Manonmaniam Sundaranar University

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Tirunelveli – 627 012. Tamil Nadu.

M.A. Economics
(Second Year)

PUBLIC FINANCE

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Public Finance

Objectives

1. To know the different types of goods
2. To gain sound knowledge on public expenditure
3. To understand the basic ideas of taxation
4. To equip the students with the knowledge of budgeting
5. To get familiar with the concept of fiscal federalism.

Unit I- Role of the Government in Economic Activity

Role of Public Finance – Major fiscal functions – Private goods – Public goods Mixed goods – Merit goods – Social goods – Market failure – Positive and Negative Externalities.

Unit II – Public Expenditure

Canons – Reasons for the growth of Public Expenditure – Theories of Public expenditure: Wages – Musgrave – Peacock Wiseman – Colin Clark – Samuelson – Effects of public expenditure.

Unit III – Public Revenue and Public Debt

Sources of Revenue – Taxation – Types: Direct – Indirect – Progressive – Proportional – Regressive – Degressive – Impact, Incidence and effects of taxation – Taxable capacity – Elasticity and Buoyancy – Tax Reform – VAX – GST. Public Debt: Causes – Sources – Growth and composition of public debt in India – Burden of public debt – Redemption of Public debt.

Unit IV – Public Budget and Deficit Financing

Purpose of Budget – Procedure – Kinds of Budgets: Balanced and Unbalanced – Revenue and Capital – Zero – base budgeting – Performance Budgeting – Different concepts of budget deficits – FRBM Act 2003. Deficit Financing: Meaning – Methods – Effects – Limitation – Deficit Financing in India.

Unit V – Fiscal Policy and Fiscal Federalism

Fiscal policy: Objectives – Instruments – Neutral, Compensatory and functional finance – Fiscal reforms in India. Fiscal federalism: Division of Functions – Division of resources – Union, State and Concurrent Lists – Union-State Financial relations – Horizontal and

Vertical imbalances – The Finance Commission – Functions – Major recommendations of the 14th and 15th Finance Commission.

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UNIT-I

ROLE OF THE GOVERNMENT IN ECONOMIC ACTIVITY

Introduction

Public finance is the branch that deals with the government's revenue and expenditure. Public Finance plays an essential role in stabilizing the supply, allocating the resources, and distribution and development of the state.

Definition of Public Finance

American Economist Richard Musgrave is the founder of modern public economics is the father of public finance. Philip E. Taylor says that public finance is a study of taxation, public expenditure, public debt management etc. R.A. Musgrave says, "The complex problems that centre on the revenue-expenditure process of government is traditionally known as public finance."

The public finance into five sections which are-

1. Public Revenue, 2. Public Expenditure, 3. Public Department, 4. Fiscal Policy and 5. Financial Administration

The Public Department functions under the direct control of the Chief Secretary and deals with important matters that concern the General Administration of the State. Public administrators are the public employees who are working in public departments and agencies, at different levels of government. The fiscal policy helps the government in collecting revenue and expenditure to influence a country's economy. A fiscal administration exhibits the reality of the government and the public organization in their provision of public goods or services for the citizens of the country.

Role of Public Finance in Stabilizing the Supply

The economy continues to face blooms and depression. This causes instability in the market. To cope up with incapability, public finance is one of the tools. The policies like deficit budgeting and surplus budgeting during the time of depression and bloom respectively help to achieve economic stability. Deficit spending is when the amount spent exceeds the revenue at a particular time. A budget surplus is when the income or the receipts are more than the expenditures or the outlays.

Role of Public Finance in the Allocation of Resources

The economy has two types of goods, known as private goods and public goods. Private goods are exclusive; this means that the person buying them will get the benefits from it. However, public goods are non-exclusive in nature and anyone and everyone get the benefit of them. Public finance deals with allocating the public funds in such a way that everyone gets the benefit of them, equally and without any discrimination. The government looks after maintaining the law and order, defense against foreign attacks, building infrastructure, and more.

Role of Public Finance in Distribution and Development

There are large disparities in income and wealth. This disparity sows the seed of crime in society. Public finance works on cutting down these disparities by its distributing function. It helps in the corrective distribution by charging high taxes from the rich and paying subsidies to the poor, by using the technique of progressive taxation, or by imposing high taxes on the luxury goods. It helps the economy to grow as a whole and promote development in the areas that have been earlier left behind.

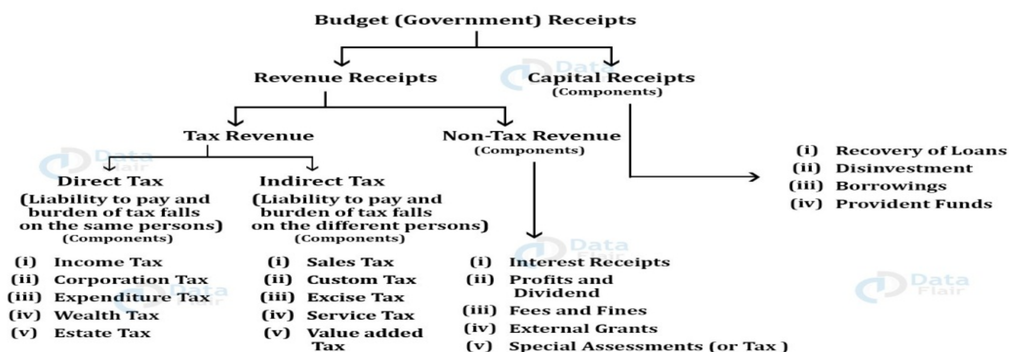
Sources of Government Revenue

Government revenue is the money that the government receives through the taxes and the non-tax sources to undertake government expenditures. The revenue receipts are recurring in nature.

A receipt is a revenue receipt if –

1. It does not create any liability for the government.
2. It should not lead to a fall in the assets of the government.

The revenue receipts are non-redeemable and can be further classified into the tax revenue and non-tax revenue.



Forms of Taxes and Subsidies

A tax is a compulsory payment that the people do to the government. There is a further division of taxes into direct taxes and indirect taxes.

Direct Taxes

Direct taxes are those taxes imposed on the property and the income of an individual or a company. This type of tax is directly paid to the government. Direct tax affects both the income level and the purchasing power of the customer. These systems can be progressive, regressive, or proportional. Examples of direct taxes are property tax, income tax, value-added tax, estate tax, gift tax, and more.

Indirect Taxes

These types of taxes impose on goods and services and are compulsory payments. These taxes affect the income and the property of an individual through their consumption expenditures. Examples of indirect taxes are sales tax, entertainment tax, excise duty, and more.

Non Tax Revenue

However, taxes are not the only medium for the government to earn revenue. There are some sources other than taxes, which are called the Non-Tax revenue. Some of the major sources of the non-tax revenue are –

a. License Fee

The license fee includes the fees charged for the attainment of the license from various industries like petroleum, communication services, broadcasting, and more.

b. Fines and Penalties

Fines and Penalties include the revenue that the government collects from the people or the organization that have violated the law of order in one way or the other.

c. Interests

This is the interest on the loans that the government has given to different states of the union territories across the country. The states and the UTs borrow loans to implement a plan or policy.

d. Power Supply Fees

It includes the fee received by the Central Electricity Authority from the power supply under the act of electricity supply.

e. Fees for Communication Services

These fees come under the subhead of the license fees. It includes the fees that are collected from the communication services companies or the telecom operators.

f. Escheats

It is a common law doctrine which transfers the real property of a person who has died without heirs to the State.

Subsidy

A subsidy is a financial aid that the government provides to an economic sector. This is to promote economic and social policy. A subsidy can be either a direct subsidy or an indirect subsidy. Cash grants and interest-free loans are examples of direct subsidy. Insurance, low-interest loans, tax breaks, etc are examples of an indirect subsidy.

There are various types of subsidies. Some of them are listed below:

a. Production Subsidy

This subsidy helps to encourage the suppliers to increase the output of a particular product by helping them cut their costs. It helps to expand the production of goods, which will promote the market and at the same time, not increase the price of the goods for the consumers.

b. Consumption Subsidy

The consumption or the consumer subsidy helps to encourage consumer behaviour. This subsidy is very common in developing countries. As to promote consumer wellbeing, the government subsidizes water, electricity, living, and more.

c. Export Subsidy

An export subsidy is the support of the government that is extended for the products that are exported. However, this subsidy is known for being abused.

d. Import Subsidy

An import subsidy is a support from the government for the products that get imported. It helps in reducing the price of the products that are imported. It can also lead to the redistribution of income.

e. Employment Subsidy

Employment subsidy helps to promote job opportunities in the market. With the promotion of job opportunities, it also helps to cut down the unemployment rate in the country.

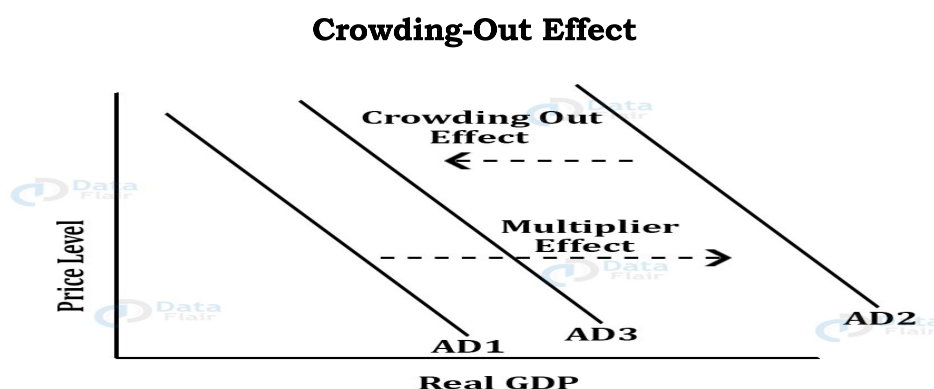
f. Transport Subsidy

Transport subsidies extend to the rail and bus service sectors. It helps in decreasing the pollution caused to the environment and also helps to reduce congestion on the roads.

g. Oil Subsidy

Oils subsidies help in cutting down the price of the oil for the consumers. This also leads to an increase in the demand for oil in the market.

Crowding-Out Effect



When the increased interest rates lead to a fall in the private investment spending in such a way that it depresses the initial increase of the total investment spending, it is known as the crowding-out effect. It happens when the government raises the taxes to fund the introduction of new welfare programs or the expansion of the existing ones. Due to higher taxes, the individuals and businesses are left with lesser discretionary income to spend. There are several effects of public expenditure on the economy. Some of them are listed below –

1. Effect on Production

Public expenditure increases production capacity. Income savings also increase and create a beneficial effect on investment and capital formation. However, sometimes it also ends up bringing adverse effects on people's willingness to work and save.

2. Effect on Distribution

The main aim of the government is to maximize the social benefit and the objective of social welfare can be attained by the help of government expenditure. Its purpose is to collect the excess income from the rich in the form of taxes and spread it into the hands of the poor in the form of subsidies. This can also be stated as the redistribution of income.

3. Effect on Consumption

This expenditure helps to redistribute the income in the favour of the poor. With that, it promotes consumption and other economic activities. It further helps to strengthen the capacity to save and consume.

4. Effect on Economic Stability

Public expenditure is a tool to strengthen economic stability in times of depression, recession, or inflation.

5. Effect on Economic Growth

Keeping in mind the growth prospects, the government allocates the funds to various departments like industry, agriculture, transport, education, and more. This helps to promote the idea of balanced growth and makes sure no sector is behind.

Conclusion

It is important to acknowledge the fact the economy cannot stay stable throughout the year and it needs a backup mechanism to help it through whenever the things go down the line. Public Finance helps to maintain this stability and sets the economy through all the ups and downs. Tax and Subsidies are also some of the mechanisms of public finance. They help in allocating the resources, redistributing the income, and maintaining stability.

Functions of Public Finance

The following are the functions:

1. Management of income and expenditure by optimum utilization of the resources.
2. Managing the growth and price stability in the economy.
3. Providing the necessary needs and infrastructure to the public.
4. Take initiatives for the development of the people, which can contribute to the nation's development.
5. Maintaining the transparency of the policies and the records of income and expenditures.
6. Compare the actual position with the budgets and accordingly alter the policies and manage the economy.
7. Monitor the functioning and effectiveness of the financial policy.
8. Preparing the economic policies for the nation's development and the economy.

Public Good and Private Good:

1. The upcoming discussion will update you about the difference between public good and private good.
2. A pure public good is a good or service that can be consumed simultaneously by everyone and from which no one can be excluded. A pure public good is one for which consumption is non-revival and from which it is impossible to exclude a consumer. Pure public goods pose a free-rider problem. A pure private good is one for which consumption is rival and from which consumers can be excluded.
3. Some goods are non-excludable but are rival and some goods are non-rival but are excludable.

1. The first feature of a public good is called non-rivalry. A good is non-rival if consumption of one unit by one person does not decrease available units for consumption by another person. An example of non-rival consumption is watching a television show.

2. A private good, by contrast, is rival. A good is rival if consumption of one unit by one person does decrease available units for consumption by another person. An example of rival consumption is eating a burger.
3. The second feature of a public good is that it is non-excludable. A good is non-excludable if it is impossible, or extremely costly, to prevent someone from benefitting from a good who has not paid for it. An example of a non-excludable good is national defence. It would be difficult to exclude a foreign visitor from being defended.
4. A private good, by contrast, is also excludable. A good is excludable if it is possible to prevent a person from enjoying the benefits of a good if they have not paid. An example of an excludable good is cable television. Cable companies can ensure that only those people who have paid the fee receive programmes.
5. Table 2 classifies goods by these two criteria and gives some examples of goods in each category. Goods like Lighthouse, National defence are known as pure public goods. One person's consumption of the security provided by our national defence system does not decrease the amount available for someone else — defence is non-rival. The army cannot select those whom it will protect and those whom it will leave exposed to threats — defence is non-excludable.

Table 2 : Private vs. Public Goods

	Pure private goods	Excludable and non-rival
Excludable	Food Car House	Cable television Bridge Motorway
	Non-excludable and rival	**Pure public goods**
Non-excludable	Fish in the ocean Air	Lighthouse National defence
	Rival	**Non-rival**

1. Many goods have a public element but are not pure public goods. An example is a motorway. A motorway is non-rival until it becomes congested. One more car on the Delhi Ring Road with plenty of space does not reduce the consumption of road services of anyone else.
2. But once the motorway becomes congested, one extra vehicle lowers the quality of the service available for everyone else — it becomes rival like a

private good. Also, users can be excluded from a motorway by toll gates. Another example is fish in the ocean.

3. Ocean fish are rival because a fish taken by one person is not available for anyone else. But ocean fish are non-excludable because it is difficult to stop other countries taking them if they are outside a country's territorial limits.
4. Public goods create a free-rider problem. A free rider is a person who consumes a good without paying for it. Public goods create a free rider problem because the quantity of the good that they person is able to consume is not influenced by the amount the person pays for the good. Markets fail to supply a public good because no one has an incentive to pay for it.

Mixed goods

Mixed goods possess characteristics of both private and public goods. These goods and services are common in the real world and raise several vital questions about the economic role of government. A mixed economy consists of both private and government/state-owned entities that share control of owning, making, selling, and exchanging good in the country. Two examples of mixed economies are the U.S. and France. As the name suggests, mixed goods possess characteristics of both private and public goods. These goods and services are common in the real world and raise several vital questions about the economic role of government.

Merit goods

Merit goods are the opposite of demerit goods - they are goods which are deemed to be socially desirable, and which are likely to be under-produced and under-consumed through the market mechanism. Examples of merit goods include education, health care, welfare services, housing, and fire protection, refuse collection and public parks. In contrast to pure public goods, merit goods could be, and indeed are, provided through the market, but not necessarily in sufficient quantities to maximise social welfare. Thus goods such as education and health care are provided by the state, but there is also a parallel, thriving private sector provision. Indeed, there is considerable disagreement between economists on the right and left of the

political spectrum over the extent to which such goods should be provided by the state or the private sector. We consider these arguments later in this section.

Before we proceed with our discussion of merit goods, and in particular the question of why merit goods tend to be underprovided by the market, it would be useful at this stage to summarise the main differences between public goods, private goods and merit goods. Have a go at filling in the blank table below. Once you have had a go, follow the link under the table to compare your answers with ours.

Main features of public, merit and private goods - full table

Merit goods will tend to be underprovided by the market because:

- they generate positive externalities;
- there is an unequal distribution of income;
- consumers may lack perfect information;
- consumers may be uncertain as to their future needs; and
- Monopoly power may arise.

We shall examine each of these factors in more detail in turn below:

Merit goods generate substantial positive externalities

Merit goods confer benefits on society in excess of the benefits conferred on individual consumers; in other words, there is a divergence between private and social costs and benefits, as the social benefits accruing to society as a whole from the consumption of such goods tend to be greater than the private benefits to the individual. This divergence means that the private market cannot be relied upon to ensure an efficient allocation of society's scarce resources. The problem is that individual consumers and producers make their decisions on the basis of their own, internal costs and benefits, but, from the standpoint of the welfare of society at large, externalities must be considered. This point can be illustrated in relation to health care and education:

Health care generates a number of positive externalities; for example, if all people receive adequate levels of healthcare, the nation's workforce is likely to be fitter and healthier, less working days would be lost through sickness, and this would have beneficial effects on the level of output and

economic growth; vaccinations and preventative health care which prevent the spread of contagious diseases such as small-pox and whooping cough, clearly not only benefit the individuals receiving the treatment, but also the rest of society at large. Indeed, a major reason for the relatively weak economic performance of many of the poorer countries of the world is the widespread incidence of ill-health and disease amongst their populations.

Similarly, in the case of education, there are a number of positive externalities from which society at large may benefit, which may not directly accrue to the individual pupil/student. Individuals clearly derive private benefits from higher levels of education as, for example, earning capacity is to a considerable extent a function of educational attainment. However, society at large receives the benefits of a more highly skilled, adaptable and thus more efficient workforce, which is one of the key ingredients of economic success - the West German post-war 'economic miracle' has, in part, been attributed to its highly educated and trained workforce. Society also benefits in less tangible ways as it could be argued that educated people are less prone to crime and racial intolerance, although this argument is obviously not foolproof!

The important point then is that if people had to pay privately through the market for such merit goods as health and education they would consider only their private benefits and their private costs and would thus consume too little from the point of view of the best interests of society as a whole. This problem of under-consumption is illustrated in Figure 1 below.

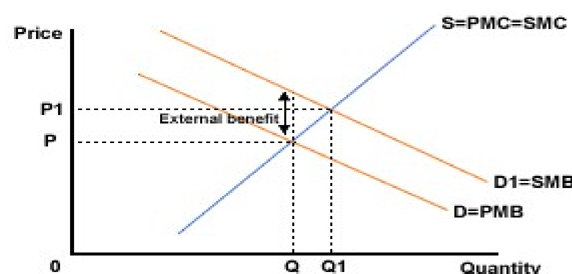


Figure 1 Under-consumption of a merit good

In the diagram, OQ is the free market level of consumption, as, at this point, individuals equate their private marginal benefit with their private

marginal cost. The existence of positive externalities means that the social marginal benefit curve lies above the private marginal benefit curve as the social benefits of consumption exceed the private benefits. Allocative efficiency would require a level of consumption of OQ1 at which SMB = SMC.

There is an unequal distribution of income

Perhaps a more basic reason for the market tending to under-provide merit goods is that, given the highly unequal distribution of income, and the widespread poverty such as exists in most economies today, many people would be unable to afford adequate education, health care and housing in the absence of state provision or subsidy. A market system only takes effective demand into account; that is, demand backed by the ability to pay the asking price. It does not respond to human demand as indicated by peoples' needs, so quite simply the poor may have to go without. Thus, on the grounds of equity, it may be decided that such merit goods as health and education should be provided free on the basis of need rather than according to ability to pay. Underpinning this approach would be the view that all have a fundamental human right to the various merit goods, which should not be determined by the market criteria of prices and profits.

Social goods

A social good is something that benefits the largest number of people in the largest possible way, such as clean air, clean water, healthcare, and literacy. Also known as "common good," social good can trace its history to Ancient Greek philosophers and implies a positive impact on individuals or society in general. Social good refers to services or products that promote human well-being on a large scale. These services or products include health care, education, clean water, and causes such as equality and women's rights.

Types of market failure

- Productive and allocative inefficiency.
- Monopoly power.
- Missing markets.
- Incomplete markets.

- De-merit goods.
- Negative externalities.

Some of the most common forms of market failure include:

1. Air and Noise Pollution.
2. Education.
3. Healthcare.
4. Water supply and other utilities.
5. Alcohol.
6. Policing.

Positive and negative externalities

Externalities are costs (negative externalities) or benefits (positive externalities), which are not reflected in free market prices. Externalities are sometimes referred to as 'by-products', 'spill over effects', 'neighbourhood effects' 'third-party effects' or 'side-effects', as the generator of the externality, either producers or consumers, or both, impose costs or benefits on others who are not responsible for initiating the effect. The key feature of an externality is that it is initiated and experienced, not through the operation of the price system, but outside the market.

Proponents of laissez-faire would argue that externalities particularly arise because of the absence of markets - as no markets exist for such things as clean air and seas, beautiful views or tranquillity, economic agents are not obliged to take them into account when formulating their production and consumption decisions, which are based on private costs and benefits i.e. those which are internal to themselves. Another way of putting this is to say individuals have no private property rights over such resources as the air sea and rivers**,** and thus ignore them in making their production and consumption decisions.

Property rights refer to those laws and rules which establish rights relating to:

1. ownership of property;
2. access to property;
3. protection of property ownership;
4. The transfer of property.

Thus a firm may feel free to dump effluent into a river as the spoiling of the environment and the killing of fish is not a cost which it would directly have to bear. Those on the political left would be more likely to argue that such an externality would arise because of the market system which is based upon the private ownership of resources, with individuals acting in their own self interest and therefore not having to consider what is in the public interest i.e. the problem is due to an absence of communal property rights and of a system of planned production.

The above example of an externality is one which is commonly cited, but it is important to establish at this stage that there are various types of externalities and that they can be classified in different ways: they can arise from acts of consumption or production, and can thus be production, consumption or mixed externalities, and, as previously mentioned they can be experienced as external costs or as external benefits. The different possibilities and provides some examples. It can be seen from this table that there are in fact four different varieties of externality:

1. **a production externality:** initiated in production and received in production;
2. **a mixed externality:** initiated in production, but received in consumption;
3. **a consumption externality:** initiated in consumption and received in consumption;
4. **a mixed externality:** initiated in consumption, but received in production.

Each of these are sub-divided into two, according to whether they are experienced as an external cost or as an external benefit, giving a total of eight varieties.

The various kinds of externality

In practice, the most important externalities are those which affect the environment, and it is these which have received widespread adverse publicity in recent years, and which have prompted the rise of 'green' pressure groups and political parties. Indeed, so great has been the impact of environmental pollution, that in addition to the externalities identified in

a global context, identify externalities which are transmitted from one country to another, and which may be mutually damaging; for example, the Chernobyl nuclear disaster in 1986 in Russia, not only contaminated the local area, but also polluted other parts of Europe; emissions of acid rain from West European nations not only harm the environment in the initiating countries, but also wreak havoc on the forests, lakes and rivers of the Scandinavian countries.

Unit-II

PUBLIC EXPENDITURE

Introduction

Public expenditure refers to Government spending incurred by Central, State and Local governments of a country.

Definition of Public Expenditure

Public Finance is the study of the financial operations of the State. According to Dalton, "public finance is concerned with the income and expenditure of public authorities and with the adjustment of one with the other". Public expenditure can be defined as, "The expenditure incurred by public authorities like central, state and local governments to satisfy the collective social wants of the people is known as public expenditure".

Classification of public expenditure is as follows:

1. Classification on the Basis of Benefit: Cohn and Plehn have classified the public expenditure on the basis of benefit into four classes: Public expenditure benefiting the entire society, e.g., the expenditure on general administration, defence, education, public health, transport.

a. Public expenditure conferring a special benefit on certain people and at the same time common benefit on the entire community, e.g. administration of justice etc.
b. Public expenditure directly benefiting particular group of persons and indirectly the entire society, e.g. social security, public welfare, pension, unemployment relief etc.
c. Public expenditure conferring a special benefit on some individuals, e.g., subsidy granted to a particular industry.

2. Classification on the Basis of Function: Adam Smith classified public expenditure on the basis of functions of government in the following main groups:

a) Protection Functions: This group includes public expenditure incurred on the security of the citizens, to protect from external invasion and internal disorder, e.g., defence, police, courts etc.

b) Commercial Functions: This group includes public expenditure incurred on the development of trade and commerce, e.g., development of means of transport and communication etc.

c) Development Functions: This group includes public expenditure incurred for the development infrastructure and industry.

4. Causes for the Increase in Government Expenditure

The modern state is a welfare state. In a welfare state, the government has to perform several functions viz Social, economic and political. These activities are the cause for increasing public expenditure.

1. Population Growth

During the past 67 years of planning, the population of India has increased from 36.1 crore in 1951, to 121 crore in 2011. The growth in population requires massive investment in health and education, law and order, etc. Young population requires increasing expenditure on education youth services, whereas the aging population requires transfer payments like old age pension, social security & health facilities.

2. Defence Expenditure

There has been enormous increase in defence expenditure in India during planning period. The defence expenditure has been increasing tremendously due to modernisation of defence equipment. The defence expenditure of the government was 10,874 crores in 1990-91 which increased significantly to 2, 95,511crores in 2018-19.

3. Government Subsidies

The Government of India has been providing subsidies on a number of items such as food, fertilizers, interest on priority sector lending, exports, education, etc. Because of the massive amounts of subsidies, the public expenditure has increased manifold. The expenditure on subsidies by central government in 1990-91 was 9581 crores which increased significantly to 2, 29,715.67 crores in 2018-19. Besides this, the corporate sectors also receive subsidies (incentives) of more than 5 lakh crores.

4. Debt Servicing

The government has been borrowing heavily both from the internal and external sources; As a result, the government has to make huge amounts of repayment towards debt servicing. The interest payment of the

central government has increased from 21,500 crores in 1990-91 to 5, 75,794crores in 2018-19.

5. Development Projects

The government has been undertaking various development projects such as irrigation, iron and steel, heavy machinery, power, telecommunications, etc. The development projects involve huge investment.

6. Urbanisation

There has been an increase in urbanization. In 1950-51 about 17% of the population was urban based. Now the urban population has increased to about 43%. There are more than 54 cities above one million populations. The increase in urbanization requires heavy expenditure on law and order, education and civic amenities.

7. Industrialisation

Setting up of basic and heavy industries involves a huge capital and long gestation period. It is the government which starts such industries in a planned economy. The under developed countries need a strong of infrastructure like transport, communication, power, fuel, etc.

8. Increase in grants in aid to state and union territories

There has been tremendous increase in grant- in-aid to state and union territories to meet natural disasters.

The canons of public expenditure have been laid down by Prof. Findlay Shirras:

1. Canon of Benefit:

This canon suggests that every public spending must ultimately be used for the cause of social benefit — general well-being of the common people. It, thus, implies that State spending should confer benefits on the community at large rather than on an individual group or section. It means public funds should be spent in such directions which pursue common interest, and promote general welfare.

2. Canon of Economy:

It implies that public expenditure should be incurred carefully and economically. Economy here means avoidance of extravagance and wastages in public spending. Public expenditure must be productive and efficient. Hence, it must be incurred only on very essential items of common benefit,

without duplication, in a way that involves minimum cost. An efficient system of financial administration is, therefore, very essential in any country.

3. Canon of Sanction:

This canon suggests that no public spending should be made without the approval of proper authority. The procedure for sanction in public expenditure is required for the enforcement of economy as well as for the prevention of misuse of public funds. As a rule, therefore, money must be spent on the purpose for which it is sanctioned by the highest authority and accounts be properly audited.

4. Canon of Surplus:

This canon suggests that saving is a virtue even for the government, so an ideal budget is one which contains an element of surplus by keeping public expenditure below public revenue. In other words, it means that the government should avoid deficit budgeting in the interest of its own creditworthiness. Besides the above stated canons of public expenditure, a few more canons are also suggested by some writers. For instance, the canon of elasticity has been stressed which implies that the spending policy of the State should be such that changes and flexibility must be possible in the expenses according to the changes in the requirements and circumstances. The canon of productivity is also advocated by many. This implies that public spending should tend to encourage production in the economy. That means a large part of public expenditure must be allocated for developmental purposes.

Meaning of Public Expenditure:

Public expenditure consists of expenditure} by central government, state governments and local authorities (such as municipalities and public corporations), with central government accounting for the major portion of such expenditure.

Effect on Production

In order to have a correct view of the effects of public expenditure on production, according to Dalton, it is necessary to consider (i) effects upon ability to work and save, (ii) effects on desire to work and save, and (iii)

effects on diversions of economic resources as between different uses and localities.

Effect on distribution

The use of progressive taxes is generally advocated as a means of influencing income distribution; it renders post-tax income distribution less unequal. Hugh Dalton has stated that like the taxes, public spending too can be made progressive.

Effect on Economic Development:

There are two principal channels, through} which government spending may influence economic growth and development. First, government spending, particularly investment, may provide such goods that enter directly into private sector production.

Adverse/Bad effect of public expenditure:

a. Unnecessary Assistance to Industries and Business
b. Excessive Expenditure on Defence
c. Tendency of gaining Political Influence
d. Advantage to a Particular Community
e. Rapid Increase in Taxation
f. Government expenditure is Misue of Scarce and Limited Resources and also Unproductive
g. Fear of Minority Political Parties
h. Dominance of Public Sector Reduced the Authority of Private Sector.

The main items of government spending are the following:

Social services such as education, health and welfare and social security; defence, that is the cost of maintaining the armed forces; environmental services, that is, spending on roads, transport services, law and order, housing and the art; national debt interest, that is, interest payments on money borrowed by the government. At present, public expenditure is about one-third of India's national income.

Principles and canon of public expenditure:

1. Principle of Maximum Social Benefit:

It is necessary that all public expenditure} should satisfy one fundamental test, viz., that of Maximum Social Advantage. That is, the

government should discover and maintain an optimum level of public expenditure by balancing social benefits and social costs.

2. Canon of Economy:

Although the aim of public expenditure is to} maximize the social benefit, yet it does not exonerate government from exercising utmost economy in its expenditure.

3. Canon of Sanction:

Another important principle of public expenditure is that before it is actually incurred it should be sanctioned by a competent authority. Unauthorised spending is bound to lead to extravagance and over-spending.

4. Canon of Elasticity: Another sane principle of public expenditure} is that it should be fairly elastic. It should be possible for public authority to vary the expenditure according to need or circumstances.

5. No Adverse Influence on Production or Distribution: It is also necessary to ensure that public} expenditure should exercise a healthy influence both on production and distribution of wealth in the community. It should stimulate productive activity so that income and employment of the living.

6. Principle of Surplus: It is considered a sound or orthodox principle} of public expenditure that as far as possible public expenditure should be kept well within the revenue of the State so that a surplus is left at the end of the year.

Main Causes of Growth of Public Expenditures

1. Income Elasticity and Increase in Per Capita Income
2. Welfare State Ideology and Wagner's Law
3. Effects of War and the Need for Defence
4. Resource Mobilisation and Ability to Finance
5. Inflation
6. The Role of Democracy and Socialism
7. The Urbanisation Effect
8. The Rural Development Effect
9. The Population Effect
10. The Growth of Transport and Communication

11. The Planning Effect.

1. Income Elasticity and Increase in Per Capita Income:

According to Musgrave, a rising share of public expenditure in national income is associated with a rise in per capita income. Thus, an increase in per capita income over a period of time may cause a relative rise in public expenditure. This is because the demand for public goods tends to expand with the rise in per capita income. Usually, it rises faster than the latter.

2. Welfare State Ideology and Wagner's Law:

The modern State is a welfare state. It aims at promoting the economic, political, and social well-being of its citizens. It makes every effort to improve the living standard of the common people. For this purpose, it has to undertake may functions and services never visualised before. Even in an avowedly capitalistic economy, there has been increasing State intervention through legislative and administrative measures for augmenting production and improving distribution. Many wants which were formerly satisfied individually by private means are now satisfied collectively through public expenditure.

In the classical era, the State was assumed to have a very limited function under the laissez faire policy. The functions of the State were restricted to justice, police, and army. Today, however, the role of the State has changed under the welfare criterion and there is a persistent trend towards an extensive and intensive increase in the scale of governmental performance. Apart from performing old functions more efficiently and on a larger scale, a modern State constantly undertakes new functions and added responsibilities day by day.

It now embraces many new ideas such as social insurance, unemployment relief, and provisions for underprivileged classes. In order to reduce inequalities of income, the State has to spend a large sum on free and cheap medical aid, subsidised food and housing, free education. Especially in underdeveloped countries such as India, the State expenditure on these social services is rising fast. In India, for instance, expenditure on social service is rising fast. In India, for instance, expenditure on social

services has gone up from Rs. 419 crores in the First Plan to Rs. 2,772 crores in the Fourth Plan. In the Seventh Plan, it was envisaged to be Rs. 29,350 crores.

Fundamentally, public expenditure in modern times shows an increasing trend on account of the "ever- increasing scale of State activity". This tendency, in economic literature, is known as "Wagner's law of increasing expansion of State activities". Adolf Wagner, a German fiscal theorist of the nineteenth century, propounded this theory according to which there is a persistent tendency towards an increase in the expenses and functions of the State, that is, there is a functional relationship between State activities and the relative growth of public expenditure owing to the "social progress" which is to be realised through State participation in economic fields. Indeed, the welfare aspect of government activity is appropriately described by Wagner as, "the pressure for social progress".

In Wagner's opinion, the pressure for social progress may be regarded as the root cause of the relative growth of public expenditure in modern times. Due to the pressure of social progress under the welfare state theory, in addition to the maintenance of law and order, government participation in the economic field for the provision of some goods, such as communication, education, medical facilities, etc. was necessitated. In short, the Wagner hypothesis states that in a welfare state, as the economy expands, public expenditure will also tend to increase persistently.

3. Effects of War and the Need for Defence:

The tremendous growth in public expenditure may also be attributed to wars and threats of war in modern times. In the Second World War, countries like England incurred heavy war expenditures, amounting to £ 15 million per day. Wars and threats of war and the consequent defence needs compel governments to spend more and more on the production of war goods. Due to the invention of nuclear weapons, there is always the danger of foreign aggression. International political situation is uncertain and insecure. Modern States are already facing a cold war. As such, every nation has to prepare itself for strong defence.

The defence expenditure is thus continuously rising. It contains expenditure on war materials, maintenance and growth of armed forces, naval and air wings, expenses on the development of military art and practice, pensions to retired war personnel, interests on war debt, cost of rehabilitation, etc. Peacock and Wiseman have referred to the 'displacement effect' in the post-war period when higher taxes and higher revenue collection drive of the war period are continued by the government, finding them easy and attractive. The displacement effect may further be supplemented by a 'scale hypotheses, i.e., adoption of new social welfare schemes by the government on a permanent basis.

4. Resource Mobilisation and Ability to Finance:

When the government innovates more and more methods of taxation and resource mobilisation, its ability to finance public expenditure increases and the size of public expenditure grows. Public sector outlays could be increased by more taxation yields, public debt, foreign aid and deficit financing.

5. Inflation:

With the rising prices, the government has to keep on increasing public expenditure to carry out its functions and maintain the supply of public goods intact. During inflation, the government has to pay additional DA to its employees which obviously call for an extra burden on public expenditure.

6. The Role of Democracy and Socialism:

The recent growth of democracy and socialism everywhere in the world has caused public expenditure to increase very much. A democratic structure of government is inevitably more expensive than a totalitarian government. In India, democracy has certainly become a costly affair. Expenditure on elections and bye-elections is increasing. The number of ministries and executive offices has also been increasing. Further, the ruling party has to fulfil its promises and launch upon new policies and programmes to achieve socialist objectives, in order to create a favourable image in the public. This also requires increasing State expenses in order to provide new amenities and opportunities to the people at large.

7. The Urbanisation Effect:

The spread of urbanisation is an important factor leading to the relative growth of public expenditure in modern times. With the growth of urban areas, there has been an increasing tendency of expenditure on civil administration. Expenses on water supply, electricity, provision of transport, maintenance of roads, schools and colleges, traffic controls, public health, parks and libraries, playgrounds, etc. have increased enormously these days. Likewise, the expenditure on courts, prisons etc. is increasing, especially in the urban sector.

8. The Rural Development Effect:

In an underdeveloped country, the government has also to spend more and more for rural development. It has to undertake schemes like community development projects and other social measures.

9. The Population Effect:

A high growth of population naturally calls for increase in the expenses as all State functions are to be performed more extensively. Rising population also poses various problems in poor countries. The State will have the added responsibility of solving such problems as food, unemployment, housing and sanitation. Further, overpopulated countries like India will have to check the population growth. The State has, therefore, to spend more and more on family planning campaigns every year.

10. The Growth of Transport and Communication:

With the expansion of trade and commerce, the State has to provide and maintain a quick and efficient transport system. Transport being a public utility, the State has to provide it cheaply also. Hence, railway and passenger transport is nationalised. Government has, therefore, to run transport services even at a loss. This obviously calls for a high expenditure for maintenance and expansion. Further, the government in a poor country has to spend a lot on constructing new railway lines, new roads, national highways, bridges and even canals to connect the different areas with a smooth transport system as a precondition of growth.

11. The Planning Effect:

In a less developed economy, the government adopts economic planning for the development of the country. In a planned economy, thus, when the public sector is expanding its role, public expenditure obviously shows an increasing trend. In India, for instance, the public sector outlay during the First Five Year Plan was just Rs. 1,960 crores, which is now estimated at Rs. 2, 47,865 crores during the Eighth Plan period (1992-97).

THEORY OF PUBLIC EXPENDITURE

There are two major theories on the pattern of public expenditure movement and explanation thereof. The basic difference between the two is whether this growth is smooth or it proceeds in a step-like manner. 13.4.1 Wagner's Law over time, in the last couple of centuries, public expenditure has been growing in almost all advanced countries. This period in those countries is also characterised by industrialisation and temporal growth of GDP per capita as also increase in population.

Adolph Wagner, a German economist and politician, observed these trends quite early in 1860s. He observed a positive long-run co-movement in the two variables: public expenditure and national income. The pace of rise in public expenditure was generally higher than economic growth. He therefore concluded that the long-run elasticity of public expenditure is above unity i.e. public expenditure is increasing absolutely as well as relatively to the economy as a whole. However, explanation on why it should be happening was needed. Wagner professed that that there would be increasing political pressure for State activities and industry would be willing to cooperate.

Though the advent of modern industrial society has been interpreted liberally as progress of civilisation, many thinkers interpret this as leading to increased state functions. Hence, Wagner's law is also called as the Law of Expanding State Activity. There would be both extensive increases as also intensive increase. One example of intensive increase is defence preparedness. Extensive increase could be illustrated as more social security provisions.

In other words, three main factors attributed to Wagner's proposition are:

(i) Expansion of social activities of the state,

(ii) Increase in administrative and protective actions and

(iii) Assumption of welfare functions.

Others factors pointed out are:

(i) Technological and institutional changes and

(ii) Democratisation along with rising per capita income.

In brief, therefore, social progress, income effect, rising population, urbanisation, technology, etc. contribute to increasing public expenditure. In view of this, Wagner's Law is also termed as 'Law of Increasing Public Expenditure'. The law has been examined empirically for different countries, for different data sets and for different periods using different techniques. Gross public expenditure, per capita public expenditure and ratio of public expenditure to GDP have been considered as dependent and GDP or GDP per capita taken as independent. Other variants of public expenditure considered in such studies include: public consumption expenditure, expenditure of total public sector, total employment by government and companies, etc. The law is generally found to hold. Some contrary hypotheses surrounding the causation factor are indicated. This takes the form that as the governments implement counter-cyclical policies to reduce the impact of business cycles, it tends to spend more and more.

Peacock-Wiseman's Hypothesis (Displacement Effect Hypothesis) Two British economists (Alan T Peacock and Jack Wiseman) examined Wagner's Law to find that Wagner missed the jumps and jerks. When one plots the ratio of Theory of Public Expenditure 13 Public Expenditure to GDP against time, for a fairly long period of time like half a century, one finds that there are sudden jumps and jerks. For instance, for US, UK, Germany, France and Japan, one would find two sudden and big jumps during 1914-18 and 1939-1944 besides several small jerks. They therefore suggest that a social upheaval such as war causes a permanent upward shift which means when normal times return the level assumed is not the same as the pre-upheaval level. This upward shift is referred to as the 'displacement effect'. Hence, their hypothesis is also known as 'displacement effect hypotheses. As an explanation to the above, Peacock and Wiseman suggest that public

expenditure is not so much determined by the notion of desired level but by the limits of taxation burden people are willing to bear.

A divergence between people's ideas of 'desired level of expenditure' and 'tolerable tax burden' persist in normal times. However, when a social upheaval or big disturbance (such as war) takes place, this divergence gets narrowed down. When normal times return, new ideas of tolerable tax levels emerge and a new plateau of expenditure is reached. Public expenditure will again assume a constant share of gross national product but a different one i.e. higher than the one previously obtaining before the upheaval. Though the relationship between tax rates and tax yields is not very straight forward, Peacock and Wiseman accept that 'with rising real GNP per capita, tax yields with given tax rates too may raise'. As far as tolerable limits are concerned, people are concerned with rates and not total payments. With better tax yields, it is likely that the peace time plateau may have a gentle upward slope. In times of crisis, people will accept methods of raising revenue previously thought to be intolerable.

At the same time, in normal times government may not feel confident to implement what they thought was desirable. After upheaval, it becomes possible for the government to implement those schemes as people are adjusted with new levels/rates of taxation. People also become conscious of their obligation which is termed as the 'inspection effect'. There is also a 'concentration effect' whereby the share of central government increases with each upheaval as the performance of stabilisation function is to be shouldered by the central government. Peacock-Wiseman hypothesis is applied more in terms of per capita public expenditure in absolute terms and not as share of public expenditure in GDP as in Wagner's Law.

This makes a direct comparison between the two difficult. However, while Wagner Law is more about a general rising tendency, Peacock Wiseman Hypothesis concerns itself with the shift in the level (i.e. in the sense of intercept) between two peace periods interspersed with an upheaval. The shift in levels due to an upheaval is interpreted as 'structural break'. This is because, ceteris paribus, the clause of constant tastes, preferences and institutions do not hold good i.e. the parameters change. "It still stands unchallenged," the economic historian Mark Blaug wrote

decades later. “Anyone with a question in the theory of public finance can be told even now, ‘it’s all in Musgrave.’ ”

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Musgrave’s research, most theoretical work by British and American economists was geared toward understanding the behaviour of prices, supply and demand as they interacted with other market forces. Governments played a secondary role, stepping in mainly to fill gaps when the markets failed. Musgrave had a different view, his wife said. He saw the government as having an important economic role and developed a theory on the way taxes and other factors interact in areas where goods and services roads, schools, courts and national defense, for example were best provided by the government.

In essence, Musgrave’s theory broke down governmental economic activity into three parts: the allocation of resources; the distribution of goods and services; and the stabilization of the broader economy. The theory paid particular attention to the process of determining what people want and need in the absence of a pricing system. In a market economy, for example, prices can be a good indicator of demand, but such information does not exist in the public sector, where consumers receive many goods and services without paying for them directly. By developing a theoretical understanding of how choices are made in that environment, Musgrave hoped to help governments perform more effectively.

Colin Clark’s Critical Limit Hypothesis:

Another hypothesis relating to the growth of public expenditure is provided by Colin Clark. The hypothesis is basically concerned with the tolerance level of taxation. It was developed by Colin Clark immediately after the Second World War.

The hypothesis draws conclusion from the empirical data drawn from several western countries for inter-war period. Clark wants to point out that in an economy; inflation emerges when the share of the government sector, as measured in terms of taxes and other receipts, exceeds 25 per cent of the aggregated economic activity in the country. When public expenditure reaches 25 percent of the total economic activity or aggregate amount of expenditure in the country, the tax payers, ability to pay more tax is

exhausted. Public expenditure beyond this limit, means, disincentive to producers and fall in production due to taxation beyond tolerance level.

The hypothesis rest upon the following two institutional factors:

(a) When tax collection by government exceeds the critical limit of 25 percent of gross national product, the income earners are badly affected by reduced incentives and decrease in their productivity. They produce less than what they are capable of doing. This leads to a reduced supply. In short, taxation beyond the critical limit, adversely affect the incentive to produce and invest.

(b) On the other hand, even if the budget remains balanced, increase in government expenditure would constitute rising demand. Therefore inflation is generated from mal-adjustment between demand and supply.

Even though Colin Clark's critical minimum effort thesis is well accepted by the business community, its significance in the academic circle is very limited. Colin Clark gave undue emphasis on his critical limit of 25 percent. In the modern world a number of countries are incurring public expenditure much beyond their limit, without facing worse situation of inflationary pressure. Impact of budgetary spending on generation of inflationary situation; depend upon the manner and nature in which public expenditure is incurred. Inflation is a complex economic phenomenon influenced and characterized by a number of mutually exclusive and inter-dependent factors. Hence we can only fairly conclude that in a marked economy, increasing state activity may create inflationary pressure.

Pure theory of public expenditure

In 1954 Paul Samuelson published his landmark paper The Pure Theory of Public Expenditure, which formalized the concept of public goods (which he called "collective consumption goods") i.e. goods that are non-rival and non-excludable. He highlighted the market failure of free-riding when he wrote: "it is in the selfish interest of each person to give false signals, to pretend to have less interest in a given collective consumption activity than he really has". His paper showed that "no decentralized pricing system can serve to determine optimally these levels of collective consumption". Excludability is the ability of producers to detect and prevent

uncompensating consumption of their products. Rivalry is the inability of multiple consumers to consume the same good. A public good is defined as a non-rival non-excludable good, such as national defense. Because public goods are not excludable, they get under-produced. The pricing system 10 cannot force consumers to reveal their demand for purely non-excludable goods, and so cannot force producers to meet that demand. The evidence for under-production of public goods is so overwhelming that, as anarchy libertarian professor Walter Block admits about the resulting justification for state intervention, "Virtually all economists accept this argument. There is not a single mainstream text dealing with the subject which demurs from it." Exhibit 1 gives the clear understanding of the theory.

Summary

Public expenditure and its basic concepts are highlighted in this content which is classified by economists into three main types. Government acquisition of goods and services for current use to directly satisfy individual or collective needs of the members of the community is classed as government final consumption expenditure. Samuelson's pure theory of public expenditure was explained in the later section followed by the structure and growth of public expenditure.

Public Expenditure:

Expenses incurred by the public authorities—central, state and local self- governments—are called public expenditure. Such expenditures are made for the maintenance of the governments as well as for the benefit of the society as whole. There was a mis-belief in the academic circles in the nineteenth century that public expenditures were wasteful. Public expenditures must be kept low as far as practicable. This conservative thinking died down in the twentieth century, especially after the Second World War. As a modern state is termed a 'welfare state', the horizon of activities of the government has expanded in length and breadth. Now we can point out the reasons for enormous increase in public expenditure throughout the world even in the capitalist countries where laissez-faire principle operates. These are the following.

Causes of Increase in Public Expenditure:

(a) Size of the Country and Population:

We see an expansion of geographical area of almost all countries. Even in no-man's land one finds the activities of the modern government. Assuming a fixed size of a country, developing world has seen an enormous increase in population growth. Consequently, the expansion in administrative activities of the government has resulted in a growth of public expenditures in these areas.

(b) Defence Expenditure:

The tremendous growth of public expenditure can be attributed to threats of war. No great war has been conducted in the second half of the twentieth century. But the threats of war have not vanished; rather it looms large. Thus, mere sovereignty, demands a larger allocation of financial sources for defence preparedness.

(c) Welfare State:

The 19th century state was a 'police state' while, in 20th and 21st centuries modern state is a 'welfare state'. Even in a capitalist framework, socialistic principles are not altogether discarded. Since socialistic principles are respected here, modern governments have come out openly for socio-economic uplift of the masses. Various socio-economic programmes are undertaken to promote people's welfare. Modern governments spend huge money for the purpose of economic development. It plays an active role in the production of goods and services. Such investment is financed by the government.

Besides development activities, welfare activities have grown tremendously. It spends money for providing various social security benefits. Social sectors like health, education, etc., receive a special treatment under the government patronage. It builds up not only social infrastructure but also economic infrastructure in the form of transport, electricity, etc. Provision of all these require huge finance. Since a hefty sum is required for financing these activities, modern governments are the only providers of money. However, various welfare activities of the government are largely

shaped and influenced by the political leaders (Ministers, MPs, and MLAs to have a political mileage, as well as by the bureaucrats (MPLAD)).

(d) Economic Development:

Modern government has a great role to play in shaping an economy. Private capitalists are utterly incapable of financing economic development of a country. This incapacity of the private sector has prompted modern governments to invest in various sectors so that economic development occurs. Economic development is largely conditioned by the availability of economic infrastructure. Only by building up economic infrastructure, road, transport, electricity, etc., the structure of an economy can be made to improve. Obviously, for financing these activities, government spends money.

(e) Price Rise:

Increase in government expenditure is often ascribed to inflationary price rise.

Types of Public Expenditure:

Public expenditure may be classified into developmental and non-developmental expenditures. Former includes the expenditure incurred on social and community services, economic services, etc. Non-developmental expenditure includes expenditures made for administrative service, defence service, debt servicing, subsidies, etc. Public expenditure is classified into revenue expenditure and capital expenditure. Revenue expenditure includes civil expenditure (e.g., general services, social and community services and economic services), defence expenditure, etc. On the other hand, capital expenditure comprises expenditures incurred on social and community development, economic development, defence, general services, etc. Public expenditure may also be classified as

a. Plan expenditure and
b. Non-plan expenditure

a. Non-plan expenditure falls under two broad heads, viz., revenue expenditure and capital expenditure. The former comprises interest payments, defence expenditures, subsidies, pensions, other general services (like health, education), economic services (like agriculture, energy,

industry, transport and communication, science, technology and environment, etc.) Expenditures on agriculture, rural development, irrigation and flood control, energy, industry and mineral resources, etc., are included in plan expenditure.

Principles Governing Public Expenditure or Canons of Public Expenditure:

Rules or principles that govern the expenditure policy of the government are called canons of public expenditure. Fundamental principles of public spending determine the efficiency and propriety of the expenditure itself. While making its spending programme, government must follow these principles. These principles, in short, are called canons of public expenditure.

Findlay Shirras has laid down the following four canons of public expenditure:

a. Canon of benefit
b. Canon of economy
c. Canon of sanction
d. Canon of surplus

(i) Canon of Benefit:

According to this canon, public spending has to be made in such a way that it confers greatest social benefits. In other words, public expenditure must not be geared in such a way that it provides benefits to a particular group of the community. Thus, public expenditure is to be made in those directions where general benefits rather than specific benefits flow in. However, often public expenditure is incurred for the benefit of a particular group. This sort of public expenditure does not violate canon of benefit. Any public expenditure for the development of a backward area does promote social interest.

(ii) Canon of Economy:

Economy does not mean miserliness. It refers to the avoidance of wasteful and extravagant expenditure. Public expenditure must be made in such a way that it becomes productive and efficient. Efficiency in public expenditure requires economy of expenditures. To enjoy the maximum aggregate benefit from any public spending programme, it is necessary that

the canon of economy is observed. An uneconomic expansion in public expenditure will result in scarcity of funds, the much-needed growth of the productive sectors will be hampered. This means lower social benefit. It is thus obvious that the canon of economy is not independent of the canon of benefit.

(iii) Canon of Sanction:

The canon of section, as suggested by Shirras, requires that public spending should not be made without any concurrence or sanction of an appropriate authority. Arbitrariness in public spending can be avoided only if spending is approved. Further, economy in public spending can never be ensured if it is not sanctioned.

(iv) Canon of Surplus:

This canon suggests the avoidance of deficit in public spending. Like individuals, saving is a virtue for the government. So the government must prepare its budget in such a way that government revenue exceeds government expenditure so as to create a surplus. It must not run deficit to cover its expenditure. However, modern economists do not like to attach any importance to Shirras' fourth canon— the canon of surplus. To them, deficit financing is the most effective means of financing economic programmes of the government.

Importance of Public Expenditure:

An old-fashioned dictum says that "The very best of all plans of finance is to spend little, and the best of all taxes is that which is least in amount." No one today believes this philosophy. In the 1930s, J. M. Keynes emphasized the importance of public expenditure. The modern state is described as the 'welfare state'. As a result, the activities of the modern government have widened enormously. Modern governments are undertaking various social and economic activities, particularly in less developed countries (LDCs).

i. Economic Development:

Without government support and backing, a poor country cannot make huge investments to bring about a favourable change in the economic base of a country. That is why massive investments are made by the government in the development of basic and key industries, agriculture,

consumable goods, etc. Public expenditure has the expansionary effect on the growth of national income, employment opportunities, etc. Economic development also requires development of economic infrastructures. A developing country like India must undertake various projects, like road-bridge-dam construction, power plants, transport and communications, etc. These social overhead capital or economic infrastructures are of crucial importance for accelerating the pace of economic development. It is to be remembered here that private investors are incapable of making such massive investments on the various infrastructural projects. It is imperative that the government undertakes such projects. Greater the public expenditure, higher is the level of economic development.

ii. Fiscal Policy Instrument:

Public expenditure is considered as an important tool of fiscal policy. Public expenditure creates and increases the scope of employment opportunities during depression. Thus, public expenditure can prevent periodic cyclical fluctuations. During depression, it is recommended that there should be more and more governmental expenditures on the ground that it creates jobs and incomes. On the contrary, a cut-back in government's expenditure is necessary when the economy faces the problem of inflation. That is why it is said that by manipulating public expenditure, cyclical fluctuations can be lessened greatly. In other words, variation of public expenditure is a part of the anti- cyclical fiscal policy.

It is to be kept in mind that it is not just the amount of public expenditure that is incurred which is of importance to the economy. What is equally, if not more, important is the purpose of such expenditure or the quality of expenditure. The quality of expenditure determines the adequacy and effectiveness of such expenditure. Excessive expenditures may cause inflation. Moreover, if the government has to impose taxes at high rates there will be loss of incentives. So, it is necessary to avoid unnecessary expenditure as far as practicable, otherwise benefits of better economic development may not be reaped. As a fiscal policy instrument, it may be counter-productive.

iii. Redistribution of Income:

Public expenditure is used as a powerful fiscal instrument to bring about an equitable distribution of income and wealth. There are good much

public expenditure that benefit poor income groups. By providing subsidies, free education and health care facilities to the poor people, government can improve the economic position of these people.

iv. Balanced Regional Growth:

Public expenditure can correct regional disparities. By diverting resources in backward regions, government can bring about all-round development there so as to compete with the advanced regions of the country. This is what is required to maintain integration and unity among people of all the regions. Unbalanced regional growth encourages disintegrating forces to rise. Public expenditure is an antidote for these reactionary elements. Thus, public expenditure has both economic and social objectives. It is necessary to ensure that the government's expenditure is made solely in the public interest and does not serve any individual's interest or that of any political party or a group of persons.

Unit-III

PUBLIC REVENUE AND PUBLIC DEBT

Introduction

The subject matter of public finance includes public revenue, public expenditure and public debt and their impact on the economy. Public finance policies are implemented through the Budget. Public Revenue is an important concept of Public Finance. It refers to the income of the Government from different sources. According to Dalton in his "Principles of Public Finance" mentioned two kinds of public revenue. Public revenue includes income from taxes and goods and services of public enterprises, revenue from administrative activities such as fees, fines etc. and gifts and grants. On the other hand public receipts include all the incomes of the government received from formal sources.

The sources of public revenue have been broadly divided into:

(A) Tax Revenue

(B) Non-Tax Revenue.

(A) Tax Revenue

Taxes are the first and foremost sources of public revenue. Taxes are compulsory payments to government without expecting direct benefit or return by the tax-payer. Taxes collected by Government are used to provide common benefits to all. Taxes do not guarantee any direct benefit for person who pays the tax. It is not based on "quid pro quo principle." The Tax has been divided into two types such as

A. Direct Taxes and

B. Indirect Taxes.

(A) Direct Taxes: Direct taxes are those taxes which are paid by the same person on whom it has been imposed. The impact and incidence of tax fall on the same person, because the tax burden cannot be shifted to others. Direct taxes include the following taxes.

I. Personal Income tax is a tax imposed on the excess income earned by an individual over and above the limit decided by the finance ministry form time to time. It is progressive in nature.

II. Corporate Tax is a tax levied on the profits earned by registered companies.
III. Capital Gains Tax is a tax imposed on the net profits earned through capital investment in stock market, real estate, Gold and Jewellery etc.
IV. Wealth Tax (or) Property Tax is a tax levied upon the property owned by individuals. The property includes Land, Building, shares, Bonds, Fixed Deposits, Gold and Jewellery etc.
V. Other taxes: These taxes include taxes like Gift tax and Estate duty.

(B) Indirect Taxes: Indirect taxes are those taxes which are imposed on one group of people, but the ultimate burden will fall on another group of people. The impact of tax and incidence of tax are on different people. In case of Indirect taxes tax burden can be shifted. There are middlemen between the Government and the tax payer.

The important Indirect Taxes are as follows:

I. Excise Duty is a tax imposed on the manufacturers as per the value of goods produced but the ultimate burden will fall on the final consumers.
II. Customs Duty is a tax imposed on import and export of Goods. Customs duty may be specific or advalorem. Advalorem duty is a tax imposed on the basis the value of goods imported while specific duty is imposed as per the number of units imported.
III. Value Added Tax (VAT) is a part of a sales tax imposed by the state government.
IV. Sales Tax revenue goes to the state government when sale or purchase takes place within the state. Sales tax revenue on interstate transactions goes to the central government.
V. Service Tax is tax imposed on services provided. The impact is on the service provider and the incidence of tax false on the customers. Service tax is the fastest growing tax in India.
VI. Octroi is a tax levied on transfer of goods from one state to another or from one region to another.

(B) Non-Tax Revenue: These sources of revenue are classified as administrative revenues, commercial revenues and grants and gifts.

a. **Grants:** Grants: are made by a higher public authority to a lower one, for example, from the Central to the State government or from the State to the local government. Grants are given so that a public authority is able to perform certain activities at the local level. There is no repayment obligation in case of grants.
b. **Gifts:** Gifts and donations are voluntarily made by individuals, organizations, foreign governments to the funds of the government, e.g. Prime Minister's Relief Fund. Such gifts are usually made at the time of crisis like war or floods. Gifts cannot be considered a regular source of revenue.
c. **Fees:** Fees are an important source of administrative non-tax revenue to the government. The government provides certain services and charges, certain fees for them. For example, fees are charged for issuing of passports, granting licenses to telecom companies, driving licenses etc.
d. **Fines and Penalties:** Another source of administrative non-tax revenue includes fines and penalties. They are imposed as a form of punishment for breaking law or non-fulfilment of certain conditions or for failure to observe some regulations. They are not expected to be a major source of revenue to the government.
e. **Special Assessment:** It is a kind of special charge levied on certain members of the community who are beneficiaries of certain government activities or public projects. For example, due to Public Park in a locality or due to the construction of a road, people in the locality may experience an appreciation in the value of their property or land.
f. **Surpluses of Public Enterprises:** Most countries have government departments and public sector enterprises involved in commercial activities. The surpluses of these departments and enterprises are an important source of non-tax revenue. These revenues are in the form of profits and interests and are termed as commercial revenues.

g. **Borrowings:** When government revenue is not sufficient to meet the public expenditure government borrows either from internal or external sources. Borrowing is income of the government which creates liability because the government has to repay the borrowings with interest.

Canons of taxation/characteristics of a Good Tax System

A good tax system is one which is designed on the basis of an appropriate set of principles, such as equality and certainty. Different objectives of taxation often conflict with each other and a balance has to be struck. Therefore, usually economists select some important objectives and work out the corresponding principles on which the tax system should be based. The first of such principles were developed by Adam Smith. There are known as Canons of Taxation. These canons are still regarded as characteristics of a good tax system.

Taxes: According to P.E. Tayler, “Taxes are compulsory payments to government without expectation of direct return or benefits to the tax payer”.

Characteristics of a Tax:

I. A tax is a compulsory contribution to the State from the citizen (or even from alien subject to its jurisdiction for reasons of residence or property and this contribution is for general or common use. Seligman emphasizes that this contribution is enforced without reference to special benefits conferred).
II. Another characteristic of tax is that the tax imposes a personal obligation. It means that it is the duty of tax payer to pay it and he should in no case think to evade it.
III. The third characteristics are that the contribution, received from the tax payer, may not be incurred for their benefit alone, but for the general and common benefit.

Canons of Taxation:

1) Canon of Equity: In the words of Adam Smith, “The subjects of every State ought to contribute towards the support of the Government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the

State". According to the economists, Adam Smith was an advocate of the system of progressive taxation. It implies that the rich should be taxed more and the poor less.

2) Canon of Certainty: According to Adam Smith, the tax which an individual has to pay should be certain, not arbitrary. The tax-payer should know in advance how much tax he has to pay, at what time he has to pay the tax, and in which form the tax is to be paid to the government. In other words, every tax should satisfy the canon of certainty.

3) Canon of Convenience: According to Canon, every tax should be levied in such a manner and at such a time that it affords the maximum convenience to the tax-payer. The reason is that the taxpayer makes a sacrifice at the time of payment of the tax. Hence, the government should see to it that the tax-payer suffers no inconvenience on account of the payment of the tax.

4) Canon of Economy: According to this Canon, the tax should be such as to bring the maximum part of the collected revenue into the government treasury. In other words, the cost of tax-collection should be the minimum. If a major portion of the tax proceeds is spent on the collection of the tax itself then such a tax cannot be considered as a good tax.

5) Canon of Elasticity: According to this Canon, every tax imposed by the government should be elastic in nature. In other words, the income from the tax should be capable of increasing or decreasing according to the requirements of the country. For example, if the government needs more income at a time of crisis, the tax should be capable of yielding more income through an increase in its rate.

6) Canon of Productivity: According to this Canon, the tax should be of such a nature as to yield sufficient income to the government. If a tax yields poor income, it cannot be considered as a productive tax. According to this Canon, it is better to go in for a few productive taxes rather than to impose a large number of unproductive taxes on the people. A large number of unproductive taxes create difficulties not only for the people but also for the government because it gets no special increase in income from them.

7) Canon of Variety: The physiocrats advocated the imposition of one single tax, viz. a tax on land. But the modern economists do not agree with this view of the Physiocrats. According to them, the tax system should contain a large variety of taxes on persons as well as commodities. The reason is that if the government levies a single tax, it will become easier for the tax-payers to evade it. But if the government imposes a large variety of taxes, it will be difficult for the people to evade or to avoid them.

8) Canon of Simplicity: According to this Canon, every tax should be simple so that the tax-payer can understand its implications without the help of experts. If the tax is complex and complicated, the tax payers will have to seek the assistance of tax experts to understand its implication.

9) Canon of Flexibility: What this implies is that the tax should be based upon certain well defined principles so that it may need no justification from the side of the government. In other words, the tax-payers should have no doubt about its desirability. From this point of view, the old taxes are considered to be better than new taxes because the people have already got accustomed to the old taxes.

Taxation

Taxes are levied in almost every country of the world, primarily to raise revenue for government expenditures, although they serve other purposes as well. This is concerned with taxation in general, its principles, its objectives, and its effects; specifically, the article discusses the nature and purposes of taxation, whether taxes should be classified as direct or indirect, the history of taxation, canons and criteria of taxation, and economic effects of taxation, including shifting and incidence. In modern economies taxes are the most important source of governmental revenue. Taxes differ from other sources of revenue in that they are compulsory levies and are unrequited—i.e., they are generally not paid in exchange for some specific thing, such as a particular public service, the sale of public property, or the issuance of public debt. While taxes are presumably collected for the welfare of taxpayers as a whole, the individual taxpayer's liability is independent of any specific benefit received.

There are, however, important exceptions: payroll taxes, for example, are commonly levied on labour income in order to finance retirement benefits, medical payments, and other social security programs—all of which are likely to benefit the taxpayer. Because of the likely link between taxes paid and benefits received, payroll taxes are sometimes called "contributions" (as in the United States). Nevertheless, the payments are commonly compulsory, and the link to benefits is sometimes quite weak. Another example of a tax that is linked to benefits received, if only loosely, is the use of taxes on motor fuels to finance the construction and maintenance of roads and highways, whose services can be enjoyed only by consuming taxed motor fuels.

Purposes of taxation

During the 19th century the prevalent idea was that taxes should serve mainly to finance the government. In earlier times, and again today, governments have utilized taxation for other than merely fiscal purposes. One useful way to view the purpose of taxation, attributable to American economist Richard A. Musgrave, is to distinguish between objectives of resource allocation, income redistribution, and economic stability. (Economic growth or development and international competitiveness are sometimes listed as separate goals, but they can generally be subsumed under the other three.) In the absence of a strong reason for interference, such as the need to reduce pollution, the first objective, resource allocation, is furthered if tax policy does not interfere with market-determined allocations. The second objective, income redistribution, is meant to lessen inequalities in the distribution of income and wealth. The objective of stabilization—implemented through tax policy, government expenditure policy, monetary policy, and debt management—is that of maintaining high employment and price stability.

Direct and indirect taxes

In the literature of public finance, taxes have been classified in various ways according to who pays for them, who bears the ultimate burden of them, the extent to which the burden can be shifted, and various other criteria. Taxes are most commonly classified as either direct or

indirect, an example of the former type being the income tax and of the latter the sales tax. There is much disagreement among economists as to the criteria for distinguishing between direct and indirect taxes, and it is unclear into which category certain taxes, such as corporate income tax or property tax, should fall. It is usually said that a direct tax is one that cannot be shifted by the taxpayer to someone else, whereas an indirect tax can be.

Direct taxes

Direct taxes are primarily taxes on natural persons (e.g., individuals), and they are typically based on the taxpayer's ability to pay as measured by income, consumption, or net wealth. What follows is a description of the main types of direct taxes. Individual income taxes are commonly levied on total personal net income of the taxpayer (which may be an individual, a couple, or a family) in excess of some stipulated minimum. They are also commonly adjusted to take into account the circumstances influencing the ability to pay, such as family status, number and age of children, and financial burdens resulting from illness. The taxes are often levied at graduated rates, meaning that the rates rise as income rises. Personal exemptions for the taxpayer and family can create a range of income that is subject to a tax rate of zero.

Taxes on net worth are levied on the total net worth of a person that is, the value of his assets minus his liabilities. As with the income tax, the personal circumstances of the taxpayer can be taken into consideration. Personal or direct taxes on consumption are essentially levied on all income that is not channelled into savings. In contrast to indirect taxes on spending, such as the sales tax, a direct consumption tax can be adjusted to an individual's ability to pay by allowing for marital status, age, number of dependents, and so on. Although long attractive to theorists, this form of tax has been used in only two countries, India and Sri Lanka; both instances were brief and unsuccessful.

Taxes at death take two forms: the inheritance tax, where the taxable object is the bequest received by the person inheriting, and the estate tax, where the object is the total estate left by the deceased. Inheritance taxes

sometimes take into account the personal circumstances of the taxpayer, such as the taxpayer's relationship to the donor and his net worth before receiving the bequest. Estate taxes, however, are generally graduated according to the size of the estate, and in some countries they provide tax-exempt transfers to the spouse and make an allowance for the number of heirs involved. In order to prevent the death duties from being circumvented through an exchange of property prior to death, tax systems may include a tax on gifts above a certain threshold made between living persons. Taxes on transfers do not ordinarily yield much revenue, if only because large tax payments can be easily avoided through estate planning.

Indirect taxes

Indirect taxes are levied on the production or consumption of goods and services or on transactions, including imports and exports. Examples include general and selective sales taxes, value-added taxes (VAT), taxes on any aspect of manufacturing or production, taxes on legal transactions, and customs or import duties. General sales taxes are levies that are applied to a substantial portion of consumer expenditures. The same tax rate can be applied to all taxed items, or different items can be subject to different rates. Single-stage taxes can be collected at the retail level, as the U.S. states do, or they can be collected at a pre-retail level, as occurs in some developing countries. Multistage taxes are applied at each stage in the production-distribution process. The VAT, which increased in popularity during the second half of the 20th century, is commonly collected by allowing the taxpayer to deduct a credit for tax paid on purchases from liability on sales. The VAT has largely replaced the turnover tax—a tax on each stage of the production and distribution chain, with no relief for tax paid at previous stages. The cumulative effect of the turnover tax, commonly known as tax cascading, distorts economic decisions.

Although they are generally applied to a wide range of products, sales taxes sometimes exempt necessities to reduce the tax burden of low-income households. By comparison, excises are levied only on particular commodities or services. While some countries impose excises and customs

duties on almost everything—from necessities such as bread, meat, and salt, to nonessentials such as cigarettes, wine, liquor, coffee, and tea, to luxuries such as jewels and furs taxes on a limited group of products alcoholic beverages, tobacco products, and motor fuel yield the bulk of excise revenues for most countries. In earlier centuries, taxes on consumer durables were applied to luxury commodities such as pianos, saddle horses, carriages and billiard tables.

Today a main luxury tax object is the automobile largely because registration requirements facilitate administration of the tax. Some countries tax gambling and state-run lotteries have effects similar to excises, with the government's "take" being, in effect, a tax on gambling. Some countries impose taxes on raw materials, intermediate goods and machinery. Some excises and customs duties are specific—i.e., they are levied on the basis of number, weight, length, volume, or other specific characteristics of the good or service being taxed. Other excises, like sales taxes, are ad valorem—levied on the value of the goods as measured by the price. Taxes on legal transactions are levied on the issue of shares, on the sale of houses and land, and on stock exchange transactions. For administrative reasons, they frequently take the form of stamp duties; that is, the legal or commercial document is stamped to denote payment of the tax. Many tax analysts regard stamp taxes as nuisance taxes; they are most often found in less-developed countries and frequently bog down the transactions to which they are applied.

Proportional, progressive, and regressive taxes

Taxes can be distinguished by the effect they have on the distribution of income and wealth. A proportional tax is one that imposes the same relative burden on all taxpayers—i.e., where tax liability and income grow in equal proportion. A progressive tax is characterized by a more than proportional rise in the tax liability relative to the increase in income, and a regressive tax is characterized by a less than proportional rise in the relative burden. Thus, progressive taxes are seen as reducing inequalities in income distribution, whereas regressive taxes can have the effect of increasing these inequalities.

The taxes that are generally considered progressive include individual income taxes and estate taxes. Income taxes that are nominally progressive, however, may become less so in the upper-income categories—especially if a taxpayer is allowed to reduce his tax base by declaring deductions or by excluding certain income components from his taxable income. Proportional tax rates that are applied to lower-income categories will also be more progressive if personal exemptions are declared.
Income measured over the course of a given year does not necessarily provide the best measure of taxpaying ability. For example, transitory increases in income may be saved, and during temporary declines in income a taxpayer may choose to finance consumption by reducing savings. Thus, if taxation is compared with "permanent income," it will be less regressive than if it is compared with annual income.

Sales taxes and excises tend to be regressive, because the share of personal income consumed or spent on a specific good decline as the level of personal income rises. Poll taxes levied as a fixed amount per capita obviously are regressive. It is difficult to classify corporate income taxes and taxes on business as progressive, regressive, or proportionate, because of uncertainty about the ability of businesses to shift their tax expenses. This difficulty of determining who bears the tax burden depends crucially on whether a national or a sub national tax is being considered.

In considering the economic effects of taxation, it is important to distinguish between several concepts of tax rates. The statutory rates are those specified in the law; commonly these are marginal rates, but sometimes they are average rates. Marginal income tax rates indicate the fraction of incremental income that is taken by taxation when income rises by one dollar. Thus, if tax liability rises by 45 cents when income rises by one dollar, the marginal tax rate is 45 percent. Income tax statutes commonly contain graduated marginal rates—i.e., rates that rise as income rises. Careful analysis of marginal tax rates must consider provisions other than the formal statutory rate structure. If, for example, a particular tax credit falls by 20 cents for each one-dollar rise in income, the marginal rate is 20 percentage points higher than indicated by the statutory rates.

Since marginal rates indicate how after-tax income changes in response to changes in before-tax income, they are the relevant ones for appraising incentive effects of taxation. It is even more difficult to know the marginal effective tax rate applied to income from business and capital, since it may depend on such considerations as the structure of depreciation allowances, the deductibility of interest, and the provisions for inflation adjustment. A basic economic theorem holds that the marginal effective tax rate in income from capital is zero under a consumption-based tax.

Average income tax rates indicate the fraction of total income that is paid in taxation. The pattern of average rates is the one that is relevant for appraising the distributional equity of taxation. Under a progressive income tax the average income tax rate rises with income. Average income tax rates commonly rise with income, both because personal allowances are provided for the taxpayer and dependents and because marginal tax rates are graduated; on the other hand, preferential treatment of income received predominantly by high-income households may swamp these effects, producing regressively, as indicated by average tax rates that fall as income rises.

Principles of taxation

The 18th-century economist and philosopher Adam Smith attempted to systematize the rules that should govern a rational system of taxation. In The Wealth of Nations (Book V, chapter 2) he set down four general canons: Although they need to be reinterpreted from time to time, these principles retain remarkable relevance. From the first can be derived some leading views about what is fair in the distribution of tax burdens among taxpayers.

These are: (1) the belief that taxes should be based on the individual's ability to pay, known as the ability-to-pay principle, and (2) the benefit principle, the idea that there should be some equivalence between what the individual pays and the benefits he subsequently receives from governmental activities. The fourth of Smith's canons can be interpreted to underlie the emphasis many economists place on a tax system that does not

interfere with market decision making, as well as the more obvious need to avoid complexity and corruption.

Distribution of tax burdens

Various principles, political pressures, and goals can direct a government's tax policy. What follows is a discussion of some of the leading principles that can shape decisions about taxation.

Horizontal equity

The principle of horizontal equity assumes that persons in the same or similar positions will be subject to the same tax liability. In practice this equality principle is often disregarded, both intentionally and unintentionally. Intentional violations are usually motivated more by politics than by sound economic policy. Debate over tax reform has often centred on whether deviations from "equal treatment of equals" are justified.

The ability-to-pay principle

The ability-to-pay principle requires that the total tax burden will be distributed among individuals according to their capacity to bear it, taking into account all of the relevant personal characteristics. The most suitable taxes from this standpoint are personal levies. Historically there was common agreement that income is the best indicator of ability to pay. There have, however, been important dissenters from this view, including the 17th-century English philosophers John Locke and Thomas Hobbes and a number of present-day tax specialists.

The early dissenters believed that equity should be measured by what is spent rather than by what is earned modern advocates of consumption-based taxation emphasize the neutrality of consumption-based taxes toward saving, the simplicity of consumption-based taxes, and the superiority of consumption as a measure of an individual's ability to pay over a lifetime. Some theorists believe that wealth provides a good measure of ability to pay because assets imply some degree of satisfaction and tax capacity, even if they generate no tangible income.

The ability-to-pay principle also is commonly interpreted as requiring that direct personal taxes have a progressive rate structure, although there is no way of demonstrating that any particular degree of progressivity is the

right one. Because a considerable part of the population does not pay certain direct taxes—such as income or inheritance taxes—some tax theorists believe that a satisfactory redistribution can only be achieved when such taxes are supplemented by direct income transfers or negative income taxes (or refundable credits). Others argue that income transfers and negative income tax create negative incentives; instead, they favour public expenditures (for example, on health or education) targeted toward low-income families as a better means of reaching distributional objectives.

Indirect taxes such as VAT, excise, sales, or turnover taxes can be adapted to the ability-to-pay criterion, but only to a limited extent—for example, by exempting necessities such as food or by differentiating tax rates according to "urgency of need." Such policies are generally not very effective; moreover, they distort consumer purchasing patterns, and their complexity often makes them difficult to institute.

Throughout much of the 20th century, prevailing opinion held that the distribution of the tax burden among individuals should reduce the income disparities that naturally result from the market economy; this view was the complete contrary of the 19th-century liberal view that the distribution of income ought to be left alone. By the end of the 20th century, however, many governments recognized that attempts to use tax policy to reduce inequity can create costly distortions, prompting a partial return to the view that taxes should not be used for redistributive purposes.

The benefit principle

Under the benefit principle, taxes are seen as serving a function similar to that of prices in private transactions; that is, they help determine what activities the government will undertake and who will pay for them. If this principle could be implemented, the allocation of resources through the public sector would respond directly to consumer wishes. In fact, it is difficult to implement the benefit principle for most public services because citizens generally have no inclination to pay for a publicly provided service—such as a police department—unless they can be excluded from the benefits of the service. The benefit principle is utilized most successfully in the financing of roads and highways through levies on motor fuels and road-

user fees (tolls). Payroll taxes used to finance social security may also reflect a link between benefits and "contributions," but this link is commonly weak, because contributions do not go into accounts held for individual contributors.

Economic efficiency

The requirement that a tax system be efficient arises from the nature of a market economy. Although there are many examples to the contrary, economists generally believe that markets do a fairly good job in making economic decisions about such choices as consumption, production, and financing. Thus, they feel that tax policy should generally refrain from interfering with the market's allocation of economic resources. That is, taxation should entail a minimum of interference with individual decisions. It should not discriminate in favour of, or against, particular consumption expenditures, particular means of production, particular forms of organization, or particular industries. This does not mean, of course, that major social and economic goals may not take precedence over these considerations. It may be desirable, for example, to impose taxes on pollution as a means of protecting the environment.

Economists have developed techniques to measure the "excess burden" that results when taxes distort economic decision making. The basic notion is that if goods worth $2 are sacrificed because of tax influences in order to produce goods with a value of only $1.80, there is an excess burden of 20 cents. A more nearly neutral tax system would result in less distortion. Thus, an important post-war development in the theory of taxation is that of optimal taxation, the determination of tax policies that will minimize excess burdens. Because it deals with highly stylized mathematical descriptions of economic systems, this theory does not offer easily applied prescriptions for policy, beyond the important insight that distortions do less damage where supply and demand are not highly sensitive to such distortions. Attempts have also been made to incorporate distributional considerations into this theory. They face the difficulty that there is no scientifically correct distribution of income.

Ease of administration and compliance

In discussing the general principles of taxation, one must not lose sight of the fact that taxes must be administered by an accountable authority. There are four general requirements for the efficient administration of tax laws: clarity, stability, cost-effectiveness, and convenience. Administrative considerations are especially important in developing countries, where illiteracy, lack of commercial markets, absence of books of account, and inadequate administrative resources may hinder both compliance and administration. Under such circumstances the achievement of rough justice may be preferable to infeasible fine-tuning in the name of equity.

Clarity

Tax laws and regulations must be comprehensible to the taxpayer; they must be as simple as possible as well as unambiguous and certain—both to the taxpayer and to the tax administrator. While the principle of certainty is better adhered to today than in the time of Adam Smith, and arbitrary administration of taxes has been reduced, every country has tax laws that are far from being generally understood by the public. This not only results in a considerable amount of error but also undermines honesty and respect for the law and tends to discriminate against the ignorant and the poor, who cannot take advantage of the various legal tax-saving opportunities that are available to the educated and the affluent. At times, attempts to achieve equity have created complexity, defeating reform purposes.

Stability

Tax laws should be changed seldom, and, when changes are made, they should be carried out in the context of a general and systematic tax reform, with adequate provisions for fair and orderly transition. Frequent changes to tax laws can result in reduced compliance or in behaviour that attempts to compensate for probable future changes in the tax code—such as stockpiling liquor in advance of an increased tariff on alcoholic beverages.

Cost-effectiveness

The costs of assessing, collecting, and controlling taxes should be kept to the lowest level consistent with other goals of taxation. This principle is of secondary importance in developed countries, but not in developing countries and countries in transition from socialism, where resources needed for compliance and administration are scarce. Clearly, equity and economic rationality should not be sacrificed for the sake of cost considerations. The costs to be minimized include not only government expenses but also those of the taxpayer and of private fiscal agents such as employers who collect taxes for the government through the withholding procedure.

Convenience

Payment of taxes should cause taxpayers as little inconvenience as possible, subject to the limitations of higher-ranking tax principles. Governments often allow the payment of large tax liabilities in instalments and set generous time limits for completing returns.

Economic goals

The primary goal of a national tax system is to generate revenues to pay for the expenditures of government at all levels. Because public expenditures tend to grow at least as fast as the national product, taxes, as the main vehicle of government finance, should produce revenues that grow correspondingly. Income, sales, and value-added taxes generally meet this criterion; property taxes and taxes on nonessential articles of mass consumption such as tobacco products and alcoholic beverages do not. In addition to producing revenue, tax policy may be used to promote economic stability. Changes in tax liabilities not matched by changes in expenditures cushion cyclical fluctuations in prices, employment, and production. Built-in flexibility occurs because liabilities for some taxes, most notably income taxes, respond strongly to changes in economic conditions. A more-active approach calls for changes in the tax rates or other provisions to increase the anticyclical effects of tax receipts.

Some economists propose tax policies to promote economic growth. This approach may imply a qualitative restructuring of the tax system or

special tax advantages to stimulate saving, labour mobility, research and development, and so on. There is, however, a limit to what tax incentives can accomplish, especially in promoting economic development of specific industries or regions. An emphasis on economic growth implies the need to avoid high marginal tax rates and the tax-induced diversion of resources into relatively unproductive activities.

Shifting and incidence

The incidence of a tax rests on the person(s) whose real net income is reduced by the tax. It is fundamental that the real burden of taxation does not necessarily rest upon the person who is legally responsible for payment of the tax. General sales taxes are paid by business firms, but most of the cost of the tax is actually passed on to those who buy the goods that are being taxed. In other words, the tax is shifted from the business to the consumer. Taxes may be shifted in several directions. Forward shifting takes place if the burden falls entirely on the user, rather than the supplier, of the commodity or service in question—e.g., an excise tax on luxuries that increases their price to the purchaser. Backward shifting occurs when the price of the article taxed remains the same but the cost of the tax is borne by those engaged in producing it—e.g., through lower wages and salaries, lower prices for raw materials, or a lower return on borrowed capital. Finally, a tax may not be shifted at all—e.g., a tax on business profits may reduce the net income of the business owner.

Tax capitalization occurs if the burden of the tax is incorporated in the value of long-term assets—e.g., a decline in the price of land that offsets an increase in property taxes. Capitalization can result where there is forward shifting, backward shifting, or no shifting. Thus, an increase in the price of gasoline resulting from higher motor fuel taxes may reduce the value of high-consumption automobiles, a tax on the production of coal that cannot be shifted forward would reduce the value of coal deposits, and a tax that reduces after-tax corporate profits may reduce the value of corporate stock. In all these cases the present owner of the asset takes a capital loss because the value of the asset will be lower by the capitalized value of the tax.

It can be difficult to determine the incidence of a tax; indeed, the tax may be partly borne by the taxpayer and partly shifted. In many cases the problem can be adequately resolved by using what economists call partial equilibrium analysis, which involves focusing on the market for the taxed product and ignoring all other markets. For example, if a small tax were to be imposed on an addictive substance, there is little doubt that it would be borne by the users of the substance, who would pay the tax rather than forgo use of the substance. More generally, the incidence of taxation depends on all of the market forces at work. In a market economy the introduction of any tax triggers a whole series of adjustments in consumption, production, the supply of productive factors, and the pattern of foreign trade.

These adjustments in turn will have repercussions on the prices of various commodities, productive factors, and assets that may be far removed from the area of the initial impact. In other words, a tax levied on a certain object may affect the prices of nontax goods and services that are not even used in the production of the object. Thus, the initial impact of a tax does not indicate where the ultimate burden will rest unless one knows what repercussions the tax will have throughout the system of interrelated economic variables—i.e., unless recourse is made to what is called general equilibrium theory, a method of analysis that attempts to identify and incorporate the economy-wide repercussions and implications of taxation. In what follows, an attempt will be made to isolate some of the factors involved. The direction and extent of tax shifting is determined basically by one principle:

The user of a tax object can avoid the tax burden to a greater extent the easier it is to find nontax or less-taxed alternatives or substitutes for the tax object; the supplier of a production factor that is taxed or used in the production of a taxed good can avoid the tax burden to a greater extent the easier it is to find equivalent nontax or less taxed alternative employment opportunities for this factor. Because the demand for substitute goods will increase, their prices may rise, thus benefiting the producers of such goods and placing part of the tax burden on those individuals who used them

before the tax was imposed. Likewise, the productive factors that seek alternative employments to avoid the tax will tend to receive lower returns in those employments, thus placing part of the burden on individuals who supplied the factors in those sectors before the tax was imposed. For example, if wine is taxed while beer is not, then—if these two beverages are regarded as perfect substitutes and the price of beer does not rise with increased demand—the tax burden will fall on the owners of land used for viticulture and on the workers engaged in it.

It will fall mainly on the landowners if the soil is specific to grapevine growing and if labour has alternative employment possibilities. If, on the other hand, wine drinkers are determined to drink only wine, they will bear most of the tax burden. If some substitution of beer for wine takes place and the price of beer rises somewhat, both wine and beer drinkers will bear the burden and owners of resources specialized to the production of beer will benefit.

In addition to the substitution effect discussed above, one must take into account the income effect. When taxation reduces real income, consumption of certain goods and services will be reduced, because people have less money to spend. Furthermore, if a tax causes a significant redistribution of real income and if different income classes have different propensities to save and different patterns of consumption, then the income redistribution will influence the demand for various goods, the supply of labour, and the demand for various resources. Other considerations affect tax shifting, but they are derived from the basic principle of substitution. The extent of shifting may vary over time, depending on how long it takes to adjust consumption patterns, reallocate land and capital, retrain labour, and so on. Those users and suppliers who have the most difficulty in adjusting will bear the largest burden.

The breadth of the tax base affects tax incidence. The broader the tax base—i.e., the more inclusive the scope of the tax—the more difficult it is to escape the tax burden, since the range of nontaxed or less-taxed substitutes is narrower. Thus, an excise tax on only a few alcoholic beverages allows the tax to be escaped through a change in the consumption pattern, while a tax

on all such beverages does not. In a similar fashion, the returns on capital will be affected less by the taxation of corporation profits alone than by the taxation of both corporation and noncooperation profits.

The smaller the jurisdictional unit imposing the tax, the easier it tends to be for a user to obtain nontaxed or less-taxed substitutes from outside the jurisdiction and for a supplier to find nontaxed or less-taxed outside employment opportunities for his goods and services. Thus, a tax levied by a sub national government on the production of a particular good is likely to be borne by suppliers of commodities and productive factors that are immobile. This is particularly relevant to the determination of the incidence of state income taxes and local property taxes, taxes that are often thought to be "exported" to out-of-state consumers. In small communities the only really immobile factors are likely to be real estate, certain local services, and perhaps poor families.

The rigidities of imperfect markets are likely to increase the uncertainty of the shifting response. Thus, a monopolist may absorb part of a tax in lower profits rather than shift the entire burden to the user of the product. In industries where there are few firms (oligopoly), the price behaviour of a firm is mainly determined by what it expects its competitors to do. It may be especially easy for regulated public utilities to shift taxes forward. Rigid product prices are likely to increase the incidence of taxes on employment, unless monetary policy allows the tax-induced changes in relative prices to take place in the setting of a generally rising price level.

All of these considerations are analytical and theoretical. Efforts have been made to measure the impact of taxation by studying the actual effects of a particular tax on income and employment. These studies reflect the obvious and inherent difficulty that the tax impact cannot be easily isolated from the economic consequences of other events. For example, studies of corporate income tax shifting vary in their results, from the conclusion that the tax is not shifted at all to the conclusion that it is shifted by more than 100 percent, depending mainly on the methods used to isolate the tax impact.

Taxable Capacity:

The purpose of finding out the taxable capacity of any country or people is to know the limit of taxation to which it could be subjected for raising public revenue. This has to be done without creating higher adverse conditions in the economy which might defeat the very object of taxation. Taxable Capacity refers to the maximum capacity that a country can contribute by the way of taxation both in ordinary and extra ordinary circumstances. In other words, it refers to the maximum capacity of the people of a country to bear the burden of taxation without much hardship. It is nothing but the maximum limit that a government can tax the people. If the government exceeds this red signal, namely the maximum limit, it will result in over-taxation.

1. Absolute Taxable Capacity:

Absolute taxable capacity refers to whatever could be taken away by the State after allowing for the barest of subsistence to the citizens. The indicator of absolute taxable capacity is that if it does not increase the revenue of the State, it then indicates that the absolute taxable capacity of the people has already been reached.

2. Relative Taxable Capacity:

Relative Taxable Capacity refers to the respective contribution made by two communities for the common expenditure of the government. In other words, it is the capacity of one community to some common expenditure in relation to the capacities of other communities. For example, there are two communities, namely the rich and the poor communities. The rich-people can be made to contribute more to a common expenditure than the poor people. The rich people have the ability to pay in view of their higher income.

Factors Affecting Taxable Capacity:

As the prosperity of nation progresses, the taxable capacity of the people also increases under the influence of many economic and non-economic factors. Therefore, the concept of taxable capacity is not very rigid rather it is dynamic. The taxable capacity of the people of a country is affected by several factors which are as follows:

1. Psychology of tax payers:

If the people are prepared to make greater sacrifices, then taxable capacity is said to have increased. In times of war, the people are made to pay more taxes. People are generally optimistic during the period of prosperity and they are prepared to pay more taxes.

2. Distribution of Wealth:

If it is distributed equally, the taxable capacity becomes limited. If it is concentrated with few people, then they can be made to shoulder heavy burden of paying taxes.

3. Nature of taxation:

If the tax system is scientifically framed, the taxable capacity increases. If the tax system produces adverse effects on the productive capacity of the people, this will reduce the taxable capacity.

4. Purpose of taxation:

If the purpose of taxation is to raise resources and to bring about economic development [on agricultural, industrial and infrastructural development], people of the country are willing to pay taxes. In contrast, if it is used for spending on ammunition and war overheads, this will inevitably reduce the taxable capacity of the people.

5. Level of economic development:

The taxable capacity of the people is determined by level of economic development of the country. Highly developed countries have greater taxable capacity than the poor countries.

6. Political conditions:

It depends on political stability and internal prosperity. If there is peace inside and outside country, there will be encouraging atmosphere for expanded economic activity, which will in turn increase the taxable capacity.

7. Population:

It depends on the size and rate of growth of population. If population increases at a faster rate than the national income rate, the taxable capacity becomes poorer.

8. Size of National Income:

The taxable capacity of any community will depend upon the size of national income which itself will depend upon such factors as the volume of natural and other resources, the degree of utilization of resources, the state of technology, and so on. The richer a community, the higher is its capacity to pay taxes. Thus, all these factors taken together determine the upper limit of taxation. As the economy goes on achieving prosperity and affluence, the taxable capacity also increases. Taxable capacity varies from country to country and from time to time in the same country. But there is no mathematical formula to measure taxable capacity.

There is a strong connection between the government's tax revenue earnings and economic growth. The simple fact is that as the economy achieves faster growth, the tax revenue of the government also goes up. Tax buoyancy explains this relationship between the changes in government's tax revenue growth and the changes in GDP. It refers to the responsiveness of tax revenue growth to changes in GDP. When a tax is buoyant, its revenue increases without increasing the tax rate.

Tax buoyancy works

The meaning of Tax buoyancy is the relationship among variations in the government's tax income change and the potential in GDP. It has to do with the sensitivity of tax revenue growth to changes in GDP. When a tax collects greater revenue without changing the rate of taxing, it is said to be buoyant. Tax buoyancy shows the association between economy's performance and the government's 'happiness' (tax revenue). It indicates the high sensitiveness of tax revenue realisation to GDP growth.

This concept reveals some interesting aspects as well as some interesting questions. First thing is that the government can feel relieved and happy if the economy achieves higher growth. It may not borrow highly to finance the budget. New schemes and programmes can be lavished because of high revenue growth. In 2007-08, the then FM, P Chidambaram could not hide his joy by declaring that he is the happiest of all FMs. Understandably, the biggest beneficiary of a higher GDP growth rate is the government itself. Second is that tax buoyancy will be highest for direct

taxes. As the economy grows fast, the additional income generated may go to the rich group. A part of that they have to pay to the government in the form of taxes. So if the GDP growth rate registers high say, nine percent, direct income tax collection will accelerate. Generally, direct taxes are more sensitive to GDP growth rate.

Tax elasticity

A similar looking concept is tax elasticity. It refers to changes in tax revenue in response to changes in tax rate. For example, how tax revenue changes if the government reduces corporate income tax from 30 per cent to 25 per cent indicate tax elasticity.

Tax Reform

1. Taxation is an important exercise for the economic and social development of the country. It provides the resources to use goods and services to the people.
2. Various tax reform committees were constituted in India in 1971, 1977, but they suggested ad-hoc measures focused on the impending crisis.
3. The Tax Reforms Committee of 1991 suggested a reduction in the rates of all major taxes, i.e., customs, individual, and corporate income and excise taxes to reasonable levels, maintaining progressivity but not such to induce evasion, broadening the base of all the taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, etc.

Issues with India's Taxation System

- Retrospective taxation has impacted the inflow of foreign capital to India.
- An unstable policy environment pertaining to tariffs and taxes needs to be resolved to boost business and investments ties.
- The complex web of taxation laws of the Central and many State Governments cause complexities and litigation.
- Increased threshold provided in case of personal income taxes and exemptions, tax cuts, preferential tax rates, deferral of tax liabilities etc. lead to a lower tax base.
- Tax evasion and corruption undermine the governance practices by the state.

- Weakness of tax administration such as lack of technical expertise and financial resources, poorly drafted laws and corruption.
- Structural issues such as low financial literacy, a large share of the informal economy and a large number of cash based transactions.

Direct Tax Reforms

- Direct tax is a progressive tax as the proportion of tax liability rises as an individual or entity's income increases. Examples of direct taxes are income tax, corporate tax, dividend distribution tax, securities transaction tax, fringe benefits tax and wealth tax.
- Various committees such as Arbind Modi Committee on Income Tax Reforms and Akhilesh Ranjan Panel on formulating a new Direct Tax Code (DTC), aims to revise, consolidate and simplify the structure of direct tax laws (like Income-tax Act, 1961; Wealth Tax Act, 1957) in India into a single legislation

Need for Direct Tax Reforms

- Rationalization of income tax structure as the tax rate structure – slabs of 10%, 20% & 30% in personal income tax - has mostly remained the same in the last 20 years
- The urgency to simplify the corporate tax structure, for example in 2014-15, small companies having a profit of up to 1 cr paid an average tax rate of 29.37% while companies having a profit of greater than 500 cr paid an average tax rate of only 22.88%.
- Widen the tax base and prevent potential revenue loss due to lower tax rates and simplified tax structure.
- Maintain the balance between direct and indirect taxes, for instance, the contribution of direct taxes has declined from 60% in 2010-11 to 52% in 2017-18.

Measures Taken By the Government

- Various initiatives were launched to increase tax compliance such as the E-Sahyog portal to facilitate online filing of the returns; extension of Indian Customs Single Window Interface for Facilitating Trade (SWIFT), etc.

- Simplification of tax laws such as specific class of persons exempted from the anti-abuse provisions of Section 50CA and Section 56 of the Income Tax Act.
- Providing relief for start-ups with Capital gains exemptions from the sale of residential houses for investment in start-ups extended till FY21, resolving angel tax issues, etc.
- Providing various anti-tax avoidance measures such as Advanced Pricing Agreements (APAs), GAAR (General Anti-Avoidance Rules), etc.

Direct Tax Code (DTC)

It was envisioned to consolidate all direct tax laws of the central government and make the tax system more efficient and resilient. DTC intends to bring horizontal equity among different classes of taxpayers in line with best international practices. It will help to phase out the multiplicity of tax exemptions and deductions in order to widen and deepen the tax base. Such tax reforms will increase compliance, therefore simpler tax lead to a stable and robust taxation system.

Proposal for Direct Tax Code (DTC)

- The government adopted the proposed increased tax slabs in the financial year 2012 – 2013.
- Corporate Income Tax should be 30% with no surcharge on corporate tax.
- The Minimum Alternate Tax (MAT) rate should be 20% from the earlier tax rate of 18.5%.
- Few schemes like PF, Gratuity, pension funds, etc would still come under EEE.

Vivad Se Vishwas Scheme

- This scheme was enacted with the goal to reduce pending income tax litigation, generating timely revenue for the government and benefiting taxpayers.
- The individuals/companies that opt for the scheme are required to pay a requisite tax following which all litigation against them are closed by the tax department and penal proceedings are also dropped.

Faceless Tax Assessment Scheme

- A taxpayer or an assesses is not required to visit an I-T department office or meet a department official for income tax-related businesses.
- It was launched in 2019 to promote an efficient and effective tax administration, minimizing physical interface, increasing accountability and introducing of team-based assessments.

Indirect Tax Framework

- Indirect taxes are consumption-based taxes that are applied to goods or services when they are bought and sold.
- The government receives indirect tax payments from the seller of the good/service, the seller, in turn, passes the tax on to the end-user i.e. buyer of the good/service.
- Examples of indirect taxes are goods and services tax, customs duty, excise duty, sales tax, etc.

Goods and Services Tax (GST)

This indirect tax system was introduced to collect and reduce tax evasion, is easy to understand for the customer and will reduce the tax burden for industry, it ensures that there is no cascading effect of the tax and there is the harmonization of tax laws, procedures, and rates of tax. GST is applicable to the supply of goods or services as compared to the manufacture of goods or on sale of goods or on the provision of services.

Recent Measures by the Government

- **Taxation Laws (Amendment) Ordinance 2019** provided a concessional tax regime of 22% for all existing domestic companies from FY 2019-20 if they do not avail any specified exemption or incentive.
- Taxation Laws (Amendment) Ordinance 2019 has led to a reduction of the tax rate to 15% for new manufacturing domestic companies if such company does not avail any specified exemption or incentive
- The rate of MAT has also been reduced from 18.5% to 15%
- The Finance Act, 2020 removed the Dividend Distribution Tax (DDT) under which the companies are not required to pay DDT.

Conclusion

Earlier tax reforms suffered from increased red-tapism and other bureaucratic hurdles that resulted in the development of a complex tax system. This complexity and presence of multiple layers encouraged leakage, corruption thereby decreasing the tax base. Various tax reforms were carried out in direct and indirect taxation that resulted in simplification of tax structure and better compliance.

Value-Added Tax (VAT)

VAT is a tax that is levied on services and goods and is paid to the government by producers although the actual tax is levied from the end-user or consumers who purchase the services and goods. This is important for GDP. Taxation refers to the process of an authority levying certain charges on goods, services and transactions. It is one of the foremost powers held by the government of any country. Various types of taxes are applicable at various stages of the sale of goods and services; VAT is one such tax.

Value Added Tax (VAT) in India

VAT is a kind of tax levied on the sale of goods and services when these commodities are ultimately sold to the consumer. VAT is an integral part of the GDP of any country. While VAT is levied on the sale of goods and services and paid by producers to the government, the actual tax is levied from customers or end-users that purchase these goods and services. Thus, it is an indirect tax which is paid to the government by customers but via producers of goods and services. VAT is a multi-stage tax that is levied at each step of production of goods and services which involves sale/purchase. Any person earning an annual turnover of more than Rs.5 lakh by supplying goods and services is liable to register for VAT payment. Value-added tax or VAT is levied both on local as well as imported goods.

VAT Rates in India

The implementation guidelines and rules of Value Added Tax vary from state to state as the tax is collected by state governments. VAT in India is categorized under 4 heads which are as follows:

1. **Nil:** Goods and services that fall under this category are exempt from VAT. These are mainly items that are basic and sold in the unorganized sector. Examples of such items include khadi, salt, etc.
2. **1%:** VAT is charged at 1% for the items under this category. 1% VAT is usually charged on relatively expensive items. The reason why VAT is charged at 1% on expensive goods is that increasing the rate of VAT will considerably increase the prices of the items that fall under this category. Some of the examples of products that fall under this category include gold, silver, precious stones, etc.
3. **4-5%:** VAT is charged at 4% to 5% on certain items that are used on a daily basis. Examples of items that attract VAT at 4-5% include cooking oil, tea, medicines, etc.
4. **General:** Items that fall under the general category attract VAT at 12% to 15. The items that fall under this category are mainly luxury items such as cigarettes, alcohol, etc.

VAT Calculated

VAT is actually calculated as the difference between input tax and output tax.

VAT = Output Tax – Input Tax

Where output tax is the tax received by the seller for the sale of his goods and services and input tax is the tax paid by the seller for raw materials required to manufacture his goods and services.

VAT Example

Suppose Ram owns a restaurant and spends Rs.50,000 towards obtaining raw materials. Input tax is 10%, so input tax becomes 10% of Rs.50,000 = Rs.5,000. Now after selling the food made by using the purchased raw materials, Ram was able to make Rs.1,00,000. Supposing 10% output tax, output tax becomes Rs.10,000. So, final VAT payable by Ram comes out to be Rs.10,000 – Rs.5,000 = Rs.5,000

VAT required and how is it useful

India was one of the last few countries to introduce VAT as a form of tax. The taxation process in India was believed to be exploited the most by businessmen and enterprises which had found loopholes for evading taxes.

VAT was introduced to minimize this evasion and render transparency and uniformity to the tax payment process. Value Added Tax is levied in multiple stages of the production of goods and services and comes under the purview of various state governments. Hence, VAT in India might slightly differ from one state to another.

- No exemptions under the VAT system. Levying tax at each stage of the production process ensures better compliance and fewer loopholes to be exploited
- VAT, when enforced properly forms an important instrument for tax consolidation of the country and as such helps towards solving the fiscal deficit issue to some extent
- Since, VAT is a globally accepted taxation system, it will help India integrate better into global trade practices

VAT Registration

VAT registration is mandatory for enterprises that make a turnover of more than Rs.5 lakh by selling goods and services. All such enterprises are required to register in their respective states of operation. Registering for VAT is necessary for enterprises to start paying VAT. On registration, each trader is given a unique 11-digit registration number which is used for all communication regarding VAT and its filing.

Register for VAT

Any firm making a turnover of more than Rs.5 lakh per annum is required to register for VAT payment.

Documents required for VAT registration:

Following is the list of documents that needs to be submitted while registering for VAT.

- Copy of PAN card
- Address proof of business
- Proof of identity of promoters
- Additional security deposit or surety

VAT Collection in India

The process of collection of VAT can be safely categorized into two broad heads based on the method of collection of value added tax.

Account-based collection of VAT

Under the account-based method of collection, sale receipts are not used, instead, tax is calculated on the value added. Value added is calculated as the difference between revenues and allowable purchases.

Invoice-based collection of VAT

Under the invoice-based VAT collection, sale receipts or invoice is used to compute the corresponding VAT. Traders when they sell their goods and services offer invoices containing separate details of VAT collected. Most countries in the world today use the invoice-based method of VAT collection. Another way to categorize VAT collection is to classify it based on the timing of collection.

Accrual-based collection of VAT

Accrual-based collection matches the revenue with the period during which it is earned and matches the cost of raw materials and expenses to the time during which they were made. This method is extremely complicated as compared to the cash-based collection of VAT. However, it also throws substantial light on information about any business.

Cash-based collection of VAT

Cash-based accounting is simpler than accrual-based calculation. Emphasis is laid on the cash that is being handled instead of whether all the bills are paid. Whenever a payment is received, that date is recorded as the date of receipt of funds.

VAT Returns

VAT returns have to be filed by businesses that have an annual turnover that is Rs.5 lakhs or higher. VAT is payable on all goods and services that are domestic or imported. VAT returns can be filed traditionally by filling and submitting the required paperwork to the appropriate authorities. It can also be filed online if registered under the VAT Act 2003 using the provided user id and password.

VAT Implementation in Various State of India

Since enforcement of VAT and collection of it comes under the purview of state governments, different states have different VAT rules and implementation guidelines. Hence, the procedure for tax implementation,

rates of VAT, timelines for VAT payment and VAT return filing, all differ from one state to another. Despite state-specific implementations, VAT in India can be divided into four main subheads.

- **NIL VAT Rate:**

  In a lot of states items that are very basic in nature are sold without levying any VAT on them. These items are mostly those sold by the unorganized sector in their most basic or natural form. Examples of these type of items are salt, khadi, condoms etc.

- **1% VAT Rate:**

  For items which tend to be highly expensive, the percentage of VAT applicable needs to be kept low since otherwise the VAT levied could be too high an amount. For such items, VAT is kept as low as 1%. Gold, silver and other precious stones as well as precious jewellery fall under this category of goods. Most Indian states have fixed VAT for these items at 1% of the amount.

- **4-5% VAT Rate:**

  A large number of daily consumption goods have been put by several state governments under this category of VAT. So VAT charged on goods like oil, coffee, medicines etc. is around 4-5% for most states in India.

- **General VAT Rate:**

  General VAT rates apply to goods which cannot be segregated and put under any of the above listed VAT categories. For goods like liquor, cigarettes etc. many governments charge high VAT rates of 12.5% or 14-15%. Also, many state governments follow a general rate of VAT for goods which cannot be categorized to suit the above classification. Such goods are taxed at 12%, 13% or even 15% in different states.

VAT help trade, consumers, and government

Trade: Trade is enhanced due to VAT's uniform rates. A taxpayer is not required to visit the tax department officer on conducting a 100% self-assessment.

Consumers: Consumers have to pay less-price for items if taxes on those goods are removed.

Government:

Since the self-assessment is conducted by the dealers under VAT, there are less resources required for the overall assessment process which allows the government to focus on collection of tax rather than worry about the administrative process.

VAT different from Sales Tax

VAT is computed on each stage of the sales of good and is completely different from sales tax as tax is collected from both producer and consumer. In case of sales tax, it is only the consumer who pays the tax. In case of VAT, fewer rates are levied, while for sales tax, a higher rate is implemented. On claiming input tax under VAT ensures that the invoicing is proper.

Value Added Tax in different states across India

VAT and sales tax have different purposes and hence are kept separate. While sales tax calculation is an easy process, VAT is a multi-level process and a more complex form of tax. Sales tax is simply calculated as a percentage of the final selling price of goods and services and is levied from customers at the time of purchase of goods and services. Some of the most striking points of differentiation between sales tax and VAT are listed below.

VAT is levied from both producers of goods and services as well as consumers while sales tax is levied only from customers; VAT is a complex taxation process because it is charged in multiple stages. Sales tax is a pretty straightforward taxation procedure, VAT is a multi-stage tax levied at each step of production while sales tax is charged from customers at the final purchase of goods or services, VAT places in a lot of checks and hence is more transparent and efficient while sales tax is easy to fiddle with, VAT collection places more burden on producers of goods and services which they might ultimately charge from customers, leading to an increased financial burden on customers and VAT is more transparent and efficient as compared to sales tax and hence generates more revenue for the government than sales tax.

Features of VAT in India

The similar goods and services are taxed equally. So a similar television from all brands will be taxed the same, VAT is levied at each stage of production and hence makes the taxation process easier and more transparent, VAT reduces chances of tax evasion and fosters compliance and Encourages transparency in sale of goods and services at the lowest level.

Goods and Services Tax (GST)

The Constitution of India was amended by the Constitution (one hundred and first amendments) Act, 2016. The GST is imposed and collected by the Centre and the States under Article 246A of the Constitution. It is a destination-based tax on the consumption of goods and services. A destination tax is a tax that would accrue to the taxing authority which has jurisdiction over the place of consumption which is also termed a place of supply.

Evolution of GST

The idea of moving to GST was first floated by the then-Union Finance Minister in his 2006-07 Budget speech. Initially, it was proposed that GST would be implemented on April 1, 2010. The Empowered Committee of State Finance Ministers (EC), which designed State VAT, was asked to develop a roadmap and structure for GST. In November 2009, the EC issued its First Discussion Paper (FDP) on the GST, based on internal and external discussions with the Central Government. This outlined the features of the proposed GST and has served as the foundation for discussions between the Centre and the states thus far. The 12th Finance commission under the Chairmanship of C Rangarajan also recommended implementing the GST. It was recommended by Kelkar Committee setup in 2004 for "Implementation of FRBM (Fiscal Responsibility & Budget Management Act, 2003)" The government implemented GST on July 1st, 2017.

Features of GST

It is to be levied at all stages right from manufacture up to final consumption with credit of taxes paid at previous stages available as set off. In a nutshell, only value addition is taxed and the burden of tax is borne by

the final consumer. It is a dual GST, with the Centre and States levying it at the same time on the same tax base. The Central GST (CGST) levied by the Centre on intra-State supply of goods and/or services is known as the Central GST (CGST) whereas the GST by the states is known as the State GST (SGST). Similarly, the Centre levies and administers Integrated GST (IGST) on all inter-state supplies of goods and services. CGST and IGST are levied and administered by the Centre, whereas SGST and UTST are levied and administered by the states and UTs. A dual GST complies with the Constitution's mandate of fiscal federalism.

Taxes Subsumed by GST

The GST would replace the following taxes:

Central taxes that are subsumed under the GST are: Central Excise duty, Duties of Excise (Medicinal and Toilet Preparations), Additional Duties of Excise (Goods of Special Importance), Additional Duties of Excise (Textiles and Textile Products), Additional Duties of Customs (commonly known as CVD), Special Additional Duty of Customs (SAD), Service Tax, Central Surcharges and Cesses so far as they relate to supply of goods and services

State taxes that are subsumed under the GST are:

The State VAT, Central Sales Tax, Luxury Tax, Entry Tax (all forms), Entertainment and Amusement Tax (except when levied by the local bodies), Taxes on advertisements, Purchase Tax, Taxes on lotteries, betting and gambling, State Surcharges and Cesses so far as they relate to supply of goods and services.

Commodities Kept Outside GST

The Products and Services Tax (GST) is defined by Article 366(12A) of the Constitution, as amended by the 101st Constitutional Amendment Act, 2016, as a tax on the supply of goods or services or both, except for the supply of alcoholic liquor for human consumption, As a result, alcohol for human use is exempt from GST under the constitution's definition of GST. Petroleum crude, motor spirit (petrol), high-speed diesel, natural gas, and aviation turbine fuel have all been temporarily prohibited. The GST Council will determine the date on which they will be subject to GST. Furthermore, power is exempt from the GST. On imported items, customs

duty and IGST will continue to be collected. Currently, petroleum and tobacco products are exempt. Liquor excise duty, stamp duty, and power taxes are all exempted as well. In the case of the aforementioned items, the present taxing structure (VAT and Central Excise) would be maintained.

Structure of GST

The government has categorised items into five major slabs for different goods and services - 0%, 5%, 12%, 18% and 28%. Cesses may be imposed on the items under the highest slab of 28%. GST Council examines issues relating to goods, services tax and makes recommendations to the Union, and the States on parameters like rates, exemption list and threshold limits. Necessities and food items are kept at the minimal rates of 0% and 5% and the luxury items and sin goods (such as tobacco, pan masala) are placed at the top bracket rate of 28%. Out of 1300 products and 500+ services, the majority of the products are placed in the 12% and 18% tax bracket.

GST Council

GST Council is a non-profit organisation dedicated to decisions regarding GST. As per, GST (Article 279A), the President will appoint a council to administer and manage the GST. Its Chairman is India's Union Finance Minister, while its members are ministers chosen by state governments. The council is set up so that the centre has 1/3 of the voting power and the states have 2/3. A 3/4th majority is required to make a decision.

Goods and Services Network (GSTN)

GSTN is registered as a not-for-profit company under the Companies Act. It has been formed to set up and operate the information technology backbone of the GST. While the Central (24.5%) and the state (24.5%) governments hold a combined stake of 49%, the remaining 51% stake is divided among five financial institutions—LIC Housing Finance with 11% stake and ICICI Bank, HDFC, HDFC Bank and NSE Strategic Investment Corporation Ltd with 10% stake each. GSTN had awarded Infosys Ltd the contract to develop the hardware and software for GST. The idea behind GSTN was to set up an entity that is equidistant from both the Central

government and the state governments, as it will advise both the Centre and the states on the information technology network.

GST (Compensation to States) Act, 2017

As per the GST (Compensation to States) Act, 2017, loss of revenue to the states on account of implementation of Goods and Service Tax is payable during the transition period of 5 years. The Act says that the financial year 2015-16 is to be taken as the base year for calculating compensation amount. The projected nominal growth rate of revenue subsumed for a state during the transition period shall be 14% per annum. The government needs extra revenue to compensate the states, and so the GST Council allowed the centre to impose additional cesses for five years on certain goods over and above the highest tax bracket of 28%. These goods on which cess will be levied include tobacco products, coal, motor vehicles, which include all types of cars, personal aircraft, and yachts.

National Anti-Profiteering Authority (NAA)

The National Anti-Profiteering Authority shall be a five-member committee consisting of a Chairman who holds or has held a post equivalent in rank to a Secretary to the Government of India; and four Technical Members who are or have been Commissioners of State tax or central tax. Additional Director General of Safeguards shall be the Secretary of the Authority. The Authority will determine the method and procedure for determining whether the reduction in rate or the benefit of the input tax credit has been passed on by the seller to the buyer by reducing the prices.

The Authority shall exist for 2 years from the date on which the Chairman enters upon his office unless the Council recommends otherwise. The GST Council will constitute a Standing Committee and a state-level Screening Committee on Anti-Profiteering, Standing Committee comprises officers of the State and Central Government as nominated by it.

New Compliances under GST

e-Way Bills: e-Way Bills are a type of electronic bill. By introducing "e-way bills," the GST created a centralised system of waybills. This system was started on April 1, 2018, for inter-state goods movement and on April 15, 2018, for staggered intra-state goods transit. Manufacturers, traders, and

carriers can easily generate e-way bills for items moved from their point of origin to their point of destination using the e-way bill system. Tax authorities' gain as well, as this technique reduces time spent at checkpoints and aids in the reduction of tax evasion.

E-invoicing

For enterprises with annual aggregate revenue of more than Rs.500 crore in any previous financial year, the e-invoicing system became effective on October 1, 2020. This system was also extended to those having an annual aggregate turnover of more than Rs.100 crore as of January 1, 2021. Every business-to-business invoice must be assigned a unique invoice reference number by uploading it to the GSTN's invoice registration page. The invoice is checked for accuracy and authenticity by the gateway. It then authorises the use of a digital signature and a QR code. E-Invoicing enables invoice interoperability and reduces data entry errors. Its purpose is to send invoice information directly from the IRP to the GST and e-way bill portals. As a result, it will reduce the need for manual data entry when filing GSTR-1 and will also aid in the preparation of e-way bills.

Reforms Brought About by GST

National Market: By combining a large number of Central and State taxes into a single tax, a common national market can be created.

Mitigation of cascading effects: The GST significantly reduced the negative consequences of cascading or double taxation, paving the path for a common national market.

Reduced Tax Burden: From the perspective of consumers, the main benefit would be a reduction in the overall tax burden on goods.

Increasing the competitiveness of Indian products: Due to the entire neutralisation of input taxes across the value chain of manufacturing, the GST is making Indian products more competitive in both domestic and foreign markets. GST would be easier to manage due to its transparency and self-policing nature.

Advantages of GST

Create a unified common market: Will assist India in establishing a unified common national market. It will also help the "Make in India" initiative and international investment. Increase the tax rate Compliance: Improved compliance environment since all returns must be filed online, input credits must be validated online, and a paper trail of transactions must be kept at each level of the supply chain. Discourage Tax evasion: By eliminating rate arbitrage between neighbouring States and between intra-state and inter-state sales, uniform SGST and IGST rates will minimise the incentive for evasion. Streamline Taxation: By harmonising tax rules, procedures, and rates between the federal government and states, as well as between states.

For Overall Economy

Will form a secure taxation system:

Bring greater certainty to the taxation system by establishing common procedures for taxpayer registration, tax refunds, uniform tax return forms, a common tax base, and a common system of classification of goods and services.

Lessen corruption:

Increasing the use of technology will eliminate the human interface between the taxpayer and the tax administration, which will help to reduce corruption.

Boost the secondary sector:

This will improve export and manufacturing activity, create more jobs, and so increase GDP through gainful employment, resulting in real economic growth; in the end, it will aid in poverty eradication by creating more jobs and financial resources.

Trade and Industry

A more straightforward tax system with fewer exemptions. Ease of doing business will improve. Reduction in the number of taxes. Certain sectors will no longer be subject to double taxes. Increasing the competitiveness of our products on the global market. Registration, returns,

refunds, and tax payments have all been simplified and automated. Reduced average tax burden on goods and services supply.

For Consumers

Visible prices: Due to the smooth flow of input tax credits between the manufacturer, retailer, and service provider, the final price of items is supposed to be transparent.

Reduction in price: Long-term reduction in the price of commodities and goods due to a reduction in the taxation's cascading effect.

Poverty eradication: It is accomplished through increasing employment and financial resources.

For the States

Broaden the Tax Base: States will be empowered to tax the entire supply chain from manufacturing to retail, which will broaden the tax base.

More economic empowerment: Giving states access to the fastest-growing sector of the economy, which was previously solely available to the federal government, will increase revenue and provide states access to the fastest-growing sector of the economy.

Enhancing Investments: Because GST is a destination-based consumption tax, it will benefit consumers. Improve the country's overall investment climate, which will inevitably boost the country's development.

Boosting Compliance: By minimising rate arbitrage between neighbouring States and between intra-state and inter-state sales, nearly uniform SGST and IGST rates will minimise the incentive for evasion.

Issues Regarding GST

All commodities are not covered:

Certain taxes, such as those on alcohol and tobacco, are still not covered by the GST. States claim that incorporating them will reduce revenue and deplete a valuable resource. However, some experts believe that the underlying explanation is a political-business alliance and high-profile lobbying. In addition, India's Finance Minister stated in parliament that a consensus on bringing alcohol and cigarettes under the GST framework is conceivable shortly.

GST Council:

There are concerns regarding how to identify which things will fall into which tax bracket and the criteria for determining which items will fall into which tax bracket. It could result in lobbying. The Finance Minister has responded by saying that the decision will be made by the GST Council only after full diligence and, most likely, by consensus.

Various tax brackets and rates:

Due to different tax rates and bands, the conceptual premise that GST stands for "One Nation, One Tax" is currently diluted. In response, the Finance Minister stated that because the target consumers of goods and services have varying capabilities, a system similar to the democratic lines must be implemented, in which higher-value consumers pay greater taxes.

The Central Government has taken away the power of the Parliament to levy taxes:

The Act gives the government the authority to announce CGST rates, subject to a cap. This means that the government can change rates up to a maximum of 20% without getting Parliament's permission. Parliament and state legislatures levy taxes under the Constitution. Though the plan to set rates through delegated legislation satisfies these criteria, the question remains whether it is proper to do so without first undergoing parliamentary examination and approval.

Confusion over consumption location:

Under GST, both the state and the federal government can tax services based on where they are consumed. Now the problem occurs because the general guideline for determining the recipient's location is his address on file; yet, there are particular requirements for various services such as telecommunications, real estate, transportation, and so on. This means that even if a service is used in numerous jurisdictions, the tax revenue is credited to the state where the beneficiary is registered or where his business is located. This could result in states with more registered offices paying a larger tax.

Anti-Profiteering Clause:

The government intends to establish an authority to determine whether or not there would be any reduction in tax rates when GST is passed on to consumers by businesses. This notion is not well received by industry and enterprises, who perceive it as a backdoor entry for inspector raj. According to experts, pricing should be established by the market, and no government agency should be in charge of setting prices for goods and services.

The issue of the casual taxable person:

If a person who is registered in one state travels to another state for a brief length of time for a commercial transaction, such as to attend a fair or exhibition, that person must register in that state for that period.

There are three types of taxes that apply under this system:

CGST: This is the tax levied by the federal government on intra-state transactions (e.g., a transaction happening within Uttarakhand)

SGST: The tax levied by the state government on intra-state transactions (e.g., a transaction happening within Uttarakhand)

IGST: It is a tax levied by the federal government on interstate transactions (e.g., Uttarakhand to Uttar Pradesh)

UTGST: This is the tax levied by the federal government on intra-union territory transactions for UTs without governing bodies. (e.g., a transaction happening within Chandigarh or Daman & Diu) In this table, we can see how the various aspects of the GST work in India. Assume the applicable GST rate for a product is 18%.

Sales From	Sales To	Amount of Sale	Type of Tax	GST Amount
Maharashtra	Maharashtra	1,00,000 INR	CGST+SGST (9,000+9,000)	18,000 INR
Maharashtra	Punjab	1,00,000 INR	IGST	18,000 INR
Daman & Diu	Daman & Diu	1,00,000 INR	CGST+UTGST (9,000+9,000)	18,000 INR
Daman & Diu	Maharashtra	1,00,000 INR	IGST	18,000 INR
Maharashtra	Chandigarh	1,00,000 INR	IGST	18,000 INR

It is a dual GST in which the Centre and the States both impose a tax on a shared basis at the same time. The GST charged by the Centre is known as Central GST (CGST), while the GST levied by the States is known as State GST (SGST). Imports of products or services would be classified as interstate supplies, subject to the Integrated Goods and Services Tax (IGST) in addition to customs taxes. GST rates will be agreed upon by both parties: CGST, SGST, and IGST are levied at rates that the Centre and the States agree on. The rates are announced based on the GST Council's recommendations.

Multiple Rates: Initially, GST was levied at four different rates: 5%, 12%, 16%, and 28%. The GST council creates a schedule or list of items that would fall under these different slabs. The GST Council, whose head is India's finance minister, has the authority to decide on any topic relating to GST. The 2016 Act mandates that Parliament reimburse states for any revenue losses incurred as a result of the GST implementation.

Conclusion

As a result, GST is a great step in transforming India's economy from one of informality to one of formality. To address the impending obstacles, it is critical to draw on the experiences of other global economies that have implemented GST before us. The implementation of GST would be a huge step forward in India's indirect tax reforms. It would lessen the negative effects of cascading and pave the way for a common national market by combining a significant number of Central and State taxes into a single tax and permitting the set-off of prior-stage taxes.

Public Debt: Classification, Growth and Method of Debt Redemption

Public debt refers to borrowing by a government from within the country or from abroad, from private individuals or association of individuals or from banking and non-banking financial institutions.

Classification of Public Debt:

(1) Internal and External:

Internal debt is raised from within the country and external debt is owed to foreigners or foreign governments or institutions.

(2) Productive and Unproductive:

The productive debt is expected to create assets which will yield income sufficient to pay the principal and interest on the loan. In other words, they are expected to pay their way; they are self-liquidating. On the other hand, loans raised for war do not create any asset; they are deadweight and are regarded as unproductive.

(3) Short-term and Long-term:

Short-term loans are repayable after short interval of time, e.g. Treasury Bills payable after three months, ways and means advances from the Central Bank. They are intended to bridge the gap temporarily between current revenue and current expenditure. It is called floating debt. Long-term loans are payable after a long time covering several years. They are also called funded debt.

Growth of Public Debt:

Borrowing by public authority is a modern practice. In the past, whenever there was an emergency, usually a war, the monarch relied on the hoarded wealth or borrowed on his own personal credit. Books on history abound in instances of fabulous hoards and accounts of loots and sacks of hoarded wealth either from king's treasuries or from temples and churches. But this method of finance is not suited to modern conditions. It will be inadequate and uneconomical. The system of public credit, making it easy for the state to borrow, has led to tremendous increase in the indebtedness of modern states. Take the case of India. While the total public debt of the country at the end of march 1951 stood at Rs. 2,054 crores, it was expected to shoot up to Rs. 87,062 crores by the end of March 1986 (B.E.— Budget Estimates), i.e., more than 42 times in 35 years.

Causes of Increase in Public debt:

The most important cause of increase in public debt is war of war-preparedness. Nations attach a great importance to their territorial integrity and they consider no sacrifice too much to defend their country. Every war, therefore, leaves the country under greater debt. The increase is also due to fairly frequent budget deficits or current account. The deficits arise from the

necessity of maintaining full economic activity in the economies which may have ceased to expand.

Increase in public debt is also due to the undertaking of welfare schemes by governments in modern times. In Public utilities, where there is no convenient profit check, no right control over cost can be maintained and there are more losses than gains. They also add to the weight of public debt. In recent years, urge for economic growth has induced the underdeveloped countries to contract debts both internally and externally. The volume of public debt has consequently swollen.

Purposes or Public Debt:

(i) Bridging Gap between Revenues and Expenditure:

It often happens that towards the end of the financial year, government experiences shortage of funds. To cover this gap between revenue and expenditure, the government raises temporary loans or gets 'ways and means, advance from the Central Bank. In India, the government issues what are called 'Treasury Bills' which are repayable after three months.

(ii) Financing Public Works Programme:

During depression, the government has to launch public works programme to provide employment. In this way, money is injected into the economy to lift the depression. For this purpose, it becomes necessary to raise public loans to ensure economic stability.

(iii) Gurbing Inflation:

When inflation is rampant and it is desired to bring down the prices, the government issues public loans. In this way, money or purchasing power is drawn from the public. Reduction in money supply will bring down prices.

(iv) Financing Economic Development:

The underdeveloped countries are now very keen on speedy economic development, which involves huge investment. They are unable to raise adequate finances through taxation. Hence resort to public borrowing becomes necessary.

(v) Financing the Public Sector:

Economic system, which is becoming increasingly popular, is that of mixed economy. For several reasons, economic, political and social, there has to be a rapidly expanding public sector. The financing of this sector is not possible without resort to public borrowing.

(vi) War Finance:

A modern war is a very costly affair. To prosecute a modern war by taxation is simply out of the question. Public borrowing becomes essential. Thus, public borrowing is necessitated by the requirements of filling the gap between revenue and expenditure, public programme, economic development and war finance.

Methods of Debt Redemption:

Modern governments make it a point of honour to repay their debts. Debt repayment maintains and strengthens the national credit. If a national emergency arises later, it will be easy to raise funds. Repayment of loans also releases funds for trade and industry.

The following are some of the methods adopted:

(i) Utilization of Surplus Revenue:

This is an old method and badly out of tune with the modern conditions. Budget surplus is not a common phenomenon. Even when there is a surplus, it is so insignificant that it cannot be used for making any substantial reduction in the public debt.

(ii) Purchase of Government Bonds:

The government may buy its own stock in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the conditions are favourable.

(iii) Terminable Annuities:

When it is intended completely to wipe off a permanent debt, it may be arranged to pay the creditors a certain fixed amount for a number of years. These annual payments are called annuities. It will appear that, during the time these annuities are being paid, there will be much greater strain on the government finances than when only interest has to be paid.

(iv) Conversion:

This is a method for reducing the burden of the debt. A government may have borrowed when the rate of interest was high. Now, if the rate of interest falls, it can convert a high-rated loan into a low-rated one. The government gives notice to the creditors that they should either agree to reduce the interest rate for future payments or it will exercise the option of repaying the loan, in case the bond-holders do not accept the lower rate, then the government will raise a new loan at lower rate of interest and, with the proceeds, pay off the old debt. The effect is to convert a high-rated loan into a low-rated one. The financial burden is consequently reduced.

(v) Sinking Fund:

This is the most important method. A fund is created for the repayment of every loan by setting aside a certain amount every year out of the current revenue. The sum to be set aside is so calculated that over a certain period, the total sum accumulated, together with the interest thereon, is enough to pay off the loan.

Burden of Public Debt:

In order to assess the burden of public debt, we shall have to consider the nature and the purpose of the public debt. If the debt is taken for productive purposes, e.g., for irrigation and railways, it will not mean any burden. On the other hand, it will confer a benefit, provided the scheme has been successfully executed. But if the debt is unproductive, it will impose both money burden and real burden on the community. The measure of the burden will depend on whether the debt is internal or external.

Burden of Internal Debt:

Internal debt involves a series of transfers of wealth within the community. For example, when the loan is raised, money is transferred from the lenders to the government. The government then makes payments to contractors, government servants or to those people from whom it buys goods and services. Money is, thus transferred from some sections of the community to the other sections. In this case, there is obviously no direct money burden of the debt on the community as a whole. But there will be a

direct real burden on the community depending on the nature of these transfers of wealth.

If by these transfers, wealth comes to be more evenly distributed i.e., wealth is transferred from the rich to the poor, then public debt will be considered beneficial instead of being burdensome. If, on the other hand, the public debt enriches the rich at the expense of the poor, it imposes a real burden. Let us analyse carefully the nature of the transfer. In order to repay the interest and the principal of the debt, the Government must levy taxes. What the tax-payers pay, the bond-holders receive. The bond-holders are generally rich people. But the tax burden does not exclusively fall on the rich, unless it is very sharply progressive which the case is seldom.

The tax burden falls ion the rich and the poor both, and, in the case of indirect taxes, it may be more on the poor than on the rich. The net result may be that the wealth is transferred from the poor to the rich. This means a net loss of economic welfare. This burden is accentuated by the fact that the transfer is from the young to the old and from the active to the Passive members of the community. “Here”, says Dr. Dalton, “If nowhere else in the sphere of public finance, the voice of equity rings loud and clear. There is also a general presumption, on grounds of production against the enrichment of the passive at the expense of the active, whereby work and productive risk-taking are penalized for the benefit of accumulated wealth.” Thus, internal debt has adverse repercussions both on production and distribution of wealth. Thus is its direct real burden. Its indirect real burden will lie in the check it imposes on production. The production is likely to be checked, if the desire and ability to work and save are reduced. If the repayment of debt involves very heavy taxation, it is likely to reduce the ability and the willingness to work and save.

Burden of external Debt:

The external debt also involves a series of transfers of wealth but not within the same country like the internal debt. This makes all the difference. When the loan is raised, wealth is transferred from the lending to the borrowing country, and when it is repaid the transfer is in the opposite direction. The account of money paid by the debtor country towards interest

and the principal is the measure of the direct money burden on the community. But if we want to know the direct real burden, we shall have to consider the proportions in which the rich and the poor contribute to these payments. The government will raise the required money by taxes. If the taxes fall largely on the rich, the direct real burden will be less than it would be if the incidence is largely on the poor.

The payment that we make to the foreign creditor gives him a control over our goods and services. He does not take away our money it is of no use to him. He buys with those money goods in our country. An external loan thus sets up a drain of goods from our country. In the absence of debt payments, these goods would have been enjoyed by us. This means a diminution of economic welfare; hence a direct real burden. The indirect burden of the foreign debt lies in the check to production of wealth in the economy. Taxes imposed, in order to raise funds for debt payment, may reduce public expenditure in the directions which would have stimulated production. Hence, production may be checked.

International payments can be made only by exporting goods. For this purpose, a country must produce more. Hence, it is said that production is stimulated. But production is stimulated only in certain directions. There is no general increase in production and employment. Factors of production are limited. If they are needed in the export industries, they will have to be drawn from the other industries which must consequently shrink. Thus, there is only a diversion of resources and no net increase in production and employment.

Role of Public Borrowing in a Developing Economy:

A developing economy has to tap all possible sources to mobilise sufficient financial resources for the implementation of its economic development plans. It has to utilise revenue surplus for the purpose, seek external aid, pitch up its level of taxation and public borrowing are the two major instruments of resource mobilisation. Public borrowing has one advantage over taxation. Taxation, beyond a certain limit, tends to affect economic activity adversely owing to its disincentive effect. There is no such danger in public borrowing. It does not have any unfavourable

repercussions on economic activity by being disincentive, partly because of its voluntary nature and partly because of expectation of return and repayment.

According to expert opinion, taxation should cover at least current expenditure on normal government services, and borrowing should be resorted to finance government expenditure which results in creation of capital assets. In that case, growing public debt will not be a burden on the economy, because such a debt is self-liquidating. But there is a limit to public borrowing, which is considered safe. Additional taxation is also necessary to implement the development plans. The classical theory frowned upon public borrowing. It was thought that the use of resources by the government was less productive than their use in private hands. But the classical reasoning was based on the assumptions of full employment, inelasticity of money supplies and unproductiveness of public expenditure. These assumptions, we know, are not valid today.

Public borrowing for financing productive investment generates additional productive capacity in the economy, which otherwise would not have been possible. It is used as an instrument to mobilise resources which, in an underdeveloped economy, would otherwise have gone into hoards or invested in real estate or jewellery. Public debt would thus divert the flow of resources into the right channels. Thus, in an underdeveloped economy public borrowing, if prudently managed and skilfully operated, can become a powerful instrument of economic development. Besides, growing public debt provides the people opportunities to hold their wealth in the form of safe and stable income-yielding assets, i.e. government bonds.

Growth and composition of public debt provides the monetary authorities with assets which they can manipulate to give effect to a monetary policy considered desirable in the context of economic development. Thus, monetary policy, which is considered essential for achieving the objectives of economic policy, becomes vitally related to public debt management. The management of public debt is used as a method to influence the structure of interest rates. This, a growing public debt, in an

underdeveloped economy, has become a powerful tool of developmental monetary policy.

There are two important ways in which the governments of underdeveloped economies raise resources through public loans:

1. Market borrowing, i.e., sales to the public of government bonds (long-term loans) and treasury bills (short- term loans) in the capital market,
2. Non-market borrowing, i.e., issue to the public of debt which is not negotiable and is not bought and sold in the capital market, e.g., issue of national savings certificates and national plan bonds and accepting deposits in the government post office.

Voluntary or Forced Loans:

Most of the types of public loans are voluntary. But, if the voluntary loans do not prove sufficient for the purpose, forced loans become necessary and are resorted to. An important example of forced loans familiar in India is that of Compulsory Deposit Scheme. Compulsory borrowing is a compromise between taxation and borrowing. Like a tax it is a compulsory contribution to the government but like a loan, it is to be repaid with interest. Compulsory loans have a special advantage in the context of an inflationary situation and are superior to voluntary public borrowing. They sterilize funds, whereas voluntary public loans result in the creation of readily cashable bonds. They are monetized to increase liquid assets in the community which produce an inflationary effect. Also, lower rate of interest can be paid on compulsory loans, thus reducing the cost of public debt. But a continuous policy of compulsory borrowing may arouse public resentment. Normally, it is the voluntary public borrowing programmes which should be chiefly relied upon.

Unit-IV

Public Budget and Deficit Financing

Introduction

Some of the important objectives of government budget are as follows: 1. Reallocation of Resources 2. Reducing inequalities in income and wealth 3. Economic Stability 4. Management of Public Enterprises 5. Economic Growth and 6. Reducing regional disparities. Government prepares the budget for fulfilling certain objectives. These objectives are the direct outcome of government's economic, social and political policies.

The various objectives of government budget are:

1. Reallocation of Resources:

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

(i) Tax concessions or subsidies:

To encourage investment, government can give tax concession, subsidies etc. to the producers. For example, Government discourages the production of harmful consumption goods through heavy taxes and encourages the use of 'Khaki products' by providing subsidies.

(ii) Directly producing goods and services:

If private sector does not take interest, government can directly undertake the production.

2. Reducing inequalities in income and wealth:

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

3. Economic Stability:

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

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

4. Management of Public Enterprises:

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

5. Economic Growth:

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

6. Reducing regional disparities:

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

Budget - Concept

The budget is referred to in the Constitution as the "annual financial statement." To put it another way, the term "budget" appears nowhere in the Constitution. It's the common name for the 'annual financial statement,' which is addressed in Article 112 of the Constitution. The President is responsible for submitting the budget to the Lok Sabha, according to Article 112 of the Indian Constitution. The yearly financial statement covers a year's worth of transactions. According to Article 77 (3), the President has delegated to the Union Finance Minister the responsibility of preparing the budget, also known as the yearly financial statement, and shepherding it through parliament. The budget represents the government of India's expected receipts and expenditures for a certain fiscal year. Each year, the fiscal year begins on April 1st.

Budget Making Process in Parliament

The budget is presented by the Finance Minister to Parliament each year during the Budget Session in February. The timing may vary during an election year. Some important documents that are tabled at the time of presentation of the Union Budget include the following: The Annual Financial Statement: Summarises the expenditure and receipts of the government

Budget at a Glance: Brief overview of the budget

Expenditure Budget: Details the expenditure of various ministries and departments including the Demands for Grants for each ministry

Receipts Budget: Details the tax and non-tax funding plan for the government

Finance Bill: Details any changes to the existing tax laws in the country

Medium Term Fiscal Strategy Document: Sets three-year rolling targets for select fiscal indicators as per the Fiscal Responsibility and Budget Management Act.

The budgetary procedure in India involves four different operations that are: 1.Preparation of the budget, 2. Enactment of the budget, 3. Execution of the budget and 4. Parliamentary control over finance.

1. Preparation of the budget

Every year, the ministry of finance begins the process of preparing the budget, which usually begins in September. For this aim, the Ministry of Finance's Department of Economic Affairs has a budget Division. The ministry of finance compiles and coordinates the estimates of various ministers and departments' expenditures in order to generate an estimate or plan outlay. The budget proposals of finance ministers are examined by the finance ministry who has the power of making changes in them with the consultation of the prime minister.

2. Enactment of the budget

Once the budget is prepared, it goes to the parliament for enactment and legislation.

The budget has to pass through the following stages:

In the Lok Sabha, the finance minister presents the budget. In the Lok Sabha, he presents his budget. At the same time, a copy of the budget is placed on the Rajya Sabha's table. Members of the parliament are given printed copies of the budget to go over the intricacies of the budgetary measures. Following the presentation of the budget, the finance bill is presented to parliament. The Finance Bill refers to proposals for new taxes, changes to current taxes, or the repeal of previous taxes.

The revenue and expenditure proposals are debated in Parliament. Members of Parliament actively participate in the debate. Grant requests are presented to Parliament at the same time as the budget. These grant requests demonstrate that the estimates of expenditure for several ministries must be voted on by Parliament. The members who propose a reduction of grant bring three kinds of cut motions which are either withdrawn or dropped because their passing will be tantamount to a vote of no confidence in the government. Still, to attract the attention of the government, the cut motions are moved to bring moral pressure on the executive.

Token Cut Motion:

It expresses a specific grievance that is within the sphere of responsibility of the government. It states that the amount of the demand will be reduced by Rs 100. On the 26th day, the Speaker puts all the remaining demands to vote and disposes of them whether they have been discussed by the members or not. This is called **‘**Guillotine closer’.

Policy Cut Motion: shows disapproval of the policy underlying a demand. It states that the amount of the demand will be reduced to Re 1.

Economy Cut Motion: asks for the economy in the proposed expenditure. It states that the amount of the demand be reduced by a specified amount by which may be either a lump-sum reduction or omission or reduction of an item in the demand.

Vote on credit

It is granted for meeting an unexpected demand upon the resources of India when on account of the magnitude or the indefinite character of the service, the demand cannot be stated with the details ordinarily given in a

budget. Hence, it is like a blank cheque given to the Executive by the Lok Sabha.

Vote on accounts

Vote on Account is a grant in advance to enable the government to carry on until the voting of demands for grants and the passing of the Appropriation Bill and Finance Bill.

Vote on exceptional grants

It is granted for a special purpose and forms no part of the current service of any financial year.

Supplementary grants

It is granted when the amount authorized by the Parliament through the appropriation act for a particular service for the current financial year is found to be insufficient for that year.

Excess grants

It is granted when money has been spent on any service during a financial year in excess of the amount granted for that service in the budget for that year. It is voted by the Lok Sabha after the financial year.

Token grants

It is granted when funds to meet the proposed expenditure on a new service can be made available by re-appropriation. Demand for the grant of a token sum (of Re 1) is submitted to the vote of the Lok Sabha and if assented, funds are made available. After the parliament votes on grant requests, the Appropriation Bill is introduced, debated, and passed by the Parliament's Appropriation Committee. It establishes the legal basis for the withdrawal of funds from the Consolidated Fund of India**.**

After the appropriation bill is passed, the finance bill is debated and passed. Members of parliament can propose and make adjustments at this point, which the finance minister can accept or reject. The Rajya Sabha receives the Appropriation Bill and the Finance Bill. The Rajya Sabha has fourteen days to return these bills to the Lok Sabha, with or without revisions. The bill, however, may or may not be accepted by the Lok Sabha. The President is asked to sign the Finance Bill. After the presidents sign the bill, it becomes a statue. The president lacks the authority to veto the bill.

3. Execution of the budget

The budget's execution begins when the finance and appropriation bill is passed. The executive department is given permission to begin collecting funds and spending it on approved projects. This is the duty of the ministry of finance's Revenue Department. Various ministries have been given authority to draw and spend the necessary funds. The Secretary of the Ministry serves as the principal accounting authority in this regard. The accounts of the various ministries are compiled in accordance with the established procedures. The Comptroller and Auditor General of India audits these accounts.

Parliament Control over Finance

The Finance Bill and the Appropriation Bill are presented, debated, and passed according to a set of rules. The executive, who makes requests, receives grants from the Parliament, which is sovereign. These demands can include requests for grants, supplementary grants, additional grants, and so forth. Other than those for the Consolidated Fund of India, expenditure estimates are provided to the Lok Sabha in the form of grant demands. The Lok Sabha has the authority to accept or reject any demand, or to accept a demand with a reduction in the sum demanded. Following the completion of the general debate on the budget, the Lok Sabha receives requests for grants from various ministries.

Previously, the finance minister introduced all demands; however, they are now formally introduced by the ministers of the relevant departments. These demands are not forwarded to the Rajya Sabha, despite the fact that a general budget debate takes place there as well. The Constitution states that the Parliament may issue a grant to cover an unanticipated demand on the nation's resources where the demand cannot be articulated with the specifics normally provided in the yearly financial statement due to the scale or indefinite nature of the service. Passing such a grant again necessitates the passage of an Appropriation Act. It's designed to serve a specific purpose, such as addressing wartime requirements.

Conclusion

The budget should be applauded for introducing significant paradigm shifts. However, its success, and thus the long-term viability of India's recovery, will now hinge on policy implementation and coordination.

Kinds of Budgeting

Following are different types of budgets prepared by individuals, businesses, and governments.

Personal Budget: An individual or family plans their monthly earnings and expenses to ensure that they don’t run out of cash before the next pay check.

Corporate Budget: It is a plan to maintain cash flow, operating cash, and emergency funds efficiently. It comprises sales, material, production, and factory overheads.

Government Budget: A financial plan prepared by the federal government accounts for the estimated national revenue for a particular financial or fiscal year. The revenue comes from taxes, fees, and grants. It also considers the anticipated expenditure over public services and infrastructure. There are two types of federal budgets—capital and revenue.

Master Budget: It is a culmination of various lower-level budgets prepared for different areas of business operations. It is a consolidated business plan.

Operating Budget: It is created at the beginning of a given period. It reflects the profit and loss accounting—accounts for fixed, non-operating, variable, and capital expenditures.

Static Budget: It is mostly formulated by the government and non-profit organizations. It is rigid and does not allow variations depending on the activity of the institution. It is a prediction of revenue and expenses—based on anticipated values. The actual results may vary from the predicted values.

Flexible Budget: It is a realistic approach adopted by businesses. A flexible plan considers changes in expenses and costs over the period and adjusts accordingly.

Financial Budget: It incorporates assets, liabilities, and shareholders equity. It charts a company's short-term and long-term financial goals.

Cash Budget: It is simply a cash flow prepared in advance. It documents anticipated payables and receivables for an upcoming period. It is prepared to ensure that the business has enough money to run the organization effortlessly.

Labour Budget: It is tailor-made for labour-intensive firms. Businesses that are heavily reliant on employees need a systematic plan balancing revenue and wages.

Budgeting Methods

Different methods of preparing financial plans are as follows.

1. Incremental Budgeting

It is a traditional method; the manager takes the previous period's budget as a benchmark. Further, the anticipated percentage change is either summed up or deducted to formulate the current budget. It includes adjustment for inflation, overall market growth, and other relevant factors.

2. Zero-based Budgeting (ZBB)

In this method, all the figures are reset to zero, and the manager begins with a fresh interpretation of all the items. The manager has to justify every new number with reasoning, in contrast to using figures from the previous accounting period. ZBB eradicates traditional expenditures that are no longer required. It is a strategic top-down approach re-evaluating every detail and decision.

3. Activity-based Budgeting

Operations or activities that generate cost to the business are identified. Ways of reducing costs are strategized. It is mostly used in mature organizations.

4. Participative Budgeting

Top-level executives often take the help of the managers and workers of different departments in designing the financial plan. It is a bottom-up approach.

5. Negotiated Budgeting

It has both top-down and bottom-up traits. Managers and employees together frame the financial plan, keeping in mind goals and targets—set by top-level management.

6. Value Proposition Budgeting

As the name suggests, every cost is re-evaluated and justified based on its impact. Unnecessary expenses are eliminated.

Balanced Budget

A balanced budget is a budgeting process or financial plan in which total revenues are equal to the spending or expenditures. The most common use of the balanced budget occurs in the federal budget or public sector budgeting. It can also be understood as a situation when total government spending is equal to the government tax receipts. The advocates of a balanced budget favour it because budget deficits burden future generations with debts. A balanced budget can also be comprehended as a budget that posts a surplus but not a deficit which means revenues can be greater than expenses but not vice versa in balanced budgeting provisions.

Definition of Balanced Budget:

Balanced Budget is defined as a type of budget in which both the total revenues and the total expenditure are balanced; that is, they are equal. A balanced budget does not show a budget deficit but can result in a budget surplus. So, it includes a surplus and not a deficit as generally surpluses are considered favourable. It is predominantly used for government budgets, yet the concept is still applicable to other organizations as long as they earn revenues and incur expenditure. Some ardent proponents believe a balanced budget to be favourable as they feel that the future generations would get weighed down due to the debt created by the budget deficits.

Importance of a Balanced Budget

A balanced budget means the amount that a federal government earns is equal to the amount it spends, that is, Revenue = Expenditure. A balanced budget mainly refers to a budget that strikes a mid-point between budget deficits and budget surpluses, but it can even refer to a budget that runs a surplus. This means that, Revenue > Expenditure

A balanced budget is essential for the following reasons:

It ensures that the government does not indulge in overspending. It helps the government to devote funds to only those key areas that demand the most attention. Budget surpluses help in saving money for urgent economic problems like recessions. So, when there is an economic slowdown, the government can use the accumulated funds to revive the economy. The government sometimes needs to take huge amounts of loans from international organizations, and usually, these organizations charge an interest rate on the loans. So, by maintaining a balanced budget, the government can do away with these charges. Lastly, during stressful years, it enables the government to exercise power over the policies. There are two main things included in a balanced budget, namely:

1. Revenue

It refers to the amount that is earned. In the case of the government, revenue comes in income tax, consumption tax, and all sorts of taxes. However, in for-profit and not-for-profit organizations, revenue is earned when they sell their goods and services.

2. Expenditure

It refers to the amount that is spent. In the case of the government, expenditure is incurred on special-interest projects in healthcare, defense, infrastructure, gross domestic product health, etc. Companies and NGOs incur expenditure on their day-to-day operations like payment of rent, wages, factors of production, etc.

Types of Balanced Budgets

1. Annual Balanced Budgets: An annual balanced budget balances the revenues and expenses in the same financial year.

2. Biennial Balanced Budgets: A biennial balanced budget is achieved in two years by recording a budget surplus in one year and a budget deficit in the other for offsetting.

3. Cyclically Balanced Budgets: A cyclically balanced budget ensures that the budget gets balanced over the business cycle by reporting a surplus when the economy is growing rapidly and a deficit when the economy is slowing down.

Budget Surplus

A budget surplus is a situation that arises when revenues are in far excess of the expenditure. For a company, this surplus is the profit that it can use to give a bonus to its employees, divide it as dividends, or invest it back in the company. A government can use the surplus to bring the economy out of recession and fund many other projects. Revenue – Expenditure = surplus

Budget Deficit

A budget deficit arises when the expenses are more significant than the revenue. The deficit increases the debt by forcing the government to borrow money or take loans from international organizations to restore the economy. Expenditure – Revenue = Deficit

Pros and Cons of a Balanced Budget

The debate over whether a balanced budget is beneficial for the economy or not tends to be a divisive one. A balanced budget and a budget deficit have always been subject to hardcore debate in economics and politics. Even the authorities tried to toy with the idea of a constitutional amendment for legally binding the Government to limit borrowing. But this amendment was also narrowly defeated. So, let us have a look at some of the upsides and downsides of a balanced budget-

Arguments for Balanced Budget

All those in favour of balanced budget stress that the government budget should be maintained just like a household budget or a company's budget by balancing its revenues against its expenditure. There is a popular argument that the entire burden of the debt created by a budget deficit would fall on the shoulders of the generations to come. It is further argued that to contain the debt, the government would have to increase the taxes so that the economy's money supply rises temporarily. This is not an excellent option for a country as it can seriously result in currency devaluation. This trickles down, thereby making it difficult for the companies and consumers to raise credit. The increased taxes can also trigger inflation, with the domino effect continuing to cripple the economic system finally.

The debt exposes the economy to a significant amount of risk, fearing that the government imposes higher taxes. This can be damaging for almost any economy because with the taxes being increased; inflation becomes imminent. Similarly, a budget surplus also fails to satisfy those who are in favour of a balanced budget as there are certain dangers associated with it. Due to the accumulated sum kept in the public account, the government will be tempted to either reduce the taxes or enhance its spending. So, to avoid the problems accompanying deficits and surpluses, a balanced budget should be the goal as it ensures that the total revenue is equal to the total expenditure.

Arguments against Balanced Budget

Some consider deficits and surplus to be significant for the smooth functioning of the federal government economy. They feel that an economy is entirely different from a household or a business. So, it is unreasonable to consider their model of a budget with a country's budget. They further argue that changes in tax rates and government spending are not only essential but also meaningful for an economy, and in the short run, the risks associated with the debt are worth having. Increased government spending pumps up economic productivity and calls for innovation. Moreover, in the private sector, it increases the savings.

Deficit spending plays a vital role in dealing with recessions. When the economy is contracting, the demand tends to fall, causing the country's GDP to slide down as well. According to Keynesians, deficit spending is a great way to motivate the private sector to spend by infusing the economy's essential sectors with money. On the other hand, when the economy is booming, they feel that the aim should be to record surpluses to hold back the demand of the private sector. Keynesians argue that when the government has the power to optimize its fiscal policy, that is, its power of spending and increasing or decreasing taxes, it should make sure that it utilizes it.

Budget Variance Analysis

A comparison of the actual figures reflected in the budget to the baseline or standard figures that are estimated is known as a budget variance analysis.

Favourable Variance

A favourable variance occurs when the actual result is better than the projection made; that is when the revenues are higher and the expenses are lower than the estimated figures.

Negative Variance

A negative variance occurs when the actual result fails to meet the projected figures; that are when the revenues are lower, and the expenses are higher than what was estimated.

Balanced Budget

There are many imponderables due to which it can get complex to strike a balance between the revenues and the expenditure or achieve a balanced budget. So, more often than not, there will be either a deficit or a surplus.

Conclusion

With the help of a balanced budget, governments can avoid excessive spending and focus their funds on those areas and services that require the funds. In addition, the budget surplus would help them to offer funds for emergencies.

A. Balanced Budget

Balanced budget is a situation, in which estimated revenue of the government during the year is equal to its anticipated expenditure. Governments estimated Revenue = Government's proposed Expenditure. For individuals and families, it is always advisable to have a balanced budget. Most of the classical economists advocated balanced budget, which was based on the policy of 'Live within means'. According to them, government's revenue should not fall short of expenditure. They also favoured balanced budget because they believed that government should not interfere in economic activities and should just concentrate on the maintenance of internal and external security and provision of basic economic and social

overheads. To achieve this, government has to have enough fiscal discipline so that its expenditures are equal to revenue.

B. Unbalanced Budget

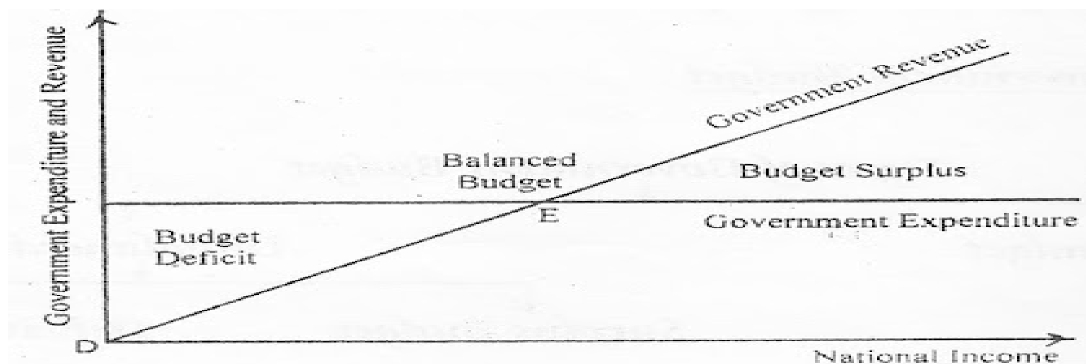
1. Surplus Budget
2. Deficit Budget

1. Surplus Budget

The budget is a surplus budget when the estimated revenues of the year are greater than anticipated expenditures. Government expected revenue > Government proposed Expenditure. Surplus budget shows the financial soundness of the government. When there is too much inflation, the government can adopt the policy of surplus budget as it will reduce aggregate demand. Increase in revenue by levying taxes on people reduces their disposable incomes, which otherwise could have been spend on consumption or saved and devoted to capital formation. Since government spending will be less than its income, aggregate demand will decrease and help to reduce the price level. However, in modern times, when governments have so many social economic & political responsibilities it is virtually impossible to have a surplus budget.

2. Deficit Budget

Deficit budget is one where the estimated government expenditure is more than expected revenue. Governments estimated Revenue < Government's proposed Expenditure. According to Prof. **Hugh Dalton**, "If over a period of time expenditure exceeds revenue, the budget is said to be unbalanced". Such deficit amount is generally covered through public borrowings or withdrawing resources from the accumulated reserve surplus. In a way a deficit budget is a liability of the government as it creates a burden of debt or it reduces the stock of reserves of the government. In developing countries like India, where huge resources are needed for the purpose of economic growth & development it is not possible to raise such resources through taxation, deficit budgeting is the only option. In Underdeveloped countries **deficit budget** is used for financing planned development & in advanced countries it is used as stability tool to control business & economic fluctuations.



At the Point E, budget is balanced. To the left of point E the government budget is in deficit and to the right of point E, the budget is in surplus. When the government incurs a budget deficit it is financed by borrowing. The government borrows from the public by issuing government bonds. This gives rise to government debt or public debt.

Zero-based Budget

Zero-based Budget refers to planning and preparing the Budget from scratch or 'zero bases'. It is different from a traditional Budget that is based on previous Budgets. The process of zero-based budgeting involves review and justification of each and every ministry's expenditure in order to receive funding at the beginning of each financial year. In zero-based Budget, no balances are carried forward, or there are no pre-committed expenses. Simply put, it is a procedure for preparing a Budget with zero prior bases. This concept emphasises identification of a task and funding of costs irrespective of the current structure of expenditure.

Zero-based Budget is built around what is needed for the upcoming period, regardless of whether each Budget is higher or lower than the previous one. Under zero-based Budget, all budgeting begins from a 'zero base' every year; that is, expenses must be justified afresh each year, no matter what was spent in the year before. While traditional budgeting calls for incremental increases over the previous year and tends to perpetuate waste, this form of budgeting puts pressure on spenders to justify expenses each time, and reduce costs.

Here is an example of how zero-based budgeting works.

Suppose crores of rupees are allotted to MPs every year under a government scheme. Only a fraction of that is spent and they are allowed to

be carried forward. In zero-based budgeting, this money would not be allotted to those who did not spend; the money will be spent where it is needed more or used more effectively. Much bigger gains will mount up when hundreds of crores will have to be justified across departments. Zero-based budgeting identifies alternative and efficient methods of utilising limited resources. ZBB was rejected by policy experts owing to the process being an impractical budget-making decision. However, after the global financial crisis of 2008, ZBB came back into the focus for its emphasis on judicious spending during the Budget formation.

Zero-based budgeting in India

In India, the ZBB was adopted by the department of science and technology in 1983. In 1986, the Indian government implemented ZBB as a system for determining Expenditure Budget. The government made it compulsory for all ministries to review their activities and programmes and prepare their expenditure estimations based on the concept of ZBB. In the seventh Five-Year Plan, the ZBB system was promoted. However, not much progress could take place later. Zero-based budgeting is a method of budgeting in which all expenses for each new period must be justified. Under zero-based budgeting, no reference was made or considered of previous years. The budget request has to be evaluated thoroughly with its commencement from the zero-base.

Evolution of zero-based budgeting (ZBB)

The Zero-based budgeting concept was advocated in 1924 by British budget authority Edward Hilton Young. He advocated complete justification of every item requested in a budget. The ZBB concept became more popular only in 1970s. In 1960s, ZBB was formally initiated in the Department of Agriculture of the USA. The ZBB as practiced today was developed at Texas Instruments Inc. during 1969 by Peter Pyhrr. The process was first adopted in Georgia. The result of ZBB in Georgia was mixed. In 1970s, Jimmy Carter was elected as American President amid recession. He vowed to recover the economy. He ordered for implementation of the ZBB in America. Soon it spread in to private organisations also. However the results are mixed. Later American President Ronald Regan dropped the ZBB concept.

Zero-based budgeting in India

In India, the principle of ZBB was initiated in the Department of Science and Technology in 1983. In 1986, the Indian government adopted ZBB as a technique for determining expenditure budget. The government made it mandatory for all ministries to review their programmes and activities and prepare their expenditure estimations based on ZBB concept. In seventh five-year plan, the ZBB system was promoted. However, later not much progress happened in this area.

Features of zero-based budgeting

ZBB works on the principle that every year, the projected expenditure for each project/programme must be start from zero. It means all budget requests should be considered freshly for every year with cost-benefit analysis.ZBB never uses the previous year's amounts so as to eliminate the past mistakes. Focus is on activities/programmes. The focus is on programs or activities instead of functional departments. Best suited to discretionary costs. ZBB is best suited to discretionary costs, for example, advertising, research development and training costs.

Decision packages

A unit makes its budget request by preparing 'decision packages' for each activity it undertakes. Funding decisions are based on activity.

Cost-effective

ZBB helps policy makers to achieve more cost-effective delivery of public services.

Bottom-up approach

ZBB starts from the lowest level activity and then moves upwards.

Accountability

It makes the functionaries accountable for the amount they are responsible for. ZBB model was formulated to correct certain flaws of traditional budgeting system, which does not allow authorities to discover optional processes.

Zero-based budgeting procedures

According to Peter Pyhrr, the zero-based budgeting is an approach, not a fixed procedure or a set of forms to be applied uniformly across all

organisations. The mechanics and management approach has differed significantly among the organisations that have adopted zero-base and the process must be adapted to fit the specific needs of each user.

Steps to the ZBB approach:

Although the specifics differ among organisations, there are 4 steps to the ZBB approach that must be followed by each organisation: Identify 'decision units' (DU). Normally different departments are considered as decision units. The basic criterion should be that it is capable of carrying out different programmes or activities to achieve one objective. Analyse each decision unit in a 'decision package' concept. The content and format of the decision package must provide management with the information it needs to evaluate each decision unit. This information might include purpose/objective, costs and benefits, performance measures, optional means of achieving aims and benefits.

Evaluate and rank all decision packages to develop the appropriations request. The ranking process provides management to allocate its limited resources by making management concentrate on these questions. 'How much should we spend' and 'where should we spend it'? The decision packages should be evaluated and ranked as per their level of significance. Some subjectivity also needs to be used in this method with cost-benefit analysis as some activities may not be quantifiable. Prepare the detailed operating budgets reflecting those decision packages approved in the budget appropriation.

Conditions for successful implementation of ZBB

There are a few conditions for successful implementation of ZBB.

Committed Management: The top management should have a participatory role and they must be committed to implement the ZBB.

Fixed Goals: Goals to be achieved must be fixed. They should not be vague.

Identification of Weak areas: Organisation must identify weak areas to be worked upon.

Trained Staff: ZBB requires a trained staff for its procedure to be implemented properly.

Review: Decision packages must be reviewed periodically.

Brainstorming Sessions: There must be brainstorming sessions at all hierarchical levels to get proper and timely feedback.

Need for zero-based budgeting

- Low priority programs can be eliminated or reduced.
- Effectiveness of programmes can be dramatically improved.
- Programmes of high priority can obtain increased funding by shifting resources within an agency.
- The government need not increase the tax revenue as ZBB can to do a more effective job with existing revenues.

Benefits of zero-based budgeting

Unbiased: The bias from previous information or data is eliminated.

Higher motivation: ZBB seeks employees to work more cohesively and closely together during the budget process. This results in high levels of motivation and interest among employees to do their work efficiently.

Effective Procedures: Zero-based budgeting will generate effective ways and methods to do the work.

New Ideas: In zero-based budgeting new technologies, methods and materials are encouraged to make the organisation more successful.

Efficient Allocation of Resources: By following cost-benefit analysis ZBB will allocate the resources very efficiently.

Planning Tool: ZBB is a planning tool used in management which helps in identification of wasteful and redundant items of expenditure.

Limitations of zero-based budgeting

Bureaucratic and Time Consuming: The ZBB approach takes a lot of time as it is a completely bottom-up approach. The process was so bureaucratic and time consuming that the organisations got discouraged to use it again.

Incorrect Assumptions: The ZBB process can be useful only if the organisation has the time and knowledge to make accurate assumptions. Incorrect assumptions by not looking at the previous year's assumptions will be of little help to the organisation.

Threat felt by Bureaucrats: Bureaucrats feel threat towards ZBB process as it evaluates the effectiveness of their programs.

Problems of Managers: The ZBB process require trained personnel fully aware of the concept, are difficult to find, who can carry out analysis of expenditure by applying the evaluative techniques like cost-benefit analysis, cost-effectiveness analysis etc.

Too Much Paper Work: It is a major factor contributing to the failure of ZBB. ZBB process requires too much of paper work and it was found unmanageable by the organisations concerned.

Organisation Hierarchy: Like traditional budgeting, ZBB was also based on organisational hierarchy. Organisational hierarchy reinforces functional barriers and fails to focus on the opportunities for improving business processes.

Plan and Non-plan Expenditure in India: India follows a system of Plan and Non-Plan expenditure. They should be dealt differently, and it becomes quite difficult to rank them as one.

Conclusion

Though ZBB is a good technique of budgeting, it was not implemented successfully. ZBB does not fit into organisations with long range objectives. Proper attention, Commitment form management and trained personnel can better implement the ZBB process.

Performance Budgeting

A budget contributes a lot in economic policy of any company. Budget is a financial plan and a list of all planned expenditures and profits. It is a chart for saving, borrowing and spending. Management theorists have explained budget as an important device that is used to relate planned resource consumption for a period of time. A budget is a plan for the achievement of programs associated with objectives and goals within a specific time period, that include an estimate of resources compulsory and an estimate of resources available, usually compared with one or more past periods and represent future requirements. Budgeting is the organized way to assign resources and an important component of financial success. It is an activity to empower organization to perform stated goals and objectives.

Performance budgeting is a method of budgeting that provides the purpose and objectives for which funds are needed, costs of programs and

related activities proposed to accomplish those objectives and outputs to be produced or services to be rendered under each program. Performance budgeting follows the validation that a relaxation of input controls and an increased flexibility enhances managers' performance as long as results are measured and managers are held responsible for their results. The major aim of performance budgeting is to improve the efficiency of public expenditure, by linking the funding of public sector organizations to the results they deliver. It adopts organized performance information to make this link. There is a good impact of performance budgeting on organizations in terms of improved prioritization of expenditure, and in improved service effectiveness.

Theoretical literature denotes that as compared to traditional budgeting, performance budgeting facilitates for more flexible use of economic resources and transforms focus from inputs to results. Performance budget focuses on the results to be accomplished. The performance budget, given its program structure, changes the focus of conversation from detailed line items to broader objectives and performance of public programs, and allows more conversant budgetary decision-making. Performance budget presents greater managerial suppleness by providing the program or department manager a fixed lump sum distribution that may be used for various needs in order to accomplish the agreed upon results in service delivery.

Performance budgeting is more than introducing performance information into the budget process. Main characteristic of the new performance budgeting procedure is the identification that, if performance is the mater, the objectives of the budget management system must be incorporated with overall responsibility, so that good budgetary performance is compensated, and poor performance is punished. Performance Based Budgeting tries to resolve issues related to decision making problems. Performance may be judged by certain programs ability to attain objectives that contribute to a more abstract goal as calculated by that programs ability to use resources efficiently by linking inputs to outputs.

Budget Classification:

Performance budgeting modifies the focus on resource allocation from the objects of expenditure to public programs designed to serve strategic objectives of the government. Funds are allocated to various objectives and spending agencies manage the lump sum allocation in seeking more cost-effective and innovative ways of achieving results and central budget control focuses on the achievement of program goals by each agency rather than by the detailed line itemization of the agency's budget.

Performance Measurement and Reporting:

A successful performance budgeting system depends greatly on consistent performance measurement and reporting. Since performance measurement and reporting do not directly influence budgetary allocations, the plan does not immediately incur financial risks for public managers and therefore serves as good efforts for the reform. The creation of a performance measurement and reporting system provides a channel for public officials to reach agreement on program goals/objectives and, discuss and compromise on the selection of performance measures, to deal with questions and concerns, and to beat their doubts about performance budgeting.

Further, a performance budgeting system requires numerous measures that determine public program from a variety of lens such as inputs, output, efficiency, service quality, and outcomes. Different measures gauge dissimilar features of budgeting practice. The use of various indicators instead of a single measure rests on unsure and distorted relationship between inputs, process, and results, an inherent feature of public programs. In other words, the outcomes or service quality associated with a government program cannot be inferred just by reporting its outputs. Therefore, one must supervise the complete results based chain in order to recognize and successfully manage government programs.

Output-focused Performance Management Paradigm:

Performance management is a requirement for the achievement of performance budgeting. Governments that do not manage for results do not budget for results. Performance budgeting cannot succeed unless it is developed into an overall managerial scheme for performance. According to

Donald Kettl (2000), there are two sets of performance management strategies. One strategy depends on market-like arrangements and the other relies on managerial norms and competence. Both strategies offer the flexibility public managers need to improve performance. The critical differences between them are the dependence on incentives and competitive spirit in the first and good will and trust in the latter. The two approaches take dissimilar viewpoint on how to reward public employees.

Informed Budgetary Decision-Making:

Performance Budgeting cannot be expected to be a mechanistic, rational system that replaces the political process of making resource choices in complex environment of competing demands. Instead, it brings more economic values in budgetary decision making and fosters an information-based consideration process that assigns significant weight to performance information, rewards good performance with managerial flexibility and other incentives. Impractical expectation for performance budgeting, by creating a direct and explicit linkage between resource allocation and budget results explains why many scholars are pessimistic about Performance Budgeting practices because there is almost never any link between performance and resource allocation in actual life.

Reason to select performance budgeting:

Since last two decades, there are major reforms in Performance Budgeting. PB reform can improve communication between budget actors, improve public management in terms of effectiveness, help more informed budgetary decision-making, and accomplish high transparency and accountability. Current Performance Budgeting initiatives are less flourishing in terms of changing appropriation levels. Four important factors of Performance budgeting that are observed from recent research experience;

Enhanced communication between budget actors and with citizens:

Performance budgeting make clear program goals/objectives and recognize performance targets, which presents companies and employees good expectation for their performance. It helps public managers converse more successfully about their activities to the executives, governmental members, and the public. A performance budget, with explanation of each

government program, performance measures, and budget information, is available to ordinary populace and therefore facilitates public managers to circulate information about their programs to the public, and to obtain public understanding and support of their activities.

Improved management in government agencies:

Performance budgeting reform can assist program managers identify organizational goals/achievement, observe program performance, have better acquaintance about problems with program structure and operation, plan for the future, improve internal control, and communicating program results.

More informed budgetary decision-making:

Performance budgeting may not downsize and change the political budgeting process, but it positively adds value to deliberations as performance information is taken into account when the level of funding is decided. With correct information, politicians can implement techniques for improvements and can better understand the issues involved. Performance information has active role in resource allocation in the following instances: justify reallocation of resources given performance information; change the focus of discussion from line items to broader objectives and performance of agencies and programs; influence decisions about proposed new programs and on funding increases or decreases to programs; and provide benchmarks useful to legislators in decision making.

Higher transparency and accountability:

The budget document is good mechanism of precision and accountability, to the legislative body and the public. When analysing traditional budgets, they fail to deliver important information regarding the implementation of the government plans. Performance budget categorizes resources by programs and also presents performance indicators. The performance budgeting system looks for results-based accountability holding managers accountable for the objective they have to accomplish.

Process of doing performance budgeting

There are four categories of performance budgeting:

Performance reporting budgeting: It provides performance information as part of the budget documentation but budgetary players do not use it for resource allocation.

Performance informed budgeting: This is a type of budgeting process that takes program performance in to account but uses the information only as a minor factor in decision making.

Performance based budgeting: It means that performance information has vital role in resource allocation but does not assess the amount of resource allocated.

Performance determined budgeting: In this budgeting procedure, allocation of resources directly and explicitly related to units of performance.

Drawbacks of performance budget: A shortcoming of a performance budget occurs if the budget document is unchanging for the whole financial year. A government or non-profits agency might use a fixed deed to systematize business activities with a specific funding level. A fixed document does not offer for changing budget allocations mid-year in response to transformed conditions. In a performance budget, an organization starts at the baseline and creates a budget request for each department. When all of the departments and activities have submitted their budget requests, executives or even a law-making body must set budget priorities. This is a drawback for programs with less political power if they need additional funding to meet program objectives; they will be denied because extra funding are usually given to programs with the most political power.

To summarize, Performance budgeting is a helpful procedure for performance accountability and budget precision. Performance Budgeting cannot be accepted to be a mechanistic, rational system that reinstates the political process of making resource choices in multifaceted environment of competing demands. But, it has the capability of facilitating informed choices. Transparency of the budget and citizens' evaluation of outputs if embodied in performance budgeting can be supportive to enhance budgetary

results. Management scholars stated that performance budgeting is an expensive process but it gives positive net benefits if accompanied by performance management culture and results-accountability to residents.

Budget Deficit

A budgetary deficit is referred to as the situation in which the spending is more than the income. Although it is mostly used for governments, this can also be broadly applied to individuals and businesses. In other words, a budgetary deficit is said to have taken place when the individual, government, or business budgets have more spending than the income that they can generate as revenue.

Types of Budget Deficits

1. Fiscal deficit
2. Revenue deficit
3. Primary deficit

Fiscal Deficit

Fiscal deficit is defined as the excess of total expenditures over the total receipts, excluding the borrowings in a year. In other words, this can be defined as the amount that the government needs to borrow in order to meet all expenses. The more the fiscal deficit, the more will be the amount borrowed. Fiscal deficit helps in understanding the shortfall that the government faces while paying for the expenditures in the absence of lack of funds. The formula for calculating fiscal deficit is as follows:

Fiscal deficit = Total expenditures – Total receipts excluding borrowings

Impact of Fiscal Deficit

The following impacts of fiscal deficit should be kept in mind.

1. **Unnecessary expenditure:** A high fiscal deficit leads to unnecessary expenditure done by the government that leads to potential inflationary pressure on the economy.
2. Printing more currency by RBI for meeting the deficit, also known as deficit financing, leads to the availability of more money in the market, leading to inflation.
3. Borrowing more will hinder the future growth of the economy, as most of the revenue will be utilised towards meeting debt payments.

Remedial Measures for Fiscal Deficit

1. Reduced public expenditure
2. Reduction in bonus, leave encashment, and subsidies
3. Increase tax to generate revenue
4. Disinvestment of public sector units

Revenue Deficit

Revenue expenditure is defined as the excess of total revenue expenditure over the total revenue receipts. In other words, the shortfall of revenue receipts as compared to that of the revenue expenditure is known as revenue deficit. Revenue deficit signals to the economists that the revenue earned by the government is insufficient to meet the requirements of the expenditures required for the essential government functions.

The formula for revenue deficit can be expressed as follows:

Revenue deficit = Total revenue expenditure – Total revenue receipts

Impact of Revenue Deficit

Revenue deficit has the following impacts on the economy.

1. **Reduction in assets:** For meeting the shortfall in the form of revenue deficit, the government has to sell some assets.
2. It leads to the conditions of inflation in the economy.
3. A large amount of borrowing leads to a greater debt burden on the economy.

Remedial Measures for Revenue Deficit

The following remedial measures can be taken by the government in reducing the revenue deficit.

1. By reducing unnecessary spending
2. By raising the rate of taxes and applying new taxes wherever possible

Primary Deficit

Primary deficit is said to be the fiscal deficit of the current year subtracted by the interest payments that are pending on previous borrowings. In other words, the primary deficit is the requirement of borrowing without the interest payment. Primary deficit, therefore, shows the expenses that government borrowings are going to fulfil while not paying for the income interest payment. A zero deficit shows that there is a

requirement for availing credit or borrowing for clearing the interest payments pending. The formula for the primary deficit is expressed as follows:

Primary deficit = Fiscal deficit – Interest payments

Measures to reduce the primary deficit can be similar to the steps taken to reduce the fiscal deficit as the primary deficit is any borrowings that are above the existing deficit or borrowings. This concludes the topic of budget deficit, which is one of the metrics of measuring the economic growth of a nation along with GDP. To read more of such interesting concepts on economics for class 12, stay tuned to our website. Budget deficit refers to the total budget expenditure exceeding the total budget receipt. Budget deficit = total expenditure minus total receipt.

There are three different types of budget deficits:

a. Revenue deficit:

The revenue deficit is the excess of total revenue expenditure of the government over its total revenue receipt. Revenue deficit = expenditure minus total revenue receipt. It indicates the dis-saving of the government because the government has to make up for the uncovered gap. It is done by using the capital receipts either by borrowing or through selling its assets. The government usually uses its capital receipt to meet the consumption expenditure which leads to an inflationary situation in the economy.

The two measures to reduce revenue deficit are:

i. The government should reduce all its unproductive expenditure.

ii. The government should increase its revenue from various tax and nontax revenue sources.

b. Fiscal deficit:

The fiscal deficit is the excess of total expenditure over total receipt of the government excluding borrowing. It indicates the capacity of the government to borrow in accordance with what it produces. It is also an indicator of the extent of the government's dependence on borrowing to meet its expenditure requirements. This increases the liability of the government to repay the loan along with the interest which leads to an increase in the

revenue deficit. The government borrows either from the central bank or from the governments of the other country.

This leads to an increased dependence on others. Borrowing from foreign countries leads to economic and political interference which increases the economic slavery of the government. The government not only has to pay the loans but they also have to pay the amount in interest which increases the financial burden. The payment of the interest increases the revenue expenditure of the government which leads to increase in the revenue deficit. This vicious circle is called a debt trap.

c. Primary deficit:

The primary deficit is the fiscal deficit minus interest payment. It is an indicator of the borrowing requirement of the government to meet the expenditure other than the interest payment on earlier loans.

Introduction

Fiscal Responsibility and Budget Management (FRBM) Act was enacted in 2003. The objective of the Act is to ensure inter-generational equity in fiscal management, long-run macroeconomic stability, better coordination between fiscal and monetary policy, and transparency in the fiscal operations of the Government. It provides a legal and institutional framework for fiscal consolidation. It is now mandatory for the Central government to take measures to reduce the fiscal deficit, to eliminate revenue deficit and to generate revenue surplus in the subsequent years. The Act binds not only the present government but also the future Government to adhere to the path of fiscal consolidation.

Body

Implementation of the FRBM Act has significantly improved India's quantitative fiscal situation such as: The implementation of the FRBM Act has improved the fiscal performance of both the centre and states. The States have achieved the targets much ahead of the prescribed timeline. The Act has helped in the issues relating to fiscal consolidation due to the mandatory medium-term and strategy statements which are required to be presented annually before Parliament.

The Act has helped in strict adherence to the path of fiscal consolidation during the pre-subprime crisis period created enough fiscal space for pursuing the countercyclical fiscal policy. Implementing the Act, the government had managed to cut the fiscal deficit to 2.7% of GDP and revenue deficit to 1.1% of GDP in 2007-08. However, due to the global financial crisis of 2008, the deadline for the implementation of the targets in the Act was suspended. The fiscal deficit rose to 6.2% of GDP in 2008–09 against the target of 3% set by the Act for 2008–09.

However, the qualitative aspects of fiscally consolidating the economy have remained largely elusive: While there is a drastic fall in deficits, it has largely been on account of reductions in expenditure in critical sectors of the economy such as education, health etc. The Union government's development expenditure as a proportion of GDP has declined over time. An analysis of revenue account of the development expenditure by states shows that in almost all sectors of development, there has been a decline in the FRBM era. Also, at times it has been seen that the government has achieved the deficit targets by manipulating the revenue and expenditure accounts such as curtailing the capital expenditure; demanding interim dividend from Public Sector Undertakings (PSUs) in advance etc.

Further, the FRBM Act ignores the possible inverse link between fiscal deficit (fiscal expansion) and bank credit. That is, if credit growth falls, fiscal deficit may need to rise and if credit rises, fiscal deficit ought to fall — to ensure adequate money supply to the economy. Data on money supply growth, bank credit and GDP establishes that both money supply growth and credit expansion have significantly reduced in relation to GDP growth. Thus, the FRBM Act has not only reduced the fiscal deficit but also starved the growing economy from much-needed investment.

Conclusion

To ensure effective and efficient operation of the FRBM Act, few steps can be followed such as: The Government should consider a medium-term framework for fiscal policy and ensure that over the medium-term targets are met. On the basis of international developments, there is a need to build

capacity in managing the fiscal policy of the government, and effective and efficient debt management of the government. Interest payments pre-empt a substantial part of revenue receipts. Given the limitations of enhancing tax collection, the Government increasingly resorts to borrowing. Therefore, there is a need to rationalize the interest expenditure of the Central Government. There is a need to be more specific on 'exceptional circumstances' when the 'pause' button can be used to stall the targets provided by the FRBM Act. Recommendations of the N.K. Singh Committee should be implemented in a time-bound manner so that the developmental needs of the economy are not unduly compromised while being on the path of fiscal prudence.

The Fiscal Responsibility and Budget Management (FRBM) Bill was introduced in the parliament of India in the year 2000 by Atal Bihari Vajpayee Government for providing legal backing to the fiscal discipline to be institutionalized in the country. Subsequently, the FRBM Act was passed in the year 2003. It is an act of the parliament that set targets for the Government of India to establish financial discipline, improve the management of public funds, strengthen fiscal prudence, and reduce its fiscal deficits.

Features of the FRBM Act

It was mandated by the act that the following must be placed along with the Budget documents annually in the Parliament:

1. Macroeconomic Framework Statement
2. Medium Term Fiscal Policy Statement and
3. Fiscal Policy Strategy Statement

It was proposed that the four fiscal indicators i.e, revenue deficit as a percentage of GDP, fiscal deficit as a percentage of GDP, tax revenue as a percentage of GDP, and total outstanding liabilities as a percentage of GDP be projected in the medium-term fiscal policy statement. In the year 2016, the NK Singh committee was set up by the government to review the FRBM Act. The task was to review the performance of the FRBM Act and suggest the necessary changes to the provisions of the act. The recommendations of the committee read that the government must target a fiscal deficit of 3

percent of the GDP in years up to March 31, 2020, subsequently cut it to 2.8 percent in 2020-21 and 2.5 percent by 2023.

Conclusion

The above work spoke about the FRBM Act, its provisions, and targets. It is a relevant topic for the UPSC 2021 and falls under the topic "Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment" in General Studies Paper 3. It is important to keep reading newspaper articles and editorials on this subject as it can be asked directly or indirectly in the IAS exam. Since there is a plethora of information on this subject, candidates should keep a note of all the points and material they have on this subject neatly classified.

Meaning of Deficit Financing:

Deficit financing in advanced countries is used to mean an excess of expenditure over revenue—the gap being covered by borrowing from the public by the sale of bonds and by creating new money. In India, and in other developing countries, the term deficit financing is interpreted in a restricted sense. The National Planning Commission of India has defined deficit financing in the following way. The term **'deficit financing'** is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on revenue or on capital account. The essence of such policy lies in government spending in excess of the revenue it receives. The government may cover this deficit either by running down its accumulated balances or by borrowing from the banking system.

Deficit Financing:

There are some situations when deficit financing becomes absolutely essential. In other words, there are various purposes of deficit financing. To finance war-cost during the Second World War, massive deficit financing was made. Being war expenditure, it was construed as an unproductive expenditure during 1939-45. However, Keynesian economists do not like to use deficit financing to meet defence expenditures during war period. It can be used for developmental purposes too.

Developing countries aim at achieving higher economic growth. A higher economic growth requires finances. But private sector is shy of

making huge expenditure. Therefore, the responsibility of drawing financial resources to finance economic development rests on the government. Taxes are one of such instruments of raising resources. Being poor, these countries fail to mobilize large resources through taxes. Thus, taxation has a narrow coverage due to mass poverty. A very little is saved by people because of poverty. In order to collect financial resources, government relies on profits of public sector enterprises. But these enterprises yield almost negative profit. Further, there is a limit to public borrowing.

In view of this, the easy as well as the short-cut method of marshalling resources is the deficit financing. Since the launching of the Five Year Plans in India, the government has been utilizing seriously this method of financing to obtain additional resources for plans. It occupies an important position in any programme of our planned economic development. What is important is that low incomes coupled with the rising expenditures of the government have forced the authorities to rely on this method of financing for various purposes. There are some situations when deficit financing becomes absolutely essential. In other words, there are various purposes of deficit financing.

The 'How' of Deficit Financing:

A budget deficit arises when the estimated expenditure exceeds estimated revenue. Such deficit may be met by raising the rates of taxation or by the charging of higher prices for goods and public utility services. The deficit may also be met out of the accumulated cash balances of the government or by borrowing from the banking system. Deficit financing in India is said to occur when the Union Government's current budget deficit is covered by the withdrawal of cash balances of the government and by borrowing money from the Reserve Bank of India. When the government draws its cash balances, these become active and come into circulation. Again, when the government borrows from the RBI, the latter gives loan by printing additional currency. Thus, in both cases, **'new money'** comes into circulation. It is to be remembered here that government borrowing from the public by selling bonds is not to be considered as deficit financing.

Effects of Deficit Financing:

a. Deficit financing and inflation

b. Deficit financing and capital formation and economic development

c. Deficit financing and income distribution.

i. Deficit Financing and Inflation:

It is said that deficit financing is inherently inflationary. Since deficit financing raises aggregate expenditure and, hence, increases aggregate demand, the danger of inflation looms large. This is particularly true when deficit financing is made for the persecution of war. This method of financing during wartime is totally unproductive since it neither adds to society's stock of wealth nor enables a society to enlarge its production capacity. The end result is hyperinflation. On the contrary, resources mobilized through deficit financing get diverted from civil to military production, thereby leading to a shortage of consumer goods. Anyway, additional money thus created fuels the inflationary fire. However, whether deficit financing is inflationary or not depends on the nature of deficit financing. Being unproductive in character, war expenditure made through deficit financing is definitely inflationary. But if a developmental expenditure is made, deficit financing may not be inflationary although it results in an increase in money supply.

To quote an expert view: "Deficit financing, undertaken for the purpose of building up useful capital during a short period of time, is likely to improve productivity and ultimately increase the elasticity of supply curves." And the increase in productivity can act as an antidote against price inflation. In other words, inflation arising out of inflation is temporary in nature. The most important thing about deficit financing is that it generates economic surplus during the process of development. That is to say, the multiplier effects of deficit financing will be larger if total output exceeds the volume of money supply. As a result, inflationary effect will be neutralized. Again, in LDCs, developmental expenditure is often pruned due to the shortage of financial resources. It is the deficit financing that meets the liquidity requirements of these growing economies. Above all, a mild dose of inflation following deficit financing is conducive to the whole

process of development. In other words, deficit financing is not anti-developmental provided the rate of price rise is slight. However, the end result of deficit financing is inflation and economic instability. Though painless, it is very much inflation-prone compared to other sources of financing.

Some amount of inflation is inevitable under the following circumstances:

(a) When the economy is fully employed, increased money supply increases aggregate money income through multiplier effect. As there is no excess capacity in the economy, such increased money income results in an increased aggregate expenditure— thereby fuelling inflationary rise in prices. Again, a persistent deficit financing policy would soon directly lead to inflationary price rise. It is true that the gestation period of capital goods is long. Thus, the effect of increased output can only be felt after a long time gap. But deficit financing immediately releases monetary resources leading to excessive monetary aggregate demand which creates demand-pull inflation.

(b) One cannot escape from the vicious circle of deficit financing once this popular method of financing is adopted. Governments usually resort to this technique since public hardly opposes it. The inflationary impact becomes stronger once the continuous deficit financing is adopted. If the government fails to stabilize the price level, rising prices lead to increased costs which compel the government to mobilize additional revenues through deficit financing. This surely threatens the price stability. Thus a vicious circle of rising price level and increased cost sets in. Thus, deficit financing has a great potentiality of fanning out demand- pull and cost-push inflationary forces.

(c) We have already said that some amount of inflation is inevitable in LDCs. In these countries, not all aggregate demand can be met because of the low production. It is due to lack of complementary resources and various types of bottlenecks that actual production falls short of potential output. The low elasticity in the supply of essential goods and the rising aggregate expenditures result in high propensities to consume and low propensities to

save. Thus, the real problem of LDCs is not the deficiency of effective demand but low rate of capital formation, market imperfections, etc.

Above all, pattern of consumption fuels inflationary price rise in these countries. For instance, demand for food grains is comparatively higher in these countries. When there is an increase in aggregate demand consequent upon deficit financing, demand for food grains rise. But its price rises due to the inelasticity in supply. Consequently, prices of non-agricultural goods rise. Thus, deficit financing is inflationary in LDCs—whether the economies remain at the state of full employment or not. The impact of deficit financing on the price level in both developed and underdeveloped countries can be demonstrated in terms of the Fig. 12.3.

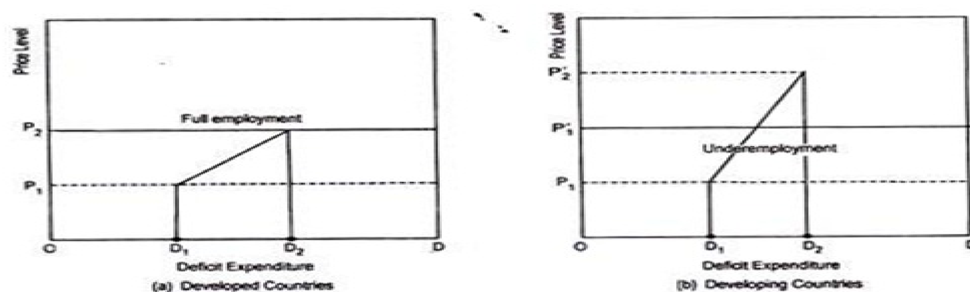


Fig. 12.3: Impact of Deficit Financing on the Price Level

On the horizontal axis the volume of deficit financing and on the vertical axis price level is measured. In developed countries, a rise in deficit financing from OD_1 to OD_2 causes price level to rise towards full employment price OP_2. But a smaller dose of deficit financing in developing countries leads to a rise in price level from OP_1 to OP_2. Thus, deficit financing and, hence, increased money supply is always associated with a high degree of inflation in developing countries like India. One estimate suggests that a deficit budget covered by deficit financing of one per cent leads to a rise in the price level by approximately 1.75 per cent.

ii. Deficit Financing and Capital Formation and Economic Development:

The technique of deficit financing may be used to promote economic development in several ways. Nobody denies the role of deficit financing in garnering resources required for economic development, though the method is an inflationary one. Economic development largely depends on capital formation. The basic source of capital formation is savings. But, LDCs are characterized by low saving-income ratio. In these low-saving countries,

deficit finance- led inflation becomes an important source of capital accumulation.

During inflation, producers are largely benefited compared to the poor fixed-income earners. Saving propensities of the former are considerably higher. As a result, aggregate savings of the community becomes larger which can be used for capital formation to accelerate the level of economic development. Further, deficit-led inflation tends to reduce consumption propensities of the public. Such is called **'forced savings'** which can be utilized for the production of capital goods. Consequently, a rapid economic development will take place in these countries.

In developed countries, deficit financing is made to boost effective demand. But in LDCs, deficit financing is made for mobilization of savings. Savings thus collected encourages increasing capital. The technique of deficit financing results in an increase in government expenditure which produces a favourable multiplier effect on national income, saving, employment, etc. However, the multiplier effect of deficit financing in poor countries must be weaker even if these countries exhibit underemployment of resources. In other words, national income does not rise enough due to deficit financing since these countries suffer from shortage of capital equipment and other complementary resources, lack of technical knowledge and entrepreneurship, lack of communications, market imperfections, etc.

Due to all these obstacles these countries suffer from deficiency in effective supply rather than deficiency in effective demand. This causes low productivity and low output. Thus, deficit financing becomes anti-developmental in the long run. However, this conclusion is too hard to digest. It helps economic development, although not in a great way. It is true that deficit financing is self-defeating in nature as it tends to generate inflationary forces in the economy. But it must not be forgotten that it is self-destructive in nature since it has the potentiality of raising output level to counter the inflationary threat.

To the underdeveloped countries, there is no escape route to bypass the technique of deficit financing. Everyone admits that it is inflationary in character. But at the same time it helps economic development. Hence the

dilemma to the policy makers. However, everything depends on the magnitude of deficit financing and its phasing over the time horizon of development plan. It has to be kept within the **'safe'** limit so that inflationary forces do not appear in the economy. But nobody knows the **'safe'** limit. In view of all these, it is said that deficit financing is an **'evil'** but a **'necessary evil'.** Much of the success of deficit financing will be available to the economy if anti-inflationary policies are employed in a just and right manner.

iii. Deficit Financing and Income Distribution:

It is said that deficit financing tends to widen income inequality. This is because of the fact that it creates excess purchasing power. But due to inelasticity in the supply of essential goods, excess purchasing power of the general public acts as an incentive to price rise. During inflation, it is said that rich becomes richer and the poor becomes poorer. Thus, social injustice becomes prominent. However, all types of deficit expenditure, not necessarily tend to disturb existing social justice. If money collected through deficit financing is spent on public good or in public welfare programmes, some sort of favourable distribution of income and wealth may be made. Ultimately, excess dose of deficit financing leading to inflationary rise in prices will exacerbate income inequality. Anyway, much depends on the volume of deficit financing.

(a) Advantages of Deficit Financing:

Firstly, massive expansion in governmental activities has forced governments to mobilize resources from different sources. As a source of finance, tax-revenue is highly inelastic in the poor countries. Above all, governments in these countries are rather hesitant to impose newer taxes for the fear of losing popularity. Similarly, public borrowing is also insufficient to meet the expenses of the state. As deficit financing does not impinge any trouble either to the taxpayers or to the lenders who lend their surplus money to the government, this technique is most popular to meet developmental expenditure. Deficit financing does not take away any money from anyone's pocket and yet provides massive resources.

Secondly, in India, deficit financing is associated with the creation of additional money by borrowing from the Reserve Bank of India. Interest payments to the RBI against this borrowing come back to the Government of India in the form of profit. Thus, this borrowing or printing of new currency is virtually a cost-free method. On the other hand, borrowing involves payment of interest cost to the lenders.

Thirdly, financial resources (required for financing economic plans) that a government can mobilize through deficit financing are certain and known beforehand. The financial strength of the government is determinable if deficit financing is made. As a result, the government finds this measure handy. Fourthly, deficit financing has certain multiplier effects on the economy. This method encourages the government to utilize unemployed and underemployed resources. This results in more incomes and employment in the economy.

Fifthly, deficit financing is an inflationary method of financing. However, the rise in prices must be a short run phenomenon. Above all, a mild dose of inflation is necessary for economic development. Thus, if inflation is kept within a reasonable level, deficit financing will promote economic development —thereby neutralizing the disadvantages of price rise. Finally, during inflation, private investors go on investing more and more with the hope of earning additional profits. Seeing more profits, producers would be encouraged to reinvest their savings and accumulated profits. Such investment leads to an increase in income—thereby setting the process of economic development rolling.

(b) Disadvantages of Deficit Financing:

Disadvantages of deficit financing are equally important.

The evil effects of deficit financing are:

Firstly, it is a self-defeating method of financing as it always leads to inflationary rise in prices. Unless inflation is controlled, the benefits of deficit-induced inflation would not fructify. And, underdeveloped countries—being inflation-sensitive countries—get exposed to the dangers of inflation. Secondly, deficit financing-led inflation helps producing classes and businessmen to flourish. But fixed-income earners suffer during inflation.

This widens the distance between the two classes. In other words, income inequality increases.

Thirdly, another important drawback of deficit financing is that it distorts investment pattern. Higher profit motive induces investors to invest their resources in quick profit-yielding industries. Of course, investment in such industries is not desirable in the interest of a country's economic development. Fourthly, deficit financing may not yield good result in the creation of employment opportunities. Creation of additional employment is usually hampered in backward countries due to lack of raw materials and machineries even if adequate finance is available.

Fifthly, as purchasing power of money declines consequent upon inflationary price rise, a country experiences flight of capital abroad for safe return—thereby leading to a scarcity of capital. Finally, this inflationary method of financing leads to a larger volume of deficit in a country's balance of payments. Following inflationary rise in prices, export declines while import bill rises, and resources get transferred from export industries to import- competing industries.

Conclusion:

In spite of this, deficit financing is inevitable in LDCs. Much success of it depends on how anti-inflationary measures are employed to combat inflation. Most of the disadvantages of deficit financing can be minimized if inflation is kept within limit. And to keep inflation within a reasonable and tolerable level, deficit financing must be kept within safe limit. Not only it is difficult to lay down any **'safe limit'** but it is also difficult to avoid this technique of financing required for planned development. Still then, deficit financing is unavoidable. It is an evil but a necessary one. Considering the needs of the economy, its use cannot be discouraged. But considering the effects of deficit financing on the economy, its use must be made limited. So, a compromise has to be made so that the benefits of deficit financing are reaped too. Deficit Financing can be defined as the practice where the government spends more money than it receives as revenue, the difference being made up by borrowing or minting new funds.

Need for Deficit Financing

- When sufficient resources are not available to carry out economic activities. Hence, deficit financing is undertaken to meet fiscal deficit targets.
- It is preferred as the price rise is considered to be a lesser evil and is therefore preferred over a lower growth rate.
- It also occurs when there is rapid growth in expenditures.
- Increased spending on unproductive and non-developmental activities can also lead to deficit financing.

Types of Deficit Financing

Government debt can be financed in the following ways:

Borrowing from Public and Foreign Governments:

Governments mostly borrow from their citizens or from foreign governments instead of withdrawing cash balances held with the RBI or borrowing from it. Borrowing from the public does not impact the money supply in the market as when the government borrows, there is a transfer in ownership of money held by people.

Withdrawing Cash Balances held with the Reserve Bank of India (RBI): This method of deficit financing increases the supply of money in the economy, which in turn can increase prices.

Borrowing from the Reserve Bank of India (RBI) Any amount of money that flows out of the RBI tends to increase the supply of money in the economy, which results in an increase in the prices in the domestic economy.

Impact of Deficit Financing

- It increases aggregate expenditure which in turn increases aggregate demand and hence the risk of inflation.
- Deficit Financing can also cause inflation.
- It also leads to the process of economic surplus which causes economic growth.
- In developing countries, it aids in meeting liquidity requirements.
- It can also cause the risk of high instability in the economy.

Conclusion

This method of financing is essential for countries with weak levels of economic growth. However, deficit financing can be a success if adequate anti-inflation measures are also undertaken. It is an unavoidable method of finance generation and therefore should be undertaken with other necessary measures.

Objectives of Fiscal Policy

Fiscal policy must be designed to be performed in two ways-by expanding investment in public and private enterprises and by diverting resources from socially less desirable to more desirable investment channels. The objective of fiscal policy is to maintain the condition of full employment, economic stability and to stabilize the rate of growth. For an under-developed economy, the main purpose of fiscal policy is to accelerate the rate of capital formation and investment. "Arthur Smithies, fiscal policy aims primarily at controlling aggregate demand and leaves private enterprise its traditional field- the allocation of resources among alternative uses." Therefore, fiscal policy in under-developed countries has a different objective to that of advanced countries.

1. Full Employment:

The first and foremost objective of fiscal policy in a developing economy is to achieve and maintain full employment in an economy. In such countries, even if full employment is not achieved, the main motto is to avoid unemployment and to achieve a state of near full employment. Therefore, to reduce unemployment and under-employment, the state should spend sufficiently on social and economic overheads. These expenditures would help to create more employment opportunities and increase the productive efficiency of the economy.

In this way, public expenditure and public sector investment have a special role to play in a modern state. A properly planned investment will not only expand income, output and employment but will also step up effective demand through multiplier process and the economy will march automatically towards full employment. Besides public investment, private investment can also be encouraged through tax holidays, concessions,

cheap loans, subsidies etc. In the rural areas attempts can be made to encourage domestic industries by providing them training, cheap finance, equipment and marketing facilities. Expenditure on all these measures will help in eradicating unemployment and under-employment.

2. Price Stability:

There is a general agreement that economic growth and stability are joint objectives for underdeveloped countries. In a developing country, economic instability is manifested in the form of inflation. Prof. Nurkse believed that "inflationary pressures are inherent in the process of investment but the way to stop them is not to stop investment. They can be controlled by various other ways of which the chief is the powerful method of fiscal policy." Therefore, in developing economies, inflation is a permanent phenomenon where there is a tendency to the rise in prices due to expanding trend of public expenditure. As a result of rise in income, aggregate demand exceeds aggregate supply. Capital goods and consumer goods fail to keep pace with rising income.

Thus, these result in inflationary gap. The price rise generated by demand pull reinforced by cost push inflation leads to further widening the gap. The rise in prices raises demand for more wages. This further gives rise to repeated wage-price spirals. If this situation is not effectively controlled, it may turn into hyper inflation. In short, fiscal policy should try to remove the bottlenecks and structural rigidities which cause imbalance in various sectors of the economy. Moreover, it should strengthen physical controls of essential commodities, granting of concessions, subsidies and protection in the economy. In short, fiscal measures as well as monetary measures go side by side to achieve the objectives of economic growth and stability.

3. To Accelerate the Rate of Economic Growth:

Primarily, fiscal policy in a developing economy, should aim at achieving an accelerated rate of economic growth. But a high rate of economic growth cannot be achieved and maintained without stability in the economy. Therefore, fiscal measures such as taxation, public borrowing and deficit financing etc. should be used properly so that production, consumption and distribution may not adversely affect. It should promote

the economy as a whole which in turn helps to raise national income and per capita income.

In this connection it is significant to quote the views of Mrs. Hicks, who observed, "now that fiscal policy has been developed as an established economic function of a government, every country is anxious to gear its public finance in pursuit of the twin aims of stability and growth, but their relative importance is very differently regarded from one country to another… A steady rate of expansion will tend to reduce the violence of such fluctuations as may occur; a successful full employment policy will provide an atmosphere which is congenial for growth."

4. Optimum Allocation of Resources:

Fiscal measures like taxation and public expenditure programmes, can greatly affect the allocation of resources in various occupations and sectors. As it is true, the national income and per capita income of underdeveloped countries is very low. In order to gear the economy, the government can push the growth of social infrastructure through fiscal measures. Public expenditure, subsidies and incentives can favourably influence the allocation of resources in the desired channels.

Tax exemptions and tax concessions may help a lot in attracting resources towards the favoured industries. On the contrary, high taxation may draw away resources in a specific sector. Above all, direct curtailment of consumption and socially unproductive investment may be helpful in mobilization of resources and the further check of the inflationary trends in the economy. Sometimes, the policy of protection is a useful tool for the growth of some socially desired industries in an under-developed country.

5. Equitable Distribution of Income and Wealth:

It is needless to emphasize the significance of equitable distribution of income and wealth in a growing economy. Generally, inequality in wealth persists in such countries as in the early stages of growth, it concentrates in few hands. It is also because private ownership dominates the entire structure of the economy. Besides, extreme inequalities create political and social discontentment which further generate economic instability. For this,

suitable fiscal policy of the government can be devised to bridge the gap between the incomes of the different sections of the society.

To reduce inequalities and to do distributive justice, the government should invest in those productive channels which incur benefit to low income groups and are helpful in raising their productivity and technology. Therefore, redistributive expenditure should help economic development and economic development should help redistribution. Thus, well-planned fiscal programme, public expenditure can help development of human capital which in turn possesses positive effects on income distribution. Regional disparities can also be removed by providing incentives to backward regions. A redistributive tax policy should be highly progressive and aim at imposing heavy taxation on the richer and exempting poorer sections of the community. Similarly, luxurious items, which are consumed by the higher section, may be subject to heavy taxation.

6. Economic Stability:

Fiscal measures, to a larger extent, promote economic stability in the face of short-run international cyclical fluctuations. These fluctuations cause variations in terms of trade, making the most favourable to the developed and unfavourable to the developing economies. So, for the purpose of bringing economic stability, fiscal methods should incorporate built-in-flexibility in the budgetary system so that income and expenditure of the government may automatically provide compensatory effect on the rise or fall of the nation's income.

Therefore, fiscal policy plays a leading role in maintaining economic stability in the face of internal and external forces. The instability caused by external forces is corrected by a policy, popularly known as 'tariff policy' rather than aggregative fiscal policy. In the period of boom, export and import duties should be imposed to minimize the impact of international cyclical fluctuations. To curb the use of additional purchasing power, heavy import duty on consumer goods and luxury import restrictions are essential. During the period of recession, government should undertake public works programmes through deficit financing. In nut shell, fiscal policy should be

viewed from a larger perspective keeping in view the balanced growth of various sectors of the economy.

7. Capital Formation and Growth:

Capital assumes a central place in any development activity in a country and fiscal policy can be adopted as a crucial tool for the promotion of the highest possible rate of capital formation. A newly developing economy is encompassed by a 'vicious circle of poverty'. Therefore, a balanced growth is needed to breakdown the vicious circle which is only feasible with higher rate of capital formation. Once a country comes out of the clutches of backwardness, it stimulates investment and encourages capital formation.

Therefore, fiscal policy must be designed to be performed in two ways-by expanding investment in public and private enterprises and by diverting resources from socially less desirable to more desirable investment channels. This Policy will help to raise the level of aggregate savings in the economy and create capital for bringing about a qualitative improvement in it. Capital formation, however, can also be facilitated by taxation, deficit spending and foreign borrowing. In fact, fiscal measures of the government can induce the private entrepreneurs to take active participation for mobilizing resources at least in the long run.

8. To Encourage Investment:

Fiscal policy aims at the acceleration of the rate of investment in the public as well as in private sectors of the economy. Fiscal policy, in the first instance, should encourage investment in public sector which in turn effect to increase the volume of investment in private sector. In other words, fiscal policy should aim at rapid economic development and must encourage investment in those channels which are considered most desirable from the point of view of society. It should aim at curtailing conspicuous consumption and investment in unproductive channels. In the early stages of economic development, the government must try to build up economic and social overheads such like transport and communication, irrigation, flood control, power, ports, technical training, education, hospital and school facilities, so that they may provide external economies to induce investment in industrial and agricultural sectors of the economy. These

economies will be helpful for widening the size of the market, reducing the cost of production and increasing the social marginal productivity of investment. Here it must be remembered that projects of social marginal productivity should wisely be selected keeping in view its practical implication.

The Concept of Functional Finance:

The chief exponent of functional finance was Prof. Abba P. Lemer who believed that fiscal measures should be judged only by their effects. The way fiscal measures function in an economy is called functional finance. Prof. Lemer asserted that fiscal policy is an effective instrument in the hands of the government for maintaining full employment and controlling economic fluctuations.

Prof. A. P. Lemer states the central idea is that government fiscal policy, its spending and taxing its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound. The principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism. The principle of Judging fiscal measures by the way they work or function in the economy we may call Functional Finance. Functional Finance entrust the government the meritorious responsibility of keeping a watch over the movements of the economy as a whole.

Whenever and where ever employment sags, income decreases, profitability declines and the economy suffers a severe setback the public authorities are advised to counteract these tendencies by un-leasing the opposite force which would rise up the dropping nerves of the system and bring the situation back normally. The government cannot remain a silent spectator of the dislocations and disturbance in the economy in tune with the non-intervention list policy of the captains of Laissez-fairism. The object of a stable economy is as much in the interest of the capitalists as in the rest of the society. Hence maintenance of a high level of demand reasonable prices, a high level of employment and income ought to be the supreme

objective of functional finance through the instrument of budgetary manipulations. Functional Finance is a positive policy in the sense that it advocates a vigorous policy of intense activity on behalf of the community undertaken by the public authority.

Rules of Functional Finance:

1. The first financial responsibility of the government is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current price would buy all goods that it is possible to produce. If total spending is allowed to go above this, there will be inflation. If it is allowed to go below this there will be unemployment. The government can increase total spending by spending more itself or by reducing taxes so that the tax payers have more money left to spend. It can reduce spending by spending less it or by raising taxes so that tax payers have less money left to spend. By these means total spending can also be kept at the required level, where it will be enough to buy the goods produced.

2. The second law of functional finance is that the government should borrow money only if it is desirable that the public should have less money and more government bonds. This might be desirable if otherwise the rate of interest would be reduced too low and induce too much investment, thus bringing about inflation. Conversely the government should lend money only if it is desirable to increase the money or to reduce the quantity of government bonds in the hands of the public.

3. Taxing is never to be undertaken merely because the government needs to make money payments. According to the principle of functional finance, taxation must be judged only by its effect. Taxation should be framed to regulate the spending habit of the people. If private spending is desirable government should reduce the volume of taxation and vice versa.

4. Lerner was of the view that printing of money (deficit finance) should take place only when it is needed to implement functional finance in spending or lending (repayment of public debt). That is deficit financing should be used when current revenue falls short of expenditure during depression under inflation hoarding or destruction of money should be

done. Functional finance thus rejects completely the traditional doctrines of **"sound finance"** and the principle of trying to balance the budget. Lerner observes **"no budget balancing principle can be used for maintaining full employment and preventing inflation".** Thus functional finance has come to stay, whatever the reactions of the orthodox school. It has demolished the basis of the fiscal policy based on sound finance.

Role of Functional Finance under Inflation:

1. Budgetary Policy:

According to the policy of functional finance, government should not adopt a balanced budget during inflation; government should follow a surplus budget. By resorting to heavy taxation and extensive borrowing, the excess purchasing power in the economy should be neutralized. Government should apply drastic cut in expenditure programmes to deal with inflationary force. All these measures should result in surplus budget, which act as an anti-dot during inflation.

2. Government Expenditure Policy:

Inflation is a situation in which aggregate effective demand increases too much due to unregulated private expenditure. To counter increased private spending government at such a time, should reduce its expenditure to the possible extend. All unproductive and wasteful expenditure should be minimized.

3. Taxation Policy:

As an anti-inflationary weapon taxation policy has much significance. During inflation, the problem is to reduce the size of the disposable income. Hence taxation must be resorted to take away the excess purchasing power from the people. For this the rate of existing taxes should be increased steeply. Moreover if needed new taxes should be imposed.

4. Public Borrowing:

The object of public borrowing should be to take away from the public excess purchasing power. Government can resort to voluntary and if needed compulsory methods to raise loans. Coupled with this the existing public debt should be managed in such a manner as to reduce the existing money supply and to prevent credit expansion. Anti-inflationary debt management

required the payment of bank held debt out of a budget surplus. That is during inflation government securities should be repaid through a budgetary surplus. Thus by resorting to a surplus budget, increasing the volume of taxation, reducing the rate of expenditure and by resorting to public borrowing, the inflationary forces can be controlled under inflation.

Role of Functional Finance under Deflation:

Deflation or unemployment is the result of deficiency in private spending. Hence fiscal policy under deflation should be fine-tuned to increasing consumption and investment expenditure.

1. Budgetary Policy:

Budgetary policy of the government is geared to fight depression and unemployment. The need of depression is an increased flow of income. This according to Keynes can only be realized through a deficit budget. Government should spend more than its ordinary revenue collection. The deficit so incurred should be met either by borrowing from the bank or through printing of currency. The injection of more money into circulation will stimulate private spending and economic recovery. In this context prof. Gunnar Myrdal remarked **"Under balancing the budget during depression is not primarily a deliberate policy but a practical necessity."** Hence as an anti-inflationary tool deficit budget is a virtue.

2. Taxation Policy:

As an anti-depression policy fiscal policy, should aim at increasing both consumption and investment expenditure. For realizing this objective taxation policy can render valuable help to the government. Taxation policy in depression, according to Keynes should be designed to stimulate both consumption and investment. This can be achieved by reducing the burden of taxation on the community. Commodity taxation should be reduced to the possible extend, to stimulate consumption. Moreover reduction in excise duty, sales tax etc. will also help to increase the propensity to consume of the community. Coupled with this to boost investment, business and corporate tax should be slashed down to increase consumption during deflation.

3. Expenditure Policy:

The deficiency in effective demand during depression can be mitigated through increased public expenditure. Public expenditure according to Keynes is a best anti-depression tool to recover economic activity. Government should increase the volume of development expenditure on public works programmes and social security measures. The expenditure incurred on public works programme and social security measures are together called compensatory spending. Keynes opines that government should always keep at hands certain well planned schemes of public works such as road construction, building, parks, schools, canals, hospitals etc. to be enforced during depression. This type of development works will generate employment not only directly but also indirectly. Increased employment leads to additional income and increased effective demand. This will help to enhance productive capacity and remove the evils of depression

4. Public Debt Policy:

During depression government should resort to a deficit budget. The deficit caused in the government budget should be met particularly or wholly by borrowed money. That is public borrowing should be resorted during deflation to meet the budget deficit. However in order to keep the burden of public debt low, the government should aim at a policy of low interest rate during depression. Government should also try to borrow from those sections of population with whom the funds are laying idle. "Thus the role of fiscal policy can be linked to the driving of a car. While driving up a gradient, what is needed is an increase in power. On the other hand, when it moves against the national interest it is necessary to control the supply of power and also to apply breaks judiciously to ensure that the vehicle does not slip out of control but keeps a moving all the same. The national exchequer could see that the breaks are not pressed so much as to bring the vehicle to a stop." What is imperative is a continuous and judicious use of fiscal policy, in tune to the existing circumstances.

Reforms in India's Fiscal Policy and Its Performance

Fiscal policy is a critical component of the policy framework pursued since the initiation of economic reforms in India in 1991 to achieve the

objectives of economic growth, price stability and equity. To achieve these objectives, it was necessary to raise more resources through taxation and restrain the growth of unproductive and non-plan expenditure. During the mid-nineties there was set back in this policy when Fifth Pay Commission's recommendations of sharp hike is wages and salaries were accepted resulting in large increase in non-plan government expenditure and consequently rise is fiscal deficit.

But since 2001-02, the Central Government has continued to follow prudent fiscal policy comprising:

(i) Balanced tax structure of direct and indirect taxation based on moderate tax rates with minimum exemptions covering a wider class of tax payers and

(ii) An expenditure policy that aims to restrain the growth in non-developmental expenditure and adequately provide for pressing social and infrastructure needs of a developing economy.

With this end in view the tax reforms undertaken since the beginning of nineties have sought to bring about a compositional shift in the structure of the tax system away from the excessive dependence on regressive indirect taxes to progressive direct taxes for raising resources for accelerating economic growth with stability. Besides, to ensure competitiveness of the products of Indian industry excise duties and custom duties have been reduced so that rapid growth of Indian exports is possible. Moreover customs duties were reduced to open up the Indian economy and to obtain gain from free trade. To compensate for this and realizing that more than per cent of India's GDP came from services, service tax was levied which has now become an important source of Government revenue. In 2013-14 service tax was expected to yield Rs. 1.30 lakh crore (BE). However, as stated above, to achieve fiscal consolidation for controlling inflation and ensuring release of resources for economic growth and employment generation, raising revenue from taxation has been given priority along with improving the quality of public expenditure.

Since, much of public expenditure is of committed nature such as interest payments for servicing past public debt, expenditure on defence,

pensions and wages and salaries of government employees, there is very little room for compression of expenditure in the short run, the objective of accelerating growth and employment generation have to be achieved by raising revenue and improving the quality of expenditure. However, in the financial year 2012-13 in order to contain fiscal deficit, Finance Minister, Mr. Chitambram reduced planned expenditure by Rs. 90,000 crore which worked to reduce rate of economic growth. In what follows we first explain the reforms in both direct and indirect tax systems that have been undertaken in the last two decades.

Reforms in Direct Taxation:

It is important to note that over the last two decades, there has been a significant reform in the tax system so that it can make larger contribution to resource mobilisation for economic growth and at the same time serves the objective of achieving equity as well. First, in the sphere of direct taxation rate of income and corporation taxes have been lowered to moderate levels. With lower tax rates revenue buoyancy from these taxes can be achieved through better compliance and minimal exemptions. Until the early eighties, direct tax rates were exorbitant, evasion of these taxes was rampant which gave birth to the enormous black money in the Indian economy.

It was realised that moderate rates of these taxes would yield more revenue by increasing tax compliance. Lower rates of direct taxes also provide incentives to work more, save more and invest more as lower rates increases after-tax returns on work, saving and investment. Long-term fiscal policy announced in 1985 rightly emphasised that "a broader base of taxation combined with moderate rates of taxes and strict enforcement, can yield better revenue results". Acting on the long-term fiscal policy V.P. Singh in his 1985-86 budgets cut the maximum marginal rate of income tax to 50 per cent and reduced personal income tax slabs from eight to four. Seven years later Dr. Manmohan Singh reduced the maximum marginal income tax rate to 40 per cent in his budget for 1992-93 and reduced the personal income tax slabs to only three. Mr. Chidambaram in his dream budget 1997-98 further reduced top marginal rate of income tax to 30 per cent.

Moreover, education cess of 3 per cent has been levied on both income tax and corporation tax.

As regards corporation tax, acting on the Chilliah Committee recommendations Dr. Manmohan Singh attempted rationalisation of corporate taxation and cut the corporation tax rate to 40 per cent and reduced exemptions in 1994-95 budgets to broaden the base of the tax. Three years later Mr. Chidambaram further reduced corporation tax to 35 percent in his budget for 1997-98 and again as Finance Minister in UPA Government he further reduced the corporation tax rate to 33 per cent in 2004-05 budgets. However, to broaden the base of corporation tax so as to increase tax revenue he lowered the depreciation allowance from 25 per cent to 15 per cent in 2007-08. Besides, to raise revenue from corporate taxation, fringe benefit tax (FBT) was levied payable by corporate employee.

Besides, Minimum Alternate tax (MAT) which was fixed at 7.5 per cent to 10 of book profits of the corporate companies has now been raised to 18.5 per cent in 2011-12 budget and long-term capital gains have been included in the book-profits. Further, securities transaction tax (STT) has been levied on the sale and purchase of shares/securities. It is thus evident from above that in the last over two decades, efforts have been made to move to moderate direct tax rates and broaden the base of direct taxation by withdrawing certain exemptions. This has improved the compliance to pay taxes and resulted in increase in revenue from direct taxes. However, there is still a vast potential for revenue buoygency of direct taxes since there are still a large number of exemptions, for example, in case of various types of financial savings and exports.

As recommended by the Task Force headed by R. Vijay Kelkar, more resources can be mobilized from direct taxes if a large number of existing exemptions which have outlived their utility are withdrawn and direct tax system is simplified and made transparent. It is now proposed to implement direct tax code without much exemption which is now awaiting the approval of parliament. An important outcome of fiscal policy pursued after 2002-03 was decline in fiscal deficit till 2007-08 which helped to keep inflation rate at around 5 per cent per annum as measured by WPI of all commodities. It

will be seen from Table 33.1 that fiscal deficit which was 6.2 per cent of GDP in 2001 -02 fell to 2.5 per cent in 2007-08, but again rose to 6.5 percent in 2009-10 due to fiscal stimulus package adopted to prevent slowdown of the Indian economy due to global financial crisis. High fiscal deficit of the order of 6 per cent and more is bad and against fiscal prudence.

Fiscal deficit can be either financed by the Government monetisation that is, printing of new money by RBI or by borrowing from the market. Monetisation of fiscal deficit is avoided as it leads to inflation in the economy. The excessive Government borrowing is also had because it causes increase in public debit which raises the burden on future generations. Besides, excessive Government borrowing from the banks dries up banking resources for the private sector, that is, reduces the availability of credit for the private sector. Further, Government borrowing from the market tends to raise interest rate. Higher interest rate causes increase in cost of credit for the private sector which impinges on their profit margins. Therefore, on the recommendation of IMF, Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2003-04.

After this, fiscal deficit consistently declined to 4.0 per cent of GDP in 2005-06 and to 2.6 per cent in the year 2007-08. This decline in fiscal deficit in these years was achieved by reducing revenue deficit from 4.4 percent of GDP in 2001-02 to 2.5 percent in 2005-06 and further to 1.1 per cent in 2007-0& on the one hand and restraining the growth of expenditure, especially non-plan expenditure. Under Fiscal Responsibility and Budget Management Act (FRBMA) it was planned to eliminate revenue deficit completely by 2008-09 and fiscal deficit to be reduced to 3 per cent of GDP in 2008-09. This was expected to release more resources for economic growth and social sector development. However, fiscal deficit rose to 6.0 per cent of GDP in 2008-09 and to 6.5 per cent of GDP in 2009-10. This is because to fight economic slowdown following the intensification of global financial crisis in 2008, the Central Government came out with fiscal stimulus programmes wherein Government expenditure had to be increased and indirect taxes reduced to keep the momentum of economic growth.

Changes in Taxation Structure: Increase in Share of Direct Taxes:

It is interesting to note that tax-GDP ratio which rose to 11.9 per cent in 2007-08 declined to 10.8% and 9.6 per of GDP in 2008-09 and 2009-10 respectively due to lowering of indirect taxes in 2008-09 and 2009-10 to prevent large economic slowdown. Besides, there has been also improvement in the taxation structure. While there has been decline in the share of regressive and resource-distorting indirect taxes in the revenue of the Central Government, there is rise in the share of direct taxes. Thus, as will be seen from Table 33.2, whereas the share of direct taxes as per cent of GDP rose from 2.8% in 1995-96 to 5.9 percent in 2007-08, the share of indirect taxes as per cent of GDP fell from 6.4 per cent in 1995-96 to 5.6 per cent in 2007-08 and further to 3.8% in 2009-10 but for 2012-13 it was budgeted to rise to 5% of GDP. On the other hand, the share of direct tax as percentage of GDP which was 3% of GDP rose to 5.6 per cent of GDP in 2012-13. This increase in share of direct taxes and fall in indirect tax in total tax revenue of Central Government has made the Indian tax system more equitable.

This change in tax structure a creditable achievement of mobilising resources from direct taxes, as this has been done despite the fact that rates of both personal income tax and corporation tax have been substantially reduced. This will also ensure equitable distribution of burden of overall tax among the people.

Reforms in the Indian Indirect Tax System:

The Indian indirect tax system as it existed in the early nineties had several drawbacks. First, the excise duties and sales tax were levied on inputs which had a cascading effect on raising prices of final products. In a way, there is 'a tax on tax'. As regards sales tax which is levied by State governments, a uniform value added tax (VAT) is proposed to be levied. VAT tax will replace different rates of sales tax levied by the state governments. Legislation has already been enacted but its implementation was deferred due to protest by traders and due to general elections in April 2004. Now, as per decision of UPA government VAT has come into effect from April 1, 2005. Implementation of VAT will eliminate the cascading effect of sales tax and

also help in achieving price stability. The experience of Haryana and Delhi which have implemented VAT shows that government revenue increased when VAT was introduced.

Reforms in Excise Duty:

To rationalise the indirect tax system at the centre by removing distortion in the structure there is a need to remove multiplicity of tax rates of central excise duties on various goods and services. With tax reform initiated since 1991, this has been now achieved with few exceptions. Now, there is a single excise duty called CENVAT (which is in the form of value added tax) at the rate of 16 per cent on all products which enter a production chain. The argument for a single 16 per cent CENVAT is that it will remove the distortions in the tax system as a result of multiplicity of rates of excise duties.

This is of course a correct approach in general but in the view of the present author the final consumption goods of the nature of income-elastic luxuries such as cars and air conditioners should be taxed at a much higher rate than CENVAT. This will enable the government to raise more revenue without harming production incentives and will thus serve well the equity objective. To simplify the indirect tax system, it is now planned to introduce Goods and Services Tax (GST) in near future. This GST will replace the service tax Central CENVAT and states VAT and a uniform rate of GST by all states will be fixed.

Revenue Mobilisation through Service Tax:

While the revenue from existing three sources, namely, direct, excise and customs taxes, is expected to increase by ensuring greater tax compliance and withdrawal of exemptions, the government seeks to collect more revenue from service tax by bringing more services under its net. Over the last four decades there has been a structural change in the Indian economy with relative contribution of agriculture to GDP significantly decreasing and of services sector sharply increasing to 54 per cent of GDP. With more services which have been brought within the service tax net in the last four budgets for the years, 2004-05, 2005-06, 2006-07, 2007-08 the total number of services on which service tax is levied has risen to more

than 100. In the year 2013-14 service tax was expected to bring in about Rs. 1.80 lakh crore (BE).

It is now well recognized that for more revenue mobilisation as well as for achieving equity and price stability there is a need to look at the whole value addition chain covering both goods and services from the viewpoint of taxation. Government intends to expand the scope of taxation of services by not only bringing additional services within the tax net, but also covering a larger number of assesses under the service tax.

Reforms in Customs Duties:

Since the early nineties revenue from customs duties as a percentage of GDP has been falling due to the reduction in customs duty rates following the policy of trade liberalisation. Dr. Manmohan Singh, the Finance Minister in his five budgets between 1991 and 1996 reduced India's absurdly high customs duties. He reduced peak tariff rates from over 200 per cent to 50 per cent and the import weighted average tariff rate from over 80 per cent to below 30 per cent. Since 1996, successive finance ministers further reduced the peak trifurcate (i. e. customs duty) first to 35 per, and then to 20 per cent in Jan. 2004.

The peak rate of customs duty has been further reduced to 15 per in 2005-06 and to 12.5 per cent in 2006-07 and to 10 per cent in 2007-08. But there are several exceptions to this peak rate. It is now planned to reduce the peak customs duties to the ASEAN level. Though India is committed to reduce tariff duties under trade liberalisation agreement of WTO, we should try to provide effective protection to some of our crucial industries such as textiles and agriculture by fixing higher customs rates than peak customs duty making a cause for their exceptional treatment. It is quite surprising to note that Kelkar Task Force on implementation of Fiscal Responsibility and Budgetary Management Act (FRBMA) proposed a shift to a three rate structure on customs duties consisting of 5 per cent, 8 per cent and 10 per cent. In our view this is going too far in trade liberalisation. This will involve not only a loss of tax revenues but will also reduce effective protection to Indian industries.

Changes in Quality of Expenditure:

A change in pattern of expenditure is also worth mentioning. It will be seen from Table 33.4 that prior to 2007-08 through the adoption of prudent fiscal policy the Government had been able to reduce total expenditure both revenue and capital, which as percentage of GDP fell from 17.3 per cent in 2001-02 to 15.4 per cent in 2004-05 and further fell to 13 .6 per cent in 2006-07, and rose marginally to 14.1% in 2007-08. As compared to plan-expenditure which as a percent of GDP rose from 3.8 per cent in 2005-06 to 4.9% in 2008-09 and 5.3% in 2009-10 non-plan expenditure fell sharply from 12.3 per cent of GDP in 2002-03 to 9.7% in 2006-07 and to 10.3 per cent in 2007-08. It is only in 2008-09 and 2009-10 that due to need of increasing public expenditure to overcome recession or slowdown of the Indian economy and to keep the growth momentum that non-plan expenditure slightly increased to 10.9% and 11.3% in 2008-09 and 2009-10 respectively.

Further, the Government has succeeded in restraining the growth of non-development expenditure incurred on interest payments, major subsidies and defense till 2007-08. It is only in 2008-09 and 2009-10 under well-designed contra-cyclical policy that Government increased its expenditure and borrowed heavily for this purpose to fight slowdown of the Indian economy and to keep the growth momentum. This resulted in increase in expenditure on interest and subsidies. As plan expenditure represents development expenditure and non-plan expenditure represents non-development expenditure, the changes witnessed in the pattern of expenditure therefore show improvement in the quality of expenditure.

For achieving 8 per cent rate of growth in GDP on a sustained basis, it is necessary to step-up public investment expenditure on agriculture and infrastructure. This requires affecting a shift in the composition of total expenditure in favour of capital expenditure. This can be done only if revenue deficit is bridged by raising more resources through taxation on the one hand and cutting non-plan expenditure on the other. One of the major objectives of Fiscal Responsibility and Budget Management (FRBM) Act, 2003 was to eliminate revenue deficit by the year 2008-09. With revenue

deficit reduced to zero, But in 2008-09 partly due to fiscal stimulus in which tax cuts were made and government expenditure increased to maintain the growth momentum and partly due to the populist programme such as waiving loans of farmers to the time of Rs.70,000 crore the target of zero revenue deficit was not achieved.

As a result revenue deficit which was lowered to 1.1 per cent of GDP in 2007-08 went up to 4.6 per cent in 2008-09. Therefore, the expectation that with zero revenue deficits, the government would be able to increase capital expenditure for investment in agriculture, industry and infrastructure was not realised. Large revenue deficit is quite bad because large expenditure incurred on revenue account does not lead to creation of durable assets which are essential to sustain growth. Thus, what is a matter of concern is the decline in capital expenditure which mostly represents investment expenditure in physical assets. As a proportion of GDP, fall in total government expenditure from a level of 17.1 percent in 2003-04 to 14.4 per cent in 2007-08 was largely driven by the steep fall in capital expenditure with revenue expenditure remaining almost steady between 2004-05 and 2007-08.

It may be however noted that revenue expenditure includes some expenditure on social sector under Sarv Shiksha Abhiyan and Mid-day Meals; health and family welfare (National Rural Health Mission), rural employment, and physical infrastructure including rural roads which are also of developmental nature. Even accounting for these the fact remains that fall in capital expenditure is disturbing and must be reversed. As regards expenditure on subsidies, the government's recent policy is to make them targeted to the poor and weaker sections of the society. To ensure that benefits of expenditure on subsidies are not usurped by those not intended be the beneficiaries of these subsidies. Delivery mechanism for providing these subsidies should be improved and made more efficient.

Under NCMP, Government is committed to control inefficiencies that increase the food subsidy burden and to target all subsidies sharply at the poor and the truly needy like small and marginal farmers, farm labour and the urban poor. To reduce expenditure on subsidies government has raised

the price of cooking gas and restricted its use by a family to 9 cylinders per year. Besides, it has decontrolled petrol and raising price of diesel by 50 paise every month. However, due to enactment of Food Security Bill, its expenditure on food subsidy will rise.

Reduction in Fiscal Deficit:

A large fiscal deficit has been a major macro-economic problem. It is persistent large fiscal deficits in the nineteen eighties that landed the Indian economy in a state of severe economic crisis reflected in the acute balance of payments problem. This acute economic crisis compelled us to approach IMF for help to tide over the crisis. Fiscal deficit is the difference between the total government expenditure on revenue and capital accounts and the total sum of revenue receipts and non-debt capital receipts. Thus fiscal deficit measures the total borrowing from the market, net borrowing from the Reserve Bank of India, small savings and external assistance.

For the achievement of macroeconomic stability, fiscal deficit should not exceed 3 per cent of GDP. Fiscal Responsibility and Business Management (FRMB) Act 2003 has prescribed to achieve the target of fiscal deficit to 3 per cent of GDP by the year 2008-09. This is generally called fiscal consolidation. But how this fiscal consolidation, that is, reduction in fiscal deficit is to be achieved so as to achieve economic growth with stability and equity. This can be done by raising tax-GDP ratio on the one hand and reducing non-plan expenditure on the other. Tax-GDP ratio can be raised by widening the base of direct taxes, especially personal income tax and corporation tax. One important way of broadening the base of the direct taxes is to withdraw many of such exemptions which have outlived their utility and are merely used to evade these taxes.

As result of these exemptions, the effective rate of corporation tax is much smaller. Economic Survey 2005-06 found that 40 per cent of corporate companies pay only 10 per cent or less corporation tax as against 30 per cent levied on them. This has also been found by Task Force headed by Vijay Kelkar. It is interesting to note that because of these exemptions Reliance Industries which made huge profits throughout its career did not pay any corporation tax for several years. Similarly, many other profitable

companies also took advantage of these exemptions and did not pay any tax for several years. Therefore, the Central government enacted' Minimum Alternative Tax (MAT) according to which these profitable companies which did not pay corporation tax would have to pay this minimum alternative tax. The efforts have been to raise more resources through levying new taxes in order to reduce fiscal deficit. The introduction of service tax in 1994-95 ushered in a major change in indirect taxes in the (BE) form of wider base and facilitated the process of rationalization of excise duties resulting in lower tax burden on productive sectors. Over the years, the number of services subject to service tax has increased and now stands at around 114. However, a further reform in the indirect tax system in the form of Goods and service tax (GST) is to be introduced from April 2012.

It is also worth noting that long-term capital gains from shares has been exempted in the budget w. e .f. 2004-05 and has been replaced by Securities Transaction Tax. Along with it, short-term capital gains tax was reduced from 20% to 10%. This is quite contrary to broadening the tax base. Indeed, there is good economic case for imposing a tax on long-term capital gains on shares, its rate may be kept lower than the general income tax rate because of the risk involved in investing funds in equity capital. The total abolition of capital gains tax on equity capital will introduce large distortions and also results in loss of revenue for the government. This loss is unlikely to be made up by levying a small securities transaction tax.

Unit-V

Fiscal Policy and Fiscal Federation

Introduction

Fiscal policy must be designed to be performed in two ways-by expanding investment in public and private enterprises and by diverting resources from socially less desirable to more desirable investment channels. The objective of fiscal policy is to maintain the condition of full employment, economic stability and to stabilize the rate of growth. For an under-developed economy, the main purpose of fiscal policy is to accelerate the rate of capital formation and investment. "Arthur Smithies, fiscal policy aims primarily at controlling aggregate demand and leaves private enterprise its traditional field- the allocation of resources among alternative uses." Therefore, fiscal policy in under-developed countries has a different objective to that of advanced countries.

Objectives of a fiscal policy in a developing economy:

1. Full Employment:

The first and foremost objective of fiscal policy in a developing economy is to achieve and maintain full employment in an economy. In such countries, even if full employment is not achieved, the main motto is to avoid unemployment and to achieve a state of near full employment. Therefore, to reduce unemployment and under-employment, the state should spend sufficiently on social and economic overheads. These expenditures would help to create more employment opportunities and increase the productive efficiency of the economy.

In this way, public expenditure and public sector investment have a special role to play in a modern state. A properly planned investment will not only expand income, output and employment but will also step up effective demand through multiplier process and the economy will march automatically towards full employment. Besides public investment, private investment can also be encouraged through tax holidays, concessions, cheap loans, subsidies etc. In the rural areas attempts can be made to encourage domestic industries by providing them training, cheap finance,

equipment and marketing facilities. Expenditure on all these measures will help in eradicating unemployment and under-employment.

The recommendations to achieve full employment in an economy:

1. To capture the excessive purchasing power and to curb private spending:
2. Compensate the deficiency in private investment through public investment;
3. Cheap money policy or lower interest rates to attract more and more private entrepreneurs.

2. Price Stability:

There is a general agreement that economic growth and stability are joint objectives for underdeveloped countries. In a developing country, economic instability is manifested in the form of inflation. Prof. Nurkse believed that "inflationary pressures are inherent in the process of investment but the way to stop them is not to stop investment. They can be controlled by various other ways of which the chief is the powerful method of fiscal policy." Therefore, in developing economies, inflation is a permanent phenomenon where there is a tendency to the rise in prices due to expanding trend of public expenditure. As a result of rise in income, aggregate demand exceeds aggregate supply. Capital goods and consumer goods fail to keep pace with rising income.

Thus, these result in inflationary gap. The price rise generated by demand pull reinforced by cost push inflation leads to further widening the gap. The rise in prices raises demand for more wages. This further gives rise to repeated wage-price spirals. If this situation is not effectively controlled, it may turn into hyper inflation. In short, fiscal policy should try to remove the bottlenecks and structural rigidities which cause imbalance in various sectors of the economy. Moreover, it should strengthen physical controls of essential commodities, granting of concessions, subsidies and protection in the economy. In short, fiscal measures as well as monetary measures go side by side to achieve the objectives of economic growth and stability.

3. To Accelerate the Rate of Economic Growth:

Primarily, fiscal policy in a developing economy, should aim at achieving an accelerated rate of economic growth. But a high rate of economic growth cannot be achieved and maintained without stability in the economy. Therefore, fiscal measures such as taxation, public borrowing and deficit financing etc. should be used properly so that production, consumption and distribution may not adversely affect. It should promote the economy as a whole which in turn helps to raise national income and per capita income. In this connection it is significant to quote the views of Mrs. Hicks, who observed, "now that fiscal policy has been developed as an established economic function of a government, every country is anxious to gear its public finance in pursuit of the twin aims of stability and growth, but their relative importance is very differently regarded from one country to another… A steady rate of expansion will tend to reduce the violence of such fluctuations as may occur; a successful full employment policy will provide an atmosphere which is congenial for growth."

4. Optimum Allocation of Resources:

Fiscal measures like taxation and public expenditure programmes, can greatly affect the allocation of resources in various occupations and sectors. As it is true, the national income and per capita income of underdeveloped countries is very low. In order to gear the economy, the government can push the growth of social infrastructure through fiscal measures. Public expenditure, subsidies and incentives can favourably influence the allocation of resources in the desired channels. Tax exemptions and tax concessions may help a lot in attracting resources towards the favoured industries. On the contrary, high taxation may draw away resources in a specific sector. Above all, direct curtailment of consumption and socially unproductive investment may be helpful in mobilization of resources and the further check of the inflationary trends in the economy. Sometimes, the policy of protection is a useful tool for the growth of some socially desired industries in an under-developed country.

5. Equitable Distribution of Income and Wealth:

It is needless to emphasize the significance of equitable distribution of income and wealth in a growing economy. Generally, inequality in wealth persists in such countries as in the early stages of growth, it concentrates in few hands. It is also because private ownership dominates the entire structure of the economy. Besides, extreme inequalities create political and social discontentment which further generate economic instability. For this, suitable fiscal policy of the government can be devised to bridge the gap between the incomes of the different sections of the society. To reduce inequalities and to do distributive justice, the government should invest in those productive channels which incur benefit to low income groups and are helpful in raising their productivity and technology. Therefore, redistributive expenditure should help economic development and economic development should help redistribution.

Thus, well-planned fiscal programme, public expenditure can help development of human capital which in turn possesses positive effects on income distribution. Regional disparities can also be removed by providing incentives to backward regions. A redistributive tax policy should be highly progressive and aim at imposing heavy taxation on the richer and exempting poorer sections of the community. Similarly, luxurious items, which are consumed by the higher section, may be subject to heavy taxation.

6. Economic Stability:

Fiscal measures, to a larger extent, promote economic stability in the face of short-run international cyclical fluctuations. These fluctuations cause variations in terms of trade, making the most favourable to the developed and unfavourable to the developing economies. So, for the purpose of bringing economic stability, fiscal methods should incorporate built-in-flexibility in the budgetary system so that income and expenditure of the government may automatically provide compensatory effect on the rise or fall of the nation's income. Therefore, fiscal policy plays a leading role in maintaining economic stability in the face of internal and external forces. The instability caused by external forces is corrected by a policy, popularly known as 'tariff policy' rather than aggregative fiscal policy. In the period of

boom, export and import duties should be imposed to minimize the impact of international cyclical fluctuations.

To curb the use of additional purchasing power, heavy import duty on consumer goods and luxury import restrictions are essential. During the period of recession, government should undertake public works programmes through deficit financing. In nut shell, fiscal policy should be viewed from a larger perspective keeping in view the balanced growth of various sectors of the economy.

7. Capital Formation and Growth:

Capital assumes a central place in any development activity in a country and fiscal policy can be adopted as a crucial tool for the promotion of the highest possible rate of capital formation. A newly developing economy is encompassed by a 'vicious circle of poverty'. Therefore, a balanced growth is needed to breakdown the vicious circle which is only feasible with higher rate of capital formation. Once a country comes out of the clutches of backwardness, it stimulates investment and encourages capital formation.

Raja J. Chelliah recommends for attaining rapid economic growth:

i. Raising the ratio of saving (s) to Income (y) by controlling consumption (c);
ii. Raising the rate of investment:
iii. Encouraging the flow of spending into productive way;
iv. Reducing glaring inequalities of income and wealth.

Therefore, fiscal policy must be designed to be performed in two ways- by expanding investment in public and private enterprises and by diverting resources from socially less desirable to more desirable investment channels. This Policy will help to raise the level of aggregate savings in the economy and create capital for bringing about a qualitative improvement in it. Capital formation, however, can also be facilitated by taxation, deficit spending and foreign borrowing. In fact, fiscal measures of the government can induce the private entrepreneurs to take active participation for mobilizing resources at least in the long run.

8. To Encourage Investment:

Fiscal policy aims at the acceleration of the rate of investment in the public as well as in private sectors of the economy. Fiscal policy, in the first instance, should encourage investment in public sector which in turn effect to increase the volume of investment in private sector. In other words, fiscal policy should aim at rapid economic development and must encourage investment in those channels which are considered most desirable from the point of view of society. It should aim at curtailing conspicuous consumption and investment in unproductive channels. In the early stages of economic development, the government must try to build up economic and social overheads such like transport and communication, irrigation, flood control, power, ports, technical training, education, hospital and school facilities, so that they may provide external economies to induce investment in industrial and agricultural sectors of the economy. These economies will be helpful for widening the size of the market, reducing the cost of production and increasing the social marginal productivity of investment. Here it must be remembered that projects of social marginal productivity should wisely be selected keeping in view its practical implication.

Instruments of Fiscal Policy

Some of the major instruments of fiscal policy are as follows: A. Budget B. Taxation C. Public Expenditure D. Public Works E. Public Debt.

A. Budget:

The budget of a nation is a useful instrument to assess the fluctuations in an economy.

i. Annual budget,
ii. cyclical balanced budget and
iii. Fully managed compensatory budget.

1. Annual Balanced Budget:

The classical economists propounded the principle of annually balanced budget. They defended it with force till the deep rooted crisis of 1930's.

The reasons for their reacceptance of this principle are as under:

i. They maintained that there should be balance in income and expenditure of the government;
ii. They felt that automatic system is capable to correct the evils;
iii. Balanced budget will not lead to depression or boom in the economy;
iv. It is politically desirable as it checks extravagant spending of the state;
v. This type of budget assures full employment without inflation;
vi. The principle is based on the notion that government should increase the taxes to get more money and reduce expenditure to make the budget balanced.

These objections are as under:

i. Classical version that balanced budget is neutral is not well based. In practice, a balanced budget can be expansionary.
ii. The assumptions of full employment and automatic adjustment are too untenable in a modern economy.
iii. Some economists also argue that annually balanced budget involves lesser burden of the taxes.

2. Cyclically Balanced Budget:

The cyclical balanced budget is termed as the 'Swedish budget'. Such a budget implies budgetary surpluses in prosperous period and employing the surplus revenue receipts for the retirement of public debt. During the period of recession, deficit budgets are prepared in such a manner that the budget surpluses during the earlier period of inflation are balanced with deficits. The excess of public expenditure over revenues are financed through public borrowings. The cyclically balanced budget can stabilize the level of business activity. During inflation and prosperity, excessive spending activities are curbed with budgetary surpluses while budgetary deficits during recession with rising extra purchasing power.

This policy is favoured on the following account:

i. The government can easily adjust its finances according to the needs;
ii. This policy works smoothly in all times like depression, inflation, boom and recession;

iii. Cyclically balanced budget simply ensures stability but gives no guarantee that the system will get stabilized at the level of full employment.

3. Fully Managed Compensatory Budget:

This policy implies a deliberate adjustment in taxes, expenditures, revenues and public borrowings with the motto of achieving full employment without inflation. It assigns only a secondary role to the budgetary balance. It lays down the emphasis on maintenance of full employment and stability in the price level. With this principle, the growth of public debt and the problem of interest payment can be easily avoided. Thus, the principle is also called 'functional finance.'

B. Taxation:

Taxation is a powerful instrument of fiscal policy in the hands of public authorities which greatly affect the changes in disposable income, consumption and investment. An anti- depression tax policy increases disposable income of the individual, promotes consumption and investment. Obviously, there will be more funds with the people for consumption and investment purposes at the time of tax reduction. This will ultimately result in the increase in spending activities i.e. it will tend to increase effective demand and reduce the deflationary gap. In this regard, sometimes, it is suggested to reduce the rates of commodity taxes like excise duties, sales tax and import duty. As a result of these tax concessions, consumption is promoted. Economists like Hansen and Musgrave, with their eye on raising private investment, have emphasized upon the reduction in corporate and personal income taxation to overcome contractionary tendencies in the economy.

Now, a vital question arises about the extent to which unemployment is reduced or mitigated if a tax reduction stimulates consumption and investment expenditure. In such a case, reduction of unemployment is very small. If such a policy of tax reduction is repeated, then consumers and investors both are likely to postpone their spending in anticipation of a further fall in taxes. Furthermore, it will create other complications in the government budget.

Anti-Inflationary Tax Policy:

An anti-inflationary tax policy, on the contrary, must be directed to plug the inflationary gap. During inflation, fiscal authorities should not retain the existing tax structure but also evolve such measures (new taxes) to wipe off the excessive purchasing power and consumer demand. To this end, expenditure tax and excise duty can be raised. The burden of taxation may be raised to the extent which may not retard new investment. A steeply progressive personal income tax and tax on windfall gains is highly effective to curb the abnormal inflationary pressures. Export should be restricted and imports of essential commodities should be liberated.

The increased inflow of supplies from origin countries will have a moderate impact upon general prices. The tax structure should be such which may impose heavy burden on higher income group and vice versa. Therefore, proper care must be taken that the government policies should not bring violent fluctuations and impede economic growth. To sum up, despite certain short-comings of taxation, its significance as an effective anti-cyclical and growth inducing investment cannot be forfeited.

C. Public Expenditure:

The active participation of the government in economic activity has brought public spending to the front line among the fiscal tools. The appropriate variation in public expenditure can have more direct effect upon the level of economic activity than even taxes. The increased public spending will have a multiple effect upon income, output and employment exactly in the same way as increased investment has its effect on them. Similarly, a reduction in public spending can reduce the level of economic activity through the reverse operation of the government expenditure multiplier.

(i) Public Expenditure in Inflation:

During the period of inflation, the basic reason of inflationary pressures is the excessive aggregate spending. Both private consumption and investment spending are abnormally high. In these circumstances, public spending policy must aim at reducing the government spending. In other words, some schemes should be abandoned and others be postponed. It should be carefully noted that government spending which is of

productive nature, should not be shelved, since that may aggravate the inflationary dangers further. However, reduction in unproductive channels may prove helpful to curb inflationary pressures in the economy. But such a decision is really difficult from economic and political point of view. It is true, yet the fiscal authority can vary its expenditure to overcome inflationary pressures to some extent.

(ii) Public Expenditure in Depression:

In depression, public spending emerges with greater significance. It is helpful to lift the economy out of the morass of stagnation. In this period, deficiency of demand is the result of sluggish private consumption and investment expenditure. Therefore, it can be met through the additional doses of public expenditure equivalent to the deflationary gap. The multiplier and acceleration effect of public spending will neutralize the depressing effect of lower private spending's and stimulate the path of recovery.

D. Public Works:

Keynes General Theory highlighted public works programme as the most significant anti-depression device. There are two forms of expenditure i.e., Public Works and 'Transfer Payments. Public Works according to Prof. J.M. Clark are durable goods, primarily fixed structure, produced by the government. They include expenditures on public works as roads, rail tracks, schools, parks, buildings, airports, post offices, hospitals, irrigation canals etc. Transfer payments are the payments such like interest on public debt, subsidy, pension, relief payment, unemployment, insurance and social security benefits etc. The expenditure on capital assets is called capital expenditure. Keynes had strong faith in such a programme that he went to the extent of saying that even completely unproductive projects like the digging up of holes and filling them up are fully admissible. Therefore, the evidence that public works programme fully satisfies, the main criteria as laid down for public expenditure. However, this form of public expenditure is subject to certain limitations and practical difficulties. Some of these are listed as under.

1. Difficult Forecasting:

The effectiveness of public works programmes always rests upon accurate forecasting of the depression or boom. But prediction of accurate forecasting is very difficult.

2. Timing of Public Works:

Another serious problem relates to the timing of public works with the moment of cycle. Due to lack of accurate forecasting, proper timing is neither feasible nor possible. Thus this factor along undermines the significance of public works as an instrument of stabilization.

3. Delay in starting:

Public works programmes are not something which can be started immediately. Actually, it is a long term programme which requires proper planning with regard to the finance and engineering. In this way, delay is the natural cause. Dernburg and McDougal have rightly noticed, "public works are, in short, clumsy and slow moving requiring time to get ready and time to turn off."

4. Scarcity of Resources:

The undertaking of public works programme may pose a serious threat due to non-availability of resources. It is likely that scarcity of resources may further aggravate the crisis instead of giving the pace of smoothness.

5. Limited Scope of Employment:

The public works programme is not capable of assuring job to all cadres of unemployed workers. Such works are only started to absorb unskilled and semi-skilled workers and not the specialised.

6. Misallocation of Resources:

As the slump gets deepened, there is wide spread unemployment of manpower and equipment. Generally, public works are located in only few selected areas. Thus, they may prove to be inadequate to cope with the requirements. Again, immobility in factors of production may also prevent the economic utilization of available resources. As a result, they reduce the efficiency of public works programme.

7. Burden of Public Debt:

The public works programme, generally, are financed through borrowing during depression. This will saddle the country with a heavy burden of repayment of principle amount and interest therein.

8. Cost Price Maladjustments:

The public works programme may perpetuate cost price maladjustments in heavy industries where public expenditure is concentrated. During the period of boom, wages and prices in construction industries have a strong upward tendency while in recession or depression; prices move downward, wages and costs remain sticky relatively. In short, such distortion in cost price structure brings more instability in the economy.

9. Effect on Private Enterprise:

In certain areas, the construction programmes undertaken by the public agencies may complete with private investment. As a result, the later is driven out of business. In such a case, public works will prove to be self-off setting and the aggregate demand will possibly fail to increase.

10. Control over Public Works:

The success of public works mostly depends on the nature of control over them. If public works are controlled by the central authority, delay is likely to arise in selected projects.

11. Political Considerations:

Public works are often started in democratic countries in certain areas not on account of economic reasons, but the political pressures at national, state and local levels sway the government decisions. Consequently, the economic utility of such public works remains very limited.

E. Public Debt:

Public debt is a sound fiscal weapon to fight against inflation and deflation. It brings about economic stability and full employment in an economy.

(a) Borrowing from Non-Bank Public:

When the government borrows from non-bank public through sale of bonds, money may flow either out of consumption or saving or private

investment or hoarding. As a result, the effect of debt operations on national income will vary from situation to situation. If the bond selling schemes of the government are attractive, the people induce to curtail their consumption, the borrowings are likely to be non inflationary. When the money for the purchase of bonds flows from already existing savings, the borrowing may again be non-inflationary. Has the government not been borrowing, these funds would have been used for private investment, with the result that the debt operations by the government will simply bring about a diversion of funds from one channel of spending to another with the similar quantitative effects on national income.

If the government bonds are purchased by non bank individuals and institutions by drawing upon their hoarded money, there will be net addition to the circular flow of spending. Consequently, the inflationary pressures are likely to be created. But funds from this source are not commonly available in larger quantity. Its main implication is that borrowings from non bank public are more advantageous in an inflationary period and undesirable in a depression phase. In short, the borrowing from non bank public are not of much significant magnitude whether it comes out of consumption, saving, private investment or hoarding.

(b) Borrowing from Banking System:

The government may also borrow from the banking institutions. During the period of depression, such borrowings are highly effective. In this period, banks have excessive cash reserves and the private business community is not willing to borrow from banks since they consider it unprofitable. When unused cash lying with banks is lent out to government, it causes a net addition to the circular flow and tends to raise national income and employment. Therefore, borrowings from banking institution have desirable and favourable effect especially in the period of depression when the borrowed money is spend on public works programmes. On the contrary, borrowing from this source dry up almost completely in times of brisk business activities i.e. boom. Actually, demand is very high during inflation period, since profit expectation is high in business. The banks, being already loaded up and having no excess cash reserves. Find it difficult

to lend to the government. If it is done, it is only through reducing their loans somewhere else. This leads to a fall in private investment. As the government spending is off-set by a reduction in private investment, there will be no net effect upon national income and employment. In nut shell, borrowing from banking institutions have desirable effect only in depression and is undesirable or with a neutral effect during inflation period.

(c) Drawing from Treasury:

The government may draw upon the cash balances held in the treasury for financing budgetary deficit. It demonstrates dishoarding resulting in a net addition in the supply of money. It is likely to be inflationary in nature. But, generally, there are small balances over and above what is required for normal day to day requirements. Thus, such borrowings from treasury do not have any significant result.

(d) Printing of Money:

Printing of money i.e. deficit financing is another method of public expenditure for mobilizing additional resources in the hands of government. As new money is printed, it results in a net addition to the circular flow. Thus, this form of public borrowing is said to be highly inflationary. Deficit financing has a desirable effect during depression as it helps to raise the level of income and employment but objection is often raised against its use at the time of inflation or boom. Here, it must be added that through this device, the government not only gets additional resources at minimum cost but can also create appropriate monetary effects like low interest rates and easy money supply and consequently economic system is likely to register a quick revival. Fiscal neutrality is when a government taxing, spending, or borrowing decision has or is intended to have no net effect on the economy. Policy changes can be considered neutral in either their macroeconomic or microeconomic impact, or both.

Compensatory Fiscal Policy

John Maynard Keynes recommended compensatory fiscal policy to counter recession. During recession, private expenditure in the form of consumption and investment may decline due to the operation of some adverse factors. This decline in aggregate demand will reduce consumption,

investment, employment etc, leading to down turn and recession in the economy. In this juncture, effort by the government through additional expenditure (and reduced taxes) will fill the gap in demand, consumption and investment. The main thrust of compensatory fiscal policy thus is that the government should inject extra expenditure to reinstate demand. In effect, the government expenditure was able to compensate for reduced private expenditure. This fiscal policy is called compensatory fiscal policy. Contra cyclical fiscal policy is to counter business cycles.

Functional Finance:

1. The Concept of Functional Finance:

The chief exponent of functional finance was Prof. Abba P. Lemer who believed that fiscal measures should be judged only by their effects. The way fiscal measures function in an economy is called functional finance. Prof. Lemer asserted that fiscal policy is an effective instrument in the hands of the government for maintaining full employment and controlling economic fluctuations. Prof. A. P. Lemer states the central idea is that government fiscal policy, its spending and taxing its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound. The principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism.

The principle of Judging fiscal measures by the way they work or function in the economy we may call Functional Finance. Functional Finance entrust the government the meritorious responsibility of keeping a watch over the movements of the economy as a whole. Whenever and where ever employment sags, income decreases, profitability declines and the economy suffers a severe setback the public authorities are advised to counteract these tendencies by un-leasing the opposite force which would rise up the dropping nerves of the system and bring the situation back normally.

The government cannot remain a silent spectator of the dislocations and disturbance in the economy in tune with the non-intervention list policy of the captains of Laissez-fairism. The object of a stable economy is as much in the interest of the capitalists as in the rest of the society. Hence maintenance of a high level of demand reasonable prices, a high level of employment and income ought to be the supreme objective of functional finance through the instrument of budgetary manipulations. Functional Finance is a positive policy in the sense that it advocates a vigorous policy of intense activity on behalf of the community undertaken by the public authority.

2. Rules of Functional Finance:

Concept of functional finance insists on the elimination of the basic causes of inflation and deflation and thereby to maintain economic stability.

The government activity under functional finance:

1. The first financial responsibility of the government is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current price would buy all goods that it is possible to produce. If total spending is allowed to go above this, there will be inflation. If it is allowed to go below this there will be unemployment. The government can increase total spending by spending more itself or by reducing taxes so that the tax payers have more money left to spend. It can reduce spending by spending less it or by raising taxes so that tax payers have less money left to spend. By these means total spending can also be kept at the required level, where it will be enough to buy the goods produced.

2. The second law of functional finance is that the government should borrow money only if it is desirable that the public should have less money and more government bonds. This might be desirable if otherwise the rate of interest would be reduced too low and induce too much investment, thus bringing about inflation. Conversely the government should lend money only if it is desirable to increase the money or to reduce the quantity of government bonds in the hands of the public.

3. Taxing is never to be undertaken merely because the government needs to make money payments. According to the principle of functional finance, taxation must be judged only by its effect. Taxation should be framed to regulate the spending habit of the people. If private spending is desirable government should reduce the volume of taxation and vice versa.

4. Lerner was of the view that printing of money should take place only when it is needed to implement functional finance in spending or lending. That is deficit financing should be used when current revenue falls short of expenditure during depression under inflation hoarding or destruction of money should be done. Functional finance thus rejects completely the traditional doctrines of "sound finance" and the principle of trying to balance the budget. Lerner observes "no budget balancing principle can be used for maintaining full employment and preventing inflation"**.** Thus functional finance has come to stay, whatever the reactions of the orthodox school. It has demolished the basis of the fiscal policy based on sound finance.

Role of Functional Finance under Inflation:

Functional finance can be used as an effective instrument to fight inflation and depression.

1. Budgetary Policy:

According to the policy of functional finance, government should not adopt a balanced budget during inflation; government should follow a surplus budget. By resorting to heavy taxation and extensive borrowing, the excess purchasing power in the economy should be neutralized. Government should apply drastic cut in expenditure programmes to deal with inflationary force. All these measures should result in surplus budget, which act as an anti-dot during inflation.

2. Government Expenditure Policy:

Inflation is a situation in which aggregate effective demand increases too much due to unregulated private expenditure. To counter increased private spending government at such a time, should reduce its expenditure to the possible extend. All unproductive and wasteful expenditure should be minimized.

3. Taxation Policy:

As an anti-inflationary weapon taxation policy has much significance. During inflation, the problem is to reduce the size of the disposable income. Hence taxation must be resorted to take away the excess purchasing power from the people. For this the rate of existing taxes should be increased steeply.

4. Public Borrowing:

The object of public borrowing should be to take away from the public excess purchasing power. Government can resort to voluntary and if needed compulsory methods to raise loans. Coupled with this the existing public debt should be managed in such a manner as to reduce the existing money supply and to prevent credit expansion. Anti-inflationary debt management required the payment of bank held debt out of a budget surplus. That is during inflation government securities should be repaid through a budgetary surplus. Thus by resorting to a surplus budget, increasing the volume of taxation, reducing the rate of expenditure and by resorting to public borrowing, the inflationary forces can be controlled under inflation.

Role of Functional Finance under Deflation:

Deflation or unemployment is the result of deficiency in private spending. Hence fiscal policy under deflation should be fine-tuned to increasing consumption and investment expenditure.

1. Budgetary Policy:

Budgetary policy of the government is geared to fight depression and unemployment. The need of depression is an increased flow of income. This according to Keynes can only be realized through a deficit budget. Government should spend more than its ordinary revenue collection. The deficit so incurred should be met either by borrowing from the bank or through printing of currency. The injection of more money into circulation will stimulate private spending and economic recovery. In this context prof. Gunnar Myrdal remarked “Under balancing the budget during depression is not primarily a deliberate policy but a practical necessity.” Hence as an anti-inflationary tool deficit budget is a virtue.

2. Taxation Policy:

As an anti-depression policy fiscal policy, should aim at increasing both consumption and investment expenditure. For realizing this objective taxation policy can render valuable help to the government. Taxation policy in depression, according to Keynes should be designed to stimulate both consumption and investment. This can be achieved by reducing the burden of taxation on the community. Commodity taxation should be reduced to the possible extend, to stimulate consumption. Moreover reduction in excise duty, sales tax etc. will also help to increase the propensity to consume of the community. Coupled with this to boost investment, business and corporate tax should be slashed down to increase consumption during deflation.

3. Expenditure Policy:

The deficiency in effective demand during depression can be mitigated through increased public expenditure. Public expenditure according to Keynes is a best anti-depression tool to recover economic activity. Government should increase the volume of development expenditure on public works programmes and social security measures. The expenditure incurred on public works programme and social security measures are together called compensatory spending. Keynes opines that government should always keep at hands certain well planned schemes of public works such as road construction, building, parks, schools, canals, hospitals etc. to be enforced during depression. This type of development works will generate employment not only directly but also indirectly. Increased employment leads to additional income and increased effective demand. This will help to enhance productive capacity and remove the evils of depression

4. Public Debt Policy:

During depression government should resort to a deficit budget. The deficit caused in the government budget should be met particularly or wholly by borrowed money. That is public borrowing should be resorted during deflation to meet the budget deficit. However in order to keep the burden of public debt low, the government should aim at a policy of low interest rate during depression. Government should also try to borrow from

those sections of population with whom the funds are laying idle. "Thus the role of fiscal policy can be linked to the driving of a car. While driving up a gradient, what is needed is an increase in power. On the other hand, when it moves against the national interest it is necessary to control the supply of power and also to apply breaks judiciously to ensure that the vehicle does not slip out of control but keeps a moving all the same. The national exchequer could see that the breaks are not pressed so much as to bring the vehicle to a stop." What is imperative is a continuous and judicious use of fiscal policy, in tune to the existing circumstances.

Reforms in India's Fiscal Policy and Its Performance

Fiscal policy is a critical component of the policy framework pursued since the initiation of economic reforms in India in 1991 to achieve the objectives of economic growth, price stability and equity. To achieve these objectives, it was necessary to raise more resources through taxation and restrain the growth of unproductive and non-plan expenditure. During the mid-nineties there was set back in this policy when Fifth Pay Commission's recommendations of sharp hike is wages and salaries were accepted resulting in large increase in non-plan government expenditure and consequently rise is fiscal deficit.

The Central Government has continued to follow prudent fiscal policy:

(i) Balanced tax structure of direct and indirect taxation based on moderate tax rates with minimum exemptions covering a wider class of tax payers and

(ii) An expenditure policy that aims to restrain the growth in non-developmental expenditure and adequately provide for pressing social and infrastructure needs of a developing economy. In the last some budgets, especially the budgets for the years 2005-06,2006-07, 2007-08,2010-11, 2011-12 and 2012-13 the fiscal strategy for achieving the above stated objectives has been primarily revenue led without expenditure compression. However, within the limits of fiscal deficit set under Fiscal Responsibility and Budget Management (FRBM) Act passed in 2003-04, there has been reprioritization of public expenditure along with revenue-ted strategy of fiscal consolidation.

To raise more revenue for achieving growth with macroeconomic stability, tax-GDP ratio has been sought to be raised. As a result of tax effort made for mobilisation of tax-GDP ratio rose to 12.6 per cent (for both the centre and states combined) in 2007-08. For this purpose various tax reforms both in the spheres of direct and indirect taxes have been carried out. It is felt that while the policy of moderate tax rate; have to be followed, the base of taxation has to be broadened. With this end in view the tax reforms undertaken since the beginning of nineties have sought to bring about a compositional shift in the structure of the tax system away from the excessive dependence on regressive indirect taxes to progressive direct taxes for raising resources for accelerating economic growth with stability. Besides, to ensure competitiveness of the products of Indian industry excise duties and custom duties have been reduced so that rapid growth of Indian exports is possible.

Moreover customs duties were reduced to open up the Indian economy and to obtain gain from free trade. To compensate for this and realizing that more than per cent of India's GDP came from services, service tax was levied which has now become an important source of Government revenue. In 2013-14 service tax was expected to yield Rs. 1.30 lakh crore (BE).However, as stated above, to achieve fiscal consolidation (i.e., reduction of fiscal deficit) for controlling inflation and ensuring release of resources for economic growth and employment generation, raising revenue from taxation has been given priority along with improving the quality of public expenditure (that is, restraining the growth of non-developmental expenditure and raising plan expenditure). Since, much of public expenditure is of committed nature such as interest payments for servicing past public debt, expenditure on defence, pensions and wages and salaries of government employees, there is very little room for compression of expenditure in the short run, the objective of accelerating growth and employment generation have to be achieved by raising revenue and improving the quality of expenditure.

However, in the financial year 2012-13 in order to contain fiscal deficit, Finance Minister, Mr. Chitambram reduced planned expenditure by

Rs. 90,000 crore which worked to reduce rate of economic growth. In what follows we first explain the reforms in both direct and indirect tax systems that have been undertaken in the last two decades.

Reforms in Direct Taxation:

It is important to note that over the last two decades, there has been a significant reform in the tax system so that it can make larger contribution to resource mobilisation for economic growth and at the same time serves the objective of achieving equity as well. First, in the sphere of direct taxation rate of income and corporation taxes have been lowered to moderate levels. With lower tax rates revenue buoyancy from these taxes can be achieved through better compliance and minimal exemptions. Until the early eighties, direct tax rates were exorbitant, evasion of these taxes was rampant which gave birth to the enormous black money in the Indian economy.

It was realised that moderate rates of these taxes would yield more revenue by increasing tax compliance. Lower rates of direct taxes also provide incentives to work more, save more and invest more as lower rates increases after-tax returns on work, saving and investment. Long-term fiscal policy announced in 1985 rightly emphasised that "a broader base of taxation combined with moderate rates of taxes and strict enforcement, can yield better revenue results". Acting on the long-term fiscal policy V.P. Singh in his 1985-86 budgets cut the maximum marginal rate of income tax to 50 per cent and reduced personal income tax slabs from eight to four. Seven years later Dr. Manmohan Singh reduced the maximum marginal income tax rate to 40 per cent in his budget for 1992-93 and reduced the personal income tax slabs to only three. Mr. Chidambaram in his dream budget 1997-98 further reduced top marginal rate of income tax to 30 per cent. Moreover, education cess of 3 per cent has been levied on both income tax and corporation tax.

As regards corporation tax, acting on the Chilliah Committee recommendations Dr. Manmohan Singh attempted rationalisation of corporate taxation and cut the corporation tax rate to 40 per cent and reduced exemptions in 1994-95 budgets to broaden the base of the tax.

Three years later Mr. Chidambaram further reduced corporation tax to 35 percent in his budget for 1997-98 and again as Finance Minister in UPA Government he further reduced the corporation tax rate to 33 per cent in 2004-05 budgets. However, to broaden the base of corporation tax so as to increase tax revenue he lowered the depreciation allowance from 25 per cent to 15 per cent in 2007-08. Besides, to raise revenue from corporate taxation, fringe benefit tax (FBT) was levied payable by corporate employee. Besides, Minimum Alternate tax (MAT) which was fixed at 7.5 per cent to 10 of book profits of the corporate companies has now been raised to 18.5 per cent in 2011-12 budget and long-term capital gains have been included in the book-profits. Further, securities transaction tax (STT) has been levied on the sale and purchase of shares/securities.

It is thus evident from above that in the last over two decades, efforts have been made to move to moderate direct tax rates and broaden the base of direct taxation by withdrawing certain exemptions. This has improved the compliance to pay taxes and resulted in increase in revenue from direct taxes. However, there is still a vast potential for revenue buoygency of direct taxes since there are still a large number of exemptions, for example, in case of various types of financial savings and exports. As recommended by the Task Force headed by R. Vijay Kelkar, more resources can be mobilized from direct taxes if a large number of existing exemptions which have outlived their utility are withdrawn and direct tax system is simplified and made transparent. It is now proposed to implement direct tax code without many exemptions which is now awaiting the approval of parliament.

An important outcome of fiscal policy pursued after 2002-03 was decline in fiscal deficit till 2007-08 which helped to keep inflation rate at around 5 per cent per annum as measured by WPI of all commodities. It will be seen from Table 33.1 that fiscal deficit which was 6.2 per cent of GDP in 2001 -02 fell to 2.5 per cent in 2007-08, but again rose to 6.5 percent in 2009-10 due to fiscal stimulus package adopted to prevent slowdown of the Indian economy due to global financial crisis. High fiscal deficit of the order of 6 per cent and more is bad and against fiscal prudence. Fiscal deficit can be either financed by the Government monetisation, which is, printing of

new money by RBI or by borrowing from the market. Monetisation of fiscal deficit is avoided as it leads to inflation in the economy. The excessive Government borrowing is also had because it causes increase in public debit which raises the burden on future generations. Besides, excessive Government borrowing from the banks dries up banking resources for the private sector, that is, reduces the availability of credit for the private sector. Further, Government borrowing from the market tends to raise interest rate. Higher interest rate causes increase in cost of credit for the private sector which impinges on their profit margins. Therefore, on the recommendation of IMF, Fiscal Responsibility and Budget Management (FRBM) Act was passed in 2003-04.

After this, fiscal deficit consistently declined to 4.0 per cent of GDP in 2005-06 and to 2.6 per cent in the year 2007-08. This decline in fiscal deficit in these years was achieved by reducing revenue deficit from 4.4 percent of GDP in 2001-02 to 2.5 percent in 2005-06 and further to 1.1 per cent in 2007-0& on the one hand and restraining the growth of expenditure, especially non-plan expenditure. Under Fiscal Responsibility and Budget Management Act (FRBMA) it was planned to eliminate revenue deficit completely by 2008-09 and fiscal deficit to be reduced to 3 per cent of GDP in 2008-09. This was expected to release more resources for economic growth and social sector development.

However, fiscal deficit rose to 6.0 per cent of GDP in 2008-09 and to 6.5 per cent of GDP in 2009-10. This is because to fight economic slowdown following the intensification of global financial crisis in 2008, the Central Government came out with fiscal stimulus programmes wherein Government expenditure had to be increased and indirect taxes reduced to keep the momentum of economic growth. However, it was reduced by the 4.8 per cent in 2010-11 and to 4.6 per cent of GDP in 2011 -12, but it again rose to 5.7% of GDP in 2011 -12 and 5.1 % in 2012-13. In his budget for 2013-14, the Finance Minister has set the target of fiscal deficit for 2013-14 at 4.8% of GDP.

Changes in Taxation Structure: Increase in Share of Direct Taxes:

It is interesting to note that tax-GDP ratio which rose to 11.9 per cent in 2007-08 declined to 10.8% and 9.6 per of GDP in 2008-09 and 2009-10 respectively due to lowering of indirect taxes in 2008-09 and 2009-10 to prevent large economic slowdown. Besides, there has been also improvement in the taxation structure. While there has been decline in the share of regressive and resource-distorting indirect taxes in the revenue of the Central Government, there is rise in the share of direct taxes. Thus, as will be seen from Table 33.2, whereas the share of direct taxes as per cent of GDP rose from 2.8% in 1995-96 to 5.9 percent in 2007-08, the share of indirect taxes as per cent of GDP fell from 6.4 per cent in 1995-96 to 5.6 per cent in 2007-08 and further to 3.8% in 2009-10 but for 2012-13 it was budgeted to rise to 5% of GDP. On the other hand, the share of direct tax as percentage of GDP which was 3% of GDP rose to 5.6 per cent of GDP in 2012-13. This increase in share of direct taxes and fall in indirect tax in total tax revenue of Central Government has made the Indian tax system more equitable. This change in tax structure a creditable achievement of mobilising resources from direct taxes, as this has been done despite the fact that rates of both personal income tax and corporation tax have been substantially reduced. This will also ensure equitable distribution of burden of overall tax among the people.

Reforms in the Indian Indirect Tax System:

The Indian indirect tax system as it existed in the early nineties had several drawbacks. First, the excise duties and sales tax were levied on inputs which had a cascading effect on raising prices of final products. In a way, there is 'a tax on tax'. As regards sales tax which is levied by State governments, a uniform value added tax (VAT) is proposed to be levied. VAT tax will replace different rates of sales tax levied by the state governments. Legislation has already been enacted but its implementation was deferred due to protest by traders and due to general elections in April 2004. Now, as per decision of UPA government VAT has come into effect from April 1, 2005. Implementation of VAT will eliminate the cascading effect of sales tax and also help in achieving price stability. The experience of Haryana and Delhi

which have implemented VAT shows that government revenue increased when VAT was introduced.

Reforms in Excise Duty:

To rationalise the indirect tax system at the centre by removing distortion in the structure there is a need to remove multiplicity of tax rates of central excise duties on various goods and services. With tax reform initiated since 1991, this has been now achieved with few exceptions. Now, there is a single excise duty called CENVAT (which is in the form of value added tax) at the rate of 16 per cent on all products which enter a production chain. The argument for a single 16 per cent CENVAT is that it will remove the distortions in the tax system as a result of multiplicity of rates of excise duties.

This is of course a correct approach in general but in the view of the present author the final consumption goods of the nature of income-elastic luxuries such as cars and air conditioners should be taxed at a much higher rate than CENVAT. This will enable the government to raise more revenue without harming production incentives and will thus serve well the equity objective. To simplify the indirect tax system, it is now planned to introduce Goods and Services Tax (GST) in near future. This GST will replace the service tax Central CENVAT and states VAT and a uniform rate of GST by all states will be fixed.

Revenue Mobilisation through Service Tax:

While the revenue from existing three sources, namely, direct, excise and customs taxes, is expected to increase by ensuring greater tax compliance and withdrawal of exemptions, the government seeks to collect more revenue from service tax by bringing more services under its net. Over the last four decades there has been a structural change in the Indian economy with relative contribution of agriculture to GDP significantly decreasing and of services sector sharply increasing to 54 per cent of GDP. With more services which have been brought within the service tax net in the last four budgets for the years, 2004-05, 2005-06, 2006-07, 2007-08 the total number of services on which service tax is levied has risen to more

than 100. In the year 2013-14 service tax was expected to bring in about Rs. 1.80 lakh crore (BE).

It is now well recognized that for more revenue mobilisation as well as for achieving equity and price stability there is a need to look at the whole value addition chain covering both goods and services from the viewpoint of taxation. Government intends to expand the scope of taxation of services by not only bringing additional services within the tax net, but also covering a larger number of assesses under the service tax.

Reforms in Customs Duties:

Since the early nineties revenue from customs duties as a percentage of GDP has been falling due to the reduction in customs duty rates following the policy of trade liberalisation. Dr. Manmohan Singh, the Finance Minister in his five budgets between 1991 and 1996 reduced India's absurdly high customs duties. He reduced peak tariff rates from over 200 per cent to 50 per cent and the import weighted average tariff rate from over 80 per cent to below 30 per cent. Since 1996, successive finance ministers further reduced the peak trifurcate (i. e. customs duty) first to 35 per, and then to 20 per cent in Jan. 2004.

The peak rate of customs duty has been further reduced to 15 per in 2005-06 and to 12.5 per cent in 2006-07 and to 10 per cent in 2007-08. But there are several exceptions to this peak rate. It is now planned to reduce the peak customs duties to the ASEAN level. Though India is committed to reduce tariff duties under trade liberalisation agreement of WTO, we should try to provide effective protection to some of our crucial industries such as textiles and agriculture by fixing higher customs rates than peak customs duty making a cause for their exceptional treatment. It is quite surprising to note that Kelkar Task Force on implementation of Fiscal Responsibility and Budgetary Management Act (FRBMA) proposed a shift to a three rate structure on customs duties consisting of 5 per cent, 8 per cent and 10 per cent. In our view this is going too far in trade liberalisation. This will involve not only a loss of tax revenues but will also reduce effective protection to Indian industries.

Changes in Quality of Expenditure:

Changes in pattern of expenditure are also worth mentioning. It will be seen from Table 33.4 that prior to 2007-08 through the adoption of prudent fiscal policy the Government had been able to reduce total expenditure both revenue and capital, which as percentage of GDP fell from 17.3 per cent in 2001-02 to 15.4 per cent in 2004-05 and further fell to 13 .6 per cent in 2006-07, and rose marginally to 14.1% in 2007-08. As compared to plan-expenditure which as a percent of GDP rose from 3.8 per cent in 2005-06 to 4.9% in 2008-09 and 5.3% in 2009-10 non-plan expenditure fell sharply from 12.3 per cent of GDP in 2002-03 to 9.7% in 2006-07 and to 10.3 per cent in 2007-08. It is only in 2008-09 and 2009-10 that due to need of increasing public expenditure to overcome recession or slowdown of the Indian economy and to keep the growth momentum that non-plan expenditure slightly increased to 10.9% and 11.3% in 2008-09 and 2009-10 respectively.

Further, as seen from Table 33.4 that Government has succeeded in restraining the growth of non-development expenditure incurred on interest payments, major subsidies and defense till 2007-08. It is only in 2008-09 and 2009-10 under well-designed contra-cyclical policy that Government increased its expenditure and borrowed heavily for this purpose to fight slowdown of the Indian economy and to keep the growth momentum. This resulted in increase in expenditure on interest and subsidies. As plan expenditure represents development expenditure and non-plan expenditure represents non-development expenditure, the changes witnessed in the pattern of expenditure therefore show improvement in the quality of expenditure.

For achieving 8 per cent rate of growth in GDP on a sustained basis, it is necessary to step-up public investment expenditure on agriculture and infrastructure. This requires to effect a shift in the composition of total expenditure in favour of capital expenditure. This can be done only if revenue deficit is bridged by raising more resources through taxation on the one hand and cutting non-plan expenditure on the other. One of the major objectives of Fiscal Responsibility and Budget Management (FRBM) Act,

2003 was to eliminate revenue deficit by the year 2008-09. With revenue deficit reduced to zero, But in 2008-09 partly due to fiscal stimulus in which tax cuts were made and government expenditure increased to maintain the growth momentum and partly due to the populist programme such as waiving loans of farmers to the time of Rs.70,000 crore the target of zero revenue deficit was not achieved.

As a result revenue deficit which was lowered to 1.1 per cent of GDP in 2007-08 went up to 4.6 per cent in 2008-09. Therefore, the expectation that with zero revenue deficits, the government would be able to increase capital expenditure for investment in agriculture, industry and infrastructure was not realised. Large revenue deficit is quite bad because large expenditure incurred on revenue account does not lead to creation of durable assets which are essential to sustain growth. Thus, what is a matter of concern is the decline in capital expenditure which mostly represents investment expenditure in physical assets. As a proportion of GDP, fall in total government expenditure from a level of 17.1 percent in2003-04 to 14.4 per cent in 2007-08 was largely driven by the steep fall in capital expenditure with revenue expenditure remaining almost steady between 2004-05 and 2007-08.

It may be however noted that revenue expenditure includes some expenditure on social sector (mainly elementary education and literacy) under Sarv Shiksha Abhiyan and Mid-day Meals; health and family welfare (National Rural Health Mission), rural employment, and physical infrastructure including rural roads which are also of developmental nature. Even accounting for these the fact remains that fall in capital expenditure is disturbing and must be reversed. As regards expenditure on subsidies, the government’s recent policy is to make them targeted to the poor and weaker sections of the society. To ensure that benefits of expenditure on subsidies are not usurped by those not intended be the beneficiaries of these subsidies. Delivery mechanism for providing these subsidies should be improved and made more efficient.

Under NCMP, Government is committed to control inefficiencies that increase the food subsidy burden and to target all subsidies sharply at the

poor and the truly needy like small and marginal farmers, farm labour and the urban poor. To reduce expenditure on subsidies government has raised the price of cooking gas and restricted its use by a family to 9 cylinders per year. Besides, it has decontrolled petrol and raising price of diesel by 50 paise every month. However, due to enactment of Food Security Bill, its expenditure on food subsidy will rise.

Reduction in Fiscal Deficit:

A large fiscal deficit has been a major macro-economic problem. It is persistent large fiscal deficits in the nineteen eighties that landed the Indian economy in a state of severe economic crisis reflected in the acute balance of payments problem. This acute economic crisis compelled us to approach IMF for help to tide over the crisis. Fiscal deficit is the difference between the total government expenditure on revenue and capital accounts and the total sum of revenue receipts and non-debt capital receipts. Thus fiscal deficit measures the total borrowing from the market, net borrowing from the Reserve Bank of India, small savings and external assistance.

For the achievement of macroeconomic stability, fiscal deficit should not exceed 3 per cent of GDP. Fiscal Responsibility and Business Management (FRMB) Act 2003 has prescribed to achieve the target of fiscal deficit to 3 per cent of GDP by the year 2008-09. This is generally called fiscal consolidation. But how this fiscal consolidation, that is, reduction in fiscal deficit is to be achieved so as to achieve economic growth with stability and equity. This can be done by raising tax-GDP ratio on the one hand and reducing non-plan expenditure on the other. Tax-GDP ratio can be raised by widening the base of direct taxes, especially personal income tax and corporation tax. One important way of broadening the base of the direct taxes is to withdraw many of such exemptions which have outlived their utility and are merely used to evade these taxes.

As result of these exemptions, the effective rate of corporation tax is much smaller. Economic Survey 2005-06 found that 40 per cent of corporate companies pay only 10 per cent or less corporation tax as against 30 per cent levied on them. This has also been found by Task Force headed by Vijay Kelkar. It is interesting to note that because of these exemptions

Reliance Industries which made huge profits throughout its career did not pay any corporation tax for several years. Similarly, many other profitable companies also took advantage of these exemptions and did not pay any tax for several years. Therefore, the Central government enacted' Minimum Alternative Tax (MAT) according to which these profitable companies which did not pay corporation tax would have to pay this minimum alternative tax. The efforts have been to raise more resources through levying new taxes in order to reduce fiscal deficit. The introduction of service tax in 1994-95 ushered in a major change in indirect taxes in the (BE) form of wider base and facilitated the process of rationalization of excise duties resulting in lower tax burden on productive sectors. Over the years, the number of services subject to service tax has increased and now stands at around 114. However, a further reform in the indirect tax system in the form of Goods and service tax (GST) is to be introduced from April 2012.

It is also worth noting that long-term capital gains from shares has been exempted in the budget w. e .f. 2004-05 and has been replaced by Securities Transaction Tax. Along with it, short-term capital gains tax was reduced from 20% to 10%. This is quite contrary to broadening the tax base. Indeed, there is good economic case for imposing a tax on long-term capital gains on shares, its rate may be kept lower than the general income tax rate because of the risk involved in investing funds in equity capital. The total abolition of capital gains tax on equity capital will introduce large distortions and also results in loss of revenue for the government. This loss is unlikely to be made up by levying a small securities transaction tax.

Fiscal Federalism in India

(1) Division of Functions:

The fiscal powers and functional responsibilities in India have been divided between the Central and State government following the principles of federal finance. The division of functions is specified in the Seventh Schedule of the Constitution in three lists vis. the Union List, the State List and the Concurrent List. The Union List contains 97 subjects of national importance, such as defence, railways, national highways, navigation, atomic energy, and posts and telegraphs. 66 items of State and local

interest, such as law and order, public health, agriculture, irrigation, power, rural and community development, etc. have been entrusted to the State governments. 47 items such as industrial and commercial monopolies, economic and social planning, labour welfare and justice, etc. have been enumerated in the Concurrent List. The concurrent list is one in which both state and the centre can make legislations. However, in case of a conflict or tie, federal laws prevail.

(2) Revenue Powers of the Centre:

The Central government has been given powers in respect of taxes on income other than agricultural income, customs duties, and. excise duties on tobacco and other goods manufactured or produced in India, corporation, tax, taxes on capital values, estate duty in respect of property other than agricultural land, terminal taxes on goods or railway passengers carried by railway, sea or air, taxes other than stamp duties on transactions in stock exchanges and futures, markets, stamps duty in respect of land, etc.; taxes on sale or purchase of news papers and on advertisements published therein; and sale, purchase and consignment of goods involving inter-State trade or commerce. In fact, the Central government does not get revenue from all the above taxes.

These revenues can be divided into four categories on the basis of levy, administration and the accrual of revenue as follows:

a. Taxes that are levied collected and retained by the Central government: e.g. Corporation Tax, Customs Duties;
b. Taxes that are levied and collected by the Centre but shared with the states: e.g. the net proceeds from Union Excise Duties under Article 270 and the net proceeds from Union Excise Duties under Article 272, respectively;
c. Taxes that are levied and collected by the centre but whose net proceeds are assigned to the states: e.g. all the eight items under Article 269 of the constitution such as Estate duty. Taxes on Railway Passenger Fares and Freights and Consignment Tax, etc.; and
d. Tax levied by the Centre but allocated and appropriated by states, such as exercise duties on medicinal and toilet preparations, etc.

(3) Revenue Powers of the State:

The State governments have been given exclusive tax powers in respect of land revenue; taxes on agricultural income; duties in respect of succession to agricultural land; estate duty in respect of agricultural land; taxes on land and buildings; excise duties on goods containing alcoholic liquors for human consumption; opium, Indian hemp and other narcotic drugs; taxes on the entry of goods into local areas; taxes on the sale or purchase of goods other than newspapers; taxes on vehicles, tolls; taxes on professions, trades, callings and employment; capitation taxes, taxes on luxuries including taxes on entertainment, amusements, betting and gambling.

(4) Division of Borrowing Powers:

The borrowing powers have also been clearly mentioned in the Constitution. Under Article 292, the central government is empowered to borrow funds from within and outside the country as per the limits imposed by the Parliament. According to Article 293(3), the States can borrow funds within the Country. Article 293(2) empowers the Centre to provide loans to State subject to conditions laid down by Parliament.

(5) Fiscal Imbalances in India:

The Constitutional fiscal arrangement shows that fiscal imbalances were deemed inevitable as most of the powers for elastic taxes are given to the Central government. Further, the division of powers and functions itself leads to vertical federal fiscal imbalance while the differences in the endowment position of natural resources across States cause horizontal federal fiscal imbalance. Visualising the fiscal imbalances, the Constitutional makers provided a mechanism of fiscal adjustment by way of fiscal transfers from the Central to the State Governments. This provision in the Constitution was made under Article 280 by way of setting up of a Finance Commission for every five years or earlier, if the President of India feels it necessary.

List I-Union List

1. Defence of India and every part thereof including preparation for defence and all such acts as may be conducive in times of war to its

prosecution and after its termination to effective demobilisation, 2. Naval, military and air forces; any other armed forces of the Union, 2A. Deployment of any armed force of the Union or any other force subject to the control of the Union or any contingent or unit thereof in any State in aid of the civil power; powers, jurisdiction, privileges and liabilities of the members of such forces while on such deployment. 3. Delimitation of cantonment areas, local self-government in such areas, the constitution and powers within such areas of cantonment authorities and the regulation of house accommodation (including the control of rents) in such areas. 4. Naval, military and air force works. 5. Arms, firearms, ammunition and explosives. 6. Atomic energy and mineral resources necessary for its production.

7. Industries declared by Parliament by law to be necessary for the purpose of defence or for the prosecution of war. 8. Central Bureau of Intelligence and Investigation. 9. Preventive detention for reasons connected with Defence, Foreign Affairs, or the security of India; persons subjected to such detention. 10. Foreign affairs; all matters which bring the Union into relation with any foreign country. 11. Diplomatic, consular and trade representation. 12. United Nations Organisation. 13. Participation in international conferences, associations and other bodies and implementing of decisions made thereat. 14. Entering into treaties and agreements with foreign countries and implementing of treaties, agreements and conventions with foreign countries. 15. War and peace. 16. Foreign jurisdiction. 17. Citizenship, naturalisation and aliens. 18. Extradition. 19. Admission into, and emigration and expulsion from, India; passports and visas. 20. Pilgrimages to places outside India.

21. Piracies and crimes committed on the high seas or in the air; offences against the law of nations committed on land or the high seas or in the air. 22. Railways. 23. Highways declared by or under law made by Parliament to be national highways. 24. Shipping and navigation on inland waterways, declared by Parliament by law to be national waterways, as regards mechanically propelled vessels; the rule of the road on such waterways. 25. Maritime shipping and navigation, including shipping and navigation on tidal waters; provision of education and training for the

mercantile marine and regulation of such education and training provided by States and other agencies. 26. Lighthouses, including lightships, beacons and other provision for the safety of shipping and aircraft.

27. Ports declared by or under law made by Parliament or existing law to be major ports, including their delimitation, and the constitution and powers of port authorities therein. 28. Port quarantine, including hospitals connected therewith; seamen's and marine hospitals. 29. Airways; aircraft and air navigation; provision of aerodromes; regulation and organisation of air traffic and of aerodromes; provision for aeronautical education and training and regulation of such education and training provided by States and other agencies.

30. Carriage of passengers and goods by railway, sea or air, or by national waterways in mechanically propelled vessels. 31. Posts and telegraphs; telephones, wireless, broadcasting and other like forms of communication. 32. Property of the Union and the revenue there from, but as regards property situated in a State subject to legislation by the State, save in so far as Parliament by law otherwise provides. 34. Courts of wards for the estates of Rulers of Indian States. 35. Public debt of the Union. 36. Currency, coinage and legal tender; foreign exchange. 37. Foreign loans. 38. Reserve Bank of India. 39. Post Office Savings Bank. 40. Lotteries organised by the Government of India or the Government of a State. 41. Trade and commerce with foreign countries; import and export across customs frontiers; definition of customs frontiers.

42. Inter-State trade and commerce. 43. Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including cooperative societies. 44. Incorporation, regulation and winding up of corporations, whether trading or not, with objects not confined to one State, but not including universities. 45. Banking. 46. Bills of exchange, cheques, promissory notes and other like instruments. 47. Insurance. 48. Stock exchanges and futures markets. 49. Patents, inventions and designs; copyright; trade-marks and merchandise marks. 50. Establishment of standards of weight and measure.

51. Establishment of standards of quality for goods to be exported out of India or transported from one State to another. 52. Industries, the control of which by the Union is declared by Parliament by law to be expedient in the public interest. 53. Regulation and development of oilfields and mineral oil resources; petroleum and petroleum products; other liquids and substances declared by Parliament by law to be dangerously inflammable. 54. Regulation of mines and mineral development to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest. 55. Regulation of labour and safety in mines and oilfields.

56. Regulation and development of inter-State rivers and river valleys to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest. 57. Fishing and fisheries beyond territorial waters. 58. Manufacture, supply and distribution of salt by Union agencies; regulation and control of manufacture, supply and distribution of salt by other agencies. 59. Cultivation, manufacture, and sale for export, of opium. 60. Sanctioning of cinematograph films for exhibition. 61. Industrial disputes concerning Union employees. 62. The institutions known at the commencement of this Constitution as the National Library, the Indian Museum, the Imperial War Museum, the Victoria Memorial and the Indian War Memorial, and any other like institution financed by the Government of India wholly or in part and declared by Parliament by law to be an institution of national importance.

63. The institutions known at the commencement of this Constitution as the Benares Hindu University, the Aligarh Muslim University and the Delhi University; the University established in pursuance of article 371E; any other institution declared by Parliament by law to be an institution of national importance. 64. Institutions for scientific or technical education financed by the Government of India wholly or in part and declared by Parliament by law to be institutions of national importance. 65. Union agencies and institutions for-(a) professional, vocational or technical training, including the training of police officers; or (b) the promotion of

special studies or research; or (c) Scientific or technical assistance in the investigation or detection of crime.

66. Co-ordination and determination of standards in institutions for higher education or research and scientific and technical institutions. 67. Ancient and historical monuments and records, and archaeological sites and remains, declared by or under law made by Parliament to be of national importance. 68. The Survey of India, the Geological, Botanical, Zoological and Anthropological Surveys of India; Meteorological organisations. 69. Census. 70. Union Public Service; All-India Services; Union Public Service Commission.

71. Union pensions, that is to say, pension's payable by the Government of India or out of the Consolidated Fund of India. 72. Elections to Parliament, to the Legislatures of States and to the offices of President and Vice-President; the Election Commission. 73. Salaries and allowances of members of Parliament, the Chairman and Deputy Chairman of the Council of States and the Speaker and Deputy Speaker of the House of the People. 74. Powers, privileges and immunities of each House of Parliament and of the members and the Committees of each House; enforcement of attendance of persons for giving evidence or producing documents before committees of Parliament or commissions appointed by Parliament.

75. Emoluments, allowances, privileges, and rights in respect of leave of absence, of the President and Governors; salaries and allowances of the Ministers for the Union; the salaries, allowances, and rights in respect of leave of absence and other conditions of service of the Comptroller and Auditor General. 76. Audit of the accounts of the Union and of the States. 77. Constitution, organisation, jurisdiction and powers of the Supreme Court (including contempt of such Court), and the fees taken therein; persons entitled to practise before the Supreme Court. 78. Constitution and organisation (including vacations) of the High Court's except provisions as to officers and servants of High Courts; persons entitled to practise before the High Courts. 79. Extension of the jurisdiction of a High Court to, and exclusion of the jurisdiction of a High Court from, any Union territory.

80. Extension of the powers and jurisdiction of members of a police force belonging to any State to any area outside that State, but not so as to enable the police of one State to exercise powers and jurisdiction in any area outside that State without the consent of the Government of the State in which such area is situated; extension of the powers and jurisdiction of members of a police force belonging to any State to railway areas outside that State. 81. Inter-State migration; inter-State quarantine. 82. Taxes on income other than agricultural income. 83. Duties of customs including export duties.

84. Duties of excise on tobacco and other goods manufactured or produced in India except- alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry. 85. Corporation tax. 86. Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies. 87. Estate duty in respect of property other than agricultural land. 88. Duties in respect of succession to property other than agricultural land. 89. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.

90. Taxes other than stamp duties on transactions in stock exchanges and futures markets. 91. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit policies of insurance, transfer of shares, debentures, proxies and receipts. 92. Taxes on the sale or purchase of newspapers and on advertisements published therein. 92A. Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce. 92B. Taxes on the consignments of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce. 93. Offences against laws with respect to any of the matters in this List. 94. Inquires, surveys and statistics for the purpose of any of the matters in this List. 95. Jurisdiction and powers of all courts, except the Supreme Court,

with respect to any of the matters in this List; admiralty jurisdiction. 96. Fees in respect of any of the matters in this List, but not including fees taken in any court. 97. Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists.

List II-State List

1. Public order (but not including the use of any naval, military or air force or any other armed force of the Union or of any other force subject to the control of the Union or of any contingent or unit thereof in aid of the civil power). 2. Police (including railway and village police) subject to the provisions of entry 2A of List I. 3. Officers and servants of the High Court; procedure in rent and revenue courts; fees taken in all courts except the Supreme Court. 4. Prisons, reformatories, Borstal institutions and other institutions of a like nature, and persons detained therein; arrangements with other States for the use of prisons and other institutions. 5. Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, districts boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration. 6. Public health and sanitation; hospitals and dispensaries. 7. Pilgrimages, other than pilgrimages to places outside India.

8. Intoxicating liquors, that is to say, the production, manufacture, possession, transport, purchase and sale of intoxicating liquors. 9. Relief of the disabled and unemployable. 10. Burials and burial grounds; cremations and cremation grounds. 12. Libraries, museums and other similar institutions controlled or financed by the State; ancient and historical monuments and records other than those declared by or under law made by Parliament to be of national importance. 13. Communications, that is to say, roads, bridges, ferries, and other means of communication not specified in List I; municipal tramways; ropeways; inland waterways and traffic thereon subject to the provisions of List I and List III with regard to such waterways; vehicles other than mechanically propelled vehicles.

14. Agriculture, including agricultural education and research, protection against pests and prevention of plant diseases. 15. Preservation,

protection and improvement of stock and prevention of animal diseases; veterinary training and practice. 16. Pounds and the prevention of cattle trespass. 17. Water, that is to say, water supplies, irrigation and canals, drainage and embankments, water storage and water power subject to the provisions of entry 56 of List I. 18. Land, that is to say, rights in or over land, land tenures including the relation of landlord and tenant, and the collection of rents; transfer and alienation of agricultural land; land improvement and agricultural loans; colonization.

21. Fisheries. 22. Courts of wards subject to the provisions of entry 34 of List I; encumbered and attached estates. 23. Regulation of mines and mineral development subject to the provisions of List I with respect to regulation and development under the control of the Union. 24. Industries subject to the provisions of entries 7 and 52 of List I. 25. Gas and gas-works. 26. Trade and commerce within the State subject to the provisions of entry 33 of List III. 27. Production, supply and distribution of goods subject to the provisions of entry 33 of List III. 28. Markets and fairs. 30. Money-lending and money-lenders; relief of agricultural indebtedness. 31. Inns and inn-keepers.

32. Incorporation, regulation and winding up of corporations, other than those specified in List I, and universities; unincorporated trading, literary, scientific, religious and other societies and associations; co-operative societies. 33. Theatres and dramatic performances; cinemas subject to the provisions of entry 60 of List I; sports, entertainments and amusements. 34. Betting and gambling. 35. Works, lands and buildings vested in or in the possession of the State. 37. Elections to the Legislature of the State subject to the provisions of any law made by Parliament. 38. Salaries and allowances of members of the Legislature of the State, of the Speaker and Deputy Speaker of the Legislative Assembly and, if there is a Legislative Council, of the Chairman and Deputy Chairman thereof.

39. Powers, privileges and immunities of the Legislative Assembly and of the members and the committees thereof, and, if there is a Legislative Council, of that Council and of the members and the committees thereof; enforcement of attendance of persons for giving evidence or producing

documents before committees of the Legislature of the State. 40. Salaries and allowances of Ministers for the State. 41. State public services; State Public Service Commission. 42. State pensions, that is to say, pension's payable by the State or out of the Consolidated Fund of the State. 43. Public debt of the State. 44. Treasure trove. 45. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.

46. Taxes on agricultural income. 47. Duties in respect of succession to agricultural land. 48. Estate duty in respect of agricultural land. 49. Taxes on lands and buildings. 50. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development. 51. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:- (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry. 52. Taxes on the entry of goods into a local area for consumption use or sale therein.

53. Taxes on the consumption or sale of electricity. 54. Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I. 55. Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television. 56. Taxes on goods and passengers carried by road or on inland waterways. 57. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III. 58. Taxes on animals and boats. 59. Tolls. 60. Taxes on professions, trades, callings and employments. 61. Capitation taxes. 62. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling. 63. Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty. 64. Offences against laws with respect to any of the

matters in this List. 65. Jurisdiction and powers of all courts, except the Supreme Court, with respect to any of the matters in this List. 66. Fees in respect of any of the matters in this List, but not including fees taken in any court.

List III-Concurrent List

1. Criminal law, including all matters included in the Indian Penal Code at the commencement of this Constitution but excluding offences against laws with respect to any of the matters specified in List I or List II and excluding the use of naval, military or air forces or any other armed forces of the Union in aid of the civil power. 2. Criminal procedure, including all matters included in the Code of Criminal Procedure at the commencement of this Constitution. 3. Preventive detention for reasons connected with the security of a State, the maintenance of public order, or the maintenance of supplies and services essential to the community; persons subjected to such detention. 4. Removal from one State to another State of prisoners, accused persons and persons subjected to preventive detention for reasons specified in entry 3 of this List. 5. Marriage and divorce; infants and minors; adoption; wills, intestacy and succession; joint family and partition; all matters in respect of which parties in judicial proceedings were immediately before the commencement of this Constitution subject to their personal law.

6. Transfer of property other than agricultural land; registration of deeds and documents. 7. Contracts, including partnership, agency, contracts of carriage, and other special forms of contracts, but not including contracts relating to agricultural land. 8. Actionable wrongs. 9. Bankruptcy and insolvency. 10. Trust and Trustees. 11. Administrators-general and official trustees. 11A. Administration of Justice; constitution and organisation of all courts, except the Supreme Court and the High Courts. 12. Evidence and oaths; recognition of laws, public acts and records, and judicial proceedings. 13. Civil procedure, including all matters included in the Code of Civil Procedure at the commencement of this Constitution, limitation and arbitration. 14. Contempt of court, but not including contempt of the Supreme Court.

15. Vagrancy; nomadic and migratory tribes. 16. Lunacy and mental deficiency, including places for the reception or treatment of lunatics and mental deficient. 17. Prevention of cruelty to animals. 17A. Forests. 17B. Protection of wild animals and birds. 18. Adulteration of foodstuffs and other goods. 19. Drugs and poisons, subject to the provisions of entry 59 of List I with respect to opium. 20. Economic and social planning. 20A. Population control and family planning. 21. Commercial and industrial monopolies, combines and trusts.

22. Trade unions; industrial and labour disputes. 23. Social security and social insurance; employment and unemployment. 24. Welfare of labour including conditions of work, provident funds, employers" liability, workmen's compensation, invalidity and old age pensions and maternity benefits. 25. Education, including technical education, medical education and universities, subject to the provisions of entries 63, 64, 65 and 66 of List I; vocational and technical training of labour. 26. Legal, medical and other professions. 27. Relief and rehabilitation of persons displaced from their original place of residence by reason of the setting up of the Dominions of India and Pakistan. 28. Charities and charitable institutions, charitable and religious endowments and religious institutions.

29. Prevention of the extension from one State to another of infectious or contagious diseases or pests affecting men, animals or plants. 30. Vital statistics including registration of births and deaths. 31. Ports other than those declared by or under law made by Parliament or existing law to be major ports. 32. Shipping and navigation on inland waterways as regards mechanically propelled vessels and the rule of the road on such waterways, and the carriage of passengers and goods on inland waterways subject to the provisions of List I with respect to national waterways. 33. Trade and commerce in, and the production, supply and distribution of,- (a) the products of any industry where the control of such industry by the Union is declared by Parliament by law to be expedient in the public interest, and imported goods of the same kind as such products; (b) foodstuffs, including edible oilseeds and oils; (c) cattle fodder, including oilcakes and other

concentrates; (d) raw cotton, whether ginned or unginned, and cotton seed; and (e) raw jute.

33A. Weights and measures except establishment of standards. 34. Price control. 35. Mechanically propelled vehicles including the principles on which taxes on such vehicles are to be levied. 36. Factories 37. Boilers. 38. Electricity. 39. Newspapers, books and printing presses. 40. Archaeological sites and remains other than those declared by or under law made by Parliament to be of national importance.

41. Custody, management and disposal of property (including agricultural land) declared by law to be evacuee property. 42. Acquisition and requisitioning of property. 43. Recovery in a State of claims in respect of taxes and other public demands, including arrears of land-revenue and sums recoverable as such arrears, arising outside that State. 44. Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty. 45. Inquiries and statistics for the purposes of any of the matters specified in List II or List III. 46. Jurisdiction and powers of all courts, except the Supreme Court, with respect to any of the matters in this List. 47. Fees in respect of any of the matters in this List, but not including fees taken in any court.

Centre State Relation- Financial Relations

Introduction

States in India were not sovereign entities prior to the foundation of the federation. As a result, no specific guidelines to protect the states were required. The central-state financial relationship has undergone a substantial transformation as a result of the 101st amendment to the constitution and the implementation of the Goods and Services Tax (GST) in India. Bilateral financial relations between the Centre and states are set out in articles 268 to 280 of the Constitution of India. An article 268-293, mentioned in Part XII of the Constitution, specifies the financial relations between the Centre and the States.

Division of taxation authorities between the federal government and the states: The Parliament has the authority to charge the union list taxes The state legislature has sole authority to impose the taxes listed in the

State List. The Concurrent List enumerates the taxes that can be levied by both the Parliament and the state legislatures. The Parliament has the residuary power of taxation (i.e., the authority to impose taxes not listed in any of the three lists). The parliament may levy a gift tax, a wealth tax or an expenditure tax under this article

There are no tax entries available on the concurrent list. In terms of tax legislation, the concurrent jurisdiction is inaccessible. However, the 101st Amendment Act of 2016 provided an exemption by establishing a unique provision for goods and services tax. The concurrent competence to make legislators/legislation controlling goods and services tax has been given to parliament and state legislatures by this amendment. As time has passed, the Finance Commission has been effective in introducing dynamic and progressive reforms in the financial relations between the centre and the states. Inequitable borrowing power distribution remains a problem and a major concern that must be addressed in light of the changing dynamics of the states-centre financial relationship.

The Constitution has placed the following restrictions over the taxation powers of the states: A state legislature may levy taxes on certain professions, crafts, callings and occupations. However, under 2500 p.a. cap, a state legislature is barred from levying a tax on the supply of goods or services or both, under the following two situations: When such supply occurs outside the state; and Where such supply occurs during the export or import process. The Parliament has the authority to establish standards for identifying whether a supply of commodities or services, or both, occurs outside of the state, or in the path of import or export. The usage or sale of electricity is subject to a tax imposed by the state legislature.

However, no tax could be levied on the sale or use of electricity, which is: Consumed by the union or sold to the union; or Consumed in the construction, maintenance, or operation of any railway by the union or by the concerned railway company or sold to the union or the railway company for a similar purpose. Any authority established by Parliament for controlling or developing any interstate river or river valley shall charge a tax on any water or power stored, generated, consumed, distributed, or sold by

a state legislature. However, in order for legislation to be effective, it must be reserved for the President's consideration and approval

Distribution of Tax Revenues

The 80th Amendment Act of 2000 and the 88th Amendment Act of 2003 changed the way tax revenues were distributed between the federal government and the states

1. The Centre imposes taxes, while the states are in charge of collecting them. (Article 268): It contains a variety of duties and tax revenues, including:
   i. Stamp duty is charged on bills of exchange, promissory notes, insurance policies, checks, stock transfers, and other documents
   ii. The collected duties levied by any state (inside the state) are given to the state rather than to the Consolidated Fund of India
   iii. The centre imposes a service tax, but the states collect and appropriate it (Article 268-A) (now outlawed amid GST)
   iv. Taxes levied and collected by the federal government but distributed to state (article 269): This category includes the following taxes:
   v. Various tariffs were levied on the sale or purchase of commodities in the course of interstate commerce or trade
   vi. Various tariffs on products sent in the course of interstate trade or commerce
   vii. All of these taxes' net proceeds do not go into the Consolidated Fund of India (CFI). According to the principles established by the Parliament, they are assigned to the involved states
   viii. Imposition and collection of Goods and Services Tax in line with interstate trade or commerce (Article 269- A):
   ix. The Centre imposes and collects the Goods and Services Tax (GST) on supplies made in the course of interstate trade or commerce
   x. However, this tax is split between the Centre and the States in the manner proposed by Parliament based on the GST Council's recommendations
   xi. Furthermore, the Parliament has the authority to develop standards for establishing the site of supply and when commodities or services, or both, are supplied in the course of interstate trade or commerce

xii. Taxes imposed and collected by the Centre but distributed amongst the Centre and the States proportionately (Article 270): This category comprises all taxes and duties referred to in the Union List except the following:
xiii. Articles 268, 269, and 269-A deal with duties and taxes (mentioned above).
xiv. Article 271 imposes a surcharge on taxes and duties (mentioned below).
xv. Any tax imposed for a specified purpose. The President, on the recommendation of the Finance Commission, prescribes the method for distributing the net earnings of all these taxes and duties (FCs).
xvi. Article 271-Surcharges on certain taxes and duties for purposes of the centre:
xvii. Articles 269 and 270 of the Constitution provide that the Parliament may impose surcharges on taxes and duties at any time.
xviii. The Centre receives all of the profits from such surcharges. In other words, the states aren't paying any of the levies. This fee is not applicable to the Goods and Services Tax (GST). To put it another way, the GST will not be subject to this surcharge.
xix. State Government Taxes: Taxes of this nature are entirely the responsibility of the governments. They are 18 in number and are included on the State List.

Grants-in-Aid to the States

In addition to taxation shared between the Union and the states, the Constitution provides grants-in-aid to the states from federal funds. Statutory grants and discretionary grants are the two types of grants-in-aid to states:

Statutory Grants

- Article 275 empowers the Parliament to offer grants to states which are in need of financial assistance, rather than to all states. Each year, these grants are charged to the Consolidated Fund of India (CFI)
- Aside from this standard provision, the Constitution additionally provides for special funds to promote the welfare of scheduled tribes (STs) in a

state or to improve the quality of administration of scheduled territories in a state, such as Assam

- Under Article 275 statutory grants (both general and particular) are awarded to states on the Finance Commission's recommendation.

Discretionary Grants

- Article 282 empowers the Union and the states to give grants for any public purpose, even if it falls outside of their own legislative jurisdiction. The Centre is responsible for enforcing this regulation

Conclusion

The financial relationship between the Centre and the States changes dramatically if a financial emergency is declared under Article 280 of the Indian Constitution. In such instances, the Centre gains enormous authority and exerts enormous influence over the States, forcing them to adhere to specific financial propriety standards and other important protections.

Introduction

Fiscal functions are carried out by the different tiers of a government in a country. The number of tiers of government involved in the fiscal functions differs from one country to another depending upon the federal structure of the government. For instance, the USA, India and Australia have a three-tier federal structure, while Holland and Switzerland have a two-tier federal structure. Each of these different tiers of government must, therefore, have a clearly demarcated functional devolution and fiscal powers based on sound principles. The theory and practice of the devolution of powers and functions among the different tiers of government involved in the fiscal operations is what is called as 'fiscal federalism'.

In other words, fiscal federalism provides a framework for the devolution of functions between the national and the sub-national governments along with a framework for sharing the revenue collected among the different tiers of governments. In this context, the present unit, inter-alia, discusses: (i) the principles on which the devolution of functions and revenue sharing is based; (ii) the types of fiscal imbalance that arises in the process and methods by which fiscal adjustment are sought to be

established; and (iii) the institutional arrangements that exist in India to recommend the norms for effecting fiscal transfers and allocate the budgetary resources among the states in the federal system.

2. Devolution of functions

Allocation Function The task of ensuring the welfare of its people requires a government to devise a system by which the allocation of public goods and services are efficiently made. An important question, in this context, is which tier of government should provide which type of services. A widely followed principle, in this respect, is that of 'benefit incidence'. Benefit incidence is a method of computing the distribution of public expenditure across different demographic groups, such as women and men. The procedure 2 8 Fiscal and Monetary Issues involves allocating per unit public subsidies (for example, expenditure per student for the education sector) according to individual utilisation rates of public services. Further, according to the benefit incidence principle, if there is a function whose benefit is nationwide, such a function is to be entrusted to the national government, while if the benefit of a function is regional or sub-regional in character, such a function should be entrusted to the State or local governments. Thus, services like defence, scientific exploration, etc. whose benefit incidence reaches the whole nation, should be provided by the Central government.

On the other hand, public goods like law and order, supply of water, electricity, sanitation, etc. whose benefit incidence is spatially limited to the State and local areas, should be provided by the State and local level governments. It is, however, to be noted that many public goods and services are required at each level of government. Therefore, these should be provided not only by the Central government, but also by the State and local governments. 10.2.2 Distribution Function Distribution of services, and therefore the resources to be raised by levying taxes for providing the services to the people is another important fiscal function. The function of distribution is assigned to the Central government. An important question in this context arises as to whether the distribution function can be effectively carried out by the sub-Central tiers in a government.

If this function is to be carried out by the sub-Central governments, it may lead to distortions in the mobility of labour leading to increase in inequality. For instance, suppose there are two regions A and B. Region A has a higher concentration of poor people who favour a high degree of redistribution of factors of production. On the other hand, region B has a relatively larger proportion of rich people who favour low or no redistribution. In such a situation, all high-income people residing in region A and opposing distribution would like to shift to region B. As a result, the degree of equalisation would become less (i.e. inequality would increase in region A) as larger number of poor people would reside in region A. Another reason for the distribution process by the State and local level governments becoming a failure is that these tiers may choose to implement the distribution process for reasons of politico-administrative factors.

However, this does not mean that the sub-Central governments cannot altogether render the distribution function. It also does not mean that the Central government is always more capable and effective in discharging the distribution function. It only means that the Central government may have a greater reach and act in the national interest than the sub-Central governments in many cases. 2 9 10.2.3 Stabilisation Function Fiscal federalism In a federal country, macroeconomic issues like unemployment, inflation, money supply, etc. are to be dealt by different levels of government. The process of aiding macro economic adjustment is known as 'stabilisation'. Stabilisation function cannot, however, be entirely entrusted to sub-central governments as they do not have adequate instruments to deal with such macro-economic issues without giving scope for economic distortion. Moreover, in most of the federations, it is the exclusive prerogative of the Central governments to deal with the 'external sector'. In view of this, in almost all the federations the Central government performs the function of stabilisation by using the tools of monetary and fiscal policies.

Thus, while the Central government has an absolute advantage in rendering the redistribution and stabilisation functions, lower layers of government can render the function of delivery of goods and services more

effectively. In the light of this, while functional responsibilities have been distributed between different layers of government (in several federations including India) on the basis of the principle of benefit incidence, functions like defence, space exploration, navigation, railways, etc. have been entrusted to the Central government. Likewise, functions like law and order, water supply, education, health, sanitation, agriculture, etc. are entrusted to the lower tiers of governments. Once the functional division takes place, each tier of government need financial resources to discharge their respective functions. So what is equally important is the distribution of revenue or tax powers.

3. Distribution of revenue powers

Generally, powers for levying taxes (i.e. revenue powers) with a narrow base are given to the State or local governments while those with a broad or national base are retained by the Central government. For instance, in India, sales tax, State excise, motor vehicle tax, property tax, profession tax, etc. are given to the sub-Central government, whereas taxes with broader base like income tax, corporation tax, customs duties, wealth tax, etc. are entrusted to the Central government. Such a distribution is, however, made not arbitrarily but is guided by economic and scientific principles. The division of revenue powers are generally made on the basis of the three important principles: (i) efficiency, (ii) suitability, and (iii) adequacy.

The fiscal resources provided through revenue powers to each tier of government should correspond to the requirements that arise due to the functional responsibilities entrusted to each government. The sub-principles, within the broad ones stated above, which are also considered for the division of revenue powers between the Centre and the States, are often referred to as the ‘Principles of Federal Finance’ [or Adarkar’s Principles]. These include the need for: (i) independence 3 0 Fiscal and Monetary Issues and responsibility, (ii) adequacy and elasticity, (iii) equity and uniformity, (iv) accountability and productivity; and (v) ease of integration and coordination. In most of the federations including India, even though the above principles are followed, situations of fiscal imbalance arise quite often. We, therefore,

now turn to know about the types of fiscal imbalance and methods of its adjustment.

4. Fiscal imbalance

When the revenue powers are divided between two or more tiers of government in a federation, in general, the Central government is entrusted with more financial resources. This is because due to its functional responsibilities like defence, space research, etc. there is always a greater demand for its expenditure requirement vis-à-vis its revenue resources. This is to say that some of its functions are required to be discharged more in the national interest than the interest of a regional dimension which warrants greater revenue powers for it. The fiscal imbalance among the States would arise because of inadequate revenue resources in comparison to their respective expenditure commitments. Such non–correspondence between the revenue resources and expenditure requirements among the states in a federation is known as Fiscal Imbalance.

The fiscal imbalance may be classified into two types:

a. Vertical Fiscal Imbalance, and
b. Horizontal Fiscal Imbalance.

a. Vertical Fiscal Imbalance

The fiscal imbalance due to the difference between the revenue resources and expenditure commitments of the Central government, and those of the State governments put together is called as the Vertical Fiscal Imbalance. It is natural that the federal governments of any country have vertical fiscal imbalance irrespective of their development status.

b. Horizontal Fiscal Imbalances

Horizontal fiscal imbalance arises due to the non-correspondence between the revenue generating potential/efficiency of the different state governments within the federal structure vis-à-vis their respective expenditure commitments. This type of fiscal imbalance arises due to the differences in the endowment (or availability) of the natural resources, even if the revenue powers and expenditure responsibilities are uniform. Thus, horizontal fiscal imbalance also exists in federations across the countries irrespective of their state of development. As fiscal imbalance of both the

types exists in all the federations of the world, a uniform system of fiscal adjustment has been developed to reduce the fiscal imbalances. We will study more about this in the subsequent section of the unit.

Introduction

The Finance Commission of India is a constitutional body that has survived for over 50 years on Indian soil. Formed under Article 280 of the Indian Constitution, the Finance Commission of India functions as a quasi-judicial body. The purpose behind the formation of this Commission is to determine the methods and formulas necessary for distributing the tax proceeds between the Centre and states as well as among the states as per the arrangement provided by the Constitution of India and current requirements. Along with this, the taxes and grants that are to be provided to the local bodies in states for their functioning are also determined by the Finance Commission of India.

It is to be noted that Article 281 of the Constitution provides that it is the President of India who is required to lay the Finance Commission report before each House of Parliament along with a note that explains the actions taken by the government on the basis of the recommendations given by the Commission. It was the 73rd Constitutional Amendment Act, 1992 that facilitated the constitution of a Finance Commission at a 5 years interval by the state governments in order to decide the division of resources between the state government, and the Panchayat institutions at all levels. From 2000 onwards, there have been five Finance Commission that has been constituted from time to time, namely;

1. The 12th Finance Commission was constituted in November 2002 under the chairmanship of former RBI governor and noted economist Dr. C Rangarajan.
2. The 13th Finance Commission was constituted on November 13, 2007, under the chairmanship of Dr. Vijay Kelkar.
3. The 14th Finance Commission was constituted on January 02, 2013, under the chairmanship of former RBI governor Dr. YV Reddy.

4. The 15th Finance Commission was constituted in November 2017, under the chairmanship of NK Singh who has been a former member of the Planning Commission.
5. In this article, the Finance Commission of India has been explained with a detailed analysis of its composition, functions, and roles.

Composition of the Finance Commission

The Finance Commission of India is composed of five members who include one Chairman, and four other members of the Commission. All of these members are appointed by the President of India who also determines the term of their office. These members are anyway subjected to reappointment as per requirement. The responsibility of determining the qualification, and the manner of appointment for the Finance Commission's members rest on the Parliament's shoulder, as have been provided by the Indian Constitution. The qualification that has been determined by the Parliament for the Chairman and the members of the Commission has been presented hereunder;

- The Chairman of the Commission must be an individual with expertise in public affairs. The current Chairman of the Commission is Mr. N.K. Singh, who has been a member of the Planning Commission alongside being an IAS officer.
- The four members of the Commission are selected from the following list;
- A high court judge or an individual who has been qualified to hold such a position.
- A person who has his or her expertise in finance and accounts of the government.
- Any person having divergent experience in financial matters and in administrative matters.
- Any person possessing special knowledge of economics, and related studies.
- The 15th Finance Commission has been formed with Mr. N. K. Singh as its Chairman followed by Mr. Ajay Narayan Jha, Prof. Anoop Singh, Mr. Ashok Lahiri, and Prof. Ramesh Chand as the members of the Commission, and Mr. Arvind Mehta as the Secretary.

Functions of the Finance Commission

The Finance Commission of India has been vested with certain functions that are determined by the President of India. The majority of these functions surround the recommendations that are supposed to be delivered by the Commission to the President of the nation. The functions of the Finance Commission have been listed hereunder;

1. It is the responsibility of the Finance Commission to recommend the distribution of the net proceeds of taxes that are supposed to be shared between the Union, and the states, along with the inter-state distribution.
2. The Finance Commission recommends the principles that are applied to govern the grants-in-aid to the states and the Union Territories by the Union from the Consolidated Fund of India.
3. The Commission recommends the measures that need to be adopted to augment the consolidated fund of a state in order to facilitate supplying of the required resources to the panchayats and the local bodies of the state so as to avoid hindrance in their functioning. The Commission has to carry out this function on the basis of the recommendations made by the state finance commissions as per their requirement.
4. As it is the President of India who carries out all the necessary formalities in relation to the Finance Commission of India, any matter which the President feels needs to be considered by the Finance Commission from time to time, will be taken up by the Commission as a function only. A report is submitted by the Commission to the President after delivering the necessary functions allotted to it. This report is further presented before the Houses of the Parliament by the President which accompanies a memorandum that explains the necessary actions taken by the Commission to fulfil its functions.

It is interesting to note that till 1960, the Finance Commission used to provide suggestions to the states of Assam, Bihar, Odisha, and West Bengal in relation to the assignment of share of the net proceeds to the export duty on jute products. Such grants were provided for a temporary period

extending up to 10 years from the commencement of the Indian Constitution.

The advisory role played by the Finance Commission

The term 'advisory' symbolizes recommendations. Therefore, the Finance Commission of India can be said to be a recommendatory body that gives advice to the President of the nation, who after going through the same, applies it to make decisions on financial matters. This advisory role of the Finance Commission is in a way binding on the President of India. The President can either accept the recommendations made or reject them. Further, whether to implement the recommendations issued by the Commission or not in matters of granting money to the states rests on the Union Government. The advisory role is neither of a binding nature nor can give rise to a legal beneficiary in the state's favour to receive money from the Union on the basis of the recommendations made by the Commission. This has been clarified by the Indian Constitution itself.

The Chairman of the Fourth Finance Commission, Dr. P.V. Rajamannar has rightly pointed out the advisory role played by the Finance Commission during his term of office. He said that "since the Finance Commission is a constitutional body expected to be quasi-judicial, its recommendations should not be turned down by the Government of India unless there are very compelling reasons". The importance of the advisory role of the Finance Commission lies in its balancing mechanism of fiscal federalism in India. Previously, the functions of the Finance Commission used to overlap with the functions allotted to the Planning Commission. This would create confusion in both the bodies, but the same has been erased by the introduction of NITI Aayog.

The 15th Finance Commission Report: an understanding

The 15th Finance Commission Report was submitted on 9th November 2020 for the period of 2021-22 to 2025-26 to the Hon'ble President of India. The Commission prepared its report as per the terms of reference and majorly recommended the following areas:

1. Apart from the vertical and horizontal tax devolution, the Commission recommended local government grants, and disaster management grants.
2. The Commission was asked to examine and recommend performance incentives for States in many necessary areas like the power sector, adoption of DBT, solid waste management, etc.
3. The 15th Finance Commission was also asked to examine the need for setting up a separate and independent mechanism for funding defence and internal security of India, and determine the functioning procedure for the same.

The 15th Finance Commission Report was organized in four volumes with Volume I and II, consisting of the main report and accompanying annexes, Volume III was completely devoted to the Central Government as it addressed the challenges in the future and possible ways of handling it and Volume IV was devoted to the states where the Commission has analyzed the finances of each state and addressed the key challenges that individual states come across.

Conclusion

The Finance Commission is perceived to be the supreme constitutional body regulating finance in India, both between the Centre and the states, and among the states. There are several prominent factors that have contributed to the fall of this esteemed institution and the same is reflected in the 12th Finance Commission. The Central government has noticed appointments made to the Commission simply on the grounds of distribution of patronages to the individuals belonging to some of the other regional parties. As India witnesses the emergence of coalition parties, the detriment suffered by the Finance Commission cannot go unnoticed. The Commission is supposed to be technical in its approach and logical in its procedure, and recommendations provided to the President require members who are experts in the subject matters related to the Commission. Ignorance of such a necessity welcomes the decaying of this constitutional body. Actions must, therefore, be taken in order to rule out the irregularities taking place within and by the Commission.

14th Finance Commission: Recommendations

Highest weight of 50 per cent is given to distance from the highest per capita income district, followed by population (1971 census) at 17.5 per cent, demography (2011 census) at 10 per cent, area at 15 per cent and forest cover at 7.5 per cent.

Centre's fiscal and revenue deficits

Fiscal deficit should come down to 3.6 per cent of GDP in 2015-16 from projected 4.1 per cent in 2014-15 and then 3 per cent in following year and kept at that for three more years. Not different from existing roadmap, though the present time frame ends in 2016-17. Wants revenue deficit to come down from 2.9 per cent in FY15 to 2.56 per cent in FY16 and then progressively reduce to 0.93 per cent by 2019-20.

States' fiscal and revenue deficits

Fiscal deficit should be at 2.76 per cent in FY16, to come down to 2.74 per cent by FY20 though it would increase in between. To be revenue surplus in all these years.

Centre's debt

To come down from 45.4 per cent of GDP in FY15 to 43.6 per cent in FY16 and then progressively should reduce to 36.3 per cent by FY20.

States' debt

Projected to increase from 21.90 per cent in FY16 progressively to 22.38 per cent in FY20.

National small saving fund (NSSF)

States is taken away from operation of NSSF with effect from next financial year.

Consolidated sinking fund

Examine the possibility of setting up of CST for amortisation of debt of the Union govt.

Rail tariff authority

Replace the advisory body with a statutory body, through necessary amendments to the Railways Act, 1989.

Advertisement tax

States should empower local bodies to impose this tax to augment their revenues boost for states' share in net proceeds of tax revenues The commission has recommended states' share in net proceeds of tax revenues be 42 per cent, a huge jump from the 32 per cent recommend by the 13th Finance Commission, the largest change ever in the percentage of devolution. As compared to total devolutions in 2014-15, total devolution of states in 2015-16 will increase by over 45 per cent.

Tax devolution is primary route of transfer of resources

The panel has recommended tax devolution be the primary route of transfer of resources to the states; the government has accepted the recommendations keeping in mind the spirit of National Institution for Transforming India (NITI)

Grants for local bodies be based on 2011 population

The commission has recommended distribution of grants to states for local bodies using 2011 population data. Grants will be divided into two broad categories on the basis of rural and urban population - (i) a grant constituting gram panchayats and (ii) a grant constituting municipal bodies.

Grants be in two parts - basic and performance

The panel has recommended the grants to states for local bodies be in two parts, a basic grant and a performance grant. The ratio of basic to performance grant is 90:10 with respect to panchayats and 80:20 in the case of municipalities.

Grants to gram panchayats & municipalities

The total grants recommended by the commission are Rs 2,87,436 crore for a five-year period from April 1, 2015 to March 31, 2020. Of this, Rs 2, 00,292.20 crore will be given to panchayats and Rs 87,143.80 crore to municipalities. The transfers for financial year 2015-16 will be Rs 29,988 crore.

States' share in disaster relief should stay unchanged

The Commission has said, with regard to disaster relief, the percentage share of states will continue to be as before and follow the existing mechanism. This will be to the tune of Rs 55,097 crore. After

implementation of GST, the recommendations of the panel on disaster relief would be implemented.

Post-devolution revenue deficit grants for states

The panel has recommended 'post-devolution revenue deficit grants' for a total of Rs 1, 94,821 crore on account of expenditure requirements of the states, tax devolution and revenue mobilisation capacity of the states. These grants will be given to 11 states.

Some central schemes be de-linked

Eight centrally sponsored schemes will be delinked from support from the Centre. Various centrally sponsored schemes will now see a change in sharing pattern, with states sharing a higher fiscal responsibility for implementing the schemes.

Other recommendations

The Finance Commission has also made recommendations on cooperative federalism, GST, fiscal consolidation roadmap, pricing of public utilities and public sector undertakings. Recently, the government accepted the 15th Finance Commission's recommendation to maintain the States' share in the divisible pool of taxes to 41% for the five-year period starting 2021-22. The Commission's Report was tabled in the Parliament.

15th Finance Commission

The Finance Commission (FC) is a constitutional body, that determines the method and formula for distributing the tax proceeds between the Centre and states, and among the states as per the constitutional arrangement and present requirements. Under Article 280 of the Constitution, the President of India is required to constitute a Finance Commission at an interval of five years or earlier. The 15th Finance Commission was constituted by the President of India in November 2017, under the chairmanship of NK Singh. Its recommendations will cover a period of five years from the year 2021-22 to 2025-26.

Vertical Devolution:

It has recommended maintaining the vertical devolution at 41% **-** the same as in its interim report for 2020-21.

- It is at the same level of 42% of the divisible pool as recommended by the 14th Finance Commission.
  - It has made the required adjustment of about 1% due to the changed status of the erstwhile State of Jammu and Kashmir into the new Union Territories of Ladakh and Jammu and Kashmir.
- **Horizontal Devolution:**
  - For horizontal devolution, it has suggested 12.5% weightage to demographic performance, 45% to income, 15% each to population and area, 10% to forest and ecology and 2.5% to tax and fiscal efforts.
- **Revenue Deficit Grants to States:**
  - Revenue deficit grants emanate from the requirement to meet the fiscal needs of the States on their revenue accounts that remain to be met, even after considering their own tax and non-tax resources and tax devolution to them.
  - Revenue Deficit is defined as the difference between revenue or current expenditure and revenue receipts, which includes tax and non-tax.
  - It has recommended post-devolution revenue deficit grants amounting to about Rs. 3 trillion over the five-year period ending FY26.
- The number of states qualifying for the revenue deficit grants decreases from 17 in FY22, the first year of the award period to 6 in FY26, the last year.

Performance Based Incentives and Grants to States:

  - These grants revolve around four main themes.
  - The first is the social sector, where it has focused on health and education.
  - Second is the rural economy, where it has focused on agriculture and the maintenance of rural roads.
- The rural economy plays a significant role in the country as it encompasses two-thirds of the country's population, 70% of the total workforce and 46% of national income.
  - Third, governance and administrative reforms under which it has recommended grants for judiciary, statistics and aspirational districts and blocks.

- Fourth, it has developed a performance-based incentive system for the power sector, which is not linked to grants but provides an important, additional borrowing window for States.

- **Fiscal Space for Centre:**
  - Total 15th Finance Commission transfers (devolution + grants) constitutes about 34% of estimated Gross Revenue Receipts to the Union, leaving adequate fiscal space to meet its resource requirements and spending obligations on national development priorities.
- **Grants to Local Governments:**
  - Along with grants for municipal services and local government bodies, it includes performance-based grants for incubation of new cities and health grants to local governments.
  - In grants for urban local bodies, basic grants are proposed only for cities/towns having a population of less than a million. For Million-Plus cities, 100% of the grants are performance-linked through the Million-Plus Cities Challenge Fund (MCF).
- MCF amount is linked to the performance of these cities in improving their air quality and meeting the service level benchmarks for urban drinking water supply, sanitation and solid waste management.

Criticism

Performance based incentives disicentivizes independent decision-making. Any conditions on the state's ability to borrow will have an adverse effect on the spending by the state; particularly on development thus, undermines cooperative fiscal federalism. It does not hold the Union government accountable for its own fiscal prudence and dilutes the joint responsibility that the Union and States have.

Horizontal Devolution Criteria

Population:

The population of a State represents the needs of the State to undertake expenditure for providing services to its residents. It is also a simple and transparent indicator that has a significant equalising impact.

Area:

The larger the area, greater is the expenditure requirement for providing comparable services.

Forest and Ecology:

By taking into account the share of dense forest of each state in the aggregate dense forest of all the states, the share on this criteria is determined.

Income Distance:

Income distance is the distance of the Gross State Domestic Product (GSDP) of a particular state from the state with the highest GSDP. To maintain interstate equity, the states with lower per capita income would be given a higher share.

Demographic Performance:

It rewards efforts made by states in controlling their population. This criterion has been computed by using the reciprocal of the total fertility ratio of each state, scaled by 1971 population data. This has been done to assuage the fears of southern States about losing some share in tax transfers due to the reliance on the 2011 Census data instead of the 1971 census, which could penalise States that did better on managing demographics. States with a lower fertility ratio will be scored higher on this criterion. The Total Fertility Ratio in a specific year is defined as the total number of children that would be born to each woman if she/they were to pass through the childbearing years bearing children according to a current schedule of age-specific fertility rates.

Tax Effort:

This criterion has been used to reward states with higher tax collection efficiency. It has been computed as the ratio of the average per capita own tax revenue and the average per capita state GDP during the three-year period between 2016-17 and 2018-19.