Directorate of Distance and Continuing Education

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# M.A. ECONOMICS

## (Second Year)

## PUBLIC ECONOMICS

**SECM32**

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# PUBLIC ECONOMICS

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# UNIT – I
# Introduction

## Role of Public Finance

Public finance plays a vital role in a nation's economic structure and society, influencing many aspects of life, including:

Economic development: Public finance helps with resource allocation, economic stability, and sustainable growth. Governments can use fiscal policy tools like taxation and spending to stimulate demand and economic activity during downturns.

Social welfare: Public finance can help ensure social welfare by redistributing income and promoting social justice.

Infrastructure: Public finance can help with infrastructure development, such as building roads and maintaining government buildings.

Education: Public finance can help with funding schools.

Healthcare: Public finance can help with ensuring hospitals have essential supplies.

Macro balance of payments: Public finance, along with monetary and exchange rate policies, can influence the macro balance of payments.

Inflation: Public finance can help manage inflation rates.

Interest rates: Public finance can influence interest rates.

Public finance is the study of economics that deals with issues related to government and political science. It examines how financial operations influence employment, prices, and growth.

## Subject Matter of Public Finance

The economics of public finance is fundamentally concerned with the process of raising and dispersion of funds for the functioning of the government. Thus, the study of public revenue and public expenditure constitutes the main division in the study of public finance.

Public economics aims at the proper utilisation of public firms in a manner which brings about a positive change in the economic welfare of society. How the public funds are raised and spent to achieve this end is the subject matter of public finance. This subject matter is studied under five parts:

1. Public Revenue
2. Public Expenditure
3. Public Debt
4. Financial Administration
5. Fiscal Policy

## Nature of Public Economics

Public economics (or economics of the public sector) is the study of government policy through the lens of economic efficiency and equity. In order to do this, microeconomic theory is utilized to assess whether the private market is likely to provide efficient outcomes in the absence of governmental interference.

The state has to raise resources for financing its many-sided activities. These state activities are not concerned with the satisfaction of individual wants of citizens, but the collective wants of the citizens of the state. The state has to maintain law and order. A modern state is a welfare state and has to create conditions of social upliftment and betterment and also provide social and economic justice. To perform these activities the state needs funds. In other words, the most significant development in the economic set up of a country in the world has been the increasing governmental operations during the last few decades and such public finance has played prominent role in regulating the economic life of the country.

**Definition of Public Finance**

Dalton defines Public Finance as “one of those subjects which lie on the borderline between Economics and Politics. It is concerned with the income and expenditure of public authorities and with the adjustment of one to the other”. The term ‘public authorities’ refers to the government or the state.

Modern economists are of the view that Public Finance deals with the finances of the public as an organised group under the institution of Government. It thus deals only with the finances of government. The finances of government include the raising and disbursement of government funds.

Prof.Benard P. Herber rightly remarks that “the forces of supply and demand and price mechanism characterise the market means of allocating resources whereas government means of allocating is relating with the budgetary practice of taxing and spending”.

Prof. Musgrave takes pubic finance as a theory of public household. He writes that the complex of problems that centre around the revenue expenditure process of government is referred to traditionally as public finance. “Therefore, we must think of our task as an investigation into the principles of public economy, or more precisely, into those aspects of economic policy that arise in the operations of the public budget”

Buchanan says “the government considered as a unit, may be defined as the subject of the study of public finance. More specifically, public finance studies the economic activity of government as a unit”.

All the above definitions make it clear that public finance is an enquiry into the facts, techniques, principles, theories, rules and policies which shape, direct, influence and govern the use of the scarce resources of the government.

## The Scope of Public Finance

The scope of public finance is not just to study the composition of public revenue and public expenditure. It covers a full discussion of the influence of government fiscal operations on the level of overall activity, employment, prices and growth process of the economic system as a whole.

1**.** Public Revenue

The income of the state is referred to as public revenue. This part of Public Finance is concerned with the methods, objectives and effects of raising public revenue. Public revenue means different sources of government's income. It deals with the methods of raising revenue for the government, principles of taxation and other related problems. Raising of tax revenue and non-tax revenue is the subject matter of public revenue. Tax revenue deals with the kinds of taxes and the impact and incidence of various taxes. Non-tax revenue includes

i.) Commercial revenue (income earned through sale of goods and services and profits earned by public sector enterprises),

ii.) Administrative revenues (Fees, license fees, special assessments),

iii) Gifts, fines and grants.

2. Public expenditure

Public expenditure deals with the principles and problems relating to the allocation of public spending. Since the modern government represents a welfare state, the responsibility of the government is to bring about maximum social welfare. In addition to this, it has to perform various other functions, which require heavy expenditures. We study in this sub-division, the fundamental principles governing the flow of government funds into different spending streams and the methods of incurring expenditure on the various activities.

3. Public debt

Public debt arises when the governments borrow when their expenditure is more than revenue. The problem relating to the raising and repayment of public loans is studied under this sub-division. Borrowing by the government from the public is called public debt. In modern world, it is not possible for the government to meet all its expenditure through tax and non-tax revenue. Hence public revenue falls short of public expenditure. As a result, governments are forced to borrow from internal and external sources. In the case of internal debt, Government borrows from the people, commercial banks and the central bank. External debt includes borrowing from international monetary institutions like IMF and World Bank and also from foreign countries. The soundness of the borrowing policy of the governments and indication of the healthy direction of spending are examined under this sub-division.

4. Financial administration

Financial administration is concerned with the organisation and functioning of the government machinery that is responsible for performing various financial activities of the state. Preparing the budget for the particular financial year is the master financial plan of the government. The various works, starting with the objectives of designing a budget, the methods of preparing it, presentation of the budget before the Parliament and State Assembly, passing or sanctioning by the Parliament, execution, auditing, implementation etc., constitute the subject matter of financial administration.

5. Fiscal Policy

This division studies the utility of public finance operations to bring about economic stability and growth in the country. Fiscal policy is designed to maintain a balance between the working of different sectors of the economy so that it may be possible to achieve a desired rate of economic growth. Federal finance is a part of the study of public finance. A federation is an association of two or more states. In a federal form of government, there are: Central, State, and local governments. The interrelationships between these forms of governments, and the problems related to them and the financial functions of all these units are studied under federal finance.

**According to Musgrave, the scope of public finance embraces the following three functions of the government's budgetary policy confined to the fiscal department:**

(i) The Allocation Branch,

(ii) The Distribution Branch, and

(iii) The Stabilisation Branch.

**These refer to three objectives of budget policy, i. e., the use of fiscal instruments:**

(i) To secure adjustments in the allocation of resources,

(ii) To secure adjustments in the distribution of income and wealth, and

(iii) To secure economic stabilisation.

Thus, the function of the allocation branch of the fiscal department is to determine what adjustments in allocation are needed, who shall bear the cost, what revenue and expenditure policies to be formulated to fulfill the desired objectives.

The function of the distribution branch is to determine what steps are needed to bring about the desired or equitable state of distribution in the economy and the stabilisation branch shall confine itself to the decisions as to what should be done to secure price stability and to maintain full employment level.

**Further, modern public finance has two aspects:**

(i) Positive aspect and (ii) Normative aspect.

In its positive aspect, the study of public finance is concerned with what are sources of public revenue, items of public expenditure, constituents of budget, and formal as well as effective incidence of the fiscal operations.

In its normative aspect, norms or standards of the government's financial operations are laid down, investigated, and appraised. The basic norm of modern finance is general economic welfare. On normative consideration, public finance becomes a skillful art, whereas in its positive aspect, it remains a fiscal science.

## Public Finance and Private Finance

Public Finance is the study of the financial operations of the government. Government is also an economic unit like a firm or household. Hence, there are bound to be similarities between the financial operations of firms and households on one hand and that of the government on the other.

**Similarities**

1. Satisfaction of human wants is the common objective of private as well as public finance. Only point is that, the individual uses his resources to satisfy his private wants but the state is concerned with the use of its resources to satisfy social wants.
2. Both kinds of finance are based on the principle of rationality. A rational individual tries to maximise his personal benefits through his expenditure. A rational government tries to maximise social benefits through public expenditure.
3. Both private and public finance have income and expenditure. The ultimate aim of both is to balance their income and expenditure.
4. When expenditure is greater than income, both try to borrow to meet the gap. Bot individuals and governments have to plan to return these loans.

5. Both are concerned with the problem of economic choice i.e., they try to satisfy unlimited ends with limited sources.

**Dissimilarities**

1. The final objectives are different. i.e., the government tries to fulfil the objectives which are different from that of firms and households. The motive of public finance is social benefit. Thus tax policy can be used to reduce conspicuous consumption or the production of harmful goods. The government spends money for public welfare, without expecting any return. But individual will spend only if it is beneficial or profitable to him. Thus while an individual sets an objective standard of utility of his expenditure, like social justice and full employment.
2. The process of adjustment of income and expenditure in private finance and public finance are diametrically opposite. An individual tries to adjust his expenditure to his income. The government however decides what it wishes to spend and then plans to get the required resources.
3. Resources of an individual are relatively limited while the state's resources are wider. An individual cannot borrow from world monetary institutions like IMF or the World Bank. In short public revenues are more elastic than individual incomes.
4. Individual plans according to the time duration over which he earns his income. But in public finance, the budget is prepared for one year.
5. Individuals always seek quick returns. They save only a small amount for future and spent more to satisfy their current needs. State spends huge sums of money on hydroelectric projects, afforestation etc. which may yield benefit after a generation or two.
6. In the case of private finance a rational consumer seeks to maximise his total satisfaction by allocating his income as per law of equi-marginal utility. He tries to

spend his income in such a way that the last unit of money, spent on each good, yields the same satisfaction. The government on the other hand seeks to get maximum social advantage. The fiscal policy of the modern government aims to achieve an equitable distribution of income in the society and to promote economic growth.

7. An individual’s spending policy has very little impact on the society as a whole. But the state can change the nature of an economy through its fiscal policy.
8. The pattern of expenditure in the case of private finance is often influenced by customs, habits, social status tec. The pattern of the government expenditure is guided by the general economic policy followed by the government.
9. Private finance is always a secret affair. Individuals need not reveal their financial transactions to anyone except for filing tax returns. But public finance is an open affair.
10. Individuals can plan to postpone their private expenditure. But the state cannot afford to postpone vital expenditures like defence, famine relief etc.
11. An individual has to earn his income by working. He cannot force one to get his income. But the government can use force or coercive power to raise revenue especially taxation.

## The Principle of Maximum Social Advantage

The best measure to test the efficiency of public finance operations is what Dr. Dalton calls, ‘Principle of Maximum Social Advantage, or what Pigou names as the Principle of Maximum Aggregate Welfare’.

In the words of Dr. Dalton, ‘one fundamental principle must lie at the root of public finance. This we may call the principle of Maximum Social Advantage. The basic idea of the Principle of Maximum Social Advantage is that all the financial operations of the government should result in benefit to the community. The objective of every state whether capitalist or communist, is the maximum good of the people. The fiscal or budget operations of the state have great impact on the economy. The revenue collected by the state through taxes and other sources and the public expenditure can have significant influence on the consumption, production and distribution of national income. Taxation and public expenditure result in transfers of purchasing power from one section of the community to another. This affects the allocation of resources. The financial transactions of the modern budgets are huge. Hence there should be some criterion to guide the financial operations of the state. Such a criterion has to be the economic welfare of the people. Any financial activity of the state which leads to an increase in economic welfare is desirable. It is undesirable if it does not result in public welfare. This is the essence of the Principle of Maximum Social Advantage.

Principle of Maximum Social Advantage has two propositions the first proposition relates to how far the state can tax and spend. Taxation by itself results in a loss of utility to the people. This disutility is due to the sacrifice involved in the payment of taxes as they have to part with purchasing power. The marginal disutility or marginal sacrifice of public revenue increases with additional doses of taxation. Similarly when the state spends money, it confers some benefit on the community. But the marginal social benefit from additional doses of public expenditure diminishes with every increase in public expenditures. So long as the marginal public expenditure is greater than the marginal disutility or sacrifice of taxation, it results in net benefit to the community.

**Diagrammatic Representation:**

In technical jargon, the maximum social net advantage is achieved when the marginal social sacrifice (disutility) of taxation and the marginal social benefit (utility) of public expenditure are equated. Thus, the point of equality between the marginal social benefit and the marginal social sacrifice is referred to as the point of aggregate maximum social advantage or least aggregate social sacrifice.

The equilibrium point of maximum social advantage may as well be illustrated by means of a diagram, as in Fig. 1.

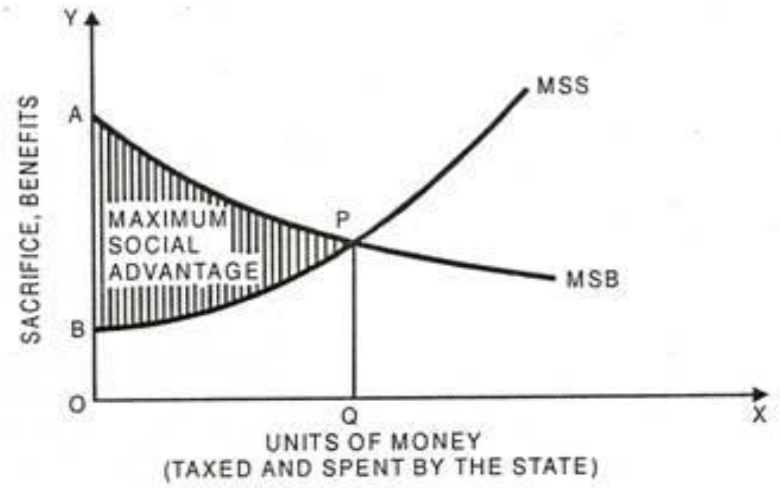



**Fig. 1. The Maximum Social Advantage**

In Fig. 1, MSS is the marginal social sacrifice curve. It is an upward sloping curve implying that the social sacrifice per unit of taxation goes on increasing with every additional unit of money raised. MSB is the marginal social benefit curve. It is a downward sloping curve implying that the social benefits per unit diminishes as the public expenditure increases.

The curves MSS and MSB intersect at point P. This equality (P) of MSS and MSB curves is regarded as the optimum limit of the state's financial activity. It is easy to see that so long as the MSB curve lies above the MSS curve, each additional unit of revenue raised and spent by the state leads to an increase in the net social advantage.

This beneficial process would then be continued till marginal social sacrifice (MSS) becomes just equal to the marginal social benefit (MSB). Beyond this point, a further increase in the state's financial activity means the marginal social sacrifice exceeding the marginal social benefit, hence the net social loss.

Thus, only under the condition of MSS = MSB, the maximum social advantage is achieved. Diagrammatically, the shaded area APB (the area between MSS and MSB curves, till both intersect each other) represents the quantum of maximum social advantage. OQ is the optimum amount of financial activities of the state.

**Further, the ideal of maximum social advantage is attained by the state, if the following principles of financial operation are followed in the budget.**

1. Taxes should be distributed in such a way that the marginal utility of money sacrificed by all the tax-payers is the same.

2. Public spending is done, such that benefits derived from the last unit of money spent on each item becomes equal.

3. Marginal benefits and sacrifices must be equated.

To sum up, all fiscal operations, both as regards revenue and expenditure, should be treated as a series of transfer of purchasing power that must ultimately increase the economic welfare of the people. In this context, Dalton enunciated the principle of maximum social advantage and asserted that financial operations of the government must be in accordance with this principle in a welfare state.

**Distinguish between Public Goods, Private Goods and Merit Goods**

**Public Goods**

Public goods refer to goods which satisfy public wants. Public goods are characterised as those which are jointly supplied. The benefit from consumption of public goods is consumed jointly by more than one person. The consumption by one person does not reduce the amount that can be made available to other consumers. The consumption of a public good is non-rival.

Public goods are defined as products where, for any given output, consumption by additional consumers does not reduce the quantity consumed by existing consumers.

There are very few absolutely public goods, but common examples include law, parks, street-lighting, public health, defence etc. As there is no marginal cost in producing the public goods, it is generally argued that they must be provided free of charge, because otherwise the people who benefit less than the cost of using the public good, will not use it. That will lead to a loss of welfare. Also the goods are mostly non-excludable, that means that if once provided everybody can use them, which when charged will lead to "free-riding". So these goods will not be provided by free markets as there is no way to charge for the usage, the solution is, that state must provide these goods and finance them from taxes collected from everybody.

Public goods are freely accessible to all members of a given public, each being able to benefit from it without paying for it. The reason standard theory puts forward for this anomaly is that public goods are by their technical character non-excludable. There is no way to exclude a person from access to such a good if it is produced at all. Examples cited include the defence of the realm, the rule of law, clean air or traffic control. If all can have it without contributing to its cost, nobody will contribute and the good will not be produced. This, in a nutshell, is the public goods dilemma, a form of market failure which requires taxation to overcome it. Its solution lies outside the economic calculus; it belongs to politics….

Economists define a public good as being non rival and non excludable. The non rival part of this definition means that my consumption does not affect your consumption of a good; I do not "use it up". In other words, even those who do not explicitly (actually) pay for the good can benefit from the good.

## Mixed goods

Mixed goods are goods that have characteristics of both private and public goods. They are private in that they are rivalrous and excludable, but they also provide non-rivalrous, non-excludable external benefits.

Here are some examples of mixed goods:

Education: An educated person receives benefits in the form of higher earnings and better job prospects, but the community also benefits from their enhanced productivity.

Health care: A mixed good that provides external benefits to the community.

Public transport: A mixed good that provides external benefits to the community.

Refuse collection: A mixed good that provides external benefits to the community.

Fire service: A mixed good that provides external benefits to the community.

The balance between private and public benefits for mixed goods varies, and it can be difficult to determine the public benefits.

**Merit Goods**

Musgrave classified public wants into social wants and merit wants. The 'merit goods' was introduced into Public Finance literature by Musgrave in 1959. Merit goods are public goods but they differ from social goods because goods result in interference with consumer choice. This may be made clear with an example. The poor and economically weaker sections of the people also need good schooling, hospital facilities etc. But private schools and hospitals are maintained at a high cost which they cannot pay. Hence the stae should provide these goods to the people or supplement the private provision directly or indirectly. Direct provision would mean starting of government schools or hospitals. Indirect provision means, government gives subsidy to provide educational or hospital facilities. Such goods are merit goods. Goods whose consumption is encouraged are merit goods and whose consumption should be discouraged (liquor, narcotic drugs etc) called non-merit goods.

On the other hand are products generally not distributed by means of the price system, but based on merit or need, because people although having perfect knowledge would buy the wrong amount of them. These goods can be supplied by free market, but not on the right quantity. Merit goods are, for example, education and to some extent the health-care. They are provided by state as "good for you".

In other words, Merit goods are those goods and services that the government feels that people will under-consume, and which ought to be subsidised or provided free at the point of use so that consumption does not depend primarily on the ability to pay for the good or service.

**Private Goods**

Private goods are goods which satisfy private wants.

They are financed and supplied by the market for price payments. They are not come under the budgetary mechanism. The market economy adheres to two principles in the provision of private goods

1. Exclusion principle – exclusion principle reveals a rival relationship between goods to be classified as private goods. If a person buys a pair of shoes, it will not be available for others. This is a rival relationship. On the otherhand, the government undertakes measures to reduce air pollution. The resulting benefit is enjoyed by all who breathe, i.e., one person's consumption does not reduce another person's benefit. A private good is thus characterised by rivalry while the consumption of a pure public good is characterised by non rivalary.
2. Revealed preference – when people have to buy in the private market, they reveal their preferences in the purchase of products by buying what they want only. These revealed preferences through the price mechanism are the signals for the

producers to produce which the people want. If the consumers do nnot reveal their preference the producers do not produce them.

A private good is a product that must be purchased to be consumed, and its consumption by one individual prevents another individual from consuming it. Economists refer to private goods as rivalrous and excludable.

A private good is defined in economics as "an item that yields positive benefits to people" that is excludable, i.e. its owners can exercise private property rights, preventing those who have not paid for it from using the good or consuming its benefits; and rivalrous, i.e. consumption by one necessarily prevents that of another. A private good, as an economic resource is scarce, which can cause competition for it.

**Social Goods**

In public finance, social goods, also known as public goods, are goods that are available to the public for free or are freely available in the environment. They are non-excludable, meaning that no one can be prevented from using them, and non-rivalrous, meaning that one person's use does not reduce the availability for others.

**Market Failure**

Market failure occurs when the distribution of goods and services in a free market is inefficient. This can happen when the demand for a good or service doesn't match the amount supplied, or when market prices don't reflect the social value of those goods and services. Market failure can have negative consequences for individuals, the environment, or society as a whole.

**Some examples of market failure include:**

Unbalanced costs and benefits: When producers produce too much or too little of a good or service

Concentrated market power: When a monopolist has a monopoly on a public service, like education

Public goods: When a good or service is non-rival and non-excludable

Externalities: When agents produce positive or negative effects that affect others, but the market mechanism can't filter them out

Lack of information: When buyers or sellers don't have access to the information they need to make a price decision, they may overpay or undercharge for a good or service

Collusion: When a small number of large buyers collude to set the price they're willing to pay for a product

Overproduction: When a factory overproduces its goods, it can create costs that are not paid by the factory or its customers, but by society as a whole.

**Definition of Market Failure**

Market failure is the economic situation defined by an inefficient distribution of goods and services in the free market. Furthermore, the individual incentives for rational behaviour do not lead to rational outcomes for the group. Put another way, each individual makes the correct decision for him/herself, but those prove to be the wrong decisions for the group. In traditional microeconomics, this is shown as a steady state disequilibrium in which the quantity supplied does not equal the quantity demanded.

## Externalities

Externalities occur when one person's actions affect another person's well-being and the relevant costs and benefits are not reflected in market prices. A positive externality arises when my neighbours benefit from my cleaning up my yard. If I cannot charge them for these benefits, I will not clean the yard as often as they would like. (Note that the free-rider problem and positive externalities are two sides of the same coin.) A negative externality arises when one person’s actions harm another. When polluting, factory owners may not consider the costs that pollution imposes on others.

Positive externalities are benefits that are infeasible to charge to provide; negative externalities are costs that are infeasible to charge to not provide. Ordinarily, as Adam Smith explained, selfishness leads markets to produce whatever people want; to get rich, you have to sell what the public is eager to buy. Externalities undermine the social benefits of individual selfishness. If selfish consumers do not have to pay producers for benefits, they will not pay; and if selfish producers are not paid, they will not produce. A valuable product fails to appear. The problem, as David Friedman aptly explains, “is not that one person pays for what someone else gets but that nobody pays and nobody gets, even though the good is worth more than it would cost to produce.”

Research and development is a standard example of a positive externality, air pollution of a negative externality….

Most economic arguments for government intervention are based on the idea that the marketplace cannot provide public goods or handle externalities. Public health and welfare programs, education, roads, research and development, national and domestic security, and a clean environment all have been labelled public goods.

# UNIT - II

# Theories of Public Expenditure

## Public Expenditure

In modern times all the countries of the world have witnessed an enormous increase in public expenditure. There are three important and well known theories of growth of public expenditure. The first theory is associated with the name of German economist, Adolph Wagner.

### Adolph Wagner's Hypothesis

Adolph Wagner a noted German political economist (1835-1917) propounded an empirical law to analyses and explains the trend in the growth of public expenditure. Wagner argued that a functional, cause and effect relationship exists between the growth of an industrializing economy and the relative growth of its public sector.

Wagner believed that a functional cause –effect relationship prevailed between economic growth and growth in public expenditure. His hypothesis of the increasing state activity lays that as the per capita income and output increase in advanced countries the public expenditure of these countries necessarily grows as a proportion to the total economic activity. F.S Nitti supported Wagner's hypothesis and concluded with the support of empirical evidence that this law was not only applicable to Germany but to various governments which differed widely from each other. The following are the important causes responsible for this tendency.

1. Expansion of Traditional functions

Traditional functions mainly include defence, administration of justice, maintenance of law and order and provision of social overheads. The coverage and variety of such functions have gradually increased. Defence expenditure has expanded rapidly because of a change in military arts and sciences. In modern times military activities has become sophisticated. From simple aggression, the modern warfare shifted to prevention of attack and use of sophisticated weapons.

Defence outlays on men, materials and maintenance have been on a rising trend in modern times. Similar is the case with expenditure on internal protection and administration. Increasing areas of administration and spread of government machinery with expertise have become more and more expensive.

2. Coverage of New Functions

Secondly the activities of the state were increasing in their coverage. Traditionally the state activities were limited to only defence, justice, law and order, maintenance of the states over heads etc. But with the growing awareness of its responsibilities to the society, the governments started expanding its activities in the field of various welfare measures to enrich the cultural life of the society.

Along with this new welfare programmes were designed to provide social security to the people. This required increasing government expenditure on education, public health, low cost housing, subsidized provision of food, agricultural inputs, old age pension, sickness benefit etc.

3. Social Progress

Wagner believed that social progress was the basic cause of the relative growth of government in the industrial economics. Social progress leads to a growth in government function which in turn leads to the absolute and relative growth of governmental economic activity.

4. Expanding Sphere of Public Goods

Almost all modern democratic governments have increasingly recognized the need to provide and expand the sphere of public goods.

The need and necessity to provide social and merit goods through budgetary allocation was increasingly recognized by the modern state. The state was trying to shift the composition of national product more in favour of public goods.

As a result state activities expanded to areas like irrigation and flood control projects, construction and maintenance of public parks, provision of education and health care facilities, creation of economic overhead capital etc., Provision of these public goods and merit goods means heavy investment in public enterprises.

Apart from the above mentioned factors, Wagner also examined the forces that operate on both the demand and supply side of public sector activity and explained how they interact. Changing production and marketing arrangements of public sector activity affect and are affected by social organizations in different ways.

5. War and Preparation of War

The most important contributory factor in incurring the public expenditure in the current century is war. Expenditure on national defence generally accounts for half and at times even more than half of the total budget expenditure.

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.

6. Growth of Population

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.

7. Urbanisation

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. Rise in Prices and National 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.

Secular rise in prices and national income have led to a significant increase in the absolute amount of public expenditure.

9. Economic Planning and Growth

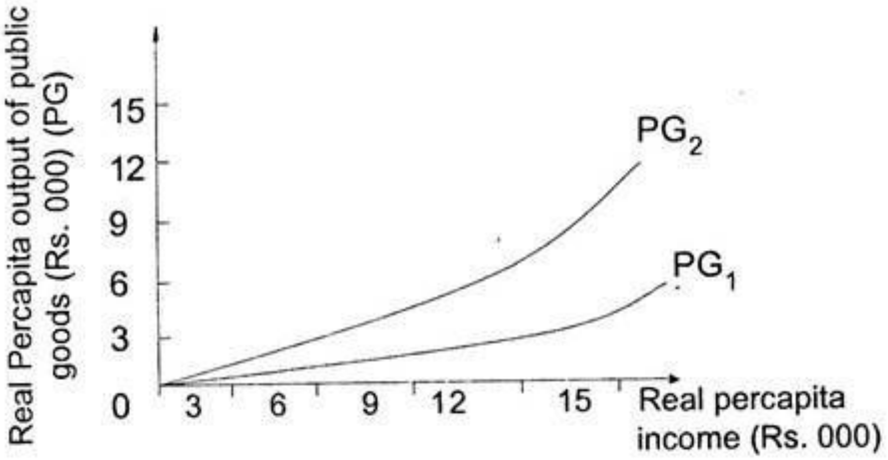
The ideals of economic planning and growth are being increasingly accepted. This implies an increase in public sector as also various efforts on the part of the government towards capital accumulation and economic growth.

10. Specialisation

The nature and size of public services now need specialisation. The quantity of the services improves, both as a historical fact as also due to circumstantial compulsions. Better quality services and higher qualified administrators, technicians and the like imply a higher cost of providing public services. Moreover, the heads like Economic Protection, Complexities of Modern Life and Mounting Public Debt also increase the public expenditure.

**Graphic Presentation of the Wagner Hypothesis:**

The modern formulation of Wagner's law is that "as per capita income rises in industrializing nations, their public sector will grow in relative importance". The Wagner's hypothesis of increasing state activity is illustrated in the below figure.




Wagner's hypothesis: The relative expansion of public sector economic activity over time

In this figure the real per capital output of public goods (PG) is measured on the vertical axis and real per capita income (Y) is measured on the horizontal axis.

Time is an important third dimension implicit in the graph, because the growth in the real per capita output of public goods and in real per capita income is realistically assumed to take place on a historical basis over an extended period of time. Line $PG^1$ represents a circumstance in which the public sector maintains a constant proportion of the total economic production of the society over time.

In other words, as real per capita income increases, due to economic development of the society, the real per capita output of public goods remains at the same proportion of total economic activity. The constant proportion line, $PG^1$, can be used as a reference point to the graphical presentation of Wagner hypothesis as depicted by the line $PG^2$.

All along the $PG^2$ the proportion of resources devoted to the output of public goods is expanding overtime.

The implication of Wagner's law can be stated in the following equations. When the real per capita output of public goods remains at the same proportion of total economic activity, i.e. $PG^1$, the equation is

$$PGa/Ya = PGo/Yo$$

In other words the income elasticity of expenditure for public goods (Ye) is elastic. Wagner's hypothesis provides the most suitable frame work for explaining economic factors, as the most important determinant of a relatively expanding public sector during industrialization and economic growth.

The functional relationships, Wagner sought to trace are complex. Wagner believed that increased public expenditure was the natural result of economic growth and the continued pressure for social progress.

**Criticism of Wagner's Hypothesis:**

Although the Wagner hypothesis has many attributes, it also has several defects. Wagner's law of increasing state activity was criticized by Allan. T. Feacock and Jack Wiseman on the following grounds:

i. Wagner's hypothesis deals with inter-disciplinary phenomenon. But it lacks interdisciplinary approach in its analytical framework.

ii. Lacks comprehensiveness in analysis Wagner's law lacks comprehensiveness. Political science, economics and sociology are among the several disciplines to be incorporated in any theory of public expenditure. The Wagner's hypothesis excludes all these characteristics.

iii. It is based on an organic self-determining theory of the state, which is not the prevailing theory of the state in most western countries.

iv. The theory ignores the influence of war on governmental spending, and

i. It stresses a long term trend of public economic activity, which tend to overlook the significant 'time pattern' or process of public expenditure growth.

## Wiseman and Peacock Hypothesis

Another hypothesis regarding the growth of public expenditure was put forth by Wiseman and Peacock, in their empirical study of public expenditure in U.K. for the period 1890-1955. The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner. The increase in public expenditure over time has occurred in jerks and step-like manner.

Wiseman and Peacock emphasize the time pattern of public spending trends rather than striving for a genuine positive theory of public sector growth. Their analysis involves three related elements.

These are displacement, inspection and concentration effects. Using empirical data for the British economy after 1890, Wiseman and Peacock observe that the relative growth of the public sector in the United Kingdom has followed a discrete step like pattern rather than a continuous growth pattern.

During the period under study they found that, government fiscal activities, in the country have risen step by step to successive new plateaus. Moreover the absolute and relative increases (steps upward) in taxing and spending activities by the British government have generally taken place during periods of major social disturbance or crisis such as war or depression.

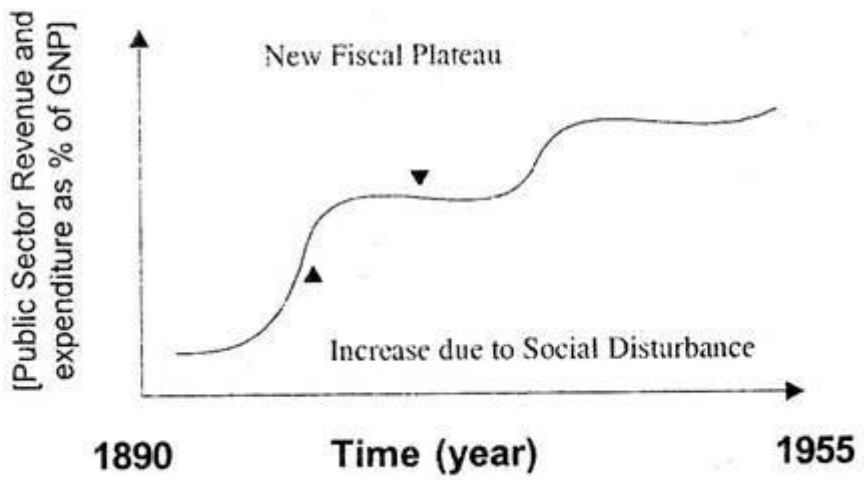
These kinds of changed fiscal situation cause the previous lower tax and expenditure levels to be replaced by new, higher, budgetary levels. This movement from the older level of expenditure and taxation to a new and higher level is called the displacement effect after the social disturbance has ended; the new level of tax is tolerated by the society.

The emerged new levels of tax tolerance make the society willing to support higher levels of public expenditure. In other words the lax threshold has increased. Thus there is no strong motivation to return to the lower pre-crisis level of taxation.

Over the secular period, 1890 -1955, this displacement procedure occurred several times in Great Britain. Thus when the major social disturbance ends, no strong motivation exists for the society to return to the lower pre-disturbance level.

The higher government revenues are used to support permanently higher levels of public sector allocation. The below figure clearly shows the displacement effect, as explained by Wiseman and Peacock.

**Displacement Effect**




The displacement effect

Figure demonstrates the displacement effect, tax threshold behaviour. Time (years) is measured along the horizontal axis, while public sector revenues (mostly taxes) and public expenditures as a percentage of gross national product are measured along the vertical axis.

The figure reveals that as the social disturbance cause a relative expansion of the public sector, the displacement effect which occurs helps to explain the time pattern by which the government growth takes place. This displacement effect does not require that the new higher plateau of expenditure, continue the same expenditure composition that was created by the social disturbance.

Some of the increased expenditures like debt interest are the direct results of the social disturbance.

While other expenditures arose as a result of technological development and expansion of government activity into new areas. For instance, war and ‘other social disturbance, frequently force the people and their government to find out a lasting solution to the long standing and pending problems, which were previously neglected.

This is known as **“inspection effect”.** Inspection effect is the inadequacy of revenue in comparison with the ‘required’ public expenditure.

In addition to the displacement and inspection effect, Peacock and Wiseman, also give narration about a concentration (scale) effect. It refers to the apparent tendency for the central government economic activity to become an increasing proportion of total public sector economic activity, when a society is experiencing economic growth.

This occurs, because central government has to initiate a number of measures to sustain higher economic activity. Since each major disturbance leads to a situation in which, the central government assuming a larger proportion of the total national economic activity, the net result is **“the concentration effect”.**

Wiseman – Peacock hypothesis appears to be quite relevant. At the outlet, the hypothesis looks quite convincing. It emphasizes jerks and jumps in public expenditure, on account of unusual and abnormal situations.

According to Prof. Aronson, for Peacock and Wiseman expenditure growth is sporadic rather than constant and revenues create their own expenditures. However, we must not forget the fact that, an account of the advance of the economy and the structural changes therein, there are constant and regular increments in public expenditure and revenue.

Public expenditure has a tendency to grow on account of a systematic expansion of government activities, both in terms of intensity and quality.

The regular and dynamic changes in state activity and public spending caused by macro variables like population growth, urbanization, awareness of civic rights on the part of citizens and political and social commitments on the part of democratic governments voted to power are major factors giving a big push to upward trend in public expenditure.

However, the influences of these factors on government spending were not systematically analyzed by Wiseman and Peacock in their hypothesis. However, Bernard. P. Herbersincerely argues that the Peacock – Wiesman hypothesis of governmental spending trends, is much more modest in what it intend to explain than in Wagner's hypothesis.

The fact is that, both the Wagner's and Peacock. Wiseman narrations contribute a lot in understanding the process of public sector growth in industrialized nations.

## 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 defence. Because public goods are not excludable, they get under-produced. The pricing system 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 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.

## Structure and Growth of Public Expenditure

There has been a phenomenal increase in public expenditure in almost all the countries of the globe. This tendency which was noted in the previous century has become crystallised in the present century.

The classical economists assumed the state has very limited functions under the laissez faire policy. The functions of the state were restricted to justice, police and arms. According to J.B. Say “the very best of all plans of finance is to spend a little”. But today 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.

### 1. Welfare State Ideology

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 ₹419 crores in the First Plan to ₹2,772 crores in the Fourth Plan. In the Seventh Plan, it was envisaged to be ₹29,350 crores. In each five year plan, India has been providing a significant portion of the total plan outlay for the health sector in order to provide quality health care to all needy people. The percentage of plan allocation to health sector increased from 3.4 in the first plan to 6.5 per cent in the eleventh plan. In the same pattern, the per capita expenditure also increased from ₹0.61 in the first plan to ₹214.62 in the eleventh plan. In the 12th five year plan, the government has decided to boost public spending in the sector to 2.5 per cent of GDP from 1.27 per cent in the 9th five year plan. The central government outlay for the health sector in the twelfth plan has been increased by about 335 per cent to ₹300018 crore over the actual outlay of ₹99491crore in the 11th plan.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.

**2. The Need for Defence**

International political situation is insecure and uncertain. Due to the invention of nuclear weapons, there is always the danger of foreign aggression. 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.

**3. The Influence of Democratic Forces**

The democratic structure of government is more expensive than totalitarian government. In India democracy is becoming a very costly affair. The Expenditure on elections and bye-elections is increasing. The recent growth of democracy and socialism everywhere in the world has caused public expenditure to increase very much.

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.

**4. 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.

**5. 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.

**6. 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.

## 7. 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.

## 8. The Planning Effect

The government through the planning commission formulates and implements plans to provide full employment, reduce inequalities of income and wealth distribution, bring about a balanced regional development and to achieve a number of other socio-economic objectives. The government has to spend huge sums on planning leading to an increase in public expenditure. 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).

## 9. 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.

### 10. Industrial Development

Industrial production contributes to increase in national income and it improves the standard of living. It is evident from the Five Year Plans, which gives top priority in the second five year plan. After that, industrial sector, in India, blooms everywhere and in turn backward regions of our country also gets benefited. Obviously all these developments are resulted by way increasing in public expenditure.

### 11. Education

In any country, social and political development can never take place unless the citizens are educated. In order to carry the benefits to weaker sections of society, the government offers them free scholarships and even maintenance grants which enable them to buy books. Hence, a substantial increase in public expenditure is needed of the hour.

### 12. Servicing of Large Public Debt

Modern governments require huge finance for its various development activities. It cannot raise funds by taxation alone. Therefore it must resort to internal and external borrowing. Hence it has to pay interest and repay capital. This leads to an increase in public expenditure.

## Public Revenue

The income of the government through all sources is known as public revenue. Public income has been defined by Dalton in a narrow sense and in a broad sense. In the narrow sense, it includes income from taxes, prices of goods and services supplied by public enterprises, revenue from administrative activities, such as fees, fines etc. It is referred to as public revenue. In its wider sense it includes all the incomes of the government during a given period of time, including public borrowings from individuals and banks and income from public enterprises. It is known as public receipts.

There are two sources of public revenue viz., tax revenue and non-tax revenue.

The revenue obtained through various taxes is known as tax revenue, while income received from administration, commercial enterprises, gifts and grants is non-tax revenue.

**Importance of Public Revenue**

As a matter of fact the whole economy is influenced by the public revenue. Thus we can say that the aims of public revenue are:

i. To raise funds
ii. To bring about equitable distribution of wealth
iii. To encourage savings and investments
iv. To direct consumption pattern
v. To encourage or control production

In short public revenue can be used as an investment of controlling nations economic activities.

## Capital and Revenue Receipts

When the business receives money it is again of two sorts. It my be a long-term receipt, a contribution by the owner, either to start the business off or to increase the funds available to it. It might be a mortgage or which brings money into the business for a long-term, but in this case it is not the owner of the business but some other investor who is supplying the money.

On the other hand, the receipt may be a short-term receipt, one which is truly a profit of the business. It may be rent received, commission received or cash for sale of goods made that day, or at some previous time.

**Capital Receipt**

Receipts which are non-recurring (not received again and again) by nature and whose benefit is enjoyed over a long period are called "Capital Receipts", e.g. money brought into the business by the owner (capital invested), loan from bank, sale proceeds of fixed assets etc. Capital receipt is shown on the liabilities side of the Balance Sheet.

**Revenue Receipt**

Receipts which are recurring (received again and again) by nature and which are available for meeting all day to day expenses (revenue expenditure) of a business concern are known as "Revenue receipts", e.g. sale proceeds of goods, interest received, commission received, rent received, dividend received etc.

**Distinction between Capital Receipt and Revenue Receipt**

| Revenue Receipt | Capital Receipt |
|---|---|
| It has short-term effect. The benefit is enjoyed within one accounting period. | It has long-term effect. The benefit is enjoyed for many years in future. |
| It occurs repeatedly. It is recurring and regular. | It does not occur again and again. It is nonrecurring and irregular. |
| It is shown in profit and loss account on the credit side. | It is shown in the Balance Sheet on the liability side. |
| It does not produce capital receipt. | Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner, business gets revenue receipt (i.e. sale proceeds of goods etc.). |
| This does not increase or decrease the value of asset or liability. | The capital receipt decreases the value of asset or increases the value of liability e.g. |

| | |
|---|---|
| | sale of a fixed asset, loan from bank etc. |
| Sometimes, expenses of capital nature are to be incurred for revenue receipt, e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt. | Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment. |

## Tax Revenue

Taxes are imposed by the government on the people and it is compulsory on the part of the citizens to pay taxes, without expecting a return. Prof. Seligman defines a tax as "a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all without reference to special benefits conferred". Prof.Taussig puts it as" the essence of a tax, as distinguished from other charges by government, is the absence of a direct *quid pro quo* between the tax payer and the public authority".

### Characteristics of a Tax

A tax possesses the following characteristics:

1. A tax is a compulsory payment levied by the state. Refusal to pay a tax leads to punishment.
2. There is no direct *quid pro quo* between the state and the people. The taxpayers cannot claim reciprocal benefits against the taxes paid.
3. A tax is a payment for meeting the expenses in the common interest of all the citizens. The state exists for the common good for all.
4. A tax is payable regularly and periodically. It is a personal obligation imposed on the tax payer. He has to pay it. He should not try to evade it.

## Non-tax Revenue

Non-tax revenue refers to the income received by the government through administration, commercial enterprises, grants and gifts.

**Administrative Revenue**

The administrative revenues arise from the administrative functions of the government. They include fees, licence fee, special assessment, fines, forfeitures and escheat.

**Fees –** Fees are charged by the government to meet the cost of administrative services rendered. For ex. Court fee

**Licence Fee** – A licence fee is similar to a fee. Licence fees are charged to give permission for something by the controlling authority. The objective of a licence fee is to control injurious activities.

**Special Assessment** – A special assessment is in the words of Seligman, a compulsory contribution, levied in proportion to the special benefits derived, to defray the cost of a specific improvement to property undertaken in the public interest".

**Fines and Penalties –** Fines and penalties are imposed on persons as a punishment for infringement of laws. They are not imposed for the purpose of obtaining revenue but to prevent crime.

**Forfeitures** – Forfeitures refer to the penalties imposed by courts for the failure of individuals to appear in the courts, to complete contracts as stipulated etc.

**Escheat** – the state may take possession of the property of a person who dies without having any legal heirs or without having made any specific wills.

**Gifts and Grants –** Patriotic, charitably-minded, public spirited or conscientious persons may give gifts to the state. The volume of gifts is not very large except in times of war or other emergency. Gifts are generally voluntary contributions.

**Revenue from Commercial enterprises**

Commercial revenues refer to the income earned by public enterprises by selling their goods and services. For example, payment for postage, tolls, interest on borrowed funds etc. Government may undertake many enterprises due to various reasons: private individuals are unwilling to take up certain essential services because of low profits or long gestation period; certain goods may be produced by the government to regulate their consumption; some enterprises may undertaken to protect the interest of the consumers.

## Sources of Tax Revenue for the Central and States

The income of government through all its sources is called public revenue. A tax is defined as a compulsory payment to the government authority without any direct benefit.

### I - Central Revenue

There are two sources of revenue to the union government of India. Tax revenue of the union government consists of

1. Tax on income and expenditure
2. Tax on property and capital transactions
3. Tax on commodities and services

Tax on income and expenditure

Under these head there are three taxes

i. Personal Income Tax – under the provisions of the CI Act, income tax is leived on all personal income other than agricultural income. It is the duty of the tax-payer to pay the tax if he is liable to pay it and should in no case think to evade it.

ii. Expenditure Tax – it is a tax on expenditure, it is levied when the income is spend. Prof.Kaldor recommended this tax in India and it was levied on 1$^{st}$ April of 1958.

iii. Corporation Taxes – the corporation tax is imposed on the profits of corporation both Indian and foreign. In entire proceeds of corporation tax is retained by the union government and no share is given to the states.

Tax on property and capital transactions

Under this head we have estate duty, wealth tax and gift tax.

ii. Estate Duty - Estate Duty is the tax payable by legal heirs on the estate of a deceased person herited by them. It was introduced on October 1953. Recently it was abolished.

iii. Wealth tax – This tax was introduced in 1957 on the recommendation of Prof.Kaldor. This tax is levied on the value of the total property exceeding Rs 2.5 lakhs.

iv. Gift Tax- the gift tax was introduced in April 1958 on the recommendation of Prof.Kaldor. Gifts are voluntary contribution from private individuals or non-government donors to the government fund for specific purpose, such as, relief fund or defence fund during a war or an emergency.

Tax on commodities and services

Under this category, we have excise duty and customs duty.

i. Union Excise duty – Excise duty levied on all commodity is produced anywhere in India except alcoholic, liquor and opium narcotics, drugs (on these goods the state can impose excise duty).

ii. Customs duty – customs duty is imposed on goods exported from India and on goods imported in India. Import duty is used to protect the domestic industry.

**II - State Revenue**

The constitution of India has provided a federal structure for India – the central and state governments. The central government has a separate source of revenue and the state government has different source of revenue.

i. Sale tax – All the state imposed tax on goods and services sold inside the states. The revenue from these tax fully retained by the state governments.
ii. Land revenue – the state government gets revenue from the tax imposed on lands.
iii. Taxes on Agriculture Income – the state government can also imposed tax on agriculture income but majority of the states do not resort to this kind of tax due to political compulsion.
iv. Taxes on lands and buildings – the state government gets revenue from the taxes on land and buildings.
v. Taxes on mineral rights - the state government gets revenue for the rights it awards for the exploitation of minerals.
vi. Excise duty on alcoholic, liquors and narcotics - the state government imposed tax on liquorand narcotics and gets a size of revenue.
vii. Entertainment tax - the state government gets revenue by imposing entertainment tax. This tax is imposed on cinema and other entertainment items.
viii. Tolls - the state government gets revenue by way of tools.
ix. Stamp duty – the state government revenue from the stamp duty when we purchase a property we have to pay stamp duty to the state government.

## Sources of Non-Tax Revenue for the Central and States

Non-tax revenue for Central

1. Interest receipts
2. Dividends and Profits
3. Revenue from fiscal services and

4. Revenue from general services
5. Cash and grants from other countries

Non-tax revenue for State

1. Fees, Licences and Permits
2. Fines and Penalties
3. Forfeitures
4. Escheat
5. Special Assessment
6. Revenue from ponds, trees and lakhs

## Sources of Revenue for Local Bodies

Local bodies and localself government refers to gram-panchayat, municipalities and co-operatives. These local governments receive their revenue from tax as well as non-tax sources. The various sources of funds for local bodies can be classified as follows.

1. Revenue from taxes imposed and collected by local bodies.
2. The share assigned to local bodies by the state government.
3. Grants-in-aid
4. Revenue from non-tax sources such as fines, tolls and fees.

The main taxes levied by the municipalities in different states are as follows,

a. Taxes on property; rates on buildings and lands including open land,
b. Taxes on goods; octroi and terminal taxes
c. Personal taxes; taxes on professions, trades, callings and employments
d. Taxes on vehicles and animals
e. Theatre or show tax

**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.

The canons of public expenditure are principles that guide a government's spending policy. These principles ensure that government spending is efficient, proper, and in the best interest of society:

**Canon of Benefit**

Public spending should be directed at activities that provide the greatest social benefit. This means that spending should be based on cost-benefit analysis, and that the benefits should outweigh the costs.

**Canon of Economy**

Public spending should be efficient and productive, and should avoid unnecessary or wasteful spending. This means that governments should seek cost-effective solutions and implement budgetary controls.

**Canon of Sanction**

Public spending should not be undertaken without the proper authority's sanction. This prevents misuse of funds.

**Canon of Certainty**

Public expenditure plans should be based on sound economic analysis, realistic revenue projections, and long-term sustainability. This helps to avoid sudden fluctuations in spending.

**Canon of Neutrality**

Public expenditure should not worsen the production-distribution-exchange relationship. Instead, it should result in increased production, productivity, and economic activity.

# UNIT - III

## Taxation

### Indian Tax System

Historical development of Indian Tax system has revealed that it has undergone several changes especially after country's independence. Indian taxation had a very limited scope since it fulfilled mainly administrative functions of the government and the system hardly paid any serious attention to the problems of tax system. After 1947, the finiancial structure of Central and state government has been consistently expanding. With the introduction of five year plans the governments were required to bring about a necessary change in the taxation policy. More and more direct taxes were introduced in order to achieve certain social and economic objectives.

Modern states are welfare states and it is now felt that taxation system has not only to help the government to discharge administrative functions but also welfare activities. In a poor country like India taxation system must aim at

i. Increasing public income
ii. Encouraging savings and investments
iii. Discouraging consumption of goods and services which are harmful to community's health and progress
iv. Containing the growth of inflationary rate
v. Helping to achieve economic and national income growth rate
vi. Reducing the income gaps in Indian society

Our tax system has failed to achieve these aims because the system suffers from serious defects.

**Defects in Indian Tax System**

India's tax system suffers from the following defects.

i. Poor tax administration
ii. Low share of taxation out of National income
iii. Unbalanced tax structure
iv. Tax evasion
v. Lack of economy
vi. Tax arrears

vii. Low share of taxation

viii. Adverse affect on saving and investment

ix. Unscientific

x. Inelastic and inflexible

**Measures for improvement**

1. Ensuring equality between direct and indirect taxes

   In order to bring about equality between direct and indirect taxation tax structure should be revised. For this purpose, tax should be imposed on higher agricultural income and total exemption on essential goods and services should be allowed.

2. To check tax evasion

   To avoid tax evasion, tax system should be broadened so that there is no scope for avoidance. Strict action should be taken for breaking the laws.

3. Agricultural income Tax

   It is essential to impose taxes on higher income groups in agricultural sector. This will not only yield larger revenue but will also justify the canon of equity.

4. Progressive taxation

   Policies should be formulated to make the tax structure more and more progressive. More burden should fall on the rich and less burden on the poor section of the society. At the same time efforts should be made check concentration of income and wealth in few hands.

5. Simplicity, flexibility and elasticity

   These are the prerequisites for a sound tax system. In order to ensure these qualities, the necessary administrative and procedural reforms should be introduced. Appropriate rate of taxation and their effective enforcement are the need of the hour.

## Revenue for the Union and States

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**I –Union Revenue**

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Under this head we have estate duty, wealth tax and gift tax.

vii. Estate Duty - Estate Duty is the tax payable by legal heirs on the estate of a deceased person herited by them. It was introduced on October 1953. Recently it was abolished.

viii. Wealth tax – This tax was introduced in 1957 on the recommendation of Prof.Kaldor. This tax is levied on the value of the total property exceeding Rs 2.5 lakhs.

ix. Gift Tax- the gift tax was introduced in April 1958 on the recommendation of Prof.Kaldor. Gifts are voluntary contribution from private individuals or non-government donors to the government fund for specific purpose, such as, relief fund or defence fund during a war or an emergency.

Tax on commodities and services

Under this category, we have excise duty and customs duty.

iii. Union Excise duty – Excise duty levied on all commodity is produced anywhere in India except alcoholic, liquor and opium narcotics, drugs (on these goods the state can impose excise duty).

iv. Customs duty – customs duty is imposed on goods exported from India and on goods imported in India. Import duty is used to protect the domestic industry.

**II - State Revenue**

The constitution of India has provided a federal structure for India – the central and state governments. The central government has a separate source of revenue and the state government has different source of revenue.

x. Sale tax – All the state imposed tax on goods and services sold inside the states. The revenue from these tax fully retained by the state governments.

xi. Land revenue – the state government gets revenue from the tax imposed on lands.

xii. Taxes on Agriculture Income – the state government can also imposed tax on agriculture income but majority of the states do not resort to this kind of tax due to political compulsion.

xiii. Taxes on lands and buildings – the state government gets revenue from the taxes on land and buildings.

xiv. Taxes on mineral rights - the state government gets revenue for the rights it awards for the exploitation of minerals.

xv. Excise duty on alcoholic, liquors and narcotics - the state government imposed tax on liquorand narcotics and gets a size of revenue.

xvi. Entertainment tax - the state government gets revenue by imposing entertainment tax. This tax is imposed on cinema and other entertainment items.

xvii. Tolls - the state government gets revenue by way of tools.

xviii. Stamp duty – the state government revenue from the stamp duty when we purchase a property we have to pay stamp duty to the state government.

**Revenue for Local Bodies**

Local bodies and localself government refers to gram-panchayat, municipalities and co-operatives. These local governments receive their revenue from tax as well as non-tax sources. The various sources of funds for local bodies can be classified as follows.

5. Revenue from taxes imposed and collected by local bodies.
6. The share assigned to local bodies by the state government.
7. Grants-in-aid
8. Revenue from non-tax sources such as fines, tolls and fees.

The main taxes levied by the municipalities in different states are as follows,

f. Taxes on property; rates on buildings and lands including open land,

g. Taxes on goods; octroi and terminal taxes

h. Personal taxes; taxes on professions, trades, callings and employments

i. Taxes on vehicles and animals

j. Theatre or show tax

## Non-Tax Revenue for the Central and States

### Non-tax revenue for Central

6. Interest receipts
7. Dividends and Profits
8. Revenue from fiscal services and
9. Revenue from general services
10. Cash and grants from other countries

### Non-tax revenue for State

7. Fees, Licences and Permits
8. Fines and Penalties
9. Forfeitures
10. Escheat
11. Special Assessment
12. Revenue from ponds, trees and lakhs

## Meaning of Canons of Taxation

By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. In fact, canons of taxation are related to the administrative part of a tax. Adam Smith first devised the principles or canons of taxation in 1776.

Even in the 21st century, Smith canons of taxation are applied by the modern governments while imposing and collecting taxes.

Types of Canons of Taxation

(i) Canon of equality or equity

(ii) Canon of certainty

(iii) Canon of economy

(iv) Canon of convenience.

Modern economists have added more in the list of canons of taxation.

**These are:**

(v) Canon of productivity

(vi) Canon of elasticity

(vii) Canon of simplicity

(viii) Canon of diversity.

**i. Canon of Equality**

Canon of equality states that the burden of taxation must be distributed equally or equitably among the taxpayers. However, this sort of equality robs of justice because not all taxpayers have the same ability to pay taxes. Rich people are capable of paying more taxes than poor people. Thus, justice demands that a person having greater ability to pay must pay large taxes.

If everyone is asked to pay taxes according to his ability, then sacrifices of all taxpayers become equal. This is the essence of canon of equality (of sacrifice). To establish equality in sacrifice, taxes are to be imposed in accordance with the principle of ability to pay. In view of this, canon of equality and canon of ability are the two sides of the same coin.

**ii. Canon of Certainty**

The tax which an individual has to pay should be certain and not arbitrary. According to A. Smith, the time of payment, the manner of payment, the quantity to be paid, i.e., tax liability, ought all to be clear and plain to the contributor and to everyone. Thus, canon of certainty embraces a lot of things. It must be certain to the taxpayer as well as to the tax-levying authority.

Not only taxpayers should know when, where and how much taxes are to be paid. In other words, the certainty of liability must be known beforehand. Similarly, there must also be certainty of revenue that the government intends to collect over the given time period. Any amount of uncertainty in these respects may invite a lot of trouble.

**iii. Canon of Economy**

This canon implies that the cost of collecting a tax should be as minimum as possible. Any tax that involves high administrative cost and unusual delay in assessment and high collection of taxes should be avoided altogether.

**According to A. Smith:"Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State."**

**iv. Canon of Convenience**

Taxes should be levied and collected in such a manner that it provides the greatest convenience not only to the taxpayer but also to the government.

Thus, it should be painless and trouble-free as far as practicable**. "Every tax"**, stresses **A. Smith: "ought to be levied at time or the manner in which it is most likely to be convenient for the contributor to pay it."**That is why, after the harvest, agricultural income tax is collected. Salaried people are taxed at source at the time of receiving salaries.

These canons of taxation are observed, of course, not always faithfully, by modern governments. Hence these are basic and classic canons of taxation.

**Other canons of taxation**

**i. Canon of Productivity**

According to a well-known classical economist in the field of public finance, Charles F. Bastable, taxes must be productive or cost-effective. This implies that the revenue yield from any tax must be a sizable one. Further, this canon states that only those taxes should be imposed that do not hamper productive effort of the community. A tax is said to be a productive one only when it acts as an incentive to production.

**ii. Canon of Elasticity**

Modern economists attach great importance to the canon of elasticity. This canon implies that a tax should be flexible or elastic in yield.

It should be levied in such a way that the rate of taxes can be changed according to exigencies of the situation. Whenever the government needs money, it must be able to extract as much income as possible without generating any harmful consequences through raising tax rates. Income tax satisfies this canon.

**iii. Canon of Simplicity**

Every tax must be simple and intelligible to the people so that the taxpayer is able to calculate it without taking the help of tax consultants. A complex as well as a complicated tax is bound to yield undesirable side-effects. It may encourage taxpayers to evade taxes if the tax system is found to be complicated.

A complicated tax system is expensive in the sense that even the most honest educated taxpayers will have to seek advice of the tax consultants. Ultimately, such a tax system has the potentiality of breeding corruption in the society.

**iv. Canon of Diversity**

Taxation must be dynamic. This means that a country's tax structure ought to be dynamic or diverse in nature rather than having a single or two taxes. Diversification in a tax structure will demand involvement of the majority of the sectors of the population.

If a single tax system is introduced, only a particular sector will be asked to pay to the national exchequer leaving a large number of population untouched. Obviously, incidence of such a tax system will be greatest on certain taxpayers. A dynamic or a diversified tax structure will result in the allocation of burden of taxes among the vast population resulting in a low degree of incidence of a tax in the aggregate.

The above canons of taxation are considered to be essential requirements of a good tax policy. Unfortunately, such an ideal tax system is rarely observed in the real world. But a tax authority must go on maintaining relentlessly the above canons of taxation so that a near- ideal tax structure can be built-up.

**v.Canon of Coordination**

There should be coordination between different taxing authorities. In a democracy, central, state and local governments impose various taxes. Therefore, it is desirable to have coordination between various governments in the interest of taxpayer and government.

## Important principles of Taxation

**1. Neutrality:**

Tax system should be designed to be neutral, i.e., it should disturb the market forces as little as possible, unless there is a good reason to the contrary.

As a general rule, people do not like tax payment. In fact, every tax provides an incentive to do something to avoid it. Since the government is under compulsion to collect taxes, it is not possible to guarantee complete neutrality. The tax system must, therefore, seek to achieve neutrality, by minimising the disturbance to the market that comes from taxation.

**2. Non-neutrality:**

Sometimes it becomes essential to maintain non-neutrality for meeting certain social objectives. These objectives can be secured by providing tax incentives. This means that in some cases, it may be desirable to disturb the private market.

For example, the government may impose tax on polluting activities, so as to discourage firms to pollute the environment. Likewise, a tax on cigarettes will serve a two-fold purpose: raising revenue and discouraging consumption of this harmful item. In both the cases, the market is disturbed but in a desirable way.

**3. Equity:**

Taxation involves compulsion. Therefore, it is important for the tax system to be fair. On grounds of equity it has been suggested that a tax system should be based on a principle of equal sacrifice or ability to pay. The latter is determined by (a) income or wealth and (b) personal circumstances.

Richard Musgrave has argued that taxes are to be judged on two main criteria: equity (Is the tax fair?) and efficiency (Does the tax interfere unduly with the workings of the market economy?) It comes to us a surprise that economists have been mostly concerned with the latter, while public discussions about tax proposals always focus on the former.

We may, therefore, start with the concept of equitable taxation:

**(a) Horizontal Equity:**

There are three distinct concepts of tax equity. The first is horizontal equity. Horizontal equity is the notion that equally situated individuals should be taxed equally. More specifically, persons of equal income should pay identical amounts in taxes. There is hardly any controversy about this principle. But it is very difficult to apply the concept in practice.

Let us consider, for example, the personal income tax. Horizontal equity calls for two families in the same income to pay the same tax. But what if one family has eight children and the other has none? Or, what if one family has unusually high medical expense, while the other has none (even if two families have the same number of members)?

**(b) Vertical Equity:**

The second concept of fair taxation follows logically from the first. If equals are to be treated equally, it logically follows that un-equals should be treated unequally. This precept is known as vertical equity. This concept has been translated into the ability to pay principle, according to which those most able to pay should pay the maximum amount of taxes. Broadly, the principle suggests that the fairest tax is one based on one's financial ability to support governmental activities through tax payments.

The ethical base of this principle rests on the assumption that one rupee paid in taxes by a rich person represents less sacrifice than does the same rupee tax paid by a poor man and that fairness demands equal sacrifice by both rich and poor in support of government. Thus, a rich man must pay more money in taxes than would a poor man for each to bear the same burden in supporting services provided by the government.

Thus, horizontal equity suggests that people who are equal should pay equal taxes: vertical equity suggest that, un-equals should be treated unequally. Specifically, the rich should pay more taxes than the poor, since wealth is considered an appropriate measure of one's ability to pay taxes.

**The Benefit Principle:**

The benefit principle was accepted by political theoreticians of the seventeenth century. According to this theory, the people should pay taxes in proportion to the benefits received by them from the state. People receiving more benefits should pay more taxes than those who get less benefits.

From the conceptual and practical points of view there is hardly any conflict between the principles of horizontal and vertical equity. But there is a third principle of fair taxation which may often violate commonly accepted notions of vertical equity.

The principle recognises that the purpose of taxation is to pay for government services. If taxes are imposed according to the benefit principle, people pay taxes in proportion to the benefits they receive from government spending.

Therefore, those who derive the maximum benefits from government services such as roads, hospitals, public schools and colleges should pay the maximum tax. However, if the benefit principle of taxation is followed, the government will be required to estimate how much various individuals and groups benefit, and set taxes accordingly.

According to the benefit principle of taxation those who reap the benefits from government services should pay the taxes. The benefit principle holds that people should be taxed in proportion to the benefits they receive from goods and services provided by the government. This principle is based on the feeling that one should pay for what one gets.

One clear example is road tax. Receipts from road taxes typically are set aside for maintenance and construction of roads. Thus, those who drive on the roads pay the tax. But one question remains unanswered: do those who use the roads pay the tax roughly in proportion to the amount they use them?

The principle also leads to an economically efficient solution to the questions of how much government should provide and who should pay for it. However, using the benefit principle has several practical difficulties that render it impossible to apply it for many publicly supplied goods and services.

When a good or service supplied by the government has the exclusive and rival characteristics of a private good, benefits can be computed rather easily and users can be charged accordingly. Examples include road tax, toll tax and transit fees. When a publicly provided service is non-rival and nonexclusive (a pure public good) the benefit principle is just a theoretical concept because the benefits cannot be measured.

**Merits**

1. Taxation is justified on the basis of benefits conferred on the people by the state

2. Benefit theory combines both the income and expenditure side of the budget processes.
3. Benefit theory is applied only to such cases where the benefit is measurable.

**Demerits**

1. It is impossible to find out the benefit received by the individual and total benefit received by the community.
2. It assumes the existence of quid pro quo relation between the state and the people.
3. In modern days, all governments have welfare oriented. They provide beneficial services like free education etc
4. Benefit principle cannot solve the problem of inequality in income distribution
5. Benefit principle will lead to regressive taxation.

**Problems:**

In fact the necessity for different taxes generally makes benefit taxation somewhat impractical for pure public goods. First, the public sector provides numerous public goods, and the cost of obtaining enough information to permit levying appropriately different taxes may be very high.

Furthermore, most individual taxpayers often refuse to reveal their ‘true’ preferences because once the ‘public’ good is provided, individuals cannot be excluded from enjoying the benefits whether they pay taxes or not. This characteristic of public goods goes by the name ‘free riders’.

Let us suppose taxes are based on one’s reported assessment of the benefits one receives from the good. In essence, taxation is voluntary. Some taxpayers might assert that they want little or none of the public good (like a road, or a public park or a bridge) in question.

Clever people might even assert that they are harmed by the public good. So, they should receive subsidies from the government. Once other people agree to buy some of the public good, free riders are able to enjoy the good or service.

If most people want to enjoy the good or service free of cost (or, they attempt to 'free ride'), the public good may not be available at all. Generally, it will be available in less than sufficient quantities. As a result of the inability to ascertain people's true preferences for public goods, the benefit principle, while interesting analytically, is seldom used in practice.

So, it is not possible to implement the principle in practice. Most people will enjoy the benefits of public expenditure but will be reluctant to pay taxes. To overcome this problem, an alternative principle has been suggested, viz., the ability to pay principle.

## The Ability-to-Pay Principle

If the objective of the government is to redistribute income, it should set taxes according to the ability-to-pay principle. However, it is difficult to measure ability. There are, in general, three measures of ability: income, expenditure and property.

Ability to pay principle states that those who possess income or wealth should contribute to the state in proportion to his ability to pay. According to Mill, "Equality in taxation means equality of sacrifice". It implies that all people should incur equal sacrifice; only then taxation becomes just and equitable.

Since taxes are defined as a compulsory payment without a quid pro quo or any direct benefit known as the ability to pay or the 'sacrifice theory' was developed. This theory is associated with such great names as J S Mill, Sidgwick, Edgeworth and Pigou. J S Mill rejected the benefit principle and emphasised equal absolute sacrifice based on 'the ability to pay doctrine'.

As Dalton puts it 'the burden of taxation should be so distributed that the direct real burden on all taxpayers is equal'.

In other words of Seligman, 'the basic point of the ability to pay principle is that the burden of taxation should be shared amongst the members of the society so as to confirm to the principle of justice and equity'. The ability to pay principle points out that this collective expenditure should be proportionate on the basis of ability to pay of the people and not on the basis of any benefits received. Tax shares be imposed on the basis of equity or justice and welfare considerations.

- Taxes should be imposed by the state in an equitable by the state in an equitable or just manner, according to the view of 'ability to pay' principle.
- Taxes should be imposed so as to minimise the total sacrifice involved.
- The third view of this approach emphasis welfare aspect not only of tax shares but also of expenditure.

There are two sides of this doctrine:

A. The Subjective or Sacrifice approach and

B. The Objective or Faculty approach

**The Subjective or Sacrifice approach**

According to John Stuart Mill, "the distribution of tax shares prevails when all individuals incur equal sacrifice while contributing to the common good".

Here, equal sacrifice refers to the sacrifice in terms of utility of income sacrifice by individuals in contributing to common good.

Assumption:

This approach is based on some fundamental assumptions.

1. Units of income are identical or correlated with units of utility or satisfaction.

2. It is assumed that as income increases, the marginal utility of income decreases, i.e., the marginal utility of income varies inversely with the amount of income.
3. It is assumed that everyone's utility function has exactly the same characteristic, different persons have divergent incomes at the same point of time.

**The Objective or Faculty approach**

There are three indices or measures of ability to pay. They are

1. Income
2. Expenditure
3. Property

**1. Income:**

Income is said to be a better measure of ability than wealth. But here also some difficulties are encountered. All work do not involve the same sacrifice. A man earning Rs.500 through toil and trouble will not be a position to pay taxes as one earning the same amount without any effort (from paternal property) or gambling or through chance (lottery).

One with the same level of income as another may have more dependents and more liability and thus lower ability to pay. Moreover, the marginal utility of money differs from man to man. It is higher to a man with lower income and vice versa. So, in the ultimate analysis, income is not a good test of ability.

**2. Expenditure:**

According to Prof. N. Kaldor, expenditure is the best possible measure of ability. He advocated an expenditure tax which was tried in India for sometime but withdrawn subsequently. A poor man may spend more if he has more dependants and if he has to look after his old parents. So, his expenditure may be higher than his colleague belonging to the same income bracket. But his expenditure does not reflect his true ability to pay.

**3. Property:**

Possession of wealth or property is a reflection of well- being, but to a limited degree. For example, if two persons have the same amount of wealth, they are not equally well-off. One may have some productive wealth like a building which yields a steady income. Another may have unproductive wealth (i.e., jewellery) of the same value. Naturally, their ability to pay taxes will differ greatly.

Two basic indices (measures) of the ability to pay, viz., income and wealth provide a justification for progressive personal taxes. If taxes are imposed on the basis of the ability to pay principle, higher taxes will be paid by those with greater ability to pay, as measured by income and/or wealth.

The measures of ability differ from tax to tax. For example, in income taxation, the measure of ability is income; in wealth taxation, it is the value of property (wealth).

## Characteristics of a Good Tax System

An ideal tax system should satisfy all the canons of taxation. It should procure sufficient revenue. It should not affect production. A good tax system is expected to satisfy the following conditions.

1. Taxes should satisfy the canon of equity. That is rich people should pay more.
2. Productivity in the tax measures
3. Adaptability to the changing requirements of the economy
4. No adverse effects on capital formation
5. It should not destroy the incentive to earn, save and invest in productive enterprises.
6. Taxes should procure sufficient amount of revenue to the government to facilitate the achievement of full employment and economic growth.

7. Cost of collecting the taxes should be minimum. Taxes should give least trouble to tax payers.
8. Tax system should provide maximum social advantage
9. The tax system should be understandable to the tax-payer
10. Allocation of taxes among different groups of people should be according to the principles of least sacrifice, cost and benefit and ability to pay.
11. Tax system has the confidence of the people.
12. Essential commodities should free from taxation
13. Tax system should have the best combination of direct and indirect taxes.

## Objectives of Taxation

The main objective of taxation is to obtain revenue to the government. In addition to this, taxation can be used for reducing inequalities in income distribution, for controlling the fluctuations in income and employment, for securing equilibrium in balance of payments and for achieving several other economic objectives.

1. Finance or revenue aspect

The classical economists believed that the main objective of taxation is that of raising revenue. Of course, non-revenue considerations also play an important role in tax policy. However, when the government needs revenue to meet increased expenditure, it relies on taxation.

2. Regulatory aspect

Now-a-days, taxation is used for regulating the economic life of the community. For example, excise duties are levied on liquor for controlling consumption.

3. Regulation of economic activity

Taxation is used to regulate national income. Taxes transfer income from individuals to government. This affects consumption and investment and hence the level of national income. Sometimes, taxes are included in the price of the commodities. This discourages the consumption of non-essential commodities.

4. Reduction in inequalities of wealth

Rapid economic development has resulted in glaring inequalities in the distribution of income and wealth. The main aim of the government is to secure social justice by reducing inequalities. Income tax, excess profits tax, inheritance tax, wealth tax etc can reduce inequalities in income and wealth.

5. Functional Finance

A.P Lerner and his followers insist that public finance should be functional finance. Functional finance implies that maintenance of adequate level of national income should be the main aim of public finance.

6. Incentive Taxation

Incentive taxation plays an important role in developing countries. In the words of Benjamin Higgins, 'The Purpose of incentive taxation is to stimulate an increase in the flow of labour or managerial effort or of savings and investment or to improve the allocation of capital, land, labour and entrepreneurs'.

7. Avoidance of cyclical fluctuations

Yet another objective of taxation is to avoid cyclical fluctuations..in other words, counter-cyclical policy of raising the rates of taxes during boom and reducing it in times of depression should be followed.

8. Allocation of Resources

Taxation aims at allocation of resources in desirable channels of investment. The available resources should be used for promoting export industries and heavy taxes should be imposed on undesirable industries.

## Incidence, Shifting and Impact of Tax

Meaning

When a tax is imposed on some person, it may be transferred to a second person and the tax may be ultimately borne by this second person or transferred to others who ultimately bear the tax. The theory of incidence deals with the determination of the ultimate burden of a tax. Seligman says that the impact is the initial phenomenon, shifting is the intermediate process and incidence is the result.

Incidence

Incidence is the final money burden of a tax on a person who is nable to shift it iosome one else. The consumer who pays a higher price for an imported good on account of import duty and is not able to shift the burden to somebody else, bears the incidence of the tax.

Shifting

Shifting refers to the process by which tax is passed from one person to another. The producer may pass the tax burden to the wholesaler, the wholesaler to the retailer and the retailer to the consumer. The shifting of a tax is done through changes in the prices of commodities. Taxes may be shifted forward, backward and onward.

Forward shifting refers to shifting the tax to the consumers. Backward shifting refers to shifting the tax to the seller. When the tax is shifted from the seller to an intermediary buyer, who sells it to another person and so on until the tax settles on the ultimate buyer then it is called ‘onward shifting’.

Impact

The impact of a tax is borne by the person on whom the government impose the tax. For example, the impact of an excise duty is on the producer and the impact of an import duty is on the importer of the commodity. The impact of the tax denotes the act of impinching. Therefore, impact refers to the immediate burden of the tax and not the ultimate burden of the tax.

## Effects of Taxation

Taxation as essential ingredient of fiscal policy has an important influence on the general level of economic activity. Dalton rightly pointed out 'the best system of taxation from economic point of view is that which has the best or the least bad economic effects'. As pointed out by economic effects of taxation can be studied under the following heads:

1. Effects of Taxation on Production
2. Effects of Taxation on income distribution
3. Other Effects of Taxation

The most important objective of taxation is to raise required revenues to meet expenditures. Apart from raising revenue, taxes are considered as instruments of control and regulation with the aim of influencing the pattern of consumption, production and distribution. Taxes thus affect an economy in various ways, although the effects of taxes may not necessarily be good. There are some bad effects of taxes too.

**Economic effects of taxation can be studied under the following headings:**

***1. Effects of Taxation on Production:***

**Taxation can influence production and growth. Such effects on production are analysed under three heads:**

(i) effects on the ability to work, save and invest

(ii) effects on the will to work, save and invest

(iii) effects on the allocation of resources.

***2. Effects on the Ability to Work Save:***

Imposition of taxes results in the reduction of disposable income of the taxpayers. This will reduce their expenditure on necessaries which are required to be consumed for the sake of improving efficiency. As efficiency suffers ability to work declines. This ultimately adversely affects savings and investment. However, this happens in the case of poor persons.

Taxation on rich persons has the least effect on the efficiency and ability to work. Not all taxes, however, have adverse effects on the ability to work. There are some harmful goods, such as cigarettes, whose consumption has to be reduced to increase ability to work. That is why high rate of taxes are often imposed on such harmful goods to curb their consumption.

But all taxes adversely affect ability to save. Since rich people save more than the poor, progressive rate of taxation reduces savings potentiality. This means low level of investment. Lower rate of investment has a dampening effect on economic growth of a country.

Thus, on the whole, taxes have the disincentive effect on the ability to work, save and invest.

***3. Effects on the will to Work, Save and Invest:***

The effects of taxation on the willingness to work, save and invest are partly the result of money burden of tax and partly the result of psychological burden of tax.

Taxes which are temporarily imposed to meet any emergency (e.g., Kargil Tax imposed for a year or so) or taxes imposed on windfall gain (e.g., lottery income) do not produce adverse effects on the desire to work, save and invest. But if taxes are expected to continue in future, it will reduce the willingness to work and save of the taxpayers.

Taxpayers have a feeling that every tax is a burden. This psychological state of mind of the taxpayers has a disincentive effect on the willingness to work. They feel that it is not worth taking extra responsibility or putting in more hours because so much of their extra income would be taken away by the government in the form of taxes.

However, if taxpayers are desirous of maintaining their existing standard of living in the midst of payment of large taxes, they might put in extra efforts to make up for the income lost in tax.

It is suggested that effects of taxes upon the willingness to work, save and invest depends on the income elasticity of demand. Income elasticity of demand varies from individual to individual.

If the income demand of an individual taxpayer is inelastic, a cut in income consequent upon the imposition of taxes will induce him to work more and to save more so that the lost income is at least partially recovered. On the other hand, the desire to work and save of those people whose demand for income is elastic will be affected adversely.

Thus, we have conflicting views on the incentives to work. It would seem logical that there must be a disincentive effect of taxes at some point but it is not clear at what level of taxation that crucial point would be reached.

***4. Effects on the Allocation of Resources:***

By diverting resources to the desired directions, taxation can influence the volume or the size of production as well as the pattern of production in the economy. It may, in the ultimate analysis, produce some beneficial effects on production. High taxation on harmful drugs and commodities will reduce their consumption.

This will discourage production of these commodities and the scarce resources will now be diverted from their production to the other products which are useful for economic growth. Similarly, tax concessions on some products are given in a locality which is considered as backward. Thus, taxation may promote regional balanced development by allocating resources in the backward regions.

However, not necessarily such beneficial effect will always be reaped. There are some taxes which may produce some unfavourable effects on production. Taxes imposed on certain useful products may divert resources from one region to another. Such unhealthy diversion may cause reduction of consumption and production of these products.

***5. Effects of Taxation on Income Distribution:***

Taxation has both favourable and unfavourable effects on the distribution of income and wealth. Whether taxes reduce or increase income inequality depends on the nature of taxes. A steeply progressive taxation system tends to reduce income inequality since the burden of such taxes falls heavily on the richer persons.

But a regressive tax system increases the inequality of income. Further, taxes imposed heavily on luxuries and nonessential goods tend to have a favourable impact on income distribution. But taxes imposed on necessary articles may have regressive effect on income distribution.

However, we often find some conflicting role of taxes on output and distribution. A progressive system of taxation has favourable effect on income distribution but it has disincentive effects on output.

A high dose of income tax will reduce inequalities but such will produce some unfavourable effects on the ability to work, save, investment and, finally, output. Both the goals—the equitable income distribution and larger output—cannot be attained simultaneously.

*6. Other Effects of Taxation:*

If taxes produce favourable effects on the ability and the desire to work, save and invest, there will be a favourable effect on the employment situation of a country. Further, if resources collected via taxes are utilized for development projects, it will increase employment in the economy. If taxes affect the volume of savings and investment badly then recession and unemployment problem will be aggravated.

Again, effect of taxes on the price level may be favourable and unfavourable. Sometimes, taxes are imposed to curb inflation. Again, as an imposition of commodity taxes lead to rising costs of production, taxes aggravate the problem of inflation.

Thus, taxation creates both favourable and unfavourable effects on various parameters. Unfavourable effects of taxes can be wiped out by the judicious use of progressive taxation.

## Principle of debt management.

The objective of the management of public debt refers to the aim that the method of borrowing funds and the repayment of loans by the government should not have any adverse effect upon the economic situation of the country. Moreover, the methods of borrowing funds and repayments of loans should help to maintain economic stability, it should reduce inflationary effects upon the economy. Therefore, all those methods which are adopted by the government to achive these objectives, through the process of borrowing funds and repayment of loans, come under public debt management.

For instance, If a government reduce its public debt, it may cause inflationary effects. If the government repays the public debt through debt financing, the effect would be inflationary. If taxation is increased to repay the loans to banks, the effect may be deflationary.

Here, the role of public debt management would be to adopt such methods which may not cause inflationary or deflationary situation. Hence, during inflation, the government increases its debt by increasing the rate of interest and vice versa.

***Various principles of public debt management are as following:***

1. The interest cost of servicing public debts must be minimized.
2. Satisfaction of the needs of investors.
3. Funding of short term debt into long-term debt.
4. Public debt policy must be co-ordinated with and monetary policy.
5. Maturity, distribution and kinds of debt holders.

**1.** ***The interest cost of servicing public debt must be minimized***:

According to this principle, the government must be in a position to create and redeem public debts, but at a minimum interest cost. This should be an important objective of public debt management. The interest cost of servicing public debt should be kept minimum because the government has to impose additional taxes. If the interest cost is minimum, the government will have to impose smaller amount of additional taxes and vice versa.

The interest cost can be minimized, if the central bank of the country is induced to keep the interest rate low by means of its monetary operation, i.e., by means of bank rate policy, etc. therefore, a low interest debt policy, contributes to an inflationary pressure which may create economic instability, when economy is at full- employment.

**2.** ***Satisfaction of the needs of investors***:

A government may find it difficult to manage the public debts, if investor's needs are not satisfied. For instance, if government desires to fund its short term debt into a long term securities such as higher interest rates on them. In such a case the general liquidity of the public debt remains more or less the same.

But, when the public debt management does not satisfy the needs of the investors, there may be disturbance in the security markets on account of the sale of securities the bond holders may cash their securities for one purpose or the other. But if the interest of the investors is kept at a high side, the cost of public debt to the government may become high. Therefore, there are some who argue that the public debt should be reduced as it matures. But, if it is serviced out by the issue of new currency, it would create inflation, and if it is serviced out through additional taxation, it would be deflationary in its effects.

**3.** ***Funding of short term debt into long term debt*****:**

This policy would tend to raise the long term rate of interest, because the demand for long term funds will have to be increased, this will also increased, the budget expenditure in future. Simultaneously it would reduce the short term interest rates because the demand for short term funds will fall. But this undue rise in the long term interest rates may cause a decline in the rate and the volume of private investment, resulting in recession and unemployment. If however there is a need for reducing private investment, the government may fund the short term debt into long term debt.

**4.** ***Public debt policy must be coordinated with fiscal and monetary policy***:

The co-ordination of public debt policy with fiscal and monetary policy is essential to maintain economic growth. For instance if the government force the central bank to follow a low interest rate policy in order to keep the cost of interest payment on public debt low, it may create inflationary condition and may result in economic instability. Hence, such an economic instability should be avoided by a proper co-ordination between the public debt policy and monetary policy.

The public debt policy along with the fiscal and monetary policy must be operated in such a manner that all the three policies contribute to economic stability and growth.

***5. Maturity, distribution and kinds of debt houses:***

If a large proportion of the total debt is short term debt and a high proportion of the total debt is held by bank there can be a high degree of liquidity, which may contribute to an inflationary pressure at a time when an anti-inflation policy may be desirable. Thus, high liquidity of debt makes the control of inflation difficult. Also the purchase of such debt will not be quite effective as an anti-inflationary device.

It is thus, obvious from the study of these principles that it may not be possible to achieve all the objectives of the public debt management. For instance, the policy of keeping the interest rate low may contribute to an inflationary condition, which the funding of debt may cause recession and unemployment.

**Redemption of Public Debt**

Redemption means repayments of a loan. All government loans, expecting permanent investment in self-supporting industries, should be repaid promptly. In order to assure the control of debts and their orderly retirement, provision of repayment should be made when debts are issued.

**Methods of repayments**

There are several methods of repaying public debt. The following are the important methods by which the government repay its debt.

1. Repudiation:

Repudiation means refusal to pay a debt the government. This method was followed in USA after the civil war and by the USSR in 1917 which repudiation czarist debts.

Repudiation shakes the confidence people and banks in the government and hence, it may find it difficult to raise new loans in the near future. It is inequitable and discriminatory because it affects only one class of property owners, i.e; the class which purchase government securities, while it leaves other unaffected. However, this method is undesirable and it is not followed.

2. Refunding

Refunding is the processof replacing maturing securities with new securities. Refunding is undertaken mainly with a view to meeting maturity requirements. Floating debt are retired by selling new securities.

A major drawback of this method is that the government would be tempted to postpone its obligation of debt redemption and hence, the total burden of the debt would continue to increase in future.

3. Conversion

Conversion of public debt means exchange of new debts for the old ones. In this method the loan is actually not repaid, but the form of debt is changed.Conversion is a special type of refunding.

# UNIT – IV

## Fiscal Federalism

Fiscal federalism is concerned with the public finances of the various orders of government in a federal system. Federal countries differ a great deal in their choices specifically, how the division of fiscal powers is allocated among various orders and the associated fiscal arrangements.

### Principles of multi unit finance

i. Principle of financial independence and responsibility

ii. Principle of Adequacy and Elasticity

iii. Principle of Administrative Economy and Efficiency

iv. Principle of Equity

v. Principle of Integration and Coordination

vi. Principle of Accountability

vii. Principle of uniformity

viii. Principle of Fiscal Access

## Fiscal Federalism in India

India has a Federal form of Government (rather quasi-federal). Therefore, the system of indirect taxation which is followed is also federal in nature. Sales Tax can be considered as one of the most important sources of revenue for the states in India. In India, the Constitution has conferred the states with some power on Sales Tax. Through the Constitutional Amendment in 1956, states were given the authority to impose Sales Tax. The Central Sales Tax Act was enacted in 1956 under the Sixth Constitutional Amendment, which gave the Parliament the power to impose a tax on purchase or sale of goods in the course of inter-state trade and commerce.

The revenue generated from this tax was to go to the States. This was done by amending Article 269 of the Constitution. Therefore, sale within the State is regulated by the state Governments and sale outside the State is governed by the Central Government. Accordingly, the Central Sales Tax is levied on purchase or sale of goods in the course of inter-state trade and commerce. Now the important point, the power to levy this tax is with the State Governments. Also, revenue from this tax is assigned to the States.

Fiscal Federalism refers to the division of responsibilities with regards to public expenditure and taxation between the different levels of the government. Having a Fiscal Federalism mechanism allows the government to optimize their costs on economies of scale, because in this manner, people will get public service which they prefer, and there will be no unnecessary expenditure. From the economic point of view also, having a federalized structure helps as it creates a unified market.

Article 246 of the Constitution lays down the list of subjects on which different levels of government can make laws. There are three lists mentioned under Article 246. The Union can make laws relating to the subject matter given under list I. The Sates has the authority to make laws relating to subjects given under list II, and list III, also known as the Concurrent List, allows both the Union and the States to make laws, relating to subjects provided by the list.

These three lists also include taxation as a subject matter. The Union List (I) includes taxes like Customs and Excise duties, Corporation Tax, taxes on income other that agricultural income, etc. List II includes taxes like taxes on vehicles, taxes on liquors, land revenue, taxes on stamp duties, taxes on entertainment and luxuries, taxes on sale or purchase of goods, etc. (List III, or the Concurrent List does not contain any major tax as such)

The Constitution has provided provisions which enable the Union and the States to work in coordination and to levy and collect these taxes through systematic arrangements, for instance, provisions like-

- Taxes levied and collected by the Centre but assigned to the States.
- Taxes levied by the Centre but collected and kept by the States.
- Sharing of proceeds of income from some taxes.
- Grant-in-aid provided by the Centre to the States.
- Grants provided for any public purpose.

Therefore, by dividing the powers of levying and collecting tax between the Centre and the state, the Constitution has allowed the States to share the resources which are accumulated by the Centre. Any amendment of the list through which the States and the

Centre derive their power of regulating the taxation system is governed by Article 368 of the Constitution. These amendments require the consent of at least half of the State Legislatures. But if any provision of Part XIIof the Constitution is to be amended it can be done by invoking Article 368 (2) which requires the assent of only 50 % members of each House of the Parliament, and therefore, the share which the States are entitled to can be altered by the Parliament.

When administrative convenience and national policy is looked into, they require that some elastic taxes are assigned to the Central Government, but the nature of these considerations is such that these are regulated by the States.

**The five main aspects of fiscal federalism are as follows:**

***(1) Division of Functions:***

The fiscal powers and functional responsibilities in India have been divided between the Central and State government following the principles of federal finance. The division of functions is specified in the Seventh Schedule of the Constitution in three lists vis. the Union List, the State List and the Concurrent List.

The Union List contains 97 subjects of national importance, such as defence, railways, national highways, navigation, atomic energy, and posts and telegraphs. Sixty six 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. Forty seven 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

(c) Tax levied by the Centre but allocated and appropriated by states, such as exercise duties on medicinal and toilet preparations, etc.

***(3) Revenue Powers of the State:***

The State governments have been given exclusive tax powers in respect of land revenue; taxes on agricultural income; duties in respect of succession to agricultural land;

estate duty in respect of agricultural land; taxes on land and buildings; excise duties on goods containing alcoholic liquors for human consumption; opium, Indian hemp and other narcotic drugs; taxes on the entry of goods into local areas; taxes on the sale or purchase of goods other than newspapers; taxes on vehicles, tolls; taxes on professions, trades, callings and employment; capitation taxes, taxes on luxuries including taxes on entertainment, amusements, betting and gambling.

***(4) Division of Borrowing Powers:***

The borrowing powers have also been clearly mentioned in the Constitution. Under Article 292, the central government is empowered to borrow funds from within and outside the country as per the limits imposed by the Parliament. According to Article 293(3), the States can borrow funds within the Country. Article 293(2) empowers the Centre to provide loans to State subject to conditions laid down by Parliament.

***(5) Fiscal Imbalances in India:***

The Constitutional fiscal arrangement shows that fiscal imbalances were deemed inevitable as most of the powers for elastic taxes are given to the Central government. Further, the division of powers and functions itself leads to vertical federal fiscal imbalance while the differences in the endowment position of natural resources across States cause horizontal federal fiscal imbalance.

Visualising the fiscal imbalances, the Constitutional makers provided a mechanism of fiscal adjustment by way of fiscal transfers from the Central to the State Governments. This provision in the Constitution was made under Article 280 by way of setting up of a Finance Commission for every five years or earlier, if the President of India feels it necessary.

**Vertical and Horizontal imbalance**

Two types of fiscal imbalances are measured: Vertical Fiscal Imbalance and Horizontal Fiscal Imbalance. When the fiscal imbalance is measured between the two levels of government (Center and States or Provinces) it is called **Vertical Fiscal Imbalance**. When the fiscal imbalance is measured between the governments at the same level it is called **Horizontal Fiscal imbalance**. This imbalance is also known as regional disparity.

**Fiscal policy**

Fiscal policy is an effective politicized sector as the government of a country entirely regulates it. In contrast with the monetary policy, the area is wholly regulated by an independent central bank. The fiscal policy objectives describe which the government should spend their money and how they want to obtain it from taxpayers.

**Objectives of Fiscal Policy**

A government has several fiscal policy objectives in mind when making decisions. Some governments may favour an objective over the other one. Below are the five main objectives of the fiscal policy.

Economic growth– As an economy develops, its citizens become flourishing on the whole. Also, the economy's government should be careful, as a violent fiscal policy may turn destructive in the long run.

Full employment– It is the primary objective of a government to get people into work. Not only do the higher taxes benefit the governments, but also the lower expenditures on social security. Although, an expansionary policy may invest in infrastructure to create employment opportunities in future. Likewise, it may also minimize taxes to supply more money to consumers to stimulate employment indirectly from purchases.

Control debt– Operating a budget deficit is not a harm. It creates more and more debt over time. If the tax receipts and economic growth do not increase its line, a nation witnesses an unsustainable debt. Thus, a rational fiscal policy tends to control to avoid drastic action.

Redistribution– The transfer of wealth from rich to poor is another government's objective. High taxes may result in high tax receipts, but not always. Although avoidance and evasion may occur, small incremental increases may not be impactful in the short term.

Control Inflation– When an economy develops strongly, it may witness inflation depending on the monetary policy. Although inflation is a monetary phenomenon, the government still takes necessary steps to stem such a situation. Nevertheless, governments take steps by increasing taxes to minimize disposable incomes and consumption.

**Instruments of Fiscal Policy-**

There are two main fiscal policy instruments, i.e., taxation and spending.

Taxation– Governments optimize taxation as a way of capitalizing expenditures. The higher taxes are not popular with voters. Still, they want higher spending on defence, education and healthcare. It aims at encouraging investment, reducing inequality, regulating consumption, preventing domestic industries etc.

Thus, there is a complex act that maximum governing bodies don't follow. Consequently, spending more than they receive.

2. Spending– Government spending plays a vital role in shaping the overall economy. Thus, trillions of amounts are spent on wealth transfers such as social security, Medicaid, and Medicare. Even in other developed nations, social transfers and healthcare are high expenditures.

**Monetary Policy and Fiscal policy**

Fiscal policy is defined as relating to government taxes and finance. In other words, fiscal policy is anything that relates to government spending and how much it brings by taxation tools.

Likewise, the monetary policy relates to the money of a country. Thus, monetary policy has to do with a country's money supply. It defines the way policies increase and decrease their supply, and the money is created.

In simple words, fiscal policy refers to government spending and tax, whereas monetary policy refers to the creation and supply of money in an economy.

**Conclusion**

Fiscal policy is an essential element of government spending and taxation for influencing overall economic conditions, mainly the macro-economic condition. Although, the fiscal policy objectives tend to cover the total employment, economic growth, and control of inflation by taking necessary steps through governing bodies. Meanwhile, fiscal policy instruments, i.e., taxation and spending, play a vital role in funding expenditures and shaping overall economic growth. Consequently, the governments can also impact the performance of their economies by practising both monetary and fiscal policy.

For example, the government may receive pressure from the public to spend more on local schools. The governing bodies may increase taxes or borrow money to form a balancing act for fiscal policymakers.

**Compensatory Fiscal Policy**

Compensatory fiscal policy is a fiscal policy that involves the government increasing its spending to compensate for a decrease in private spending during a recession or economic slowdown. The goal is to fill the gap in demand, consumption, and investment.

English economist John Maynard Keynes first recommended compensatory fiscal policy to help counter the Great Depression.

Here are some ways the government can use compensatory fiscal policy:

**Increase spending**

The government can increase spending to compensate for a decrease in private spending.

**Decrease taxes**

The government can decrease taxes to compensate for a decrease in private spending.

The government can also use other fiscal policies to stabilize the economy, such as:

Expansionary fiscal policy: The government runs a large budget deficit during economic downturns.

Contractionary fiscal policy: The government runs a budget surplus when the economy is growing.

## Fiscal Policy for Economic Stability and Growth

Fiscal policy plays a pivotal role in the government's financial operations, focusing primarily on revenue generation through taxation. It exerts a direct impact on the financial resources available to the public. In economic terms, fiscal policy entails the government's strategic use of revenue collection and spending to shape the economic landscape. This influence becomes apparent when the government modifies taxation levels and expenditure patterns.

The primary challenge faced by governments in many developing countries lies in balancing their infrastructure and social investment needs while ensuring fiscal responsibility. This blog delves into the impact of fiscal policy on the dynamic economic landscape.

**Objectives of the Fiscal Policy**

**Resource Mobilisation for Rapid Development**

Fiscal policy aims to ensure swift economic growth and development, a goal achieved through effective resource mobilisation. In India, the central and state governments leverage fiscal policies to attain this objective.

**Mobilising Financial Resources Involves**

Taxation: By employing sound fiscal policies, the government mobilises resources via both direct and indirect taxes, making taxation the cornerstone of resource collection in India.

Public Savings: Resource accrual is facilitated through public savings, achieved by curbing government expenditure and bolstering surpluses in the public sector.

Private Savings: Through judicious fiscal measures, such as tax incentives, the government can raise resources from the private sector and households. Moreover, resources can be mobilised via government borrowings, encompassing treasury bills, the issuance of government bonds, loans from domestic and foreign entities, and deficit financing.

**Equity and Income Equality**

Fiscal policy is harnessed to foster equity and social justice by narrowing income disparities among distinct societal segments. Direct taxes, particularly income tax, impose higher burdens on the affluent in contrast to lower-income groups. Similarly, indirect taxes exact greater tolls on semi-luxury and luxury items, predominantly consumed by the upper middle class and the wealthy. The government dedicates a significant portion of its tax revenue to implementing Poverty Alleviation Programmes aimed at enhancing the circumstances of underprivileged individuals.

**Stabilising Prices and Taming Inflation**

One of the fiscal policy's core imperatives is inflation control and price stabilisation. Consequently, the government diligently endeavours to curtail inflation by reducing fiscal deficits, introducing tax-saving initiatives and ensuring the judicious utilisation of financial resources.

**Promoting Employment**

Governmental efforts to augment employment opportunities entail multifaceted fiscal measures. Infrastructure investments translate into both direct and indirect job creation. Subdued taxes and duties on small-scale industrial (SSI) units stimulate increased investment, ultimately generating more employment. Assorted rural employment initiatives, under the aegis of the Government of India, target rural challenges. Similarly, self-employment schemes are launched to provide opportunities for technically qualified individuals in urban locales.

**Balanced Regional Development**

Various government-backed projects, spanning dam construction, electrification, school establishments, road development, and industrial ventures, address regional imbalances. Public expenditure becomes the linchpin for mitigating regional disparities.

**Balancing the Balance of Payments**

Government initiatives include providing export incentives to boost outbound trade and implementing import curbs to control inbound trade. The amalgamated impact of these measures enhances the nation's balance of payments.

### Augmenting National Income

Fiscal policy yields considerable influence in achieving the desired economic outcomes. For instance, when the government seeks to augment the country's income, it may adjust tax rates, either increasing them to raise revenue or reducing them to incentivise greater tax compliance.

### Infrastructure Development

Government investments in projects like railways, schools, dams, electrification, roads, and more bolster citizens' welfare while enhancing the nation's infrastructure. Improved infrastructure plays a pivotal role in accelerating economic growth.

### Boosting Foreign Exchange Earnings

Through incentives such as customs duty exemptions and excise duty concessions, the central government stimulates foreign investors to expand their investments within the country. This strategy bolsters foreign exchange earnings and encourages economic growth.

An expansionary economic policy stance hinges on an in-depth understanding of the implementation context and the measurement of their consequences. This process entails meticulous scrutiny of various alternatives, grounded in available data. This calls for policymakers with a diverse skill set, crucial for the effective delivery of policies to their designated beneficiaries.

### Effectiveness of Fiscal policy

Fiscal policy in India is a key tool for economic management and development, and it can be effective in achieving a range of economic goals:

### Economic growth

Fiscal policy can stimulate economic growth by increasing public spending and investments in key sectors. For example, the government can invest in infrastructure projects like roads, schools, and dams to improve citizens' welfare and accelerate economic growth.

**Price stability**

Fiscal policy can help maintain price stability by regulating demand and controlling inflation.

**Social and Developmental goals**

Fiscal policy can address social and developmental goals by allocating resources to education, healthcare, and infrastructure.

**Fiscal deficits**

Fiscal policy can help curb fiscal deficits and ensure long-term sustainability.

**Taxation**

The government can adjust tax rates to increase revenue or reduce tax compliance. Reducing taxes can leave individuals and businesses with more income to spend and invest, which can boost economic growth. Increasing taxes can help cool down an overheated economy.

**Disinvestment**

The government can sell or liquidate its assets to reduce fiscal burden.

The effectiveness of fiscal policy can depend on a number of factors, including the slope of the LM curve, the exchange rate regime, and the sensitivity of money demand to interest rates.

**Fiscal Federalism**

Fiscal federalism is the study of how financial powers and responsibilities are divided between different levels of government. It's a subfield of public economics that's concerned with how to best allocate competencies and fiscal instruments across different levels of government.

## Finance Commission

The Finance Commission is constituted by the President under article 280 of the Constitution, mainly to give its recommendations on distribution of tax revenues between the Union and the States and amongst the States themselves.

As a federal state, India suffers from both vertical and horizontal fiscal imbalances. Vertical imbalances between the central and state governments result from states incurring expenditures disproportionate to their sources of revenue, in the process of fulfilling their responsibilities. However, states are better able to gauge the needs and concerns of their inhabitants and therefore more efficient at addressing them. Horizontal imbalances among state governments result from differing historical backgrounds or resource endowments, and can widen over time.

The Finance Commission was established in 1951 by Dr. B.R. Ambedkar, the then-incumbent Law Minister, to address these imbalances. Several provisions to bridge the fiscal gap between the Centre and the States were already enshrined in the Constitution of India, including Article 268, which facilitates levy of duties by the Centre but equips the States to collect and retain the same. Similarly, Articles 269, 270, 275, 282 and 293, among others, specify ways and means of sharing resources between the Union and States. In addition to the above provisions, the Finance Commission serves as an institutional framework to facilitate Centre-State Transfers.

Article 280 of the Indian Constitution defines the scope of the Commission:

1. The President will constitute a Finance Commission within two years from the commencement of the Constitution and thereafter at the end of every fifth year or

earlier, as the deemed necessary by him/her, which shall include a chairman and four other members.

2. Parliament may by law determine the requisite qualifications for appointment as members of the Commission and the procedure of selection.
3. The Commission is constituted to make recommendations to the president about the distribution of the net proceeds of taxes between the Union and States and also the allocation of the same amongst the States themselves. It is also under the ambit of the Finance Commission to define the financial relations between the Union and the States. They also deal with devolution of non-plan revenue resources.

## Functions

1. Distribution of net proceeds of taxes between Centre and the States, to be divided as per their respective contributions to the taxes.
2. Determine factors governing Grants-in Aid to the states and the magnitude of the same.
3. To make recommendations to president as to the measures needed to augment the Fund of a State to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.
4. any other matter related to it by the president in the interest of sound finance
5. finance commission is autonomous body which is governed by the government of India

## List of Finance Commissions

| Finance Commission | Year of Establishment | Chairman | Operational Duration |
|---|---|---|---|

| | | | |
|---|---|---|---|
| First | 1951 | K. C. Neogy | 1952–57 |
| Second | 1956 | K. Santhanam | 1957–62 |
| Third | 1960 | A. K. Chanda | 1962–66 |
| Fourth | 1964 | P. V. Rajamannar | 1966–69 |
| Fifth | 1968 | MahaveerTyagi | 1969–74 |
| Sixth | 1972 | K. Brahmananda Reddy | 1974–79 |
| Seventh | 1977 | J. M. Shelat | 1979–84 |
| Eighth | 1983 | Y. B. Chavan | 1984–89 |
| Ninth | 1987 | N. K. P. Salve | 1989–95 |
| Tenth | 1992 | K. C. Pant | 1995–2000 |
| Eleventh | 1998 | A. M. Khusro | 2000–2005 |
| Twelfth | 2002 | C. Rangarajan | 2005–2010 |
| Thirteenth | 2007 | Dr. Vijay L. Kelkar | 2010–2015 |
| Fourteenth | 2013 | Dr. Y. V Reddy | 2015–2020 |
| Fifteenth | 2017 | N. K. Singh | 2020–2025 |

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

1. The share of states in the net proceeds of the shareable Central taxes should be 42%. This is 10 percentage points higher than the recommendation of 13th Finance Commission.
2. Revenue deficit to be progressively reduced and eliminated.
3. Fiscal deficit to be reduced to 3% of the GDP by 2017–18.
4. A target of 62% of GDP for the combined debt of centre and states.
5. The Medium Term Fiscal Plan(MTFP) should be reformed and made the statement of commitment rather than a statement of intent.

6. FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.
7. Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act(GST).
8. Initiatives to reduce the number of Central Sponsored Schemes(CSS) and to restore the predominance of formula based plan grants.
9. States need to address the problem of losses in the power sector in time bound manner.

**Fourteen Finance Commission**

The 14th FFC was constituted on January 2, 2013 and its term continued from April 1, 2015, to March 31, 2020. The commission's chairman was former Reserve Bank of India governor Y. V. Reddy.

**The 14th Finance Commission (FFC) of India made several recommendations, including:**

Grants to local bodies

The FFC recommended grants to local bodies to support the delivery of basic services. The grants were divided into two parts: a basic grant and a performance grant. The ratio of basic to performance grant was 90:10 for Gram Panchayats and 80:20 for Municipalities.

Revenue deficit grants

The FFC provided revenue deficit grants to states with high revenue deficits to help them meet their basic expenditure needs.

Increased transfer to states

The FFC increased the amount that the Centre has to transfer to the states from the divisible pool of taxes by 10 percentage points, from 32 per cent to 42 per cent.

Incentivization for states

The FFC recommended incentivizing states that adhere to fiscal discipline to encourage them to maintain a healthy fiscal position.

Greater autonomy for states

The FFC emphasized greater autonomy and flexibility for states in designing and implementing their schemes and programs.

Transparent criteria for relief allocation

The FFC recommended that inter-state allocation of relief should be based on a transparent criteria.

Include lightning and snake-bite in natural calamities

The FFC recommended that lightning and snake-bite should be included in the list of natural calamities.

**Fifteen Finance Commission**

Constitution of Fifteenth Finance Commission

The Government of India, with the approval Hon'ble President of India, has constituted Fifteenth Finance Commission in pursuance of clause (1) of article 280 of the Constitution, read with the provisions of the Finance Commission (Miscellaneous Provisions) Act, 1951 w.e.f. 27th November, 2017. The Commission will make recommendations for the five years commencing on April 1, 2020.

2. This Commission will be headed by Shri. N.K.Singh, former Member of Parliament and former Secretary to the Government of India. Shri Shaktikanta Das, former Secretary to the Government of India and Dr.Anoop Singh, Adjunct Professor, Georgetown University shall be the members of the Commission. Dr. Ashok Lahiri, Chairman (Non-executive, part time), Bandhan Bank and Dr. Ramesh Chand, Member, NITI Aayog shall

be the Part time members of the Commission. Shri Arvind Mehta shall be the Secretary to the Commission.

The Finance Commission is a constitutional body formed by the President of India to give suggestions on centre-state financial relations. The 15th Finance Commission (Chair: Mr. N. K. Singh) was required to submit two reports. The first report, consisting of recommendations for the financial year 2020-21, was tabled in Parliament in February 2020. The final report with recommendations for the 2021-26 period was tabled in Parliament on February 1, 2021. Key recommendations in the report for 2021-26 include:

Share of states in central taxes

The share of states in the central taxes for the 2021-26 period is recommended to be 41%, same as that for 2020-21. This is less than the 42% share recommended by the 14th Finance Commission for 2015-20 period. The adjustment of 1% is to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the centre.

Criteria for devolution

Commission to determine each state’s share in central taxes, and the weight assigned to each criterion. The criteria for distribution of central taxes among states for 2021-26 period is same as that for 2020-21. However, the reference period for computing income distance and tax efforts are different (2015-18 for 2020-21 and 2016-19 for 2021-26), hence, the individual share of states may still change.

## Planning Commission

The Planning Commission was set up by a Resolution of the Government of India in March 1950 in pursuance of declared objectives of the Government to promote a rapid rise in the standard of living of the people by efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community. The Planning Commission was charged with the responsibility of making assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilisation of resources and determining priorities. Jawaharlal Nehru was the first Chairman of the Planning Commission.

The first Five-year Plan was launched in 1951 and two subsequent five-year plans were formulated till 1965, when there was a break because of the Indo-Pakistan Conflict. Two successive years of drought, devaluation of the currency, a general rise in prices and erosion of resources disrupted the planning process and after three Annual Plans between 1966 and 1969, the fourth Five-year plan was started in 1969.

The Eighth Plan could not take off in 1990 due to the fast changing political situation at the Centre and the years 1990-91 and 1991-92 were treated as Annual Plans. The Eighth Plan was finally launched in 1992 after the initiation of structural adjustment policies.

For the first eight Plans the emphasis was on a growing public sector with massive investments in basic and heavy industries, but since the launch of the Ninth Plan in 1997, the emphasis on the public sector has become less pronounced and the current thinking on planning in the country, in general, is that it should increasingly be of an indicative nature.

**Organisation**

The Prime Minister is the Chairman of the Planning Commission, which works under the overall guidance of the National Development Council. The Deputy Chairman and the full time Members of the Commission, as a composite body, provide advice and guidance to the subject Divisions for the formulation of Five Year Plans, Annual Plans, State Plans, Monitoring Plan Programmes, Projects and Schemes.

**Functions**

The 1950 resolution setting up the Planning Commission outlined its functions as to:

a. Make an assessment of the material, capital and human resources of the country, including technical personnel, and investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation’s requirement;
b. Formulate a Plan for the most effective and balanced utilisation of country's resources;
c. On a determination of priorities, define the stages in which the Plan should be carried out and propose the allocation of resources for the due completion of each stage;
d. Indicate the factors which are tending to retard economic development, and determine the conditions which, in view of the current social and political situation, should be established for the successful execution of the Plan;
e. Determine the nature of the machinery which will be necessary for securing the successful implementation of each stage of the Plan in all its aspects;
f. Appraise from time to time the progress achieved in the execution of each stage of the Plan and recommend the adjustments of policy and measures that such appraisal may show to be necessary; and
g. Make such interim or ancillary recommendations as appear to it to be appropriate either for facilitating the discharge of the duties assigned to it, or on a consideration of prevailing economic conditions, current policies, measures and development programmes or on an examination of such specific problems as may be referred to it for advice by Central or State Governments.

**Evolving Functions**

From a highly centralised planning system, the Indian economy is gradually moving towards indicative planning where Planning Commission concerns itself with the building of a long term strategic vision of the future and decide on priorities of nation. It works out Sectoral targets and provides promotional stimulus to the economy to grow in the desired direction.

Planning Commission plays an integrative role in the development of a holistic approach to the policy formulation in critical areas of human and economic development. In the social sector, schemes which require coordination and synthesis like rural health, drinking water, rural energy needs, literacy and environment protection have yet to be subjected to coordinated policy formulation. It has led to multiplicity of agencies. An integrated approach can lead to better results at much lower costs.

The emphasis of the Commission is on maximising the output by using our limited resources optimally. Instead of looking for mere increase in the plan outlays, the effort is to look for increases in the efficiency of utilisation of the allocations being made.

With the emergence of severe constraints on available budgetary resources, the resource allocation system between the States and Ministries of the Central Government is under strain. This requires the Planning Commission to play a mediatory and facilitating role, keeping in view the best interest of all concerned. It has to ensure smooth management of the change and help in creating a culture of high productivity and efficiency in the Government.

The key to efficient utilisation of resources lies in the creation of appropriate self-managed organisations at all levels. In this area, Planning Commission attempts to play a systems change role and provide consultancy within the Government for developing better systems. In order to spread the gains of experience more widely, Planning Commission also plays an information dissemination role.

**First Plan (1951–1956)**

The first Indian Prime Minister, Jawaharlal Nehru presented the First Five-Year Plan to the Parliament of India and needed urgent attention. The First Five-year Plan was launched in 1951 which mainly focused in development of the primary sector. The First Five-Year Plan was based on the Harrod–Domar model with few modifications.

The total planned budget of Rs.2069 crore(2378 crore later) was allocated to seven broad areas: irrigation and energy (27.2%), agriculture and community development (17.4%), transport and communications (24%), industry (8.4%), social services (16.64%), rehabilitation of landless farmers (4.1%), and for other sectors and services (2.5%). The most important feature of this phase was active role of state in all economic sectors. Such a role was justified at that time because immediately after independence, India was facing basic problems—deficiency of capital and low capacity to save.

The target growth rate was 2.1% annual gross domestic product (GDP) growth; the achieved growth rate was 3.6% the net domestic product went up by 15%. The monsoon was good and there were relatively high crop yields, boosting exchange reserves and the per capita income, which increased by 8%. National income increased more than the per capita income due to rapid population growth. Many irrigation projects were initiated during this period, including the Bhakra, Hirakud, Mettur Dam and Damodar Valley dams. The World Health Organization (WHO), with the Indian government, addressed children's health and reduced infant mortality, indirectly contributing to population growth.

At the end of the plan period in 1956, five Indian Institutes of Technology (IITs) were started as major technical institutions. The University Grants Commission (UGC) was set up to take care of funding and take measures to strengthen the higher education in the country. Contracts were signed to start five steel plants, which came into existence in the middle of the Second Five-Year Plan. The plan was quasi successful for the government.

**Second Plan (1956–1961)**

The Second Plan was particularly in the development of the public sector and "rapid Industrialisation". The plan followed the Mahalanobis model, an economic development model developed by the Indian statisticianPrasanta Chandra Mahalanobis in 1953. The plan attempted to determine the optimal allocation of investment between productive sectors in order to maximise long-run economic growth. It used the prevalent state of art techniques of operations research and optimization as well as the novel applications of statistical models developed at the Indian Statistical Institute. The plan assumed a closed economy in which the main trading activity would be centred on importing capital goods.

Hydroelectric power projects and five steel plants at Bhilai, Durgapur, and Rourkela were established with the help of Russia, Britain (the U.K) and West Germany respectively. Coal production was increased. More railway lines were added in the north east.

The Tata Institute of Fundamental Research and Atomic Energy Commission of India was established as research institutes. In 1957 a talent search and scholarship program was begun to find talented young students to train for work in nuclear power.

The total amount allocated under the Second Five-Year Plan in India was Rs.48 billion. This amount was allocated among various sectors: power and irrigation, social services, communications and transport, and miscellaneous."The target growth rate was 4.5% and the actual growth rate was 4.27%.

**Third Plan (1961–1966)**

The Third Five-year Plan, stressed agriculture and improvement in the production of wheat, but the brief Sino-Indian War of 1962 exposed weaknesses in the economy and shifted the focus towards the defence industry and the Indian Army. In 1965–1966, India fought a War with Pakistan. There was also a severe drought in 1965. The war led to inflation and the priority was shifted to price stabilisation. The construction of dams continued. Many cement and fertilizer plants were also built. Punjab began producing an abundance of wheat.

Many primary schools were started in rural areas. In an effort to bring democracy to the grass-root level, Panchayat elections were started and the states were given more development responsibilities.

State electricity boards and state secondary education boards were formed. States were made responsible for secondary and higher education. State road transportation corporations were formed and local road building became a state responsibility.

The target growth rate was 5.6%, but the actual growth rate was 2.4%.

Due to miserable failure of the Third Plan the government was forced to declare "plan holidays" (from 1966–67, 1967–68, and 1968–69). Three annual plans were drawn during this intervening period. During 1966–67 there was again the problem of drought. Equal priority was given to agriculture, its allied activities, and industrial sector. The government of India declared "Devaluation of Rupee" to increase the exports of the country. The main reasons for plan holidays were the war, lack of resources, and increase in inflation after that plan holiday was created.

**Fourth Plan (1969–1974)**

At this time Indira Gandhi was the Prime Minister. The Indira Gandhi government nationalised 14 major Indian banks and the Green Revolution in India advanced agriculture. In addition, the situation in East Pakistan (now Bangladesh) was becoming dire as the Indo-Pakistan War of 1971 and Bangladesh Liberation War took funds earmarked for industrial development. India also performed the Smiling Buddhaunderground nuclear test (Pokhran-1) in Rajasthan on May 18, 1974, partially in response to the United States deployment of the Seventh Fleet in the Bay of Bengal. The fleet had been deployed to warn India against attacking West Pakistan and extending the war.

The target growth rate was 5.6%, but the actual growth rate was 3.3%.

**Fifth Plan (1974–1978)**

The Fifth Five-Year Plan laid stress on employment, poverty alleviation (GaribiHatao), and justice. The plan also focused on self-reliance in agricultural production and defence. In 1978 the newly elected Morarji Desai government rejected the plan. The Electricity Supply Act was amended in 1975, which enabled the central government to enter into power generation and transmission.

The Indian national highway system was introduced and many roads were widened to accommodate the increasing traffic. Tourism also expanded. The twenty-point programme was launched in 1975. It was followed from 1974 to 1979.

The Minimum Needs Programme (MNP) was introduced in the first year of the Fifth Five Year Plan (1974–78). The objective of the programme is to provide certain basic minimum needs and thereby improve the living standards of the people. The target growth rate was 4.4% and the actual growth rate was 4.8%.

**Rolling Plan (1978–1980)**

The Janata Party government rejected the Fifth Five-Year Plan and introduced a new Sixth Five-Year Plan (1978–1980). This plan was again rejected by the Indian National Congress government in 1980 and a new Sixth Plan was made. The Rolling Plan consists of three kind of plans that were proposed. The First Plan is for the present year which comprises the annual budget and Second is a plan for a fixed number of years, which may be 3, 4 or 5 years. Plan number two is kept changing as per the requirements of the Indian economy. The Third Plan is a perspective plan which is for long terms i.e. for 10, 15 or 20 years. Hence there is no fixation of dates in for the commencement and termination of the plan in the rolling plans. The main advantage of the rolling plans is that they are flexible and are able to overcome the rigidity of fixed five year plans by mending targets, the object of the exercise, projections and allocations as per the changing conditions in the country's economy. The main disadvantage of this plan is that if the targets are revised each year, it becomes very difficult to achieve them which are laid down in the five-year period and it turned out to be a complex plan. Frequent revisions resulted in lack of stability in the economy which is essential for its balanced development and progress.

**Sixth Plan (1980–1985)**

The Sixth Five-Year Plan marked the beginning of economic liberalisation. Price controls were eliminated and ration shops were closed. This led to an increase in food prices and an increase in the cost of living. This was the end of Nehruvian socialism. The National Bank for Agriculture and Rural Development was established for development of rural areas on 12 July 1982 by recommendation of the Shivaraman Committee. Family planning was also expanded in order to prevent overpopulation. In contrast to China's strict and binding one-child policy, Indian policy did not rely on the threat of force. More prosperous areas of India adopted family planning more rapidly than less prosperous areas, which continued to have a high birth rate.

The Sixth Five-Year Plan was a great success to the Indian economy. The target growth rate was 5.2% and the actual growth rate was 5.7%.

**Seventh Plan (1985–1990)**

The Seventh Five-Year Plan was led by the Congress Party with Rajiv Gandhi as the prime minister. The plan laid stress on improving the productivity level of industries by upgrading of technology.

The main objectives of the Seventh Five-Year Plan were to establish growth in areas of increasing economic productivity, production of food grains, and generating employment through "Social Justice".

As an outcome of the Sixth Five-Year Plan, there had been steady growth in agriculture, controls on the rate of inflation, and favourable balance of payments which had provided a strong base for the Seventh Five-Year Plan to build on the need for further economic growth. The Seventh Plan had strived towards socialism and energy production at large. The thrust areas of the Seventh Five-Year Plan were: social justice, removal of oppression of the weak, using modern technology, agricultural development, anti-poverty programmes, full supply of food, clothing, and shelter, increasing productivity of small- and large-scale farmers, and making India an independent economy.

Based on a 15-year period of striving towards steady growth, the Seventh Plan was focused on achieving the prerequisites of self-sustaining growth by the year 2000. The plan expected the labour force to grow by 39 million people and employment was expected to grow at the rate of 4% per year.

Some of the expected outcomes of the Seventh Five-Year Plan India are given below:

- Balance of payments (estimates): Export – ₹330 billion (US$5.1 billion), Imports – (-)₹540 billion (US$8.4 billion), Trade Balance – (-)₹210 billion (US$3.3 billion)
- Merchandise exports (estimates): ₹606.53 billion (US$9.5 billion)
- Merchandise imports (estimates): ₹954.37 billion (US$14.9 billion)

- Projections for balance of payments: Export – ₹607 billion (US$9.5 billion), Imports – (-) ₹954 billion (US$14.9 billion), Trade Balance- (-) ₹347 billion (US$5.4 billion)

Under the Seventh Five-Year Plan, India strove to bring about a self-sustained economy in the country with valuable contributions from voluntary agencies and the general populace.

The target growth rate was 5.0% and the actual growth rate was 6.01% and the growth rate of per capita income was 3.7%.

**Annual Plans (1990–1992)**

**Eighth Plan (1992–1997)**

In 1989–91 was a period of economic instability in India and hence no five-year plan was implemented. Between 1990 and 1992, there were only Annual Plans. In 1991, India faced a crisis in foreign exchange (forex) reserves, left with reserves of only about US$1 billion. Thus, under pressure, the country took the risk of reforming the socialist economy. P.V. Narasimha Rao was the tenth Prime Minister of the Republic of India and head of Congress Party, and led one of the most important administrations in India's modern history, overseeing a major economic transformation and several incidents affecting national security. At that time Dr.Manmohan Singh (later Prime Minister of India) launched India's free market reforms that brought the nearly bankrupt nation back from the edge. It was the beginning of liberalization, privatisation and globalization (LPG) in India.

Modernization of industries was a major highlight of the Eighth Plan. Under this plan, the gradual opening of the Indian economy was undertaken to correct the burgeoning deficit and foreign debt. Meanwhile, India became a member of the World Trade Organization on 1 January 1995. The major objectives included, controlling population growth, poverty reduction, employment generation, strengthening the infrastructure, institutional building, tourism management, human resource development, involvement of Panchayati Raj, Nagar Palikas, NGOs, decentralisation and people's participation.

Energy was given priority with 26.6% of the outlay.The target growth rate was 5.6% and the actual growth rate was 6.8%.

To achieve the target of an average of 5.6% per annum, investment of 23.2% of the gross domestic product was required. The incremental capital ratio is 4.1. The saving for investment was to come from domestic sources and foreign sources, with the rate of domestic saving at 21.6% of gross domestic production and of foreign saving at 1.6% of gross domestic production.

**Ninth Plan (1997–2002)**

The Ninth Five-Year Plan came after 50 years of Indian Independence. Atal Bihari Vajpayee was the Prime Minister of India during the Ninth Five-Year Plan. The Ninth Five-Year Plan tried primarily to use the latent and unexplored economic potential of the country to promote economic and social growth. It offered strong support to the social spheres of the country in an effort to achieve the complete elimination of poverty. The satisfactory implementation of the Eighth Five-Year Plan also ensured the states' ability to proceed on the path of faster development. The Ninth Five-Year Plan also saw joint efforts from the public and the private sectors in ensuring economic development of the country. In addition, the Ninth Five-Year Plan saw contributions towards development from the general public as well as governmental agencies in both the rural and urban areas of the country. New implementation measures in the form of Special Action Plans (SAPs) were evolved during the Ninth Five-Year Plan to fulfill targets within the stipulated time with adequate resources. The SAPs covered the areas of social infrastructure, agriculture, information technology and Water policy.

**Budget**

The Ninth Five-Year Plan had a total public sector plan outlay of ₹859,200 crore (US$130 billion). The Ninth Five-Year Plan also saw a hike of 48% in terms of plan expenditure and 33% in terms of the plan outlay in comparison to that of the Eighth Five-Year Plan. In the total outlay, the share of the center was approximately 57% while it was 43% for the states and the union territories.

The Ninth Five-Year Plan focused on the relationship between the rapid economic growth and the quality of life for the people of the country. The prime focus of this plan was to increase growth in the country with an emphasis on social justice and equity. The Ninth Five-Year Plan placed considerable importance on combining growth oriented policies with the mission of achieving the desired objective of improving policies which would work towards the improvement of the poor in the country. The Ninth Five-Year Plan also aimed at correcting the historical inequalities which were still prevalent in the society.

**Objectives**

The main objective of the Ninth Five-Year Plan was to correct historical inequalities and increase the economic growth in the country. Other aspects which constituted the Ninth Five-Year Plan were:

- Population control
- Generating employment by giving priority to agriculture and rural development
- Reduction of poverty
- Ensuring proper availability of food and water for the poor
- Availability of primary health care facilities and other basic necessities
- Primary education to all children in the country

- Empowering the socially disadvantaged classes like Scheduled castes, Scheduled tribes and other backward classes
- Developing self-reliance in terms of agriculture
- Acceleration in the growth rate of the economy with the help of stable prices

**Strategies**

- Structural transformations and developments in the Indian economy.
- New initiatives and initiation of corrective steps to meet the challenges in the economy of the country.
- Efficient use of scarce resources to ensure rapid growth.
- Combination of public and private support to increase employment.
- Enhancing high rates of export to achieve self-reliance.
- Providing services like electricity, telecommunication, railways etc.
- Special plans to empower the socially disadvantaged classes of the country.
- Involvement and participation of Panchayati Raj institutions/bodies and Nagar Palikas in the development process.

**Performance**

- The Ninth Five-Year Plan achieved a GDP growth rate of 5.4% against a target of 6.5%
- The agriculture industry grew at a rate of 2.1% against the target of 4.2%
- The industrial growth in the country was 4.5% which was higher than that of the target of 3%
- The service industry had a growth rate of 7.8%.
- An average annual growth rate of 6.7% was reached.

The Ninth Five-Year Plan looks through the past weaknesses in order to frame the new measures for the overall socio-economic development of the country. However, for a well-planned economy of any country, there should be a combined participation of the governmental agencies along with the general population of that nation. A combined effort of public, private, and all levels of government is essential for ensuring the growth of India's economy.

The target growth was 7.1% and the actual growth was 6.8%.

**Tenth Plan (2002–2007)**

The main objectives of the Tenth Five-Year Plan were:

- Attain 8% GDP growth per year
- Reduction of poverty rate by 5% by 2007
- Providing gainful and high-quality employment at least to the addition to the labor force
- Reduction in gender gaps in literacy and wage rates by at least 50% by 2007
- 20-point program was introduced
- Target growth: 8.1% – growth achieved: 7.7%
- The tenth plan was expected to follow a regional approach rather than sectoral approach to bring down regional inequalities
- Expenditure of ₹43,825 crore (US$6.8 billion) for tenth five years

Out of total plan outlay, ₹921,291 crore (US$140 billion) (57.9%) was for central government and ₹691,009 crore (US$110 billion) (42.1%) was for states and union territories.

**Eleventh Plan (2007–2012)**

- It aimed to increase the enrollment in higher education of 18-23 years of age group by 2011-12.
- It focused on distant education, convergence of formal, non-formal, distant and I.T. education institutions.

- Rapid and inclusive growth. (poverty reduction)
- Emphasis on social sector and delivery of service therein.
- Empowerment through education and skill development.
- Reduction of gender inequality.
- Environmental sustainability.
- To increase the growth rate in agriculture, industry and services to 4%, 10% and 9% respectively.
- Reduce total fertility rate to 2.1.
- Provide clean drinking water for all by 2009.
- Increase agriculture growth to 4%.

**Twelfth Plan (2012–2017)**

The Twelfth Five-Year Plan of the Government of India has been decided to achieve a growth rate of 8.2% but the National Development Council (NDC) on 27 December 2012 approved a growth rate of 8% for the Twelfth Five-Year Plan.

With the deteriorating global situation, the Deputy Chairman of the Planning Commission Montek Singh Ahluwalia has said that achieving an average growth rate of 9 percent in the next five years is not possible. The Final growth target has been set at 8% by the endorsement of the plan at the National Development Council meeting held in New Delhi.

"It is not possible to think of an average of 9% [in the 12th plan]. I think somewhere between 8 and 8.5 percent is feasible," Ahluwalia said on the sidelines of a conference of State Planning Boards and departments. The approached paper for the 12th Plan, approved last year, talked about an annual average growth rate of 9%.

"When I say feasible... that will require major effort. If you don't do that, there is no God given right to grow at 8 percent. I think given that the world economy deteriorated very sharply over the last year...the growth rate in the first year of the 12th Plan (2012–13) is 6.5 to 7 percent.”

He also indicated that soon he should share his views with other members of the Commission to choose a final number (economic growth target) to put before the country’s NDC for its approval.

The government intends to reduce poverty by 10% during the 12th Five-Year Plan. Ahluwalia said, “We aim to reduce poverty estimates by 9% annually on a sustainable basis during the Plan period". Earlier, addressing a conference of State Planning Boards and Planning departments, he said the rate of decline in poverty doubled during the 11th Plan. The commission had said, while using the Tendulkar poverty line, the rate of reduction in the five years between 2004–05 and 2009–10, was about 1.5%points each year, which was twice that when compared to the period between 1993–95 to 2004–05. The plan aims towards the betterment of the infrastructural projects of the nation avoiding all types of bottlenecks. The document presented by the planning commission is aimed to attract private investments of up to US$1 trillion in the infrastructural growth in the 12th five-year plan, which will also ensure a reduction in the subsidy burden of the government to 1.5 percent from 2 percent of the GDP (gross domestic product). The UID (Unique Identification Number) will act as a platform for cash transfer of the subsidies in the plan.

## NITI Aayog

The National Institution for Transforming India, also called NITI Aayog, was formed via a resolution of the Union Cabinet on January 1, 2015. The Chairperson of NITI Aayog is the Prime Minister; Shri. NarandraModi and the vice Chairperson is Dr. Rajiv Kumar. NITI Aayog is the premier policy ‘Think Tank’ of the Government of India, providing both directional and policy inputs. While designing strategic and long term policies and programmes for the Government of India, NITI Aayog also provides relevant technical advice to the Centre and States.

The Government of India, in keeping with its reform agenda, constituted the NITI Aayog to replace the Planning Commission instituted in 1950. This was done in order to better serve the needs and aspirations of the people of India. An important evolutionary change from the past, NITI Aayog acts as the quintessential platform of the Government of India to bring States to act together in national interest, and thereby fosters Cooperative Federalism.

At the core of NITI Aayog's creation are two hubs – **Team India Hub** and the **Knowledge and Innovation Hub**. The Team India Hub leads the engagement of states with the Central government, while the Knowledge and Innovation Hub builds NITI's think-tank capabilities. These hubs reflect the two key tasks of the Aayog.

NITI Aayog is also developing itself as a State of the Art Resource Centre, with the necessary resources, knowledge and skills, that will enable it to act with speed, promote research and innovation, provide strategic policy vision for the government, and deal with contingent issues.

## Functions of NITI AAYOG

**1**. NITI Aayog (National Institution for Transforming India):

- To evolve a shared vision of national development priorities sectors and strategies with the active involvement of States in the light of national objectives
- To foster cooperative federalism through structured support initiatives and mechanisms with the States on a continuous basis, recognizing that strong States make a strong nation
- To develop mechanisms to formulate credible plans at the village level and aggregate these progressively at higher levels of government

- To ensure, on areas that are specifically referred to it, that the interests of national security are incorporated in economic strategy and policy
- To pay special attention to the sections of our society that may be at risk of not benefiting adequately from economic progress
- To design strategic and long term policy and programme frameworks and initiatives, and monitor their progress and their efficacy. The lessons learnt through monitoring and feedback will be used for making innovative improvements, including necessary mid-course corrections
- To provide advice and encourage partnerships between key stakeholders and national and international like-minded Think tanks, as well as educational and policy research institutions.
- To create a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and other partners.
- To offer a platform for resolution of inter-sectoral and inter departmental issues in order to accelerate the implementation of the development agenda.
- To maintain a state-of-the-art Resource Centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their dissemination to stake-holders
- To actively monitor and evaluate the implementation of programmes and initiatives, including the identification of the needed resources so as to strengthen the probability of success and scope of delivery
- To focus on technology up gradation and capacity building for implementation of programmes and initiatives

- To undertake other activities as may be necessary in order to further the execution of the national development agenda, and the objectives mentioned above

# UNIT – V

# Financial Administration

## Financial Autonomy in India

Financial autonomy in India is a complex issue that affects various entities, including regulatory authorities, the judiciary, and states:

### Regulatory authorities

The legal framework for financing regulators includes parent statutes, which provide a broad framework for how regulators can source funds, what they can spend on, and how they are audited. The General Financial Rules, 2017 also apply to autonomous and statutory authorities.

### Judiciary

The judiciary has financial autonomy and is free from interference from the executive or legislature. However, the executive must approve rules governing the condition of service of judicial officers, such as salaries, leave, or pension.

### States

States in India have seen a decline in their ability to finance current expenditures from their own revenues. In 1955-56, states were able to finance about 69% of their current expenditures from their own revenues, but this decreased to less than 38% in 2019-20.

### Urban local bodies

Urban local bodies also need financial autonomy.

## Recent Taxation Committee Reports

### Kelkar Committee Tax structure

The Kelkar Committee refers to a group headed by Vijay Kelkar, which was established by the Indian government to provide recommendations for improving the country's tax system. The committee played a significant role in shaping India's modern tax policy.

### Key Recommendations of the Kelkar Committee

**Simplification of Tax Laws:**

Simplify direct and indirect tax laws to improve compliance.

Reduce ambiguities in tax provisions.

**Direct Taxes:**

Lower income tax rates for individuals and corporations to encourage compliance and broaden the tax base.

Rationalize exemptions and deductions to reduce complexity and improve transparency.

Suggest a shift toward a tax system with fewer exemptions but lower rates.

**Indirect Taxes:**

Rationalize the indirect tax structure by moving toward a Value Added Tax (VAT) or a Goods and Services Tax (GST) system.

Reduce cascading effects of taxes by eliminating multiple layers of taxation.

**Broadening the Tax Base:**

Include more individuals and entities in the tax net.

Reduce reliance on a narrow section of the population for tax revenues.

Encourage voluntary compliance by making the tax system more taxpayer-friendly.

**Reduction in Fiscal Deficit:**

Use tax reforms to address fiscal imbalances by increasing revenue generation.

Propose measures to curtail wasteful expenditure while improving tax collections.

**Tax Administration:**

Strengthen the administration and enforcement mechanisms.

Use technology to improve efficiency and reduce the scope for corruption.

Transition to GST:

Lay the foundation for the implementation of the Goods and Services Tax (GST), which eventually replaced the complex indirect tax system in 2017.

**Impact of the Kelkar Committee**

Many recommendations of the Kelkar Committee were instrumental in shaping India's tax reforms, particularly the shift to GST and the focus on reducing corporate tax rates.

The emphasis on simplification and transparency led to a more taxpayer-friendly system.

Some recommendations, such as the reduction of subsidies and exemptions, were politically sensitive and implemented only partially.

## Taxation Enquiry Commission

In 1953, the government of India appointed a Taxation Enquiry Commission under the Chairmanship of Dr. John Mathai. It examined the incidence of taxation, the suitability of the tax system, effects of taxation on capital formation and the use of taxation as a fiscal instrument to control inflation and deflation. The commission submitted its report in February 1955. It is divided into three volumes. The first deals with the tax system as a whole, the second with central taxation and the third with the state and local taxation.

**Main Recommendations:**

1. Tax Policy

   The commission touching the basic point of our tax policy observed, 'there was a need to strike a balance between the objectives of achieving economic equality through the tax mechanism and of maintaining unimpaired the flow of investment and savings which make for the continued progress of productive enterprise'. The commission has suggested four principal aims of tax policy viz;

   i. Improvement in distribution
   ii. Furthering of development in the public sector
   iii. Increase in production in private sector and
   iv. Promoting economic stability in the country

2. Equity in Taxation

   The commission felt that inequality is an essential characteristic of an underdeveloped economy and in India some further increase in inequality has been observed partly because of the exclusion of agricultural income for tax purposes and partly due to increasing tendency of tax evasion. The following measures for achieving equity in taxation.

   i. More effective enforcement of tax laws
   ii. Additional taxes on luxury items
   iii. A wide base of indirect taxation

iv. A ceiling on net personal incomes after tax which generally speaking should not exceed approximately thirty times the prevailing average per family income in the country.

3. Promoting Savings and Investment

The commission studied the problem of effects on taxation on production and it held the view that appropriate measures in the tax system were necessary to encourage savings and investments to promote industrial expansion and production. The commission recommended a restrain on consumption through taxation to stimulate public investment and not to swell administrative and non - development expenditure

4. Taxable Capacity

The commission found that there is sufficient scope for further taxation in the country. The commission recommended some measures to raise additional tax resources for fulfilling developmental needs. They are:

i. An increase in income tax with additional reliefs for savings and investments

ii. An increase in excise duties

iii. Increase in non-tax revenue with a suitable pricing policy

iv. Buying land revenue surcharge

v. Introduction of agricultural income tax

vi. More extensive adoption of property taxes with a tax on transfer of property by local bodies.

vii. Extending the scope of sales tax

viii. Improvement in the receipts from irrigation schemes and state electric supply undertakings.

5. Taxation as a tool to control inflation and deflation
6. Uniformity in state tax structure

**Working of Fiscal Federalism in India**

Fiscal federalism in India refers to the financial relationship and distribution of revenue between the central and state governments in a federal structure. It is a critical aspect of governance, as it ensures that both levels of government have sufficient resources to perform their respective constitutional functions.

**1. Framework of Fiscal Federalism in India**

India's fiscal federalism operates within the framework laid down by the Constitution of India, which provides for:

Division of Powers: Defined in the Union List, State List, and Concurrent List under the Seventh Schedule.

Division of Revenue: The Constitution delineates tax sources for the Union and the states. For instance:

The Union levies taxes like income tax (except agricultural income), customs, and central excise.

The states levy taxes like property tax, excise duty on alcohol, and sales tax on goods (now subsumed under GST).

Finance Commission: Article 280 mandates the establishment of the Finance Commission to recommend the distribution of revenues between the Union and states.

**2. Mechanisms of Fiscal Transfers**

Fiscal federalism in India includes mechanisms to address fiscal imbalances and ensure equitable distribution of resources:

Finance Commission Transfers: Recommendations by the Finance Commission address vertical (Union to state) and horizontal (among states) imbalances.

Goods and Services Tax (GST): GST has subsumed many indirect taxes, ensuring a unified tax regime. The GST Council is a unique example of cooperative federalism.

Central Grants and Centrally Sponsored Schemes (CSS): Grants are provided for specific projects or schemes like health and education, often with shared financial responsibilities.

Borrowing and Loans: States can borrow from the market but are subject to limits set by the central government.

**3. Challenges in Fiscal Federalism**

Vertical Fiscal Imbalance:

The Union collects a larger share of taxes but the states bear the brunt of developmental expenditures.

Horizontal Fiscal Imbalance:

Resource-rich and industrialized states like Maharashtra and Gujarat have higher revenues, while poorer states like Bihar and Odisha depend heavily on central transfers.

Disputes over GST Compensation:

Delays in GST compensation payments have strained state finances, highlighting friction in revenue sharing.

Erosion of State Autonomy:

Centrally Sponsored Schemes and conditional grants often limit states' discretion in resource allocation.

Debt Sustainability:

Many states face rising fiscal deficits and debt burdens, further aggravated by pandemic-related expenditures.

**4. Recent Developments**

15th Finance Commission (2021-26):

Recommended a vertical devolution of 41% of the divisible pool of taxes to states.

Addressed issues like disaster management funding and performance-based incentives.

**Digital Taxation and Reforms:**

Efforts to enhance tax compliance through digitization and the introduction of e-invoicing in GST.

**Revised Borrowing Limits:**

The central government allowed states to borrow up to 4-5% of their Gross State Domestic Product (GSDP) during the COVID-19 pandemic.

**5. Way Forward**

**Strengthening Cooperative Federalism:**

Greater collaboration between the Union and states through platforms like the GST Council and NITI Aayog.

**Enhancing State Revenues:**

Empower states with more taxation powers or provide more untied funds for flexible usage.

**Performance-based Transfers:**

Linking resource transfers to development outcomes and governance reforms.

**Streamlining CSS:**

Reducing the number of schemes and aligning them with state priorities.

**Improving Debt Management:**

Adopting fiscal discipline at both Union and state levels to ensure sustainable public finances.

In essence, while fiscal federalism in India has evolved over the years to accommodate dynamic economic and political challenges, continued reform and dialogue are essential to balance resource distribution, ensure equity, and sustain growth.

**Value-Added Tax**

Value-Added Tax (VAT) is a consumption tax levied on the value added at each stage of production and distribution of goods and services. Here are its merits and demerits:

**Merits of VAT**

**Fair and Neutral Taxation**

VAT ensures taxation at every stage of the supply chain, making it a fair system that avoids tax cascading (tax on tax).

**Broad Tax Base**

As it applies to a wide range of goods and services, it ensures revenue generation from multiple sectors.

**Encourages Compliance**

Since businesses can claim input tax credits, they are incentivized to maintain proper records and pay taxes, promoting transparency.

**Revenue Stability**

VAT provides a steady source of revenue for governments, as it is linked to consumption, which remains relatively stable.

**Reduction in Tax Evasion**

The system of input tax credits and regular audits makes it harder for businesses to evade taxes.

**Encourages Exports**

In many VAT systems, exports are zero-rated, which enhances competitiveness in the global market by avoiding domestic taxes on exported goods.

**Demerits of VAT**

**Complex Administration**

VAT implementation requires extensive record-keeping, which can be challenging for small businesses and involve higher compliance costs.

**Regressive Impact**

VAT can disproportionately affect lower-income groups, as they spend a larger share of their income on VAT-inclusive goods and services.

**Initial High Setup Costs**

Establishing a VAT system involves significant administrative, infrastructure, and training costs for governments and businesses.

**Possibility of Tax Fraud**

Despite its design, VAT is vulnerable to fraud schemes like carousel fraud, where businesses exploit the system of refunds for fake exports.

**Economic Distortion**

High VAT rates can discourage consumption, potentially leading to economic slowdowns, especially during recessions.

**Administrative Burden for Businesses**

Filing VAT returns, maintaining input-output documentation, and handling audits can be cumbersome for businesses, particularly small enterprises.

**Conclusion**

While VAT is an efficient and reliable source of revenue, it requires robust administration and measures to mitigate its regressive effects and compliance burdens.

**Goods and Service Tax -GST**

The Goods and Services Tax (GST) is a comprehensive, multi-stage, destination-based indirect tax implemented in India on July 1, 2017. It is designed to replace a host of indirect taxes previously levied by both the central and state governments, creating a uniform tax structure across the country.

**Key Features of GST:**

Comprehensive Nature: It subsumes various taxes such as excise duty, service tax, VAT, entertainment tax, and more.

Multi-Stage: GST applies at every stage of the supply chain—manufacture, sale, and consumption.

Destination-Based Taxation: GST is levied at the point of consumption rather than production. For example, if goods are manufactured in Maharashtra and sold in Karnataka, the tax revenue goes to Karnataka.

Dual GST Structure:

Central GST (CGST): Levied by the Central Government.

State GST (SGST): Levied by the State Governments.

Integrated GST (IGST): Levied on inter-state transactions and collected by the Central Government.

Tax Rates: GST has multiple tax slabs—0%, 5%, 12%, 18%, and 28%. Essential goods are taxed at lower rates, while luxury items attract higher rates.

Input Tax Credit (ITC): Businesses can claim credit for taxes paid on inputs, reducing the tax liability on the final output.

E-Way Bill: Ensures smooth movement of goods by requiring online documentation for goods worth above a certain threshold.

**Benefits of GST:**

Simplifies Taxation: Consolidates multiple indirect taxes into one system.

Promotes Economic Growth: Removes the cascading effect of taxes (tax on tax), leading to lower prices and increased consumption.

Boosts Transparency: With online filing, the GST system reduces tax evasion.

Enhances Compliance: Uniform rules and a common IT infrastructure ensure better tax compliance.

**Challenges of GST:**

Compliance Burden: Small businesses often struggle with compliance due to frequent updates and complex filing requirements.

Revenue Loss for States: Some states faced initial revenue shortfalls after implementation.

Rate Rationalization Issues: Complexity in categorizing goods and services under various slabs has created confusion.

GST Council:

The GST Council is the governing body responsible for setting rates, rules, and exemptions under the GST regime. It is composed of the Union Finance Minister, State Finance Ministers, and other officials.

GST represents a major tax reform aimed at improving the ease of doing business and creating a unified Indian market. However, continuous adjustments and refinements are needed to ensure its efficiency and fairness.

The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 is a landmark legislation in India that aims to ensure fiscal discipline by setting targets for the government to reduce its fiscal deficits and control public debt. It applies to both the central and state governments and is a critical framework for maintaining financial stability and transparency in public finances.

**Key Objectives of the FRBM Act:**

Fiscal Discipline: Reduce fiscal deficit and eliminate revenue deficit.

Macroeconomic Stability: Ensure long-term economic growth by controlling inflation and public debt.

Transparency: Improve transparency in fiscal operations through reporting and monitoring mechanisms.

Accountability: Hold the government accountable for deviations from fiscal targets.

**Salient Features of the FRBM Act:**

Fiscal Targets:

Reduction in fiscal deficit to a specific percentage of GDP (initially set at 3%).

Elimination of revenue deficit over a defined timeline.

Limitations on public debt to ensure sustainability.

Medium-Term Fiscal Policy (MTFP):

The government must present a medium-term fiscal policy statement along with the Union Budget every year.

Includes a roadmap for fiscal indicators such as fiscal deficit, revenue deficit, and total liabilities.

**Rules and Guidelines:**

The Act provides for the formulation of rules to implement its provisions effectively.

Includes annual reduction targets for fiscal deficit and revenue deficit.

Exemptions:

Allows the government to deviate from fiscal targets in case of unforeseen circumstances like national security, natural calamities, or severe economic downturns.

Transparency Mechanisms:

Regular audits and reports are mandated to keep the public informed about fiscal performance.

**Amendments to the FRBM Act:**

2004 Amendment: Introduction of "effective revenue deficit," which excludes grants for capital asset creation from the revenue deficit.

2012 Amendment: Extended the fiscal deficit target deadline due to the global financial crisis.

2018 Amendment (FRBM Review Committee Recommendations):

Introduced a "debt-to-GDP" ratio as a fiscal parameter.

Recommended replacing the revenue deficit with the "primary deficit" as a key metric.

Fiscal Council establishment to enforce compliance and monitor deviations.

**Challenges and Criticisms:**

Rigid Targets: Fiscal targets sometimes constrain the government during economic crises.

Exemptions Misuse: Deviations under the guise of extraordinary circumstances have been questioned.

Poor Implementation: States and the central government often struggle to meet the targets.

Need for Reform: Fiscal metrics like fiscal deficit and revenue deficit do not adequately capture the nuances of capital investments.

**Importance of the FRBM Act:**

It remains an essential tool for maintaining fiscal prudence.

Provides a framework for sustainable economic growth.

Promotes investor confidence and macroeconomic stability.

## Issues of Fiscal deficit

Fiscal deficit occurs when a government's total expenditures exceed its total revenue (excluding borrowings) in a given fiscal year. While some level of fiscal deficit can be beneficial to stimulate economic growth, persistent or excessive deficits can lead to several challenges. Here are the key issues associated with fiscal deficit:

### 1. Impact on Inflation

A high fiscal deficit often leads to increased borrowing by the government. If the borrowing is monetized (e.g., through printing money), it can result in higher inflation as more money chases the same amount of goods and services.

Inflationary pressures may erode purchasing power, particularly affecting lower-income groups.

### 2. Rising Public Debt

Governments finance fiscal deficits through borrowing, leading to a buildup of public debt.

A high debt-to-GDP ratio can make it difficult for a country to manage future repayments, creating a debt trap.

Servicing the debt (paying interest and principal) can consume a large portion of government revenues, reducing funds available for essential services.

### 3. Crowding Out of Private Investment

When governments borrow heavily from domestic markets, they compete with the private sector for financial resources.

This crowding out effect increases interest rates, making borrowing costlier for businesses and individuals, potentially stifling economic growth.

### 4. Adverse Impact on Credit Ratings

Persistent fiscal deficits can signal poor fiscal management and lead to downgrades in sovereign credit ratings.

Lower ratings increase the cost of borrowing for the government and the country’s businesses in international markets.

**5. Pressure on External Accounts**

A fiscal deficit may lead to a current account deficit if government spending fuels imports.

It can weaken the country's currency and lead to a depletion of foreign exchange reserves, particularly for economies dependent on external borrowing.

**6. Reduced Fiscal Space**

High fiscal deficits limit the government’s ability to respond to future crises (e.g., natural disasters, pandemics).

A lack of fiscal space can hinder the government's capacity to invest in long-term infrastructure or social welfare programs.

**7. Structural Issues**

Persistent fiscal deficits may indicate structural issues like inefficiencies in revenue generation (e.g., tax evasion) or excessive unproductive spending (e.g., subsidies without reform).

Addressing these requires structural reforms, which may face political resistance.

Managing Fiscal Deficit

To address fiscal deficits responsibly, governments can:

Improve Tax Revenues: Widen the tax base and curb tax evasion through reforms like the GST (Goods and Services Tax).

Rationalize Expenditure: Focus on productive investments (infrastructure, health, education) and reduce unproductive subsidies.

Disinvestment: Monetize government assets and privatize inefficient public sector enterprises.

Debt Management: Rely on long-term borrowing rather than short-term debt to reduce repayment burdens.

By balancing fiscal stimulus and sustainability, governments can ensure that fiscal deficits do not compromise long-term economic stability.

**Fiscal Policy and Economic Downturn**

Fiscal policy is a key tool used by governments to manage the economy, especially during an economic downturn. An economic downturn is characterized by reduced economic activity, declining GDP, rising unemployment, and lower consumer confidence. Fiscal policy can help stabilize the economy by influencing aggregate demand through government spending and taxation.

**Fiscal Policy Tools**

**Government Spending**

During a downturn, governments often increase public spending on infrastructure, healthcare, education, and other sectors. These expenditures aim to create jobs, boost demand, and stimulate economic growth.

**Taxation Policies**

Reducing taxes during an economic downturn puts more money in the hands of consumers and businesses, encouraging spending and investment. This can help revive economic activity.

**Deficit Spending**

In periods of low economic activity, governments may intentionally run budget deficits, spending more than they collect in revenues, to inject liquidity into the economy. This is often financed through borrowing.

## How Fiscal Policy Addresses Economic Downturns

### Stimulus Packages

Governments may introduce stimulus packages, including direct cash transfers, unemployment benefits, and incentives for businesses to retain workers. For example, during the COVID-19 pandemic, many countries provided fiscal stimulus to mitigate economic shocks.

### Multiplier Effect

Increased government spending can have a multiplier effect on the economy. For instance, building a new highway creates jobs directly for construction workers and indirectly for suppliers and local businesses.

### Automatic Stabilizers

Programs like unemployment benefits and progressive taxation automatically adjust during downturns, cushioning the economy without the need for new legislation.

## Challenges of Fiscal Policy in a Downturn

### Time Lags

Fiscal measures often take time to implement and may not address immediate economic challenges.

### Debt Accumulation

Prolonged deficit spending can lead to high public debt levels, raising concerns about long-term fiscal sustainability.

### Inflation Risks

If fiscal policy is overly expansionary, it may lead to inflation once the economy recovers, complicating monetary policy objectives.

### Political Constraints

Political debates can delay the approval of fiscal measures, reducing their effectiveness during crises.

**Real-World Examples**

The Great Depression (1930s)

The U.S. implemented the New Deal, a series of public works and social programs, to combat unemployment and economic stagnation.

Global Financial Crisis (2008)

Many countries introduced fiscal stimulus packages, such as the U.S. American Recovery and Reinvestment Act, to stabilize their economies.

COVID-19 Pandemic (2020)

Governments worldwide provided massive fiscal support, including cash transfers, wage subsidies, and healthcare spending, to address the economic and health crises.

**Conclusion**

Fiscal policy plays a vital role in mitigating the effects of economic downturns. However, its success depends on timely implementation, effective targeting, and coordination with monetary policy. Striking a balance between short-term recovery and long-term fiscal health is critical to achieving sustainable economic growth.

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