DJN3A: PUBLIC FINANCE

Unit I – Introduction:

Meaning and definition - scope and subject matter of public finance – Functions of a state – private and public finance – Principle of Maximum Social Advantage.

Unit II - Public Expenditure

Meaning and definition – public and private expenditure – classification of public expenditure - canons of public expenditure – causes for the growth of public expenditure – Effects of public expenditure - Control of public expenditure in India.

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Meaning of budget – characteristics of a good budget – principles of budgeting – functions of a budget – types of budget – Budgetary procedure in India – Zero based budgeting – Finance Commissions and their functions – recommendation of last two finance commissions – Fiscal Policy

Book for Reference

1. Public Finance – B.P.Tyagi
2. Public Finance – Theory and Practice – S.K. Singh
3. Public Finance –Otto Eckstein

UNIT –I

INTRODUCTION

MEANING AND DEFINITION OF PUBLIC FINANCE

Public finance or Fiscal Economics is a specialised branch of Economics which deals with the principles and techniques of obtaining funds and spending them by governmental authorities. In short, the term 'Public Finance' is used to express the science of revenue and expenditure of all kinds of government. The meaning of public finance is also brought out in a slightly different definition that public finance is concerned with the income and expenditure of public authorities and with the adjustment of the one to the other. In this definition, 'Public Authorities' include all sorts of territorial governments. In modern civilised communities, 'Public authorities' include the central, provincial and local governments. These public authorities undertake many-sided activities like education, industries, agriculture, roads, health and sanitation, etc., for the welfare of their respective subjects.

The following are some of the important definitions of Public Finance.

1. Hugh Dalton

"Public Finance is concerned with the income and expenditure of public authorities, and with the adjustment of the one to the other."

2. Bastable

"Public Finance deals with the expenditure and income of public authorities of the state and their mutual relation as also with the financial administration and control."

3. Prof. Adams

"The investigation into the nature and principles of state expenditure and state revenue is called public finance."

In fact, almost all economists have defined 'Public Finance' more or less in the same manner.

SCOPE AND SUBJECT-MATTER OF PUBLIC FINANCE

(SUB – DIVISION OF PUBLIC FINANCE)

The various definitions of the term 'Public Finance' enumerated in chapter I indicate the scope and subject-matter of public finance. Public Finance deals with the study of income and expenditure of a public authority like central or state or local government.

The subject of public finance embraces the following divisions.

1. Introduction :

In this first division, we study the meaning and definitions of public finance, its scope and subject-matter, nature and functions of a public authorities, theories of public finance, principle of public finance and a few more aspects.

2. Public Revenue :

Public revenue means revenue of a public authority. This is the second division of this subject.

In this division, we deal with the various sources of revenue of the central and state governments. In the course of study of this division, we deal with a number of topics like canons of taxation, theories of taxation, effect of taxation, classification of taxes, taxable capacity, shifting and incidence of taxation, and also specific taxes.

3. Public Expenditure :

Public expenditure refers to the expenditure of a public authority. This division deals with the various dynamic channels through which the public authority spends its income. In this division we study the meaning and need for public expenditure, nature of public expenditure, principles of public expenditure, canons of public expenditure, classification of public expenditure, effects of public expenditure, etc.

4. Public Borrowing :

When public revenue falls short of public expenditure, the government resorts to borrowing. The government may borrow internally or internationally. This is known as public borrowing. In this division we study sources of public borrowing, meaning and nature of public debt, consequences of public debt, methods of redeeming public debt, debt management and allied aspects.

5. Budget :

Budgeting is the technique of raising revenues and spending them by the government. In this division, we deal with the study of meaning and definitions of budget, budgetary procedures, kinds of budget, principles and qualities of a good budget, performance budgeting, etc., This division also deals with financial control and management.

6. Other divisions :

Public finance also deals with certain other divisions like federal finance, war finance, local finance, etc.

FUNCTIONS OF PUBLIC AUTHORITY

A modern state performs a wide variety of functions. The following are some of the important functions of a state.

1. Maintenance of internal peace and order :

It is the most important primary function of the State. The government had to maintain a large police department to ensure internal peace in the country.

2. Defence :

Defence is also a primary function of the State. Every government must maintain a large army to ensure defence of the country. In fact, it functions under a separate ministry. (Ministry of Defence). Nearly 40 to 70 percent of our national income is spent on defence.

3. Justice :

Judiciary plays a very important role in the settlement of disputes between persons, states and governments. It is one of the three major items of expenditure for a government. Judiciary is an independent body. It functions along with executive and legislature.

4. Regulation and control of economic enterprises :

Every government regulates and controls economic enterprises. Examples are coinage, weights and measures, regulation of business practices, state ownership and operation of certain enterprises.

5. Promotion of social welfare :

Promotion of social welfare is a very important activity of the State. It is important for social and cultural advancement of the people.

EXAMPLE: Education, Social Relief, Social Insurance, Health Control, Family Planning and other activities.

6. Conservation of Natural Resources :

Conservation of natural resources is an important activity of a State. Forests, mines, rivers, seas etc., are some of the examples of natural resources. These resources have to be preserved. Every state is spending a large share of its income for the conservation of natural resources.

7. Promotion of State unity :

Every State must remain as a united one. Divisions and sub-divisions of a country should be discouraged. A unified State is possible by having effective means of transportation and communication. Therefore every state concentrates on the development of the means of transportation and communication

8. Administration :

Administration of a State is the most important and the most difficult activity of a State. Government departments are established and government officers are appointed by the State. They must be paid their salaries and allowances. Apart from this, expenses on stationary and other items are incurred. This administration is largely responsible for internal law and order and other establishing cordial foreign relations.

9. Financial system :

The management of finances of a State is also an important function of a State. The Government's revenues and expenditures should be carefully planned by the government. An unscrupulous government will face disastrous failures.

10. Religion :

Very occasionally certain governments perform religious functions also.

PRIVATE AND PUBLIC FINANCE

Private finance deals with the income and expenditure of private individuals and with the adjustment of one to the other. Public finance deals with the income and expenditure of public authorities, and with the adjustment of one to the other.

SIMILARITIES

The following are the important points of similarity between private finance and public finance.

1. An individual earns income, spends money, borrows money and repays debt. Similarly a public authority raises a certain amount of income, distributes it on various lines of expenditure, borrows money internally as well as internationally and pays back its debt.
2. Private finance may be wise or foolish. Public finance may also be wise or foolish.
3. Private finance may be effective or ineffective. Public finance may also be effective or ineffective.
4. Private finance may be productive or unproductive. Public finance may also be productive or unproductive.
5. A Private individual is engaged in production, exchange, saving, capital formation, investment and so on. A public authority is also engaged in production, exchange, saving, capital formation, investment, and so on.
6. The problems and decisions of both the individual and the public authority are similar.
7. Both can strike a balanced or surplus or deficit budget.

DISSIMILARITIES

The following are the points of dissimilarity between private finance and public finance.

1. Determination of income and expenditure :

Broadly speaking, while an individual's income determines the amount of his probable expenditure, a public authority's expenditure determines the amount of its necessary income. The individual knows his income and he must arrange his scheme of expenditure to suit his purse. But a public authority calls for an estimate of expenditure from the various departments, determines the total amount of expenditure and then raises the revenue accordingly. This is not always true; but it may be considered for all practical purposes to be valid.

2. Motive :

The aim of the private individual in earning and spending is that of maximising his individual wealth whereas the object of a public authority is that of maximising social welfare. In other words, private finance emphasises individual wealth and public finance attempts to promote social welfare. “In the private economy, the chief objective is wealth and in the public economy, it is welfare”. (**Prof. Seligman**)

3. Principle of equi-marginal utility :

In the case of private finance, “an individual so distributes his expenditure on various commodities and services, that the marginal utilities of all these expenditures are equal and the total utility of the whole expenditure is maximum.” In reality, most individuals do not equalise their marginal utilities with any great amount of exactitude. Yet in the scheme of all except the least intelligent who have no scheme at all, there is an approach towards such equalisation.

4. Nature of resources :

An individual has only limited resources at his disposal. His income generally comes from his current income, savings of the past and borrowing. But a public authority has tremendous power in its financial operations. It can draw its incomes from various sources like taxes, fees, fines, special assessments, earnings of public enterprises, public borrowings, printing of currency in times of need, etc.,

5. Period of budgeting :

An individual attempts to balance his budget within a shorter period of time, say a month or so. But a public authority attempts to balance its budget in a longer period of one year.

6. Nature of budget :

An individual always tries to strike a surplus budget. For him, surplus budgeting implies savings which will become capital later on and make him richer.

But this is not the case with the budget of the public authority. The public authority can strike a surplus budget either through a high level of taxation or a low level of expenditure. The public will not like this or the public authority can strike a deficit budget either through a low level of taxation or a high level of expenditure. The public authority will not like this. The government can have a balanced budget only in normal conditions.

7. Considerations of investment :

An individual invests in those fields of business where the returns are quick and immediate. He will not invest in those fields of business where the returns are nominal and delayed.

But the government is not influenced by these considerations. It takes a long-term view of investment. Hence, it undertakes such projects also if they are in the interest of public welfare, Eg. construction of multi purpose hydroelectric projects in India. Hence many expenditure for public purposes are made for the future as much as for the present i.e., future is as important as present and the State can afford them in a way in which the individual cannot.

8. Compulsory character of expenditure :

An individual expenditure is optional. He can or cannot spend. He can spend or postpone it. His expenditure is not compulsory.

But expenditure of a public authority is compulsory. **Findlay Shirras** observes : "Another characteristic of public expenditure is its compulsory character." The State cannot avoid or postpone its expenditures.

9. Possibilities of changes :

Generally there are not many changes in the income and expenditure of an individual. But there may be deliberate changes in the financial operations of a public authority. The public authority can make big and fundamental changes in its budget.

10. Secrecy and Publicity :

Private finance is shrouded in mystery. Secrecy is the keynote of an individual's income and expenditure. No individual ordinarily likes to show or discuss his financial affairs before others. Small business houses also do not like to show their financial affairs to others. The only exceptions are the big companies. On the other hand, public authority gives the greatest publicity to its budget.

11. Coercive Power :

In private finance, an individual has no coercive power whereas in public finance, the public authority has different degrees of coercive authority. The individuals can never use any force or authority to get their revenues, but the public authority can use different degrees of force to secure its income.

PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

or

PRINCIPLE OF PUBLIC FINANCE

Introduction:

The fundamental principle that should govern the financial policy of the State or the management of public finance is the principle of Maximum Social Advantage. Public finance comprises of two operations- raising of revenue and spending it. The income and expenditure cannot be looked at separately. Public finance involves a series of transfers of purchasing power from the public to the government and the principle of sound finance must ensure that it results in some benefit to the community. Prof. Pigou and subsequently Dr. Dalton are the two prominent economists who are credited for formulating and popularising this principle of public finance. Dr. Dalton called the principle as the Principle of Maximum Social Advantage and Prof. Pigou called it as the Principle of Maximum Aggregate Welfare.

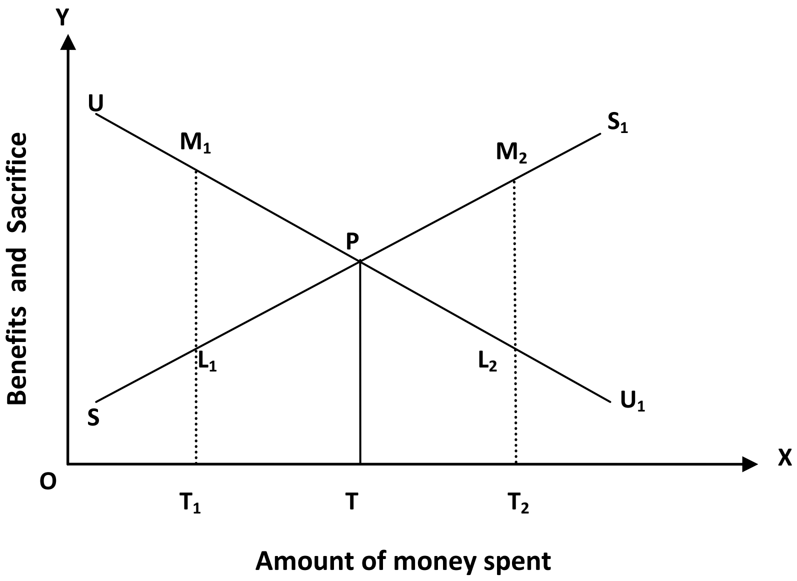
TAXATION AND EXPENDITURE

The main purpose of the theory of public finance is to combine the principles of taxation and expenditure and to point out how much by way of revenue the government should obtain and spend in order to maximize social welfare of the community.

Taxation involves sacrifice on the part of the tax payer. It is subject to the law of increasing sacrifice. Equal additions of public revenue involves a greater amount of sacrifice or loss of utility to people. Public expenditure, on the other hand, is subject to the law of diminishing utility. Equal additions of public expenditure should be carried upto that point where the social benefit from marginal expenditure is just equal to the social sacrifice caused by raising of marginal amount of public revenue.

DIAGRAMMATIC REPRESENTATION

The principle can be explained with the help of diagram. SS_1 is the sacrifice curve the trend of which is towards increase. UU_1 is the utility curve from public expenditure which proves the application of the law of diminishing utility. These curves intersect each other at the point P. This is the ideal point where the sacrifice and utility are equal. The State should realise OT amount from the public and should spend the same amount. The point P is the point of maximum social advantage.



If the State decides to realise OT_1 amount and the spend the same amount, the sacrifice will be T_1L_1 and utility T_1M_1. Here utility will be greater than sacrifice. Hence there is scope for more taxation.

If the State increases the amount of its expenditure and revenue realised to OT2, utility will be T_2L_2 and sacrifice T_2M_2. Here the sacrifice will be more than utility. Hence there is a case for reduction in taxation.

HOW MAXIMUM SOCIAL ADVANTAGE IS ACHIEVED

There are three fundamental principles of financial operation. They help the state in achieving the ideal of maximum social advantage.

1. Public expenditure should be carried on upto the point where the benefit received from the last unit of money spent by the state is just equal to the sacrifice imposed in raising that unit of revenue.
2. The resources of the state should be so distributed on different heads of expenditure that the marginal return of satisfaction from each of them is the same.
3. The taxes should be so distributed that the marginal utility of the money paid in taxation is equal to all tax payers.

TESTS OF MAXIMUM SOCIAL ADVANTAGE

According to **Prof. Dalton**, the following are the important tests of maximum social advantage.

1. **Preservation of the community:**

Internal peace and external security create confidence and promote the economic life of the citizens. They enhance the social advantage. The State has the responsibility of increasing the economic and non-economic welfare of the citizens. Thus the State has the responsibility of preserving the community from internal disorders and external dangers.

2. **Improvement in Production:**

The State also has the responsibility of increasing the level of production. Improvement in production increases the economic welfare of the citizens.

Improvement in production implies three things :

a) Increases in production power, that is, a larger product per worker with a smaller effort.
b) Improvement in the organisation of production so as to reduce the wastes of economic resources and
c) Improvements in the composition or pattern of production so as to serve best the need of the community. Hence the operation of public finance should aim at securing all these objectives, so as to increase the production and economic welfare of the community

3. Improvement in distribution :

In an economy, the welfare of the community can be increased through a better distribution of income and wealth. Taxation may be so imposed that it falls on the richer sections of the community, while public expenditure is so planned that the real income of the lower income groups of people is raised. Thus the distribution can be improved through reduction in the inequality of income and wealth in the country.

4. Stability and full employment :

Economic instability is a characteristic feature of free economies and is the cause of so many evils i.e. unemployment and over-production in the community. The social advantage to the community can be increased if business conditions in the country are stable and all fluctuations are eliminated. Hence the aim of fiscal operations should be to bring and maintain economic stability at high level of employment.

5. Provision for the future :

Individuals are mortal but the community lives on. The Government has, therefore, the double responsibility of looking after the interests of the present generations and promote the interests of the generations to come. The State therefore should prefer large social advantage in the future to a smaller one today.

The principle of maximum social advantage is very difficult to practise in so far as the comparative estimate of the advantages of different types of expenditure and different kinds of taxes considered to be difficult. In spite of this, the principle should be kept in mind by the public authorities of the country.

LIMITATIONS OF THE MAXIMUM SOCIAL ADVANTAGE

1. The State cannot apply the principle of cost benefit analysis in public economic activities.
2. The disutility of the tax payer in a micro problem relating to individual whereas the utility of the public expenditure to the society is a macro problem. Thus there is a methodological inconsistency.
3. Governments also make public borrowing and enhance benefits for the people. In this case there is no disutility involved. Disutility arises only in the payments of taxes.

4. In modern days the fiscal operations are adopted as a counter cyclical measure. There is no consideration of equalising marginal benefit and sacrifice.

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UNIT-II

PUBLIC EXPENDITURE

MEANING

Public Expenditure is the expenditure of the public authorities. It is the expenditure incurred by the government – central, state or local. It is generally incurred for the satisfaction of collective needs of the citizens or for promoting the economic and social welfare of the people. The advantages of public expenditure were not fully appreciated by the traditional economists. They considered market mechanism as a better method whereby the working of the economy could be guided and the allocation of the resources could be decided.

PRIVATE AND PUBLIC EXPENDITURE

Private finance starts with a given income as the frame work within which expenditure must be planned. But Public finance starts with a given expenditure plan and the public authorities must adjust their income to match their expenditure.

Similarities :

Following are the similarities between private expenditure and public expenditure.

1. Neither private units nor public authorities would like to waste their expenditure without any corresponding revenue.
2. Both try to achieve their objectives with minimum possible expenditure.
3. There is an element of flexibility in both private expenditure and public expenditure.
4. Both take a collective view of income, expenditure and the possibilities of adjustments in each. An individual will consider the possibilities of shifting his total time between an effort to earn and leisure. But a public authority will consider the cost of earning more and spending more.
5. Both individual units and public authorities have more than one way of raising additional income.
6. There are problems of overall efficient and integrated management of finances in both private and public expenditures.
7. There are different levels at which solutions will be found in both private and public expenditures.

Thus, private expenditure and public expenditure are similar to each other in their overall and complex ramifications.

Dissimilarities :

Following are the differences between private expenditure and public expenditure.

1. The private expenditure is determined by income of the individual whereas the public expenditure determines the income of the public authority.
2. The private expenditure is optional whereas the public expenditure is compulsory.
3. An individual, while spending money, aims at striking a profit – oriented budget whereas the public authority does not aim at this.

4. An individual, while spending money, calculates the amount of benefit accruing to him due to that expenditure. But a public authority does not make any such calculation.
5. An individual calculates short - run benefits out of his expenditure whereas a public authority calculates only the long - run benefits out of its expenditure.

CLASSIFICATION OF PUBLIC EXPENDITURE

Meaning:

Classification of public expenditure refers to a systematic and orderly arrangement of various kinds of public expenditure on the basis of some scientific or economic consideration.

Need for classification:

Classification of public expenditure is important for the following reasons.

(i) To study the nature and effects of each kind of public expenditure
(ii) To compare the effects of one public expenditure with that of another
(iii) To study the relative importance of public expenditure under different heads
(iv) To examine and evaluate the effects and efficacy of the various matters in which the funds have been allocated and
(v) To determine the most appropriate expenditure policy of the government.

VARIOUS CLASSIFICATIONS

Different economists have given different classifications of public expenditure on the basis of different scientific or economic considerations. There are numerous classifications. The following are some of them.

1. Accounting classification:

Accounting classification is perhaps the oldest classification. It is through this classification that the executive maintains the effective control and check over public expenditure and possible leakages and wastages, divisions and misappropriations. This classification may be made on the basis of either departments or heads of expenditure.

This classification is good for auditing purposes and also safeguarding against misappropriations.

2. Classifications on the basis of benefits conferred on the public:

German writer Cohn and American writer Plehn have classified public expenditure on the basis of benefits conferred on the public.

(i) Public expenditure that confers a special benefit to certain individuals: eg, poor relief, rehabilitation of refugees, etc.

(ii) Public expenditure that confers a common benefit on the entire community ; eg, defence, general administration education, etc.

(iii) Public expenditure that confers a special benefit on certain individuals and at the same time a common benefit on the rest or the community; eg administration of justice.

(iv) Public expenditure that confers a special benefit on particular groups; eg, subsidy granted to particular industries.

This classification is over lapping. All expenditure is incurred in the interest of the public as a whole. Hence this is not a good and representative classification.

3. Nicholson's Classification :

F. S. Nicholson has classified public expenditure on the basis of amount of revenue obtained by the state in return for the services which it rendered.

i) Expenditure without direct return of revenue of revenue ; eg poor relief, war expenditure, etc.,

ii) Expenditure without direct return, but with indirect benefit to revenue; eg. Education.

iii) Expenditure with partial direct return on revenue; eg. Education, for which fees are charged, subsidised railway services, etc.

iv) Expenditure with full return of revenue or profit eg. Post and telegraphs, gas services, industries, etc.,

This classification is also overlapping. Hence this is not a good and representative classification.

4. Adam Smith's Classification:

Adam Smith, in his "Wealth of Nations" in which he includes a memorable chapter on "The Expenses of the Sovereign or Commonwealth" divides the duties of a government into three – (a) defending the society from the violence and injustice of other independent societies (b) securing internal justice between citizens and (c) erecting and maintaining public institution and works.

Based on this classified of functions of a public authority, he classifies public expenditure into the following three categories.

i) Protective functions – defence, police, courts, etc.,

ii) Commercial functions – bounties, industrial exhibitions, etc.,

iii) Development functions – education, roads, rivers, irrigations, recreation, collection of statistics etc.,

5. Hick's Classification:

Following Adam Smith, Mrs. Ursula K . Hicks has also adopted a detailed classification of public expenditure. She classifies public expenditure into the following four categories.

(i) Defence expenditure eg. –capital equipment, factories, payment of wages and pensions for army personnel etc.,

(ii) Civil or administrative expenditure – eg. Police, law and order, courts and justice etc.,

(iii) Expenditure for economic ends – eg. Provision of subsidies and benefit to industries.

(iv) Expenditure for social ends – eg. education, public health, social insurance schemes etc.,

6. Rocher's Classification:

Rocher's has classified public expenditure into three categories - necessary, useful and superfluous or ornamental. Necessary expenditure is that expenditure which the state has necessarily to incur and which cannot be delayed or postponed. Useful expenditure which the state has to incur, but which can be delayed or postponed. Superfluous or ornamental expenditure which the state may or may not incur.

This classification has many overlaps. A necessary expenditure is useful and an unnecessary expenditure is also useful.

It is wrong to assume that the state has to incur superfluous expenditure in it.

7. Shirra's classification:

According to Prof. G. Findlay Shirras, a public authority performs two types of functions - primary and second function, and hence, the expenditure of the public authority is of two kinds – primary expenditure and secondary expenditure.

Primary functions are those functions which are performed by the government. These functions are intended for uplifting the standard of living of the people and protecting the people from foreign aggression. The primary functions are generally grouped under four main heads – (i) defence, (ii) law and order, (iii) civil administration and (iv) debt services,

Secondary functions are those functions which are performed by the government. These functions are performed by the public authority for providing social welfare measures and other things. These functions are intended to raise the socio – economic welfare of the people. The secondary functions are grouped under many heads. (i) social services, (ii) education, (iii) public health, (iv) poor relief, (v) unemployment insurance, (vi) famine relief and (vii) other services.

8. Mehta's classification:

According to Prof. J.K. Mehta, public expenditure is of two kinds–constant expenditure and variable expenditure

"Constant expenditure is that the amount of which does not depend upon the extent of the use by the people in whose interest it is incurred, make of the services that are furnished by it." Eg, Defence expenditure, street lights, lights poles at aerodromes, etc.,

"Variable expenditure likewise is that which increase with every increase in the use of public services by this people for whose benefit it is incurred." Eg, postal services, railway services, education, etc.,

9. Economic classification :

Public expenditure may also be classified into two kinds-revenue expenditure and capital expenditure. This classification is known as economic classification. This was introduced in India since 1957-58.

10. Classification on the basis of productivity of public expenditure :

Public expenditure is classified into productive and unproductive expenditure. This classification is made on the basis of productivity of public expenditure. Productivity expenditure includes all kinds of investment expenditure and expenditure on education, public health and social welfare schemes. Unproductive expenditure includes all kinds of consumption expenditure and expenditure on wars.

Public expenditure may also by classified into two categories –(a) Public expenditure intended to preserve the country against external aggression and internal chaos and (b) public expenditure intended to improve the quality of the social welfare of the community. This classification is not a very important one.

PRINCIPLES OF PUBLIC EXPENDITURE

(OR)

CANONS OF PUBLIC EXPENDITURE

The following are the important principles or canons of the public expenditure laid down by Prof. Findlay Shirras.

1. **Canon of Benefit :**

This canon suggests that every public spending must be ultimately used for the cause of social benefits, namely social well being of the people. More and more of areas can be brought under cultivation and more and more people can be given employment. Public expenditure should benefit the people.

2. **Canon of Economy :**

Public expenditure shall be very carefully done in such a way that wastages can be avoided and the entire expenditure should promote the common cause. For proper implementation of this canon of economy, there are parliamentary and administrative checks on expenditure of the democratic governments. In India there is the Public Accounts Committee consisting of the members of parliament.

3. **Canon of Sanction :**

According to this canon, the public spending should not be done without the approval of proper authority. Money must be spent with the sanction of the higher authority and accounts have to be properly audited.

4. **Canon of Surplus :**

As in the case of private expenditure, public expenditure should also provide some surplus for the future development of the country. The surplus can be used for further development of the economy.

Other canons:

5. **Canon of Elasticity:**
   This canon maintains that there should be a fair degree of elasticity in public expenditure. It should be possible for the public authorities to change the public expenditure according to circumstances. Public expenditure should be elastic.
6. **Canon of Productivity:**
   According to this canon the expenditure policy of the government should encourage production and productive efficiency in the country. This means that the major part of public expenditure should be allocated for production and developmental purposes.
7. **Canon of Equitable Distribution:**
   This canon is particularly important in those countries where glaring inequalities of income and wealth are present. It is mainly for this reason, the underdeveloped countries have given particular importance to this canon.

CAUSES FOR THE GROWTH OF PUBLIC EXPENDITURE

There has been a persistent and continued increase in public expenditure year after year in all the country due to the following reasons.

1. Welfare State :

A modern state is a welfare state protecting the welfare of the people. It is interested in promoting all the welfare measures such as education, health etc., and these services help the welfare of the people.

2. Defence :

The defence expenditure of the government is going on increasing year after year. As pointed out by Adam Smith defence is better than opulence. It contains expenditure on war materials, maintenance and growth of armed forces, naval and air wings, expenses on the development of military art, pensions to war personnel, interest on war loans, rehabilitation of war cost and cost on. A large amount of money is spent on research and development in this area.

3. Democracy and socialism :

The recent growth of democracy and socialism everywhere in the world has caused public expenditure to increase very much. The democratic structure of the economy is more expensive than a totalitarian government. In India democracy has become a costly affair. The election and administration of various offices are very costly in India.

4. Urbanisation :

The spread of urbanisation is an important factor leading to the relative growth of public expenditure in modern days. Expenditure on water supply, schools, colleges, public health, roads, play grounds etc., has increased in modern days.

5. Rural development :

The government in all countries has the major aim of improving the rural and backward areas. For this purpose a lot of money from the government is being spent.

6. Population expansion :

The spectacular growth of population calls for increase in public expenditure. Rise in population creates various problems in poor countries. The state has the responsibility of solving many problems regarding unemployment, housing and sanitation.

7. Growth of transport and communications :

With the expansion of trade and commerce the state has to provide and maintain a quick and efficient transport system also. Industrial and commercial developments depends very largely on the quality and extent of transportation and communication services. Hence every year huge amounts are to be spent on modernisation, construction of roadways, railways, waterways and airways .

8. Economic Planning :

Planning is more or less a pattern of all the poor countries . In a planned economy the public sector is expanding its role and hence there is an increase in public expenditure. 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.

EFFECTS OF PUBLIC EXPENDITURE

Introduction :

For a long time it was thought that public expenditure was a waste. Adam Smith and his followers held that money in the hands of the public should be more useful than in those of the state. But modern economists have developed the idea that public expenditure should be used, as a deliberate investment to influence the level of economic activity. The effects of public expenditure can be discussed under two heads namely,

a. Effects on Production.
b. Effects on Distribution.

a. EFFECTS OF PUBLIC EXPENDITURE ON PRODUCTION :

The expenditure on development is meant to promote production and employment in the country. The enormous expansion in expenditure has been to increase the demand for goods and services and thus to boost production.

Prof. Dalton has discussed three important effects of public expenditure on production, viz

i. Efficiency Effect.
ii. Incentive Effect.
iii. Allocative Effect.

i. Efficiency Effect :

Public Expenditure can increase the ability of the people to work, save and invest. If public expenditure increase the efficiency of the people to work will promote production and national income. Public expenditure incurred on subsidised food, cheap housing facilities, free education can be of great help in improving the physical and mental improvement of the people. These public goods and services may be provided to those in the poor areas. General education improves the general abilities of the people and technical education improves the technical efficiency of the people. Thus public expenditure can promote ability to work ,save and invest and promote production, employment and national income.

ii. Incentive Effect :

Public expenditure can promote the incentive to work, save and invest. Some public expenditure promote the desire to work and save. For example, old age pension, unemployment allowances, provident fund, etc., have adverse effects on the precautionary motive of the people to work and save. On the other hand bonus in government enterprises, incentives in factories, developmental projects, etc., can increase the incentive effect of the people.

iii. Allocative Effects :

Public expenditure helps production through the allocation of resources. Allocation of resources is made between different uses and regions.

- Public expenditure causes diversion of economic resources from one use to another. For example, the resources from private use to public use can be generated.
- Public expenditure can increase the productive power of the community. Public expenditure can create economic overheads like roads, railways, irrigation projects, etc.,
- Public expenditure can exploit the utilised and unutilised resources. In that way, a country can invest on a large number of key and basic industries like iron and steel, chemicals and fertilisers. The resources can be transferred from less productive use to more productive use. The long term efficiency of the people depends upon the desirable infrastructure facilities.
- Public expenditure promotes the future needs of the society. A better allocation of resources between the present and future can be made through public expenditure.

Finally public expenditure can divert the resources between the different regions in such a way that the country is able to achieve the balanced regional development. The regional imbalances can be very much reduced.

b. EFFECTS OF PUBLIC EXPENDITURE ON DISTRIBUTION

A modern state is interested in reducing the inequalities of income and wealth. Public expenditure can be used as an important instrument for reducing the inequalities. According to Dalton, “That system of public expenditure is the best which has the strongest tendency to reduce the inequality of income.” Public expenditure can supply social goods and services free or below cost and hence affect the distribution of income in a socially desirable way. Social security measures like free medical aid, free education, unemployment allowance to the poor, etc., will obviously benefit the poor than the rich and bring about changes in distribution of income and wealth.

Expenditure on roads, electrification, water supply, police, defence and courts do not affect the distribution of income and wealth.

According to Dalton, public expenditure can be classified into three types as follows:

(i) Regressive Expenditure :

Under this type the benefits from public expenditure will go to the upper income groups rather than the lower income groups. The government increases inequalities. For example, interest on public debt or subsidy on private saving is regressive in nature.

(ii) Proportional Expenditure :

In this form of expenditure, neither the inequalities increase nor decrease. Everybody is proportionately benefited according to the income. For example, a fixed house rent allowance of 10% of the salary to all the government servants is an example of proportional expenditure.

(iii) Progressive Expenditure :

Expenditure is progressive when the proportional addition is made by the government grant is larger. For example, the houses built for low income group are an example for progressive expenditure. In this category free education, subsidised housing, free medical care, fair price shop are provided for the public.

The present day policy of the government is to increase development expenditure and reduce non – development expenditure.

FINANCIAL CONTROL WITH REFERENCE TO INDIA

(OR)

CONTROL OF PUBLIC EXPENDITURE IN INDIA

Introduction :

Public expenditure refers to the expenditure of the government. Therefore it cannot go without any check. It has to be controlled because of the involvement of public money. There are three important methods of financial control in India.

I. Administrative Control:

The internal control is exercised by Financial Ministry. The Finance Ministry, exercises control through control of estimates, power of sanctioning expenditure and internal audit.

After the budget is passed by the Parliament, the Finance Ministry distributes the grants to the spending departments. There are financial rules which have to be strictly followed.

II. Audit Control:

It is the purpose of auditing to check irregularities of expenditure and accounting. For these, it is essential that the auditing authority should be independent of all the authorities. The Comptroller and Auditor General looks into the audits of all the Government accounts in the country. He audits the accounts of the State Governments also.

An independent audit is necessary for protecting the state against misappropriation of funds. The audit must be truly independent to discharge its functions efficiently and effectively. In India, the independence of audit is complete and fully guaranteed through the constitution. The Comptroller and Audit General is discharging his duties as the guardian of public funds.

DUTIES AND POWERS OF AUDITOR GENERAL

- He audits and reports on all expenditure from the revenues of the Central and State Governments.

- He audits and reports all transactions of the Central and States relating to debt, deposits, sinking funds, advances, etc.,

- He is responsible for keeping accounts for the centre except those relating to defence and railways.

- He prepares each year's accounts showing the annual receipts and disbursements.

III. Parliamentary Control:

The Parliament has a right to look into the expenditure. There are three important Committees in the Parliament.

a. Committee of Public Undertakings :

It consists of 15 members from the Lok Sabha and from the Rajya Sabha. The speaker of the Lok Sabha nominates the Chairman of the committee from among the members of the Lok Sabha.

The Committee evaluates the performance of public undertakings in all aspects. The management finance and the progress of the public undertakings are examined by this body. Later on it will submit a report to the government.

b. Public Accounts Committee :

This Committee is constituted by Parliament for the purpose of scrutinising the report of the Comptroller and Auditor General. This committee consists of more than 20 elected members of the house. The chairman of the committee is appointed by the Speaker. This Committee is above party politics. It examines the content of public expenditure in the past. It can summon the representations of the various departments and also the officers for any misappropriation.

c. Estimates Committee :

This Committee consists of 30 members including a Chairman appointed by the speaker. The Finance Minister is not the member of the committee. The Following are the important functions of the committee.

- To report the economic improvements in organisations and administrative reforms which are necessary.

- To suggest alternative policies in order to bring about efficiency and economy in administration.

- Examines whether money is allotted within the limits of the policies.

- To suggest the form in which the estimates shall be presented to the Parliament.

Conclusion :

Thus Public expenditure is not left to the free hand. Since public expenditure is made from public revenue, all efforts are made in all the countries to have a watch over public expenditure. In a parliamentary democracy like India, the legislature is supreme and the legislature in India has full control over public expenditure. Parliament is the true custodian of the public funds.

UNIT – III

PUBLIC REVENUE

MEANING

Public Revenue refers to the revenue of a public authority – Central, State and Local Governments.

The term 'Public revenue' may be defined both in a narrow and a broad sense.

In the narrow sense of the term, it includes income from taxes, prices of goods and services supplied by public enterprises, revenues from administrative activities such as fees, fines, etc., and gifts and grants. The incomes from the above sources are described as public revenue. In the narrow sense, it includes only those receipts which increase the assets of the public authorities without increasing its liability.

In the broad sense of the term, it includes all 'incomings'. It includes, besides public revenue, many other sources of income like public borrowings, issue of paper money, etc. Thus, the term, in its broad sense, includes all kinds of incomes. It is generally described as 'public receipt'.

Thus,

Public Revenue = Taxes + Income from sale of public assets + Administrative revenues + Gifts and grants.

Public Receipt = Public Revenue + Public Borrowing + Repayment of loan + Issue of paper currency.

Public Revenue constitutes an important branch of Public Finance.

SOURCES OF PUBLIC INCOME

The various sources of public income may be grouped into four categories – tax revenues, commercial revenues, administrative revenues and grants and gift.

1. Taxes

Meaning and Definition :

Taxes form the most important part of the revenues of any State.

"A tax is a compulsory contribution of wealth of person or body of persons for the services of public powers" (**Bastable**).

"Taxes are compulsory contributions to public authorities to meet the general expenses of Government which have been incurred for public good and without reference to special benefits" (**Findlay Shirras**).

Characteristics of a Tax :

A tax possesses the following three important characteristics.

- A tax is a compulsory contribution from the citizen to the public authority. Refusal on the part of the tax payer to a particular tax to the public authority is liable for punishment by the court of law.
- A tax imposes a personal obligation on the tax payer. The tax payer has the obligation to show of all his incomes to the government and pay the eligible amount of tax to the government. He should not hide the particulars of his income and evade payment of tax.
- The tax revenues are spent for the general and common benefit.

2. Fees

A fee is a charge imposed on the occasion of a special service, the service incidentally in connection with some comprehensive function, according to H.C.Adams.

Prof. Seligman defines a fee as a "payment to defray the cost of each recurring service undertaken by the government, primarily in the public interest but conferring a measurable special advantage on the fee payer.

In simple terms, it is a charge made by the State for a service which is for the general good but which also confers a special benefit to the fee payer.

Examples :-

Court Fees,

Registration fees for legal documents,

Gun licence fees,

Contract fees for marriages, mortgages deeds, etc.,

Fees paid into the postal dept,

Copy right of books,

Issue of passports,

State inspection of weights and measure, etc.,

3. Licences

Sometimes, licences are granted to individuals to do something. As a matter of fact, there is very little difference between a fee and a licence. Very often, a licence is included under the head of 'fees'.

4. Fines and Forfeitures

Fines and forfeitures are more or less similar to each other. Fines are penalties levied for the breach of rules and regulations laid down by the government. They are meant to deter people from doing something forbidden by law. Forfeitures are penalties imposed on people for failing to fulfil certain duties. Failures to appear before courts, to complete contracts as stipulated etc., are examples of forfeitures.

4. Escheats

When owners of estates expire without legal heir or will, those estate will belong to the Government. The value of these estates are known as escheats.

5. Special Assessments

A special assessment is a levy to defray the cost of a particular improvement, and is theoretically in proportion to but never excess of, the resulting benefit accruing to the property against which it is levied, according to Prof. Shultz. In simple terms, when the value of the property of people living in an area may rise as a result of some project or improvement undertaken by the Government, like undertaking of an irrigation project or construction of roads, is quite reasonable that the cost of such project is distributed in part or in whole among the property owners. These special assessments are usually levied by the local authorities, but Central and State Governments also make use of them.

Professor Seligman points out that the special assessment has certain characteristics.

a. There is an element of special purpose.
b. The special benefit to the individuals is measurable.
c. These assessments are not progressive, but proportional to the benefits conferred.
d. They are only for special improvements.
e. They are to defray the cost of specific project concerned.
f. They represent the exercise of the taxing power.
g. They are a compulsory payment.
h. They are capable of apportionment.

6. Receipts from public property

Income from the sale or lease of public property like lands, buildings, mines, forests, etc., constitutes one of the items of public revenue.

7. Receipts from public enterprises

The Government receives profit from public enterprises like railways, post-office, the central bank, tolls, electricity department, etc. Public enterprises are commercial as well as quasi-commercial enterprises. Commercial enterprises are those whose sole aim is profit-maximisation eg. French Tobacco Monopoly. In these enterprises, the prices charged are usually higher than what the prices would be under competition. Quasi-commercial enterprises are those whose motive is also service or convenience of the people eg. hospital. In these enterprises, prices may or may not be charged. Of course, incidentally such services bring profits to the public authority.

8. Public Borrowings

Public borrowings refer to the proceeds of loans floated by the governments. Generally the Governments borrow from their own citizens, banks in their countries, foreign countries, and international financial institutions like the I. M. F and the I. B. R. D, etc., Voluntary public loans from its own citizens are also accounted for under this category.

9. Receipts from the use of the printing press

Receipts from the use of the printing press by the use of paper money for the purpose of meeting public expenditure are classified under this heading. The issue of token coins also yields a profit to the Government. Even inflation can be included in this category as a source of income to the Government.

10. Grants and Gifts

Grants are usually made by one government to another for the performance of a certain specified function in a specified manner. Grants-in-aid are given by the Central Government to the State Government and local bodies, and by the State Governments to the local bodies.

Gifts are voluntary contributions by private donors to the Government generally for some specified purpose, especially in periods of war, famines, floods, etc.,

CLASSIFICATION OF PUBLIC REVENUE

Different economists have classified the sources of public revenue differently. The object of classification is to know the similarities and differences between the various sources of public revenue, to analyse the effects and incidence of various taxes.

1. Adam Smith's classification:

Adam smith divided public revenue into two-revenue from the people and revenue from state property. Revenue from the people refers to the revenue obtained through taxation while revenue from state property includes profits of public sector enterprises.

2. Bastable's classification:

Bastable also classified public revenue into two parts.

a) Income received by the government from its various functions. e.g., fees and prices.

b) Income received by the government in the capacity of "state" e.g., taxes and levies.

This classification is also narrow and limited like that given by Adam Smith because it is not possible to classify fee, gifts, fines and special assessments into separate groups.

3. Adam's classification :

Prof. Adam has divided public revenue into three groups.

a) Direct revenue : It refers to the revenue obtained directly from the state owned property. It includes revenue from public land, rail, roads, high ways post and telegraph etc.,

b) Derivative revenue : Incomes derived from the citizens of the state are included under this category. Taxes, fees, fines, penalties, etc., fall under this category.

c) Anticipatory revenue : It refers to the anticipated income of the government obtained through sale of treasury bills, floating new loans, etc., This classification is also defective in the sense that it include both commercial and administrative revenues which are fundamentally different in nature.

4. Seligman's classification :

Seligman has divided public revenue into three parts.

a) Gratuitous revenue : It refers to the revenue obtained by the government free of cost. This includes gifts, donations, etc.,

b) Contractual revenue : This revenue is derived by the state as a result of the contracts between the public and the government. Income from land, mines, public enterprises fall under this category.

c) Compulsory revenue : This category is divided into eminent domain, penal power and taxing power. The state exercises its power of eminent domain when it expropriates the property of its citizens. The state exercises its penal power by imposing fines and penalties. The state may tax the citizens through its taxing power.

5. Lutz's classification :

Lutz has classified public revenue into six categories.

a) Commercial revenue
b) Administration revenue
c) Taxation
d) Public debt
e) Subventions and grants
f) Book keeping revenues or transfers

The last three are not included in public revenue today.

6. Prof. Shirras's classification :

Prof. Shirras classified public revenue into two categories namely tax and non-tax revenue.

a)**Tax Revenue :** It is an important source of revenue and it includes fees and special assessments. It is called as 'revenue from the people' by Adam Smith and as 'derivative revenue' by Adam. A special assessment is defined as a "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". Fees refer to revenue obtained from monopoly enterprises.

b)**Non-Tax Revenue :** It includes revenue from public undertakings, like railways, irrigation, post and telegraph, telephone etc., revenue from social services like education and hospital fee; revenue from loans; and miscellaneous items like military receipts, exchange and receipts in aid of superannuation.

7. Taylor's classification :

The most logical and scientifically based classification of public revenue is provided by Taylor. He has divided public revenue into four groups.

a) Grants and gifts.
b) Administrative revenue
c) Commercial revenues
d) Taxes

a) Grants and gifts :

Grants and gifts are the financial assistance given by one government to another to perform a specified function. Education and health grants are given by the Centre to the State. The state governments need not repay it. "Gifts are voluntary contributions from non-governmental donors for specified purposes". Grants and gifts are voluntary in nature and there is absence of quid pro quo.

b) Administrative Revenue :

It includes fees, licences, fines, forfeiture, escheats and special assessments. There is no close relationship between the amount of assessment and value of the benefit or cost incurred. It arises from the administrative function of the government and therefore, it is called as administrative revenue.

c) Commercial Revenue :

It refers to the revenue obtained from the prices of government produced commodities. There is a direct receipt of a good in return for payment. It includes payments for postage, toll, prices for liquor etc.,

d) Taxes :

Taxes are compulsory contributions made by the public to the government. There is no direct quid pro quo.

Taylor's classification is sound and scientific and therefore, considered to be more logical and useful.

8. Economic classification :

Since all these classifications are not suitable for making economic interpretations, comparative study of income and expenditure and for analysing various aspects, an economic classification of the budgetary transactions was adopted in India in 1957-58. This classification divides income and expenditure into Revenue Account and Capital Account. Revenue account includes tax revenue and non-tax revenue. Market borrowings, external assistance, small savings, provident funds are all included in Capital Account.

This classification is satisfactory as there is no over-lapping. It is useful for making economic interpretations.

CANONS OF TAXATION

OR

PRINCIPLES OF TAXATION

Introduction :

There are some important qualities necessary for a good taxation. They are known as canons of taxation. Canons refers of principles.

Adam Smith's Canons of Taxation :

i. Canon of Equality :

According to this canon, all the citizens of a country are equal before the law. All people should be treated in an equal way for the purpose of taxation.

ii. Canon of Certainity :

According to this canon, every citizen should know the time of payment, the mode of payment, the quantity to be paid etc. For example, even in modern days people should know exactly how much they can pay by way of income tax and other taxes.

iii. Canon of Convenience :

According to this canon taxes should be imposed in such a manner that the people should find it convenient to pay. For example, farmers can pay tax after harvest. This will help to reduce the burden of taxation.

iv. Canon of Economy :

According to this canon, the administrative cost of tax collection should be minimum. As a result the government need not spend a large amount of money in the collection of taxes.

Canons of taxation by other writers:

v. Canon of Productivity :

According to this canon, taxation should be able to increase productivity.

vi. Canon of Elasticity :

The government should follow the principle of elasticity while taxes are imposed. According to this principle, there should be more revenue during the prosperity and less revenue during the slack season.

vii. Canon of Diversity :

According to this principle, there should be a number of taxes in a country. A good taxation should not depend on a number of taxes like direct and indirect taxes.

viii. Canon of Simplicity :

The tax payer should understand the nature, aims, time of payment, methods of payment and basis of taxation easily.

ix. Canon of Expediency :

A good tax should be taken into account from different angles. It should be studied from the Government's point of view, tax payer's point of view, development point of view etc. Then only it satisfies the principle of expediency.

x. Canon of Co-ordination :

There should be co-ordination between the different bodies in the matter of taxation.

Conclusion :

A good system of taxation should based on all the above principles. Without these principles there can be no good taxation. Taxation is necessary for the economic and social well being. The canons of taxation laid by Adam Smith are applicable even to modern days.

KINDS OF TAXES

There are two kinds of taxes. They are direct taxes and indirect taxes.

According to Dalton, a direct tax cannot be shifted while an indirect tax can be easily shifted to others. According to J.S Mill, a tax legally paid by one person is direct tax. On the otherhand, an indirect tax can be paid by a number of people. According to Shirras, direct taxes are levied directly on the property and the income of the people. These taxes are paid by the people directly to the state. For example income tax, wealth tax and corporation tax are direct taxes. On the otherhand, indirect taxes are paid through the consumption of the people. For example, customs duties and excise duties are collected as indirect taxes.

Merits of Direct Taxes :

i. Economy :

The administrative cost of collecting direct taxes is low because most of the direct taxes are paid by the tax payers themselves.

ii. Certainity :

Direct taxes satisfy the canon of certainity. The tax payer is certain as how much he is expected to pay and the state is also certain as how much it has to receive income from direct taxes.

iii. Equity :

Direct taxes are considered to be just equitable because they are generally based on the principle of progression. They fall more heavily on the rich than on poor.

iv. Reduction of inequality :

Since the direct taxes are progressive in nature the rich people are subjected to higher rates of taxation. At the same time the poor people exempted from direct tax obiligation. Hence inequality in a country can be reduced with the help of direct taxes.

v. Elasticity :

The direct taxes also satisfy the canon of elasticity because the government revenue can be increased by raising the rate of taxation.

vi. Civic consciousness :

The direct taxes create civic consciousness among the tax payers. The tax payer can take an intelligent and keen interest in public expenditure.

Demerits of Direct Taxes :

i. Unpopular :

The direct taxes are generally not shifted. Hence tax payers oppose it.

ii. Inconvenient :

The direct taxes have to be paid at the source of income itself. Hence they are found to be inconvenient.

iii. Evasion :

A direct tax is a tax on honesty and is not evaded by the people.

iv. Injustice :

Some times the burden of direct taxes is not uniform. Hence direct taxes are not on the basis of ability to pay.

II Indirect Taxes

Merits of Indirect Taxes :

i. Convenient :

Indirect taxes are convenient to pay. They are paid in small amounts at intervals instead of lump sum. Indirect taxes are generally included in the price of the commodity.

ii. Elasticity :

Indirect taxes can be elastic because revenue from indirect taxes can be increased when the governments want more revenue.

iii. Can not be evaded :

Indirect taxes are generally difficult to be evade because they are included in the price of the commodity. A person can evade an indirect tax only if he is not purchasing a commodity. But in modern days indirect taxes are evaded through smuggling and false accounts.

iv. Progressive :

Indirect taxes can also be made progressive by means of imposition of heavy taxes on luxuries.

v. Wide coverage :

With the help of indirect taxes, the tax system can broad based.

vi. Productive :

The income from indirect taxes can be made highly productive by imposing a few taxes. Indirect taxes can be levied on those commodities for which the demand is inelastic.

Demerits of Indirect Taxes :

i. Regressive :

The indirect taxes are generally regressive in nature because they fall heavily upon the poor than upon the rich.

ii. Administrative cost :

The administrative cost of collecting indirect taxes is generally high.

iii. Discourage savings :

Indirect taxes discourage savings because they are included in the price. The people have to spend more on essential commodities.

iv. Uncertainity :

The income from indirect tax is said to uncertain because the taxing authority cannot estimate the yield from indirect taxes. This is because there are different demands for different goods.

v. No Civic Consciousness :

Indirect taxes are collected through middle men like traders. Hence they have no direct impact. Hence they do not increase the civic consciousness of the people.

COMPARISON OF DIRECT AND INDIRECT TAXES

Direct and indirect taxes can be compared on the basis of allocation, administration and distribution.

a) Allocative Effects :

A consumer gets greater satisfaction under direct taxation than under indirect taxation. This is because the burden of tax or sacrifice in direct taxation is greater than in indirect taxes.

b) Administrative Aspects :

The administrative costs of indirect taxes are lower than direct taxes. Hence from the point of view of administrative aspect, indirect taxes are superior than direct taxes.

c)Distribution Aspects :

Direct taxes can reduce the inequalities of income and wealth in a country. They fall more heavily on the rich than on the poor. Thus, they are regressive in nature.

Conclusion :

Both direct and indirect taxes are essential for economic development. A developing country like India has to depend more on indirect taxes than direct taxes.

The income from direct taxes cannot be adequate for satisfying the expenditure of the country. Hence both direct and indirect taxes have to be combained a good tax system.

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.

a) Taxes should satisfy the canon of equity. That is rich people should pay more.
b) It should not destroy the incentive to earn, save and invest in productive enterprises.
a) Taxes should procure sufficient amount of revenue to the government, to facilitate the achievement of full employment and economic growth.
c) Cost of collecting the taxes should be minimum. Taxes should give least trouble to taxpayers.
d) Tax system should be balanced. It means that there should be all kinds of taxes in a proper balance. There must be both direct and indirect taxes. A good tax system should also have both proportional and progressive taxes.
e) Tax system should provide maximum social advantage.
f) A good tax system should have built in elasticity. That is, revenue should increase along with an increase in national income.
g) The tax system should be understandable to the tax-payer.
h) Cost of administration should be low.
i) Allocation of taxes among different groups of people should be according to the principles of least sacrifice, cost and benefit and ability to pay.

j) A good tax system should ensure equitable distribution of income and an increase in national income.

TAX OBJECTS IN INDIA

The following are the important tax objects in India :-

1. Economic Growth :

Economic growth refers to an increase in the real per capita income. All the under-developed countries want to achieve economic growth. Taxation can help economic growth in a number of ways. It can increase the capital of the country by promoting a number of measures to save. It can also promote more and more of employment opportunities. The employment opportunity in turn can bring about more and more of production.

2. Redistribution of Income and Wealth :

There are inequalities of income and wealth in most of the under-developed countries. The inequalities can be very much reduced with the help of direct taxes. For example, taxation on income can reduce the inequalities. Similarly, welfare measures can be given to the poor people.

3. To Control Inflation :

India is facing a severe inflation. The evils of inflation are large. Taxation can reduce this evil. Thus taxation can control inflation also. Excess of money supply can be reduced by taxation.

4. Economic Stability :

India wants a stable economy. For this purpose, we want a good amount of taxes and also reduction in the price level. There should be uniform economic activity. All these things can be easily achieved with the help of good fiscal policy. Economic instability can be achieved with the help of various fiscal measures like counter – cyclical measures.

TAXABLE CAPACITY

Introduction :

It refers to the maximum capacity a country can contribute by way of taxation. According to Musgrave, the term taxable capacity refers to the sacrifice made by the community. This term can be interpreted in two senses, namely absolute taxable capacity and relative taxable capacity.

a)Absolute Taxable Capacity :

It refers to the maximum amount which can be collected from a community without caring any unpleasant effect.

b)Relative Taxable Capacity :

It refers to the taxable capacity of one community as compared to another. For example the taxable capacity of two countries or two states can be compared. According to Colin Clark, the maximum taxable capacity of most of the countries is 25% of its national income. But this limit can be applied only to developed countries and not to developing countries.

FACTORS AFFECTING TAXABLE CAPACITY

a) Size of National Income:

a. Larger the size of national income, greater would be the taxable capacity. On the other hand, smaller the size of the national income, smaller would be the taxable capacity.

b) Size of population:

a. The size of the population is also affecting the taxable capacity. When population is increasing there would be a low taxable capacity. On the other hand, when population is low, taxable capacity is high.

c) **Distribution pattern:**
    a. The distribution pattern of a country is also responsible for taxable capacity. In a country when there is an equitable pattern of distribution there would be low taxable capacity. On the other hand when there are inequalities the taxable capacity is more.

d) **Pattern of Taxation:**
    a. The pattern of taxation also decides the taxable capacity. There should be a good mixture of direct and indirect taxes. Then only there will be more taxable capacity. On the other hand, when the pattern of taxation is limited to only a few taxes there would be a low taxation capacity.

e) **Stability of Income:**
    a. When income is stable the taxable capacity is higher. On the otherhand when income is not stable the taxable capacity is lower.

f) **Psychological effect on the Tax Payer:**
    a. The psychological effect on the tax payer is an important factor affecting the taxable capacity. People when they are ready for taxation taxable capacity would be high. On the other hand when the people are not psychologically ready the taxable capacity is low.

g) **Economic Condition:**
    a. During prosperity there would be a higher amount of taxable capacity. On the other hand during depression the taxable capacity would be low.

h) **Political Condition:**
    a. Stable political conditions and successful planned economic development can create a confidence in the minds of the tax payers. On the other hand, the taxable capacity is low under instable socio-political conditions.

TAXABLE CAPACITY IN INDIA

The taxable capacity in India is only 15% of our rational income. According to Clark, it should be 25% of the national income. But this cannot be applied to a developing economy like India. The following are the major reasons for the low taxable capacity in India.

1. The rate of growth of population is 2.4% per annum. Hence there is a mounting population pressure and we cannot increase our taxable capacity.
2. Indian Economy is an agriculture economy and as such we may not be able to get a steady income. When agriculture fails our taxable capacity also fails.
3. The entire Indian economy is not a monetised one. There are a number of barter transactions and hence we have low taxable capacity.
4. The volume of international trade is very much limited in India. International trade can offer a good scope for commodity taxation. The proportion of foreign trade to national income is very much limited in India.

USES OF THE CONCEPT OF TAXABLE CAPACITY

1. With the help of taxable capacity we mobilise the resources for the economic development. Five Year Plans can be drawn with the help of the taxable capacity.
2. The effects of taxation and production on income can be studied with the help of taxable capacity. It may useful for us to know the impact of taxation in an economy.
3. This is useful for Central Government for distributing the resource between the Central and the State Governments. Weaker states can be given more financial aid than rich states.
4. This concept is useful to know that how much money is to be collected from the people to finance an emergency like war.
5. It is useful for the purpose of comparison of the burden of taxes between the different states.

SHIFTING AND INCIDENCE OF TAXATION

Introduction :

The burden of a tax does not always lie on the person from whom it is collected. In many cases other people also bear the burden. There are three concepts involved in the process of taxing.

First of all, a tax may be imposed on a person,

Secondly it may be transferred by him to a second person,

Thirdly it may be ultimately borne by the second person or transferred to others by whom it is finally consumed.

IMPACT OF TAX

The person who originally pays the tax and does not bear its ultimate burden bears the impact of the tax. The impact of tax is on the person who pays the money in the first instance.

Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to the another.

Incidence of a tax refers to the money burden of a tax on the person who ultimately bears it. In other word when a tax finally come to rest on the ultimate tax payer it is known as the incidence of a tax. The incidence of a tax remains upon the person who cannot shift its burden to any other person. In short these are three different conception namely the impact, the shifting and the incidence of the tax which correspond respectively to the imposition the transfer and the setting or coming to the rest of the tax. The impact is the initial phenomenon, the shifting is the intermediate process and incidence is the result.

DIFFERENCE BETWEEN IMPACT AND INCIDENCE

There are certain important differences between incidence and impact. The impact refers to the initial burden of the tax while incidence refers to the ultimate burden of the tax.

Impact is felt by the tax payer at the point of imposition while incidence in felt by the tax payer at the point of settlement or rest of the tax.

Impact of a tax can be shifted but the incidence of tax cannot be shifted.

IMPORTANCE OF INCIDENCE OF TAX

The concept of incidence of taxation is important in the theory of public finance because the burden of taxation can be easily assessed with this concept. The government should know on whom a tax burden is falling. Then only it can levy a new tax. After knowing incidence the government is in a position to determine the just and fair distribution of taxes.

FACTORS AFFECTING THE INCIDENCE OF A TAX

The following are the important factors which affect the incidence of a tax.

1. **Price :**

Price acts a medium of shifting. Tax shifting takes place when the imposition of tax results in price changes. The shifting and incidence will depend upon the conditions which brought about changes in demand and supply after the imposition of the tax. The shifting of the incidence may be forward or backward. The shifting is done by raising the prices so that the incidence would ultimately fall upon the buyers. The extent to which it can be shifted forwarded will depend upon the extent to which price can be raised.

2. **Nature of Demand :**

The nature of demand is also an important factor affecting the incidence of a tax. The nature of demand for different goods is different because the elasticity demand for different goods is different. Hence the demand for necessaries is inelastic while the demand for luxuries is elastic. Therefore the relative incidence of a tax on different goods would be different. The burden of tax is divided almost equally between buyers and sellers in the case business which is not easily shifted to the consumers.

3. **Nature of Supply :**

The nature of supply depends upon certain conditions. Those industries which have a large fixed and immobile capital do not have a very inelastic supply. When the supply is inelastic the burden of tax is not easily shifted.

4. **Effects of period on Shifting :**

The shorter the period of time the lesser is the scope of adjusting the supply. The supply of a commodity cannot be increased in the short period. But in the long period the supply of the commodity will be relatively elastic because it is easy to change the capacity of a plant.

5. **Area :**

The size of the area in which a tax is applicable is also important in its shifting. It may be very difficult to shift a purely local tax if it is heavy. On the other hand a light local tax can be easily shifted.

6. **General Business Conditions :**

During prosperous times taxes can be easily shifted while during depression taxes cannot be easily shifted.

INCIDENCE OF SPECIFIC TAXES

There are two types of tax on income namely taxes on the net income of the individual and taxes on net incomes of business firms.

A) TAXES ON NET INDIVIDUAL INCOME

A tax imposed upon individual is net income is not generally shifted. Personal incomes are generally received through wages, interest and rent. The shifting is difficult the case of a tax on income because of the following reasons.

- ❖ The scope of progressive income taxes is limited.
- ❖ The burden of taxes falls upon the surplus income.
- ❖ Market forces generally remain and favourable to shifting.

In general the burden of taxes on net individual income cannot be shifted.

B) TAXES ON NET INCOMES OF THE BUSINESS FIRMS

A tax on a income of a firm can be shifted to the buyers of the product of the firm. Hence again it depends upon the elasticity of demand and supply. If the demand for the commodity is highly elastic and the supply is inelastic, forward shifting is not possible. On the other hand if the supply is highly elastic and the demand is inelastic, forward shifting is possible.

C) TAX ON PURE PROFIT

It cannot be shifted because such a tax does not affect the price level.

In the short period the incidence of tax on the profit of the firm will remain upon its numbers. On the other hand in the long run a competitive industry may be in a position to shift the income tax burden to the buyers. The firm with enjoy the marginal profits will leave the industry and the supply position would be affected. Hence the price of the commodity may be raised. Therefore a part of the tax burden may be shifted forward.

D) INCIDENCE OF SALES TAX AND EXCISE DUTIES

The sales tax is imposed at the time of a sale of a commodity and the excise duties impose when the commodity is a product. Such a tax is called commodity taxation. The incidence of such a tax will depend upon the elasticity of demand and supply. If the elasticity of demand is equal to the elasticity of supply, the tax burden would be equally divided between buyers and sellers. Hence the price will raise by half the amount of tax. If the demand is inelastic and supply is elastic the raise in price will be more than the amount of tax and vice-versa. Generally sales and excise taxes are shifted forward through backward shifting of taxes is possible. There are some other factors also deciding the incidence of such taxes. They are listed below.

- ❖ During prosperity shifting of taxes is easier.
- ❖ If a taxed product has an untaxed substitute forward shifting would be difficult.
- ❖ When people are accustomed to certain goods the forward shifting of taxes is easy.

E) INCIDENCE OF CUSTOMS DUTIES

Import and export duties are known as custom duties. The incidence of import and export duties is determined by the elasticity of demand of the commodities to each country. For example if the demand for India's product to American is inelastic then the major part of export duty will be upon the buyers in America. On the other hand if the demand for America's product in India is inelastic, then the major part of export duty will be upon the consumers in India. Let us suppose there are two countries America and Britan and understand the incidence of imports and exports duties.

FACTORS DETERMINING THE INCIDENCE OF AN EXPORT DUTIES :

1. If the commodity is produced in America and necessary in Britan the burden of a export duty will fall upon the consumer of Britan.
2. If America has a monopoly power in the production of the commodity then the export duty will be upon the people of Britan.
3. If the supply of a commodity to any country is elastic the burden of export duties will be largely upon the importing country.

FACTORS DETERMINING THE INCIDENCE OF AN IMPORT DUTIES :

1. If the America is monopolist then the import duty will be on America if the demand for the product is elastic. On the other hand if the demand for the product in Britan is inelastic then Britan will have to bear the import duty.
2. If a country imports the major portion of the total world supply of a commodity, the burden of import duty will depend upon the foreign country.
3. If a commodity is facing completion in the foreign market the burden of import duty may be partly upon the exporting country and partly upon the importing country.

CONCLUSION :

Thus the incidence and shifting of taxation differ from tax to tax and time to time. Hence the incidence and impact are not always uniform.

EFFECTS OF TAXATION

INTRODUCTION:

Taxation is used not only for raising revenues but also for achieving the socio-economic objectives in a country. For example taxation is interested in achieving economic growth, control of trade cycles and removal of income and wealth. Dalton has discussed the effects of taxation under the following heads.

1. Effects of taxation on production.
2. Effects of taxation on distribution.
3. Other effects of taxation.

1. EFFECTS OF TAXATION ON PRODUCTION

The effects of taxation on production can be discussed in the following ways :

a. EFFECTS ON ABILITY TO WORK AND SAVE :

Taxation means transfer of purchasing power from the hands of individual to the Government. The purchasing power of the tax payer is reduced. This effect felt more strongly by the poor people. It curbs the consumption of necessaries and comforts. Therefore heavy taxation on the people affect their efficiency and ability to work.

At the same time all taxes do not adversely affect the ability of the people. For example, taxes on commodities like liquor and opium will not affect productivity. They will increase the efficiency of labour.

Saving depends on income and when income is reduced by taxation saving automatically declines. Therefore heavy taxation affects the saving also.

b. EFFECTS ON THE DESIRE TO WORK AND SAVE :

Taxation affects the incentives of the people to work, save and invest. If the incentives of the people are affected production will also automatically affected. Hence we have to analyse the effects of taxation on the incentives to work, save and invest. The effect of taxation on economic incentives depend upon the nature of taxes and the psychological reaction of the tax payers.

Direct taxes like income tax affect the desire to work and save. At the same time taxes on wind falls will not affect the desire to work and save. Similarly a tax on monopoly profit will not affect the desire to work and save. But commodity taxation within reasonable limits will not affect the desire to work and save. On the other hand, if the commodity taxation is heavy it may affect the desire to work and save.

The comparative effects of an income tax, wealth tax, inheritance tax, and expenditure tax differ in nature. The income tax and wealth tax generally check the desire of the people to work hard and save more. A highly progressive income tax discourages most of the tax payer to working hard and saving more. But wealth tax has less effect, on the desire to work on the tax payer. In the inheritance tax is paid by the tax payer from his unearned income and it does not affect his desire to work and save.

The expenditure tax will have more favourable effects on the desire to work one save than income tax. A progressive expenditure tax will discourage wasteful expenditure on consumption and encourage saving and investment. The expenditure tax may be used to change the composition of consumption.

The psychological reaction of the tax payer also affects the desire to work and save. When a tax is announced the tax payer immediately feels that it will reduce its income. The psychology of the tax payer may affect his desire to work hard and save more. This is known as “the announcement effect”.

The rate of elasticity of income on desire to work and save is also important. If a person has an elastic demand for income, his incentive to work and save may be affected. Hence production may suffer. On the other hand if a person has an inelastic demand for income the incentive to work and save may not be affected by taxation.

During prosperity the burden of taxation is not felt by the tax payers. During times of war also people does not feel the burden of taxation.

c. EFFECTS OF TAXATION ON DIVERSION OF RESOURCES :

Taxation can affect the composition and pattern of production. Taxation may be used as an instrument of physical policy for the diversion of resources between industries and regions. Thus taxation can affect not only the size and growth of production but also the composition and pattern.

If the product of certain industries are taxed their prices would rise and hence the demand for their would be reduced. As a result the profit also reduced. Therefore the resources may be shifted from one industry to another. There are different types of diversion are discussed below.

- **BENEFICIAL DIVERSION :**

Some diversions are readily beneficial to the progress and prosperity of the people. For example taxes on intoxication may affect the health and welfare of the people. Therefore these articles may be taxed.

As a result the resources employed may be shifted from these industries to useful industries.

- **HARMFUL DIVERSION :**

When taxes are levied on essential goods the production of these goods affected. As a result the profit is reduced and may try to produce non-essential goods. In this case the resources are diverted from the production of useful goods to that of less useful goods.

- **DIVERSION OF RESOURCES FROM PRESENT TO FUTURE :**

Some times taxes are imposed in order to discourage consumption and to encourage savings. As a result the resources are diverted from present uses to the future uses. It may affect present production.

- **DIVERSION OF RESOURCES FROM ONE STATE TO ANOTHER STATE :**

When a particular state taxes heavily the investment may be shifted from that state to another. As a result the resources are diverted from one part to another part. Sometimes even resources may be shifted from one country to another country.

2. EFFECTS OF TAXATION ON DISTRIBUTION :

According Wagner, a German economist taxation should be used as an instrument to reduce the inequality of income and wealth. The effects of taxation on the distribution of income and wealth depend upon two factors namely,

a) Nature of taxation.
b) Kinds of taxes.

a. NATURE OF TAXATION :

The nature of taxation refer to the burden of taxation. In the case of regressive taxation the inequality of income and wealth may increase. In the case of proportional taxation the inequalities of income and wealth would remains the same. But in the case of progressive taxation the inequality of income would be reduced.

b. KINDS OF TAXES :

The burden of indirect taxes is generally regressive in nature. Even the poor people are rejected to heavy taxation. There is no exemption to the poor people in the case of commodity taxation. Therefore burden of indirect taxes falls more heavily on the poor people than on rich people.

Direct taxes can be used as an instrument for the equitable distribution of income and wealth. For example income tax can be made as a progressive tax. The larger incomes are taxes at higher rates than smaller income. Again the exemption is granted to the low incomes. In the case of property tax, it reduces the incomes of the owner of the property.

3. OTHER EFFECTS

a. EFFECTS OF TAXATION ON EMPLOYMENT :

Taxation reduces the purchasing power of the people which ultimately reduces the effective demand. As a result the employment also falls down. On the other hand without taxation production and effective demand improve. This leads to the generation of more and more of employment.

But the above situation may true of developed countries. The Government needs a large amount of money for large expenditure in underdeveloped countries. The public expenditure improves the level of economic activity which turn increases the level of employment.

b. TAXATION AND INFLATION :

The aim of taxation during inflation is reduce to the purchasing power of the people. As a result the consumption may fall down leading to stability in the economic activity. At the same time new industries can be encouraged by exempting them from taxation.

CONCLUSION :

Thus taxation has a number of effects on income, raising employment and price level. In modern days it has some regulatory effects also. Thus taxation is not a mere tool for getting income but also powerful instrument for socio-economic changes.

VALUE ADDED TAX (VAT)

MEANING AND DEFINITION :

The Value Added Tax (VAT) was introduced in France on 1954 in order to do away with the evils of the complex and unmanageable system of turnover taxes. Since then, it has been receiving increasing attention from tax authorities and fiscal economists all over the world. It is a tax on the value added to a commodity or service. It is imposed on the value that business firm adds to the goods and services that it purchases from other firms. It adds value by processing or handling these purchased items with its own labour force or its own machinery, building or other capital goods. It then sells the resulting product to consumers or to other firms. Thus, there is a difference between the sale proceeds and the cost of the materials, etc., that it has purchased from other firms. This difference is the value added to a commodity and that is the tax base of the Value Added Tax.

MERITS OF VALUE ADDED TAX

The Value Added Tax (VAT) has the following advantages.

1. Simplicity :

The Value Added Tax is popularly known for its simplicity. Though it is a multi-point tax, it is very much like a single stage tax in terms of its impact.

2. **Neutral in allocation of resources :**

   It is perfectly neutral in allocation of resources.

3. **Minimises scope for tax evasion :**

   The Value Added Tax minimises the scope for tax evasion. Under the VAT system, the major chunk of tax revenue comes from large concerns which are generally not in a convenient position to evade tax.

4. **Easy supervision by tax authorities :**

   The VAT is collected only from large-sized firms. It is therefore, easier for the tax authorities to supervise the taxation procedures.

5. **Less burdensome :**

   The VAT is collected in small sums and also at different levels of production and sale. Therefore, the tax payers do not feel the burden of the tax.

6. **Benefit of cross audit :**

   The VAT system is based on the principle of cross audit and cross-checking.

7. **Encourages investment :**

   The VAT system encourages investment. Under consumption type of VAT, capital goods are exempted from the tax and this facilitates increase in investment and production.

8. **Encourages exports :**

   The burden of the VAT is generally less. The fiscal authority also permits refund of taxes paid earlier. It does not enter into the cost and price. Therefore, the prices of such goods are low and hence, these commodities can compete with foreign goods in international markets.

9. **Conductive to efficiency :**

   A firm pays VAT only on the value produced by it, and not on profits. Therefore, every firm tries to improve its efficiency and reduce the cost of production.

10. **Burden shared by all factors :**

    The burden of the VAT falls on all the four factors of production on rent, wages, interest and profits.

DEMERITS OF VALUE ADDED TAX

The Value Added Tax system also suffers from the following limitations.

1. **Inflationary character :**

The Value Added Tax its consumers with larger disposable incomes. Therefore it is inflationary in character.

2. **Complicated :**

The VAT system, as already indicated earlier, is not a simple one, but a complicated one. The scheme, no doubt, contains some simple features. In practice, it is a multi-rate system with exemption to certain industries. This makes the system too complicated.

3. **Additional burden :**

The VAT system involves maintenance of accounting records at every stage from the farmer to the retailer. It requires larger tax officials also. Thus, the system puts an additional burden on tax authorities, producers and shopkeepers.

4. **Not neutral :**

The VAT system is acclaimed as neutral in effect. But it is not so in reality. It permits exemption to certain industries. Thus the VAT is not a perfectly neutral tax.

5. **Less productive :**

The revenue collected under the VAT system is far less than the revenue collected under the multi-stage turnover tax system.

6. **Larger tax evasion :**

Its success largely depends on the co-operation of the tax payers because in this system, tax evasion becomes a major possibility and a common practice. The firm creates false purchase invoices and escape taxation.

7. **Not conductive to efficiency :**

When in an economy of shortages there are speculative hoardings, non-competitive price rise and similar practices are quite common, goods will be purchased irrespective of their inferior quality and high prices. Therefore, the VAT system cannot improve the efficiency in these countries.

UNIT – IV

PUBLIC DEBT

INTRODUCTION:

The term 'Public Debt' refers to the total amount of debt owned by the public authority including the Central Government, State Government and local governments to their own citizens or to the foreigners in their individual or corporate capacity. Thus, all kinds of obligations of a public authority (including the currency obligations) are included in the public debt. The Government may borrow from Banks, business organisations, business houses and individuals. The borrowing of the Government may be internal or external.

CAUSES OF PUBLIC DEBT

First of all, when the income of the Government was not sufficient it is forced to borrow internally and externally,

Secondly in a depression when private demand is insufficient the Government may borrow the idle savings of the people and spend them to increase the effective demand and thereby create additional income and employment in the country,

Thirdly a modern state is a welfare state and as such it has to spend more and more of the people. This also increases the size of public debt,

Fourthly most of the countries in the world are planned economics. As a result the Government has to spend more money through borrowing.

Fifthly modern wars and defence expenditure have also increased public debt. Many economists like Keynes have advocated increased public expenditure financed through borrowing and not through taxation. While taxation reduces incomes and demand, public debt has no such effect.

Sixthly borrowing is done in order to control inflation. The excess money can be collected through public borrowing.

Seventhly borrowing is also undertaken for financing public enterprises

CLASSIFICATION OF PUBLIC DEBT

I.INTERNAL DEBT AND EXTERNAL DEBT :

Internal debt refers to the public loans floated within the country. External debt refers to the borrowing from foreign countries. It is believed that an external loan is a burden because the country has to pay to the other country. Again there is a special problem in the case of external loans that both the principal and interest have to be made in the currency of the lending countries. This leads to the problem of transfer of commodities and services from the borrowing country to the lending country. It also increases the problem of adverse balance of payments. However foreign loan should not be coincide a burden provided they are used for useful purposes.

II.PRODUCTIVE AND UNPRODUCTIVE DEBT :

Productive debt is used for productive purposes such as the construction of railways, irrigation and power project. It also includes the establishment of heavy industries like Iron and steel, cement and fertilizers. Unproductive debt is used for war and relief. In the unproductive debt the economy is not getting any return.

III. REDEEMABLE AND IRREDEEMABLE DEBT :

Redeemable loans are those loans the government promise to pay off at some future date. These loans have to be repaid at some future date. On the other hand for those loans for which no promise is made regarding the repayment are known as irredeemable loans.

When a loan is redeemable the government has to make some arrangement for its repayment. It has to find out the ways and means of repaying the debt. In the case of irredeemable loans the government has to pay only the interest regularly.

IV. FUNDED AND UNFUNDED DEBT :

Funded debts are long term debt the payment of those may be made at least after a year or may not be made at all. In other words funded debts are those that are redeemable after a year or not redeemable at all. Unfunded debts are those that are paid off within a year. Bonds are unfunded debts. It should be noted that in the case of funded debts the government has the obligation to pay a fixed amount of interest to the creditor subject to the option of the government. The creditor has no right to anything except the interest.

V. VOLUNTARY AND COMPULSORY LOANS :

Generally government debt is of a voluntary nature. The government invites the individuals and institutions to purchase the government bonds. But compulsory loans are not common in modern times. The government may have to exercise this pressure for getting loans during an emergency like war and also during the period of high inflation.

OBJECTIVES OF PUBLIC DEBT

The following are the reasons why a public authority might incur public debt.

1. **REVENUE :**

The modern governments have expanded their activities in recent years. This has necessitated increase in public expenditure. In such circumstances government expenditure far exceeds government revenue.

2. **NATIONAL EMERGENCIES :**

National emergencies such as natural calamities, floods, droughts and famines, earthquakes or outbreak of war, etc., may arise. Government spending under such situations become both urgent and imperative. Such situations cause a sudden spurt in government expenditure.

3. **WELFARE STATE :**

Modern governments are called welfare states. They undertake a number of functions for promoting the welfare of the people. Old - age pensions, retirement benefits, pensions, disabled benefits, unemployment insurance, etc., are the welfare measures of modern governments. Hence, they have to necessarily borrow.

4. **REVIVAL OF ECONOMIC ACTIVITY :**

Depression is characterised by falling prices, decreasing profits and incomes, and slackening of business activity. Fall in prices and consequently profits, compel the businessmen and entrepreneurs to close down their business or cut short their scale of business activity. The increased expenditure, financed by borrowed money, increases income, effective demand, investment, employment, production and national income and thereby brings about recovery in the economic activity.

5. **CONTROL OF INFLATION :**

In modern days, inflation occurs too frequently. Inflation refers to a situation in which too much money chasing too few goods or the volume of money far exceeds the volume of goods and services. It introduces the spirit of gambling. It pauperises the middle class and destroys the very foundation of the economy. It is a specie of taxation, cruellest of all and an open robbery.

To control inflation, money supply should be reduced through increased public borrowing. The government by raising public debt can withdraw a large volume of money from circulation and thus, it may check rising prices. But modern economists prefer taxation to public borrowing, as an anti-inflationary measure because money received through public borrowing increases the liability of the government for its repayment.

6. **ECONOMIC DEVELOPMENT :**

An underdeveloped economy is characterised by low capital formation, high unemployment percentage, low productivity and low national income. Therefore the government of an underdeveloped country has to play an active role in the economic development of the country. Most of these countries have adopted economic planning as a means to economic development. Government’s economic activity is therefore, extended to the development of agriculture, industry, mining, electricity, transport and the provision of other economic infrastructural facilities.

7. **FINANCING PUBLIC ENTERPRISES :**

Government are running certain commercial enterprises. These are generally productive ones and hence, should be run efficiently. Therefore, the governments borrow for financing such commercial enterprises.

8. **EXPANSION OF EDUCATION AND HEALTH SERVICES :**

Education, public health, etc., are important for the nation as a whole. They improve the efficiency of the people and hence, the general social well-being. Government may borrow for financing such services. That is they are not productive in terms of money.

9. **FINANCING WAR :**

Defence is of paramount importance in modern days. The modern age is the age of atomic warfare and increasing international tensions. Hence every country increases its expenditure on defence services and up-to-date equipments to protect itself from foreign aggression. But income through taxation alone is not sufficient and hence, the government is forced to borrow internally as well as externally for the purpose of financing war.

THE BURDEN OF PUBLIC DEBT

INTRODUCTION :

The burden of public debt refers to the sacrifice it will impose on the community through a raise in taxation for the payment of interest. The burden of public debt may be direct and indirect. Direct money burden is measured by the extent of money involved and the raise in taxation needed. Direct real burden is equal to the loss of economic welfare (Sacrifice of goods and services made by the tax payers) on account of the direct money burden of increased taxation. Indirect burden of public debt refers to the extent of adverse effect of increased taxation on the level of production.

BURDEN OF INTERNAL DEBT

As far as the burden of internal debt is concerned there may be no direct burden on the community as a whole because the payment of interest and the increased taxation to meet the burden of debt involved a transfer of purchasing power from one group of persons to another. In fact when the creditors and the tax payers are the same there not be any net burden of the community. On the other hand if the creditors and the tax payers belong to different income groups, the changes in the distribution of income among the different sections of the community takes place.

While estimating the burden of public debt the purpose of loan should be considered. If a loan is utilised for productive purposes, it can be paid out of the profits of investments. On the other hand if a loan is made to finance a war it may be a dead weight in the domestic economic set up.

It can be concluded that internal debt impose burden upon the community as a whole and the belief that the internal debt not impose any burden on the community is theoretically incorrect and practically unrealistic.

BURDEN OF EXTERNAL DEBT

The nature of external debt is different from that of internal debt. The burden of external debt is greater than the internal debt because in case of internal debt interest charges and the repayment of principle within the country whereas external debt involves the payment of one country to other country. Again there is also the direct real burden because the country that is paying to foreign country loses some of the goods and services it can consume. The money burden may be realised by payment of taxes from the rich people.

The direct real burden of external debt also depends upon the purpose for which the debt is incurred. If external debt is incurred to meet war expenditure it may be called dead weight debt. On the other hand if an external debt is incurred for a productive purpose like importing machinery, raw material and technical know-how it is known as productive debt. Thus we conclude an external debt is not a burden provided it is used for productive purpose. If it is used for unproductive purpose like war it is known as an unproductive debt.

REDEMPTION OF PUBLIC DEBT

OR

METHODS OF REPAYMENT

Redemption means repayment of public debt. Repayment has the following advantages.

First of all it saves the Government from bankruptcy,

Secondly it discourages extravagant expenditure of the Government,

Thirdly it maintains the confidence of the lenders,

Fourthly it saves the future generation from the burden of debt.

METHODS OF REPAYMENT

1. **REPUDIATION :**

This is the refusal to pay a debt by the government. Only the Soviet Russia followed this method in 1917. But in modern democratic days this method is not possible because contracts have to be accepted and respected. If one country repudiates an external debt other countries will not have trade relationship with that country.

2. **REFUNDING :**

If a government sells its bonds to pay its debts it is known as refunding. Refunding is the process by which the maturing bonds are replaced by new bonds. The refunding is undertaken mainly to meet maturity requirements. A drawback of this method in the government would be tempted to postpone its obligation of debt redemption and hence the total burden of debt would continue to increase in future.

3. **CONVERSION :**

Conversion of public debt means exchange of new debt for the old ones. In this method the loan is not actually repaid but the form of debt is changed. The process of conversion consists in converting or altering a public debt from a higher to a lower rate of interest. The government might have borrowed at a time when the rate of interest is high. It may convert an old loan into a new loan at a lower rate. This will minimise the burden of the state in the matter of debt.

4. **ACTUAL REPAYMENT :**

The following measures can be undertaken for the actual repayment of public debt.

a. **SINKING FUND :**

In this method a fund is creating into which a certain amount of revenue is deposited every year for the repayment of outstanding debt. Originally sinking funds are accumulated until debit are matured. In modern days they may be used to retire debt as fast as funds are available. According to Dalton a sinking fund should be made out of the current revenue of the treasury and not out of the loans.

b. **SURPLUS REVENUE :**

A policy of surplus budget may be followed annually for clearing of public debt gradually instead of creating a fund for its repayment on maturity. But in recent years, due to increase public expenditure surplus budget is a rare phenomenon.

c. **TERMINAL ANNUITIES :**

A government may issue terminal annuity, a part of its matures every year according to a serial order decided every year. In this method, the loan is repaid annually and hence the burden of the state is also very much reduced.

d. **CAPITAL LEVY :**

Capital levy refers to a very heavy tax on property and wealth. It is a once for all tax imposed on the capital assets above the certain value. In fact capital levy is changed immediately after the war due to unproductive war debt.

EFFECTS OF PUBLIC DEBT

The following are the important effects of public debt:

1. **EFFECTS ON CONSUMPTION :**

Individuals, financial institutions, commercial banks and the central Bank of the country are the important internal sources of debt for the public authorities. Public debt from all these internal sources affect consumption pattern and expenditure directly or indirectly. Public debt from internal sources results in a transfer of purchasing power and hence, the real resources from the general public authorities. This curbs consumption and has an anti-inflationary effect on the economy.

If people purchases bonds out of their present savings, the public debt affects directly the consumption pattern and expenditure of the people. Here, public debt affects consumption in the same way as taxation.

If, on the other hand, people purchase bonds out of their past savings or out of idle savings, the public debt does not affect private consumption directly. In this case, public debt affects private consumption only indirectly. The indirect effect of public debt is as follows : The past savings, whether idle or active, comes through commercial banks. This reduces the cash balances with the banks and hence, the credit creation power of the banks. The reduction in money supply adversely affects consumption of the people.

2. **EFFECTS ON PRIVATE INVESTMENT :**

When people purchase bonds out of their present savings, it curbs private consumption, lowers price level, creates deflationary tendencies in the economy and ultimately hinders private capital investment.

If, however, people purchase bonds out of their past savings, it does not affect the present consumption expenditure in any way and therefore the present private investment will not at all be affected.

3. **EFFECTS ON LIQUIDITY :**

Public debt is represented by bonds. Bonds are highly negotiable. They can be easily converted into cash. Thus public debt is responsible for the existence of highly negotiable and highly liquid form of assets.

4. **EFFECTS ON PUBLIC INVESTMENT :**

The effects of public debt on investment are not very clear. Two apparently contradictory effects can be visualised.

Huge public debt may be followed by high taxation rates in order to service the debts. Heavy taxation to service public debt may generate fear and uncertainty in the minds of the investors. It will have adverse effects on the willingness of the people to work, save and invest. Consequently investment will decline.

Huge public debt may be followed by a very low rate of interest in order to keep the interest obligations of the government at the lowest amount possible. Therefore borrowing and investment will be encouraged.

5. EFFECTS ON COST OF PRODUCTION :

The effect of public debt on cost of production depends mainly on how the borrowed fund is utilised by the public authority.

The cost of production of a commodity generally depends on the price of raw materials and other factors of production. If for example the state utilise the borrowed funds to supply raw materials to the producers at reasonable rates or to provide transport and training facilities or to promote industrial research or to give subsidies to private enterprises, the cost of production will be low.

6. EFFECTS ON RESOURCES ALLOCATION AND NATIONAL INCOME :

If the borrowed fund is used for productive purposes, it increases production and national income. The cumulative multiplier effect results in further increase in investment, employment, production and rise in the level of national income.

If the borrowed fund is not used for productive purpose, production decreases and national income falls cumulatively.

PUBLIC DEBT MANAGEMENT

MEANING :

The method of borrowing funds and repayment of loans by the public authority should not have any adverse effect on the economic scene of the country. They should also help to maintain economic stability by avoiding inflation and deflation. For all these, an effective management of public debt is an absolute necessity.

It refers to the various authoritative decisions, policy formulations and their implementation concerned with the receipts, assessment and utilisation of public debt collected from internal as well as external sources.

OBJECTIVES OF PUBLIC DEBT MANAGEMENT

There are five important objectives of public debt management in any country.

A) To subserve the economic policy of the government :

The public debt policy plays an important role in the formulation of the economic policy of the government. It should help to raise the purchasing power and demand in the economy during a period of depression and to reduce the purchasing power and demand in the economy during a period of inflation. It should provide adequate funds for the needs of the government for the purposes of war or economic development or for any valid economic reason.

B) To avoid adverse effects in the economy :

Avoidance or at least, minimisation of the adverse effects in the economy is the second important objective of public debt management. That is the public debt management should help fight inflationary and deflationary evils in the economy and should ensure smooth flow of money. This objective is closely related to the first one.

C) To increase the advantages of the government :

The public debt management must be so designed as to increase the advantages of the government resulting from the borrowing and repaying operations. This is largely a matter of timing and rate of interest etc. Borrowing should be undertaken at such times and in such a way that the cost is the least; conversion, refunding and repayment should also be undertaken from the same point of view.

D) To co-ordinate with fiscal and monetary policies :

The public debt policy, fiscal policy and the monetary policy are closely connected with each other for the determination of economic policy. Therefore, they should work in coordination with each other. Otherwise, the public debt policy will prove ineffective. Here arises the importance of public debt management.

E) To eradicate poverty :

The public debt management must be so undertaken as to create more job opportunities, building up of basic industries and breaking up the vicious circle of poverty.

PRINCIPLES OF PUBLIC DEBT MANAGEMENT

An effective management of public debt is evolved on the basis of the following principles.

1. **THE INTEREST COST OF SERVICING PUBLIC DEBT MUST BE MINIMISED :**

That is, the public authority should raise public debt at low rate of interest. If the rate of interest is low, the burden of public debt on the society will be small; otherwise the burden of public debt on the society will be larger. Therefore, the cost of obtaining and redeeming public debt must as far as possible be very low.

2. **SATISFACTION OF THE NEEDS OF THE INVESTORS :**

That is the needs of the investors worth regard to the types of the government securities and the terms of issue re satisfied. If the needs of the investors are not satisfied production will be affected and the government will find it difficult to manage its debts.

3. **FUNDING OF SHORT-TERM DEBT INTO LONG-TERM DEBT :**

That is funding of short-term debt into long-term debt should be done as far as possible without affecting the economic stability. But this policy has certain limitations. First, the demand for long-term funds will increase and hence the long-term rate of interest will rise. Second, the budget expenditures in the future will also increase. Third, the demand for short-term funds will decrease and hence, the short-term rate of interest will fall. Fourth, private investment may be affected. Therefore, the technique of funding of short-term debt into long-term debt should be very carefully resorted to.

4. **CO-ORDINATING OF PUBLIC DEBT MANAGEMENT POLICY WITH FISCAL POLICY AND MONETARY POLICY :**

The public debt policy, fiscal policy and monetary policy are closely connected with each other for the determination of economic policy, and therefore, they should work in co-ordination with each other. All the three policies, when operated with co-ordination, will contribute to economic stability and growth.

5. **MATURITY, DISTRIBUTION AND KINDS OF PUBLIC DEBT :**

If a large volume of aggregate debt is short-term debt or if a large volume of aggregate debt is held by banks, there is a high degree of liquidity. This may create inflationary tendencies in the economy. Therefore, the maturity distribution and kinds of public debt should be carefully planned in such a way that economic stability is ensured.

PUBLIC DEBT IN INDIA

INTRODUCTION :

Public debt is an important source of Governments revenue. India's public debt has increased from the introduction of economic planning in 1950. The public debt in India is undertaken for the following reasons.

- ❖ For promoting economic development we have been borrowing both internally and externally.
- ❖ Public debt is also incurred due to the increased defence expenditure. Though we follow a policy of non- alignment, it is necessary to build a sound military and unclear- liase.
- ❖ The social and cultural development expenditure has increased plans after plan in order to build a sound education, and health. The population of India is increasing at the rate of 2.4% per annum. Hence they have to increase our investment in education and society.
- ❖ All the state Governments have to spend more on education, security and health in their respective states. They are forced to demand more and more of shares from the Central Government. The increase in debt charges is also another important reason for the growth of public debt by 20 times.

- ❖ Rise in the price level on inflation in India is also an important reason for the growth of public debt in India. Inflation affect both the private and also public sectors.
- ❖ The creation of more and more of administrative posts in India is also an important cause in the growth of public debt in India. As a result our public debt has to be increased year after year due to the growth of administrative expenditure.
- ❖ The pay-scales and allowances have increased in modern days due to the rise in prices. As a result the public debt has also increased in India.
- ❖ Deficit budgets are also responsible both at the centre and the states for the growth of public debt in India.

BENEFITS OF PUBLIC DEBT IN INDIA

Public debt in India has benefited the economy in the following ways.

- ❖ It has helped in the development of Indian economy. All the sectors of the economy are being developed with the help of public debt.
- ❖ The national income of India has increased as the result of the policy of public debt.
- ❖ Public debt has also increased the employment opportunities in India.
- ❖ Through the expansion of social services, public debt has improved the human resources in the country.
- ❖ Public debt has provided an opportunity for the people to invest in government securities. Thus savings are promoted.
- ❖ The Indian army has been modernised with the help of public debt.

PROBLEMS OF PUBLIC DEBT IN INDIA

(DISADVANTAGES)

- ❖ The greatest problem of public debt is the problem of repayment. Year after year our public debt is increasing. Debt charges are also increasing. Therefore we must find out ways and means for the repayment of public debt in India.
- ❖ When public debt increases, public expenditure is also increasing. The government should not spend extravagantly.
- ❖ The resources raised by public debt should not be wasted and there should be well invested in definite projects.
- ❖ Many people have criticised that India has been mortgaged to foreign countries. The recent IMF loan of Rs. 5000 cores is criticised by a number of people. India has to pay Rs 72 lakhs per day by way of interest and repayment.
- ❖ To some extent, foreign loans even affect our economic freedom.
- ❖ Some times to relieve the foreign debt, heavy tax is imposed.
- ❖ The adverse balance of payments in India is also due to our heavy public debt.

Market loans, floating debt, special floating loans, etc., constitute the internal debt of India externally we borrow from the countries as well as international financial institutions like the IMF, IBRD etc., Both internal and external loans have also grown in magnitude. This is because we are not able to rise the resources through taxation only. Again loans are expected mop-up the excessive purchasing power from the people. The ratio of internal public debt to national income in India is not high compared to the ratio in most of the countries in the world.

UNIT – V

BUDGET

MEANING AND DEFINITION :

The word "budget" is derived from the French word "bougette" which means a small leather bag. The term came to imply the documents which were contained in the bag, namely plans for Government finances submitted for the approval of the legislature.

According to **Shirras**, "The budget is an annual statement of expenditure and revenue to meet that expenditure prepared by public authorities, and it usually covers at least two fiscal periods - the closing period and the period to come".

According to **W.F. Willoughby**, "A budget is at once a report, an estimate and a proposal, that is, it is the instrument by which all the processes of financial administrations are correlated, compared and co-ordinated ".

The best definition for budget runs as follows :-

" A budget is a comprehensive programme, ready for execution containing an estimate for revenue and expenditure for a definite period, usually a year prepared and presented by the Executive before the Legislature to be voted for".

CHARACTERISTICS OF A GOOD BUDGET :

- A budget is a plan for future action. It should be ready for action. It should be framed on the basis of past experience and available data. It should not be a mere ideology but an action oriented programme. It must be systematic and well organised.
- The budget is not more programme. It should be accepted by the legislature. Hence, the executive should try to impress upon the legislature about the various aspects of budget.
- The items included in the budget are merely estimates. Hence they may not turn into actual.
- The budget is comprehensive plan. Hence it covers all the activities of all the departments and agencies of the government.
- The budget is an annual plan. Sometimes a budget may cover a longer period of time. But usually annual budget are common.
- A budget is always prepared and presented on behalf of the executive.
- The budget is put before the legislature to be voted for. This is due to the democratic organisation of the Government.

CANONS OR PRINCIPLES OF BUDGETING

According to **Prof. Harold D. Smith** the following are the important canons of budgeting :-

1. **EXECUTIVE PROGRAMMING :**

The budget is the work programme of the Government. It reflects all Governmental responsibilities. Hence the formulation of the budget is necessarily under the supervision of the Chief Executive. Both budgeting and programming are under the direct supervision of the Chief Executive.

2. **EXECUTIVE RESPONSIBILITY :**

The Chief Executive has the responsibility of fulfilling the various interests of all departments.

3. **REPORTING :**

Information should be provide to the executive as well as to the legislature regarding the various projects and programmes, expenditure incurred revenue raised, aims achieved etc.,

4. **TOOLS :**

The budget in order to become effective should have enough tools. The Chief Executive should be provided with all the tools necessary for the implementation of the budget.

5. **MULTIPLE PROCEDURE :**

The functioning of the Government differ. Hence different procedures should be adopted for their effective management. The methods of budget vary for different types of activities.

6. **EXECUTIVE DIRECTIONS :**

The executive should be capable of giving enough directions in the implementation of the budget.

7. **FLEXIBILITY IN TIMING :**

There should be flexibility in the timing of the budget. A rigid timing cannot help in the execution of a good budget.

8. **TWO-WAY BUDGET ORGANISATION :**

An ideal budget needs a two-way organisation. In each department, there should be a budget office. At the same time the Central Office and the various department should have a two-way contact.

FUNCTIONS OF A BUDGET

A Government budget has four important functions namely, allocation, distribution, economic stabilisation and long – term economic growth.

1. THE ALLOCATION FUNCTION :

When the pricing mechanism is ineffective in securing an efficient allocation of resources, Government intervention becomes a necessity. This type of government intervention is necessary in the case of social wants. In fact certain social wants can be satisfied only by the government budget such as National Defence, Highways, Public Health, Family Planning, Education etc., The purchasing power of individuals vary in an economy. Flood control projects, slum clearance, nutritional programmes, Milk and Midday Meals Schemes in Schools Library, Public Health facilities etc., increase the general welfare of the whole community. Hence a Government should provide them through a budget.

A Good budget should fix the priorities. Public expenditure should be pushed in all directions up to the points at which the last rupee spent is equal to the satisfaction to in respect of the last rupee called up on government service. This is the concept of Welfare economics developed by Prof. A.C. Pigou. In this approach marginal social benefit derived from marginal social cost is the deciding factor.

2. DISTRIBUTION FUNCTION :

A proper distribution of income and wealth is essential or efficient use of resources and for increasing the standard of living of the people.

Therefore the budget is expected to secure a desirable state of distribution of income and wealth. All the developing countries in the world aim at economic growth with social justice. A budget can achieve the redistributive task through transfer payment, increasing earning capacity by providing educational and training facilities, creating job opportunities etc., In its distributive function, the budget policy aims at shifting income from the disposal of the well-off to the disposal of those in need.

3. STABILISATION FUNCTION :

After the famous depression of 1930's an important object of budget is to stabilise the economy. The fluctuations in the economy would affect income, employment, output etc., The Government is expected to offset fluctuations in private spending through its budgetary policy. It is known as "Compensatory fiscal policy". The Government is required to compensate for any inadequacy in private demand by increasing its expenditure and creating a deficit.

4. ECONOMIC GROWTH :

Economic Growth refers to an increase in the real per capital income. The budget is an important instrument for promoting economic growth. It implies a policy fixing priorities for expenditure to satisfy public wants and needs of economic growth. A very important aspect of this policy is to create conditions for raising saving and investment in both public and private sectors.

In short, a good budget has no single goal. It has a number of objectives.

CLASSIFICATION OF BUDGET

A) MULTIPLE AND UNIFIED BUDGET :

This classification was popular in the U.S.A. A budget divided into parts is related to the specialised function of the government. It is called multiple budget. But it is not popular now. On the other hand, a unified budget is one which contains all aspects of expenditure and income of the public authorities.

B) REVENUE AND CAPITAL BUDGET :

A budget is divided into revenue (current) and capital accounts. Revenue account covers all those items which are of recurring nature. The revenue budget is an ordinary operating budget of current receipts and expenditures. On the other hand, capital budget is a record of financial transactions, incomings on account of loan repayments and deposits of subsidiary funds and outgoings in respect of new lending operations and withdrawal of deposits of the major portion of expenditure of the capital budget is devoted to developmental expenditure.

C) PERFORMANCE AND PROGRAMME BUDGET :

The formulation of the budget is directly related to the extent to which it can be implemented. The implementation of the budget depends on a variety of political, social and economic factors. Very often the actual results do not confirm to the planned ones. Hence performance and programme budget is necessary. This type of budgeting consists of three stages.

First of all, the objectives have to be well defined.

Secondly, a cost-benefit approach has to be applied. This will help in finding out alternative ways of achieving the desired goals.

Thirdly, current programmes and policies are related to the future.

D) FUNCTIONAL CLASSIFICATION OF BUDGET :

The word function refers to a function of the government such as defence, education, health etc., This classification covers only the expenditure and not the receipts. The aim of functional classification is to show government expenditure on short-term purposes served.

E) ECONOMIC CLASSIFICATION OF BUDGET :

The primary purpose of economic classification of the budget is to present government income and expenditure in economically significant categories. It is useful for distinguishing between payments for capital formation, payments for government consumption etc., It provides material for policy making.

BUDGETARY PROCEDURE IN INDIA

The Constitution of every country lays down a specific procedure in this regard and the budget is framed and passed. In the Parliament in accordance with that specified procedure. However this procedure is almost similar in almost all the countries of the world. The budgetary procedure can be divided into the following five stages :

1. Preparation of the Budget
2. Presentation of the Budget
3. General discussion
4. Voting and
5. Execution of the Budget

1. PREPARATION OF THE BUDGET :

The Finance Department supplies Administrative Ministries and Heads of Departments with Skeleton forms. The Administrative Ministries and Heads of Departments are expected to prepare the estimates of expenditure in these forms.

The prescribed form has four different columns :

a) Actual of the previous year
b) Sanctioned estimates for the current year
c) Revised estimates for the current year and
d) Budget estimates for the next year.

The ministries, after examining these estimates pass them on to the Ministry of Finance.

2. PRESENTATION OF THE BUDGET :

After the budget is prepared, the Finance Minister obtains the concurrence of the cabinet with regard to the tax proposals and estimates of expenditure. After this is over, the Finance Minister presents the budget in the legislature for approval.

The Finance Minister presents the budget in the Parliament usually on the last day of February. Exactly at the appointed hour, the Finance Minister, accompanied by minister of Parliamentary Affairs, enters the house, makes a speech and presents the budget. That day is known as budget day and his speech the budget speech. The budget speech is a very important document. It gives a bird's eye-view of the economic conditions of the country and the reasons for the financial proposals of the government. Thus the budget is presented in the Lok Sabha. Then, the budget is also presented in the Rajya Sabha by a junior minister in the Ministry of Finance.

3. GENERAL DISCUSSION :

There will be no discussion on the budget in the budget day. The time and day for discussion are fixed by the speaker. Then there is a general discussion on the budget. The discussion generally lasts for three or four days. The general discussion takes place in both the houses.

The general discussion is an important stage in budgeting procedure. All items of expenditure, votable and non-votable, are subject to discussion. During the general discussion, the members are free to express their appreciation or apprehensions about the tax proposals on any item of the budget. Thus, the members of the legislature have the opportunity of placing the grievances of the tax payers before the House during the course of general discussion.

4. VOTING :

After the general discussion is over, the demands of various ministries are put to vote one after another. The demands of various ministries for grant are called votable expenditures. The demand of each ministry is introduced by the Minister-in-charge of the respective ministry or by somebody else on his behalf. The Lok Sabha examines the demand thoroughly and much time is devoted for discussion. A maximum time limit is also fixed to be two or three days for each particular demand. After discussion, the demand is voted and it becomes a grant.

There are certain items which are a charge on the Consolidated Fund of India and are, therefore non-votable items. Non-votable items include

- Salary and allowances of the President of India
- Salary and allowances of the Judges of the Supreme Court
- Salary and allowances of the Comptroller and Auditor-General of India
- Public debt charges including repayment of public debt
- Salary and allowances of the Chairman and Deputy Chairman of Rajya Sabha
- Salary and allowances of the Speaker and Deputy Speaker of the Lok Sabha and
- Any expenditure required to satisfy any judgment, degree or award of any court or arbitration or tribunal

After the demands have been voted, a Finance Bill is prepared and brought before the House for approval as per the proposals and estimates given in the budget. When the Finance Bill is passed, an Appropriation Bill is presented to accord legality to the voted Demand-Grants and to authorise the government to incur expenditure from the Consolidated Fund of India. Thus, after passing of the Finance Bill and Appropriation Bill by the Parliament, the budget is sent to the President of India who normally gives his assent. After the President assent is given, the budget is sent to the Government for execution.

5. EXECUTION OF THE BUDGET :

The execution of the budget is the responsibility of the government. It is the last and also the most important step in budgeting. The budget should be executed with a high degree of integrity and efficiency, otherwise, it will fail to accomplish its objectives.

The execution of the budget consists of three aspects :

- Distribution of grants to different Administrative Machineries and Departments
- Collection of revenues and
- Proper custody of the collected funds.

Proper distribution of grants or funds :

The distribution of grants is done by the controlling officers. The distribution plan is sent to the Accountant-General who, in turn, communicates the distribution plan of grants to treasuries so that they may have a control over expenditure.

Collection of revenue :

Collection of revenue is also an important step in the execution of the budget. It involves two kinds of operation – (a) Assessment of revenue and (B) Collection of revenue. The Central Board of Direct Taxes and the Central Board of Excise and customs are responsible for assessment, supervision of collection and adjudication of revenue disputes.

Custody of collected funds :

After collection of revenue, proper custody of government funds is the most important step. There is a District Treasury in each district. Each treasury has under it one or more Sub-Treasuries. Receipts and disbursements of money take place daily in treasuries and sub-treasuries on behalf of the Central and State governments. The accounts, thus received from the various treasuries and sub-treasuries are complied and consolidated by the Accountant-General on monthly and annual basis.

ZERO BASED-BUDGETING

More and more governments have switched over from the traditional expenditure budgeting to one or another form of rationalistic budgeting viz., performance budgeting, programme budgeting, planning-programming-budgeting, zero base budgeting.

The Government of India decided to switch over to performance budgeting as far back as in the year 1968-69. The practice so far has been the "incremental addition" to the existing schemes without questioning the rationale behind their continuation. Zero base budgeting will be introduced in a small way in 1986-87, and it will be implemented in full in budget formulations from 1987-88.

CONCEPT :

Explanations of what zero base-budgeting (ZBB) is and how it is supposed to work are numerous. It means the budget as a whole is considered rather than to examine incremental change only. To put it in the word of Prof. Musgrave, "as the term suggests, the idea is to consider the budget as a whole, rather than to examine incremental change only".

The concept of ZBB is that all the financial requirements of a budget unit are analysed; evaluated and justified annually and not just the increased or additional requirements. Thus, no consideration is given to the past or existing at present, any programme may be included or excluded. The Budget is considered as a whole and a fresh, i.e., from Zero-Base.

MERITS OF ZERO BASED BUDGETING :

- It will focus the budget process on a comprehensive analysis.
- It provide of coherent link between planning and budgeting.
- It raise cost consciousness.
- To evaluate in detail the cost effectiveness of their operations.
- It expand executive participation in budgeting at all levels of the managements.
- It provide an objectives basis to reduce or eliminate programmes which have out-lived their utility and expand high-impact programmes.

PROBLEMS :

The problems which might come up in the way of successful implementation of ZBB in India are broadly attitudinal and organisational or operational. The institution of a reform such as ZBB may meet with a resistance from old line populist politicians and employees organisations. These groups of people are likely to resist to ZBB because they might see in ZBB, respectively, a danger to their 'game of convenient number', 'pet-programmes' and 'employment' in the existing schemes, likely to be rated low priority and reduce or eliminated.

The present Indian system of fund allocation in the government though it has some elements quite useful for the introduction of ZBB such as executive participation, higher level administrative scrutiny and judgment and works prioritisation; it lacks the orientation and outlook, skills, data and exposure necessary for the successful implementation of ZBB. The process of preparing budget proposals so far has been largely 'ritualistic'. In addition to this, The multiple levels of decision-making, labyrinth procedures, poorly developed methods of communication, information and retrieval of date, erratic transfers of key officials are some other organisational deficiencies which are likely to pose serious problems in the successful implementation of ZBB in India.

FINANCE COMMISSION

The finance commission is a salient feature of the Indian Constitution. It is a quasi-judicial body. Under the Article 280 of the Constitution of India the president is required to appoint a Finance Commission every five years for the specific purpose of devolution of non plan revenue resources. The functions of Finance Commissions are to make recommendations to the President in respect of :

- ❖ The distribution of net proceeds of taxes to be shared between the union and the states and the allocation of share of such proceeds among the states.
- ❖ The principles which should govern the grants in-aid of the revenues of the states.
- ❖ The continuance or modifications of any agreement entered into between the centre and any of the states and
- ❖ Any other matter concerning financial relations between the union and states.

FUNCTIONS OF THE FINANCE COMMISSION :

1. The percentage of the net proceeds of the taxes which may be divided between the union and the states,
2. The allocation of the share of the proceeds of such taxes between the states,
3. The principles which shall govern the distribution of grants-in-aid out of the Consolidated Fund of the Government of India between the states,
4. The continuance or modification of term of agreement with Part B states regarding the levy of duties,
5. Grants-in-aid for tribal areas, and
6. Special grants for any particular state.

The institution of Finance Commission provides flexibility in the optimum distribution of national resources between different governments in the country in accordance with their needs. No fixed distribution of resources will satisfy the needs, especially in a developing economy where regional inequalities exist. The Finance commissions enable the financial relations between centre and the unit to be altered in accordance with changes in needs and circumstances.

RECOMMENDATIONS OF LAST TWO FINANCE COMMISSIONS

ELEVENTH FINANCE COMMISSION (2001-2005)

The eleventh finance commission was constituted by the president on July 3, 1998. Eleventh Finance Commission was appointed under the chairman of A. M. Khusro in July 1998.

The major recommendation of EFC accepted by the government is summarized below;

- It was recommended that only 28% of the net tax revenue of the centre should be shared with the state.
- The total share of the state in net proceeds or union taxes and duties would be 29.5%.
- Another 1.5% of the net tax revenue produced is shared in lieu of the additional excise duties.
- A lump-sum provision of Rs. 11000 crores in the central budget 2000-01 for revenue deficit grants to states.
- Grants totalling to Rs. 4972.63 crores given for the upgradation of standard of administration.
- Grants totalling to Rs. 10000 crores for local bodies for the maintenance of civic services of this, Rs.16000 crores per annum is for local bodies and Rs 400 crores per annum is for urban local bodies,
- Grants of Rs. 11007.59 crores be given for the continues of the existing scheme of calamity relief fund.
- Grants-in-aid of Rs 35359 core for revenue deficits to 15 states only the remaining 10 states are revenue surplus states.
- A national food security buffer stock of 10million tonnes should be maintained at all times.
- To reduce subsides on food.

a) SHARING OF INCOME TAX :

The share of the state in the net proceeds of income tax is 75%. The commission recommended that the shareable proceeds of income tax were to be distributed among the states in the following manner.

- 10 percent on the basis of distance of population of 2001.
- 62.5% on the basis of distance of perception income of a state from the state.
- 7.5% on the basis of area of the state.
- 7.5% on the basis of index of infrastructure prepared by the basis of Eleventh Finance Commission.
- 5% on the basis of tax effort.

- 7.5% on the basis of fiscal discipline.

b) SHARING OF TAX REVENUE :

The commission recommended that 28% of the net tax revenue of the centre should be shared with the states.

1.5% of the net tax revenue proceeds should be shared in lieu of the additional excise duties.

c) SHARING OF EXCISE DUTIES :

The commission recommended that the total share of the states in the net proceeds of union taxes and excise duties would be 29.59%.

d) GRANTS IN LIEU OF UPGRADATION OF STANDARDS OF ADMINISTRATION :

The commission estimated Rs 4972.63 crores as financial requirement of certain states for special problems to upgradation of standards of administration to some sectors.

e) GRANTS FOR LOCAL BODIES :

The amounts of Rs. 10000 crores for local bodies for the maintenance of civic services, Rs. 400 crores per annum are to be meant for urban local bodies and Rs. 1600 crores are to be meant of rural local bodies.

F) GRANTS IN LIEU OF CALAMITY RELIEF FUND:

The amount of Rs 11007.59 crores are to be continued as calamity relief fund during 2000-2005.

g) GRANTS-IN-AID :

Grants-in-aid under article 275(1) of the constitution amounting to Rs. 35359 crores as plan revenue deficits for some 15states (assessed) which states are considered as revenue deficit state and the remaining 10 states are considered as revenue surplus.

h) GRANTS IN LIEU OF RAILWAYS :

Railways play a vital role in the economic and social development of the country. In order to improve, modernise and expand railway infrastructure the resources required. Therefore the commission recommended the amount for railways are Rs. 11000 core in 2000-01.

i) TELCOM SERVICES :

The functions of the department of telecom services (DTS) and the Departments of Telecom Operations (DTO) have been transferred to Bharat Sanchar Nigam Limited (BSNL) a public sector enterprises formed under the administrative control of the Department of Communications from 1st October 2000.

TWELTH FINANCE COMMISSION (2005-2010)

It was appointed by the president of India on 1st November 2002, under the chairmanship of Dr. C. Rangarajan. The commission covers the period from 2005-10. The recommendations are as follows :

Plan for restructuring public finance :

- By 2009-10 the combined tax-GDP ratio of the centre and the states should be increased to 17.6%.
- The combined debt GDP ratio with extract debt should be brought down to 75%.
- The fiscal deficit to GDP ratio target for to centre and the state may be fixed at 3%.
- The centre’s interest payment should reach 28% and the state’s interest payment should fall to 15%.
- The revenue deficit relative to GDP ratio for the centre and the state should brought down to 0.

Sharing of union Tax Revenue :

- The share of the state in the net proceeds of shareable central taxes should be reduced to 29.5%.
- The overall transfers to state may be fixed at 38% of the central Gross Revenue Receipt.

Local Bodies :

- A total grant of Rs. 20000 crores for the Panchayat Raj institutions and Rs. 5000 crores for the urban local bodies may be given to the states.
- At least 50% of the state grants provided by the centre used for the transferring the grants to local bodies a rate the grants are released by the Central Government.

Calamity Relief :

- The scheme of CRF be continued with contribution from the centre and state in the ratio of 75:25.
- The size on CRF is Rs. 21,333.33 crores
- The scheme of national calamity contingent fund (NCCF) be continued with Rs. 5000 cores.

Grants-in-aid to state :

- The system of imposing a 70:30 ratio between loans and grants for extending plan assistance to non-special category states.

- For total non plan revenue deficit a grant of Rs. 56,855 core recommended for fifteen states.
- For education sector a grants of Rs. 10171 crores recommended for (to) eight states.
- For the health sector a grants of Rs. 5887 crores recommended for (to) seven states.
- For maintenance of public building. A grant of Rs 1000 crores recommended for the maintenance of forest.
- A grants of Rs. 625 crores is recommended for heritage conservation .
- An amount of Rs. 7100 core has been recommended as grants for state specific needs.

Fiscal Reform Facility :

- The scheme of fiscal reform facility may not continue over the period 2005-10.

Debt Relief and Corrective measures :

- An amount of Rs. 128795 core (within 7.5% interest rate) is advanced as loans to states by the centre.

Profit petroleum (Non-Tax revenue) :

- The profit petroleum from NELP areas should be the centre with the state in the ratio of 50:50.

FISCAL POLICY WITH REFERENCE TO INDIA

INTRODUCTION :

According to Mrs. Hicks, fiscal policy is "concerned with the manner in which the different elements of public finance are primarily concerned with carrying out their own duties may collectively be geared to forward the aims of economic policy". Fiscal policy refers to the taxation, expenditure and deficit financing policy of a government. The various fiscal instruments should try to achieve the desired goals laid down by the economic policy from time to time.

The classical economists laid down the following principles as sound fiscal policy.

- A government should tax the least and spend the least.
- Taxation should be minimum because it would affect production adversely.
- Public expenditure is unproductive.
- Balanced budget should be followed :

Modern economists have rejected the classical approach to public finance. Modern economists headed by Keynes believe in the concept of functional finance.

FUNCTIONAL FINANCE

This idea was stated by Keynes and developed by A. P. Lerner. According to Lerner, the fiscal measures should be judged only by their effects. The way in which fiscal measures work in the economy is called functional finance. Budget is an instrument for achieving and maintaining full employment with stability. Judging a fiscal policy by it effects in an economy is called functional finance. According to the concept of functional finance, the operations of public finance must eliminate the basic causes of inflation and deflation. However, functional finance is more concerned with the developed countries than with the developing countries.

FISCAL POLICY IN DEVELOPING COUNTRIES :

The following are the objectives of fiscal policy in developing countries like India.

1. **MOBILISATION OF RESOURCES :**

The developing economics need more and more of resources for the purpose of economic growth.

Prof. R. N. Tirpathy has suggested the following methods to raise the incremental saving ratio :

- Direct physical control.
- Increase in the rates of existing taxes.
- Imposition of new taxes.
- Surplus from public enterprises.
- Public borrowing of a non-inflationary nature.
- Deficit financing.

2. **PROMOTION OF ECONOMIC GROWTH :**

Economic growth refers to an increase in real per capita income. Public expenditure can promote the social and economic overheads. These investments will enlarge the economies of large scale production, extend the market, raise the productivity and reduce the cost of production. The government can also undertake investment in industries. Industrialisation will promote the rate of economic growth. At the same time agriculture can be modernised. A balanced growth of agriculture and industry can ultimately bring about economic growth.

3. **INCREASE OF EMPLOYMENT OPPORTUNITIES :**

The government can provide employment opportunities through public works programmes. In fact, even developed economies use this type of public works. This type of work is known as pump-priming. Provision of social and economic overheads will mitigate unemployment.

4. ECONOMIC STABILITY :

A developing economy has to protect itself from the cyclical fluctuations. Cyclical fluctuations due to international factors would affect the stability. Export and import duties can be used for this purpose.

5. REDUCTION OF INEQUALITIES :

Fiscal policy can also achieve an egalitarian society by reducing the inequalities of income and wealth. Progressive taxation of the rich and government investments for improving the economic position of the poor can be followed.

Nurkse pointed out that, “not a change inter-personal income distribution but an increase in the proportion of national income devoted to capital formation is the primary aim of public finance in the context of economic development.

CONCLUSION :

Besides the above objectives fiscal policy should aim at achieving a diversified and self-reliant economy. All the objectives should be well balanced.

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