analyse the reports of various Finance Commissions in India

### 11.2 PROBLEMS OF CENTRE AND STATE FINANCIAL RELATIONS IN INDIA

India is a federal economy and in such an economy, the policies of State revenue and expenditure are directly affected by policies relating to inter-governmental transfer. The optimum fiscal policy of a State is dependent upon the rules that transferring agencies apply to fund sub-national governments. The weightage assigned is affected by three things: Distance, deficit financing and revenue effort.

When the optimum policy is compared with the actual State's own revenue and expenditure policies, it is seen that the expenditure of the States exceeds that level which is their estimated optimum level and their revenue collection is far below the estimated optimum level.

The State governments and the Central government have both been given their own specific powers by the Constitution of India for raising revenue and also spending it independently. There clearly exists a vertical imbalance in the power of taxation between the State and the Centre and this is clearly admitted by the Constitution. Since the State has higher responsibility for expenditure, it is directed by the Constitution that the Central government needs to transfer resources to the State. The purpose of these transfers is to bridge the gap that exists between the resources that the States themselves can raise and the resources required by the State to fulfill the responsibilities that they have been assigned.

In India, there exists a three-tier transfer constitutionally demarcated system which is a mechanism that allocates funds based on specific functions as specified in three separate mandates. The Central government uses the channel of the Planning Commission, the Finance Commission and of discretionary transfers through various union ministries and agencies for the purpose of transferring the various funds. Low power of enforcing taxing power and high responsibility for managing the expenditure leads the governments of the States to be completely dependent on the Central government for resources. The transfer made by the Centre covers a major portion of the State governments' revenue.
India’s Constitution states specifically the responsibilities and the roles the three tiers are to perform, and these are differentiated based on the issues of micro/macro nature. Let us take an example. Matters that are of national importance, like macroeconomic management, international trade, transportation infrastructure and defence are solely the responsibility of the Centre. Following the provisions of the State List, the State holds responsibility to matters pertaining to State and regional importance, like local governments, agriculture, irrigation, housing, sanitation, public health and law and order. The third is the Concurrent List which forms the final tier. This list pertains to sectors like bankruptcy and insolvency, education, contracts, social and economic social planning, employment and labour welfare, electricity, stamp duties and all other sectors which need consensus of the Centre and State.

In the Indian Constitution, there are ‘quasi-federal’ features that can be seen very distinctly. The Constitution seems to be biased, in both judicial and administrative arrangements, towards the Centre. The centripetal bias in fiscal policy has been mainly due to the passing on of all of the residuary powers to the Centre. With the passage of time, it has been seen that in the Indian system, the Centre-biased quasi-federalism has become deep rooted. In 1992, the 73rd constitutional amendment made provision for the statutory recognition of local governments and States. The amendment also provided a list of the functions and funding sources for the local bodies, both in the urban and rural areas. In addition, it was mandated that every State appoints a State Finance Commission for the allocation of taxes and fees to the local government as well as recommending the State’s tax devolution and grants. Over time, there had not been any change or development in the Central-State fiscal relationship in the light of India’s evolving fiscal set-up. It is believed that the Centre is fully aware of the welfare of the State. Furthermore, such institutions that the previous governments had established for the purpose of overseeing division and allocation of funds are no more relevant to the current system of India.

11.2.1 Goals of Inter-governmental Fund Allocation

Based on current literature, it can be said that inter-governmental fund distribution has two main purposes: Bridging the fiscal gap and balancing the inter-State capacities.

The main reason for the fiscal capacities being different between the State governments and the Union Government, or even from one State government to the other, is due to different capacities of different governments for taxation and responsibility for expenditure. In the current taxation and expenditure assignment system, it becomes impossible for States to maintain a balance between the expenditures they have to incur and the revenues that they can raise. Generally, this is termed as vertical fiscal imbalance. Because of a mismatch like this, it is required that the Centre allocates funds so that the inadequacy can be removed. Even with the augmentation of revenue at the State level, there has been a further
rise in dependency. The reason for this is that though there has been steady increase of revenue, it is not fast enough to keep pace with the rising need of expenditure.

Besides vertical imbalances, there are also horizontal disparities that the States have to deal with. The degree of inadequacy varies from State to State. The reason for this is the lack of uniform tax base across the States. Adding to this is the fact that there is also a difference in expenditure from State to State. Since such a huge divergence exists, it is essential that balancing mechanisms be put in place in some form or the other.

**Balancing of Inter-State Capacities**

It is known that revenue as well as the spending requirement vary from State to State. If parity needs to be maintained, redistribution of the funds must take place. This phenomenon is well defined by Robin Broadway and Frank Flatters. According to them, for maintaining parity, it is essential that two persons who are equally well-off but living in different provinces, must remain equally well-off post taxation and the provision of public goods. It is to say, though they are in two different provinces, they must have the same level of well-being. Hence, due to disparity in the States—any State that a person resides—persons who are equally well-off must not be deprived of enjoying the same level of well-being. This goes to address the horizontal disparity issue in some manner.

**11.2.2 Fund Allocation Process**

Since there is imbalance of a quasi-federal structure of government, there are four different channels through which the government transfer funds in India. There are mainly two commissions that are employed for the purpose of allocation. These are the Finance Commission and the Planning Commission. Another channel is via the Centrally Sponsored Schemes and funds; this channel is used for the purpose of some specific spending. Projects under such schemes work jointly via a cost-sharing mechanism between the Centre and the State. The last option for the States to obtain revenue is through borrowing from the market. Furthermore, for commercial banks, it has been made mandatory that they retain 35 per cent of the lendable resources that they have as more liquid assets (the Statutory 3 Liquidity Ratio). An example of such an asset is State government bonds. In this way, there is an incentive for banks to buy government bonds.

**1. Finance Commission**

The responsibility for allocation of funds of the Finance Commission is just limited to non-plan current expenditures because of the Planning Commission performing similar functions. According to Article 280, every five years, the Finance Commission is appointed by the Prime Minister. The following steps are involved in the transfer of funds by the Commission: (i) Making an estimate of the overall available budget based on the Union’s and State’s total resource requirement, (ii) Making an estimate of the States’ current revenues and non-plan expenditures,
(iii) Making an assessment of the proportion of proceeds from Central tax which will go to the States and distributing this amount amongst the States, and (iv) Making available Grants-in-Aid to bridge any existing gaps between revenue and non-plan current expenditure. In step (iii), the transference of tax proceeds is there for the purpose of handling the horizontal and the vertical imbalance. The transference act itself addressed vertical imbalances and weights assigned to specific key factors help in the correction of horizontal imbalances. The main purpose of the transfers is economic efficiency and discouraging financially initiated migration within the country. In the Thirteenth Finance Commission (FC-XIII), four specific criteria have been employed for the transference of taxes: Population, area, fiscal capacity distance and fiscal discipline.

(i) Population: Population as a factor aims at making certain that there is equity across all States. As population rises, so do needs. The assumption is correct that the State that has more population needs more funds to ensure that residents receive comparable degree of public goods as in other States. A weight of 25 per cent for population has been assigned by FC-XIII.

(ii) Area: Area as a factor aims at equity by taking into consideration the varying cost disability of different States. A State that is larger in size will need to have more spending as far as administrative costs for public service delivery are concerned. In line with this rationale, there is a 10 per cent weight given to this criterion.

(iii) Fiscal capacity distance: Fiscal capacity distance as a factor has its basis in the principle of raising efficiency. Its aim is to incentivize States to increase tax efforts while taking into account the fiscal disadvantages of the States. The weight for fiscal capacity distance has been fixed at 17.5 per cent by FC-XIII.

(iv) Fiscal discipline: Fiscal discipline is based on the fact that besides resources being distributed equally, it is also of key importance to reduce their inefficient utilization. It is, therefore, recommended by the Commission that there should be rewards for the prudent utilization of resources. FC-XIII has assigned a 17.5 per cent weight to fiscal discipline and this percentage is more than that provided by the previous Commission by a whole 10 per cent.

You will learn about the successive Finance Commissions further in the unit.

2. Planning Commission

While the Finance Commission aims at fiscal equalization, the Planning Commission is more development oriented. The Planning Commission transfers funds so that the States’ fiscal capacity can be increased. Such fund transfer is done via two specific mechanisms—grants and loans. Previously, the components of these mechanisms were mainly project-based. Nevertheless, after 1969, the Gadgil formula is employed by the Planning Commission. The Gadgil formula has been revised on various occasions and the version which is in use at present is referred to as the Gadgil formula.
to as the National Development Council (NDC) revised Gadgil-Mukherjee Formula. In case of special category States, the process of transfer is not the same as that used for other major States. All of the 11 mountainous States of North and North-East India together form a group of special category States. Of these, seven states have received this status because of their distinctive economic requirements and capacities. Of the total funds, 30 per cent is allotted to these States by the Planning Commission. Out of the 30 per cent, 90 per cent is sent out in the form of grants and the ten per cent that remains is used to provide loans. Of the total funds, 70 per cent are kept for the rest of the States and the Gadgil-Mukherjee Formula is employed for their distribution.

Since Independence, the fiscal linkages of India have remained mostly unaltered and over the years, these linkages seem to have possibly further cemented. The debate and the struggle between the Centre and States has become more and more intense over the years. Though several arguments have been put forth against the system presently in use, those that are more significant seem to target a single basic problem and it is this specific problem that has stood as a hurdle to this relationship’s reformation and it being able to modernize and evolve with changing time and economic environments.

In simple words, it is politics which is the basic problem. Politics plays a huge strain on the relationship, and more so on those States which are represented by parties in the opposition or those States that have fallen out of favour of the Centre. Also, the allocation of funds is used as a means to entice parties to join or align with certain political alliances and it is also being used as a punishment by holding back funds from persons who are in opposition. Another argument that is majorly employed against the relationship that exists presently is that it lays too much emphasis on need-based fund allocation instead of fund allocation on merit basis, and this makes the well-performing States disillusioned. Moreover, certain States have been allocated special status and there is decentralization of decision-making with regard to allocation of funds for economic activities and these are all points of contention.

Planning Commission has now been replace by the Niti Aayog post the 2014 elections. You will learn more about it further in the unit.

11.2.3 Criticism of the Federal Finance Structure of India

The problems of Centre and State financial relations can be best understood through the problems of the aforementioned financial allocation structures. These are discussed in this section of the unit.

The federal finance structure of India is heavily criticized due to the following three critical issues:

- States have no allocation autonomy for funds that the Centre disperses.
- Fund allocation is not merit-based but need-based.
- Fund allocation is used as a political tool.
1. States Lack Allocation Autonomy on Funds

The practice for some certain allocation of funds to the States is based on schemes, and these schemes come with their own guidelines for the utilization of the allocated funds. Most of the times, these funds are named after political leaders and are made available for States for only certain specific purposes and issues which are believed by the Centre to be vital for the State, and this many a times circumvents the real requirement of the States.

For a State government, it is imperative that it represents the demands and the needs of the local population and by this virtue, in most cases, they are a better judge of the importance/relevance of an issue. Therefore, the States argue that without autonomy deciding on the usage of such funds leads to huge quantities of resources often times getting diverted to such activities which do not prove to be of any benefit to the local population. They are also in the long run not beneficial for the Centre. Hence, it is proposed by several State governments that they should be provided autonomy in the allocation of funds flowing from the Centre. Such autonomy will enable the local government body to select and decide the most critical and pressing issues to which the resources and funds must be allocated instead of the allocation being forced upon them from someone outside the local system who may not understand the actual requirement. In cases where there is no autonomy, the trend will continue where the funds are diverted to such programmes and schemes which might not prove to be of any benefit to the intended segment of population or the State, and this will in effect be both a waste of precious resources and a means of nurturing misuse, bribery and corruption.

2. Merit-based Allocation and Need-based Allocation

In the allocation of funds to sectors such as employment and education, the government adopts a practice which is fundamentally based on need but not merit. With fiscal linkages and transfer, a completely reverse method is employed. The basis is that those States that are performing the worse need to be provided with fund allocation preference over States that are performing better. There is an argument opposing this which says that such States that are performing better feel that their better performance and their better contribution to the nation’s revenue is not being rewarded but is being punished.

This method of fund allocation is being justified based on the theory that if funds are made available to such States that fall in the need-based model, then such funds will spur and even generate economic activity. Nevertheless, it is thought by States that if resources are invested in such economic activities that provide healthy returns, there will be a continuation of the positive cycle, creating over time a greater surplus and a decrease in the need for the Centre allocating funds. Yet, in such States whose economic performance is not good, this is impossible to attain where the funds from the Centre are being employed for other purposes which are not providing returns.
Finally, the argument becomes one which is fought between long-run gains and short-run gains. In case of the short-run outlook, reinvestment in any economic activity which is healthy would lead to that activity generating increased returns, and this will enable the State in becoming less dependent on the government for fiscal transfers. The other side of this argument remains that investments made in sickly economic activity or under-performing States will spur economic growth and boost returns. It is in the second theory that the real problem lies. Long-run investments due to which there is a spur in economic growth are subject to a huge number of variables that are needed for a sector’s revival. Of all the reasons for this under performance of the States that lead to the need for long-term investment, one reason might be systemic problems within the State, and putting in more and more resources could just be adding to the existing problem.

For reviving economic activity at such a scale and getting the sector to reach a level that makes it self-generating would most probably need investment for several years. The problem that is attached with the long-run concept is also that if funds are moved to activities that are less economically healthy, the Centre will be moving funds out of such programmes that are actually successful. For Central transfers, the primary goal must be the creation of such an economic system which has lower dependence on Central accounts than it had in the previous year. There is a heavy bias against merit-based allocation of 7.5 per cent and 17.5 per cent of total weight for the Planning Commission and the Finance Commission in the methodologies adopted by them. Yet, this does not prove that there is no need for need-based allocation. Nevertheless, long-run investments to revive economies over short-run investments to boost positive performance will keep not only the need-based States dependent on Central funds but may also bring the better performing States back into the fold of dependency.

3. Allocation: A Political Tool

The highest criticism that is made of the Central-State fiscal linkage resides in the fact that a huge number of times, the relationship is dependent on what kind of political relationship is shared by a State with the government at the Centre. Often, it is found that in case the State is governed by a party that does not have a good relationship or is not in alliance with the political party at the Centre, the State stands to lose as it is not provided much favour or priority in comparison with such States which are inclined and aligned politically with the Centre. Despite the fact that the equation which is employed for fund allocation as well as the Finance Commission’s mandate are non-partisan, still there is regular occurrence of political favouritism. Any State which is under the rule of the opposition has less probability of getting special funds or special status in comparison to such States which are under the rule of the same party which is also ruling at the Centre. Furthermore, States are given special funds and special status so that their political alliance can be obtained.
11.2.4 Criticism of the Planning Commission

Policy makers and experts have again and again raised questions regarding how relevant is the role of the Planning Commission. There are other commissions which exist and perform the duties of the Planning Commission, hence they believe that it is unwarranted that the Planning Commission also continues. While the debate has just begun questioning as to how relevant the Commission has remained, it has now become larger and now has gone so far as to ask for its total reform and even dismantling it.

‘Since the Planning Commission has defied attempts to reform it to bring it in line with the needs of a modern economy and the trend of empowering the States, it is proposed that the Planning Commission be abolished,’ the Independent Evaluation Office had said in a report.

Following are some of the criticisms that are made against the Planning Commission:

- To begin with, it is said that the basis for the creation of the Planning Commission was of setting up of such an organization that would formulate economic policy for those States of the Indian Union which were newly formed and economically weak. It would be the one to coordinate between ministries and government institutions, and it would be the unit which covered all those areas which were not overseen by any specific ministry. With the passage of time, there has been tremendous change in the economic status of States, because of each State’s functioning economic units. Hence, there has been a transfer of the needs for policy formulation to planning boards and State governments from the Commission. Furthermore, in 1951, when the Planning Commission was established, several economic activities like earth sciences, shipping, atomic energy, corporate affairs, steel and development were under direct charge of the Commission and not represented by a specific ministry. Now, there are specific ministries that look after such activities and due to this there has been a reduction in the mandate of the Commission. The specific ministries oversee the strategy, planning, coordination and implementation within specific sectors.

- The second point is that the Finance Commission already holds the responsibility of formulating and calculating the equation which is applied to allocating and transferring, and it is extremely well suited to take care of the allocation too. Thus, there seems to be little use or purpose of one additional ‘independent’ authority, more so when there is already a separate commission which handles the task of designing and implementing financial transfers.

- The third point is that of the proximity and association that the Planning Commission has with the Central government. It appears to be a fact that the appointment of the organizational head of the Commission is a politically motivated nomination. This by itself, since there will be political bias, renders the Commission non-independent when it comes to taking Centre-State...
fiscal decisions. Since the Commission will have political leaning, resource allocation will even more become a tool for political gain applied as reward or punishment towards States based on the present political alignment of the State.

- The fourth point is that when the Commission was formed, the vision was that the Commission would employ the services of policy maker experts in the process of decision-making with respect to creation of schemes and allocation of resources. In the present times, the Commission does not actively encourage this policy and the offices and ranks in the Commission are all filled in by political appointments and by senior bureaucrats. According to the Commission’s original mandate, it was supposed to advise the Prime Minister’s Office (PMO) on the varied and various developmental issues having taken expert opinions of domain specialists, and specifically regarding such issues that the Central Government’s decision-making officials may not understand easily. In the original mandate, the Planning Commission was also required to perform both in-depth research and analysis for scheme and policy creation for the nation and also provide criticism as far as activities of the Centre were concerned. Currently, there is a shift in the Commission’s mandate and it is now seen to support the government’s policies and claims under every condition even if far removed from ground realities.

- Lastly, it can be seen that the Commission employs methods that are outdated for the purpose of calculation of allocations and policy creation and these are neither in line with the contemporary economic systems nor with the recipient and stakeholder needs. When in-depth research and analysis is missing, the only role that the Planning Commission is playing in policy formulation lacks any sort of alignment with economic realities and is in a way also obsolete.

Niti Aayog

As mentioned earlier, the Planning Commission was replaced by the NITI Aayog. The Government of India, in keeping with its reform agenda, constituted the NITI Aayog to replace the Planning Commission instituted in 1950. This was done in order to better serve the needs and aspirations of the people of India. An important evolutionary change from the past, NITI Aayog acts as the quintessential platform of the Government of India to bring States to act together in national interest, and thereby fosters Cooperative Federalism. The National Institution for Transforming India, also called NITI Aayog, was formed via a resolution of the Union Cabinet on January 1, 2015.

At the core of NITI Aayog’s creation are two hubs – Team India Hub and the Knowledge and Innovation Hub. The Team India Hub leads the engagement of states with the Central government, while the Knowledge and Innovation Hub builds NITI’s think-tank capabilities. These hubs reflect the two key tasks of the Aayog.
Instead of the Five Year Plans, NITI Aayog has been tasked with preparing the following documents:

(i) A vision document keeping in view the social goals set and/or proposed for a period of 15 years;
(ii) A 7-year strategy document spanning 2017-18 to 2023-24 to convert the longer-term vision into implementable policy and action as a part of a ‘National Development Agenda’; and
(iii) A 3-year Action document for 2017-18 to 2019-20 aligned to the predictability of financial resources during the 14th Finance Commission Award period. This is also to help translate into actions the goals of the government to be achieved by 2019.

The decision to discontinue Five Year Plans has also meant that the distinction between plan and non-plan expenditures conventionally made will no longer be made in the future Budgets beginning 2017-18. This is a suggestion that has long been made by economists. The principal distinction will now be between revenue and capital expenditures.

Check Your Progress
1. Why does the Centre need to transfer resources to the State?
2. What is the main purpose of inter-governmental fund distribution?
3. List the various steps involved in the transfer of funds by the Finance Commission.
4. How many States are clubbed as a group of special category States in India?
5. Why is the federal finance structure of India often criticised?

11.3 REPORTS OF FINANCE COMMISSIONS IN INDIA

The Finance Commission (FC) is a salient feature of the Indian fiscal federalism. It is a ‘tenure’ body, that is, it is constituted for a specific period of time and with specified terms of reference (that is, the issues it is to study and make recommendations pertaining to them for a specified period). Under Article 280, a Finance Commission was to be constituted within two years of the commencement of the Constitution, and thereafter, every fifth year or earlier. Its working is further governed by the Finance Commission (Miscellaneous Provisions) Act, 1951. It is an advisory body and deals with the transfer of resources from the Centre to the states, determination of individual shares of states in the transferred resources, reviewing the financial situation of both the Centre and the states, and several other related issues and problems as mentioned in its terms of reference (ToR).
Once the FC has been constituted, final decisions regarding the transfer of resources from the Centre to the states can be taken only after consideration of its recommendations. Acceptance of its recommendations is not binding upon the Centre, but they are rarely rejected or modified.

11.3.1 Rationale Behind the Formation of FC

The institution of FC provides a much needed flexibility in the interest of optimum distribution of national resources between different tiers of governments in accordance with their respective needs. No permanently fixed distribution of resources can meet the requirements of an ever-changing situation, especially in a developing economy like ours moving on a path of multi-directional development. The institution of FC provides a periodic review of the inter-governmental fiscal arrangements and identifies needed re-adjustments in them. However, it cannot be claimed that the FC is guaranteed to provide us with the best possible solution of all problems and issues. It also works under some inherent limitations. Amongst others, its recommendations cover only a portion of the total transfers from the Centre to states. Its estimates and projections are not flawless and the principles and criteria chosen by it for making recommendations are frequently rated sub-optimal by the critics. The FC is not a permanent body and there is no permanent secretariat or a data research wing to assist it.

Formation of FC in Chronological Order

Till date, fifteen Finance Commissions have been appointed and fourteen have submitted their reports. The recommendations of the FC-XV will cover a five year period from April 1, 2020 to March 31, 2025.

The First FC was constituted on 22nd November 1951 and submitted its report at the end of December 1952. The Second FC was constituted on 1st June 1956 and submitted its report in September 1957. The Third FC was constituted on 2nd December 1960 and submitted its report on 14th December 1961. The Fourth FC was constituted on 5th May 1964 and its report was submitted on 12th August 1965. The Fifth FC was constituted on 29th February 1968 and its report came in on 31st July 1969. The Sixth FC was constituted on 28th June 1972 and its report was submitted on 28th October 1973 for the period 1974–75 to 1978–79. FC-VII was constituted on 22nd June 1977 and submitted its report on 28th October 1978 for 1979–84. The 8th FC was constituted on 20th June 1982 to make recommendations for the period 1984-89. It submitted an interim report on 14th November 1983 followed by the final report on 30th April 1984. The 9th FC was constituted on 17th June 1987. It was asked to submit two reports.

The first report was submitted in July 1988 for the period 1989–90. The second report was submitted on 31st December 1989 for the period 1990–95. The FC-X was constituted on 15th June 1992 to make recommendations for the period 1st April 1995 to 31st March 2000. It submitted its Report on 26th November 1994. The FC-XI was constituted on 3rd July 1998 to make recommendations for
the period 2000–2005. It submitted its Interim Report on 15th January 2000, its Final Report on 7th July 2000 and a Supplementary Report on 30th August 2000. FC-XII was constituted on 1st November 2002 under the Chairmanship of Dr. C. Rangarajan and submitted its report on 30th November 2004. FC-XIII was appointed on 13th November, 2007 (Chairman, Dr. Vijay Kelkar) and submitted its report on 29th December, 2009, its recommendations covering a period of five years from 1st April 2010 to 31st March 2015. The XIV FC was constituted on 2nd January 2013 and its recommendations are presently in force since 2015 till 2020. The latest XV FC was constituted in November 2017 and its recommendations will come in force from 2020 and will continue till 2025.

11.3.2 Recommendations of Finance Commissions

First FC

In view of increasing needs of the states, FC-I increased the state’s share from 50% to 55%. It determined their individual shares on the basis of collection (20%) and population census (80%). The share of Part C states was increased from 1% to 2.75% with 83.75% of the balance going to Part A states and 16.25% to Part B states.

Second FC

This Commission raised the share of states from 55% to 60%. It wanted determination of the shares of individual states only in proportion to their population size. But recommended that during the tenure of its own recommendations, only 10% of states’ share was to be distributed on the basis of collection and the remaining 90% on the basis of population. It hoped that, in future, the entire amount would be distributed on the basis of population only.

The share of UTs in was again reduced to 1% while the balance (99% of the states’ collective share) was divided between the states on the above-said criteria.

Third FC

An amendment of the corporation tax had curtailed the transfer of resources from the Centre to states. Therefore, to compensate them, their share was increased from 60% to 66.66% of net proceeds of income tax. The Commission also reverted to the sharing formula of population (80%) and collection (20%). The share of UTs was again increased to 2.5% and the balance (97.5%) was divided between states on the above-mentioned basis.

Fourth FC

In response to the states’ plea, their share was increased to 75%, and for reasons of stability, population and collection were assigned weights of 80% and 20%, respectively in determining shares of individual states, after assigning 2.5% to the UTs.
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Fifth FC

Plea of states was accepted for inclusion of advance income tax collections in the divisible pool. The Commission retained the collective share of the states at 75% out of which union territories were assigned 2.6%. It reopened the question of determination of individual shares of states and recommended that 90% of their collective share should be distributed between them on the basis of population and 10% on the basis of assessment (and not collection). It asserted that assessment was a more reliable index of the contributions of a state to the divisible pool than the collection.

Sixth FC

Accepting arguments put forth by the states, their share in the divisible pool of income tax was increased from 75% to 80% and determined the shares of individual states on the criteria of population (90%) and assessment (10%). Out of the remaining 20%, UTs were assigned 1.79%.

Seventh FC

The Seventh FC, after considering various pleas put before it, set aside 2.19% of the net proceeds of income tax for the UTs and allocated 85% of the remaining balance between states on the basis of population (90%) and contribution (10%). In October 1978 (when the Commission submitted its Report), income tax was not being levied in Sikkim, but it could be levied in future. (The Income Tax Act was extended to Sikkim from the assessment year 1989–90 by a notification of the President issued on 7th Nov. 1988). Accordingly, the Commission provided two sets of percentage figures of the states’ shares in which one included Sikkim, and the other did not.

Eighth FC

In spite of increasing needs of the states, FC-VIII did not increase their share in the divisible pool and having allocated 1.792% to the UTs, awarded 85% of the balance to the states. The Commission adopted a complex formula for determining individual shares of states as follows:

(i) 10% on the basis of their population size; (ii) of the remaining 90%, (a) 25% on the basis of fiscal need, (b) 25% on the basis of the ‘Income Adjusted Population’, that is, the product of state’s 1971 population and its average per capita income for the years 1976–79, and (c) 50% on the basis of the distance of state’s average per capita income of Punjab, multiplied by its 1971 population. The income distance of Punjab was taken from average per capita income of Haryana.

The percentage figures were worked out for all states (i) with Sikkim, and (ii) without Sikkim.
Ninth FC

FC-IX made recommended the inclusion of penalties and interest recoveries in the divisible pool of income tax receipts. It submitted two reports. These are:

A. First Report (for 1989–90): The Commission allocated 1.044% of the divisible pool to the union territories and 85% of the balance to the states. Of the states’ share, 10% was distributed amongst them on the basis of their contribution as given by the amount of assessment of tax for the years 1982–83 to 1984–85. The remaining 90% was divided between individual states in the following manner.

(i) 25% on the basis of 1971 population.
(ii) 50% on the basis of the distance of a state’s domestic per capita income for 1982–83 to 1984–85 from the corresponding per capita income of Punjab multiplied by its 1971 population, the distance taken for Goa, Punjab and Maharashtra being the same.
(iii) 12.5% on the basis of inverse of per capita income of a state multiplied by its 1971 population.
(iv) 12.5% on the basis of the proportion of poor people in the state to the total of poor people in the country according to 1983–84 estimates made by the Planning Commission.

The Commission worked out two percentage shares (including Sikkim and excluding Sikkim) for all states.

B. Second Report (for 1990–95): The Commission allocated 1.437% of the divisible pool to the union territories and the balance of the divisible pool was divided between the states and the Centre in the ratio of 85:15.

As regards the shares of individual states, the Commission recommended as follows:

1. 10% was allocated on the basis of contribution as measured by the assessment of income tax for the years 1985–86 to 1987–88.
2. In order to reduce the weight assigned to population factor, FC-IX split the remaining 90% of states’ combined share into four parts as follows, namely, (a) 45% on the basis of distance of per capita income multiplied by 1971 population figure, (b) 22.5% on the basis of population, (c) 11.5% on the basis of the product of inverse of state’s per capita income multiplied by the state population in 1971, and (d) 11.5% on the basis of a composite index of backwardness compiled by the Commission.

Tenth FC

As usual, the states pleaded for a greater share in the divisible pool of income tax, but the Commission was of the view that the Centre, being the levying and collecting authority, should have a substantial interest in tapping this source and, therefore, the resources transferred to the states should be increased through some other
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component. Accordingly, backed by expert opinion, the Commission recommended that:

1. The share of states in the divisible pool should be reduced to 77.5%.
2. The share of union territories should be 0.92%.
3. ‘Penalties’ and ‘interest receipts’ should form a part of the divisible pool.
4. The gains on account of pre-emptive sale of immovable properties should not be included in the divisible pool.
5. The cost of collection as between corporation and income tax should be in the ratio of 1:6.5.

While determining the shares of individual states, the Commission noted certain deficiencies in the formulas used by 8th and 9th FCs. In its view, population size as a determining factor was not progressive. Similarly, while the criteria of ‘distance’ of per capita income and ‘inverse income’ were both progressive, middle income states suffered in the case of latter criterion. In the end, the 10th FC replaced the complex formulations recommended by its predecessors by a far more complex formulation of its own as follows:

1. 60% of divisible pool was to be divided on the basis of ‘distance’ of state per capita income (for 1987–90) from that of the state with the highest per capita income, ‘scaled’ by population of the state under consideration. For Punjab and Goa, the distance taken was from per capita income of Maharashtra.
2. 20% on the basis of population.
3. 5% on the basis of area, with adjustments made in the upper and lower end states as worked by the Commission and subject to the condition that the proportion going to any individual state would be between 2 and 10%.
4. 5% on the basis of infrastructural disparities, as measured by the distance of state-wise index of infrastructural facilities and ‘scaled’ by the population of the state under consideration.
5. 10% on the basis of tax effort of states. Tax effort of a state was estimated as its \( \left( \frac{\text{per capita tax}}{\text{per capita SDP}} \right) \).

Eleventh FC

FC-XI made its recommendations in accordance with 80th and 88th Amendments of the Constitution. Mention has already been made of the Constitutional changes in the system of tax sharing resulting from 80th and 88th Amendments. Recommendations of the 11th FC were made in the light of the new provisions.

1. **Collective Share of states in the shareable taxes:** This was fixed at 28% of the net proceeds of all taxes and duties referred to in the Union List except those referred to in articles 268 and 269, and the surcharges and cesses, for each of the years 2000–01 to 2004–05. The recommendations
made in the Interim Report stood, accordingly, modified. Note that ADE had become a part of the shareable taxes of the Centre while the service tax was still out of it. The states were to get additional 1.5% on account of ADE, thus increasing the share of states to 29.5%. Inter-se distribution of this 1.5% between states was done in the same manner as the distribution of component of 28%. Further, if any state levied and collected sales tax on sugar, textile and tobacco, it would not get any share from this 1.5%.

2. **Inter-se shares of states:** The ToR of FC-XI contained a reference to ‘incentives that need to be provided for better utilisation of tax and non-tax revenues.’ The FC-X had introduced an index of tax effort to provide the needed incentive. FC-XI added to it an index of ‘fiscal discipline’ with its own complex formula. This measure was such that if the performance of all states taken together deteriorated, then the state with relatively lower deterioration was rewarded. Similarly, if the performance of all states taken together improved, then the state with relatively better improvement was rewarded relatively more.

Thus the criteria and their relative weights used by 11th FC were as follows:

1. Population, 10.0%;
2. Income (Distance Method), 62.5%;
3. Area, 7.5% (it was introduced for the first time by the 10th FC);
4. Index of Infrastructure, 7.5%;
5. Tax Effort, that is, Tax/GDP ratio, average of 1994–95 to 1996–97, 5.0%; and
6. Fiscal Discipline, that is, Index of Fiscal Self Reliance, 7.5%.

Since the method (used by earlier FCs) of calculating ‘income distance’ from the per capita income of the highest income state had some limitations, the 11th FC used a complicated substitute for it. It took a weighted average of per capita incomes of three states (Punjab, Maharashtra and Goa) as the benchmark and measured the ‘income distance’ of each state from this average. Also the distances of these three states were obtained as a fraction of the distance of Haryana from the benchmark figure.

**Twelfth FC**

It raised the share of states in the shareable central taxes, including ADE, to 30.5%. It was also recommended that if states were allowed to levy sales tax (or VAT) on the items currently subject to ADE, then the share of states in the net of proceeds of central taxes would be reduced to 29.5%. Another important recommendation of the 12th FC related to service tax. It said that any legislation on service tax must ensure that the revenue accruing to a state under the legislation was not less than the share that would accrue to it had the entire service tax been part of the shareable pool. The Commission, accordingly, separately worked out the percentage shares
of individual states in all shareable central taxes (excluding service tax), and service
tax (excluding J & K because it was not leviable in that state).

As regards the criteria and their weights in determining shares of individual
states in the shareable pool of central taxes, the 12th FC discussed the criteria
and their weights used by the 11th FC and made its own recommendations as follows.

i. Population: Its weight was increased from 10% to 25%.
ii. Income Distance: Its weight was reduced from 62.5% to 50%.
iii. Area: Its weight was increased from 7.5% to 10%.
iv. Index of Infrastructure: The 11th FC had assigned it a weight of 7.5%. 12th
FC omitted this criterion altogether.
v. Tax Effort: Its weight was increased from 5% to 7.5%. A complex formula
was used for estimating this weight for each state.
vi. Fiscal Discipline: Its weight was retained at 7.5%.

The 12th FC also recommended, as had been done by the 11th FC, that
any legislation enacted in respect of service tax must ensure that the revenue accruing
to a state under this legislation would not be less than the share that would accrue
to it, had the entire service tax proceeds been part of the shareable pool.

Thirteenth FC

This Commission noted that all goods had been exempted from the levy of Additional
Duties of Excise from 1 March 2006 and, on this account, the Centre had adjusted
the basic duties on sugar and tobacco products and the basic duties had become
a part of the shareable taxes of the centre. Therefore, it recommended that the
share of states in the net proceeds of the shareable central taxes should be retained
at 32%. This percentage share was not to change even in the event of states
levying sales tax or VAT on these commodities. Further, in the event of any legislation
relating to 88th Amendment of the Constitution, it should be ensured that the revenue
accruing to a state should not be less than the share that would accrue to it, had the
entire service tax been part of the shareable pool of central taxes. The Commission
also recommended that the centre should review the levy of cesses and surcharges
with a view to reducing their share in its gross tax revenue.

The recommendations of the XIV and XV FCs will be discussed in the last
section of the unit.

11.3.3 Finance Commission’s Jurisdiction

In this section, let’s study the factors important to understanding the Jurisdiction of
the Finance Commission.

Resource Transfers

The FC recommends transfers from the Centre to states in two forms, namely,
Tax-sharing and Grants. Their relevant details are as follows.
A. Tax-sharing

Tax sharing between the Centre and states underwent a fundamental transformation with the Constitutional (80th Amendment) in 2000 and 88th Amendment of 2003 enacted in 2004. The latter Amendment relates to levying of service tax by the Centre and its collection and appropriation by both the Centre and the states according to legislation enacted for this purpose by the Parliament.

Position Prior to Amendments

1. **Income Tax:** The net proceeds of income tax (excluding surcharge on it) were shared with states on a mandatory basis. The Commission made recommendations regarding
   - The proportion of collective share of states out of the ‘divisible pool’ of the net income tax proceeds; and
   - The proportionate share of each individual state within the collective share of all states.
   However, it could not recommend any change in the components or quantum of the divisible pool itself, such as the inclusion of corporation tax or surcharges in the divisible pool of income tax, or changes in exemptions and rate structure of income taxation.

2. **Union Excise Duties:** Sharing of Union excise duties was not obligatory for the Centre. The President had the discretion to refer the question of their sharing with the states to the Commission. In effect, this matter was always included in its ToR. Here again the Commission recommended the sharing of net proceeds of these duties (excepting earmarked cesses) between the Centre and state, and the distribution of their collective share between individual states. It was not necessary for the Commission to recommend the sharing of all duties; or a common and uniform basis of their sharing. In this case, therefore, it could identify the shareable duties and the share of states in each of them.

3. **Additional Duties of Excise:** Additional Duties of Excise were being levied by the Centre in lieu of sales tax by states on three items, namely textiles, tobacco including manufactured tobacco, and sugar. The proposal of the Centre to replace sales tax on all items with additional duties of excise, with later stand that at least five more commodities (namely, vanaspati, petroleum and petroleum products, paper and paper board, drugs and toilet preparations, and cement) should be covered by this scheme, had been successfully opposed by the states. The FC, in this case, only determined the principles on which shares of individual states were to be determined in the net proceeds.

The Ninth FC was asked to study the feasibility of merging the Additional Duties of Excise with Basic Union Excise Duties and determining a suitable formula for compensating the states for their loss by allocating them a part
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of excise revenue. However, in the face of stiff opposition by the states, the Commission did not recommend this merger.

4. **Taxes under Art. 269:** This Article contained a number of entries. The net proceeds of all taxes levied under this Article went to states and the FC was not authorised to recommend, on its own, on the removal, levy, or rate modification of any such tax. It only recommended the manner in which net proceeds of a tax of this category were to be divided between individual states. Over time, the Centre chose to levy only three taxes under this Article.

- **Tax on railway passenger fares:** It was levied in 1957 and repealed in 1961.
- **Estate Duty:** The budget for 1983–84 scrapped this duty in respect of agricultural lands (though a state subject, the Centre was levying this duty by virtue of enabling resolutions of the states to this effect), and the duty on properties other than agricultural lands was abolished in the budget for 1985–86.
- **Within the overall programme of the adoption of Value Added Tax (VAT) by states, and introduction of Goods and Services Tax (GST), rate of Central Sales Tax (CST) was reduced to 2% w.e.f. 1/6/2008 and was expected to be reduced to 1% w.e.f. 1/4/2009 and to NIL on 1/4/2010. However, it continues to be at 2% even in 2012–13 and its abolition is contingent on the introduction of GST.**

**Position after Amendments**

Consequent to 80th and 88th Amendments of the Constitution, all taxes and duties referred to in the Union List, except the duties and taxes referred to in Articles 268, 268(A) and 269, respectively, surcharges on taxes and duties, and any cess levied for specific purposes under any law made by Parliament are to be levied and collected by the Government of India and their *net proceeds* are to be shared with the states. The actual percentage of the divisible pool to be distributed among the states and their individual shares are to be determined by the President after considering the recommendations of the FC.

As noted earlier, Constitution (80th Amendment) Act, 2000, brought about a fundamental shift in the sharing of tax proceeds between the Centre and the States. Prior to the 80th Amendment, the only taxes shared between the Centre and States were income tax, Central Excise Duties and Additional Duties of Excise in lieu of Sales Tax on sugar, tobacco and textiles. It should also be noted that recommendations regarding the sharing of these taxes could vary from one tax to the other.

**Income Tax**

Before 80th Amendment, income tax was the only tax which was *compulsorily* shareable with the states under Article 270. However, sharing of Corporation tax
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(which is a tax on income of companies), and any Union surcharge on income tax, corporation tax or any other tax, were specifically prohibited. Further, divisible pool of income tax proceeds did not include the proceeds of income tax attributable to UTs and taxes payable in respect of Union Emoluments. In addition, the states complained that the Centre had been making an excessive use of cesses and surcharges. Exclusion of corporation tax from the divisible pool also deprived them from a buoyant source of revenue and the provisions of the Finance Act of 1959 had further reduced the divisible pool.

In view of these facts, the states had been able to convince successive FCs to increase their collective share in the divisible pool of income tax. However, they continued pressing for different criteria for determining their individual shares; each state advocating those criteria which suited it most. The criteria advocated most forcefully were those of ‘assessment’, ‘collection’, ‘origin’ and ‘need’. None of these could be termed an ‘ideal’ criterion and each suffered from the problems of theoretical soundness, objectivity, data availability, and methodology of quantification. In some cases, such as in the case of ‘need’, some proxy variables had to be used and this process was inherently subjective and arbitrary. For example, it can be argued that a state’s share should be in proportion to the collection of tax receipts, more so because the revenue needs of a state can be accommodated through grants. Also the assessment of comparative needs of states remains equally difficult in both cases. Some proxy variables have to be used for its quantification. Population size has been a favourite proxy variable with most FCs, though area, administrative standards, poverty and several other variables are also strong candidates.

Most FCs used a combination of collection and need (as determined on the basis of some criteria like the population size, backwardness, and fiscal need etc.) for determining shares of individual states.

B. Union Excise Duties

Government of India has been levying a variety of excise duties and they continue to be a very important and rapidly growing source of its tax revenue.

Position Prior to 80th Amendment

- Sharing of basic duties of excise was permitted under Article 272 of the Constitution. The First FC recommended sharing of only three duties. Over time, however, all basic duties came to be shared with the states.
- Similarly, entire net proceeds of ADE in Lieu of Sales Tax (because they were being levied on a tax rental basis by the Centre under Article 252) were transferred to the states.
- Additional Duties on Textiles and Textile Articles (they are different from the ADE mentioned above) were not sharable with the states.
- Cesses and surcharges went entirely to the Centre.
Sharing of Excise Duties

Each FC had to face three questions while dealing with basic excise duties, namely:

(i) Identifying the duties to be shared with the states;

(ii) Determining the collective share of states in the divisible pool (that is, in their net proceeds); and

(iii) Determining the shares of individual states in their collective share.

Expectedly, while all states wanted a bigger collective share, they differed on the criteria for determining their individual shares because no single set of criteria suited all of them.

These criteria under consideration included:

- Fiscal needs of states;
- Desirability of removing regional economic disparities;
- Contribution of individual states to the divisible pool; and
- Consumption data.

The argument in favour of the criterion of consumption data is that the incidence of an excise duty is finally borne by consumers and not by producers. However, in India, non-availability of usable consumption data persisted in spite of pleas for successive FCs for removing this deficiency. Accordingly, most Commissions had to use population size of a state as a proxy variable for both its contribution and fiscal needs.

Recommendations

First FC

The First FC decided that growing revenue needs of states should be met by sharing a small number of duties with high yields. Accordingly, it recommended sharing of duties on only three items, namely, tobacco (including manufactured tobacco), matches, and vegetable products, with states getting 40% of the net proceeds. The collective share of states, with the exception of J and K, was distributed between them in proportion of their population figures of 1951 census. It also recommended that Bombay, Madras and Madhya Pradesh should also be allowed to levy taxation on tobacco (just as other states could), and the compensation payable to them for refraining from doing so should be stopped.

Second FC

The revenue from Union Excise Duties (UED) had increased both on account of their elasticity and their extended coverage from 13 to 19 items. The Second FC, agreeing with states, extended the sharing of UED to five more items, namely, sugar, tea, coffee, paper and vegetable non-essential oils, but it reduced their share from 40% to 25%. Faced with the absence of relevant consumption data,
the Commission distributed 90% of states’ share on the basis of population with 10% used as an adjustment factor.

**Additional Duties of Excise in Lieu of Sales Tax (ADE)** also came within the category of shared taxes. In 1956, the National Development Council had resolved that the Centre should levy these duties on some specified commodities to facilitate trade and for checking tax evasion. Accordingly, the Additional Duties of Excise (Goods of Special Importance) Act 1957 was passed, and three items, namely, sugar, textiles, and tobacco including manufactured tobacco, were subjected to these duties. They were levied and collected by the Centre, but their entire net proceeds were assigned to the states. Technically, a state remained free to opt out of the scheme and re-impose sales tax, subject to the forfeiture of its share of the revenue from the additional excise duties on these commodities. However, in practice, states were prevented from doing this by Section 14 of the Central Sales Tax Act, 1956, according to which these goods had been declared as goods of special importance. Because of this declaration, the states could not impose sales tax on these commodities at a rate which exceeded the one specified under the Act. Moreover, sales tax on these commodities could be levied only at one stage and the local tax was to be refunded if such goods subsequently came under inter state sales tax. On account of all these repercussions, the states did not find it worthwhile to re-impose sales tax and opt out of the scheme.

The Second FC assigned 1% of the net proceeds of these duties to the union Territories, and 1.25% to Jammu and Kashmir. Out of the balance, it set aside a sum of Rs. 32.50 crore as guaranteed amounts and divided the rest amongst the states on the basis of their consumption, corrected with reference to population.

**Third FC**

In view of increasing revenue needs of states, the Third FC extended the sharing of UED to all items (excluding motor spirit) from which the yield of duty was Rs. 50 lakhs or more. This increased the number of shared duties to 35. But it reduced the combined share of states to only 20% of the net proceeds. Since some duties were being levied on investment and producer goods also, the Commission did not favour the use of consumption data for determining the shares of individual states. Instead, it used a combination of (i) population, (ii) financial needs, and (iii) percentage of scheduled tribes and scheduled castes in the state’s population. The exact weights of these factors were not disclosed.

ADE: Following the pattern laid down by the Second FC, the Third FC allotted 1% of the net proceeds to the UTs and 1.5% to J & K, and set aside the guaranteed sums of Rs. 32.54 crore (inclusive of Rs. 4 lakhs as ADE on silk fabrics). In the absence of reliable consumption data, it estimated the percentage increase in sales tax revenue in each state since 1957–58, and modified these figures with the population factor and determined the individual shares of states on that basis (after setting aside the guaranteed amounts). Note that this approach had its own limitations.
because an increase in sales tax revenue from other items is not necessarily indicative of the potential increase in the excise revenue from the items under consideration.

**Fourth FC**

The Centre had been following the policy of levying (or replacing the existing) non-sharable new duties in almost every budget. Therefore, the Fourth FC not only recommended the sharing of all the existing duties but also the ones to be imposed later. *The share of the states was, however, retained at 20% of the net proceeds.* Individual shares of states were determined by giving a weight of 80% to population and 20% to economic backwardness (indicated by per capita value added by manufacturing, and percentage of workers to total population, etc.).

ADE: The Commission adopted a new basis for dividing the amounts over and above the guaranteed sums; namely, *‘the proportion of sales tax revenue realized in each state to the total sales tax collection in all the states taken together’* during 1961–64. This formula also suffered from limitations similar to the ones used by the Third FC. The Fourth FC allotted 1% of the net proceeds to the UTs, 1.5% to J & K, 0.05% to Nagaland and the balance 97.45%, after setting aside the guaranteed sums of Rs. 32.54 crore, was divided amongst states on the above-said basis.

**Fifth FC**

Let us recall that the Centre could supplement basic excise duties by additional levies under several names like additional duties, special duties, auxiliary duties, regulatory duties, etc. Therefore, unless the Commission specifically recommended the sharing of all duties (by whatever name levied), the Centre could impose a non-shareable additional duty under a name not listed by the Commission. And in fact the Centre had been doing so.

Rejecting the plea of the states for raising their percentage share, the Fifth FC *retained their share at 20%*. However, it included yield from special excise duties also in the divisible pool. It adhered to the rule that 80% of the states’ share should be distributed amongst them on the basis of population and the remaining 20% on the basis of their backwardness. However, it spelt out a more comprehensive index of backwardness with seven components, viz., per capita income, scheduled tribes population, number of the factory workers per lakh of population, net irrigated area per cultivator, length of railways and surface roads per 100 sq. km, shortfall in the number of school going children as compared with those of school going age, and the number of hospital beds per 1,000 population. It assigned equal weightage to all the seven components. Two third of the 20% proceeds were divided between those states whose per capita income was below the national per capita level, ‘in proportion to the shortfall of the state’s per capita income from other states’. For this purpose, per capita income of
Nagaland was considered to be equal to that of Assam. The remaining one third of 20% was distributed on the basis of a composite index of the remaining components of backwardness. The actual percentages of different states were fixed on the basis of this complex formula.

**ADE:** The Fifth FC believed that sales tax yield was not a good proxy for consumption data, especially because it was being levied on all types of goods including luxuries, raw materials, and intermediate goods. Therefore it gave an equal weightage to population and sales tax collection. It assigned 2.05% of the net proceeds to the UTs, 0.83% to J & K, and 0.09% to Nagaland. Of the remaining 97.03% of the net proceeds, the guaranteed sums were set apart and the balance was divided between the states in the manner described above.

**Sixth FC**

The Sixth FC noted that while the Fifth FC had recommended the inclusion of special duties in the divisible pool, it had not specifically mentioned the inclusion of regulatory duties. The Centre took advantage of this by replacing regulatory duties imposed in 1971 by auxiliary duties in 1973 thereby keeping them out of the divisible pool.

The Sixth FC recommended that the yield from auxiliary duties should also become divisible from 1976–77 onwards. However, share of states in the divisible pool was retained at 20%. Further, the Commission replaced the composite index of backwardness with the factor of per capita income and determined the shares of individual states by assigning weights 25% and 75% respectively to backwardness and population.

**ADE:** Regarding ADE, the Sixth FC discarded the practice of setting aside guaranteed sums since, in any case, each state would be getting more than the guaranteed amount. The Commission also accepted the compensation principle in determining the states’ share, and in the absence of reliable consumption data, used three factors, namely, population, state domestic product at current prices and production. 1.41% of states’ collective share was allocated to UTs.

**Seventh FC**

The Seventh FC was of the view that the transfer of resources from the Centre to state:

- should be mainly in the form of tax sharing rather than in the form of grants; and
- should aim at reducing economic disparities between states.

Therefore, it raised the share of states in all excise duties to 40% of net collection (excluding duties earmarked by law for specific purposes). It also believed in adopting an overall indicator of backwardness, instead of partial indicators. Accordingly, it decided that the shares of the individual states should be determined by giving equal weightage to
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(i) The population factor,
(ii) The inverse of the per capita state Domestic Product,
(iii) The percentage of the poor in each state, and
(iv) A formula of revenue equalization which the Commission had worked out.

At the time of the submission of Commission’s Report, Union excise duties were not leviable in Sikkim and, therefore, using the above-mentioned factors, it recommended two sets of percentage shares (excluding Sikkim and including Sikkim).

ADE: The Commission noted the continued absence of reliable consumption data of goods under ADE. At that time, Sikkim was levying sales tax on textiles only. Accordingly, it decided that Sikkim should get a share of ADE on sugar and tobacco, but not of duties on textiles.

[Tables 11.1, 11.2, and 11.3 summarize the recommendations of the successive Finance Commissions on Income Tax, Union Excise Duties and ADE].

The Seventh Commission, having selected various ‘suitable’ proxies for consumption data, recommended that 3.271% of the duty on sugar be retained by the Centre as the portion attributable to UTs. The corresponding figure for both textiles and tobacco was 2.192%. The balance in each case was divided amongst states by estimating their shares in consumption by using some proxy variables.

Eighth FC

Earmarked cesses and duties had risen to an unacceptably high proportion (11%) of total excise revenue. Also, the scheduled abolition of duty on generation of electricity on 1st October 1984 would further reduce the transfers to states. Accordingly, FC-VIII increased the share of states from 40% to 45% of the net proceeds and assigned them the entire proceeds of duty on generation of electricity till its abolition.

The shares of individual states were determined on a progressive basis.

- 40% of the proceeds were divided amongst the states in the same manner as the division of 90% of their collective share from income tax proceeds (described above).
- The remaining 5% proceeds were allocated to those eleven states which showed deficits after taking into account their share of devolution of all taxes and duties (including excise duties but excluding estate duty). The share of an individual state was determined by the ratio of its deficit to the total of the deficits of all states as estimated by the FC and was worked out for each year of the forecast.

ADE: The Commission recommended that ADE should be divided amongst states by giving equal weightage to (i) State Domestic Product averaged for three years (1976–77 to 1978–79) and (ii) population, as given in the 1971 census. Union
territories were assigned 2.391% of the total net proceeds, and the balance was divided amongst the states on the basis of the above mentioned weightage.

**Ninth FC [First Report (for 1989–90)]**

The 9th FC, after considering relevant aspects of the problem, came to the conclusion that for 1989–90, all duties including special excise duties but excluding both (a) Additional Duties of Excise (Textiles and Textile Articles) and (b) all earmarked cesses were to be shared with the states. Further, it retained the share of the states at (40 + 5) % of the divisible pool of excise duties. The 5% portion was assigned to 13 deficit states. The division of the 40% portion was effected as below:

(a) 25% on the basis of 1971 population;

(b) 50% on the basis of distance of per capita income of the state for 1982–83 to 1984–85 from that of Punjab multiplied by 1971 population of the state. The shares of Punjab and Goa were determined with reference to the distance from Maharashtra;

(c) 12.5% on the basis of Income Adjusted Total Population, that is to say, 1971 population of a state multiplied by the reciprocal of its average SDP for 1982–83 to 1984–85 as a proportion of the sum of such products for all states;

(d) 12.5% on the basis of poverty ratio, that is, the proportion of poor in the state as estimated by the Planning Commission in 1983–84 in the total for all the states.

### Table 11.1 Sharing of Income Tax Proceeds

<table>
<thead>
<tr>
<th>Centre States &amp;</th>
<th>Finance Percentage share in the divisible pool</th>
<th>States in (2)</th>
<th>Distribution of (3) amongst states: Weights assigned to States</th>
</tr>
</thead>
<tbody>
<tr>
<td>UTs / Part C</td>
<td>States in (2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>45</td>
<td>35</td>
<td>2.75</td>
</tr>
<tr>
<td>II</td>
<td>40</td>
<td>60</td>
<td>1.00</td>
</tr>
<tr>
<td>III</td>
<td>33.33</td>
<td>66.66</td>
<td>2.50</td>
</tr>
<tr>
<td>IV</td>
<td>25</td>
<td>75</td>
<td>2.50</td>
</tr>
<tr>
<td>V</td>
<td>25**</td>
<td>75**</td>
<td>2.60</td>
</tr>
<tr>
<td>VI</td>
<td>20**</td>
<td>80**</td>
<td>1.79**</td>
</tr>
<tr>
<td>VII</td>
<td>15**</td>
<td>85**</td>
<td>2.19**</td>
</tr>
<tr>
<td>VIII</td>
<td>15**</td>
<td>85**</td>
<td>1.792**</td>
</tr>
</tbody>
</table>

### Notes

- Inclusive of advance tax collection
- Divisible pool net of Union Territories’ Share
- Percentage share of total net proceeds
- Divisible pool inclusive of penalties and interest receipts

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Self-Instructional Material

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NOTES

Centre and State Financial Relations
NOTES

Second Report (for 1990–95): The 9th FC retained the share of states in the Union Excise Duties at 45% of the divisible pool and the entire amount was to be divided between the states on the following basis:

(i) 25% on the basis of 1971 population.
(ii) 12.5% on the basis of Income Adjusted Total Population (IATP). For calculating IATP, the 1971 population of the states was weighted with the inverse of their respective average per capita income as per the New Series for three years from 1982–83 to 1984–85. The share of a state was determined by the percentage of its IATP to the aggregate of the IATP of all states.
(iii) 12.5% on the basis of the index of backwardness.
(iv) 33.5% on the basis of distance of per capita income (New Series) of a state during 1982–83 to 1984–85 from that of the state having the highest per capita income (that is from Punjab; and for Punjab and Goa, from that of Maharashtra) multiplied by 1971 population.
(v) The remaining 16.5% was distributed between deficit states on the basis of the proportion of deficit of each state to the total deficit of all states. The deficit of a state was worked out after taking into account its share from the Income Tax, Excise Duties (above mentioned 83.5% portion), Additional Duties of Excise and the grant in lieu of the repealed Tax on Railway Passenger Fares.

Additional Duties of Excise [First Report (for 1989–90)]. The merger of ADE with basic duties of excise was mooted in the paper on Long Term Fiscal Policy (LTFP) of December 1985 as a measure of simplification and administrative streamlining. The FC, however, postponed the consideration of the merger issue to the Second Report. Further, for 1989–90, it had adopted the same basis as did the 8th FC for determining the shares of individual states, namely, equal weightage to per capita average SDP for 1982–83 to 1984–85 and the population of 1971. Union territories were allocated 2.023% of the net proceeds. The shares of individual states in the balance were determined as explained above.

Second Report (for 1990–95). The Commission decided not to recommend the merger of ADE with basic duties. This was done mainly due to serious objections by almost all states to the proposal. The Commission further recommended that if during any year, the ad valorem incidence of ADE fell short of the level of 10.8% of the value of clearance, the shortfall should be made good by the Government of India by providing an equivalent grant to be distributed in the same manner as applicable to the distribution of ADE.

Persistent absence of direct and reliable consumption data from any official or non-official source prompted the Commission to rely on the proxies for consumption data, namely (i) SDP and (ii) population of the respective states. The Commission averaged SDP for three years 1982–83 to 1984–85 along with
1981 census figures of population for determining the respective shares of states in the net proceeds of ADE. The share allocated to the UTs was put at 1.903% and individual shares of states were determined by using the above-mentioned two factors.

**Tenth FC**

It raised the share of states to 47.5% of the net proceeds. Of this 7.5% was distributed only among the deficit states, as assessed after taking into account (a) devolution of income tax, (b) 40% of UED, (c) Additional Duties of Excise, and (d) grants in lieu of tax on railway passenger fares. The percentage share of an individual state in this component was equal to the proportion of its deficit in the total deficit for all states.

As regards the remaining 40% of the net proceeds of UED, the shares of individual states were determined exactly on the same basis and resulted in the same percentage shares as in the case of income tax.

**ADE:** The 10th FC noted the long-standing complaints of states and the failure of the Centre to honour its commitments fully. For example, the agreed ratio of ADE/ UED of 1:2 and the absolute level of ADE (10.80%) were achieved only by 1989–90, while levying of ADE on *ad valorem* basis had not been achieved even at the time of writing the Report of the Commission. The Commission also noted the changes in criteria adopted by successive FCs in the distribution of ADE, as also the absence of reliable consumption data or proxy variables. Even the latest round of NSSO in 1987–88 did not meet the need. Hence it had to determine the shares of state in ADE on the basis of some proxy variables only without bringing in the criteria of inter-state progressivity because levying and collection of ADE by the Centre was in the nature of a tax rental arrangement. The choice of proxy variables was also dictated by the fact that the taxed goods were of mass consumption. The Commission recommended that after assigning 2.203% to UTs, the shares of individual states in the remainder of the divisible pool of ADE be determined as follows:

1. 50% on the basis of population of 1991 census.

As every FC before it, the Tenth FC also urged the Centre to collect and maintain relevant consumption data of both household and non-household sectors.

**Eleventh FC**

As noted in the section dealing with sharing of income tax, Union Excise Duties had become part of the total divisible pool of central taxes. Therefore, the Commission did not recommend any separate sharing of UED.
Further, ADE were no more fully assigned to states, they had become shareable with the states. Therefore, the Commission further recommended that an additional 1.5% of all shareable Union taxes and duties be allocated to states, thus bringing the total to 29.5% of the net proceeds of all shareable Union taxes and duties. Inter-se distribution of this 1.5% among the states was done in the same manner as the distribution of 28%. Further, if any state levied and collected sales tax on sugar, textile and tobacco, it would not get any share from this 1.5%.

Twelfth FC
The Commission, while recommending 30.5% of shareable Central taxes for the states, stated that in its assessment, ADE represented 1% of this. Accordingly, in case, states were allowed to levy sales tax or VAT or the items subjected to ADE, their share would be reduced from 30.5% to 29.5% of the shareable taxes.

Thirteenth FC
As noted above, the ADE had been removed from all commodities from 1 March 2006, and the Centre had adjusted basic duties on sugar and tobacco products to accommodate this factor. Moreover, basic excise duties remained shareable with the states. Accordingly, this Commission retained the share of states in the net proceeds of the shareable central taxes at 32% without any additional transfer on account of excise duties.

C. Estate Duties
Estate duties came into existence in 1957 and were abolished in the 198-86 budget. Further, in certain states, estate duty on agricultural lands was also imposed and collected by the Government of India and such net proceeds were assigned to only those states from which this duty was collected.

During 1974–79, net proceeds of estate duty, as per recommendations of the Sixth FC were being distributed amongst states as described below:
(i) 2.5% of the net proceeds were retained by the Centre as attributable to the UTs.
(ii) The balance 97.5% was divided into two portions in the ratio of gross values of movable and immovable properties assessed during the year;
(a) The portion which was thus ascribed to immovable property was distributed amongst states in the ratio of gross value of the immovable property located in each state and brought into assessment in that year;
(b) The portion ascribed to movable property was distributed amongst the states in the ratio of their respective population.
The Seventh Commission did away with the distinction between proceeds of duty attributable to movable and immovable property and recommended that the estate duty to each state be determined in proportion to the gross value of the property (other than agricultural land) in each state brought into assessment in that year. The property located abroad was to be deemed to be located in the state where it was brought to assessment. The Eighth FC recommended that the arrangement recommended by the Seventh Commission should continue.

The duty was, however, abolished in the Budget for 1985–86. The 1989–90 Budget imposed a tax on transfer of wealth through inheritance but this tax was not shared with the states.

Table 11.2 Sharing of Net Collection of Union Excise Duties

<table>
<thead>
<tr>
<th>Finance commission</th>
<th>Number of items</th>
<th>%age share of states in divisible pool</th>
<th>Division of (%) amongst states:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Population</td>
</tr>
<tr>
<td>I</td>
<td>3</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>II</td>
<td>8</td>
<td>25</td>
<td>90</td>
</tr>
<tr>
<td>III</td>
<td>35</td>
<td>20</td>
<td>Formula</td>
</tr>
<tr>
<td>IV</td>
<td>All Items*</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>V</td>
<td>All Items***</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>VI</td>
<td>All Items***</td>
<td>20</td>
<td>75</td>
</tr>
<tr>
<td>VII</td>
<td>All Items****</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>VIII</td>
<td>All Items</td>
<td>45</td>
<td>See text</td>
</tr>
<tr>
<td>IX (Two Reports)</td>
<td>All Items</td>
<td>45</td>
<td>See text</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Finance commission</th>
<th>Number of items</th>
<th>%age share of states in divisible pool</th>
<th>Division of (%) amongst states:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Population</td>
</tr>
<tr>
<td>X</td>
<td>All Items</td>
<td>47.5</td>
<td>See text</td>
</tr>
</tbody>
</table>

* Excluding regulatory, special and earmarked cesses but including those which might be imposed in future.

** Excluding regulatory duties and earmarked cesses but including special duties for the year 1972–73 and 1973–74.

*** All items inclusive of auxiliary duties (which had replaced regulatory duties since 1973–74) from 1976–77 onwards.

**** Entire duty on generation of electricity attributable to a state to be transferred to that state. All other basic duties to be shared.

¹ Index of economic backwardness composed of seven components. Two-third of this 20% to be assigned to states with a per capita income below the national average and one-third to be assigned to states with a per capita income above the national average.

² Economic backwardness of a state as indicated by its per capita income.

³ Equal weights to (i) population, (ii) inverse of per capita State Domestic Product, (iii) percentage of poor in the state population, (iv) a formula of revenue equalisation worked out by the Commission.
### NOTES

#### Table 11.3 Distribution of Additional Duties of Excise Amongst States

<table>
<thead>
<tr>
<th>Finance commission</th>
<th>To UTs (%)</th>
<th>To J &amp; K (%)</th>
<th>Guaranteed amounts</th>
<th>Basis of division of the balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>II</td>
<td>1</td>
<td>1.25</td>
<td>Yes</td>
<td>Consumption corrected with respect to population</td>
</tr>
<tr>
<td>III</td>
<td>1</td>
<td>1.5</td>
<td>Yes</td>
<td>Percentage increase in sales tax revenue modified with population factor</td>
</tr>
<tr>
<td>IV</td>
<td>1</td>
<td>1.5</td>
<td>Yes</td>
<td>Percentage of sales tax revenue realized in each state to total sales tax revenue of all states</td>
</tr>
<tr>
<td>V</td>
<td>2.5</td>
<td>0.83</td>
<td>Yes</td>
<td>Equal weightage to population and sales tax collection</td>
</tr>
<tr>
<td>VI</td>
<td>1.41</td>
<td>0.09**</td>
<td>No</td>
<td>(i) Population, (ii) state domestic product at current prices, and (iii) production</td>
</tr>
<tr>
<td>VII</td>
<td>3.271 for Sugar; 2.192 each for textiles and tobacco</td>
<td>-</td>
<td>No For sugar: Average despatches in 3 years 1974–77; for textiles and tobacco: Average per capita SDP and population</td>
<td></td>
</tr>
<tr>
<td>VIII</td>
<td>2.391</td>
<td>-</td>
<td>No</td>
<td>Equal weightage to 1971 population and average state domestic product</td>
</tr>
<tr>
<td>IX (First Report)</td>
<td>2.023</td>
<td>-</td>
<td>No</td>
<td>SDP and 1971 population</td>
</tr>
<tr>
<td>IX (Second Report)</td>
<td>1.903</td>
<td>-</td>
<td>No</td>
<td>SDP and 1981 population</td>
</tr>
</tbody>
</table>

*To Nagaland

#### Grants for LBs by 13th Finance Commission

Grants for LBs awarded by FC-XIII had two components, namely, a basic component and a performance-based component. The basic grant was equivalent to 1.50% of the previous year’s divisible pool. All states were entitled to this grant for all the five years. In addition, the FC-XIII awarded performance grant which was to start in 2011–12 at 0.5% of the divisible pool of the previous year and was to increase to 1% thereafter. Only those states were entitled to receive performance grants which satisfied certain conditions laid down by FC-XIII. The projected figures of these two grants for the entire award period was Rs. 56,335 crore and Rs. 29,826 crore respectively, aggregating Rs. 86,161 crore. Using population figures, RPIs were allocated 73.18% of these grants, the balance (26.82%) going to ULBs. Division of these grants between individual local bodies was on the basis of criteria and weights shown in the accompanying table.
Further, in order to provide for exempted states and areas (termed 'special areas' by FC-XIII), the Commission awarded, on a per capita p.a. basis, a total Rs. 1,357 crore comprising general basic grant of Rs. 798 crore and performance grant of Rs. 559 crore. These grants were also divided between individual LBs on the basis of criteria and weights indicated in the accompanying table.

Total grants awarded to LBs by the FC-XIII were Rs. 87,519 crore.

### 11.3.4 Setting up of 14th Finance Commission

The 14th Finance Commission was constituted on 2 January 2013 under the Chairmanship of Dr Y.V. Reddy, former RBI Governor. Other members of the commission are: (i) Professor Abhijit Sen, (ii) Ms Sushma Nath (iii) Dr M.Govinda Rao (iv) Dr Sudipto Mundle.

The following are the broad Terms of Reference and the matters to be taken into consideration by the 14th Finance Commission in making the recommendations:

1. (i) The distribution between the union and states of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the states of the respective shares of such proceeds;

(ii) The principles which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India and the sums to be paid to the states which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and

(iii) Measures needed to augment the Consolidated Fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.

2. The Commission has been mandated to review the state of finances, deficit, and debt levels of the union and states and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the FRBMAs currently in force. The
Commission has been asked to consider and recommend incentives and disincentives for states for observing the obligations laid down in the FRBMAs.

3. In making its recommendations, the Commission *inter alia* is required to consider:

   i. The resources of the central government and the demands on the resources of the central government; the resources of the state governments and demands on such resources under different heads, including the impact of debt levels on resource availability in debt stressed states;
   
   ii. The objective of not only balancing the receipts and expenditure on revenue account of all the states and the union but also generating surpluses for capital investment; the taxation efforts of the central government and each state government and the potential for additional resource mobilization;
   
   iii. The level of subsidies required for sustainable and inclusive growth and equitable sharing of subsidies between the central and state governments;
   
   iv. The expenditure on the non-salary component of maintenance and upkeep of capital assets and the non-wage-related maintenance expenditure on Plan schemes to be completed by 31 March 2015 and the norms on the basis of which specific amounts are recommended for the maintenance of capital assets and the manner of monitoring such expenditure;
   
   v. The need for insulating the pricing of public utility services like drinking water, irrigation, power and public transport from policy fluctuations through statutory provisions;
   
   vi. The need for making public-sector enterprises competitive and market oriented;
   
   vii. Listing and disinvestment;
   
   viii. Relinquishing of non-priority enterprises;
   
   ix. The need to balance management of ecology, environment, and climate change consistent with sustainable economic development; and the impact of the proposed goods and services tax on the finances of the centre and states and the mechanism for compensation in case of any revenue loss.

4. The Commission is required to generally take the base of population figures as of 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid; however, the Commission may also take into account the demographic changes that have taken place subsequent to 1971.
5. The Commission is to review the present public expenditure management systems in place including budgeting and accounting standards and practices; the existing system of classification of receipts and expenditure; linking outlays to outputs and outcomes; best practices within the country and internationally and to make appropriate recommendations thereon.

6. The Commission is to review the present arrangements as regards financing of Disaster Management with reference to the funds constituted under the Disaster Management Act 2005 (53 of 2005) and make appropriate recommendations thereon.

7. The Commission is to indicate the basis on which it has arrived at its findings and make available the state-wise estimates of receipts and expenditure.

The Fourteenth Finance Commission submitted its report in December 2014. The following are some of its major recommendations as per Press Information Bureau:

- With regard to vertical distribution, FFC has recommended by majority decision that the States’ share in the net proceeds of the Union tax revenues be 42%.

- In reckoning the requirements of the States, the FFC has ignored the Plan and Non-Plan distinction; it sees the enhanced devolution of the divisible pool of taxes as a “compositional shift in transfers from grants to tax devolution”.

- FFC has recommended distribution of grants to States for local bodies using 2011 population data with weight of 90% and area with weight of 10%. The grants to States will be divided into two, a grant to duly constituted Gram Panchayats and a grant to duly constituted Municipal bodies, on the basis of rural and urban population.

- FFC has recommended that up to 10 percent of the funds available under the SDRF can be used by a State for occurrences which State considers to be ‘disasters’ within its local context and which are not in the notified list of disasters of the Ministry of Home Affairs.

- While calculating grants to the States they “have departed significantly from previous Finance Commissions, by taking into consideration a States’ entire revenue expenditure needs without making a distinction between Plan and Non-Plan”.

- Based on the above, over 30 Centrally Sponsored Schemes have been identified which ought to have been transferred to the States because expenditure on them has already been taken into account as State expenditure, in arriving at the greater devolution of 42% to the States.

- In addition to the recommendations regarding Vertical, and Horizontal devolution and grants, the FFC has made certain other recommendations.
These relate to cooperative federalism, Goods & Services Tax, Fiscal Consolidation Roadmap, Pricing of Public Utilities and Public Sector Enterprises.

The Government has accepted most of the recommendations except only 8 CSS have been delinked from the support from Centre. In view of the recommendations regarding disaster relief, the Government has decided that the percentage share of the States will continue to be as before, and that the flows will also be of the same order, as in the existing system; and that, once GST is in place, the recommendation of FFC on disaster relief would be implemented in the manner recommended by the Finance Commission.

XV Finance Commission

It is important to note here that the fifteenth Finance Commission has been constituted in November 2017. The Commission will make recommendations for the five years commencing on April 1, 2020. This Commission will be headed by Shri. N.K. Singh, former Member of Parliament and former Secretary to the Government of India. Shri Shaktikanta Das, former Secretary to the Government of India and Dr. Anoop Singh, Adjunct Professor, Georgetown University shall be the members of the Commission. Dr. Ashok Lahiri, Chairman (Non-executive, part time), Bandhan Bank and Dr. Ramesh Chand, Member, NITI Aayog shall be the Part time members of the Commission. Shri Arvind Mehta shall be the Secretary to the Commission.

Check Your Progress
6. What is the role of Finance Commission?
7. When was the first Finance Commission constituted?
8. When did tax-sharing between the Centre and States undergo a fundamental transformation?
9. When was the 14th Finance Commission constituted?

11.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Since the State has higher responsibility for expenditure, it is directed by the Constitution that the Central government needs to transfer resources to the State. The purpose of these transfers is to bridge the gap that exists between the resources that the States themselves can raise and the resources required by the State to fulfill the responsibilities that they have been assigned.

2. Based on current literature, it can be said that inter-governmental fund distribution has two main purposes: Bridging the fiscal gap and balancing the inter-State capacities.
3. The following steps are involved in the transfer of funds by the Commission:
   (i) Making an estimate of the overall available budget based on the Union’s and State’s total resource requirement, (ii) Making an estimate of the States’ current revenues and non-plan expenditures, (iii) Making an assessment of the proportion of proceeds from Central tax which will go to the States and distributing this amount amongst the States, and (iv) Making available Grants-in-Aid to bridge any existing gaps between revenue and non-plan current expenditure.

4. All of the 11 mountainous States of North and North-East India together form a group of special category States.

5. The federal finance structure of India is heavily criticized due to the following three critical issues:
   - States have no allocation autonomy for funds that the Centre disperses.
   - Fund allocation is not merit-based but need-based.
   - Fund allocation is used as a political tool.

6. Finance Commission is an advisory body and deals with the transfer of resources from the Centre to the states, determination of individual shares of states in the transferred resources, reviewing the financial situation of both the Centre and the states, and several other related issues and problems as mentioned in its terms of reference (ToR).

7. The First Finance Commission was constituted on 22nd November 1951 and submitted its report at the end of December 1952.

8. Constitution (80th Amendment) Act, 2000, brought about a fundamental shift in the sharing of tax proceeds between the Centre and the States. Prior to the 80th Amendment, the only taxes shared between the Centre and States were income tax, Central Excise Duties and Additional Duties of Excise in lieu of Sales Tax on sugar, tobacco and textiles.

9. The 14th Finance Commission was constituted on 2 January 2013 under the Chairmanship of Dr Y.V. Reddy, former RBI Governor. Other members of the commission are: (i) Professor Abhijit Sen, (ii) Ms Sushma Nath (iii) Dr M.Govinda Rao (iv) Dr Sudipto Mundle.

11.5 SUMMARY

- The State governments and the Central government have both been given their own specific powers by the Constitution of India for raising revenue and also spending it independently. There clearly exists a vertical imbalance in the power of taxation between the State and the Centre and this is clearly admitted by the Constitution.
- Since there is imbalance of a quasi-federal structure of government, there are four different channels through which the government transfer funds in...
India. There are mainly two commissions that are employed for the purpose of allocation. These are the Finance Commission and the Planning Commission.

• Since Independence, the fiscal linkages of India have remained mostly unaltered and over the years, these linkages seem to have possibly further cemented. The debate and the struggle between the Centre and States has become more and more intense over the years.

• Policy makers and experts have again and again raised questions regarding how relevant is the role of the Planning Commission. There are other commissions which exist and perform the duties of the Planning Commission, hence they believe that it is unwarranted that the Planning Commission also continues.

• Under Article 280, a Finance Commission was to be constituted within two years of the commencement of the Constitution, and thereafter, every fifth year or earlier. Its working is further governed by the Finance Commission (Miscellaneous Provisions) Act, 1951.

• The institution of FC provides a much needed flexibility in the interest of optimum distribution of national resources between different tiers of governments in accordance with their respective needs. No permanently fixed distribution of resources can meet the requirements of an ever-changing situation, especially in a developing economy like ours moving on a path of multi-directional development.

• Tax sharing between the Centre and states underwent a fundamental transformation with the Constitutional (80th Amendment) in 2000 and 88th Amendment of 2003 enacted in 2004. The latter Amendment relates to levying of service tax by the Centre and its collection and appropriation by both the Centre and the states according to legislation enacted for this purpose by the Parliament.

• Constitution (80th Amendment) Act, 2000, brought about a fundamental shift in the sharing of tax proceeds between the Centre and the States. Prior to the 80th Amendment, the only taxes shared between the Centre and States were income tax, Central Excise Duties and Additional Duties of Excise in lieu of Sales Tax on sugar, tobacco and textiles. It should also be noted that recommendations regarding the sharing of these taxes could vary from one tax to the other.

• Before 80th Amendment, income tax was the only tax which was compulsorily shareable with the states under Article 270. However, sharing of Corporation tax (which is a tax on income of companies), and any Union surcharge on income tax, corporation tax or any other tax, were specifically prohibited.
- The Centre had been following the policy of levying (or replacing the existing) non-sharable new duties in almost every budget. Therefore, the Fourth FC not only recommended the sharing of all the existing duties but also the ones to be imposed later.

- Rejecting the plea of the states for raising their percentage share, the Fifth FC retained their share at 20%. However, it included yield from special excise duties also in the divisible pool. It adhered to the rule that 80% of the states’ share should be distributed amongst them on the basis of population and the remaining 20% on the basis of their backwardness.

- The Seventh Commission, having selected various ‘suitable’ proxies for consumption data, recommended that 3.271% of the duty on sugar be retained by the Centre as the portion attributable to UTs.

- Regarding ADE, the Sixth FC discarded the practice of setting aside guaranteed sums since, in any case, each state would be getting more than the guaranteed amount. The Commission also accepted the compensation principle in determining the states’ share, and in the absence of reliable consumption data, used three factors, namely, population, state domestic product at current prices and production. 1.41% of states’ collective share was allocated to UTs.

- The merger of ADE with basic duties of excise was mooted in the paper on Long Term Fiscal Policy (LTFP) of December 1985 as a measure of simplification and administrative streamlining. The FC, however, postponed the consideration of the merger issue to the Second Report.

- The 10th FC noted the long-standing complaints of states and the failure of the Centre to honour its commitments fully. For example, the agreed ratio of ADE/UED of 1:2 and the absolute level of ADE (10.80%) were achieved only by 1989–90, while levying of ADE on ad valorem basis had not been achieved even at the time of writing the Report of the Commission.

- Estate duties came into existence in 1957 and were abolished in the 1986 budget. Further, in certain states, estate duty on agricultural lands was also imposed and collected by the Government of India and such net proceeds were assigned to only those states from which this duty was collected.

- The Seventh Commission did away with the distinction between proceeds of duty attributable to movable and immovable property and recommended that the estate duty to each state be determined in proportion to the gross value of the property (other than agricultural land) in each state brought into assessment in that year.

- Grants for LBs awarded by FC-XIII had two components, namely, a basic component and a performance-based component. The basic grant was equivalent to 1.50% of the previous year’s divisible pool. All states were entitled to this grant for all the five years.
The 14th Finance Commission was constituted on 2 January 2013 under the Chairmanship of Dr Y.V. Reddy, former RBI Governor. Other members of the commission are: (i) Professor Abhijit Sen, (ii) Ms Sushma Nath (iii) Dr M. Govinda Rao (iv) Dr Sudipto Mundle.

The fifteenth Finance Commission has been constituted in November 2017. The Commission will make recommendations for the five years commencing on April 1, 2020. This Commission will be headed by Shri N.K. Singh, former Member of Parliament and former Secretary to the Government of India.

11.6 KEY WORDS

- **Quasi federal**: This refers to government organized similar to a union of states under a central government rather than the individual governments of the separate states.

- **The Gadgil formula**: This is named after Dhananjay Ramchandra Gadgil, a social scientist and the first critic of Indian planning. It was evolved in 1969 for determining the allocation of central assistance for state plans in India.

- **Excise duty**: An excise or excise tax is any duty on manufactured goods which is levied at the moment of manufacture, rather than at sale.

- **Policy of levying**: A levy actually permits the government to seize and sell the property to pay the tax debt.

- **Estate duty**: This is a tax on the total market value of a person’s assets (cash and non-cash) at the date of his or her death. It does not matter if the person has a will or not, the assets are still subject to estate duty. The deceased person’s assets, as a whole, are called an estate.

- **FRBMA**: Fiscal Responsibility and Budget Management Acts (FRBMA) provides public debt and relief measures to the States.

11.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. How does the Centre transfer resources to the States?
2. What are the main problems of Centre and State financial relations?
3. Write a short note on the role of Planning Commission in India.
4. Enumerate the constitutional mandate for the functioning of Finance Commission in India.
5. What are the specific criteria that Finance Commission has to look into for making any recommendations?

6. How did various Amendments change the resource-sharing arrangement of various taxes between the Centre and the States?

**Long Answer Questions**

1. Discuss the specific financial powers of the Centre and the States as envisaged in the Constitution.

2. Analyse the role of successive Finance Commissions in fixing allocation of funds to the States.

3. Discuss how income tax and excise duty are shared between the Centre and the State.

4. Analyse how the shares of individual states are determined by Finance Commission.

**11.8 FURTHER READINGS**


‘Websites’

http://pib.nic.in/newsite/PrintRelease.aspx?relid=115810

http://pib.nic.in/newsite/PrintRelease.aspx?relid=173905
Indian Tax System

NOTES

BLOCK IV
TAX SYSTEMS IN INDIA

UNIT 12 INDIAN TAX SYSTEM

Structure
12.0 Introduction
12.1 Objectives
12.2 Revenue of the Union, States and Local Bodies
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12.0 INTRODUCTION

As the development of a nation depends upon the mobilization of revenue and its spending, Indian constitutions has provided legislative autonomy and financial independence to the Centre and the States. There are constitutional guarantees to avoid overlapping of tax powers between the union and states Article 246 lays down that Parliament has exclusive power to make laws with respect to any matter enumerated in Union List. And the states have complete power to make laws with respect to any matter enumerated in the State List and both have power to make laws with respect to any matter enumerated in the Concurrent List. To avoid duplication in tax administration, and to minimize tax rivalry between the Union and States, they have no concurrent powers of taxation. Although local bodies do not have a provision of taxing powers, the states may assign any of the taxes to the local governments from the state list. Generally, local bodies are provided with property taxes, Octroi and taxes on vehicles, etc. As the state governments undertake most of developmental activities, their need for revenue is growing and there is specific provisions to set apart a portion of central revenues which could supplement the revenues in accordance with their needs.

However, this arrangement faces numerous hurdles and one of the reasons is that tax powers is biased towards the Union which creates revenue imbalance between the Union and the states.

You have already studied the tax related revenue sources of the Union, States and local bodies under tax sharing system in the previous unit. In this unit, you will study the broad issues related to the concept.
12.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand Indian tax system
- Enumerate the basic objectives of tax system
- Discuss the division of tax between the Centre and the States
- Analyse revenue of the Union, States and local bodies

12.2 REVENUE OF THE UNION, STATES AND LOCAL BODIES

Taxation occupies a prominent position in every government’s policy framework. Academicians, analysts, administrators and legislators have been paying an uninterrupted attention to its various dimensions including the response of economic decision makers (individuals, households, businesses, etc.) to changes in its framework and ingredients. Since it is next to impossible to have an ideal tax system on account of various hurdles including those posed by inherent dynamism of most economies, the debate regarding the exact format of an ideal tax system continues unabated. Those, who are in favour of a market-oriented economic system, advocate a few basic objectives which a tax system should aim at. These are as follows:

1. It should be neutral in its effects. Factually, however, it is impossible to achieve this objective because of the sheer size of the public budget and its impact on the demand and supply flows.
2. To the extent possible, it should be equitable, that is, its burden upon taxpayers should be in proportion to their respective paying capacities.
3. Every tax system has its own economic cost for the country. This cost should be minimized including the cost of compliance for the taxpayer.
4. To ensure that changes in demand and supply flows are smooth and not disruptive, tax system should be stable with only infrequent and essential changes.
5. The system as a whole should be transparent and rule-based so that it does not result in avoidable litigation and other problems, including those of tax avoidance and tax evasion.

12.2.1 Hurdles in the Way of a Suitable System of Taxation

For a country like ours, devising a suitable system of taxation poses a host of problems and it is not easy to solve them to an acceptable level of satisfaction. In contrast with developed countries, a country like ours faces several hurdles in the task of structuring an optimum system of taxation. These are:
1. The first problem relates to the choice of an optimum proportion of (Tax Revenue/GDP). A textbook prescription, supported by most economists, is that this ratio should be increased to a level as close as possible to that prevailing in developed countries. However, while making this recommendation, a few essential facts are ignored. These are:
   i. The level of tax receipts cannot be decided without first deciding the level of public expenditure. Moreover, while in developed countries, the proportion of wasteful public expenditure is very low, it is just the opposite in India. Consequently, the level of optimum tax revenue cannot be decided satisfactorily even when the level of public expenditure has been decided.
   ii. In India, in addition to very low productivity of public expenditure, its composition is also highly skewed. It is neither in harmony with social priorities, nor in conformity with the objective of economic growth. Thus, for example, while several fanciful projects are undertaken, basic necessities of the people like clean drinking water, nutritious food, education, health services, communication, roads, transport, and housing etc. remain neglected. Similarly, very low priority is accorded to the provision of infrastructure without which a rapid and sustained economic growth is not possible. Instead, policies that are pursued encourage conspicuous consumption.

2. In the context of Indian fiscal federalism, the problem of division of taxation powers between different layers of government also crops up. Indian Constitution has tried to solve it in the best possible manner. However, some difficulties still remain. Firstly, the local bodies are still not assigned, in their own right, any taxation powers. Secondly, the arrangements have not been worked out with complete objectivity and responsibility. Thirdly, our Constitution does not allow taxation of the same tax base by both the Centre and states. However, with changing circumstances, a need has arisen for replacing most indirect taxes into a single tax on goods and services. The details of this new tax regime are being worked out, and it is expected to be operative in the near future.

3. In our country, choice of taxes is often guided by conflicting objectives, which include several aspects of equity (inter-regional, inter-sectoral, inter-individual, etc.), employment generation, capital formation and so on. In the process, questions crop up relating to the choice between direct and indirect taxes, the degree of progression, exemptions and rebates and so on. In recent years, another constraint has emerged in the form of international commitments.

4. Moreover, in the process of meeting a multiple set of objectives, our tax system has become very complex, while the need is to simplify it.
5. It is noteworthy that steps are being taken to bring about a radical transformation of our tax system. Thus, the contents of a proposed code for direct taxes are being debated and are likely to be adopted in the near future. Similarly, steps are under way to replace service tax and a large number of taxes on goods by a single integrated tax on goods and services (GST).

12.2.2 Features and Assessment of the Indian Tax System

The features of our tax system should be studied with reference to our socio-economic objectives and its assessment should also be attempted in a similar manner.

1. Division of Tax Powers between Centre and States

Our Constitution does not allow concurrency of taxation powers between the Centre and states (that is, a given tax base cannot be taxed by both the Centre and states). Moreover, local bodies are assigned taxation powers by states or, if they are in union territories, by the Centre, out of the State List for their respective territorial jurisdictions. This feature of non-concurrency was incorporated in our Constitution so as to satisfy three criteria of **uniformity, economy, and efficiency of the tax system as a whole**.

In this context, the following observations are also noteworthy.

(a) The Centre-state division of taxation powers provided in our Constitution creates a vertical fiscal imbalance in favour of the Centre, and this imbalance has an inherent tendency to widen further over time.

(b) Criteria of uniformity, efficiency and economy dictate that, with the passage of time, states should surrender some tax heads in favour of the Centre. For obvious reasons, states are opposed to this economic principle.

(c) Our tax system was bound to acquire increasing complexity with the growth and diversification of our economy. In their pursuit for augmenting tax revenue, authorities found it both necessary and possible to not only restructure the existing taxes but also introduce several new ones. In the process, our tax system has become very complex and is in dire need for simplification. It is noteworthy that, comparatively speaking, the Central tax system became more complicated than that of the states. However, as noted above, some degree of simplicity is likely to be achieved in the near future with the adoption of a code for direct taxes and an integrated GST.

(d) Till recently, most state taxes, including excise and sales taxes, lacked inter-state uniformity. This was hindering unification of the segmented
Indian market into a single integrated one. Now a process has been set in motion to remove this defect. For achieving an all-India integrated market, a beginning was made in 1998 when Chief Ministers of states agreed to replace state sales tax with VAT. By now, all states have switched over to VAT format. Similarly, now most Central excise duties are VAT-able and have been converted from specific to ad valorem ones. In addition, the phasing out of Central Sales Tax also started on the above-said date. The states have experienced an increase in their revenue receipts with the introduction of VAT, partly on account of reduced tax evasion and partly on account of better tax compliance by traders. Next stage of fruitful evolution of indirect tax regime is the introduction of GST.

2. Equity

Officially, our tax system is not regressive, and it does not add to regional and inter-sectoral inequities. However, this claim can be easily refuted.

- The authorities claim that the rates of direct taxes are quite progressive, while in indirect taxation, most basic necessities are exempt and luxuries are taxed at higher rates. In practice, however, the criterion of equity is grossly violated by large scale evasion of both direct and indirect taxes.
- By feeding inflation, indirect taxes strengthen inequalities.
- Moreover, our tax provisions are loaded in favour of capital intensive techniques, thereby discouraging generation of employment, particularly in rural areas. This not only adds to inequalities, through widespread unemployment and underemployment, but also forces migration of labour to urban areas with all its concomitant problems and consequences.
- It is commonly believed our tax system is inequitable as between different sectors of the economy and geographical regions.

3. Adequacy

A tax system may be rated as adequate if it is sufficiently buoyant and elastic and if it is able to meet the expenditure needs of the authorities. It is seen that, on the whole, our tax system meets the first test but fail in the second. It has exhibited a good deal of buoyancy and tax revenue as a proportion of GDP has registered an upward trend. The tax system has also exhibited elasticity, when we note that, year after year, the tax revenue has increased substantially through variations in coverage and rates of taxation. Even state taxation satisfies the joint criterion of buoyancy and elasticity.

Unfortunately, the government has not been able to contain the growth of its own expenditure within reasonable limits. Therefore, even a rapid increase in tax revenue has not been able to meet its expenditure needs, and it has to repeatedly resort to market borrowings and deficit financing.
4. Efficiency

Our tax system fails the test of efficiency. The cost of collection is quite high for both Central and state taxes—more so in the latter case. The cost of compliance for the taxpayers is higher still, that is, taxpayers are made to suffer a lot in terms of time, effort and expenses in meeting the ever changing and complicated procedural requirements of the tax rules and provisions. In addition, they also face the whims of the tax collecting bureaucracy. An important manifestation of inefficiency of our tax system is the prevalence of wide-spread tax evasion which, in turn, is attributable to a number of its other features like high rates, complexity, ongoing modifications, and so on.

5. Simplicity and Certainty

Our tax system fails miserably on both these counts. It suffers heavily from the ills of complex tax laws and rapid changes in their provisions. It is widely recognized that our tax laws are replete with defectively defined basic concepts. This results in ambiguity and uncertainty in interpretation of tax provisions with a concomitant erosion of the efficiency of the entire system. Admittedly, there are some inherent considerations in a developing economy like ours which contribute to the complexity of tax system. These include, for example, ever-increasing complexity and diversity of the economy, its increasing monetisation and the potential of using tax measures as policy tools. However, a simplified, transparent and certain tax system is also indispensable for the dual objective of sustained economic development and socio-economic justice. In this context, three important aspects of our tax deserve a special attention.

1. It appears that the government does not take a comprehensive (all-inclusive) view of our tax system resulting in contradictory provisions for achieving socio-economic objectives. It is now saddled with widespread incentives and deterrents, making it highly complex.

2. It proceeds on the assumption that the economy responds readily and quickly to every tax change even when it is abrupt and reversible.

3. The authorities frequently change the contents and applicability of tax laws retrospectively. This not only violates the principle of certainty but also militates against long term investment planning.

The extent to which recent steps being taken to adopt a Direct Taxes Code (DTC) and an integrated GST for covering most of the indirect taxes may improve our tax system is yet to be seen. Their exact impact would depend upon the contents of the proposed measures and their implementation. Between the two, contents of proposed DTC are still a subject of debate and controversy.

6. Evasion

In our country, widespread tax evasion is an acknowledged fact. Several factors are responsible for this phenomenon including, for example, high tax rates, complex
It is a matter of great concern that tax evasion not only exists but is also increasing rapidly. The authorities have tried to tackle this problem by making tax provisions and procedures more complicated and by arming bureaucracy with greater discretionary powers. They have, however, paid insufficient attention to real causes of this malady.

7. Reduction in Inequalities

Various studies confirm the widely held view that our direct taxes have not been helpful in reducing inequalities. The impact of highly progressive rates is counterbalanced by widespread tax evasion. Additionally, the pre-VAT regime of indirect taxes also contributed to inequalities. Taxation of inputs and intermediate goods further aggravated the regressivity of the system. This is because such taxes have a cost cascading effect. In an economy like ours which suffers from widespread shortages, an all-pervasive regulatory regime, and a bureaucracy with widespread arbitrary powers, the manufacturers and sellers are able to mark up prices far in excess of the taxes imposed. Moreover, the system breeds a process of taxation of taxes and this pushes up costs and prices still further. And inflation, as we know, contributes to inequalities.

It may be added here that regressivity of indirect taxation is substantially counteracted under VAT and to that extent its contribution to inequalities is weakened. However, VAT also reduces tax evasion, and because of that it increases prices and strengthens inequalities.

Further, the system of direct taxation in our country is loaded in favour of capital intensive techniques, thereby contributing to income and wealth inequalities.

Currently a view is gaining ground that the government should abandon the pretense of using tax measures for reduction in inequalities. Instead, it should use its expenditure policy for this purpose.

8. Capital Accumulation

Ideally speaking, our tax provisions should help the economy in achieving a faster rate of capital accumulation and a growth-oriented investment pattern. Officially, we have always been subscribing to this view. For decades, our direct taxes remained studded with a large number of exemptions, rebates and the like for encouraging savings, and influencing investment pattern. Even now, income from some specified saving instruments enjoys tax concessions; and specified saving investments get a more favourable treatment. This system of incentives had a valid logic when private enterprise was not well developed and when the primary responsibility of growth-oriented investment had been assumed by the authorities.

It may be mentioned that the system of fiscal incentives and regulations relating to saving and investment yielded only sub-optimal results because of some inherent weaknesses of the official machinery. The resultant complexity of tax
laws also helped in tax evasion. Chelliah Committee (Tax Reforms Committee) was of the view that our tax system had failed in encouraging savings. It had succeeded in only influencing the pattern of investment, which should have been left to the market forces. In accordance with this thinking, in recent years, the authorities are changing their policy under which most saving and investment decisions are to be guided by market forces and the government is to act as a facilitator and a regulator.

9. Service Tax
The Centre has found a new segment of indirect taxation in the form of service tax, first by using its residuary powers, and then through a Constitutional amendment. This tax is justified on account of a growing share of services in our GDP. Service tax has been added to the Union List and its collection and appropriation is regulated by law made by Parliament. Successive Central budgets have been extending the coverage of service tax and raising its rates. In the Budget for 2012–13, the basic rate of service tax was raised from 10% to 12%. A small negative list of services was drawn and the coverage of the tax was extended to all services not mentioned in the negative list.

States are also keen to have the power to tax this lucrative source of revenue. Accordingly, the incoming GST model accommodates this demand of states. Currently, only taxation of goods is vatable. The introduction of GST would make taxation of services also vatable.

10. Reforms in Excise Duties since 1996–97
Government of India adopted a phased policy of complete overhauling of the structure of Union excise duties, and the process of this overhauling is now complete. It was hoped that a reformed excise duty regime would be able to boost productivity, cut costs, remove distortions in resource allocation, reduce tax evasion, and bring in additional revenue. The components of this restructuring included:

- VAT format of duties;
- to the extent possible, shifting them to ad valorem basis;
- reducing the number of classifications of taxed goods;
- reducing the number of tax rates;
- reducing the number of slabs of special duties;
- removing exemptions to the extent possible, particularly sector-specific and end-use related ones;
- extending concessions to small scale industry; and
- simplification of the assessment procedures.

To begin with, the Centre aimed at having only three rates of ‘normal’ duty, namely, the central rate, the merit rate and the demerit rate. The Budget for 2000–01
shifted to a single, MODVAT, Central Value Added Tax (CENVAT) of 16%. The stated objective of this step was to provide long-term stability, remove uncertainties and eliminate disputes regarding classification. Changes introduced in successive budgets eventually resulted in one general CENVAT rate or ‘mean rate’ of 8% ad valorem. The budget for 2009–10 took further steps to revise central excise duty rates to this mean rate. Currently, the Centre is pursuing the policy of modifying duty rates for only those items which need specific attention for some reason. This policy is expected to facilitate the objective of introducing a GST both at national and state level.

11. Reforms in Customs Duties

For over four decades, we had pursued a policy of protecting domestic industry and agriculture with a combination of quantitative and tariff restrictions on imports. But the introduction of the era of liberalisation and globalisation on the one hand and our commitments to the WTO on the other led to basic changes in the regime of customs duties as well. We committed ourselves to do away with quantitative restrictions and to reduce our tariff duties to ASEAN levels in a phased manner, tempered with the need to protect our interests in the face of changing global circumstances like the crisis of 2008 and enhancing the competitiveness of Indian exports. In addition, successive budgets have been reducing the duties for specific items or exempting them totally.

12. Direct vs. Indirect Taxes

It is conventional to classify tax receipts into those of direct and indirect taxes and use them as inputs for fiscal policy. However, there is no universally valid optimum proportion of these two categories of tax receipts. Their target proportion depends upon an assessment of ground realities and perception of the decision-makers. In Indian context, some of the noteworthy ground realities are as follows:

- In India, the division of tax-heads between the Centre and states is such that state taxes are overwhelmingly indirect while the Centre is having a fair proportion of both direct and indirect ones.
- As of now, Indian economy offers only a limited scope for raising additional revenue through direct taxation and more so in the case of states.
- Our Constitution permits the Centre to levy direct taxes on almost all forms of ‘income’ and its ‘disposal’. However, while corporation tax and other taxes on income (with their appended components) have always been there, Centre has persistently explored other permissible direct taxes and levied them for varying time intervals. Examples of such taxes include expenditure tax, gift tax, wealth tax, interest tax, and the like. Some other taxes like the Fringe Benefits Tax were levied and withdrawn. Leading indirect taxes of the Centre happen to be customs duties, excise duties (with a few exceptions), and service tax. Similarly, several ‘taxes of union territories’, also belong to the category of indirect ones.
• Direct taxes of states include tax on agricultural income, land revenue, tax on professions, trade, callings and employment and tax on non-urban immovable properties. Their indirect taxes are of a wide variety and include state excise duties, general sales tax (now VAT), motor spirit sales tax, stamps and registration fees, taxes on vehicles, taxes on goods and passengers, tax and duty on electricity, entertainment tax, advertisement tax, betting tax and so on.

• Central taxes shared with states include both direct and indirect ones. However, surcharges and cesses levied by the Centre are not shared with them.

• With the introduction of GST in the form of its proposed dual model, both Centre and states would acquire concurrency over a number of existing indirect taxes. In addition, the states would also acquire the right to levy service tax.

• States are reluctant to tax agricultural income; and their receipts from tax on professions are subject to Constitutional restrictions. In the final analysis, direct tax revenue of states is primarily confined to Land Revenue, Tax on Professions, and Tax on Urban Immovable Properties. In contrast, they have some very buoyant and elastic indirect taxes like general sales tax (VAT), state excise duties, stamps and registration, motor vehicles tax, etc. An important but highly obnoxious indirect tax happens to be octroi which has been abolished by all states except Maharashtra.

• Direct taxes with the Centre are highly elastic and buoyant. For this reason, the Centre has been able to maintain a high proportion revenue from direct taxes. Data show that in 2003–04, gross receipts of its direct taxes (from corporation tax, personal income tax, interest tax, other taxes on income and expenditure, estate duty, wealth tax, and gift tax) were 41.32% of its total gross tax receipts. This proportion registered an uptrend in subsequent years on account of various reasons and in 2009–10 peaked at 58.8%. Since then, however, this proportion again started declining and was budgeted at 52.5%. This downturn was the combined result of a robust growth of service tax and withdrawal of some obnoxious direct taxes. Analysts assert that the Centre should follow a policy of moderate rates coupled with plugging of tax evasion.

• In contrast to the position at the Centre, States’ own tax revenue is overwhelmingly from indirect taxes. For example, indirect tax receipts accounted for 97–98% of their own tax receipts in the years 2009–10 and later. The reasons for this phenomenon are well known. Direct taxes of the states suffer from a low potential and the states are also hesitant in their optimum exploitation. The adoption of GST is expected to further ensure that the proportion of revenue from indirect taxes does not decline in the foreseeable future.
• It is noteworthy that, by their very nature, extending the coverage and enhancing rates of indirect taxes is easier for the authorities. It is more so when indirect taxes are ad valorem. These steps face milder resistance from the taxpayers and the suppliers, particularly because the latter are able to pass on their incidence to the buyers.

• The authorities claim that they reduce the regressivity of indirect taxes by taxing luxuries at higher rates and exempting some basic necessities like raw food. In effect, however, indirect taxes remain highly regressive. The fact that they feed inflationary forces adds to their regressivity.

• The authorities claim that their tax policy is aimed at improving resource allocation in the economy, generating employment and reducing regional disparities. However, critics claim that, in their policy decisions, the authorities are primarily guided by revenue considerations.

• Some analysts claim that in our country tax/GDP ratio is lower than what it ought to be. However, this claim ignores several pertinent facts including the following:
  (a) There is nothing like some universally valid ideal tax/GDP ratio. It varies in line with the totality of circumstances faced by an economy.
  (b) In general, tax/GDP ratio ought to be lower in a poorer country.
  (c) In India, this ratio has registered a secular uptrend from 6.22% in 1950–51 to around one-fifth of GDP in 2012–13, highlighting an inherent elasticity and buoyancy of the Indian tax system.
  (d) A long-term uptrend in tax/GDP ratio does not necessarily mean an improvement in a tax system.
  (e) An appropriate tax/GDP ratio can be selected only after taking into account all the aspects of the expenditure side of the budget. This ratio ought to go up if it can be ensured that revenue receipts will be spent efficiently, productively and in line with the needs of the society and economy.

It is important to remember here that a Goods and Services Tax (GST) has come into effect since 1st July 2017. It has subsumed many indirect taxes in the country. And the tax sharing is now done on the basis of the provisions of the Goods and Services Act.

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**Check Your Progress**

1. What is non-concurrency of taxation between the Centre and States?
2. Why is there a widespread tax evasion in India?
3. Why has the Centre added service tax to the Union List?
12.3 ANSWERS TO ‘CHECK YOUR PROGRESS’ QUESTIONS

1. Our Constitution does not allow concurrency of taxation powers between the Centre and states (that is, a given tax base cannot be taxed by both the Centre and states). Moreover, local bodies are assigned taxation powers by states or, if they are in union territories, by the Centre, out of the State List for their respective territorial jurisdictions. This feature of non-concurrency was incorporated in our Constitution so as to satisfy three criteria of uniformity, economy, and efficiency of the tax system as a whole.

2. In our country, widespread tax evasion is an acknowledged fact. Several factors are responsible for this phenomenon including, for example, high tax rates, complex tax laws, lack of proper accounts and information, and administrative weaknesses.

3. The Centre has found a new segment of indirect taxation in the form of service tax, first by using its residuary powers, and then through a Constitutional amendment. This tax is justified on account of a growing share of services in our GDP. Service tax has been added to the Union List and its collection and appropriation is regulated by law made by Parliament.

12.4 SUMMARY

- Since it is next to impossible to have an ideal tax system on account of various hurdles including those posed by inherent dynamism of most economies, the debate regarding the exact format of an ideal tax system continues unabated.

- For a country like ours, devising a suitable system of taxation poses a host of problems and it is not easy to solve them to an acceptable level of satisfaction. In contrast with developed countries, a country like ours faces several hurdles in the task of structuring an optimum system of taxation.

- In India, in addition to very low productivity of public expenditure, its composition is also highly skewed. It is neither in harmony with social priorities, nor in conformity with the objective of economic growth.

- The Centre-state division of taxation powers provided in our Constitution creates a vertical fiscal imbalance in favour of the Centre, and this imbalance has an inherent tendency to widen further over time.

- Our tax provisions are loaded in favour of capital intensive techniques, thereby discouraging generation of employment, particularly in rural areas. This not only adds to inequalities, through widespread unemployment and underemployment, but also forces migration of labour to urban areas with all its concomitant problems and consequences.
• Unfortunately, the government has not been able to contain the growth of its own expenditure within reasonable limits. Therefore, even a rapid increase in tax revenue has not been able to meet its expenditure needs, and it has to repeatedly resort to market borrowings and deficit financing.

• It appears that the government does not take a comprehensive (all-inclusive) view of our tax system resulting in contradictory provisions for achieving socio-economic objectives. It is now saddled with widespread incentives and deterrents, making it highly complex.

• Various studies confirm the widely held view that our direct taxes have not been helpful in reducing inequalities. The impact of highly progressive rates is counterbalanced by widespread tax evasion. Additionally, the pre-VAT regime of indirect taxes also contributed to inequalities.

• Chelliah Committee (Tax Reforms Committee) was of the view that our tax system had failed in encouraging savings. It had succeeded in only influencing the pattern of investment, which should have been left to the market forces.

• The Centre has found a new segment of indirect taxation in the form of service tax, first by using its residuary powers, and then through a Constitutional amendment. This tax is justified on account of a growing share of services in our GDP.

• To begin with, the Centre aimed at having only three rates of ‘normal’ duty, namely, the central rate, the merit rate and the demerit rate. The Budget for 2000–01 shifted to a single, MODVAT, Central Value Added Tax (CENVAT) of 16%.

• For over four decades, we had pursued a policy of protecting domestic industry and agriculture with a combination of quantitative and tariff restrictions on imports. But the introduction of the era of liberalisation and globalisation on the one hand and our commitments to the WTO on the other led to basic changes in the regime of customs duties as well.

• In India, the division of tax-heads between the Centre and states is such that state taxes are overwhelmingly indirect while the Centre is having a fair proportion of both direct and indirect ones.

• Our Constitution permits the Centre to levy direct taxes on almost all forms of ‘income’ and its ‘disposal’. However, while corporation tax and other taxes on income (with their appended components) have always been there, Centre has persistently explored other permissible direct taxes and levied them for varying time intervals.

• States are reluctant to tax agricultural income; and their receipts from tax on professions are subject to Constitutional restrictions. In the final analysis, direct tax revenue of states is primarily confined to Land Revenue, Tax on Professions, and Tax on Urban Immovable Properties.
• Direct taxes with the Centre are highly elastic and buoyant. For this reason, the Centre has been able to maintain a high proportion revenue from direct taxes.

• It is noteworthy that, by their very nature, extending the coverage and enhancing rates of indirect taxes is easier for the authorities. It is more so when indirect taxes are ad valorem. These steps face milder resistance from the taxpayers and the suppliers, particularly because the latter are able to pass on their incidence to the buyers.

• An appropriate tax/GDP ratio can be selected only after taking into account all the aspects of the expenditure side of the budget. This ratio ought to go up if it can be ensured that revenue receipts will be spent efficiently, productively and in line with the needs of the society and economy.

12.5 KEY WORDS

• CENVAT: The introduction of CENVAT Credit Rules served to be instrumental in codifying the credit mechanism into a single law for availing and utilisation of credit of taxes paid on goods as well as services for both the manufacturers and the service providers.

• VAT: A value-added tax (VAT) is a consumption tax placed on a product whenever value is added at each stage of the supply chain.

• GST: Goods and Services Tax (GST) is an indirect tax imposed in India on the supply of goods and services. It is a comprehensive multistage, destination based tax. Comprehensive because it has subsumed almost all the indirect taxes except few.

• Tax-to-GDP Ratio: When a country’s tax revenues grow at a slower rate than the GDP, the tax-to-GDP ratio drops. As tax revenue grows quicker than the GDP, the ratio will increase.

12.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Why is it not possible to have an ideal tax system?
2. Why has India been unable to solve the problem of division of taxation powers between different layers of government so far?
3. What steps are being taken to make tax system simple in India?
4. What makes tax system to be rated as adequate?
5. Write a short note on reforms in Excise Duties in India.
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Long Answer Questions

1. Discuss the evolution of tax system in India.
2. Analyse the constitutional provisions for revenue of the Centre, States and local bodies.
3. Discuss the essential features of the Indian tax system.

12.7 FURTHER READINGS

UNIT 13 MAJOR TAXES IN INDIA

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13.0 Introduction
13.1 Objectives
13.2 Tax Revenue and Non-Tax Revenue of Centre, State and Local Bodies
   13.2.1 Tax Revenues
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13.0 INTRODUCTION

As we had also discussed in the previous unit, tax revenue and non-tax revenue are the two sources of public revenue. While the former is a compulsory levy and its refusal is a punishable offence, the latter comprises all other taxes that government or public authority generate. Tax revenue is collected through various direct and indirect taxes namely income tax, corporation tax, property or estate tax, custom and excise, sales and service tax, VAT, etc. However, there is a *quid pro quo* in non-tax source of public revenues and it doesn’t have similar features. Three-fourths of the States’ own non-tax revenue come from administrative non-tax receipts such as receipts from general, social and economic services. In the 10 years ending 2009-10, non-tax revenues had grown at a compound annual rate of 7.6 per cent. The Centre and the States share the revenue as determined by various institutionalised agencies like Finance Commission. Sources of revenue for local bodies are mostly from their own resources, grants and loans.

This unit discusses in detail the sources of tax and non-tax revenue of the Centre, State and local bodies.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand major taxes in India
- Explain the tax revenue of Centre, State and local bodies
- Discuss the non-tax revenue of Centre, State and local bodies
13.2 TAX REVENUE AND NON-TAX REVENUE OF CENTRE, STATE AND LOCAL BODIES

As shown in Figure 13.1, there are two sources of public revenue, namely tax revenue and non-tax revenue. A tax is a compulsory levy imposed by a public authority on persons and organizations to meet public expenditures. It is the compulsory payment made to the government. Refusal to pay the tax is a punishable offence. Every tax involves some sacrifice on the part of tax payers. A tax is not a fine or penalty. Non-tax revenue includes all revenues other than taxes, accruing to the government. These are internally generated funds, such as administrative revenues, commercial revenues, and grants and gifts.

<table>
<thead>
<tr>
<th>Public revenue</th>
<th>Tax revenue</th>
<th>Non-tax revenue</th>
</tr>
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<tbody>
<tr>
<td>Direct taxes</td>
<td>Indirect taxes</td>
<td>Interest receipts,</td>
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<td>Income tax, wealth</td>
<td>Central excise,</td>
<td>dividends and fees</td>
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<td>tax</td>
<td>customs, VAT</td>
<td>from licenses,</td>
</tr>
<tr>
<td></td>
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</table>

Fig. 13.1 Sources of Public Revenue

13.2.1 Tax Revenues

Let us discuss the various sources of tax revenues.

1. Direct Taxes

A direct tax is a kind of charge, which is imposed directly on the taxpayer and paid directly to the government by the persons (juristic or natural) on whom it is imposed. A direct tax is one that cannot be shifted by the taxpayer to someone else. Some important direct taxes imposed in India are:

- **Income Tax**: Income Tax Act, 1961 (as amended) imposes tax on the income of the individuals or Hindu undivided families or firms or co-operative societies (other than companies) and trusts (identified as bodies of individuals associations of persons) or every artificial juridical person. The inclusion of a particular income in the total incomes of a person for income-tax in India is based on his residential status. There are three residential status, viz., (i) Resident & Ordinarily Residents (Residents) (ii) Resident but not Ordinarily Residents and (iii) Non-Residents. There are several steps involved in determining the residential status of a person. All residents are taxable for all their income, including income outside India. Non-residents are taxable only for the income received in India or Income accrued in India. Not
ordinarily residents are taxable in relation to income received in India or income accrued in India and income from business or profession controlled from India.

- **Corporation Tax:** The companies and business organizations in India are taxed on the income from their worldwide transactions under the provision of Income Tax Act, 1961 (as amended). A corporation is deemed to be resident in India if it is incorporated in India or if it’s control and management is situated entirely in India. In case of non-resident corporations, tax is levied on the income which is earned from their business transactions in India or any other Indian sources depending on bilateral agreement of that country.

- **Property Tax:** Property tax or ‘house tax’ is a local tax on buildings, along with appurtenant land, and imposed on owners. The tax power is vested in the states and it is delegated by law to the local bodies, specifying the valuation method, rate band, and collection procedures. The tax base is the Annual Rateable Value (ARV) or area-based rating. Owner-occupied and other properties not producing rent are assessed on cost and then converted into ARV by applying a percentage of cost, usually six percent. Vacant land is generally exempted from the assessment. The properties lying under control of Central are exempted from the taxation. Instead a ‘service charge’ is permissible under executive order. Properties of foreign missions also enjoy tax exemption without an insistence for reciprocity.

- **Inheritance and Estate Taxes:** These taxes are levied on the demise of a person. A tax levied on those who inherit from the deceased person is termed as an inheritance tax and is usually assessed with reference to the overall tax liability of the inheritor. In contrast, an estate duty is levied on the entire wealth of the deceased person before and after the tax balance is inherited. Note that both taxes can be levied simultaneously.

  In India, estate duties came into existence in 1957 and were abolished in the budget for 1985-86 because of their widespread ill-effects and extremely small collection. The duties were imposed and collected by the Centre, the net proceeds were divided between the States. Similarly, estate duty on agricultural lands can be imposed only by the States. Some States were doing so and the Centre was collecting it on their behalf and distributing the net proceeds between them. They were also abolished. However, the 1989-90 budget imposed a tax on transfer of wealth through inheritance and this tax was not shared with the States.

  In recent years, some ingredients of erstwhile estate duty have been replaced by some forms of wealth tax.

- **Gift Tax:** Gift tax in India is regulated by the Gift Tax Act which was constituted on 1st April, 1958. It came into effect in all parts of the country except Jammu and Kashmir. As per the Gift Act 1958, all gifts in excess of
25,000, in the form of cash, draft, check or others, received from one
who doesn’t have blood relations with the recipient, were taxable. However,
with effect from 1st October, 1998, gift tax got demolished and all the gifts
made on or after the date were free from tax. But in 2004, the act was
again revived partially. A new provision was introduced in the Income Tax
Act 1961 under section 56 (2). According to it, the gifts received by any
individual or Hindu Undivided Family (HUF) excess of ₹50,000 in a year
would be taxable.

2. Indirect Tax

An indirect tax is a tax collected by an intermediary (such as a retail store) from
the person who bears the ultimate economic burden of the tax (such as the
customer). An indirect tax is one that can be shifted by the taxpayer to someone
else. An indirect tax may increase the price of a good so that consumers are
actually paying the tax by paying more for the products. The some important
indirect taxes imposed in India are as under:

- **Customs Duty**: The Customs Act was formulated in 1962 to prevent illegal
  imports and exports of goods. Besides, all imports are sought to be subject
to a duty with a view to affording protection to indigenous industries as well
as to keep the imports to the minimum in the interests of securing the
exchange rate of Indian currency. Duties of customs are levied on goods
imported or exported from India at the rate specified under the customs
Tariff Act, 1975 as amended from time to time or any other law for the time
being in force. Under the custom laws, the various types of duties are leviable.

- **Basic Duty**: This duty is levied on imported goods under the Customs
  Act, 1962.

- **Additional Duty (Countervailing Duty) (CVD)**: This is levied under
  Section 3 of the Custom Tariff Act and is equal to excise duty levied on a
like product manufactured or produced in India. If a like product is not
manufactured or produced in India, the excise duty that would be leviable
on that product had it been manufactured or produced in India is the duty
payable. If the product is leviable at different rates, the highest rate among
those rates is the rate applicable. Such duty is leviable on the value of goods
plus basic custom duty payable.

- **Additional Duty to compensate duty on inputs used by Indian
  manufacturers**: This is levied under Section 3(3) of the Customs Act. (4)
Anti-dumping Duty: Sometimes, foreign sellers abroad may export into India
goods at prices below the amounts charged by them in their domestic markets
in order to capture Indian markets to the detriment of Indian industry. This
is known as dumping. In order to prevent dumping, the Central Government
may levy additional duty equal to the margin of dumping on such articles.
There are however certain restrictions on imposing dumping duties in case
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of countries which are signatories to the GATT or on countries given “Most Favoured Nation Status” under agreement.

- **Protective Duty**: If the Tariff Commission set up by law recommends that in order to protect the interests of Indian industry, the Central Government may levy protective anti-dumping duties at the rate recommended on specified goods.

- **Duty on Bounty Fed Articles**: In case a foreign country subsidises its exporters for exporting goods to India, the Central Government may impose additional import duty equal to the amount of such subsidy or bounty. If the amount of subsidy or bounty cannot be clearly determined immediately, additional duty may be collected on a provisional basis and after final determination, difference may be collected or refunded, as the case may be.

- **Export Duty**: Such duty is levied on export of goods. At present very few articles such as skins and leather are subject to export duty. The main purpose of this duty is to restrict exports of certain goods.

- **Cess on Export**: Under sub-section (1) of Section 3 of the Agricultural & Processed Food Products Export Cess Act, 1985 (3 of 1986), 0.5% ad valorem as the rate of duty of customs be levied and collected as cess on export of all scheduled products.

- **National Calamity Contingent Duty**: This duty was imposed under Section 134 of the Finance Act, 2003 on imported petroleum crude oil. This tax was also leviable on motor cars, imported multi-utility vehicles, two wheelers and mobile phones.

- **Education Cess**: Education Cess is leviable @ 2% on the aggregate of duties of Customs (except safeguard duty under Section 8B and 8C, CVD under Section 9 and anti-dumping duty under Section 9A of the Customs Tariff Act, 1985). Items attracting Customs Duty at bound rates under international commitments are exempted from this Cess.

- **Secondary and Higher Education Cess**: Leviable @1% on the aggregate of duties of Customs. **Road Cess**: Additional Duty of Customs on Motor Spirit is leviable and Additional Duty of Customs on High Speed Diesel Oil is leviable by the Finance Act (No.2), 1998 and the Finance Act, 1999 respectively.

- **Surcharge on Motor Spirit**: Special Additional Duty of Customs (Surcharge) on Motor Spirit is leviable by the Finance Act, 2002.

- **Central Excise Duty**: The Central Government levies excise duty under the Central Excise Act, 1944 and the Central Excise Tariff Act, 1985. Central excise duty is tax which is charged on such excisable goods that are manufactured in India and are meant for domestic consumption. The term “excisable goods” means the goods which are specified in the First Schedule
and the Second Schedule to the Central Excise Tariff Act 1985. It is mandatory to pay Central Excise duty payable on the goods manufactured, unless exempted, for example, duty is not payable on the goods exported out of India. Further various other exemptions are also notified by the Government from the payment of duty by the manufacturers. Various Central Excise are:

i. **Basic Excise Duty**: Excise Duty, imposed under Section 3 of the ‘Central Excises and Salt Act’ of 1944 on all excisable goods other than salt produced or manufactured in India, at the rates set forth in the schedule to the Central Excise tariff Act, 1985, falls under the category of Basic Excise Duty in India.

ii. **Special Excise Duty**: According to Section 37 of the Finance Act, 1978, Special Excise Duty is levied on all excisable goods that come under taxation, in line with the Basic Excise Duty under the Central Excises and Salt Act of 1944. Therefore, each year the Finance Act spells out that whether the Special Excise Duty shall or shall not be charged, and eventually collected during the relevant financial year.

iii. **Additional Duty of Excise**: Section 3 of the ‘Additional Duties of Excise Act’ of 1957 permits the charge and collection of excise duty in respect of the goods as listed in the Schedule of this Act.

iv. **Road Cess**:
   - Additional Duty of Excise on Motor Spirit: This is leviable by the Finance Act (No.2), 1998.
   - Additional Duty of Excise on High Speed Diesel Oil: This is leviable by the Finance Act, 1999.

v. **Surcharge**:
   - Special Additional Duty of Excise on Motor Spirit: This is leviable by the Finance Act, 2002.
   - Surcharge on Pan Masala and Tobacco Products: This Additional Duty of Excise has been imposed on cigarettes, pan masala and certain specified tobacco products, at specified rates in the Budget 2005-06. Bidis are not subjected to this levy.

vi. **National Calamity Contingent Duty (NCCD)**: NCCD was levied on pan masala and certain specified tobacco products vide the Finance Act, 2001. The Finance Act, 2003 extended this levy to polyester filament yarn, motorcar, two wheeler and multi-utility vehicle and crude petroleum oil.

vii. **Education Cess**: Education Cess is leviable @2% on the aggregate of duties of Excise and Secondary and Higher Education Cess is Leviable @1% on the aggregate of duties of Excise.
vIII. Cess: A cess has been imposed on certain products.

- **Service Tax:** The service providers in India except those in the state of Jammu and Kashmir are required to pay a Service Tax under the provisions of the Finance Act of 1994. The provisions related to Service Tax came into effect on 1st July, 1994. Under Section 67 of this Act, the Service Tax is levied on the gross or aggregate amount charged by the service provider on the receiver. However, in terms of Rule 6 of Service Tax Rules, 1994, the tax is permitted to be paid on the value received. The interesting thing about Service Tax in India is that the Government depends heavily on the voluntary compliance of the service providers for collecting Service Tax in India.

- **Sales Tax:** In India, sales tax can be imposed only by the States on the sale/purchase, etc. of goods. Most States were doing so. It was being levied at successive sales of an item on the full sale value. This system had its own ill-effects particularly in the form of adding to the costs and prices. Therefore, in accordance with what several other countries had done, in India States were persuaded to switch over to another form of sales tax, termed VAT. It is also levied on successive transactions of an item but only on the “value added” after the preceding transaction. If implemented properly, VAT has several advantages over sales tax such as avoidance of taxation of the already paid taxes. In addition, the Centre levies Central Sales Tax on inter-state transactions and its net proceeds go to the States. CST is scheduled to be abolished once the GST (Goods and Services Tax) comes into effect on an all-India basis.

- **Value Added Tax (VAT):** The practice of VAT executed by State Governments is applied on each stage of sale, with a particular apparatus of credit for the input VAT paid. VAT in India classified under the tax slabs are 0% for essential commodities, 1% on gold ingots and expensive stones, 4% on industrial inputs, capital merchandise and commodities of mass consumption, and 12.5% on other items. Variable rates (State-dependent) are applicable for petroleum products, tobacco, liquor, etc. VAT levy will be administered by the Value Added Tax Act and the rules made there are similar to a sales tax. It is a tax on the estimated market value added to a product or material at each stage of its manufacture or distribution, ultimately passed on to the consumer. Under the current single-point system of tax levy, the manufacturer or importer of goods into a State is liable to sales tax. There is no sales tax on the farther distribution
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channel. VAT, in simple terms, is a multi-point levy on each of the entities in the supply chain. The value addition in the hands of each of the entities is subject to tax. VAT can be computed by using any of the three methods:

i. **Subtraction method:** The tax rate is applied to the difference between the value of output and the cost of input.

ii. **The Addition method:** The value added is computed by adding all the payments that is payable to the factors of production (viz., wages, salaries, interest payments etc).

iii. **Tax credit method:** This entails set-off of the tax paid on inputs from tax collected on sales.

- **Securities Transaction Tax (STT):** STT is a tax, which is levied on all transactions done on the stock exchanges. It is applicable on purchase or sale of equity shares, derivatives, equity-oriented funds and equity-oriented mutual funds. Current STT on purchase or sale of an equity share is 0.075%. A person becomes an investor after payment of STT at the time of selling securities (shares). Sale of shares after 12 months does not attract this tax or tax on long-term gains. However, a gain on selling of shares before 12 months is termed short-term gain and attracts a tax at a flat rate of 10%. Further, for a trader, all his gains are treated as trading (Business) gains and he has to pay tax as per tax sables. In this case, the transaction tax paid by him can be claimed back/adjusted in tax to be paid.

13.2.2 Non-tax Revenues

Non-tax sources of public revenues are defined as payment made to the Government for which there is a *quid pro quo* (an exchange of goods or services, where one transfer is contingent upon the other). However, these non-tax sources do not have similar features and are classified into three categories:

i. First, there are some sources that are compulsory and requited payments. These sources include penalties (other than penalties on non-compliance of taxes) and fines.

ii. The second category consists of voluntary and unrequited receipts. These payments include donations and contributions made to the Government or any unclaimed funds lying with the Government.

iii. The third category comprises voluntary and requited payments, including revenue earned from the resources owned by the Government such as forest, marine, riparian habitats and wildlife. This category also has revenue earned by sale of usage rights, admission fee, as well as the royalties and rental payments received by the Government. Income earned in the form of
dividends and the interest receipts from investments made by the Government
also fall into this category. Interest, profits and dividends arising from the
States’ commercial undertakings are also included in this category.

Administrative non-tax receipts
This source accounts for about three-fourths of the States’ own non-tax revenue.
In the future, this is likely to be the most productive and reliable source of non-tax
revenues for the States. Three broad components of administrative receipts, viz.
general services, social services, and economic services.

(i) Receipts from General Services: These comprise receipts from Public
Service Commission, Police, Jails, Supplies and disposals, Stationery and
printing, Public works, other administrative services, Contribution and
recoveries towards pension and other retirement benefits, and other
miscellaneous general services.

(ii) Receipts from Social Services: The major items that come under this
class are (a) Education, sports, arts and culture, (b) Medical and public
health, (c) Family welfare, (d) Water supply and sanitation, (e) Housing, (f)
Urban development (g) Information and publicity, (h) Labour and
employment, (i) Social security and welfare, and (j) Other social services.

(iii) Receipts from Economic Services: Major items under this class are (a)
Crop husbandry, (b) Animal husbandry, (c) Dairy development, (d) Fisheries,
(e) Forestry and wild life, (f) Co-operation, (g) Other agricultural and rural
programmes, (h) Special area programmes, (i) Major and medium irrigation,
(j) Minor irrigation, (k) Village and small scale industries, (l) Industries, (m)
Non-ferrous mining and metallurgical industries, (n) Roads and bridges, (o)
Tourism, and (p) Others.

User charges
The non-tax revenue in lieu of the provision of goods and services by the
Government is derived through ‘user charges’. These charges indicate payments
that are administratively determined for the goods and services provided by the
Government. As stated by the OECD, these are requited payments. However, the
link between payments and services provided may vary considerably in terms of
degree of cost recovery. These include payments in exchange for non-capital goods
and services—e.g. charges for education and health; entry charge for museum,
parks, etc.; and rent for housing.

However, the OECD definition is subject to some ambiguities as it
distinguishes between capital, and non-capital goods and services. The Government
is providing capital goods in the form of urban infrastructure. These are used for
domestic as well as for industrial purposes and accordingly, the user charges should
also vary.
Current status of non-tax revenues in India

Non-tax revenues grew at a compound annual rate of 7.6 per cent in the 10 years ending 2009-10. The spurt in 2010-11 owed to higher-than-budgeted realization from the proceeds of auction of telecom 3G/broadband wireless access spectrum. As against the estimated revenue of ₹1,25,435 crore in 2011-12 (BE), the realization fell marginally short at ₹1,24,307 crore notwithstanding the fact that the auctions of telecom spectrum and phase III FM Radio which were to bring in ₹14,600 crore could not take place. Budget 2012-13 estimated a growth of 32.0 per cent over 2011-12 (RE) in non-tax revenue mainly on account of estimated receipts of ₹40,000 crore from the telecom spectrum auction. As the 2G telecom spectrum auction elicited lukewarm response on account of the high reserve price in the current year, the government has revised the reserve price downwards. As such, the proceeds from this component are as yet an important risk to the actual fiscal outcome for 2012-13. The other main component is dividends and profits, which have also in the past exhibited sluggish growth.

13.2.3 Current Status of Tax and Non-tax Revenues in India

The Budget for 2012-13 estimated higher tax revenues on the strength of several measures announced like widening of the base of service tax through a single negative list (of exempted categories), a new schedule of rates and slab for personal income tax, raising of the standard rate of excise duty as well as merit rates and the peak rate of customs duty of 10 per cent that had been left unchanged notwithstanding the pickup in import demand. The details of the trends in different components of tax revenue and non-tax revenue are discussed in the following paragraphs.

- **Direct taxes:** As is evident from Table 13.1, there has been a compositional change in gross tax revenues since 2007-8. As a proportion of GDP, direct taxes accounted for 5.5 per cent in 2011-12, well below the peak of 5.9 per cent in 2007-8. The Budget for 2012-13 envisaged a growth of 13.9 per cent in direct taxes over 2011-12 (RE). Continuing with the policy of moderation of tax rates, the Budget has further broadened the slabs for individual taxpayers. The exemption limit for individual taxpayers below the age of 60 years has been enhanced from ₹1,80,000 to ₹2 lakh. The income slab for 20 per cent tax rate has been broadened for all individual taxpayers irrespective of their age and will now be applicable to total income between ₹5 lakh and ₹10 lakh instead of the earlier slab of ₹5 lakh and ₹8 lakh. The tax rate of 30 per cent will now be applicable to total income exceeding ₹10 lakh. Securities transaction tax on certain transactions in specified securities has been reduced from the existing 0.125 per cent to 0.1 per cent.

- **Indirect taxes:** The Budget for 2012-13 estimated revenue from indirect taxes to grow by 26.7 per cent over 2011-12 (RE) on the strength of assumed economic recovery. In so far as union excise duties are concerned,
the BE 2012-13 envisaged a growth of 29.1 per cent in revenue over 2011-12 (RE). An increase in the effective rate of excise duty on non-petroleum products from 10 per cent earlier to 12 per cent in BE 2012-13 and a pickup in the manufacturing sector were the bases for these assumptions.

The Budget for 2012-13 also made the following other changes: raised the concessional rate of excise duty on non-petroleum products from 5 per cent to 6 per cent; increased the lower rate on non-petroleum products without Cenvat Credit from 1 per cent to 2 per cent with the exception of coal and fertilizers; enhanced the rate of excise duty from 22 per cent to 24 per cent and from 22 per cent ₹15,000 per vehicle to 27 per cent on certain categories of automobiles; increased the rates of specific excise duty on cigarettes (both filter and non-filter) of length exceeding 65mm; raised the excise duty on cigars, cheroots, and cigarillos to 12 per cent or ₹1,370 per thousand, whichever is higher; increased the basic excise duty on hand-rolled biddis from ₹ 8 to ₹ 10 per thousand and on machine-rolled biddis from ₹19 to ₹21 per thousand.

In so far as revenue from customs is concerned, the Budget for 2012-13 envisaged a growth of 22.0 per cent over 2011-12 (RE). The two important general reductions in customs duties were the exemption of education cess and secondary and higher education cess from the CVD portion of customs duty so as to avoid computation of such cesses twice; the duty-free allowance under the baggage rules has been increased for adult passengers of Indian origin from ₹25,000 to ₹35,000 (returning after stay abroad of more than three days) and from ₹12,000 to ₹15,000 (returning after stay abroad of three days or less).

In 2011-12, growth in service tax revenue was 37.4 per cent amounting to ₹97,579 crore, which indicated that service tax has been emerging as an important source of revenue. Budget 2012-13 envisaged a growth of 30.5 per cent in the revenue from service tax vis-à-vis 2011-12 (RE). This was based on the increase in the rate from the existing 10 per cent to 12 per cent and a change in the tax base (Table 13.2). As against the usual practice of expanding the list of services, the Budget for 2012-13 introduced a ‘negative list’ approach effective 1 July 2012. For operationalizing the negative list approach, a number of changes have been made in Chapter V of the Finance Act 1994 (when service tax was initially introduced). Service of transportation of passengers with or without accompanied belongings by railways in first class or an air conditioned coach and services by way of transportation of goods by railways has been subjected to service tax effective October 1, 2012. Following the revision in the rate of service tax, changes have also been made in specific and compounding rates of tax for services in relation to purchase and sale of foreign currency including money changing; promotion, marketing, organizing, or in any manner assisting in organizing lottery; and reversal of Cenvat credit under rule 6(3)(i).
**NOTES**

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**Goods and Services Tax**

As mentioned earlier, a new ‘one-India’ tax has been introduced and in effect since July 2017 known as the Goods and Services Tax. It subsumes a majority of indirect taxes in India and is referred to as taxes on goods and services. The Act provides concurrent powers to the State and the Centre to levy GST.

**Table 13.1 Tax Revenue from Different Sources**

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct (a)</th>
<th>Personal income tax</th>
<th>Corporation tax</th>
<th>Indirect (b)</th>
<th>Customs</th>
<th>Excise</th>
<th>Service tax</th>
<th>Gross tax revenue #</th>
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Sources: Union Budget (2013-14) documents and controller General of Accounts.

# includes taxes referred in (a) and (b) and taxes of Union Territories and ‘other’ taxes.

Notes:

1. Direct taxes also includes taxes pertaining to expenditure, interest, wealth, gift, and estate duty.

2. The ratios to GDP at current market prices are based on the CSO’s National Accounts 2004-5 series.
Table 13.3 Tax and Not Tax Revenue as per the Receipts Budget 2018-19

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<tr>
<td>2. Non-Tax Revenue</td>
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<td>3. Total Revenue Receipts</td>
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Source: Receipts Budget 2018-19

13.2.4 Revenue of Local Bodies in India

In India, the resources of local bodies can be found under four heads. These are as follows:

1. Own Resources
2. Assigned/Shared Resources
3. Grants
4. Loans

Own resources consist of own taxes, fees and other non-tax revenue. The own taxes comprise of property/house tax, profession tax, vehicle tax, tax on agricultural land, and so on. Assigned revenue refers to taxes levied, collected, and passed on to the local bodies by the state government, as well as the taxes levied, collected and shared by the state government with the local bodies. As far as grants are concerned, there is no specific system for grants. They are either given as incentives for tax efforts, or for matching of efforts for maintenance of services. They are thus discretionary in nature. Loans are availed by local bodies for the creation of infrastructure, with the permission of the government, subject to the capability to discharge the debt service.
Major Taxes in India

Check Your Progress

1. List some of the important direct taxes imposed in India.
2. What is indirect tax? When was the Customs Act formulated?
3. What is Basic Excise Duty in India?
4. What is the significance of administrative non-tax receipts in non-tax revenue?
5. List the resources of revenue of local bodies in India.

13.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Some important direct taxes imposed in India are:
   i. Income Tax
   ii. Corporation Tax
   iii. Property Tax
   iv. Inheritance and Estate Taxes
   v. Gift Tax

2. An indirect tax is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the customer). An indirect tax is one that can be shifted by the taxpayer to someone else. An indirect tax may increase the price of a good so that consumers are actually paying the tax by paying more for the products. The Customs Act was formulated in 1962 to prevent illegal imports and exports of goods.

3. Excise Duty, imposed under Section 3 of the ‘Central Excises and Salt Act’ of 1944 on all excisable goods other than salt produced or manufactured in India, at the rates set forth in the schedule to the Central Excise tariff Act, 1985, falls under the category of Basic Excise Duty in India.

4. Administrative non-tax receipts account for about three-fourths of the States’ own non-tax revenue. In the future, this is likely to be the most productive and reliable source of non-tax revenues for the States. Three broad components of administrative receipts, viz. general services, social services, and economic services.

5. The resources of local bodies can be found under four heads. These are:
   i. Own resources,
   ii. Assigned/shared Resources
   iii. Grants
   iv. Loans
13.4 SUMMARY

- There are two sources of public revenue, namely tax revenue and non-tax revenue. A tax is a compulsory levy imposed by a public authority on persons and organizations to meet public expenditures. It is the compulsory payment made to the government. Refusal to pay the tax is a punishable offence.

- Non-tax revenue includes all revenues other than taxes, accruing to the government. These are internally generated funds, such as administrative revenues, commercial revenues, and grants and gifts.

- Income Tax Act, 1961 (as amended) imposes tax on the income of the individuals or Hindu undivided families or firms or co-operative societies (other than companies) and trusts (identified as bodies of individuals associations of persons) or every artificial juridical person. The inclusion of a particular income in the total incomes of a person for income-tax in India is based on his residential status.

- Property tax or ‘house tax’ is a local tax on buildings, along with appurtenant land, and imposed on owners. The tax power is vested in the states and it is delegated by law to the local bodies, specifying the valuation method, rate band, and collection procedures.

- The Customs Act was formulated in 1962 to prevent illegal imports and exports of goods. Besides, all imports are sought to be subject to a duty with a view to affording protection to indigenous industries as well as to keep the imports to the minimum in the interests of securing the exchange rate of Indian currency.

- The Central Government levies excise duty under the Central Excise Act, 1944 and the Central Excise Tariff Act, 1985. Central excise duty is tax which is charged on such excisable goods that are manufactured in India and are meant for domestic consumption.

- In India, sales tax can be imposed only by the States on the sale/purchase, etc. of goods. Most States were doing so. It was being levied at successive sales of an item on the full sale value. This system had its own ill-effects particularly in the form of adding to the costs and prices.

- Under the current single-point system of tax levy, the manufacturer or importer of goods into a State is liable to sales tax. There is no sales tax on the further distribution channel. VAT, in simple terms, is a multi-point levy on each of the entities in the supply chain.

- STT is a tax, which is levied on all transactions done on the stock exchanges. It is applicable on purchase or sale of equity shares, derivatives, equity-oriented funds and equity-oriented mutual funds. Current STT on purchase or sale of an equity share is 0.075%. A person becomes an investor after payment of STT at the time of selling securities (shares).
Major Taxes in India

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• Non-tax sources of public revenues are defined as payment made to the Government for which there is a quid pro quo (an exchange of goods or services, where one transfer is contingent upon the other). However, these non-tax sources do not have similar features.

• Administrative non-tax receipts account for about three-fourths of the States’ own non-tax revenue. In the future, this is likely to be the most productive and reliable source of non-tax revenues for the States.

• The non-tax revenue in lieu of the provision of goods and services by the Government is derived through ‘user charges’. These charges indicate payments that are administratively determined for the goods and services provided by the Government. As stated by the OECD, these are required payments.

13.5 KEY WORDS

• **Special excise duty**: It is charged on all excisable goods on which there is a levy of basic excise duty and is levied at the rates specified in the second schedule of Central Excise Tariff Act, 1985.

• **Surcharge**: As the name suggests, surcharge is an additional charge or tax.

• **A cess**: It is imposed by the central government and is a tax on tax, levied by the government for a specific purpose.

• **Securities Transaction Tax (STT)**: The rate of STT differs based on the type of security traded and whether the transaction is a purchase or a sale. For instance, while buying or selling an equity share (delivery-based), purchaser and seller both need to pay 0.1% of share value as STT.

• **A user charge**: This is a charge for the use of a product or service. A user charge may apply per use of the good or service or for the use of the good or service.

• **OECD**: The Organisation for Economic Co-operation and Development (OECD) is an intergovernmental economic organisation with 36 member countries, founded in 1961 to stimulate economic progress and world trade.

• **Profession tax**: A person earning an income from salary or anyone practicing a profession such as chartered accountant, company secretary, lawyer, doctor etc. are required to pay this professional tax. Different states have different rates and methods of collection.

• **Tax on agricultural land**: Agricultural land in rural area in India is not considered a capital asset. Therefore, any gains from its sale are not taxable under the head Capital Gains.
13.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. How does a tax revenue differ from a non-tax revenue?
2. How are inheritance and estate taxes levied?
3. On which item National Calamity Contingent Duty (NCCD) is levied in India?
4. What are the major items which come under Receipts from Social Services?
5. Write a short note on revenue of local bodies in India.

Long Answer Questions

1. Discuss in detail the various taxes which come under the tax revenue of Centre and State.
2. Analyse the salient features of non-tax revenue.
3. Discuss the current status of tax and non-tax revenues in India.

13.7 FURTHER READINGS


Websites

UNIT 14 REFORMS IN DIRECT AND INDIRECT TAXES

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14.0 Introduction
14.1 Objectives
14.2 Tax Reforms
   14.2.1 The Indirect Taxation Enquiry Committee (Jha Committee)
   14.2.2 Tax Reforms Committee (Chelliah Committee), 1991
   14.2.3 Task Forces on Direct and Indirect Taxes, 2002 (Kelkar Committee)
14.3 Trends in Revenue: An Overview
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   14.4.1 Effects of Public Debt
   14.4.2 Public Debt as a Means of Regulating the Economy
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14.6 Summary
14.7 Key Words
14.8 Self Assessment Questions and Exercises
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14.0 INTRODUCTION

For policy makers and economists, Indian tax system still looks complicated as it consists of many outdated and inconsistent provisions. If these are withdrawn, it will herald a qualitative change in Indian tax system and help it cope with the changing economic scenario in the world. They argue that the tax system and laws should be simple and must be rational from the economic point of view. Successive committees appointed to examine the tax structure have emphasised the need of simplification of taxation law.

It’s time to align the tax structure with the universally accepted standards. It is to be noted that demand for the tax reform stems from a perception that high tax rates and numerous superfluous provisions are interfering in the process of collecting taxes and it is only with suitable reforms that the country can afford to achieve the level of mobilization of financial resources for its economic growth. Taxation needs to be rational with its proper and efficient implementation and collection. Failure to do so will adversely affect its responsibility of revenue mobilization and fiscal operations of the government resulting in severe repercussions on the socio-economic development of the country. In recent times, various committees with inputs and support from the government, academicians, professionals, taxpayers
Reforms in Direct and Indirect Taxes

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Self-Instructional Material

and tax officers have recommended for structural reforms in law governing India’s direct and indirect tax.

This unit aims at putting into perspective various reforms in direct and indirect tax, trends in revenue and expenditure and the role of public debt in post-inform period.

14.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand various reforms in direct and indirect tax
- Describe trends in revenue and expenditure
- Discuss the suggestions and recommendations for reform in tax system
- Analyse the public debt in the post-reform period.

14.2 TAX REFORMS

In this section, you will study about some of the major tax reforms in India.

14.2.1 The Indirect Taxation Enquiry Committee (Jha Committee)

The Report of this Committee is an important landmark in the process of a long term shift to a system of VAT in our country. Growing dissatisfaction with our indirect tax system led the Centre, in July 1976, to appoint the Indirect Taxation Enquiry Committee under the chairmanship of Shri L.K. Jha. The Committee had very broad terms of reference. It was asked to study the issue of a balance between direct and indirect taxes; and to thoroughly review the existing structure of indirect taxes of Centre, States and Local Bodies, including their elasticity and buoyancy. It was to assess their existing incidence and the scope for their use as a policy tool for influencing resource allocation, etc. In particular, it was asked to examine the feasibility of a VAT, and if found feasible, the manner in which it should be implemented.

The Committee submitted its final report in October 1977. It noted that there had been a steady increase in the share of indirect taxes in India and that it was far greater than the corresponding figures in either developed or underdeveloped countries. But it maintained that it was not possible to lay down on a priori grounds an optimum proportion between the two. However, the Committee pointed out some prime criteria of soundness of an indirect tax system. These included adequacy, progressive incidence, and satisfaction of the conventional canons of taxation.

The Committee found that there were no set policy guidelines for prevalent system of indirect taxes. There was an abundance of unnecessary diversity in
Reforms in Direct and Indirect Taxes

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rates, coverage and procedures etc., especially in state level indirect taxes. Its biggest defect was its cost cascading impact with all the attendant ill-effects which included:

- Difficulties in controlling the incidence on final products;
- Incentives for vertical integration for captive consumption and tax evasion;
- Reduced effectiveness of indirect taxation as a policy tool; and
- Hindering exports.

Suggestions and Recommendations

The Committee made detailed recommendations for reforming the existing system of indirect taxes, based on the assumption that ‘the proposed changes should ensure an adequate and rising flow of resources to the Government and pave the way for an integrated indirect tax system in the country which should be more efficient, more equitable and better oriented to further the objective of planned development’. The recommendations of the Committee included a set of overlapping short-term and long-term measures. These are:

Custom Duties: The Committee recommended a lowering of import duties, on both raw materials and capital goods.

Excise Duties: The Committee argued in favour of replacing specific duties with ad valorem ones because of their lower regressivity, greater buoyancy and elasticity, and lesser need for frequent revisions. It also made detailed recommendations regarding their rate structure, slabs, exemptions and concessions.

Though it accepted the case for merging the sales tax with excise duties and earmarking the enhanced proceeds for the states, the state governments were against such a merger because of their unhappy experience with additional excise duties in lieu of sales tax. It, therefore, did not recommend this merger. Instead, it favoured a single point sales tax at the last stage and a lowering of the rates of Central sales tax.

Octroi: The Committee, like all earlier Committees, found octroi to be an obnoxious and a harmful levy. It emphatically recommended its abolition, even if it had to be done in stages. To accomplish this task, it recommended that alternative sources of funds should be identified for the local bodies.

VAT: There was also a need for and possibility of long-term reforms covering the tax system as a whole. In this context, the Committee made a strong case for the adoption of VAT. It recommended a VAT system at the manufacturing level—the so-called MANVAT. It was to start with 3 or 4 industries producing final products. Such a pilot project would enable tax administration to test out procedures and gradually extend the coverage of VAT.

In 1985, the Government introduced MANVAT under the name MODVAT or Modified VAT. The scheme left sales tax out of its purview because the latter was a state subject.
Over time, the term MODVAT has come to mean an arrangement under which the assessed tax liability of an assessee is reduced by the amount of taxes already paid on the inputs. Accordingly, an excise duty (or a sales tax) is termed MODVATABLE or VATABLE if this credit is allowed and non-modvatatable if this credit is not allowed.

Some Comments on Indirect Taxation

Historical Landmarks

The need for some fundamental changes in our system of indirect taxes was recognized long ago. The report of the Jha Committee had highlighted this need and suggested some preliminary preparatory measures in this direction. In response to the recommendations of the Jha Committee, VAT was introduced in 1985 by the Centre for some selected items. Over years, Union excise duties were progressively shifted to \textit{ad valorem} basis with features of a VAT. In 1991, Chelliah Committee recommended that a comprehensive VAT should replace the (i) existing system of Central Excise, (ii) the state sales tax, and (iii) other indirect taxes.

However, the states were apprehensive of replacing their sales tax with VAT, and feared an adverse impact on their revenue receipts. They also feared that they would lose an important policy tool with which to attract business investment. Moreover, in a sales tax regime, it was easier to manipulate rates, exemptions, rebates, tax holidays, and so on. In contrast, it was more difficult to incorporate such provisions in VAT, particularly when the aim was to have an inter-state uniformity. The response of business circles was also a mixed one since it involved self-policing and self-assessment and made tax evasion more difficult. Even then, the history of indirect taxes in our country is dotted with some significant reforms. Thus, both Union excise duties and state sales taxes have been shifted to VAT format relieving them of cost and price cascading effects. Central Sales Tax is in the process of being phased out. Tax rates at both the Centre and state levels have been reasonably rationalized, resulting in near absence of inter-state tax wars, and harmonization of classification has been achieved more or less satisfactorily. The slabs and rates of customs duties have also been reduced and the peak rate is fast approaching the ASEAN level. Classification and other procedural reforms have made a creditable progress.

A series of steps at facilitating the introduction of state-level VAT led to the convening of Chief Ministers’ Conference on 15th September 1998. The Conference set up an Empowered Committee of the State Finance Ministers, under the Chairmanship of Dr. Asim Kumar Dasgupta. The Committee worked untiringly for a number of years. In the process, doubts of states were clarified and the Centre promised to compensate them for the loss of revenue resulting from switching over from sales tax to VAT. Though hesitantly, all states and union territories replaced their general sales tax with VAT. However, adoption of VAT was only a step towards an eventual all-engulfing tax on goods and services.
Transforming Indirect Tax System into GST

[The observations given below are with reference to the status on the eve of scheduled introduction of GST in 2012–13].

Though a big step in the right direction, introduction of GST is bound to throw up several problems of its own, both seen and unseen. It is going to be the next leg of a long journey towards an ideal goal.

Deficiencies of the Existing Indirect Tax System

Receipts from indirect taxes have always been a dominating proportion of the total tax revenue. Even then, there was an absence of a well-considered and consistent long-term policy governing these taxes. The entire system of indirect taxes evolved in a haphazard manner with expedient measures and, in the process, acquired several demerits. It triggered tax wars between States, fed inflationary forces, worsened income distribution, created inter-sectoral distortions, prevented the achievement of a unified national market and eroded competitive strength of the Indian producers.

Switching over to VAT format has weakened some of these deficiencies. But our indirect tax system still suffers from several deficiencies, including the following prominent ones.

- Cenvat (Central VAT) does not cover chain of value addition in the distributive trade below the stage of production.
- Cenvat does not cover several Central indirect taxes, like the additional excise duties, additional customs duty and surcharges etc.
- In State-level VAT scheme, load of CENVAT on the goods has not been removed and the cascading effect of that part of tax burden remains intact.
- Several State taxes have not been subsumed in (that is, covered by) the VAT, such as Luxury Tax, Entertainment Tax, Entry Tax in Lieu of Octroi, etc.
- VAT on goods has not been integrated with tax on services at the State level.
- Although the burden of Central Sales Tax (CST) on inter-State movement of goods has been lessened with a reduction of CST rate, this burden has not been fully phased out.

Reforming the System

It is widely believed that the reformed regime of indirect taxes should satisfy the following criteria.

- They should be a rich and buoyant source of revenue receipts.
• Allocation of productive resources and comparative competitive position of suppliers should be determined by free working of *market mechanism*. Indirect taxes should, therefore, be *neutral* in their impact on
  i. resource allocation,
  ii. choice of techniques,
  iii. inter-sectoral competitiveness and terms of trade,
  iv. size of business units and their location, and
  v. supply costs and prices, etc.
• The system of indirect taxation should facilitate the creation of an all-India integrated and hurdle-free market.
• It should have a unified coverage of both goods and services.
• It should help us in acquiring and retaining international competitiveness.

**Essential Features:** It is rightfully claimed that only a single tax covering both goods and services (GST) and subsuming all Central and State indirect taxes (including service tax) can meet all the above-said criteria. Such a GST should have none or minimum necessary exempted items and should also cover inter-state transactions and imports.

However, ground realities demand that the reforms should be undertaken in a phased manner. Our federal fiscal structure necessitates that in the first stage, the GST model should have the following features.

• GST should have two parallel and independent segments, namely, the Central level GST (CGST) and state level GST (SGST). Thus an item may be simultaneously subjected to both CGST and SGST. Both should be vatable, but without cross utilization of input tax credit, that is, credit for input tax in one segment of GST must be utilized in the same segment.
• For the states, in SGST, there should be an optimum mix of their tax autonomy and need for an inter-state uniformity, that is, to the extent possible, rates of SGST in all states and union territories should be uniform.
• States should be allowed to tax services. The Constitution should be amended to allow both the Centre and states to levy service tax at a single rate.
• To the extent possible, all indirect taxes should be subsumed in the respective CGST or CGST, as the case be.
• The combined burden of CGST and CGST should be well within a reasonable limit.
• To the extent possible, exemptions (zero rate) and concessional rates should be applicable only to those items which deserve special treatment
Reforms in Direct and Indirect Taxes

for some specific reason, such as necessities, exports and items produced in special economic zones.

- There should be a threshold limit for registration of suppliers of goods and services, higher for the Centre and lower for the states. The Empowered Committee suggested that these threshold limits should be ₹10 lakh and ₹1.5 crore for SGST and CGST, respectively.

- Some states may suffer a loss of revenue when SGST is introduced and replaces their indirect taxes. The Centre should have an objective and efficient arrangement to estimate such losses and fully compensate the concerned states for five years.

- The Centre is also agreeable to allow the states to levy service tax, thus introducing a limited concurrency of taxation powers which till now is not at all there. To this end, the Constitution is to be amended.

The Empowered Committee took the view that duties and taxes levied on imports, tobacco products, items containing alcohol, and natural gas need separate treatment.

The suggestions of the Committee were as follows:

**Imports:** Both CGST and SGST should be levied on imports. The liability to pay them should be fixed on the destination principle and the tax revenue in case of SGST should accrue to the state where the imported goods and services are consumed. Full set-off should be available on the GST paid on imported goods and services.

**Items containing Alcohol:** GST should not be applicable to alcoholic beverages. Instead, existing practice of levying on them Sales Tax/VAT and/or excise duty should continue.

**Tobacco Products:** Tobacco products should be subjected to both GST and inter-state transaction tax (ITC). Centre should also be allowed to levy excise duty on tobacco products over and above GST without ITC.

**Petroleum Products:** The committee recommended that the existing arrangement of taxing petroleum products should continue and these products should be kept outside GST. Sales Tax could continue to be levied by the states on these products with prevailing floor rate. Similarly, Centre could also continue its levies on them. However, the Committee did not take a final view on whether Natural Gas should be kept outside the GST or not.

The Committee also made several procedural and administrative recommendations to ensure smooth introduction and working of the GST.

**Benefits**

Once an integrated system of taxation of goods and services is achieved, it is expected to spell several advantages including the following:

- Over time, tax revenue of both Centre and states would increase because of reduced evasion, better compliance, and better disclosure.
• The scope for using taxation as a policy tool for guiding resource allocation and investment pattern would be reduced. Consequently, these decisions would be guided by the market forces and would be more cost-effective.

• With tax evasion becoming more difficult, it would be possible to lower tax rates.

• Exports will benefit because of zero tax on exports and enhanced competitiveness of our export sector.

• It is claimed that VAT does not generate a cost-price cascading effect.

• A comprehensive VAT would help in the development of a unified market for the country as a whole and thereby stimulate economic growth.

14.2.2 Tax Reforms Committee (Chelliah Committee), 1991

In pursuance of its commitment to reform the tax system, the Government of India constituted the ‘Tax Reforms Committee’ in August, 1991 under the chairmanship of Prof Raja J Chelliah. It submitted its Interim Report on in December 1991, Final Report (Part I) in August 1992 and Final Report (Part II) in January 1993. The ToR of the Committee were quite comprehensive and asked it to address deficiencies from which our tax system suffered and make suitable recommendations for reforming it, so as to make it exhibit all the features expected of a good tax system.

The Committee discussed the feasible framework of an ideal tax system as also the extent to which this ideal had to be compromised in view of ground realities. It pointed out the deficiencies of the existing system and the faulty premises on which it had been erected. It also highlighted the fact that our tax system was an outcome of piecemeal and haphazard steps and lacked a long term vision. Several tax measures turned out to be self-contradictory and created a lot of uncertainty. This had resulted in only making our tax system unnecessarily complicated and with a wrong emphasis on the objective of additional resource mobilization (ARM). This was a faulty approach because of two reasons:

• The economy cannot and did not respond quickly enough to ever changing tax measures.

• The Government used most of the additional revenue for meeting its own expenditure needs.

The Committee observed that the taxpayer in general was increasingly convinced that under the circumstances it was no longer immoral to evade taxes. However, the Committee believed that, with an appropriate and comprehensive policy approach, our tax system could be cured of these ills and it could be made an effective instrument of fast, non-inflationary and equitable economic growth. To this end, the Committee aimed at making the tax system sensitive to the working of non-regulated market forces. Therefore, it recommended, with only a few exceptions, elimination of all exemptions, deductions

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and rebates. It recommended that the Government should give up its discretionary powers to alter statutory rates of excise and customs through executive notifications because this resulted in instability, complexity, irrationality and rate multiplicity of the tax structure.

Based on an analytical coverage of the existing tax structure, the Committee made several detailed recommendations which, in its view, met several criteria, such as, ensuring horizontal and vertical equity in taxation of personal income in conformity with the taxable capacity of the taxpayers. It recommended that wealth tax should be levied only on ‘unproductive’ assets.

In the field of indirect taxes, the Committee recommended, amongst others, lowering of import duties and reducing the number of import tariffs. Correspondingly, for domestic production, it recommended a simple and easily administrable VAT with only two or three rates. It also recommended that excise duties should be ad valorem and more items should be brought under them. Services should also be taxed.

The Committee also made detailed recommendations covering tax administration, procedures and audit etc. The stated thrust of these recommendations was to protect honest taxpayers from harassment and make tax officials accountable for their actions. The tax administration was to have a system of rewards for efficiency and honesty and punishment for lapses.

However, some of the recommendations of the Committee had the potential of unintended ill-effects as well. The Committee failed to notice the unbearable burden resulting from the tax structure visualized by it on honest taxpayers. For example, it considered even a self-occupied residential house an ‘unproductive’ asset and recommended that its value and notional income should be taxed. It overlooked a simple principle that current tax liabilities of a taxpayer should not exceed his current income. Its recommendations made tax compliance harder for honest taxpayers. Furthermore, the bifurcation of assets into productive and unproductive ones was such that it pushed the asset holders to shift from tangible assets into financial ones. It is a well-known fact that financial assets may help in the production of goods and services but by themselves they cannot produce the same. Similarly, in itself, the concept of a presumptive tax is highly meritorious. But its contents, as recommended by the Committee, were such that the tax authorities were forced to either fully trust the assessee or investigate every case thoroughly.

The Committee took note of the widespread defects in the existing corporate taxation, like favouring debt financing, encouraging mergers, double taxation of dividend incomes, distorting choice between corporate and non-corporate form of business, etc. However, in the name of improving the administration of tax system, the Committee recommended withdrawal of concessions for making donations to associations and institutions carrying out rural development or any scheme or project for promoting social and economic welfare. Similarly, deductions for business expenses were to be restricted to taxes and duties, etc. However,
while not allowing interest on any loan from any public financial institution, the Committee recommended that even contributions to provident funds and gratuity funds for the welfare of the employees, or similar other funds should not be deductible business expenses.

14.2.3 Task Forces On Direct And Indirect Taxes, 2002 (Kelkar Committee)

In September, 2002, two task forces were set up under the Chairmanship of Shri Vijay L Kelkar.

The Term of Reference (ToR) of the Task Force on Direct Taxes included:

- Rationalization and simplification of the direct taxes with a view to minimising exemptions, removing anomalies and improving equity;
- Improvement in taxpayer services so as to reduce compliance cost, impart transparency and facilitate voluntary compliance;
- Redesigning procedures for strengthening enforcement so as to improve compliance of direct tax laws; and
- Any other matter related to the above points.

Correspondingly, the terms of reference of the Task Force on Indirect Taxation were:

i. To review customs and Central excise law and procedures and make recommendations on their simplification, reducing cost of compliance and facilitating voluntary compliance;
ii. To make recommendations relating to increased use of automation for a user friendly and transparent tax administration;
iii. To review statutorily prescribed records, documents and returns and suggest their simplification;
iv. To make recommendations for in-built procedures for time-bound disposal of matters; and
v. Any other matter relating to legal provisions and administration for facilitating taxpayers and improving compliance.

The Task Force on Direct Taxes was required to submit a consultation paper to the Government containing the recommendations, including those on improvement in ‘taxpayer services’, and procedures for strengthening enforcement. Similarly, the Task Force on Indirect Taxes was required to submit a consultation paper containing its recommendations on simplification, reduction in the cost of compliance of customs and central excise duties, automation of tax administration, simplification of statutory returns, records, procedures for time bound disposal of matters and different aspects of legal provisions to facilitate taxpayers and to improve tax compliance. The consultation papers were submitted in November, 2002 and the final reports in December, 2002.
The Task Force on Direct Taxes took the stand that in personal taxation, the number of tax slabs should be few, their range should be wide, and the highest rate should be moderate. It also favoured elimination of all exemptions and removal of restrictions on the manner in which a saver may keep his savings. At the same time, for the sake of equity, its recommendations were meant to have a human face and protect the interests of the vulnerable sections. However, it did not favour a single tax rate because of its various drawbacks. The Task Force also made elaborate recommendations for reforming the tax machinery and making the entire tax system transparent and non-discriminatory.

I. Personal Income Tax

1. Increase in exemption limit to ₹1 lakh with a higher exemption limit for widows and senior citizens.
2. Replacement of three slabs by two slabs of tax; 20% up to an income of ₹4 lakh and 30% for incomes exceeding ₹4 lakh. Elimination of surcharge on income tax.
3. Elimination of Standard Deduction.
4. Reduction of interest on housing loans deductible from income from ₹1, 50,000 to ₹50,000. Alternatively, an interest subsidy of 2% on housing loans below ₹5 lakh.
5. A tax rental agreement whereby states should agree to let the Centre levy and collect tax on agricultural incomes and transfer the tax proceeds back to the states.
6. Elimination of various tax incentives for savings and interest income etc. (under Sections 80, 80L, and 10).
7. Deduction under Section 80CCC for contribution to pension funds to be increased from ₹10,000 to ₹20,000. The scope of this Section to be enlarged to cover a large number of pension/annuity schemes within this ceiling.

II. Corporate Taxation

1. Reduction in corporate tax to 30% for domestic companies. Tax rate for foreign companies to be 35%. Exemptions from tax on dividends and capital gains from listed equity.
2. General rate of depreciation to be reduced from 25% to 15%.
3. Elimination of minimum alternate tax (MAT).
4. Long-term capital gains to be aggregated with other incomes and taxed at normal rates. Exemption to continue if gains invested in a house or bonds of National Highway Authority.
5. Removal of exemptions under several Sections.
6. Income of mutual funds derived from short-term capital gains and interest to be taxed at a flat rate in the hands of the mutual funds.
7. Merger of tax on expenditure in hotels with service tax.

III. Both Personal and Company Taxation
Abolition of Wealth Tax.

IV. Tax Administration
There were a number of recommendations for improving the quality of tax machinery; including those on raids and seizures, enhancing accountability of tax officials, extension of PAN to all economic transactions, and so on.

Recommendations of the Task Force on Indirect Taxes

I. Excise Duties
1. All levies to be replaced by only one levy, namely, CENVAT.
2. Zero excise duty on life saving drugs and equipment, security items, food items and agricultural products; varying rates of duties on several other specified categories.
3. Duty exemption for small scale sector to be limited to only units with turnover of ₹ 50 lakh. Duty exemption limit for larger SSI units to be brought down gradually to ₹ 50 lakh.
4. Uniformity in all state legislations, procedures and documentation relating to VAT.
5. Extension of service tax in a comprehensive manner leaving out only a few services by including them in a negative list. A separate legislation on service tax to be integrated finally with the Central excise law.

II. Customs Duties
1. Multiplicity of levies to be reduced to three, namely, basic duty, additional duty, and anti-dumping duty.
2. A set of different specified duties on specified items, such as 150% on specified agricultural products and demerit goods.
3. All exemptions to be removed except in the case of life saving goods, goods of security and strategic interest, goods for relief and charities and international obligations including contracts.

III. Tax Administration
The Task Forces made a number of recommendations for making all procedures trust based, simple, fast and transparent, full automation of all Customs and Excise Commissionerates, etc.
Comment on the Task Forces’ recommendations:

1. The Task Forces made penetrating and far-reaching recommendations relating to reforms of tax administration. They were designed to improve the efficiency of the tax administration by making it less arbitrary and more transparent.

2. In the areas of excise and customs duties, need for specific exceptions to the general rules was recognized and recommendations made.

3. But the principle of essential exception and other factual realities were forgotten by the Task Force on Direct Taxes. It goes without saying there are forceful arguments in favour of simplifying our tax laws and procedures by removing avoidable exemptions, rebates and other concessions. However, in our country, certain specific facts dictate that these tax concessions should not be removed indiscriminately without considering their associated effects on certain economic activities and social groups. In the light of these facts, some of the recommendations of the Task Force should have been ignored or were suitably modified.

- Standard deduction was available only to the salaried classes. It so happens that this is the only class which can hardly escape its tax liability. The self-employed and the business classes are known to successfully conceal a part of their taxable incomes. Accordingly, removal of standard deduction created an added element of inequity as between different classes of taxpayers.

- Similarly, social security is nearly non-existent in our country. A large number of people depend upon income from specified savings. Therefore, removal of tax concessions on income from specified savings is not justified, unless the initial exemption limit is raised quite high and the rate of the first tax slab is very nominal.

- In our economy, house building occupies a special place. It has beneficial multiplier effects. It has a huge potential of generating income and employment and, in the process, reduce poverty and improve living standards of the masses. Tax incentives for housing activity are provided even in very rich countries like the United States. By recommending the phasing out of tax incentives on house building, the Task Force prescribed a deadly blow to the economy as a whole as also to the poor and middle classes.

- The Task Force recommended a levy of capital gains tax in such a manner that it would discourage saving and long-term investment and instead encourage consumption and short-term speculative transactions—something which cannot be justified for our poor economy.

- Recommendations of the Task Force were based upon the philosophy of discouraging saving and encouraging immediate consumption. The
Task Force forgot the basic reality that a developing country like ours needs savings and safe and remunerative avenues of their investment for accelerating and sustaining economic growth. The bubble of economic growth fed by current consumption cannot be sustained and is bound to result in a crisis sooner or later.

Guided by the recommendations of the Kelkar Committee, the measures taken by the Centre introduced additional complexities in our tax system, introduced some obnoxious taxes like the ‘Fringe Benefits Tax’, removed various exemptions and concessions which, instead of strengthening our social security system, weakened it further. Examples of such retrograde measures include (i) enlisting residential houses as unproductive assets, (ii) reducing incentives for savings, (iii) penalizing those who contribute towards rural welfare and uplift programmes or contribute to the education, health and housing etc. of their employees, and so on.

**Goods and Services Tax related Reforms**

In India, tireless efforts have been made over the past few years to work out a workable ‘optimum’ model of GST. In this context, apart from widespread discussions in academic and political circles, work done by the Empowered Committee of State Finance Ministers and the study done by the task force constituted by the Thirteenth Finance Commission deserve a special mention.

**The Empowered Committee**

Major recommendations of the Empowered committee in its First Discussion Paper of 10th November 2009 were as follows. These recommendations have both historical and academic value.

- There should be two separate and parallel components of GST, one at the Central level termed CGST and the other at the state level, termed SGST.
- GST should be applicable to all transactions of goods and services made for a consideration except exempted goods and services and transactions which are below the threshold limits.
- CGST and SGST should be paid into Central and state accounts separately.
- There should be no entitlement to cross utilization of input tax credit (ITC).
- Threshold limit for registration of dealers should be a turnover of ₹10 lakhs in the case of SGST and ₹1.5 crore in the case of CGST.
- The Committee also made several recommendations for ensuring an efficient, transparent, smooth and taxpayer friendly administration of GST.
- The following Central indirect taxes were to be subsumed under CGST, namely, (a) Central Excise Duty, (b) Additional Excise Duty, (c) Excise Duty levied under the Medicinal and Toiletries Preparation Act, (d) Service Tax, (e) Countervailing Duty, (f) Special Additional Duty of Customs, (g) Surcharges and (h) Cesses.
• The following state taxes were to be subsumed under SGST, namely, (a) VAT/Sales Tax, (b) Entertainment Tax except when levied by a local body, (c) Luxury Tax, (d) Tax on Lotteries, Gambling and Betting, (e) State Cesses and Surcharges in so far as they are related to the transaction of goods and services, (f) Entry Tax not in lieu of Octroi.
• Whether purchase tax should be subsumed under SGST or not was to be decided later.
• Petroleum products and items containing alcohol were to be out of the purview of GST.
• Tobacco products were to be subjected to SGST with ITC in addition to CGST without ITC.
• For inter-state transactions, an innovative model of integrated GST was to be adopted by an appropriate combination of CGST and SGST.
• SGST rate structure would be as follows. There would be a standard rate for general goods and a lower rate for necessities and items of basic importance; there would be a special rate for precious metals; there would be a list of exempted goods.
• CGST would also have a two-rate structure in line with the rate structure of SGST.
• Services would be subjected to a single rate for both CGST and SGST.
• Exact rates of CGST and SGST were not mentioned by the Committee.
• Exports and products of SEZs were to be zero rated, with the exception of those products of SEZs which were meant for domestic market.
• Where necessary, imports were to be subjected to both CGST and SGST, with complete set off facility.
• As regards Special Industrial Schemes, the tax exemptions and remissions, if at all needed, were to be converted into cash refund schemes.
  · The Committee emphasized the need for adequate compensation for those states which would lose revenue on the introduction of GST.

Task Force of Thirteenth Finance Commission
Task Force of the Thirteenth FC finalized its report in mid-December, 2009 and contained the following major recommendations. These recommendations have also their academic and historical value.
• GST should have two components, the Central GST and the state GST.
• The respective rates of CGST and SGST were to be 5% and 7% respectively.
• There would be no cross utilization of input tax credit.
• Sin goods should also be subjected to both CGST and SGST, without any tax credit even in the case of imports.
• Products of SEZs should be out of the purview of GST.
- There should be no area-based exemptions for small-scale industries.
- GST should also cover the power sector, financial services, and vehicles.
- CGST should subsume estate duty, service tax, additional customs duty, cesses, and surcharges.
- Taxes subsumed under SGST would include VAT, purchase tax, entertainment tax (unless levied by local bodies), entry tax, luxury tax, lotteries, gambling and betting, state surcharges and cesses, entry tax in lieu of octroi.
- There would be no unilateral revision of GST rates by a state or the Centre.
- The threshold limits for registration of dealers for SGST and CGST were to be a turnover of ₹10 lakh and ₹1.5 crore respectively.
- Exports were to be zero-rated.

**Goods and Services Act**

The salient features of Goods and Services Tax Act as in action since July 2017 are as under:

(i) GST is applicable on ‘supply’ of goods or services as against the present concept on the manufacture of goods or on sale of goods or on provision of services.

(ii) GST is based on the principle of destination-based consumption taxation as against the present principle of origin-based taxation.

(iii) It is a dual GST with the Centre and the States simultaneously levying tax on a common base. GST to be levied by the Centre would be called Central GST (CGST) and that to be levied by the States would be called State GST (SGST).

(iv) An Integrated GST (IGST) would be levied on inter-state supply (including stock transfers) of goods or services. This shall be levied and collected by the Government of India and such tax shall be apportioned between the Union and the States in the manner as may be provided by Parliament by Law on the recommendation of the GST Council.

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

(vi) CGST, SGST & IGST would be levied at rates to be mutually agreed upon by the Centre and the States. The rates would be notified on the recommendation of the GST Council. In a recent meeting, the GST Council has decided that GST would be levied at four rates viz. 5%, 12%, 16% and 28%. The schedule or list of items that would fall under each of these slabs has been worked out. In addition to these rates, a cess would be imposed on “demerit” goods to raise resources for providing compensation to States as States may lose revenue owing to the implementation of GST.
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(vii) GST would replace the following taxes currently levied and collected by the Centre:
   a) Central Excise Duty
   b) Duties of Excise (Medicinal and Toilet Preparations)
   c) Additional Duties of Excise (Goods of Special Importance)
   d) Additional Duties of Excise (Textiles and Textile Products)
   e) Additional Duties of Customs (commonly known as CVD)
   f) Special Additional Duty of Customs (SAD)
   g) Service Tax
   h) Cesses and surcharge in so far as they relate to supply of goods and services.

(viii) State taxes that would be subsumed within the GST are:
   a) State VAT
   b) Central Sates Tax
   c) Purchase Tax
   d) Luxury Tax
   e) Entry Tax (All forms)
   f) Entertainment Tax and Amusement Tax (except those levied by the local bodies)
   g) Taxes on advertisements
   h) Taxes on lotteries, betting and gambling
   i) State cesses and surcharges in so far as they relate to supply of goods and services.

(ix) GST would apply on all goods and services except Alcohol for human consumption.

(x) GST on five specified petroleum products (Crude, Petrol, Diesel, ATF & Natural Gas) would by applicable from a date to be recommended by the GSTC.

(xi) Tobacco and tobacco products would be subject to GST. In addition, the Centre would have the power to levy Central Excise duty on these products.

(xii) A common threshold exemption would apply to both CGST and SGST. Taxpayers with an annual turnover not exceeding Rs.20 lakh (Rs.10 Lakh for special category States) would be exempt from GST. For small taxpayers with an aggregate turnover in a financial year upto 50 lakhs, a composition scheme is available. Under the scheme a taxpayer shall pay tax as a percentage of his turnover in a State during the year without benefit of Input Tax Credit. This scheme will be optional.
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(xiii) The list of exempted goods and services would be kept to a minimum and it would be harmonized for the Centre and the States as well as across States as far as possible.

(xiv) Exports would be zero-rated supplies. Thus, goods or services that are exported would not suffer input taxes or taxes on finished products.

(xv) Credit of CGST paid on inputs may be used only for paying CGST on the output and the credit of SGST paid on inputs may be used only for paying SGST. Input Tax Credit (ITC) of CGST cannot be used for payment of SGST and vice versa. In other words, the two streams of Input Tax Credit (ITC) cannot be cross-utilised, except in specified circumstances of interstate supplies for payment of IGST. The credit would be permitted to be utilised in the following manner:

a) ITC of CGST allowed for payment of CGST & IGST in that order;
b) ITC of SGST allowed for payment of SGST & IGST in that order;
c) ITC of IGST allowed for payment of IGST, CGST & SGST in that order.

(xvi) Accounts would be settled periodically between the Centre and the States to ensure that the credit of SGST used for payment of IGST is transferred by the Exporting State to the Centre. Similarly, IGST used for payment of SGST would be transferred by the Centre to the Importing State. Further, the SGST portion of IGST collected on B2C supplies would also be transferred by the Centre to the destination State. The transfer of funds would be carried out on the basis of information contained in the returns filed by the taxpayers.

(xvii) The laws, regulations and procedures for levy and collection of CGST and SGST would be harmonized to the extent possible.

The whole GST system will be backed by a robust IT system. In this regard, Goods and Services Tax Network (GSTN) has been set up by the Government. It will provide front end services and will also develop back end IT modules for States who opted for the same.

Check Your Progress

1. What were the particular term of reference of Indirect Taxation Enquiry Committee headed by Mr. L.K. Jha?
2. How did the Centre respond to the Jha committee report?
3. Why and when did the Centre form the Chelliah Committee?
14.3 TRENDS IN REVENUE AND EXPENDITURE: AN OVERVIEW

In this section, you will study about the trends in receipts and expenditure.

14.3.1 Trends in Receipts

Bear in mind, the trends discussed in this section are till the year 2012-13. The trends for the later years have been presented in Table 14.1.

Table 14.1 Trends in Receipt

| Source: Receipts Budget 2018-19 |
A. Revenue Account

Revenue receipts of the Centre (net of states’ share) have shown an uninterrupted growth year after year. From a mere ₹406 crore in 1950–51, they were budgeted to reach ₹9,35,685 crore in 2012–13. For most of the period their rate of growth works out to be greater than that of the GDP. As a result, revenue receipts as a proportion of GDP have also registered a substantial increase. Further, tax receipts comprise more than four-fifths of total net revenue receipts of the Centre. Various factors have contributed to this outcome, including changing in the structure and coverage of the tax system.

1. Non-tax Revenue

Non-tax revenue is a small but important component of the revenue receipts of GOI and currently accounts for about 17% of its total net revenue receipts. Starting from a small figure of only ₹49 crore in 1950–51, they were budgeted to reach ₹1,64,614 crore in 2012–13. We may specifically note the following main features of non-tax revenue of GOI.

- **General:** Non-tax revenue is highly responsive to changes in the economy, as also price variations. Consequently, it has a tendency to show an uneven variation from year to year. In certain cases, it may even register a decline.
- **Administrative Receipts:** They have always been a small proportion of the total non-tax revenue receipts.
- **Dividends and Profits:** These are earnings from various forms of investment by the GOI including those in public undertakings (including railways). These receipts registered a rapid increase in 1990s and later. From just ₹716 crore in 1989–90, receipts under this head jumped to ₹13,578 crore in 2000–01, ₹50,250 crore in 2009–10 and ₹50,153 crore in 2012–13. As a proportion of total net revenue of GOI, ‘dividends and profits’ stood at 7.1% in 2000–01 and 5.4% in 2012–13.
- **Interest Receipts:** GOI is a major lender to the railways, states and UTs, and several other parties and receives interest on them around ₹20,000 crore p.a. There was a steady increase in interest receipts till 2003–04 followed by a rapid decline after that. In the past, GOI had pursued a policy of advancing sizable loans to states, union territories, public undertakings, and other parties year after year with resultant increase in its interest receipts. This trend persisted in spite of debt relief received by states under the recommendations of successive FCs. An overwhelmingly large proportion of GOI loans and advances was received by states and union territories. However, with a basic shift in the lending policy of GOI, a downtrend in absolute figure of interest receipts began in 2004–05. Also, with the institution of NSSF, the Centre ceased to borrow collections of small savings and re-lend them to states. In addition, the 12th FC also recommended an extension of this policy to the effect that the Centre should...
stop borrowing on behalf of states in the open market except in special cases. It also recommended that the Centre should adopt a policy of assisting states only through grants and not loans. The recommendations of the FC-XIII were also along similar lines. The combined effect of all these developments is reflected in the declining proportionate share of interest receipts in total non-tax revenue of the Centre. From 67.1% of total non-tax revenue receipts of the Centre, and 50.2% in 2003–04, this proportion was budgeted at 11.7% (₹19,231 crore) for 2012–13.

2. Tax Revenue

In 2012–13, tax revenue of GOI (net of states’ share) was budgeted at around 82.4% of its total net revenue receipts. Given below is a brief description of leading taxes levied and collected by the Centre.

(a) Direct Taxes

(i) Income Tax: It is a tax which is levied on the taxable income of the non-corporate taxpayers and is structured on a progressive slab system. It should be remembered that the Centre cannot tax agricultural income. The concept of taxable income of non-corporate taxpayers has been undergoing frequent and extensive changes. The concept has been studded with a variety of rebates and exemptions, but there has been a lack of long term consistency in these measures.

Gross yield from income tax has been quite substantial. It increased from ₹133 crore in 1950–51 to ₹1,89,866 crore in 2012–13. Actually, its rate of growth has been astoundingly fast since 2002–03. This rapid increase can be attributed to several factors including rising prices, removal/reduction of several exemptions and rebates, slight downward trend in initial tax rates, better collating of information and the like.

Before 80th Amendment of the Constitution, income tax was compulsorily shareable with the states. Now its net proceeds (with some deductions) form a part of the total divisible pool of Central taxes. However, cesses and surcharges levied on income tax are still not shared with the states.

(ii) Personal Consumption Expenditure Tax: Taxation of personal consumption expenditure (supplementing or replacing personal income tax) has been a subject of debate in our country. Earlier in the book, we have noted arguments for and against imposition of this tax, and the same need not be repeated here. Factually speaking, this tax, in various forms, has been levied now and then in India. It was first imposed on the recommendation of Professor Kaldor who considered it as an essential part of an integrated system of direct taxes. It was advocated as an effective measure for plugging all loopholes for tax evasion and for discouraging unnecessary consumption. However, the yield of this tax was very small and its administration very difficult.
It was abolished in 1962, reintroduced in 1964 and again abandoned in 1966. It was re-introduced on selected items in 1987–88.

A Study Group was constituted in 1986 to study the desirability and feasibility of levying a tax on personal consumption expenditure. The Group came to the conclusion that such a tax should not be levied either to replace or to supplement personal income tax. It believed that all the advantages expected from this tax could be derived from a suitably modified system of income tax. Moreover, expenditure tax was far more cumbersome to administer and expensive to collect.

(iii) **Interest Tax:** Interest income of a recipient is included in estimation of taxable income of that entity, with some exemptions and rebates including exemption of interest income of those entities (like banks) whose business is to earn interest. Here the head ‘interest tax’ refers to a tax on interest receipts of such exempted entities. A tax on interest earnings of banks was levied in July 1974, abolished in 1978–79, revived in 1980, withdrawn in 1985–86 and again levied in 1990–91 with some modifications in later years. In 1999–2000, it fetched ₹1,211 crore and was abolished after that.

(iv) **Some Other Direct Taxes**

**Wealth Tax:** It is an annual levy on non-agricultural net worth of individuals and Hindu Undivided Families. It was introduced in 1957 on the recommendations of Professor Kaldor. Yield from this tax has been quite moderate compared with that of other direct taxes levied by the Centre. It is noteworthy that, in 1992–93, ‘all productive assets’ were exempted from wealth tax. It was abolished on assets such as shares, bank deposits, fixed deposits, bonds, debentures, etc. However, so-called unproductive assets were subject to this tax and included residential houses, farm houses, urban land, jewellery, bullion, motor car, planes, boats, yachts, etc. It is obvious that the classification of assets into productive and unproductive categories is quite faulty. In 2012–13, this tax was budgeted to yield a revenue of ₹1,244 crore.

**Estate Duty:** This is a tax which is levied on the property left by a deceased person before it is passed on to his heirs. It is different from inheritance tax which a tax payer pays on the property inherited by him. Entire net proceeds of estate duty were assigned to the states. It was abolished in 1985–86 budget on account of its pernicious ill-effects and very low yield.

**Gift Tax:** This tax also has an interesting history. It was introduced in 1958 as a part of a set of direct taxes recommended by Prof. Kaldor. A tax on gifts was thought to prevent evasion of other direct taxes. It was not imposed upon gifts of small values and the rate of tax was determined on a slab system. However, it yielded a very small amount of only around ₹10 crores p.a. The budget for 1990–91 shifted the base of this tax from donor to the recipient. It was abolished with effect from 1st October, 1998. Some critics argue that its
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abolition helps tax evasion. However, those in favour of its abolition emphasise its extremely low yield and argue that it hampers free mobility of capital assets and comes in the way of capital formation and its efficient allocation.

Fringe Benefits Tax (FBT): This new variety of tax was introduced in the Central Budget for 2005–06 and was imposed on the corporate sector. The government machinery, at all levels, was exempt from this levy. FBT was defined as ‘any privilege, service, facility, or amenity directly or indirectly provided by an employer whether by way of reimbursement or otherwise to his employees (including former).’ However, FBT was not applicable to expenses for meeting statutory obligations, work hazards minimisation, and first-aid care in company-owned medical facilities. Thus, it was a tax which was levied on the employer for providing those collective benefits to the employees in which shares of individual employees could not be specifically estimated. Charitable institutions, trusts and funds that already enjoyed tax exemption, as also individuals and HUF engaged in business or profession were exempt from this tax. The Finance ACT 2005 identified 18 categories of such benefits, including contributions to superannuation funds for the employees. FBT evoked a widespread opposition and disapproval. It was a widely held view that this tax had all the features of a bad and obnoxious tax, including the following:

(a) It militated against welfare of the workers. It deprived them of an important means of social security by taxing contributions by the employer to even approved superannuation funds for employees.

(b) FBT was leviable in case an employer arranged to protect the workers against work hazards and provided first-aid through some outside agency.

(c) It was also likely to encourage capital-intensive technology in a labour-surplus country like ours and thereby hinder the growth of employment opportunities.

(d) It had a high compliance cost for the employers, and exposed them to the whims of and harassment by the tax-machinery.

(e) It ate into competitiveness of the entire Indian economy which, in an atmosphere of liberalisation and globalisation, was highly damaging to it. Consequently, apart from hindering growth of employment, it was also likely to weaken our external sector with all the attendant ill-effects.

(f) While most other countries were trying to simplify their tax regimes, FBT injected an unnecessary and avoidable complexity in the Indian tax system.

(g) FBT was highly inequitable because the government sector was not covered by it.
Under the pressure of these arguments, some provisions of FBT were made less stringent and it was finally abolished in 2009–10.

‘Banking Cash Transaction Tax’ and ‘Securities Transactions Tax’:
In 2005–06, the corporate sector was subjected to a levy of these two taxes also. GOI claimed that the primary objective of these levies was to plug possibilities of tax evasion, etc., and not revenue collection. However, guided by ground realities, the former was removed with effect from 1st April, 2009, but the latter tax was not removed. It is a tax at the rate of 0.125% of the value of shares bought and sold on a stock exchange irrespective of the profit or loss associated with these transactions. In 2012–13, its rate was reduced to 0.1%. It is likely to remain in effect even after the introduction of Direct Taxes Code.

(v) Corporation Tax: This tax is levied on the earnings of the corporate (that is, business) sector. It is defined in Clause (6) of Article 366 of our Constitution. Unlike income tax, corporation tax is not based upon a progressive slab system. However, the concept of taxable income of a corporate entity is subject to several deductions, rebates, and exemptions, etc., applicable from time to time.

Initially, yield from corporation tax was quite small compared with that from income tax. However, with the passage of years, it not only caught up with income tax but also raced ahead of it. Currently, it is around twice the yield of income tax. After 80th Amendment of the Constitution, Corporation tax has become shareable with states except cesses and surcharges on it.

Text book reasoning dictates that so far as possible, direct taxes should receive priority in the tax system. In line with this reasoning and in conformity with the situation prevalent in some advanced countries, economists have frequently advocated that Indian tax system should also be restructured so as to increase the share of direct taxation in its total tax revenue. However, factual position in our country does not allow implementation of this recommendation. Any good tax system should have an inter-sectoral balance. And the growth of our economy with a rapidly changing composition of our GDP dictates concentration on the exploitation of indirect taxes including the tax on services. Accordingly, the have been left with the option of only piecemeal changes in direct taxes.

(b) Indirect Taxes
These taxes have always contributed a very large proportion of Centre’s tax revenue. In 1950–51, Customs Duties and Union Excise Duties (UED) were the only main taxes in this category. These two yielded 63% of total gross tax revenue (that is, ₹225 crore out of ₹357 crore). Over years, yield from these two taxes registered a rapid increase and were supplemented by several new taxes, the latest ones being the service tax and some others, as also the proposed GST.
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Customs Duties: Till 80th Amendment of the Constitution, revenue receipts from customs duties were not shareable with states. Moreover, right from the beginning, an overwhelmingly large proportion of customs revenue was on account of import duties because, as a matter of policy, export duties were avoided by the Centre. Even in 2012–13, this item was budgeted to contribute only ₹11,584 crore out of total receipts of ₹186,694 crore.

Customs Duties were the biggest source (44%) of Centre’s tax revenue in 1950–51 with ₹157 crore out of total of ₹357 crore (net of state’s share). Over years, there has been a steady increase in revenue from these duties. In 2012–13, they were budgeted to contribute over 17% of the Centre’s gross tax receipts. Such a large proportion, in spite of the centre’s long term policy of lowering import duties on most items to the ASEAN level, is attributable to the following factors.

- There has been a rapid increase in the volume and value of our imports, particularly since the introduction of the policy of liberalisation, globalisation and switch from import-substitution to export-led growth. Partly, the increase in value of imports results from their increasing prices, and the duty receipts increase because of ad valorem rates.
- Quantitative restrictions have been removed under our commitments to WTO.
- The Centre has imposed several additional levies on imports (over and above Basic Duties).

Some Salient Features: Customs duties in India have a few noteworthy features including the following.

- Till early 1990s, our foreign trade policy, coupled with over-regulation of the domestic economy, was a strong hindrance in the growth of our foreign trade, and our share in the world trade was steadily registering a downtrend. Stringent import restrictions failed to provide a lasting remedy for our balance of trade deficit, because they were eroding our export competitiveness. Though, officially speaking, we were pursuing a policy of encouraging exports, in effect, they were subjected to all manners of obstructions. In addition, the government was also pursuing a policy of import substitution which hindered the import and adoption of new technology and management practices. Consequently, almost entire customs revenue was derived only from import duties. And this is roughly the position even now. We are still to find a long term solution of balance of trade deficit and facilitate foreign trade to the extent needed.
- With the introduction of liberalisation and globalisation as well as our obligations as a member of the WTO, the Centre is under pressure to lower import duties and avoid quantitative restrictions on imports. They are being brought down, in a phased manner, to the level prevalent in
ASEAN countries. This implies that any increase in customs revenue has to be a result of imports increasing faster than the reduction in duty rates.

- A compensatory increase in customs revenue may be expected due to an increase in prices of our imports in line with world inflation.

(ii) **Union Excise Duties:** An excise duty is a tax on the production of an item. Centre has the authority to levy excise duties on all items with the exception of a few ones reserved for the states. Receipts of Union Excise Duties (UED) were not shareable with states before the 80th Amendment of the Constitution. Currently, UED include Basic and Special Duties, Cess on Motor Spirit, Cess on High Speed Diesel Oil, National Calamity Contingent Duty, Surcharge on Motor Spirit, Surcharge on Pan Masala and Tobacco Products, Education Cess, and Secondary and Higher Education Cess.

**Phased Reforms:** It is noteworthy that in 1996–97, the Centre initiated a phased process of complete overhauling of excise duty structure. The objective was to boost productivity, cut costs, remove cost-price distortions caused by excise duties, and reduce tax evasion. And the Centre has succeeded, to a large extent, in achieving these objectives. The components of these reforms included:

- Shift to VAT mode;
- Shifting to *ad valorem* basis;
- Reduction in the number of tax slabs, and slabs of special duties;
- Removing sector specific and use-related exemptions;
- Extending concessions to small scale industries; and
- Simplification of assessment procedures.

Through successive budgetary modifications, a three-tier duty structure was achieved, and now only marginal changes are made to accommodate individual duty rates where need be.

Revenue from excise duties registered a commendable increase from just ₹ 68 crore in 1950–51 to ₹ 1,23,611 crore in 2007–08 and ₹ 1,93,729 crore in 2012–13. This uptrend is explained by several factors including the following:

- Economic growth;
- Rising prices and shift of excise duties from specific to *ad valorem* mode;
- Increasing coverage, a variety of cesses and surcharges;
- Better administration;
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- Making these duties more responsive to growth and diversification of the economy;
- Near complete shift from specific to ad valorem format; and
- Shift to VAT mode.

It is expected that the integration of taxes on goods and services in VAT format (GST) would provide a further boost to revenue from excise duties.

(iii) Service Tax: It is a tax on the provision of a specified service. It is in the nature of an ad valorem excise duty on a service. In our country, an excise duty may be levied only on a manufactured item. It is claimed that in the final analysis, we should have an integrated system of excise taxation covering both goods and services. With the states having switched to VAT (in place of sales tax) and with the phasing out of Central Sales Tax, such an integrated all-India tax on goods and services (GST) is scheduled to be introduced shortly.

Justification for taxing services lies in their growing share in our GDP. It is perceived to be most promising component of tax revenue in the years to come. Having realized the potential of this new form of taxation, the Centre introduced it on a selective basis in 1994–95. Since then, its coverage has been systematically extended. In 2012–13, it was extended to all services with the exception of those mentioned in the ‘negative list’. Also its basic rate was revised upwards in stages, and in 2012–13 it was raised from 10% to 12%. From ₹407 crore in 1994–95, it was budgeted to yield ₹1,24,000 crore in 2012–13 (11.5% of Centre’s gross tax receipts), registering hefty annual growth rate.

It is noteworthy that before 80th Amendment of the Constitution placed it in the Union List, the Centre was levying this tax under its residuary powers of taxation. However, as of now, unlike other Central taxes, service tax is not shareable with the states. Its actual levying and appropriation can be in the hands of both the Centre and the states as laid down by law by Parliament.

B. Capital Account

Capital receipts of the Centre comprise a variety of borrowings, deposits, grants, etc., as also recovery of loans and advances made by it to third parties. It should be kept in mind that in recent years, there has been a revision of the way in which capital receipts are recorded, and this makes it difficult to determine the yearly trend, and the data are often misleading. For example, while earlier all capital receipts were recorded as ‘net’ receipts, now several receipts are gross amounts. This is more so with receipts from the Public Account. In Tables 14.3 and 14.4, main components of net capital receipts are shown for the years 1979–80 to 2012–13, and exhibit following noteworthy features. These are

(a) Individual components of capital receipts are prone to violent fluctuations due to various unforeseen developments. This reflects in wide and
unpredictable variation in aggregate receipts as well. Prominent forces causing these variations included collections of small savings, recovery of loans (in pursuance of debt relief granted to states on the recommendations of the FCs), and ‘Other Items’.

(b) As a proportion of total receipts of GOI, they moved in the range of 26 to 54% with no consistent uptrend or downtrend.

(c) Component-wise some important facts are as follows:

- **Market Borrowings**: Centre has restructured its borrowing activities in line with market forces. In addition, instead of the Centre, collections of small savings are now borrowed by NSSF. When NSSF invests them in GOI or state securities, they are recorded as borrowings from the market. Amongst others, these developments have led to a rapid increase in the share of market borrowings in total capital receipts of the Centre, reaching a budgeted figure of 86.3% in 2012–13.

- **External Aid**: It is mainly in the form of loans and has always been a small, uncertain and widely fluctuating portion of Centre’s total capital receipts. Its inflow is closely linked with our balance of payments, foreign exchange reserves, and international political and economic climate. It was budgeted to be 1.8% of Centre’s capital receipts in 2012–13.

- **Recovery of Loans**: This item registered an uptrend in absolute terms in spite of debt relief granted to states by successive Finance Commissions and peaked during 2003–04 and 2004–05. But in subsequent years, there was a rapid decline in this item. In 2007–08, it touched a low of ₹ 5,100 crore. However, in 2008–09, it resumed its upward trend, touched ₹ 14,258 crore in 2011–12 and was budgeted at ₹ 11,650 crore in 2012–13.

- **Small Savings and State Provident**: Till the creation of NSSF, these two items registered an impressive increase in absolute terms, mainly due to an overall increase in household savings and the incentives for putting them in government hands. But the creation of NSSF brought about a drastic change in this arrangement. Now collections of small savings are picked up by NSSF as loans against itself and invested in securities of the Centre and state governments. In 2012–13, net receipts on these two accounts were respectively budgeted at ₹ 1,198 crore and ₹ 12,000 crore only.

- **Special Deposits**: This item includes investments with GOI of a part of net accretions to non-Government provident funds, superannuation and gratuity funds and surplus funds of LIC, GIC, Employees’ State Insurance Corporation, etc. From mid-1980s to mid-1990s, this item occupied a leading position in capital receipts of GOI. Since then, there has been a substantial decline in its percentage share in total capital receipts, and since 2006–07, it has totally vanished. This outcome is
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mainly attributable to the policy of liberalisation pursued by the government.

- **Other Items:** This category of receipts is an amalgam of several miscellaneous items and is, by its very nature, highly volatile. For example, as a percentage of total capital receipts of GOI, this category varied from (-) 0.12 in 2010–11 to 17.3 in 2011–13 and 2.0 in 2012–13.

- **Disinvestment of PSU Equity:** Recording sales proceeds of erstwhile investments of GOI in PSU as capital receipts is conceptually debatable. Even then, there have been wide fluctuations in this item on account of market uncertainties, infirmities in official policy, and other factors. The targets set for disinvestment have been frequently missed. The target for 2012–13 was ₹30,000 crore.

### 14.3.2 Trends in Expenditure

Public sector investment and consumption expenditure have constituted important constituents of effective demand in the Indian economy. The investment process was initiated in the planning period with the public sector being in charge of the “commanding-height” of the industrial sector, representing infrastructure, heavy industries and defence that required heavy doses of capital formation.

The spurt in public investment during the late Seventies reflected government’s response to the second oil shock by expansionary adjustment through increased investment and reorienting investment for boosting oil production and removing infrastructural constraints. However, in the wake of two successive monsoon failures in 1986 and 1987, the government had to resort to expenditure cuts that affected capital formation. Since the mid-Eighties, the public sector capital formation slackened which, however, did not narrow the saving-investment gap of the public sector as the public sector saving deteriorated more rapidly than investment. The asset-wise distribution of public sector capital formation shows the predominance of investment in construction rather than machinery and equipment reflecting its greater accent on infrastructure. A noteworthy feature has been a decline in the share of construction in the gross fixed capital formation in the public sector with a corresponding increase in that of machinery and equipment up to the Nineties which has somewhat reversed thereafter reflecting renewed emphasis on infrastructure.

Up till the mid-eighties, public sector consumption witnessed an upward trend that reflected the overall expansion in the government sector. Since the mid-eighties, public sector consumption has shown sporadic episodes of expansion resulting from the revision of government employees’ salaries and wages. Many economists have raised concerns regarding the sustainability of the growth process in the late nineties. The public sector outlays reflected the change in government strategy regarding the development and growth process. Simultaneously, the government’s role was rationalized allowing market forces to have a greater role. There were serious implications arising from the increased borrowings and
monetization of government deficits on the overall investment and growth of the economy. This was evident from the macroeconomic crisis occurring in the early nineties. This resulted in the need of fiscal consolidation and a number of measures in terms of government expenditure and revenue. However, due to the need of aligning tax rates with international standards revenue enhancement got restrained and therefore the fiscal correction was done mainly from the expenditure side.

**Government expenditure pattern**

Government expenditure comprises expenditure on economic, social and general services. The pattern in government expenditure since the Eighties has been mainly influenced by a change in role of the government in the growth process, financing pattern of the deficits (debt and interest payments) and the need for fiscal consolidation. As noted above, the revenue mobilization was constrained by the need for rationalization of tax structure and aligning the tax rates with international standards. Despite the initiation of tax reforms in the early Nineties, in the Indian context, the typical “Laffer curve effect” did not fructify and expected increase in tax buoyancies did not occur. The tax-to-GDP ratio of the centre declined from an average of 9.9 per cent during the Eighties to 9.7 per cent in the first half of the Nineties. In this scenario, the only way out from the macroeconomic crisis was to undertake an expenditure compression strategy. Accordingly, the overall size of the government sector (centre and states) expenditure after reaching a peak of 32.3 per cent of GDP in 1986-87 showed a steady decline till first half of the Nineties. However, on account of predominance of committed expenses, curtailment could not take place in the revenue expenditure. The overall pattern in expenditure was primarily shaped by the central government while the states’ expenditure remained.

As noted above, there has been a slowing down of public sector capital formation since the Eighties which is also reflected in the switch in pattern of government expenditure more towards revenue expenditure. The sharp increases in revenue expenditure reflected continued growth in non-plan expenditure on account of interest payments, subsidies, administrative and defence expenses.

**i. Interest payments**

The widening of fiscal deficit and consequent rise in debt stocks during the last two decades have resulted in mounting expenditure on interest payments. The debt-to-GDP ratio rose from 40.4 per cent of GDP at the beginning of the Eighties to around 62 per cent by the beginning of the Nineties. The fiscal consolidation process in the first half of the Nineties facilitated some control in the debt burden of government. However, the fiscal stress in the latter half of the Nineties again built up the debt burden.

As a result of the mounting debt burden of the government, interest payments registered substantial increases during the Eighties. The interest burden kept on increasing even in the second half of Nineties despite a softer interest rate regime reflecting impact of sizeable outstanding liabilities contracted at higher interest rates.
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ii. Subsidies
Expenditure on subsidies is a crucial element of government expenditure particularly in the light of targeting poverty alleviation and the growing need to rationalise expenses for fiscal consolidation. The total burden of subsidies on government finances should take into account, in addition to the explicit subsidies, several implicit subsidies in the form of lower user charges for economic and social services provided by the government. The major element of explicit subsidies is food subsidies which is determined by the minimum support price of food grains, operational efficiency of public distribution.

iii. Wages, salaries and pensions
The rising bill in respect of wages, salaries and pensions is considered to be an important element in the fiscal health of the government, particularly in the recent years. These components partly represent the committed expenditure obligations of the government. An intertemporal analysis of the behaviour of the expenditure on these components shows periodic spurts co-terminus with the implementation of wage revisions. For instance, the impact of Fifth Pay Commission Award by the central government could be seen in the rise of spending on wages.

iv. Defence
The central government also undertakes revenue and capital expenditures for defence purposes which act as a public good at the national level.

Check Your Progress

4. Name the amendment till which revenues from receipts custom duties were not shareable with states.
5. In which light is expenditure on subsidies a crucial element of government expenditure?
6. What is wealth tax?

14.4 PUBLIC DEBT IN THE POST-REFORM PERIOD

Normally, the government of a country has a large variety of debt obligations. Therefore, public debt may be defined in several ways covering their alternative combinations and to suit the purpose of the definition. Thus at one extreme, it may include all financial liabilities of a government (including its currency) while at the other extreme, it may include only a few of them. A clear cut stand has also to be
taken regarding inter-governmental obligations like loans from the Central Government to the States. Similarly, a decision is required as to whether the central bank of the country is to be considered a part of the government or not for the purpose of estimating the volume and composition of public debt.

It would be helpful if we have a brief idea of the type of obligations which the government of a country usually incurs.

Firstly, there is the currency itself. Generally, however, the government creates only a part of the currency; the rest is created by the central bank of the country. Therefore, the entire currency circulating in the market can be a part of public debt only if the central bank is classified as a part of the government sector. In any case, currency obligations normally remain dormant or inactive and the government does not “pay them off”. At the most one set of currency is replaced by another set and that is all.

Secondly, another set of obligations of the government constitutes its short-term debt. These obligations are normally of a maturity of less than one year at the time of issue and consist of items like the treasury bills.

Thirdly, some obligations do not have any specific maturity but may be repayable subject to various terms and conditions. They are referred to as floating debt. Examples of this category include provident funds, small savings, reserve funds and deposits, and so on. In India, the Government of India has also issued certain special securities to meet its obligations towards international institutions like the International Bank for Reconstruction and Development and the International Monetary Fund. These special securities may be called special floating debt.

Fourth category of government obligations consists of the permanent or funded debt. Such loans have a maturity of more than one year at the time of issue. In practice, their maturity is usually between three and thirty years. Some of them may even be non-terminable (or perpetuities) so that the government is only to pay the interest on such debt without ever repaying the principle amount.

Fifthly, obligations owed to foreigners - governments, institutions, firms and individuals are called external loans. They may have a variety of maturities and be subject to a variety of terms and conditions.

It should be clear by now that depending upon the purpose and context, institutional arrangements and so on, different people could define public debt differently. At one extreme all financial obligations of the government including the demand debt (that is currency obligations) are sought to be included in the definition of public debt, while in other cases only some of the above-mentioned categories of obligations are considered. In general, however, the currency obligations of the government are usually excluded from the definition of the public debt and only the floating, funded, external and other obligations are included in it.
Public Debt and Private Debt

In certain respects government borrowings resemble the private ones. Like a private borrower, the government may also borrow either for consumption or for investment purposes. It will also be paying interest on such borrowings. But the dissimilarities between the two are more glaring. These are as follows:

(i) A private economic unit cannot borrow internally, that is to say, it cannot borrow from itself. However, the government usually borrows internally, that is, from its own subjects and from within the country.

(ii) While a private economic unit can repay the debt either out of its earnings or out of its accumulated assets or by borrowing from other sources (thus substituting one debt for the other), such need not be the case with the government. The government is the creator of currency and can pay its debt straight-away by creating more of it. The fact that it usually does not do so only reflects its concern for the welfare and stability of the economy and not the lack of its power to do so. However, external debt can be discharged in this manner only if it is repayable in local currency. But creation of domestic currency cannot be the means of repaying it if the foreign debt is repayable in foreign currency or gold. In that case, foreign currency will have to be procured through export earnings or through some other means, failing which gold will have to be paid out.

(iii) Public borrowings have a profound effect on various dimensions of the economy, distribution, capital accumulation, economic growth, income and employment stability, and so on. This way, public debt is both a source of problems and a tool of economic management in the hands of the authorities.

14.4.1 Effects of Public Debt

A. Contribution to the Financial System of the economy: Economic growth brings monetisation of an increasing proportion of economic activities. In other words, economic activities result in corresponding financial transactions. As a result, the financial requirements of the economy increase both absolutely and in relation to the national income. Financial assets may be divided into two parts, viz., ‘inside money’ and ‘outside money’. The former refers to financial claims against the private sector of the economy while outside money refers to financial claims against the government sector. Simultaneously, government obligations act as an acceptable and sound base for the private financial assets. Credit being ultimately an expression of confidence, its best base can only be the government obligations. There is no risk of default in their case and they have a ready marketability and these qualities are not found in as much measure in private debt obligations. Therefore, existence of government debt becomes a precondition for the existence of a developed financial system of the economy.
B. Contribution to the saving effort of the Economy: An underdeveloped country is characterized by a shortage of capital resources. Since the saving capacity of the masses is very low, the authorities have to take appropriate measures to step up rates of saving and investment in the economy. Resorting to public borrowings and investing the same is one of the several measures that can be adopted for this purpose. However, the net effect of public borrowings also depends upon the sources from which they come.

1. In the case of borrowings from the market, if the public reduces its own consumption and lends its savings to the government, the result will be a net increase in the rate of savings. This may happen if people voluntarily save more under the temptation of an interest income. However, if loans to government are given by diverting the savings from private investment, then there would be no net increase in saving and investment activity. But public loans can still help economic growth through reallocation of resources. Public investment is more likely to be in the capital goods sector while private investment tends to concentrate in consumption goods sector because of its greater profitability.

2. When the authorities borrow from the central bank of the country, there is an addition to aggregate money supply in the country. This causes an addition to demand and an upward pressure on prices. A part of the supplies is purchased away by the authorities by spending the newly created money and the market is left with smaller supplies. In that sense, this process of forced savings and capital accumulation is not always a desirable one on account of its harmful inflationary effects.

Public Debt and Inflation

The above considerations lead us to look at the relationship between public debt and inflation. Most governments’ market borrowings only divert funds from the market into the hands of the government. As a result, there is no net addition to aggregate demand and hence no increased pressures on prices.

This reasoning is quite misleading because it tries to hide some basic facts. These are:

Firstly, even if public debt does not add to aggregate demand, it is bound to be inflationary because the economy’s productive resources get diverted from the production of consumption goods into that of capital goods. By their very nature, investment goods industries have longer gestation periods and therefore for the intervening period, the demand for consumption goods tends to exceed their supply.

Secondly, borrowings used for war activities, for meeting natural calamities and for other relief measures are most likely to be inflationary in their impact because they are basically consumption-oriented.

Thirdly, when a government borrows from the central bank, there is an addition in money supply which in turn adds to demand and pushes up prices.
Fourthly, holding of public debt by commercial banks can also lead to an addition in demand and inflationary pressures. Banks rate government securities as highly liquid which can be encashed at any time without much of capital loss. This assured liquidity position, therefore, tempts them to increase their loans and advances and thus add to the inflationary pressures in the market.

However, if public debt is used to bring about an increase in productivity of the economy leading to an increased supply of the demanded goods, inflationary forces would be checked to that extent. In addition, the authorities may resort to price controls, rationing and other measures to keep prices under control.

14.4.2 Public Debt as a Means of Regulating the Economy

It is possible to regulate the economy’s financial system through variations in the volume, composition and yield rates of public debt. A lengthening of the maturity composition of public debt is expected to reduce its over-all liquidity, while a shortening is expected to have the opposite effect. The authorities therefore can swap longer maturities with the shorter ones and vice versa as a matter of policy. Since public debt usually forms a major portion of the total supply of credit in the country, liquidity variations in it become an important policy tool in the hands of the authorities. In the process they affect the yield structure of the public debt and other financial assets. There are of course differences of opinion as to the exact margins by which variations in public debt affect the yield structure on public debt and the yield structure in the economy but the fact of its existence cannot be denied.

Ownership of government securities enables its holder to quickly and easily convert it into spendable purchasing power. Therefore, through various public debt policies the authorities can directly influence the sum total of purchasing power or ‘liquidity’ of the public debt. However, public debt is an imperfect substitute of money so that one rupee of public debt can do the job of less than a rupee of cash. Further, shorter-maturity debt is a closer substitute for money than the longer maturity one because it carries a smaller capital risk.

A lot of discussion has taken place on this question in economic literature. The classical philosophy of laissez faire equated a sound budgetary policy with that of private budgeting. Just as a private economic unit cannot and should not run into a persistent deficit, similarly, the government should avoid repeated deficits. Any deficit, indebting the government to the market, should be wiped out as soon as possible. “The national debt used to be regarded as an aftermath of war, an incubus to be swept away as quickly as the tax-payer would allow; and the management of the debt used to consist of a search for the cheapest way of dealing with a nuisance.” In line with this philosophy, public debt was often divided into productive and dead-weight categories. The general idea was that the government should not raise loans for consumption activities; at the most it may do so for the investment activities only. Public debt should not become a drain upon its budget. Debts raised during a war etc. were, therefore, very obnoxious according to this approach.
The same line of reasoning, that is, interest payment on public debt should be taken to represent a "burden of debt" was emphasized and elaborated by E. D. Domar. He related the interest payments to the level of national income and thus pointed out that as interest on debt as a proportion of national income rises, a larger portion of national income will have to be taxed to pay that interest. We must, however, remember that the tax revenue collected for interest payment, is being disbursed to the debt holders. The burden that arises from a large public debt and a large tax collection for interest payment, therefore, really depends upon three things. These are:

Firstly, it depends upon the resources used in administering the tax collections and interest payments.

Secondly, it manifests itself in the form of a loss of manoeuvrability in the public budget and related constraints.

Thirdly, it depends upon the distributive effects that such a process generates. If, for example, through this taxation and interest payments, the income inequalities increase, public debt may be claimed to have added to the burden of the debt. In India, for example, most of the funded public debt and treasury bills are owned by the Reserve Bank of India and other institutions. This, therefore, does not cause any distributive problem through interest payments. Additionally, the government obligations arising out of provident funds, small savings and so on are generally owned by middle class income groups and this again is expected not to increase the income inequalities. Financing of these interest payments, however, may be forcing the authorities to resort to indirect taxes, which of course tends to increase inequalities.

There have been other views also according to which public debt is burdensome. Some of these views are not completely logical because they distinguish between the private and government sectors of the economy and try to consider the effect upon private sector only that also, in many cases, without conceding the fact that there are transfers from the government sector to the private sector also. Thus, one such view is that debt financing is burdensome as compared with tax financing because it involves future taxation also to service the debt. We have seen above that the burden involved here may arise out of extra cost to the economy in conducting all these operations and through their re-distributive effects but not on account of these transfers as such. These transfers are within the economy from some economic units to the others. The real worrisome burden of debt which these discussions leave out is the erosion of budgetary manoeuvrability. An increasing portion of budgetary expenditure becomes a committed component and the public authorities are not able to take policy decisions in full freedom. In case the debt is too large, they fall into a debt trap wherein fresh borrowings are needed to service the existing debt. Large public borrowings raise the interest rates and not only increase interest cost for the government but also cause distortions in the working of the economy.

While internal debt does not cause a direct variation in resource availability for the country, external debt does. At the time of contracting external loans, the
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debtor country gains in terms of real resources. It either gets consumption goods or capital goods from the lender country. However, at the time of interest and principal repayments, an outflow of resources takes place. In ordinary terms, if the borrowing country had acquired consumption goods, it would not add to its productive capacity and so at the time of repayment of the loans, there will be a net loss of resources. To the extent that the loans carried interest also, the outflow of resources will be larger than was the inflow. It must, however, be remembered that it need not always be so. Since final payment of the debt has to be in terms of excess of exports over imports, the net outflow will also depend upon the changes in terms of trade from the time of contracting the loans to the time of their repayment. If the terms of trade have moved in favour of the debtor country, then to that extent the burden of the debt is reduced. The debtor country may even gain in the net.

Foreign loans, however, may be used for investment purposes in which case the productive capacity of the debtor country will increase out of which the debt repayment can take place. In this case, therefore, there need not be any net burden. Of course, if the loans have not been invested in export-oriented industries, or if otherwise the exports of the debtor country do not increase, then there will be balance of payments difficulties at the time of repayment. This has happened with many underdeveloped countries. Their net earnings of foreign exchange have not increased sufficiently. While many African countries are not able to repay their foreign debts because they are too poor, a number of Latin American countries have failed in generating the export surplus needed for meeting their debt obligations and have walked into an external debt trap. Numerous plans and proposals have brought only insufficient relief and the Third World Debt has registered a heavy increase since the beginning of 1980s.

Debt Redemption

The traditional thinking on this problem has already been noted. It prescribed a policy of paying off the public debt as soon as possible (though in practice some governments defaulted in debt repayment and even repudiated it). Current thinking, however, considers debt retirement in the context of over-all debt and fiscal policies of the government and favours repayment of the debt under normal conditions.

One simple way of ending the debt obligations is to repudiate the debt. But it is wrong on the part of the government to do so. It hits the credit of the government and creates difficulties for future borrowing programmes. It is disastrous for the financial system as a whole and more so for those individual creditors who had invested their life-long savings in government debt or who were relying upon the interest payments as a regular source of income.

There are two systematic approaches for retiring public debt. The first is to create a sinking fund in which the government regularly puts in some money and uses the accumulated fund for periodic and partial retirement of the debt. The second approach is that of regularly retiring a small portion of the debt every year. It is obvious that for either method of debt retirement, the government budget
must have an over-all surplus. Alternatively, the government may resort to printing of additional currency.

Sinking fund approach is practised by a number of countries. But this method can succeed in retiring the debt only if the government has a substantial budgetary saving every year, uses the saved amount for this purpose and does not resort to additional borrowings. Interest earned on the balances should also be credited to the sinking fund. In olden days, public debt was usually raised during wars and other emergencies and could not be paid off quickly. Therefore, sinking fund technique was considered a sound and practical one. However, of late, this practice has degenerated into only a semblance of it. Compared to the total outstanding debt the amounts credited to the fund are paltry. Sometimes authorized amounts are not credited to the fund or they are even diverted to other uses.

The method of paying off a portion of the debt every year may be effected in two ways. The loans outstanding may have staggered maturity dates. The public debt in this case can be in the form of serial bonds. The advantage of this method is that the repayment obligations are well-spread over time and do not concentrate the burden in a single year. It may not, however, be always possible to serialize the existing bonds without unduly disturbing the government bonds market. Accordingly, the second method adopted is that of earmarking a portion of the budget for debt retirement, purchasing the bonds in the market and cancelling them. The danger with this method is that it is of a voluntary character. Under short-term pressures, a government may not adhere to the practice steadfastly and there may be ‘gap’ years.

When the government does not want to reduce its outstanding debt obligations, it may ‘fund’ the maturing loans. This means that the existing debt is converted into a new one of longer maturity. The holders of maturing debt are given an option to subscribe to the new debt by surrendering the older one. In addition, fresh cash subscriptions may also be accepted. Funding is considered quite a legitimate alternative to retiring the debt when the government is not in a position to do so or does not want to do so for policy reasons. In India, it is a normal practice to borrow in excess of maturing loans resulting in a continuous addition to our public debt.

**14.4.3 Growth of India’s Public Debt**

Lack of credit growth forced commercial banks to buy government securities in bigger numbers, taking their share in outstanding government securities marginally higher in the quarter ended June 2010. The share of mutual funds, however, continued to decline, their share dropping to 0.38% of the total, less than half of a year ago, data on public debt showed.

India’s overall public debt increased marginally by 2.8% to ₹ 27.77 lakh crores in the first half of the current financial year, but better management saw average maturity of outstanding long-term increase to 9.83 years at end-September 2010 from 9.71 years at end-June 2010. The average coupon (or interest rate) of
outstanding stock also dropped to 7.85% from 7.79% over the same period. In the first quarter it had gone up by 4.2%, according to the finance ministry's quarterly report on public debt for the second quarter. Internal debt constitutes 89.4% of the government's total public debt.

The government reduced its borrowing target for the current financial year by ₹10,000 crore to ₹4.47 lakh crore, thanks to windfall revenue from auction of 3G telecom licences and buoyant tax collections.

The central government ran up a fiscal deficit of ₹1.33 lakh crore in the first half of the current fiscal, or 35% of the budgeted ₹3.81 lakh crore for the whole year. By the same time last year, the government’s fiscal deficit was almost half of that budgeted. The fiscal deficit, or the excess of expenditure over receipts that has to be met with borrowed funds, for the entire year is pegged at 5.5% of GDP.

Banks continued to dominate as the major investor category with further increase in their share in holding of government securities to 51.7% at end-June 2010 from 50.6% at end-March 2010.

### Table 14.2 Debt Position of the Central Government (in Actuals)

<table>
<thead>
<tr>
<th>Components</th>
<th>Actuals</th>
<th>Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Public Debt (A1+A2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2489920</td>
<td>2523192</td>
<td>4996708</td>
</tr>
<tr>
<td>B. Internal Debt (A+B)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2467315</td>
<td>3326623</td>
<td>3749564</td>
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<tr>
<td>a. Marketable Securities (i-v)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>787685</td>
<td>7640859</td>
<td>7450057</td>
</tr>
<tr>
<td>(i) Treasury Bills</td>
<td></td>
<td></td>
</tr>
<tr>
<td>718619</td>
<td>7552770</td>
<td>301177</td>
</tr>
<tr>
<td>(ii) Bills 1st December</td>
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<td></td>
</tr>
<tr>
<td>109869</td>
<td>352305</td>
<td>566015</td>
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<tr>
<td>(i) 14 Day Interim T-Bills</td>
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<td></td>
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<tr>
<td>105810</td>
<td>487379</td>
<td>50180</td>
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<tr>
<td>(ii) 15 Days Interim T-Bills</td>
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<td>26485</td>
<td>39358</td>
<td>15226</td>
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<td>(iii) Debts issued to Int. Trad. Institutions</td>
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<td></td>
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<tr>
<td>76275</td>
<td>76275</td>
<td>76275</td>
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<tr>
<td>(iv) Debts issued to Int. Trad. Institutions &amp; Other Obligations</td>
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<td></td>
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<tr>
<td>318985</td>
<td>61668</td>
<td>235162</td>
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<tr>
<td>(v) Special issue under PDS</td>
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<td></td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>B. External Debt (A+B)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>278871</td>
<td>322977</td>
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<td>(a) National Small Savings Fund</td>
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<td>47955</td>
<td>47955</td>
<td>47955</td>
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<tr>
<td>(b) State Provident Fund</td>
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<td></td>
</tr>
<tr>
<td>20975</td>
<td>20975</td>
<td>20975</td>
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<tr>
<td>(c) Other Accounts</td>
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<td></td>
</tr>
<tr>
<td>90967</td>
<td>90967</td>
<td>90967</td>
</tr>
<tr>
<td>(d) Reserve funds and Deposits</td>
<td></td>
<td></td>
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<tr>
<td>987262</td>
<td>113671</td>
<td>113671</td>
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<tr>
<td>(e) Saving schemes</td>
<td></td>
<td></td>
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<tr>
<td>50457</td>
<td>50457</td>
<td>50457</td>
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<tr>
<td>(f) Other Savings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>95120</td>
<td>95120</td>
<td>95120</td>
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<tr>
<td>C. Total Liabilities (A+B)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3538980</td>
<td>4152784</td>
<td>780065</td>
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</table>

Source: ‘Status Paper on Government Debt’ (Feb 2018), Department of Economic Affairs, Ministry of Finance
Table 14.3 Debt Position of the Central Government (as a percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<th></th>
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<tbody>
<tr>
<td>A. Public Debt (A1+D2)</td>
<td>43.1</td>
<td>40.5</td>
<td>37.0</td>
<td>35.1</td>
<td>33.0</td>
<td>31.0</td>
<td>29.0</td>
<td>27.2</td>
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<tr>
<td>a. Marketable Securities (a1i)</td>
<td>70.1</td>
<td>57.7</td>
<td>51.1</td>
<td>41.6</td>
<td>34.6</td>
<td>31.5</td>
<td>28.2</td>
<td>24.7</td>
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<tr>
<td>(i) Direct Securities</td>
<td>77.6</td>
<td>76.4</td>
<td>10.9</td>
<td>11.1</td>
<td>11.9</td>
<td>11.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>(ii) Treasury Bills</td>
<td>1.1</td>
<td>2.3</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
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<tr>
<td>b. Non-marketable Securities (b1c)</td>
<td>2.9</td>
<td>4.2</td>
<td>1.1</td>
<td>0.6</td>
<td>0.8</td>
<td>0.6</td>
<td>0.6</td>
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<tr>
<td>(i) 14-Day Intermediates TBs</td>
<td>1.3</td>
<td>1.1</td>
<td>1.2</td>
<td>0.8</td>
<td>0.7</td>
<td>0.7</td>
<td>0.7</td>
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<tr>
<td>(ii) Unrecognized &amp; Other Debts</td>
<td>0.4</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
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<td>(iii) Securities issued from the Reserve Bank</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
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<tr>
<td>c. Securities against small savings</td>
<td>3.8</td>
<td>4.2</td>
<td>5.5</td>
<td>7.0</td>
<td>7.1</td>
<td>7.1</td>
<td>7.1</td>
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<tr>
<td>(i) Special SDs against PPF</td>
<td>0.0</td>
<td>0.3</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>A1. External Debt</td>
<td>3.6</td>
<td>3.7</td>
<td>3.3</td>
<td>3.3</td>
<td>3.0</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>E. Public Account Other Liabilities to Rs.</td>
<td>1.0</td>
<td>0.7</td>
<td>0.1</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>(a) National Road Development Fund</td>
<td>0.5</td>
<td>0.7</td>
<td>0.8</td>
<td>1.0</td>
<td>0.8</td>
<td>1.0</td>
<td>0.8</td>
<td>0.8</td>
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<tr>
<td>(b) State/Local Fund</td>
<td>1.4</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>(c) Other Accounts</td>
<td>3.0</td>
<td>3.2</td>
<td>2.6</td>
<td>2.8</td>
<td>2.5</td>
<td>2.3</td>
<td>2.1</td>
<td>1.9</td>
</tr>
<tr>
<td>(d) Reserve Bank &amp; Deposits (i.e)</td>
<td>1.7</td>
<td>1.5</td>
<td>1.4</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>(e) Other Interest</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>(f) Net Interest</td>
<td>0.7</td>
<td>0.7</td>
<td>0.6</td>
<td>0.6</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>C. Total Liabilities (i=1)</td>
<td>45.8</td>
<td>43.2</td>
<td>42.3</td>
<td>43.0</td>
<td>42.3</td>
<td>43.7</td>
<td>46.1</td>
<td>44.2</td>
</tr>
</tbody>
</table>

Source: “Status Paper on Government Debt” (Feb 2018), Department of Economic Affairs, Ministry of Finance

Check Your Progress
7. Which set of government’s obligations are referred to as floating debt?
8. What are the two approaches of retiring public debt?
9. Mention the situation in which the government may ‘fund’ the maturing loans.

14.5 ANSWERS TO ‘CHECK YOUR PROGRESS’ QUESTIONS

1. In particular, the Committee headed by Mr. L. K. Jha was asked to examine the feasibility of a VAT, and if found feasible, the manner in which it should be implemented.

2. In response to the recommendations of the Jha Committee, VAT was introduced in 1985 by the Centre for some selected items. Over years, Union excise duties were progressively shifted to ad valorem basis with features of a VAT.
3. In pursuance of its commitment to reform the tax system, the Government of India constituted the ‘Tax Reforms Committee’ in August, 1991 under the chairmanship of Prof Raja J Chelliah. The ToR of the Committee were quite comprehensive and asked it to address deficiencies from which our tax system suffered and make suitable recommendations for reforming it, so as to make it exhibit all the features expected of a good tax system.

4. Till 80th Amendment of the Constitution, revenue receipts from customs duties were not shareable with states.

5. Expenditure on subsidies is a crucial element of government expenditure particularly in the light of targeting poverty alleviation and the growing need to rationalise expenses for fiscal consolidation.

6. Wealth tax is an annual levy on non-agricultural net worth of individuals and Hindu Undivided Families. It was introduced in 1957 on the recommendations of Professor Kaldor.

7. Some obligations of the government do not have any specific maturity but may be repayable subject to various terms and conditions. They are referred to as floating debt. Examples of this category include provident funds, small savings, reserve funds and deposits, and so on.

8. There are two systematic approaches for retiring public debt. The first is to create a sinking fund in which the government regularly puts in some money and uses the accumulated fund for periodic and partial retirement of the debt. The second approach is that of regularly retiring a small portion of the debt every year. It is obvious that for either method of debt retirement, the government budget must have an over-all surplus. Alternatively, the government may resort to printing of additional currency.

9. When the government does not want to reduce its outstanding debt obligations, it may ‘fund’ the maturing loans. This means that the existing debt is converted into a new one of longer maturity. The holders of maturing debt are given an option to subscribe to the new debt by surrendering the older one. In addition, fresh cash subscriptions may also be accepted.

14.6 SUMMARY

- Growing dissatisfaction with our indirect tax system led the Centre, in July 1976, to appoint the Indirect Taxation Enquiry Committee under the chairmanship of Mr. L.K. Jha. The Committee had very broad terms of reference.

- The Committee headed by Mr. L.K. Jha submitted its final report in October 1977. It noted that there had been a steady increase in the share of indirect taxes in India and that it was far greater than the corresponding figures in either developed or underdeveloped countries.
• The report of the Jha Committee had highlighted this need and suggested some preliminary preparatory measures in this direction. In response to the recommendations of the Jha Committee, VAT was introduced in 1985 by the Centre for some selected items. Over years, Union excise duties were progressively shifted to ad valorem basis with features of a VAT.

• A series of steps at facilitating the introduction of state-level VAT led to the convening of Chief Ministers’ Conference on 15th September 1998. The Conference set up an Empowered Committee of the State Finance Ministers, under the Chairmanship of Dr Asim Kumar Dasgupta.

• Based on an analytical coverage of the existing tax structure, the Chelliah Committee made several detailed recommendations which, in its view, met several criteria, such as, ensuring horizontal and vertical equity in taxation of personal income in conformity with the taxable capacity of the taxpayers. It recommended that wealth tax should be levied only on ‘unproductive’ assets.

• The Task Force on Direct Taxes took the stand that in personal taxation, the number of tax slabs should be few, their range should be wide, and the highest rate should be moderate. It also favoured elimination of all exemptions and removal of restrictions on the manner in which a saver may keep his savings.

• The Task Forces made penetrating and far-reaching recommendations relating to reforms of tax administration. They were designed to improve the efficiency of the tax administration by making it less arbitrary and more transparent.

• Guided by the recommendations of the Kelkar Committee, the measures taken by the Centre introduced additional complexities in our tax system, introduced some obnoxious taxes like the ‘Fringe Benefits Tax’, removed various exemptions and concessions which, instead of strengthening our social security system, weakened it further.

• It is noteworthy that in 1996–97, the Centre initiated a phased process of complete overhauling of excise duty structure. The objective was to boost productivity, cut costs, remove cost-price distortions caused by excise duties, and reduce tax evasion.

• Capital receipts of the Centre comprise a variety of borrowings, deposits, grants, etc., as also recovery of loans and advances made by it to third parties. It should be kept in mind that in recent years, there has been a revision of the way in which capital receipts are recorded, and this makes it difficult to determine the yearly trend, and the data are often misleading.

• Public sector investment and consumption expenditure have constituted important constituents of effective demand in the Indian economy. The investment process was initiated in the planning period with the public sector being in charge of the “commanding-height” of the industrial sector,
representing infrastructure, heavy industries and defence that required heavy doses of capital formation.

- Government expenditure comprises expenditure on economic, social and general services. The pattern in government expenditure since the Eighties has been mainly influenced by a change in role of the government in the growth process, financing pattern of the deficits (debt and interest payments) and the need for fiscal consolidation.

- The rising bill in respect of wages, salaries and pensions is considered to be an important element in the fiscal health of the government, particularly in the recent years. These components partly represent the committed expenditure obligations of the government.

- Some obligations do not have any specific maturity but may be repayable subject to various terms and conditions. They are referred to as floating debt. Examples of this category include provident funds, small savings, reserve funds and deposits, and so on.

- Since the saving capacity of the masses is very low, the authorities have to take appropriate measures to step up rates of saving and investment in the economy. Resorting to public borrowings and investing the same is one of the several measures that can be adopted for this purpose.

- In case the debt is too large, they fall into a debt trap wherein fresh borrowings are needed to service the existing debt. Large public borrowings raise the interest rates and not only increase interest cost for the government but also cause distortions in the working of the economy.

- Sinking fund approach is practised by a number of countries. But this method can succeed in retiring the debt only if the government has a substantial budgetary saving every year, uses the saved amount for this purpose and does not resort to additional borrowings.

- The method of paying off a portion of the debt every year may be effected in two ways. The loans outstanding may have staggered maturity dates. The public debt in this case can be in the form of serial bonds.

- Funding is considered quite a legitimate alternative to retiring the debt when the government is not in a position to do so or does not want to do so for policy reasons. In India, it is a normal practice to borrow in excess of maturing loans resulting in a continuous addition to our public debt.

14.7 KEY WORDS

- ToR: Terms of Reference (ToR) defines the purpose and structures of a project, committee, meeting, negotiation, or any similar collection of people who have agreed to work together to accomplish a shared goal.
• **Fringe Benefits Tax (FBT):** This is a tax payable by employers for benefits paid to an employee (or an employee’s associate e.g. a family member) in place of salary or wages. This is separate to income tax and is calculated on the taxable value of the fringe benefits provided.

• **Floating debt:** This is a short-term debt that is continually refinanced, renewed, or rolled over to meet ongoing operational requirements.

• **Sinking fund:** A sinking fund is a fund established by an economic entity by setting aside revenue over a period of time to fund a future capital expense, or repayment of a long-term debt.

### 14.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

#### Short Answer Questions

1. What were the short- and long-term measures which were recommended by the Jha committee for reforming the indirect tax system?

2. What did the Chelliah Committee recommend to remove widespread defects in the existing corporate taxation?

3. Enumerate the stand taken by Task Force on Direct Taxes on personal taxation.

4. Write a short note on various taxes under Direct Tax which are levied and collected by the Centre.

5. What are the main components of capital receipts of the Centre?

6. Why has public debt in the Third World countries registered a heavy increase since the beginning of 1980s?

7. Explain the set of obligations which constitute the part of government’s short-term debt.

#### Long-Answer Questions

1. Discuss the impact of suggestions and recommendations by successive committees in reforming India’s direct and indirect tax system.

2. Analyse the measures taken by the Centre in response to Reports submitted by the tax-reforming committees.

3. Discuss how do indirect taxes contribute a very large proportion of Centre’s tax revenue.

4. Analyse the role of public debt as a means of regulating the country’s economy.

5. Discuss the growth of public debt in India.
14.9 FURTHER READINGS


