Module 1

1

INTRODUCTION

Unit Structure

1.0 Objectives

- To know the scope of public finance
- To understand difference between Public finance and Private finance
- To know difference between efficiency and equity
- To understand the concept of market failure
- To understand the concept of market failure
- To know the term externality
- To know the term public goods and private goods

1.1 Meaning and scope of Public finance

Classical and neo-classical economists discussed public finance in the context of money raising and money spending activities of the government. In Public finance we study the finances of the government . Thus public finance deals with the questions of how the government raises its resources to meet its ever- rising expenditure .

One of the first books exclusively written on the subject was by Bastabls in 1892. According to Bastabls ," Public Finance deals with expenditure and income of public authorities of the state and their mutual relation as also with the financial administration and control ".

1.1.1 Definition of Public Finance

1. **Huge Dalton :** According to Dalton , "Public finance is concerned with the income and expenditure of public authorities and the adjustment of one with the other ".
2. **Otto Eckstein :** According to Otto Eckstein, "Public finance is the study of the effects of the budget on the economy , particularly the effects on growth , stability, equity and efficiency".
3. **Richard Musgrave :** According to Richard Musgrave, "Public finance is concerned with the complex of problems that centre around the revenue - expenditure process of government".

It also deals wih fiscal policies which ought to be adopted to achieve certain objectives such as price stability , economic growth, more equal distribution of income. As per the thinkers view the role of public finances changes from time to time. Classical economist believe that government should play minimum role i.e less intervention of government is the thought of classical and neo-classical economist. Whereas Keynesian i.e John Maynard Keynes in his famous book "The General Theory of Employment , Interest and Money" which was published in 1936, have mentioned that the state means government plays significant role importance is given to government activity. According to J.M.Keynes , government plays a vital role in maintaining or stabilising the volatility of Economic Activity.And also to improve the Aggregate demand level in the economy which was experienced by the U.S economy during great depression. Thus it is considered as functional finance and important concept associates with public finances are (a) Fiscal policy (b) Budgetary policy.

1.1.2 Scope of Public Finance

According to the traditional explanation of public finance, it relates to financing of state activities. In a narrow sense, Public finance is the function or activities /role of government at National state and local levels. According to classical view government play minimum role. They are believer of Laissez faire policy. Government play role of basic Law and Order, Defence and Justice . Other than these important activity government does not intervene. Importance of role of government realised during depression period of 1929. It is great economist Abba P. lerner who coined the term Functional finance . Later on J.M.Keynes popularised this term functional finance by proving through the incidence which took place during 1929 -30 great depression of U.S.Economy . With the help of government intervention it become easy to get recover by raising government expenditure and reducing taxation. This activity helps to improve Aggregate output.

Prof. Dalton categorises the scope of public finance into focus areas which includes public Revenue, Public Expenditure , Public Debt or Public Borrowing and financial administration.

1) Public Revenue :

Primary scope of public finance is Public Revenue. The main sources of income for the government like taxes, fees, fines, special assessment and commercial revenues, from public undertakings. Here in scope of Public Revenue the concept of canon of taxation, different types of taxation, merit and demerits of taxation and different types of tax rates need to be studied.

2) Public Expenditure :

One of other important instrument of public finance is public expenditure. Public expenditure important for implementing various policies of the government with respect to welfare , growth, stabilization and so, on. Here again it is more relevant to study canon, classification and effects of public expenditure.

3) Public Debt/ Public Borrowings:

When public expenditure exceeds Public Revenue it leads to Burden on economy and thus Public Debt takes place in the economy. Here we will learn different types of Public Debt Internal and External public debt and its impact on economy.

4) Financial Administration :

The scope of financial administration various financial process and operations of Public Revenue,Public expenditure and Public Debt. It administers collection, custody and disbursement of public money. It covers the preparation of the budget, the execution of the budget and also auditing the finances of the state.

1.2 Public Finance VS Private Finance

1) Meaning :

Public finance is concerned with the revenue / incomes and expenditure borrowings etc of the economy or government Private finance is the study of income and expenditure, borrowing etc of individuals household and business firms.

2) **Adjustment :**

Public Finance - Government adjust the income according to the size of expenditure on different segments

Private Finance - Individuals adjust their spending as per their Income

3) **Objective :**

Public Finance - aim to offer the maximum social advantage to society

Private Finance - aims to fulfill private interests

4) **Nature of budget :**

Public Finance - the government prefers a deficit budget.

Private Finance - a individual attempts to maintain a surplus budget

5) **Financial transaction** :

Public Finance - Transactions are open and know to all

Private Finance – Transactions are kept secret .

6) **Determination of expenditure :**

Public Finance - Government first determines the volume and different ways of its expenditure .

Private Finance – An individual considers his Income and then determines the volume of expenditure

7) **Right to print currency :**

Public Finance - The government can print notes through Reserve Bank of India

Private Finance - Private Individual does not enjoy right to print currency

8) **Effect on economy :**

Public Finance - has tremendous impact on the economy of country .

Private Finance - has marginal effect on the economy of a country.

1.3 Market failure

- **Market :**

Market is a place where buyers and sellers come in close contact with each other. Either directly or indirectly. In economics we study different forms of market, perfect market and imperfect market. Perfectly competitive market is form of perfect market and other market such as monopoly, oligopoly , monopolistic competitive market , oligopsony and monopsony are also special form of imperfectly competitive market sellers have an objective of maximising profit whereas buyers opine to maximise utility. An ideal market is the market where both are equally satisfied which generally we find in perfectly competitive market.

- **Market failure :**

  Generally market failure occurs when quantity demanded by consumer does not get equated or supplied by producer. On the other hand when resources are misallocated or allocated inefficiently.

  According to Michael Todoro market failure is a "phenomenon that results from the existence of market imperfections that weaken the functioning of a free market economy i.e it fails to realise its theoretical beneficial results. "

1.4 Public goods and Private goods

1.4.1 Public goods:

Public goods are those goods which satisfy collective wants or social wants in general. Public goods are those goods and services which are jointly and equally consumed by many people at the same time and its consumption by one person does not alter its availability for another person. The examples of public goods and services are public roads street lights, defence and education services.

According to J.Sloman , public goods refers to "a good or service which has the features of non-rivalry and non-excludability and as a results would not be provided by the free market ".

Features of public goods:

1) **Non - Rivalrous:** It refers to the fact that no one has an exclusive right over the consumption of the goods. It can be consumed by any number of people simultaneously , without diminishing the amount available to be consumed by others. A good is nonrival in consumption because one person's enjoyment of the goods does not reduce anyone's else's enjoyment of them.

2) **Non- excludable:** it is simply if one person consumes the good it is become impossible to prevent other from consuming it. A good is not excludable because of inability to keep people, specifically non-payers from consuming the good or service.

3) These goods are of collective consumption

4) Public goods may not be produced through the free market pricing mechanism.

5) Public goods are indivisible

6) Public good is always joint and equal. Thus public goods are produced and supplied by the society to meet its collective wants for increasing social welfare.

7) Public goods create externalities or divergences between social and private benefits.

Common examples of public goods are street lighting , national and domestic security, national public parks and beaches, public welfare programmes , education, roads , research and development and a clean environment. In these cases consumption by one does not impose an opportunity cost or other and non-payers can not be excluded from consumption. In all such examples market fails to efficiently allocate the production, consumption or provision of the goods.

1.4.2 Private goods :

Just inverse to what public goods private goods and services satisfy individual wants and have the characteristics of rivalry and exclusiveness. These goods can be produced by the free markets pricing mechanism. Private goods are rival in consumption their consumption by a person reduces the amount available to others. All those who have to enjoy or fulfill the utility have to pay for it. And those who do not show interest to pay will not be able to get benefit of that. Private goods are subject to the principle of exclusion. Eg . food, clothing, shelter, transportation and communication etc.

Characteristic of private goods

1) Private goods are rivalrous in consumption

2) These goods are subject to the exclusion principle

3) These goods satisfy individual wants.

4) These can be produced through free market pricing mechanism.

5) Private goods are divisible into so far as their use is concerned

6) Marginal cost of providing a private good to an extra consumer is always positive.

1.5 Externality:

An externality is interpreted as spill over effect or third-party effect. These are two different possibility of externality (a) positive externality (b) negative externality. Externality arises when a person engages in an activity which directly or indirectly influences positively or negatively and do not get any compensation for that effect. The third parties can be an individual, an organisation or it can be community as well who get indirect benefit or suffer as a result of consumers and producers attempting to pursue their own self- interest.

Examples of externality can be interpreted in both form. It can be in the form of consumption and production as well.

1) **Consumption externality :** suppose a person wants privacy thus he builds a high fence which may obstruct the sunshine to his neighbours house.

2) **Production externality :** it exist when production activity of firm directly affects the production activity of another firm. Example when firm X discharges effluents into a river, which may increase the cost of production of firm Y downstream. Two types of externality

   (a) **Negative externality :** when third party adversely get affected it is termed as negative externality. Negative externality leads markets to produce a larger quantity than is socially desirable. Eg . when the firms do not pay for the pollution their cost would be low and they would produce more.

   (b) **Positive externalities :** when third party get benefited with any activity. Example: If an entrepreneur stage a firework show, people can watch the show from their windows or backyards. Positive externalities leads markets to produce a smaller quantities than is socially desirable. The main problem with externality in production and consumption is that their cost or benefits are not reflected in the market price. The externality make it impossible for the market to reach a pareto optimum.

1.6 Efficiency versus equity

- **Efficiency** It is concerned with the optimal production and allocation of resources given existing factors of production.

For eg. producing at lower cost, efficiency in an economy means “that society is getting the maximum benefits from the scarce resources” under ideal conditions markets ensures that the economy is pareto efficient. There are two different types of efficiency 1) productive efficiency 2) allocative efficiency.

- **Equity** - Equity is concerned with the relative income how resources are distributed throughout society.

  There are two types of equity discussed here

  1) Horizontal equity

  2) vertical equity

  Economic efficiency is measured by the quantity and variety of goods and services that its members produce, consume and distribute out of their limited available resources. The most efficient market is one where, it is possible to decide what combination of goods and services people want and delivering that combination. It is more efficient when market is able to produce at low cost and sell it out at lowest possible price. The ideal efficient outcome of market is referred to as pareto optimal. When it is not possible to make at least one person better off without making one or more persons worse off.

- **Productive and allocative efficiency :**

  It involves minimization of cost for producing a given level of output or producing maximum possible output of various goods from a given amount of outlay or cost incurred on productive resources. And hence on the basis of there it is expected that free market mechanism can achieve best possible resource allocation and produce optimum output also it is possible to reach pareto optimum in a free market through efficient resource allocation and production

  The concept of production and allocation efficiency can be explain with the help of suitable diagram of pareto optimality.

Figure No. 1.1 Pareto Optimality

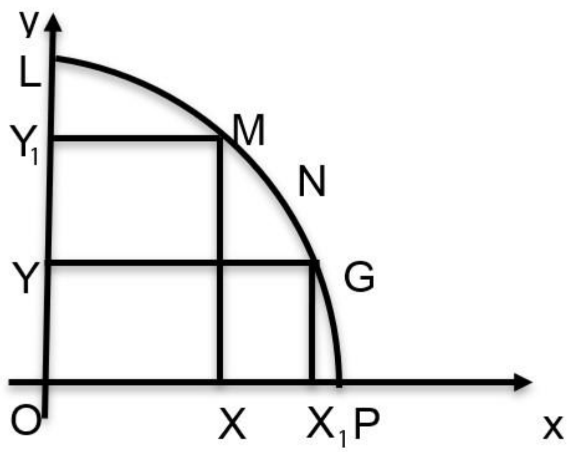

Fig 1.1 curve LP is the production possibility curve. The point m,n,g are the points where the maximum (optimum) output of goods X and Y can be produced. Any point inside this curve let say R brings out inefficient production. Any movement from R towards LP curve will bring about more efficiency. For e.g if it move from R to G we increase the production of X from OX to OX_1, without decreasing output of Y similarly if we move from R to M we produce more of Y from OY to OY_1, without reducing quantity of x so these shifting from R to M from R to G all these are productive efficiency.

★ **Productive efficiency:** It will be achieve on any point on the PPC curve (PPC - production possibility curve) productive efficiency is possible at level where maximum output is gained at minimum cost which is possible at level where marginal product of each pair of factors is made equal to the ratio of their prices. When we apply this condition to an industry productive efficiency can be obtained when marginal cost of producing the last unit of output of a firm must be same for each firm in any industry.

★ **Allocative efficiency :** It implies that the pattern of products produced should correspond to the desired pattern of consumption of the people. Allocative efficiency is achieved when the resources are allocated to the production of various goods that it results in maximum possible satisfaction of the people. When it is impossible to change the allocation of resources in such a way as to make a person better off without making another person worse off.

In fig 1.1 allocative efficiency concerns the choice among alternative points on the PPC, that is between M,N,G. Among these point only one point at a given time is allocatively efficient while others are inefficient.

An economy reaches the point of allocative efficiency when, for each goods produced, its marginal cost is equal to its price.

1.7 Questions

Q1. What do you understand by the concept Public Finance ?

Q2. Explain scope and subject matter of Public Finance.

Q3. Explain the concept of market failure.

Q4. Distinguish between public goods and private goods

Q5. What do you understand by the term externality ?

Q6. Explain the concept of Efficiency and Equity.

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2

SOUND FINANCE AND FUNCTIONAL FINANCE

Unit Structure

2.0 Objective

- To understand the principle of sound finance and functional finance
- To know various functions government
- To understand the concept of stabilization
- To know growth function of Government

2.1 Principle of Sound Finance

Most of the classical and Neo classical economist such as Adam Smith, David Ricardo, J.B say, John stewart mill and Thomas Malthus are follower of sound finance. Prior to 1930 classical economist has an assumption that the less the intervention of government in economic activity better the life of people. So their should be Laissez faire capitalism, which is a system where economic transaction are largely between private owners of factors of production and such transactions are free from government restrictions taxation and subsidies. Classical's were against unwanted intervention of government, According to them due to too much involvement of government unnecessary expenditure takes place. Government tries to provide welfare to the people but that is also at the cost of people. If suppose Govt provide any program like survey Siksha Abhiyan, Indradha- nush yojna, Atal pension yojna etc then ultimately it shoots the expense of the government and to run such expenditure government charges additional taxes to earn public revenue. At last Government intervenue and provide welfare at the cost of tax on masses. Classical and Neo classical opines that due to such circumstances as it is mentioned above the role of the government was expected to be restricted to traditional areas like defence, law and order, justice, provision of civic amenities and therefore most government expenditure was expected to be restricted to these areas.

Hence they believe that government's budget should be small and budget should be balance. These multiple beliefs of less intervention of government, with balance budget are some key opinions which form the basis of the principle of the sound finance by classical and Neo classical economist.

- The following are some of the key features of sound finance:

  a) **Say‘s law :** Classical economist interpreted the basic theory based on the assumption of supply create its own demand and because one person expenditure become another persons income hence, aggregate demand will always be equal to aggregate demand which forms the base of sound finance.

  b) **Full Employment :** As classical economist are in favour of AD= AS, so there is less possibility of wastage or we can say no overproduction & underproduction. And because they are believer of free market mechanism so in expectation of maximum profitability they will be optimally using all resources. So full employment occur and only voluntary and frictional unemployment may exist.

  c) **Invisible hand :** Adam Smith has given this concept which is applicable in case of sound finance simply because private owners of factors of production will always achieve maximum level of efficiency in their use of resources to get maximum of profitability. Thus private self interest will result in collective social goods.

  d) **Taxation:** Taxation lends to sacrifice. Taxation are always burdensome to tax prayers. There is no quid pro quo. So the amount of taxation should be minimum higher the progreeive taxation slower the economic growth thus classical economist believe that taxes are harmful they adversely affect the willingness and ability to work save and invest.

e) **Public expenditure:** Classical school of economist believe that government spending should be minimum. It should be on traditional area like defence, law and order justice and civic amenities. It is believe that the size of budget is small and that too for these traditional function. Because if government tries to go for more welfare expenditure then ultimately they will ask for more taxes to run addition expenditure. Thus classical economist support sound financing recommends least is the best which means less the expenditure by the government better the economic condition.

f) **Balanced budget:** Classical economist believe that budget should always in balance. Since in classical thought Private Owners are in pursuance of maximising profit by optimally utilising resources. So very less scope of wastage. As full employment prevail, thus AD=AS. Expenditure incurred by the government would not increase total demand for factors of production as there is already full employment. Except war time rest period budget in balance.

g) **Market efficiency:** It is assumed that free market mechanism prevails in the economy with Laissez faire policy. If any disequilibrium takes place leading to market failure. With the help of invisible hand it is self correcting byself.

h) **Ricardian equivalence theorem:** This is one of famous and fundamental theorem by classical economist. Proving that Budget deficit are uneconomical, harmful and socially undesirable. According to theorem, deficit will not boost the economy. To meet deficit ultimately they need to raise revenue by raising tax. And general masses need to sacrifice their consumption due to tax payment. So indirectly it is loss of welfare.

2.2 Principle of Functional Finance:

Year 1920 of Europe and 1930, of united states was great depressionary period. It was that time realised that market can fail and do not always correct themselves, leading to tough time for people. Thus most Laissez faire capitalism transform themselves into welfare state. The role of government increased, government activities expanded from only tradition area to other activities also. Example, reduction in poverty, unemployment, promoting welfare, good health and various other programme. Government started using fiscal policy to avoid another depression, control inflation and keep aggregate demand high. Thus fiscal policy used contra-cyclical measure. Such type of fiscal policy to bring about desired changes in the economy is known as functional finance and main advocate of this type of fiscal policy was John maynard keynes. Sound financing system of classical economist were challenged by John maynard keynes, A.C pigou, edgeworth and most significantly, Abba P. Lerner. The term ‘functional finance’ is given by Abba P. Lerner.

The following are some feature of functional finance.

a) **Market failure:** modern economist believe that market cannot be perfect, it can fail also. They are not capable always to do self correction and adjust. Market failure can also lead to severe depression or it may also influence through hyper- inflation. Example of 1930 united states great depression brought the powerful economy at downtrend. And various other factors causing volatility and unstable economic situation of economy.

b) **Importance of fiscal policy:** modern economist believe that important or main aim of public finance is to maintain balance situation in the economy not only public revenue. And to maintain stability use of instrument like public expenditure, tax, public debt are adopted. Basically budget are considered as an instrument of economic change.

c) **Aggregate demand:** aggregate demand consist of consumption demand, investment demand, government demand and foreingn demand. AD= C+I+G+(X-M). Classical economist believed that ‘supply creates its own demand’ whereas modern economist particularly keynesian economist believe demand is the base and with the help of his study and book on general theory of employment interest and money which was published in 1936 tried to prove that if the economy is facing depression. Then with the help of increase in aggregate demand economy will be able to recover and slowly will be able to overcome from such recessionary situation. During 1930’s it was applied and economy was really able to overcome from such circumstances.

d) **Budget :** modern economist believe that with the help of its instrument like public expenditure, public borrowing and public revenue will be able to maintain full employment in the economy. Modern economist rejected the ideology of balance budget of classical economist. Modern economist believe that Deficit budget is applied during to overcome from the problem of recession and vice versa to release economy from inflation surplus budget play significant role. During Recession government will be raising welfare expenditure and vice verse during inflation raising of taxes and reduction of expenditure.

e) **Income redistribution :** modern economist believe that fiscal policy can provide social justice through better Income distribution as well as benefit economic growth through higher investment. Government will charge heavy tax to rich section of society and provide welfare by redistributing the tax revenue in the form of public welfare expenditure to poor section of economy. By this way Average propensity to consume(APC) will increase and govt bring about equality in the economy.

f) **Welfare capitalism:** Karl marx had predicted that, due to the inherent crisis, the capitalist system will collapse and make new way and more equal system. Keynesian through fiscal measure tried to prevent capitalist system in a better way by increasing aggregate demand in the economy. Thus the economy was able to prevent from collapse level.

g) **Social objectives:** social objectives are the key focus of functional finance. The basic objective of taxation is to redistribute income to provide welfare in the form of reducing poverty, reduction in unemployment providing better measure of improved standard of living, good and quality education etc.

Thus functional finance proved to be more effective to eradicate the basic problems faced by the economy. Through the concept of functional finance has been criticised by many economist. But most of the countries directly or indirectly using functional finance to overcome from disequilibrium in the economy.

2.3 Function of the Government:

Basic objective of government into perform key function in the economy.

a) Allocation function
b) Distribution function
c) Stabilization function
d) Growth function

a) **Allocation function:** The most important function of fiscal policy is to determine how the country's resources will be allocated. What should be the share of different sectors of the economy in terms of resource allocation? Allocation of resources depends upon the collection of taxes and size and composition of government expenditure. Government can use taxation and subsidies to indirectly influence resource allocation. Example - Tax incentives given to S.E.Z units to encourage investors to direct resources to those units.

b) **Distribution function:** The national Income should be properly distributed so that the fruit of development are fairly shared by all people. Equality in Income, wealth and opportunities must form an integral part of economic development and social advance. Fiscal policy can influence spending in two ways.

1) The direct changes in total spending brought about by the government increasing or decreasing its own expenditure.

2) Increasing or reducing private spending by varying its own tax revenue.

Thus redistributing Income in favour of poor section of society by collecting tax revenue from rich class.

c) **Stabilisation function:** Stabilisation function is another important function of fiscal policy, especially in developed economies that experience business cycle. Business cycle is inclusive of various type of phases. Eg Prosperity, Peak, Recession, Depression, trough, recovery, … and cycle move recur again and again leading to influence economic variables like, income, employment, output, saving and investment. Fiscal policy is meant to counter these fluctuations. This is known as counter- cyclical fiscal policy. To curtail down the effect of fluctuation contra cyclical fiscal policy is used.

Thus during the period of recession government by increasing public expenditure and reducing taxation i.e by adopting deficit budget can stabilise the fluctuation and contrary to that during inflation using of surplus budget i.e raising taxes and reducing public expenditure and bring out stability in the economy.

d) **Growth function:** For accelerating the rate of growth, allocation of higher proportion of the fully employed resources is needed. Such activities increase the productive capacity of the economy. Hence fiscal policy is used through its tax instrument to encourage investment and discourage consumption so that production may increase. It is also require to increase capital formation that is possible through reducing tax on personal Income. Through various programme and projects government can provide social and economic overheads and depending upon the availability for example developing country like India we have excess of labour as compare to capital. Government should involve labour more by establishing labour based projects.

2.4 Questions

Q1. What do you understand by the concept of allocation function of government?

Q2. Explain principle of sound finance and functional finance.

Q3. Describe Distribution function of Government.

Q4. Explain various functions of Government.

2.5 Reference

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Module 2

3

FISCAL POLICY: BUDGET AND TAXATION-I

Unit Structure

3.0 Objective

- To understand Dalton and Musgrave version of maximum social advantage
- To know role of government in modern economy.
- To know application of principle of maximum social advantage
- To understand limitations of maximum social advantage

3.1 Introduction

One of the fundamental principles of public finance is known as the principal law of maximum social advantage. Classical economist where against of too much intervention of government. According to classical view if government has to provide welfare to the people, then they collect tax. Budgetary activities of the government result in transfer of purchasing power with in society. Taxation causes transfer of purchasing power from taxpayers to government. Example, Let's say, when person A pays tax, his/ her purchasing power reduces up to the amount paid in the form of tax to the government. This amount goes to the government so purchasing power transferred to government with such collected tax revenue government provides welfare i.e. public expenditure takes place to the people as per need of society.

According to J.B. Say, (French classical economist), “The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount.” Thus, it is crucial to manage the taxes and expenditure and its effect on economic activity.

3.2 Dalton’s version of the Law of Maximum Social Advantage:

The principle of maximum social advantage was propounded by British economist Hugh Dalton.

According to Hugh Dalton, “Public Finance is concerned with income and expenditure of public authorities and with the adjustment of one with the other.”

According to Hugh Dalton, “The best system of public finance is that which secures the maximum social advantage from the operations which it conducts.”

The principle of maximum social advantage is based on following assumptions:

1. Taxes collected by public authorities leads to sacrifice and all public expenditure provide benefits.
2. Public revenue collected by government is the only source of income to the public authorities that is government no other source other than tax is available to government.
3. It is assumed that government has only balanced budget.
4. Public expenditure based on diminishing marginal social benefit
5. Public revenue through tax are subject to increasing marginal social sacrifice.

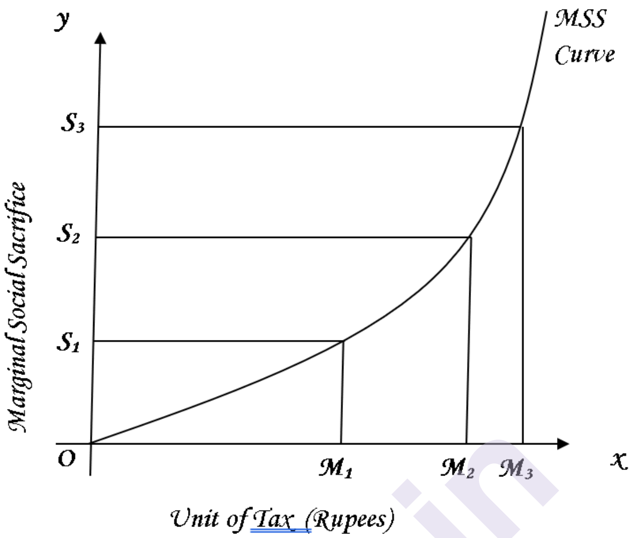
The application of maximum social advantage(MSA) is based on the fact that marginal social sacrifice equal to marginal social benefit. Where to achieve such objective marginal utility concept has been utilised. And at such equilibrium level of MSB=MSS it is assumed that maximum welfare is achieved.

The principle of maximum social advantage interprets Public Finance resulting to economic welfare. Welfare will be achieved at that level where by benefit derived by marginal utility of expenditure is equal to marginal disability of sacrifice causing due to taxation.

The Law of maximum social advantage can better way explained with the help of concepts like marginal social sacrifice and marginal social benefit.

1. Marginal social sacrifice: (MSS)

Figure No. 3.1: Increasing Marginal Social Sacrifice



It is necessary to understand MSS. Marginal social sacrifice refers to that amount of social sacrifice undergone by public due to the imposition of an additional unit of tax. If government raises Tax amount which brings public revenue to public authority. But as government charges higher tax more the sacrifice that taxpayer has to face, Does we can say there is direct relationship between taxation and sacrifice.

The relationship can be explained with the help of diagram in the given figure 3.1. On x-axis units of tax in terms of rupees is measured and on y-axis marginal social benefit has been given. When the Tax amount is OM_1, the sacrifice level is OS_1 and when tax increases from OM_1 to OM_2, sacrifice level also increases from OS_1 to OS_2 likewise. Tax increases OM_2 to OM_3 and sacrifice increases from OS_2 to OS_3 and thus the joining curve of such combination given upward sloping MSS curve. Showing that as there is direct relation upward toward right slope of MSS curve represents higher the tax more the sacrifice involved to taxpayers and vice versa.

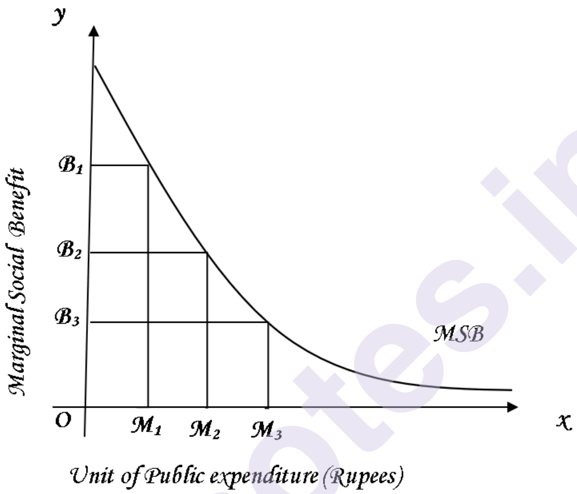
2. Marginal social benefit :

Imposition of taxes on people puts burden or increases sacrifice. Whereas public expenditure which is carried out by the government benefit to people.

Government provide welfare by doing public expenditure on defence, education, health, infrastructure etc.

The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal Social Benefit (MSB). As we are aware about the term diminishing marginal utility, as the marginal utility from a commodity to a consumer declines as more and more units of commodity are made available to him, the social benefit from each additional unit of public expenditure declines as more and more units of public expenditure are spent. The term maximum social benefit (MSB) can be explained with the help of following diagram:

Figure No. 3.2: Diminishing Marginal Social Benefit curve



On x-axis units of public expenditure is measured on y axis marginal social benefit. When public expenditure is OM_1, MSB is OB_1 and when public expenditure rises to OM_2, MSB falls to OB_2 and also with the further increase in OM_2 to OM_3, MSB falls from OB_2 to OB_3.

In the beginning, the units of public expenditure are spent on the most essential social activities. Subsequent doses of public expenditure are spent on less and less important social activities. As a result, The curve of marginal social benefit slopes downward from left to right as it is shown in figure 3.2

3. **Maximum social advantage:**

The point of maximum social advantage:

Social advantage is maximized at the point where marginal social sacrifice cuts the marginal social benefits curve. I.e. when MSS = MSB which is achieved at point P in the fig. 3.3.

Figure No. 3.3: Maximum Social Advantage

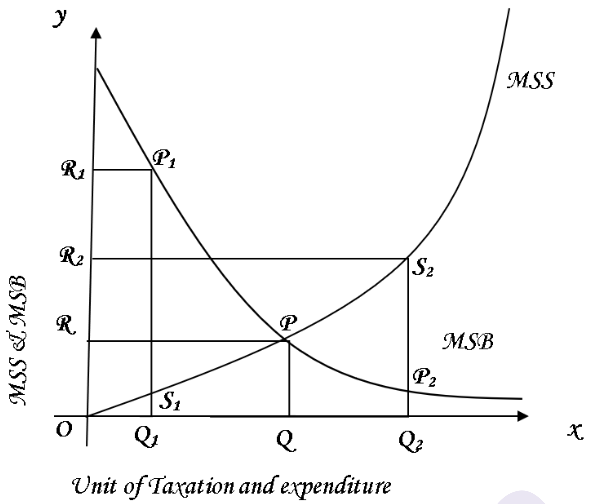


Fig. 2.3 Maximum Social Advantage

The marginal disutility or social sacrifice is equal to the marginal utility or social benefits at this point. Beyond this point, the marginal disutility or social sacrifice will be higher and marginal utility or social benefit will be lower. At point P social advantage is maximum. If we go through point P_1, At this point marginal social benefit is on P_1Q_1 which is greater than marginal social sacrifice S_1Q_1. Since MSB> MSS it become more relevant to that government should expand the level of taxation and public expenditure Which will raise the Net Social Advantage.

Net Social Advantage (NSA)= MSB- MSS.

This process of increasing taxation and public expenditure will goes on in continuation to the levels of taxation and public expenditure are towards the left of point P.

On the contrary to this any point (P_2) forward to OQ level of units the MSS i.e. $S_2Q_2 > P_2Q_2$, MSB Therefore beyond the point P_1 any further expansion in the level of taxation and public expenditure may bring down the social advantage. This occurs due to the fact that each subsequent unit of additional taxation will increase the marginal disutility or social sacrifice which will be more than marginal utility or social benefit.

Thus this will be optimal level where the net social advantage is zero. I,e MSB=MSS , In the figure at point P. Which yields maximum social advantage.

3.3 : Musgrave's Approach:

The principle of maximum social advantage is explained by economist Richard Musgrave who termed it as maximum welfare principle of budget determination.

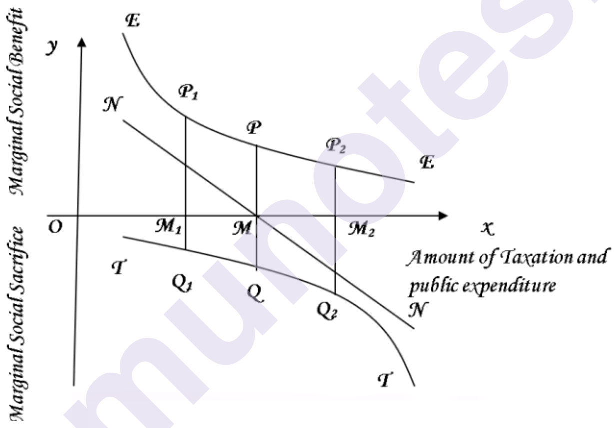
According to Musgrave, Dalton has proposed two principles of budget policy.

1. Resources should be distributed among different direction in such a way as to equalise the marginal returns of satisfaction for each type of Expenditure.

2. public expenditure should be pushed to the point where the satisfaction gained from the last rupee spent is equal to satisfaction lost from the last rupee taken in Taxes.

Hence the size of the budget is determined in such a way which will bring maximum welfare to the society. This can be explain with the help of following figure 3.4.

Figure No. 3.4: Gains ans Losses from Budget operation



In the given figure 3.4 the size of budget (level of taxation and public expenditure) is represented on x-axis. On the positive part of y axis MSB is measured and on the negative part of y axis MSS is measured. The curve EE in the first quadrant, represents the MSB e of successive units of money spent as public expenditure, allocates optimally between different public uses. The reason behind downward slope from left to right of EE curve at first quadrant is that as public expenditure increases, MSB declines.

On the contrary curve TT on the fourth quadrant, represents the marginal social sacrifice (MSS). As taxation increases the sacrifice involved will also increase. Hence curve TT Slopes downward from the left to right at fourth quadrant indicate higher tax result to more sacrifice.

The curve NN represents the marginal net benefit MNB which derived from the successive addition to public budget. MNB can be estimated by deducting MSS from MSB i.e. MNB = MSB - MSS. The vertical difference among EE curve and TT curve measure MNB at different size of budget. in the above diagram in figure 3.4 the optimum size of budget is determined at OM, where the difference between MSB and MSS is Nil i.e. zero. Since MSB and MSS are measured in opposite direction, the MNB curve NN cuts the x-axis At point M where MNB is zero (MSB-MSS=0). Any movement from optimal level M will ultimately push the economy to reach the optimal position.

Example - At point M_1, MSB will be greater than MSS and MNB is positive. Hence it will be beneficial at this situation to increase the size of budget as long as MNB is positive. Ultimately there is a tendency to further move from M_1 to M. and on the contrary to it, if the budget exceeds from M to M_2 then MSS> MSB and MNB is negative. Which make it sensible to government to cut down size of budget and shift from M_2 to M.

Hence from this it is clear that, according to Musgrave, the optimum size of the budget is given by the point where the marginal net benefit is zero. This point corresponds to the point of maximum social advantage at this point MSB= MSS.

3.4 Application of Principle of Maximum Social Advantage :

Though the law of MSA has been criticized by many economist as purely theoretical and has no practical application. But Dalitan has provided certain relevance to the government of this principle which are as follows :

1. **Helps to improve in income distribution**

   An improvement in the distribution of national income covers both efficiency and equality dimensions with the help of public finance equity can be maintained as rich people have less utility for money. Thus with the application of progressive taxation More tax is levied on high income group based on the principle of ability to pay for it. And collected public revenue will be redistributed for the poor people in the form of more public expenditure on social welfare activity.

2. **Protecting and defence preserving society / community:**

   Ultimate objective of all public finance is protecting the country defence from foreign external disturbance and also preserving society by maintaining law and order.

3. Helps to improve production capacity:

This is applicable to how far government operations promote production of goods and services. the application of tax and public expenditure policies should be such that production increases up to optimal level.

4. Helpful to stabilize the economy:

Fluctuations on income and employment influence economic activity negatively. Business cycle needs to stabilize with the help of public policies. So during recession low tax and more expenditure and during inflation vice-versa and stabilize economy.

5. Full employment and economic growth:

Full employment is the level where all the resources are optimally utilised. Fiscal policy is helpful in achievement of this objective and ultimately to enhance and leading to economic development.

3.5 Limitations of the Principle of Maximum Social Advantage

1. Unrealistic assumptions “The principle of maximum social advantage is based on unrealistic assumptions of the term MSB and MSS. It means government expenditure always benefit and taxation is always burdensome. But the fact is that tax on demerit goods may be beneficial. Eg. Tax on alcohol, cigarette etc.

2. Conceptual differences : In case of direct tax specially taxes are paid by individual. No shifting of tax is tax. Thus it become micro concept. Where is public finance is for the Welfare of entire society. Public expenditure gives rise to public goods that are jointly consumed by all in a community. The benefits are at micro level. Thus for some criteria use of both micro and macro terms are not acceptable.

3. Economic Conditions are not static: Economic conditions are continuously keep on changing. Thus it's difficult to determine the maximum social advantage level. During some unforeseen situation government has to undergo with the major adjustment of increase in public expenditure as well as increasing public revenues to reach the level of required to maintain economic conditions.

4. Absence of divisibility : In order to maintain marginal benefit from public expenditure and marginal social sacrifice from taxation the government

resources are required to be divided into small units. But due to lack of divisibility it is not possible practically.

5. Difficult to measure : the principle of maximum social advantage is based on marginal utility concept which itself is criticized by many economist and the Cardinal measurement of utility concept is unaccepted by most of The Economist. The marginal benefit of public expenditure and the marginal disutility on sacrifice of public revenue are concepts, the objective measurement of which is extremely difficult.

6. Difficult to estimate large budget size: The public authorities are not capable of estimating the marginal benefit and marginal sacrifices. It is almost impossible to apply practically size of budget that will maximize the Welfare of the community

3.6 Role of Government in Modern Economy

One of the basic differences of Fiscal economy with rest of the economy is existence or relevance of intervention of government. Government plays key role in modern economic activity. Most important function of public expenditure and Public revenue (Taxation) influence National Income, output, consumption, production and various other economic variables. Economic activities are largely market based influenced activity. It is not very confirm that market will always be in favorable situation. Sometime due to some factor discrepancy arise which leads to market failure. Now it become very crucial to prevent economy from market failure. Hence we introduce government here to prevent economy from market failure. Though classical economist were against with the intervention of government, but for some important function like defence, law and order, justice they also agreed the fact that to run these function government intervention is needed. Presence of political and social ideologies can be realized with the help of presence of government. Government play vital role in correcting market failure and also bring about economic stability which is needed for economic efficiency. Government pursue social values of equity by altering market outcomes.

Modern Economy felt need of government to stabilize the economy. The task of price stability and full employment is not so easy. But it is the Keynesian who for the first time during 1930s promoted the influential role of government by way of adjustment in its budget by its weapon i.e public expenditure and taxation and maintaining aggregate demand which ultimately affect employment and output.

Two important Principle of Fiscal Policy are given below:

1. Imposition of taxes reduces purchasing power of people because disposable income of people falls due to which the aggregate demand also reduces.

2. Public expenditure helps to boost the economic condition by way of increasing effective demand.

This principle is strongly applicable depending upon the form of phases of business cycle. During prosperity which may bring inflationary situation in economy by way of raising tax and reducing public spending which will normalize the aggregate demand.

On the contrary during the period of slowdown of economy or recession to overcome from this problem the reduction in taxation and raising public expenditure will bring out stability and aggregate demand also increase which improves the possibility of recovery from depression level.

Important objective of fiscal policy are optimum allocation of resources, full employment, economic stability, increase in rate of investment and capital formation etc. According to J.M Keynes the primary objective of fiscal policy that is government in modern economy is to maintain aggregate demand by way of adjustment in consumption, investment, government expenditure and net foreign demand as all these variables are inter related.

Disposable income, public and private investment, government expenditure and net foreign income these all are interrelated economic variables. Interrelationship between them can be shown as follows:

$$\mathbf{AD = C + I + G + (X - M)}$$

Where,

AD = Aggregate demand C = Consumption demand I = Investment demand

G = Government Demand

X = Export

M = Import

In the short run,

$C = f(Y_d)$ and $M = f(Y)$ $\mathbf{Y_d = Y - tY + TR}$ Where,

Y = gross income

Y_d = disposable income (it is income which is left with people after spending)

t = tax rate (direct tax is imposed as a proportion of income Y)

TR = Transfer payments (e.g. pension, subsidies, unemployment benefits)

Aggregate demand highly get influence by fiscal policy. Consumption increases by reducing taxes and reduction in consumption by raising taxes which bring down the disposable income. Investment can be raised through tax exemption as well as subsidies to producers. Import also get affected by fiscal policy import can be raised by providing subsidies and can be reduced by import duties. Similarly export can be promoted by tax incentives to export.

It become important to take be very careful while taking decision regarding any fiscal policy change. Let say if government increases government expenditure and reduces tax in order to raise aggregate expenditure and boost GDP in short run. Leading to increase in fiscal deficit causing inflation, because of which money supply increase and government have to meet this burden by heavy borrowings. Government borrowing also put burden of increasing interest burden. All these burden will slowdown the economic growth in the long period of time.

Thus the role of government is crucial in modern economy in overall functioning of economic variable but need to take care while taking decision.

3.7 Questions:

Q1. Explain Daltons version of the Law of Maximum Social Advantage.

Q2. Describe Musgrave's Approach of Maximum Social Advantage.

Q3. Explain importance of Maximum Social Advantage.

Q4. What are the Limitations of Maximum Social Advantage?

Q5. Explain Role of Government in determination of economic activity.

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Module 2

4

FISCAL POLICY: BUDGET AND TAXATION-II

Unit Structure

4.0 Objective

- To know different types of Public Budget
- To Understand Structure of Public Budget
- To Know Features of Good Tax System
- To understand the concept of Impact, Incidence and Shifting of Taxation
- To Understand different types of elasticity and incidence of tax burden on buyer and seller

4.1 Introduction:

The public budget is represented as a financial plan of a government. It is a systematic record of income and expenditure and related programmes and policies related with it. The term budget is derived from French word "Bougette" which means bag containing financial statement of country consisting of various sources of public revenue to the government and expenditure plan for the year. According to P.E. Taylor, "The budget is the master financial plan of government. It brings together estimates of anticipated revenues and proposed expenditure employing the schedule of activities to be undertaken as a means of financing these activities".Public budget is an annual statement of the fiscal policies with corresponding financial plans prepared by the government of country. There is three different possibility of budget. When public revenue is greater than expenditure surplus budget takes place, public revenue less than expenditure causing deficit in the budget and optimal budget level is one when, public revenue is just equal to expenditure.

Objectives of Public Budget:

As per classical view budget was just a statement consisting of only balanced condition of income and expenditure of economy. But as per welfare economist it is more wider than mere a statement of income and expenditure. According

to modern economy budget is an instrument of fiscal policy through which government can achieve multiple objectives depending upon the requirements.

The objectives of public budget are as follows:

1. **Allocation of Resources**: This is fundamental objective of any public budget. As resource are limited so to optimally utilize such resources government tries to divert available resources at required productive purpose.

2. **Reduction of Poverty and Income Inequalities**: one of the major challenges in front of developing nation is the gap between the rich and poor, widening the problem of inequality. But on the basis of ability to pay principle government will be charging tax to the rich as they are able to pay and from collected revenue government provides welfare program and project. Boost the standard of living which reduces the gap between rich and poor

3. **Economic Growth**: Public Budget helps to promote the GDP of the economy. Government plan various policy considering the factors required to have economic growth. Mobilizing saving, increase in productive investment and also mobilizing resources for capital formation and encourage investment.

4. **Economic Stability**: Most volatile factors are cyclical fluctuation of trade cycle. Inflation and recession are the critical situation for economy which causes unstable economy. So to bring back the stability in economy again government uses its fiscal instrument of tax and expenditure. Hence during inflation government increases tax rate and reduces public expenditure vice versa during recession economy is slow down thus to improve the economic condition government increase government expenditure and reduces tax rate.

By doing so demand increases leading to increase multiplier effect increase in employment.

5. **Management of Public Enterprises**: Public entreprises are owned managed and controlled by public authority i.e government. Public enterprise have multiple responsibility of providing basic necessary goods at subsidized rate example are food, health, education and medical facilities. When the resources fall short of fund to achieve to fulfil these objectives then government choose to disinvest in its budget.

6. **Employment Generation**: Government in its budget tries to include various programe related to employment generating scheme. Example MGNREGA, and also tries to promote industries by focusing more on MSME.

4.2 Types of Public Budget:

1. **Traditional budget**: this is most common budget, where changes over the past years are taken in to consideration. Incremental approach is implemented in traditional approach. Hence previous years programmes and projects are continued and funded.

2. **Zero based Budget**: In Zero based Budget all item is included rather than only changes. The process of zero-based budgeting starts from a "zero base," and every function within an organization is analyzed for its needs and costs. Zero-based budgeting is a more granular process that aims to identify and justify expenditures.

3. **Balanced Budget**: When public revenue is equal to public expenditure it is consider as balanced budget. Classical economist believes in balance budget, when there is full employment. Aggregate supply and aggregate demand are in equilibrium at full employment, due to which income is equal to expenditure. Hence ultimately budget is in balance.

4. **Unbalanced budget**: on the contrary to balanced budget unbalanced budget is the budget which is due to disequilibrium in public revenue and public expenditure by the government. The examples of unbalanced budget are surplus budget and deficit budget. In case of surplus budget of government Public revenue > Public expenditure, vice versa deficit budget is the budget where public revenue fall short of public expenditure i.e public revenue < public expenditure.

5. **Performance Budget**: performance budget is based on the functions and activity involve in an economy and efficient utilization of resources to achieve the ultimate goal of economy. It is one that reflects both the input of resources and the output of services for each unit of an organization. Performance budget inclusive of three aspects which are understanding of final outcome, the tools and strategies adopted to reach to those final outcomes and the specific activities that are to be carried out to ensure those outcomes.

6. **Programme Budget**: A program budget is a budget formed specifically for a project or program. This type of budget includes expenses and revenues related to one specific project. No revenues or expenses of any other projects are mixed with this particular project. Government has to work on multiple task and responsibilities. So, they divide these functions into specific programmes, activities and projects. Depending upon the size and requirement and also the urgency of the programme fund is allocated.

7. **Unified Budget**: A unified budget is a form of federal government budget in which receipts and expenditures from central resources and the Social Security Trust Fund are merged. The change to a unified budget resulted in a single measure of the fiscal status of the government, based on the sum of all government activity. This is one of the most inclusive measure of the government's annual finances.

8. **Multiple Budget**: multiple budget is subdivided in various parts in such pattern that each and every part highlights the specialised functions of the government showing their budget.it is in practice in India as well. Indian government announces Railway budget and the Union Budget disjointedly.

9. **Legislative Budget**: A legislative Budget is prepared by the various committees appointed by the legislature from among its members. Elected representative of government are key participant of it. The power of enactment, amend and repealing of laws are in their hands.

10. **Executive budget**: An executive budget, on the other hand, is the one which is prepared by the executive branch of the government. The responsibility of implementation of budget is in the hands of executive authority of budget.

11. **Revenue Budget**: Revenue budget includes those items which is in recurring form which repeats again and again. There are two components of revenue budget those are revenue receipt and revenue expenditure. Revenue receipts are sources of recurring form of revenues to the government example – (a) tax revenue (b) Non tax revenue. Tax revenue further classified as (i) direct

tax (ii) indirect tax. On the contrary to this Revenue expenditure are basically to run the recurring form of spending which government has to bear. Such expenses generally done from revenue received by the government either directly or indirectly. Higher the need of maintenance of public service of public welfare more will be requirement of revenue expenditure in the list of budget.

12. **Capital Budget**: Like revenue budget capital budget also has two components those are (a) capital receipts (b) capital expenditure. Capital budget is non-recurring, both receipt and expenditure of capital is in decades or once or twice of life of asset but does not repeat again and again. Example of Capital expenditure are disinvestment, borrowing, loans from public or foreign governments, Reserve Bank of India, etc and capital expenditure are like expenditure on development of machinery, health facilities, etc.

4.3 Structure of Public Budget:

There are three tier system of government as per the constitution of India. Those are central government which is also called as union government, state government and Local government (like Municipal corporation, Municipal committee, Zila Parishad etc.). All these three governments have their own system of preparation of budget. Structure of budget for all these government is almost similar, but the sources of revenue and the spending are different to each of them. The budget framed by central government is formed by taking in to consideration the welfare of entire nation. Which is called as central budget or Union Budget. Budget formed by particular state for the development or promotion of that particular state it is called as state budget. Example budget formed by Maharashtra government, this budget is formed by considering for

the growth and development of Maharashtra sources of revenue will be from Maharashtra and spending will also be for the welfare of Maharashtra only. As central government and state government cannot reach at all remote and interior part of the economy. Then it became responsibility of local government to improve the condition of local area by forming the optimum Budget as per the need and requirement, such budget is called as Municipal Budget.

Here the core study is of Central Budget. Central Government is constitutionally required to present annual financial statement before both the houses of Parliament. This statement is conventionally called Government Budget. Accordingly in India every year central Budget for the coming finance year is presented by the Union Finance Minister in the Lok Sabha normally on the last working day of the month of February. Year 2020 -21 is intertwined in three major themes, those are Aspirational India, Economic Development and a Caring Society. The dream of Prime Minister '**Sabka Saath, Sabka Vikas,**

Sabka Vishwas' which address the aspirations of India. Union Budget gives item wise details of the government receipts and expenditure for three consecutive years those are Actuals for the preceding year, Budget estimates for the current year. Revised estimates for the current year and budget estimate for the coming year.

Structure/Components of Government Budget are classified in two important component i.e revenue and capital which is further classified in revenue receipt and revenue expenditure and capital receipt capital expenditure.

Revenue Budget : Revenue budget includes recurring form of sources of income to the government which will be part of revenue receipt.

Example: Revenue from direct taxes and indirect taxes are tax revenue Sources. Fees, fines, penalty, administrative fees, grants etc. are Non – Tax Revenue sources.

On the contrary to which revenue expenditure are those expenses where government is liable to pay for it. The funding of which government do from the amount received through revenue receipt.

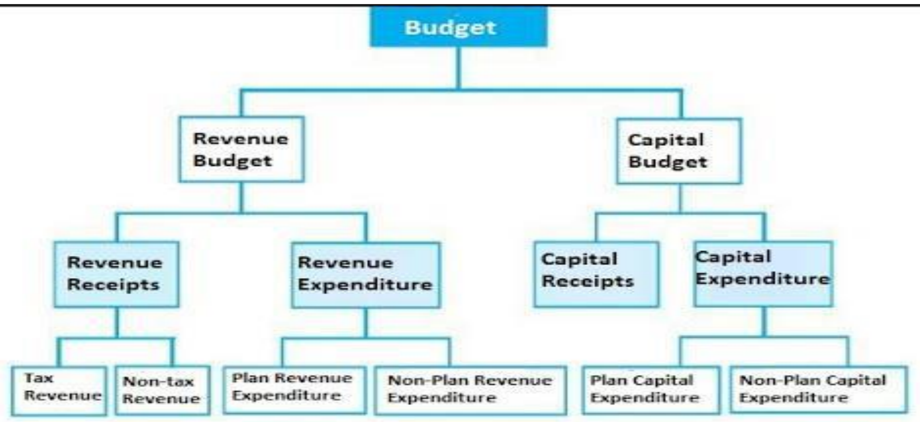
Example: Defence expenditure, interest payment, Major Subsidies. Capital Budget: Just like Revenue Budget capital budget also have two components capital receipt and capital expenditure, the only difference is that it is non - recurring does not repeat again and again. Capital receipts are the sources of income to the government which they earn not in recurring form.

Example of Capital Receipt are Disinvestment, recovery of loan, Borrowings and other liabilities.

Capital expenditure are those expenses which is born by government for creation of assets and investment.

Following flow chart is representing components or structure of Budget:

Figure No. 4.1



Components of Government Budget

4.4 Role of Taxation:

Government has to perform various function for the welfare of economy, thus they need funding for expenses to run the economy. The amount which is collected by the people of country following canon or principle are known as public revenue. Revenue can be collected in two different ways. Firstly through taxation and Non – Tax revenue. Tax revenue is most popular source of revenue to the government. According to Dalton, "a tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the tax payers in return and not imposed as a penalty for any legal offence. He further stated that " a tax, by definition is a payment in return for which no direct and specific and specific quid – pro – quo is rendered to the tax payer."

Taxation is of two different types : (a) Direct Tax

(b) Indirect Tax

Features of Taxation:

1. People who are liable to pay tax can not refuse to pay it to the government, thus tax can not be avoided it is compulsory payment.
2. It is not necessary that if tax is paid by person in return that person will get benefit of that with equal proportion. So there is no quid – pro – quo.
3. There is no give and take relationship.
4. No one get pleasure by paying tax because it reduces disposable income thus it involves sacrifice.

Taxation plays vital role in following ways:

1. **Helpful in attaining the objective of revenue**: revenue is must for government to run the expenses of the economy. In modern world it is also used as an instrument to frame policy.

2. **Reduces income inequlity**:Taxation also helpful in achieving equality in two different income group i.e the gap between rich and poor can be eradicated.

3. **Full employment** : taxation helps in achieving objective of full employment. With the help of use of taxation disposable income get influence hence also affecting demand. A reasonable rate of taxation will increase the disposable income which will increase demand for goods and services. Effect of increase in demand will also be on investment positively and multiplier effect is on income and employment.

4. **Price Stability**: Due to some uninvited circumstances disequilibrium exist in economy. Taxation plays vital role in bringing back to equality level to the economy and thus stabilise the economy. During the period of inflation by raising tax rate inflationary effect can be absorbed. And just opposite to that during recession to bring back to stable economy the technique of reducing tax rate is applied.

5. **Economic Development :**Economic development is continuous long term process, for which huge capital formation is required. In less developed countries due to lack of finance there is shortage of resources to form capital. Optimum taxation policy helps to allocate the resources for productive purposes. Productive utilisation of resources increases investment level which increases income and employment in multiplier form.

6. **Reducing the imbalance in Balance of Payment:** Balance of Payment is double column entry of countries receipts and payment record. It consist of current and capital account. Generally less developed countries face the disequilibrium in balance of payment i.e they have import > export. But balance of payment should to be in balance for which taxation plays very crucial role. By imposing taxes like custom duties import can be reduced, and the objective of Balance of payment can be achieved.

4.5 Merits and Demerits of Direct and Indirect Tax:

4.5.1 Direct Tax: Direct tax is one of the sources of tax revenue to the government. Direct taxes are borne by the individual or organisation on whom it imposed. Such type of taxes can not be shifted on other. Impact and incidence of tax is on the same person in case of direct tax. Direct taxes are progressive in nature, which means with increase in increase in income of person rate of tax also increases. Hence direct taxes are useful in bringing equality in nation. More taxes levied on high income group and revenue collected from that used to redistribute to poor section of economy.

Example of Direct Tax: Income Tax, Wealth tax, gift tax, corporate tax etc.

Merits of Direct Tax:

1. **Certain:** Direct tax are certain on the basis of various aspects i.e the amount of tax, the time period, the procedure and the manner of tax payment.

2. **Economical**: Direct tax follows the canon of economy. The cost incurred to collect direct tax is low. It get collected directly from the source of salaried people in case of direct tax.

3. **Elastic:** Direct taxes are flexible, it satifies the canon of elasticity.

   Depending upon the need and requirement of country government do changes in tax rate. During boom period to protect the economy from problem of inflationary situation tax rate increased by the government. And just contrary to that during recession to improve the economic condition government reduces tax rate.

4. **Civic Consciousness**: in democratic country like India, direct tax create civic consciousness in the mind of tax payer. The tax which is paid by them is their hard earned money so they are concern about its uses, they show interest on where the government is spending their money.

   They feel responsibility towards the growth, welfare and development of economy.

5. **Equity:** Direct taxes are based on the most important canon of taxation i.e ability to pay. The tax burden is distributed throughout economy(people and institution) in equitable manner. Direct tax are progressive in nature which support to reduce inequality in rich and poor class of economy.

6. **Simple**: Direct taxes are simple and easy to understand.

Demerits of Direct Tax:

1. **Arbitrary and possibility of injustice**: Direct taxes are levied on the basis of the recommendations of the tax authority. There is involvement of many other factors also which may lead to error in the process. Some time in some cases it become difficult to identify the true income of person and the source of it. So the ability to pay principle does not prevail successfully. Hence burden of tax does not get distributed equally leading to arbitrage and injustice.

2. **Inconvenient:** Direct tax are inconvenient basically to less educated because of its formality. The procedure of return filling is not so convenient to tax payers.

3. **Unpopular**: Direct taxes are not so popular as it discourages the disposable income of person. Biggest factor responsible for unpopularity of direct tax is that it cannot be shifted, the burden and pain of tax is on tax payer itself.

4. **Do not cover large population**: In less developed country maximum population belong to low income(poor),they are exempted from payment of taxes.

5. **Tax Evasion**: Direct tax involve sacrifice thus tax payers try to evade themselves from paying taxes. So possibility of cheating is more in such type of taxes.

4.5.2 Indirect Tax: Indirect tax is another important source of revenue to the government. Indirect taxes are imposed on goods and services and thus it is also called as commodity tax. Indirect taxes are regressive in nature. Whether the person is rich or poor, but if person wants to get the benefit of it then liability of paying tax is born on them. Due to its policy in case of poor people basically due to imposition of tax on commodity it become more expensive for them and their purchasing power reduces, thus it is regressive in nature. One can shift the burden of tax. Generally tax is impose on manufacturer and finally they forward the burden of tax partially or fully on consumer. Impact and incidence are not compulsory to be on same person. There is quid – pro – quo in most of the cases.

Example of Indirect taxes are – GST, Custom duty, union excise duty etc.

Goods and Service tax – GST is one of the most popular example of indirect tax which has changed the economic structure of economy. Goods and services Tax (GST) was launched in India on 1st July 2017, which is more comprehensive, Multi stage, destination based tax that is levied on every value addition. There are total of 5, GST tax rates those are 0%, 5%, 12%, 18% and 28%.

Merits of Indirect Tax:

1. **More Convenient to Pay** : Unlike direct tax, indirect taxes are more convenient as tax is included in the price of product so people don't feel like burden of tax. The other reason for convenience is that one can pay in instalment in small amount. It is also convenient to the government as well because tax is collected in lumpsum form manufacturer or the importers.

2. **Elastic**: Indirect tax on some commodity fulfils the principle of elasticity. Government can raise revenue by imposing such taxes on inelastic demand. Butneed to consider the situation of poor people before imposing such taxes on necessary goods.

3. **Wide Coverage**: indirect tax collected by the government covers large number of population. Because it is levied on all section of society. It is not imposed on selected class like in direct tax poor section of society as per the policy they are exempted due to ability to pay principle.

4. **Control over consumption of demerit Goods**: Demerit goods like Alcohol, Cigarette, opium, ganja etc are harmful and not accepted by society. So by imposing heavy indirect tax like excise duty on production of such goods and even consumption also can be controlled. Producer will try to transfer the burden of tax on the consumer by raising price of such goods. And due to high price of such commodity and lack of ability to buy they will not consume it.

5. **Tax Evasion is Difficult**: Scope of tax evasion in case of indirect tax is less. Tax evasion is illegal practice where people try to avoid the tax liable to pay.

Demerits of Indirect Tax:

1. **Regressive Character**: one of the biggest drawback of indirect tax is that it is regressive which is unjust for poor section of the economy. Commodity tax affect more to poor, due to imposition of tax on basic necessity price of such commodity increases. Rich person don't mind to pay small addition in the price but poor suffer more because their ability to pay is less.

2. **Uneconomical**: The administrative cost of collecting tax is expensive. They have to appoint inspectors to check and supervise the accounts, stocks of producers, wholesalers and retailers whether they are paying tax or not.

3. **Uncertainty**: Revenue which government has to earn through indirect tax is totally uncertain. Because once price increased due to imposition of tax there is possibility of reduction in demand for such goods. Thus government cannot predict exact amount of revenue collection from indirect tax.

4. **Inflationary**: Indirect tax has its direct negative effect on economic condition, it increase the price of goods and services. Which influence other factor in spiral and disturb the whole economy.

5. **Adverse effect on production and employment**: Due to impositions of various duties on production become costly and producer may get discourage due to which they will produce less. Layoff of workers will also take place.

4.6 Features of Goods Tax System:

A tax system is considered as good tax system only when it fulfils the desired principle which is also called as Canons of taxation. Tax involve sacrifice, tax payer never find pleasure to pay tax. Hence the revenue which is collected through tax should be used in optimum and productive way. Because it is someone's hard money. Adam Smith, father of economics supported effective use of taxation by introducing four canons of taxation which he believe that good tax must follow.

Canons of taxation by Adam Smith are

(1) Equality

(2) Certainty

(3) Convenience

(4) Economy.

Adam Smith was more concerned with how the wealth of nations or productivity can be raised. According to him one of the most important objective is that government should be able to raise sufficient revenue to run the expense of Defence, Law and Order, Justice etc. Later on, with further development of economy and promotion of welfare economy there were addition in the canons of economy with the help of many other economist.

Following Canons are required to fulfil to be consider as good tax:

1. **Canon of Equality**: Most effective canon of taxation is canon of equality. According to Adam Smith canon of equality means every person should pay to the government as per their ability to pay. Thus people belong to high income group i.e rich will pay more tax and poor will have to pay less based on the ability to pay principle. There are two aspects of ability to pay principle.

   (a) Horizontal Equity – It means those who have same income will pay same amount of tax with no discrimination among them.

   (b) Vertical Equity - People with different income group will be paying as per their ability. Various tax rates should be levied on people with different levels of income. Rich people have to pay more as they are at top level and bottom class i.e poor due to less ability will be paying less.

   A good tax system must be able to ensure both these aspect of ability to pay principle , i.e horizontal and vertical equity.

2. **Canon of Certainty**: According to Adam Smith "The Tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person". As per the study of

   Adam Smith uncertainty leads to corruption. Canon of certainty in relation to taxation a good tax system system, "individual should be secure against unpredictable taxes levied on their wages or other income. The law should be clear and specific; tax collection should have little discretion about how much to assess tax payers, for this is a very great power and subject to abuse." The certainty aspect include (a) certainty of incidence (b) Certainty of liability (c) Certainty of revenue. Canon of certainty in taxation is also useful to the government in assessing the tax income which is relevant for budget formulating.

3. **Canon of Convenience**: According to Adam smith the third Canon of taxation i.e Canon of Convenience is also very important aspect to fulfil to consider tax as a good tax. He represents that the sum, time and manner of payment of a tax should not only be certain but the time and manner of its payment should also be convenient to the contributor.

   Example: If a land revenue is collected at the time of harvest, it will be convenient since at this time farmers reap their crop and obtain income. Another example of convenience with respect to India, income tax in India is levied on the basis of income received rather than income accrued during a year.

4. **Canon of Economy**: Tax imposition and tax collection these are two different concepts. Collection of tax includes cost, since such cost do not add any productivity to the nation. These addition cost to the nation should be minimised. According to Adam Smith, there is lack of economy when,

   (a) Tax administration is costly on account of complicated taxes.

   (b) Taxes are unduly heavy which would discourage investment, so that the general level of income reduces and hence the relative tax yields.

   (c) Tax collection machinery is elaborated and administrative expenses are high.

   (d) Taxes are unproductive in yielding sufficient revenue.

   Thus more the complexity in procedure and formalities higher will be cost of collection. Hence tax should be simple and tax laws should not be subject to different interpretation.

5. **Canon of Productivity**: Productivity implies resource should optimally get

utilised and should yield something in return. Thus canon of productivity in taxation means that tax system should be able to bring enough revenue for the treasury. It is more relevant to Indian economy so that country can provide more welfare and leads to developmental activities. On the contrary to this if the tax system do not get success to yield enough resources, the government will resort to deficit financing which is harmful for economic activity.

6. **Canon of Elasticity**: According to the Canon of elasticity of the taxation system means changes in tax revenue as per the changing state of the economy, as national income increases due to economic growth government revenue from tax source should also increase. Progressive form of tax on income and wealth leads to elasticity to the tax system.

   Example: More indirect tax on luxury goods having high income elasticity of demand also makes the tax system elastic.

7. **Canon of Simplicity**: Tax system should be simple. The mode of payment, way of calculation and various other procedure need to be simple, so that it is understandable to tax payer. And tax payer do not find difficulty in paying tax.

8. **Canon of Flexibility**: It means absence of rigidity. Taxation system need to be flexible as per the need and requirement of economy.

9. **Canon of Coordination**: As Indian government has three tier federal government system. These are Central government, State Government and Local Government. Some power is shared among different level of government. The tax authority from different level of government need to coordinate among themselves then only it will be considered as good tax.

10. **Canon of Diversity**: It indicates that there should be multiple tax system rather than single. The single tax system may not be able to fulfil the requirement of the economy i.e shortage of revenue may arise. Whereas multiple tax system helps to collect revenue from multiple sources and large number of populations contributing to pay taxes. Hence the burden of tax is not on limited number of members of economy. It has wider coverage.

4.7 Concept of Impact, Incidence and Shifting of Taxation:

4.7.1 Impact of Taxation:

Impact of taxation is the immediate burden of tax on the tax payer. Its initial stage of tax burden on the person who is liable to pay. The impact of tax is the first point of contact. The impact of tax is on the person on whom it is imposed

first. The term impact is used to represent the immediate result of or original imposition of the tax.

<u>4.7.2 Incidence of Taxation</u>: Incidence of tax is the final resting point at which the ultimate burden of tax gets settled. It is economic term to find the ultimate source on whom finally tax get settled.

Example: Person A is producer of commodity X let assume that due to new government policy he has to bear additional cost of GST for his product. Then the impact of tax is on person A, but he may forward the tax burden by raising the price of his product exactly equals to the amount of GST which he has to

pay it to the government. Hence it become very clear that the incidence of tax is on Buyer of commodity X. thus incidence of tax is the final resting point who finally pay the tax.

According to Dalton: incidence of taxation is classified further in two form –

(i) Real Burden: The sacrifice incurred in payment of tax is the real burden on tax payer.

(ii) Money Burden: The money burden or the amount which is imposed on the tax payer.

The other classification of incidence of taxation by Mrs. Urusula Hicks are

(i) Formal Incidence – The tax authority collect tax revenue, the direct money burden of such tax is formal incidence of taxation.

(ii) Effective Incidence – Due to imposition of taxation the entire economy activity get affected. Thus overall economic effect of tax is called as effective incidence.

Table No. 4.1: Distinguish between Impact and Incidence of Taxation

SR. NO.	IMPACT	INCIDENCE
1.	Impact refers to initial burden of tax	Incidence refers to ultimate burden of tax
2.	Impact is at the point of imposition	Incidence occurs at the point of settlement.
3.	The impact of a tax falls upon the person from whom the tax is	The incidence rests on the person who pays it eventually.
4.	Impact may be shifted	Incidence cannot
5.	Example – Direct Tax i.e Income tax in which impact and incidence	Example – Indirect Tax i.e GST in which impact and incidence are not on

4.7.3 Shifting of taxation:

Shifting of taxation relates to transferring the money burden of tax on someone else. The objective behind shifting of taxation is to escape self from payment of taxation. Tax shifting is the intermediate process of between the impact and incidence of taxation. Commodity taxation is the source where shifting of taxation is possible. The price is the medium through which the shifting of taxation can be done. Due to shifting of taxation the price of the product increases the buyer has born the burden of shifting of tax, or the other possibility is that if the price remains same the quality of quantity get affected. There are different types of shifting of taxation.

1. **Forward Shifting**: This is most common tendency of shifting of taxation. Here the burden of tax is forwarded further. Example – Tax levied by the government leads to addition in the cost of production to the producer. Then Producer shift the money burden of tax on to the buyer by raising the price of its product.

2. **Backward Shifting**: backward shifting is the process where the impact and incidence of tax is not on the buyer i.e the price do not get change. Perhaps the producer shift the money burden of tax backward by reducing the wages of workers on by bargain to reduce the cost of raw material to the seller of raw material.

3. **Combination Shifting**: By name itself we can understand that here combination of both forward and backward shifting takes place. Producer tries to shift forward partial burden of tax on buyer by raising price partially and partially shift backward on factors of production like workers by reducing wages or deteriorating the quality of input.

4. **Single point and Multi –Point Shifting** –

   Single point shifting of taxation is at single source i.e when the burden of tax is shifted from producer to the consumer it is called as single point shifting.

   Multi point shifting - It is the shifting of tax burden at various level. First level is government when they impose tax on producer, for example excise duty on production of commodity. Producer forward the addition cost of such tax burden to the retailer and finally retailer forward it to the buyer who is the ultimate tax payer.

4.8 Elasticity and determination of tax burden.

According to Dalton, the incidence of commodity taxation is shared between buyers and sellers in the ratio of the elasticity of supply of the taxed commodity to the elasticity of demand for it

$$\frac{E_s}{E_d} = \frac{Incidence\ on\ Buyers}{Incidence\ on\ Seller}$$

4.8.1 Elasticity of Demand:

Dalton put down two propositions with regard to the general principle of incidence of commodity taxation.

1) Other things remain the same, the more elastic the demand for the taxed commodity, the more will be the incidence of the tax upon the seller.

2) Other things remains same, the more elastic the supply of the taxed commodity, the more will be the incidence of the tax upon the buyer.

On the basis of these proposition the tax incidence differ on elasticities of Demand and Supply.

I . Elasticity of demand:

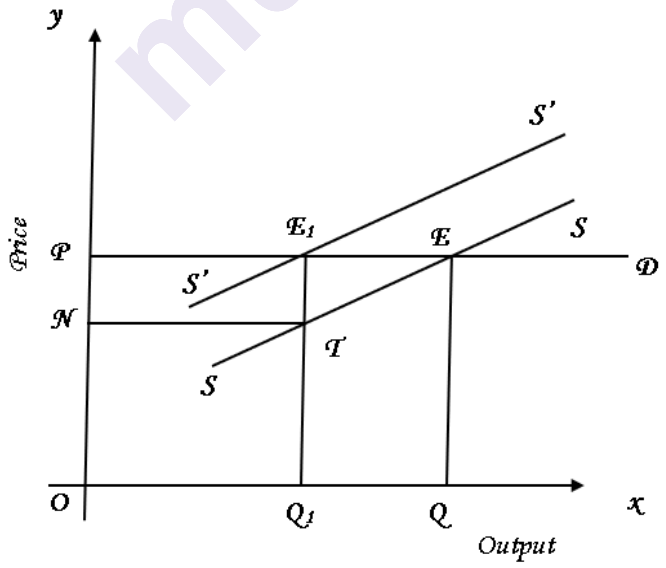
$$\text{Ed} = \frac{proportionate\ change\ in\ demand}{proportionate\ change\ in\ price}$$

Given Elasticity of supply we will explain different types of elasticity of demand and tax incidence

1) Perfectly Elastic Demand:

Given supply elasticity, when demand is perfectly elastic. The entire tax burden is on the seller. On x-axis output is mentioned on Y axis price.

Figure No. 4.2



In fig 4.2 DD is Demand curve Horizontal showing perfectly elastic demand SS is original supply curve. Equilibrium is at E. Due to imposition of tax SS curve shift upward at S'S' the vertical gap between the two supply curve is tax amount equilibrium changes from E to E_1 But price remains same at OP.

The tax amount in fig 4.2 is TE_1PN which lie below the price charged. Thus the entire burden of tax burden (i.e incidence) is borne by the seller.

2) Perfectly inelastic demand:

Figure No. 4.3

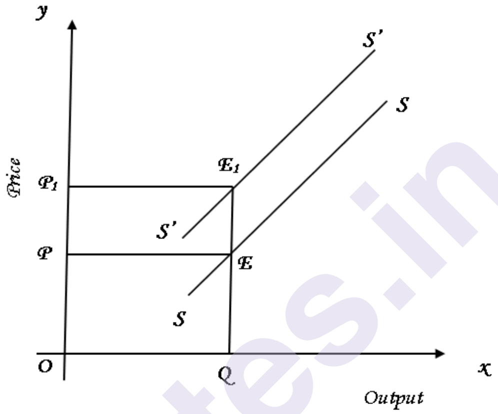


Figure 2.2 represent perfectly inelastic demand. Supply curve is SS demand curve is vertical i.e DD the price is OP. Now due to imposition of tax the new supply curve is SS' the gap between SS and S'S' is tax amount EE' here we can see that the price rise from OP to OP' due to tax. Thus we can understand with this, that in case of perfectly inelastic demand the entire tax burden in borne by buyer.

3) Relatively Elastic Demand:

Figure No. 4.4

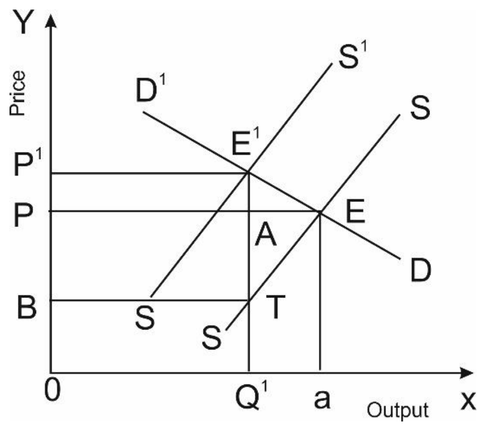


Fig 4.4, Demand curve is flatter indicating more elasticity tax amount is E’T PP’E’A > PABT out of which area upto PP’E’A is born by buyer and PABT is born by seller. So we can say that in Relatively elastic demand, more burden of tax is on seller and the smaller burden falls on buyer.

4) Relatively inelastic demand:

Figure No. 4.5

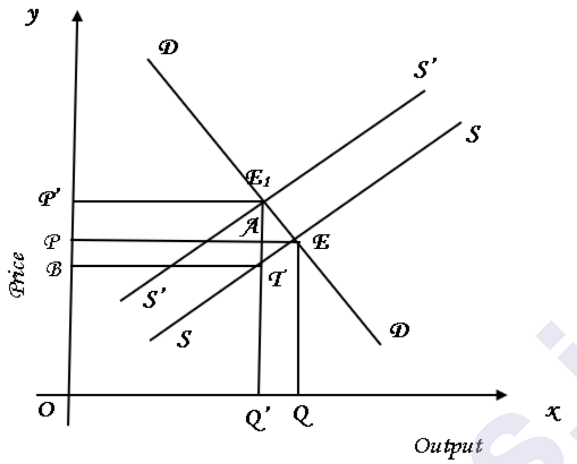
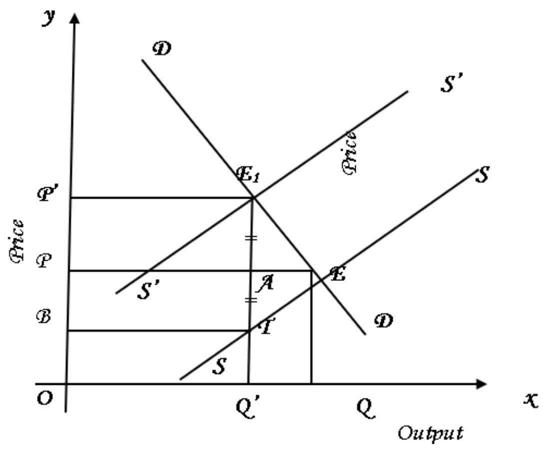


Fig 4.5 is the case where we have steeper demand curve which is due to Relatively inelastic demand situation. Here tax amount is E’T. out of which the buyer has to pay more tax as compare to seller. □PP’E’A > PBAT. Here PP’E’A is the amount born by buyer and PABT is born by seller. In this case seller is able to shift maximum burden of tax on buyer and only partial tax by seller.

5) Unitary elastic demand :

Fig 4.6 represent that the tax amount E’T is equally shared among both of them i.e buyer as well as seller. □PP’E’A = □PABT. So

Figure No. 4.6



Thus the money burden of tax will be divided equally between the buyer and the seller.

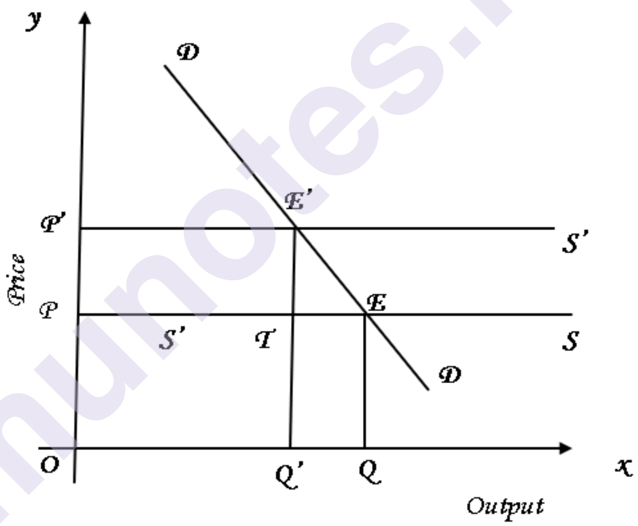
4.8.2 Elasticity of supply:

$$E_s = \frac{proportionate\ change\ in\ supply}{proportionate\ change\ in\ price}$$

Elasticity of supply also influence to a greater extent in determining incidence of a tax. Sellers can affect the market by changing supply and hence the price. To what extent price change that can be determined by elasticity of supply. Here we assume that demand elasticity is constant. More precisely we can say that given the elasticity of demand, higher the elasticity of supply greater will be the burden on the buyer. Different types of elasticity of supply and tax incidence.

1)Perfectly elastic supply:

Figure No. 4.7

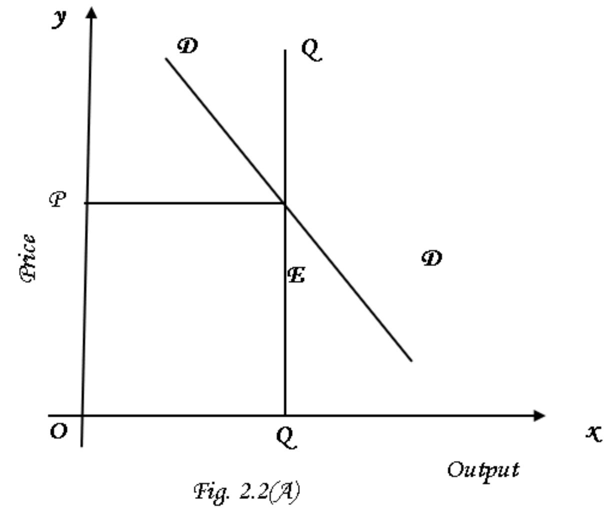


In fig 4.7 (A) SS in perfectly elastic supply curve keeping elasticity of demand constant equilibrium is at point E and AS tax imposed supply curve S'S' shift upward horizontally. New equilibrium is at E'. The tax amount is the distance between old supply curve and new supply curve E'T. as here the price before tax was OP and after imposition of tax, the price rises to OP'. Thus it indicates that entire burden of tax is on buyer.

2) **Perfectly inelastic supply**:

Here in case of perfectly inelastic supply, the supply curve is vertical and the seller is not able to shift the burden of tax on anyone else. Thus fig 4.8 shows that entire burden of tax is borne by seller himself.

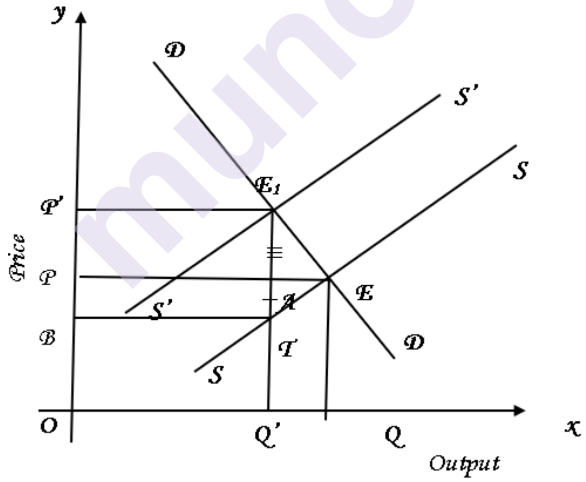
Figure No. 4.8



3) Relatively more elastic supply:

In figure 4.9 the supply curve is flatter showing more elasticity tax amount is E'T of which greater portion of tax burden fall on buyer and smaller proportion of tax on seller. Buyer has to bear (E'A) and seller (AT).

Figure No. 4.9



4) Relatively inelastic supply:

Figure 4.10 represents relatively inelastic supply situation where the supply curve is steeper. Tax amount is ET where greater proportion of tax burden is on seller smaller proportion of tax incidence is on buyer. Area PP'E'A is borne by buyer and area PBAT is borne by seller.

Figure No. 4.10

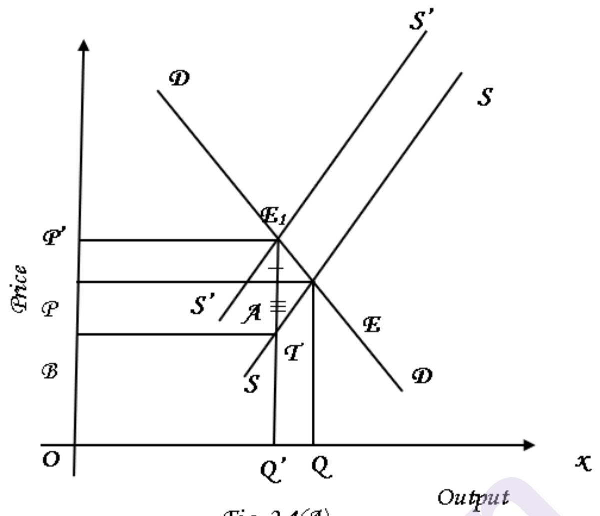


Fig. 2.4(A)

5) Unitary elastic supply:

Like fig 4.6 in this case also tax is divided equally among buyer and seller.

Hence we conclude that greater the elasticity of demand, lesser will be the possibility of the seller is to shift the incidence of tan on buyer. On the contrary to it higher the elasticity of supply, the greater is the possibility of the seller to shift the tax on the buyers.

4.9 Questions

Q1. Explain different types of Public Budget.

Q2. Describe in detail the role of Government in economic welfare.

Q3. Distinguish between impact and incidence of taxation.

Q4. Explain incidence of tax burden on buyer and seller with the help of suitable diagrams.

Q5. What are the features of good taxation?

Q6. Distinguish between direct tax and indirect tax.

4.10 References

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Module 3

5

FISCAL POLICY: PUBLIC EXPENDITURE

Unit Structure:

5.0 Objective

- To understand the concept of Public Expenditure.
- To familiar students with the Canons and Classification of Public expenditure.
- To enable the learners to grasp fully the theoretical rationale behind Wagner's law of Public expenditure.
- To explain the students public expenditure as an instrument of Fiscal policy.

5.1 Introduction

The 19th century State was mainly a police State, but the 20th Century State is a Welfare State whose main objective is to promote the economic, political and social well-being of citizens. Government spend money to create and maintain full employment, development programmes, education [free] and on social security measures. Expenditure on national defence generally accounts for half of the total expenditure. Larger the country, greater the percentage of revenue allotted to national defence. The continuous process of urbanization brings an expansion in expenditure on the protection of life and prosperity, and on public health, educations and other functions like hospitals, playgrounds, organized recreations, water, sewerage growth of network of roads, railways and provision of welfare and assistance.

The great depression of 1929-33 demonstrated the need for government to interfere and participate in economic activity and new functions. The government took various measures for the active encouragement of industry, agriculture, labour full employment, promoting public welfare, and control over all sectors of the economy.

The other causes for the growth of public expenditure includes, rise of democracy, rise in price levels, increase in public debt followed by increased interest rates, growth of the spirit of economic nationalism and desire for self-sufficiency, etc.

In the previous chapters on public finance, we have examined budget and taxation as an important aspect of public finance. Classical economists have been interested in the problems of taxation for a long time. Modern economists believe that the question of public expenditure is not less important than that of taxation. In fact, public expenditure is another very important side of public finance. In this chapter, we shall examine public expenditure as an important area of public finance.

5.2 Meaning Of Public Expenditure

Public expenditure refers to expenditure of the government. i.e. government spending for public welfare. It is incurred by Central, State and Local governments of a country. Public expenditure can be defined as , “The expenditure incurred by public authorities like central, state and local governments to satisfy the collective social wants of people is known as public expenditure.”

Public expenditure is important branch of public finance. It is not nearly a financial mechanism. Classical economists believed that **“that government is the best**

which governs the least". It means the role of government in the economy should be minimum. The classical economist were the followers of laissez faire policy. (i.e. no government intervention.)

New approach to public finance however evolved in the 1930s, since the Keynesian revolution in economic thought. Modern economists believe that public expenditure has a positive role to play, to achieve definite ends. Its goal is to promote maximum social welfare. Today the state is recognized as a welfare state, therefore it has to perform many other functions.

In modern era, public expenditure has the following objectives;-

1. To make provision of social wants in order to maximize social and economic welfare.
2. To make provision of optimum level of investment in order to maintain full level of employment and economic growth.
3. To make provision of infrastructure by improving capital formation.
4. To provide equal distribution of income and wealth.
5. To maintain national security.
6. Maintenance of law and order and internal security.

5.3 Importance of Public Expenditure

Public expenditure plays a significant role in the development process of a country in the following ways:-

1. By building economic overheads.
2. To buy balanced regional development.
3. By augmenting the development of agriculture and industry.
4. By exploitation and development of mineral resources, coal and oil.
5. By rural electrification Programme which can bring rural development.

5.4 Principles / Canons of Public Expenditures

The principles of public expenditure are certain guidelines for the public authorities in spending government money. They are also known as canons of expenditure.

These canons are:

1. Principle of Maximum Social Advantage

The objective behind this principle is that public money should be spent for general cause and must promote social welfare. It should not be spent for the benefit of a particular group of society. Public expenditure should result in increased production, elimination of inequality and promotion of welfare of all. It should secure internal peace and also protection from external aggression.

2. Canon of Economy

The authorities are expected to follow utmost economy in its expenditure. Public money should not be misused and not result in any wastage. Whenever money is raised by taxation, public expenditure in return should bring maximum benefit. It should not produce unfavorable effect on production. Canon of economy does not mean niggardliness or miserliness. It simply means the prevention of extravagance and waste of all kinds.

3. Canon of Sanction

Without the sanction of the public authority, no money should be spent. At the same time, the amount of money must be spent for the purpose for which it was sanctioned.

This will ensure that:

- waste and extravagance are avoided,
- there is proper audit done compulsorily,
- there is control and legislative supervision over public expenditure,
- It is seen whether the expenditure has fulfilled the objective.

In the absence of proper sanction, there may be misuse and misappropriation of public funds. The Public Accounts Committee established by every legislature sees that these objectives are achieved.

4. Canon of Elasticity

This implies that there should be scope for varying the expenditure according to need or circumstances. There should not be any rigidity in public expenditure.

5. Canon of Surplus

To greater extent, the government expenditure should lead to increased production, employment and income. The expenditure should be with in the revenue of the State. Deficit is permitted only for a short duration. In times of crisis, government is allowed to have deficit budget. The deficit must be made good after the normalcy returns.

Finally, public expenditure should promote economic growth, stability and social justice. Public expenditure should be directed to achieve economic and social objectives of the country.

5.5 Effects of Public Expenditure

Public expenditure is beneficial since it influences the economy in many directions. The effects of public expenditure are always beneficial. It increases the capacity of the people to produce output efficiently. It influences the production not only directly but also indirectly. It increases the community's productive power. It promotes social and economic equality and finally increases income, employment and welfare.

1. **Effects on production**

   Expenditure on defence becomes productive and it becomes a protective expenditure. Development of infrastructures facilitates production and thereby helps to increase national income and in turn per capita income. Expenditures on social services like free education, health and medical aid, which increase the capacity of the people to work and save and productive power.

2. **Effects on distribution**

   Public expenditure is an ideal medium to remove economic inequalities in society. The government should tax more the rich. The amount so collected should be spent on free education, medical aid, cheap food, subsidized houses, old age pension, etc. This process of public expenditure will bring about redistribution of national income in favour of the poor.

3. **Effects on income and employment**

   Public expenditure affects the level of income and employment in the country by removing the widespread unemployment. Investing more on public works like roads, hydro-electric generating works, etc. will create a multiplier effect on the economy and thereby increases the income and employment. This results in increased consumption and in turn develops the consumption goods industries and capital goods industries.

Thus, public expenditure plays a vital role in the economic development of a country. It also creates necessary environment for the expansion of private enterprise and initiative.

5.6 Classification of Public Expenditure

Different economists have classified Public Expenditure into different forms. Prof. Adam Smith has classified public expenditure on the basis of functions performed by the government. They are defence expenditure, commercial expenditure and development expenditure. Classification of public expenditure refers to the systematic arrangement of different items on which the government incurs expenditure.

Public expenditure has been classified into various categories. Firstly, Government expenditure has been classified into revenue expenditure and capital expenditure. Revenue expenditure is a current or consumption expenditure incurred on civil administration (i.e., police, jails and judiciary), defence forces, public health and education.

This revenue expenditure is of recurrent type which is incurred year after year. On the other hand, capital expenditure is incurred on building durable assets. It is a non-recurring type of expenditure. Expenditure incurred on building multipurpose river projects, highways, steel plants etc., and buying machinery and equipment is regarded as capital expenditure.

Transfer Payments and Expenditure on Goods and Services. Another useful classification of public expenditure divides it into transfer payments and non-transfer payments. Transfer payments refer to those kinds of expenditure against which there is no corresponding transfer of real resources (i.e., goods and services) to the Government.

1. **Revenue and Capital Expenditure:**

   (A) Revenue Expenditures are recurrent or consumption expenditures incurred on public administration, defence forces, public health and education, maintenance of government machinery, subsidies and interest payments. These expenditures are recurrent in nature and they do not create any capital assets. Revenue expenditure is classified into development and non-development expenditure

   i) **Development Expenditure:** The part of revenue expenditure that directly or indirectly contributes to the development of the country is known as development revenue expenditure. It includes expenditures on the maintenance and functioning of social and community services and physical infrastructure. For example, maintenance of education and public health infrastructure like schools, hospitals, irrigation facilities, electricity boards etc.

ii) **Non-Development Expenditure:** The part of revenue expenditure that may not directly contribute to economic development is known as non-development revenue expenditure. They include expenditures on the maintenance of defence establishments, administrative expenditure, interest payments, payment of old age pension etc.

(B) Capital Expenditures are incurred on building durable assets, like highways, multipurpose dams, irrigation projects, buying machinery and equipment. They are a non-recurring type of expenditure in the form of capital investments. Such expenditures are expected to improve the productive capacity of the economy.

i) **Not all capital expenditures are productive.** Non-development capital expenditure on defence establishment which does not have any direct impact on economic development but is necessary for the security of the nation.

ii) **Capital expenditures on social infrastructure** like government schools, hospitals, primary health centers may not generate revenue and therefore cannot be termed productive in that sense, but they indirectly contribute to improving productivity.

2. Productive and Unproductive Expenditure

(a) **Productive Expenditure:** Expenditure on infrastructure development, public enterprises or development of agriculture increase productive capacity in the economy and bring income to the government through tax and non-tax revenues. Thus they are classified as productive expenditure.

(b) **Unproductive Expenditure:** Expenditures in the nature of consumption, such as defence, interest payments, expenditure on law and order, public administration do not create any productive asset which can bring income or returns to the government. Such expenses are classified as unproductive expenditures.

3. Non-Transfer and Transfer Expenditure:

(a) **Non-transfer Expenditures:** Are incurred for buying or using goods and services. These include expenditure on defence, education, public health etc. Investment expenditures on capital assets are also non-transfer expenditures as the government gets capital goods and assets in return for them.

(b) **Transfer Expenditures:** Refer to those expenditures against which there is no corresponding transfer of real resources i.e. goods or services. These include expenditures incurred on old age pension, unemployment allowance, sickness benefits, interest payments on public debt and subsidies.

4. **Plan and Non-Plan Expenditure:**

(a) **Plan Expenditures:** Refer to the spending of the annual funds allocated by the Central government for development schemes outlined in the ongoing Five Year Plan. For example: Industrial Development, Agricultural Development, Infrastructure, Education & Health etc.

(b) **Non-Plan Expenditures:** Include all those expenditures of the government that are not included in the ongoing Five-Year Plan. They include both development and non-development expenditure. Part of the expenditure is obligatory in nature e.g. interest payments, pensions etc. and a part is essential obligation e.g. defence and internal security.

5.7 Dalton's Classification of Public Expenditure

Economist Hugh Dalton has provided the following comprehensive classification of public expenditure:

i. Expenditures on political executives i.e. maintenance of ceremonial heads of state, like the President.

ii. Administrative expenditure to maintain the general administration of the country, like government departments and offices.

iii. Security expenditures to maintain armed forces and the police forces.

iv. Expenditures on administration of justice include maintenance of courts, judges, public prosecutors.

v. Developmental expenditures to promote growth and development of the economy, like expenditure on infrastructure, irrigation etc.

vi. Social expenditures on public health, community welfare, social security etc. vii) Public debt charges include payment of interest and repayment of principal amount.

5.8 Wagner's Law of Increasing State Activity

First, there is Wagner's Law of Increasing State Activity. According to Wagner, a German economist, there are inherent tendencies for the activities of the Government to increase both extensively and intensively. In other words, according to this law as an economy develops over time, the activities or functions of the Government increase.

With the development of the economy, the Government undertakes new functions, activities, and old functions are performed more thoroughly. The expansion in the Government functions and activities leads to the increase in public expenditure. Though Wanger based his law on the historical evidence drawn from economic growth of Germany, this applies equally to other countries, both developed and developing ones.

The size of public expenditure has been rising in developed countries since early twentieth century and in developing countries since the middle of twentieth century. This is because governmental functions have increased. This increase has far reaching impact on economic growth and development through production, distribution, consumption, saving and investment. Wagner's Law and Wiseman-Peacock Hypothesis have explained increase in public expenditure. According to Wagner public expenditure in any economy increases because of an increase in the role of government.

The government in every economy is performing the following fundamental duties.

1) The government is involved in the production of materialistic goods.

2) The government plays an important role in maintaining internal and external security.

3) The government also provides social justice through court i.e. maintaining law and order.

In the process of performing its duties the public expenditure increases. In India, there has been spectacular rise in public expenditure since 1950-51. The ratio of public expenditure to GDP rose steadily until 1990-91. From 9.1 percent of GDP in 1950-51, the ratio rose to 28.5 per cent of the GDP in 1990-91. From 1990-91 to 1995-96, there was a decline in this ratio. Since then, this trend has reversed and the public expenditure GDP ratio has been rising.

Total Public Expenditure (Revenue and Capital) since 1990-91

Year	Rs. Crores	% of GDP
1990-91	1,05,298	19.7
2007-08	7,12,671	14.4
2009-10	10,20,838	16.6

5.8.1 The following are the causes of growth of public expenditure in India:

1. **Defence:** One of the major contributors to rising public expenditure in India is the growing defence expenditure. Defence expenditure has increased from Rs.3,600 crore in 1980-81 to Rs.86,879 crore in 2009-10.

2. **Population:** In 1951, India's population was 36 crore. It rose to 102.9 crore in 2001. This massive growth in population has made it necessary for the government to spend ever increasing amounts on education, health, infrastructure, subsidies and development programmes.

3. **Rise in National Income:** Rise in public expenditure is directly related to rise in national income and per capita income. This is because, as income rises beyond subsistence level, and the basic necessities of people are satisfied, demand for public goods like education, communication, transportation, health care etc. tend to increase. Thus, governments are expected to spend more on such goods.

4. **Urbanization:** With economic development and industrialization, urbanization has taken place. In 1951, the percentage of urban population was 17 percent, whereas in 2001 it was around 28 percent. With urbanization, public expenditure or urban infrastructure has increased.

5. **Subsidies:** The government gives subsidies to different sectors in order to make essential goods and services affordable to the poor. In India Central Government subsidies have increased from Rs.9,581 crore in 1990-91 to Rs.1,06,004crore in 2009-10.

6. **Development Programmes:** The government of India has always been committed to planned development. This requires heavy investments in various physical and social infrastructure projects. The Government's Plan expenditure was Rs.3,25,149crore in 2009-10.

7. **Poverty Alleviation and Employment Generation:** As part of the planned programme, the government has launched several programmes to directly attack the problems of poverty and unemployment. These require continuous ongoing expenditure for their implementation.

8. **Servicing of Public Debt:** Most plan capital expenditures in India have been financed through public debt from various sources. There has been a continuous growth in the total outstanding debt of the government. In India, interest payment is the single largest item of expenditure. It has increased from Rs.2,604 crore in 1980-81 to Rs.2,25,511crore in 2009-10.

9. **Administrative Machinery:** Indian government's administrative machinery is vast and has expanded many times over the years. Maintenance of various ministries, departments and offices, payment of salaries to a large staff has increased administrative expenditure over the years.

10. **Judiciary and Internal Security:** India has a strong and extensive judicial system that is designed to protect the rights of its citizens. Huge expenditure has to be incurred for the maintenance of courts and jails, salaries of the judges and other staff, as well as police forces involved in maintaining internal law and order.

11. **Democracy:** India is the world's largest democracy, Periodic elections and maintenance of the political representatives have increased public expenditure to a great extent over the years.

5.9 Public Expenditure as an Instrument of Fiscal Policy

Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including aggregate demand for goods and services, employment, inflation, and economic growth. Fiscal policy refers to the use of government spending and tax policies to influence economic conditions. Fiscal policy is largely based on ideas from John Maynard Keynes, who argued governments could stabilize the business cycle and regulate economic output. During a recession, the government may employ expansionary fiscal policy by lowering tax rates to increase aggregate demand and fuel economic growth. In the face of mounting inflation and other expansionary symptoms, a government may pursue contractionary fiscal policy.

Public expenditures are income generating and include all types of government expenditure such as capital expenditure on public works, relief expenditures, subsidy payment of various types, transfer payments and other social security benefits. Government expenditure is an important instrument of fiscal policy.

It includes governments expenditure towards consumption, investment and transfer payments. Government expenditures includes:_

1. expenditures to meet the day to day running of the government.
2. to capital expenditures which are in the form of investment made by the government in capital equipment and infrastructure.
3. transfer payments that is government spending which does not contribute to the GDP because income is only transfer from one group of people to another without any direct contribution from the receivers.

Government may spend money on performance of its large and ever growing functions and also for deliberately bringing is stabilization during recession. It may initiate a fresh wave of public work such as construction of roads, irrigation facilities, sanitary works, ports, electrification of new areas etc. Government expenditure involved employment of labour as well as purchase of multitude of goods and services. These expenditures directly generate income to labour and supplier of materials and services. Apart from direct effects, there is also indirect effect in the form of working of multiplier. The income generated are spent on purchase of consumer goods. The extent of spending by people depends on the on their marginal propensity to consume (MPC). There is generally surplus capacity in consumer goods industries during recession and an increase in demand for various goods leads to expansion in production in those industries as well. Additionally, a program of public investment will strengthen the general conference of the businessperson and consequently their willingness to invest. Primary employment in public works programs will induce secondary and tertiary employment and before long the economy is put on the expansion track.

A distinction is made between the two concepts of public spending. During depression, namely the concept of 'pump priming' and the concept of 'compensatory spending'. Pump priming involves a one-shot injection of the government expenditure into a depressed economy with the aim of boosting business confidence and encouraging larger private investment. It is a temporary fiscal stimulus in order to set off the multiplier process. The argument is that with the temporary injection of purchasing power into the economy through the rise in government spending financed by borrowing rather than taxes, It is possible for government to bring about permanent recovery from a slump. Pump priming was widely used by the governments in the post-war era in order to maintain full employment.

However, it become discredited later when it fails to halt rising unemployment and was held responsible for inflation. Compensatory spending is said to be resorted when the government spending is deliberately carried out with obvious intention to compensate the deficiency in private investment. Public expenditure is also used as a policy instrument to reduce the severity of inflation and to bring down the prices. This is done by reducing government expenditure when there is a fear of inflationary rise in prices. Reduced incomes on account of decrease public spending helps to eliminate excess aggregate demand.

5.10 Conclusion

Public expenditure is necessary to address the diverse social, economic and regulatory requirements of an economy. The links between public expenditure and economic growth are well recognized. Public expenditure also contributes towards economic growth and social development through multiple channels; for instance, investments in agricultural and industrial infrastructure creates backward and forward links and leads to employment opportunities. Similarly, investments in health and education can lead to higher labour productivity and contribute towards economic growth. While public expenditure is expected to generate significant growth-multiplier effects, there are several constraints when deciding upon the magnitude of public expenditure. The effectiveness of public expenditure is particularly sensitive to the composition of expenditure allocations and the state of the fiscal environment.

5.11 Questions

Q1. What is Public expenditure? Explain its objectives and importance.

Q2. What are the Canons of Public expenditure?

Q3. Explain in detail, the Classification of Public expenditure.

Q4. What are the causes of rising public expenditure in modern era?

Q5. What are the effects of public expenditure on production and distribution in the economy?

Q6. How does the public expenditure used as an effective instrument of Fiscal policy.

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Module 3

6

FISCAL POLICY: PUBLIC DEBT

Unit Structure:

l.0 Objective

- To understand the concept of Public Debt.
- To familiar students with the meaning, importance and types of Public Debt.
- To enable the learners to grasp fully the burden of public debt.
- To understand the principles of management of public debt.
- To acquaint the students with the different concepts of Deficits.

6.1 Introduction

In the previous chapter, we have seen that taxation is one of the sources through which the government of a country collects revenue and public expenditure is that which the government spends for the progress of the economy. This implies that revenue is one side and expenditure (spending) is another side of the budget. Nowadays, the fiscal operation of the government has increased to such an extent that the current revenues from taxation fall short of the total expenditure. The deficit is bridged by up in two ways:

1. By borrowing from the public
2. By printing new currency called Deficit financing.

Public debt is the total amount borrowed by the government of a country. So, why is public debt significant? Let's take a closer look. In the Indian context, public debt includes the total liabilities of the Union government that have to be paid from the Consolidated Fund of India. Sometimes, the term is also used to refer to the overall liabilities of the central and state governments. However, the Union government clearly distinguishes its debt liabilities from those of the states. It calls overall liabilities of both the Union government and states as General Government Debt (GGD) or Consolidated General Government Debt.

Since the Union government relies heavily on market borrowing to meet its operational and developmental expenditure, the study of public debt becomes key to understand the financial health of the government. The study of public debt involves the study of various factors such as debt-to-GDP ratio, and sustainability and sources of government debt. The fact that almost a fourth of the government expenditure goes into interest payment explains the magnitude of the liabilities of the Union government.

In this chapter, we will examine the various aspects of government borrowing and its management.

6.2 Meaning of Public Debt

Modern governments need to borrow from different sources when current revenue falls short of public expenditures. Thus, public debt refers to loans incurred by the government to finance its activities when other sources of public income fail to meet the requirements. In this wider sense, the proceeds of such public borrowing constitute public income.

However, since debt has to be repaid along with interest from whom it is borrowed, it does not constitute income. Rather, it constitutes public expenditure. Public debt is incurred when the government floats loans and borrows either internally or externally from banks, individuals or countries or international loan-giving institutions.

What is true about public borrowing is that, like taxes, public borrowing is not a compulsory source of public income. The word **'compulsion'** is not applied to public borrowing except in certain exceptional cases of borrowing.

The State generally borrows from the people to meet three kinds of expenditure:

(a) to meet budget deficit,

(b) to meet the expenses of war and other extraordinary situations and

(c) to finance development activity.

(a) Public Debt to Meet Budget Deficit:

It is not always proper to effect a change in the tax system whenever the public expenditure exceeds the public revenue. It is to be seen whether the transaction is casual or regular. If the budget deficit is casual, then it is proper to raise loans to meet the deficit. But if the deficit happens to be a regular feature every year, then the proper course for the State would be to raise further revenue by taxation or reduce its expenditure.

(b) Public Debt to Meet Emergencies like War:

In many countries, the existing public debt is, to a great extent, on account of war expenses. Especially after World War II, this type of public debt had considerably increased. A large portion of public debt in India has been incurred to defray the expenses of the last war.

(c) Public Debt for Development Purposes:

During British rule in India public debt had to be raised to construct railways, irrigation projects and other works. In the post-independence era, the government borrows from the public to meet the costs of development work under the Five Year Plans and other projects. As a result the volume of public debt is increasing day by day.

6.3 Classification of Public Debt

The structure of public debt is not uniform in any country on account of factors such as categories of markets in which loans are floated, the conditions for repayment, the rate of interest offered on bonds, purposes of borrowing, etc.

In view of these differences in criteria, public debt is classified into various categories:

i. Internal and external debt

ii. Short term and long term loans

iii. Funded and unfunded debt

iv. Voluntary and compulsory loans

v. Redeemable and irredeemable debt

vi. Productive or reproductive and unproductive debt/deadweight debt

i. Internal and External Debt:

Sums owed to the citizens and institutions are called internal debt and sums owed to foreigners comprise the external debt. Internal debt refers to the government loans floated in the capital markets within the country. Such debt is subscribed by individuals and institutions of the country.

On the other hand, if a public loan is floated in the foreign capital markets, i.e., outside the country, by the government from foreign nationals, foreign governments, international financial institutions, it is called external debt.

ii. Short term and Long Term Loans:

Loans are classified according to the duration of loans taken. Most government debt is held in short term interest-bearing securities, such as Treasury Bills or Ways and Means Advances (WMA). Maturity period of Treasury bill is usually 90 days.

Government borrows money for such period from the central bank of the country to cover temporary deficits in the budget. Only for long term loans, government comes to the public. For development purposes, long period loans are raised by the government usually for a period exceeding five years or more.

iii. Funded and Unfunded or Floating Debt:

Funded debt is the loan repayable after a long period of time, usually more than a year. Thus, funded debt is long term debt. Further, since for the repayment of such debt government maintains a separate fund, the debt is called funded debt. Floating or unfunded loans are those which are repayable within a short period, usually less than a year.

It is unfunded because no separate fund is maintained by the government for the debt repayment. Since repayment of unfunded debt is made out of public revenue, it is referred to as a floating debt. Thus, unfunded debt is a short term debt.

iv. Voluntary and Compulsory Loans:

A democratic government raises loans for the nationals on a voluntary basis. Thus, loans given to the government by the people on their own will and ability are called voluntary loans. Normally, public debt, by nature, is voluntary. But during emergencies (e.g., war, natural calamities, etc.,) government may force the nationals to lend it. Such loans are called forced or compulsory loans.

v. Redeemable and Irredeemable Debt:

Redeemable public debt refers to that debt which the government promises to pay off at some future date. After the maturity period, the government pays the amount to the lenders. Thus, redeemable loans are called terminable loans.

In the case of irredeemable debt, government does not make any promise about the payment of the principal amount, although interest is paid regularly to the lenders. For the most obvious reasons, redeemable public debt is preferred. If irredeemable loans are taken by the government, the society will have to face the consequence of burden of perpetual debt.

vi. Productive (or Reproductive) and Unproductive (or Deadweight) Debt:

On the criteria of purposes of loans, public debt may be classified as productive or reproductive and unproductive or deadweight debt. Public debt is productive when it is used in income-earning enterprises. Or productive debt refers to that loan which is raised by the government for increasing the productive power of the economy.

A productive debt creates sufficient assets by which it is eventually repaid. If loans taken by the government are spent on the building of railways, development of mines and industries, irrigation works, education, etc., income of the government will increase ultimately.

Productive loans thus add to the total productive capacity of the country.

In the words of Findlay Shirras: "Productive or reproductive loans which are fully covered by assets of equal or greater value, the source of the interest is the income from the ownership of these as railways and irrigation works."

Public debt is unproductive when it is spent on purposes, which do not yield any income to the government, e.g., refugee rehabilitation or famine relief work. Loans for financing war may be regarded as unproductive loans. Instead of creating any productive assets in the economy, unproductive loans do not add to the productive capacity of the economy. That is why unproductive debts are called deadweight debts.

6.4 The Burden of Public Debt

When a country borrows money from other countries (or foreigners) an external debt is created. It owes its all to others. When a country borrows money from others it has to pay interest on such debt along with the principal. This payment is to be made in foreign exchange (or in gold). If the debtor nation does not have sufficient stock of foreign exchange (accumulated in the past) it will be forced to export its goods to the creditor nation. To be able to export goods a debtor nation has to generate sufficient exportable surplus by curtailing its domestic consumption.

Thus an external debt reduces society's consumption possibilities since it involves a net subtraction from the resources available to people in the debtor nation to meet their current consumption needs. In the 1990s, many developing countries such as Poland, Brazil, and Mexico faced severe economic hardships after incurring large external debt. They were forced to curtail domestic consumption to be able to generate export surplus (i.e., export more than they imported) in order to service their external debts, i.e., to pay the interest and principal on their past borrowings.

The burden of external debt is measured by the debt-service ratio which returns to a country's repayment obligations of principal and interest for a particular year on its external debt as a percentage of its exports of goods and services (i.e., its current receipt) in that year. In India it was 24% in 1999. An external debt imposes a burden on society because it represents a reduction in the consumption possibilities of a nation. It causes an inward shift of the society's production possibilities curve.

THREE PROBLEMS

When we shift attention from external to internal debt we observe that the story is different.

It creates three problems:

(1) Distorting effects on incentives due to extra tax burden,

(2) Diversion of society's limited capital from the productive private sector to unproductive capital sector, and

(3) Showing the rate of growth of the economy.

Public debt is one of the sources of deficit financing. When the government expenditure exceeds its revenue it borrows either from people within the country or from external sources. Since it is a income with liability government has to repay in future course of time. Repayment of both internal and external debts impose burden on the community.

6.4.1 Burden of Internal Debt:

Internal public debts are raised and repaid within the country. Therefore, they have no direct money burden. The repayment of such debts results in transfer of purchasing power from one group of people to another. The government taxes some people to repay the interest and the principal to the creditors. Such debts give rise to real burden.

1. **Direct Real Burden:** Transfer of purchasing power will take place as the government imposes tax to repay the internal debts. When purchasing power is transferred from the tax payers to the public creditors, it will influence the distribution of income in the country. While, repaying debt, if tax burden falls more heavily on the poor then inequality of income distribution will increase. If the debt is repaid by imposing heavy taxes on the higher income groups, then the direct real burden will be less. In most cases, repayment of internal debt is more likely to transfer purchasing power from the poor to the rich. This is the direct real burden of such debts.

2. **Indirect Real Burden:** High rates of taxation generally have a negative effect on people's ability and willingness to work, save and invest. This in turn will affect productivity, production and investment in the economy.

3. **Burden on Future Generations :**It is usually the older generation who subscribe to government bonds and securities with their accumulated wealth. But the debts are repaid through taxes which are paid by the younger working population. Thus there is also transfer of purchasing power from the active to the passive population.

4. **Effect on Private Investments:** In order to borrow on a large scale, the government offers high rates of interest. Most people believe that government securities and small savings are a safe place to park their money in. Therefore, a large chunk of domestic savings are directed towards public debt. This reduces funds available for the private sector and adversely affects the growth of this sector.

5. **Effects on Capital Expenditure:** In most developing countries, including India, public debt is incurred to meet revenue deficit. Such use of public debt

is considered unproductive. As government's debts become larger, the interest burden also increases. A very large portion of government revenue is then spent on paying interests. Thus the government is unable to make adequate capital expenditure on development of infrastructure.

6. **Inflation:** If indirect taxes are raised in order to repay internal debts, then inflation may take place. Inflation will reduce the real income or purchasing power of the poor. Therefore, though internal debts do not have direct money burden, they result in making some people better off than others through transfer of resources between them.

6.4.2 Burden of External Debt:

During a given period, the direct money burden of external debt is the interest payment as well as the principal repayment (i.e., debt servicing) to external creditors. The direct real burden of such external borrowing is measured by the sacrifice of goods and services which these payments involve to the members of the debtor country. External debt are raised from foreign countries. When such debts are raised they result in inflow of capital into the borrowing country. But when these debts need to be repaid it results in outflow of money in the form of interest and principal.

External debts create the following money and real burden:

1. **Direct Money Burden:** It is equal to the sum of money payments for principal and interest made to the creditor country.

2. **Direct Real Burden:** It is measured in terms of loss of welfare suffered by the people of the debtor country due to the repayment of debt. It will vary according to the proportion in which various members of the community contribute to the repayment in the form of higher taxes.

3. **Indirect Money Burden and Indirect Real Burden:** This may be measured in terms of effects on production and allocation of resources. To repay public debt, the government may increase taxes to reduce public expenditure. These will cause reduction in production and consumption in the economy. This is termed as indirect money and real burden of external debt.

4. **Burden of Unproductive Foreign Debt:** If foreign debts are taken for unproductive purposes then the burden of repayment will be very high on the community.

5. **Foreign Currency Burden:** Repayment of external debts has to be made in foreign currency. Foreign exchange reserves can be increased by increasing exports and controlling imports. Therefore the government may give a lot of incentives to the export sector. This will divert resources from other sectors and result in unbalanced development. Besides, if import of essential items is controlled to increase foreign exchange reserves, it may have an adverse effect on development of the nation.

6. **Domination by Creditor Country:** Heavy dependence on one or more powerful creditor country may result in the debtor country being economically and politically dominated by the creditor countries.

6.5 The Meaning And Frame Work Of Public Debt Management

Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and to meet any other debt management goals of the government, such as developing and maintaining an efficient market for government securities. The governments should try to ensure that the level and rate of growth of their public debt is sustainable, and can be serviced under a wide range of circumstances while meeting cost and risk objectives. Debt mangers of government debt should ensure that there is a strategy to reduce excessive levels of debt.

6.5.1 Importance of Public Debt Management:

1. A good public debt management can help reduce borrowing cost in many ways.

2. A carefully balanced composition of securities can contain financial risk, which are difficult to manage in countries having few alternative source of finance.

3. Good public debt management can also help to develop the domestic financial market. A well-developed domestic financial market can facilitate economic development, and make the economy more resilient to external shocks, such as capital outflows.

4. The economies with well-regulated and sound bond markets are less affected by shocks / crises or recovered faster.

6.5.2 Framework for Public Debt Management:

The IMF and World Bank have prepared the following framework for public debt management.

1. **Debt Management Objectives and Co-ordination:**

   The main objective of debt management is to ensure financing needs and payment obligations are met at the lowest possible cost. To achieve the objectives, debt managers, fiscal policy advisors, and central bankers should share an understanding of the objectives of debt management, fiscal, and monetary policies. Since their different policy instruments are inter-dependent, there should be better co-ordination between the above agencies.

2. **Transparency and Accountability:** The allocation of responsibilities among the Ministry of Finance, Central bank and debt agency should be disclosed. It is also important to provide information about the past, current and projected fiscal activity and consolidated financial position of the government.

3. **Institutional Framework:** There should be legal frameworks which clarify the authority to borrow, and issued new debt, invest, and undertake transactions on behalf of the government. Organizational framework should be specified and the roles are to be specified.

4. **Debt Strategy and Risk Management:** An effective debt strategy should be implemented. Risks in the portfolio should be mitigated by modifying the debt structure.

5. **Efficient Market for Government Securities:** An important instrument of public debt management is to ensure that the policies and operations are consistent with an efficient market for government securities. It is necessary to achieve a board investor base, with due regard to cost and risk, and need to treat investors equitably. The debt managers, central banks, ministry of finance should work closely with market participants and regulators for the development of efficient market.

Broad Principles of Debt Management:

Important principles of debt management are:

(i) **Low interest cost of servicing debt:** Interest cost of servicing a debt should be kept as minimum as possible.

(ii) **Satisfy the needs of investors:** The public debt should be structured in such a way that meets the needs of various types of investors.

(iii) Co-ordination between public debt, fiscal and monetary policies: Since the public debt, fiscal and monetary policies have common objective of stabilization of the level of economic activity, they should work in unison.

(iv) Funding of short-term debt into long-term debt: If possible, the government should try to convert short-term debt into long-term debt. The funding operations should be undertaken in such a manner that they do not lead to undue rise in the long-term interest rates.

6.6 Effects of Public Debt

A peculiar profile of public borrowing is its voluntary nature, as contrasted to the compulsory features of taxation. When the government offers its securities to the public, persons are free to purchase them.If they subscribe government bonds, they suffer no net diminution in their wealth, as occurs when they pay taxes. In exchange for liquid cash, they receive bonds or other securities which bear interest and which will ultimately be paid off.

The government in turn receives money for meeting its expenditure, but incurs a liability for the payment of interest and the repayment of principal in the future. The economic effects of a government programme financed by borrowing are different from the effect of a similar programme financed by taxation. This is partly because the lending of money to the government is purely voluntary and partly because the making of such loans does not reduce the personal wealth of the lenders but merely changes its form.

A major consequence of these types of fund mobilization is that borrowing, on the whole, is likely to have a less contractionary effect upon aggregate demand, than raising an equivalent amount by way of taxation.

Hence, a programme of expenditure financed by borrowing is likely to have a greater net expansionary effect upon the economy than a programme of the same magnitude financed by taxation.

1. **Effect of Borrowing upon Consumption:**

   In the case of borrowing, curtailment of consumption spending is likely to be slight, except in wartime borrowing programmes in which substantial pressure is applied to individuals to reduce consumption and buy bonds.

   Hence compared with taxation, public debt do not have any serious effect on the level of current consumption. In the case of individuals, their consumption pattern is set by their current income. Loans are advanced out of saving, whereas taxes are paid out of income.

Under certain conditions, there is greater possibility of an increase in the spending on consumption, due to government borrowing. The bond holders regard their bonds as wealth and a source of income.

Moreover, by holding government bond, their liquidity position is not very much effected because bonds can be converted into cash at any time. Hence there will be a tendency to increase spending on consumption.

2. Effect of Borrowing on Saving and Investment:

The floating of public debt influences saving and investment through the interest rate mechanism. Floating of public debt will raise the rate of interest. Since savings are interest elastic, creation of public debt will raise savings.

Investment expenditure of the bond holders are influenced through the claim effect on investment. That is through increase or decrease in interest rate. When bonds are issued, the ratio of money supply to debt supply will be reduced and as a result rate of interest will increase.

As a result the effect of public debt will be, reduced investment expenditure. On the other hand when bonds are purchased by the government from the open market, or when government repay public debt, the ratio of money supply to debt supply increases and the rate of interest declines.

This will lead to an increase in investment. The overall effect on the economy depends largely on the way in which the investment is made in the public sector, compared with what could have been achieved in the private sector.

The effect of public debt on investment also depends on the method of raising loans. Suppose if the government borrows from commercial banks and central bank of a country, it will increase the money supply or purchasing power and hence the funds available for investment will not be reduced.

However, if the government bonds are subscribed by the public and financial institutions, out of funds meant for investment, then automatically investment expenditure will be curtailed.

3. Effect of Borrowing on Production:

In general, government borrowing results in enhancing the productive capacity of the economy. If the borrowed money is used by the government to finance developmental projects, it will generate income and employment opportunities.

Such investments strengthen the capital base of the economy and help to increase the production of goods and services. Moreover, the government will be able to repay the debt and interest charges in future without much difficulty.

Whereas, if the public purchases government bonds, by selling their shares or debentures, invested in private industrial concerns, it will create an adverse effect on private investment. However, when the borrowed money, as stated above is used for highly productive activities, overall production is not affected badly. Likewise, if the public subscribe government bonds by withdrawing their bank deposits, it will adversely affect the lending capacity of commercial banks and thereby private investment activities.

However, if public debt is purchased by the individuals, utilizing their idle funds, it will not adversely affect private investment. Whereas borrowing resorted to meeting current expenditure or for financing a war, would result in the diversion of resources from productive activities to wasteful expenditure flows.

4. Effect of Public Debt on Distribution:

Borrowing leads to transfer of resources from one section of the community to another section. If this transfer takes place from the rich to the poor, the inequality in the distribution of income and wealth would be reduced and as a result the economic welfare of the community will be enhanced.

On the other hand if the transfer of wealth takes place from the poor to the rich, the disparity in the income distribution will be aggravated.

Usually, government bonds are subscribed by the richer income group. Whereas, the burden of taxation imposed for financing debt service and repayment of public debt, falls on the poor section. Therefore generally public debt has a tendency to increase economic inequality. Whereas suppose the public debt is mobilized through the small savings of lower income group. Correspondingly debts are serviced and repaid through taxation imposed on the richer income group. Then public debt will not result in increased income inequality. Hence, loan finance can be used as a means to redistribute income between different segments of the society.

5. Other Effects of Public Debt:

(a) Public debts in the form of government bonds are negotiable credit instruments. They are highly liquid form of assets. The investors can freely convert them into liquid cash at any time to meet their demand for money.

Moreover, as far as financial institutions are concerned, it adds to the liquidity position of these institutions, because of its transparency in convertibility.

(b) During times of inflation, when the government borrows from the people, the purchasing power in the hands of the public will be reduced. As a result inflationary pressure in the economy will be reduced.

On the contrary, during depression, when the borrowed funds are utilized for development projects, it will generate additional purchasing power, employment and income. Hence, during depression, public debt can be utilized as an effective instrument to curb deflationary fluctuations in economic activity.

Hence, in modern times, public debt is used as an important instrument to bring about economic stability in the economy. In fact, one of the major objectives of government borrowing today is to strengthen the economy by freeing it from the evils of depressions and also to build up the economy and stable economic growth. Owing to this reason, rapid increase in public debt need not be viewed with concern.

6.7 Methods of Redemption / Repayment of Public Debt

Redemption of debt refers to the repayment of a public loan. Although public debt should be paid, debt redemption is desirable too. In order to save the government from bankruptcy and to raise the confidence of lenders, the government has to redeem its debts from time to time.

Sometimes, the government may resort to an extreme step, such as repudiation of debt. This extreme step is, of course, violation of the contract. Use of repudiation of debt by the government is economically unsound.

Here, instead of concentrating on the repudiation of debt, we discuss below other important methods for the retirement or redemption of public debt:

i. Refunding:

Refunding of debt implies issue of new bonds and securities for raising new loans in order to pay off the matured loans (i.e., old debts).

When the government uses this method of refunding, there is no liquidation of the money burden of public debt. Instead, the debt servicing (i.e., repayment of the interest along with the principal) burden gets accumulated on account of postponement of the debt- repayment to save future debt.

ii. Conversion:

By debt conversion, we mean reduction of interest burden by converting old but high interest-bearing loans into new but low interest-bearing loans. This method tends to reduce the burden of interest on the taxpayers. As the government is enabled to reduce the burden of debt which falls, it is not required to raise huge revenue through taxes to service the debt.

Instead, the government can cut down the tax liability and provide relief to the taxpayers in the event of a reduction in the rate of interest payable on public debt. It is assumed that since most taxpayers are poor people while lenders are rich people, such conversion of public debt results in a less unequal distribution of income.

iii. Sinking Fund:

One of the best methods of redemption of public debt is sinking fund. It is the fund into which certain portion of revenue is put every year in such a way that it would be sufficient to pay off the debt from the fund at the time of maturity. In general, there are, in fact, two ways of crediting a portion of revenue to this fund.

The usual procedure is to deposit a certain (fixed) percentage of its annual income to the fund. Another procedure is to raise a new loan and credit the proceeds to the sinking fund. However, there are some reservations against the second method.

Dalton has opined that it is in the Tightness of things to accumulate sinking fund out of the current revenue of the government, not out of new loans. Although convenient, it is one of the slowest methods of redemption of debt. That is why economists often recommend capital levy as a form of debt repudiation.

iv. Capital Levy:

In times of war or emergencies, most governments follow the practice of raising money necessary for the redemption of the public debt by imposing a special tax on capital.

A capital levy is just like a wealth tax in as much as it is imposed on capital assets. This method has certain decisive advantages. Firstly, it enables a government to repay its (emergency) debt by collecting additional tax revenues from the rich people (i.e., people who have huge properties).

This then reduces consumption spending of these people and the severity of inflation is weakened. Secondly, progressive levy on capital helps to reduce inequalities in income and wealth. But it has certain clear-cut disadvantages too. Firstly, it hampers capital formation. Secondly, during normal time this method is not suggested.

v. Terminal Annuity:

It is something similar to sinking fund. Under this method, the government pays off its debt on the basis of terminal annuity. By using this method, the government pays off the debt in equal annual instalments.

This method enables government to reduce the burden of debt annually and at the time of maturity it is fully paid off. It is the method of redeeming debts in instalments since the government is not required to make one huge lump sum payment.

vi. Budget Surplus:

By making a surplus budget, the government can pay off its debt to the people. As a general rule, the government makes use of the budgetary surplus to buy back from the market its own bonds and securities. This method is of little use since modern governments resort to deficit budget. A surplus budget is usually not made.

vii. Additional Taxation:

Sometimes, the government imposes additional taxes on people to pay interest on public debt. By levying new taxes—both direct and indirect— the government can collect the necessary revenue so as to be able to pay off its old debt. Although an easier means of repudiation, this method has certain advantages since taxes have large distortionary effects.

viii. Compulsory Reduction in the Rate of Interest:

The government may pass an ordinance to reduce the rate of interest payable on its debt. This happens when the government suffers from financial crisis and when there is a huge deficit in its budget.

There are so many instances of such statutory reductions in the rate of interest. However, such practice is not followed under normal situations. Instead, the government is forced to adopt this method of debt repayment when situation so demands.

6.8 Concepts of Deficit

Budget is a financial statement of the government dealing with the public revenue and public expenditure and balancing both of them. In every economy budget plays a significant role in process of economic development. When the total revenue is more than the total expenditure it is called surplus budget. When total revenue is equal to the total expenditure it is called balanced budget. If the total expenditure exceeds the total revenue it is called a deficit budget. In most of the developing countries and under developed countries there is always deficit budget and it has become a permanent feature.

Budgetary deficit is a multi-dimensional concept. It is quite easy to say that a budgetary deficit is simply the excess of public expenditure over public revenue. However, in practice, the concept admits of many variations, and yields widely divergent measures of budgetary deficit.

The existence of such a large number of measures is explained by the fact that each measure has analytical and policy relevance, and there is no single measure which may be universally preferred over all others for all time to come.

The choice of the correct measure would depend upon the purpose of analysis. A brief description of the various concepts of budgetary deficit is as follows.

1. Revenue Deficit:

The excess of expenditure on revenue account over receipts on revenue account measures revenue deficit. Receipts on revenue account include both tax and non-tax revenue and also grants. Tax revenue is net of States' share as al so net of assignment of Union Terri Tory taxes to local bodies. The non-tax re venue includes interest receipts, dividends and profits, and non-tax receipts of Union Territory's Grants include grants from abroad also.

Expenditure on revenue account includes both Plan and Non-Plan components. Thus, the Plan component includes Central Plan and Central Assistance for States and Union Territory Plans.

Non- Plan expenditure includes interest payments, defence expenditure on revenue account, subsidies, debt-relief to farmers, postal services, police, pensions, other general services, social services, economic services, non-plan revenue grants to States and Union Territories, expenditure of Union Territories with legislature, and grants to foreign governments.

Revenue deficit means dissaving's on government account and the use of the savings of other sectors of the economy to finance a part of the consumption expenditure of the government.

An important objective of fiscal policy should be to ensure surplus in the revenue budget so that the government also contributes to raising the rate of saving in the economy.

Revenue Deficit = ↓R.R. – R. Exp. ↑

2. **Budgetary deficit:** Budgetary deficit denotes the difference between all receipts and expenditure of the government, both revenue and capital. It implies that government incurs more expenditure that its normal receipt from revenue and capital goods. Budget deficit is financed either by drawing down cash balances with the central bank or by borrowing from central bank against treasury bills. This is called deficit financing. As deficit financing results in creation of new money, it may lead to inflation.

3. **Capital Deficit:**

   The excess of capital disbursements over capital receipts measures the capital deficit.

   Capital Deficit = Expenditure on Capital Account – Capital Receipts

   Plan capital disbursements include those on Central Plan and Assistance for States and Union Territories. Non-Plan Capital disbursements include defence expenditure on Capital account, other non-plan capital outlay, loans to public enterprises, States and Union Territory Governments, foreign governments and others; and non-plan capital expenditure of Union Territories without legislature. The items of capital receipts include recoveries of loans extended by the centre itself, but only net receipts of loans raised by it.

   It may be noted that receipts on account of sale of 91 days treasury bills and drawing down of cash balances do not form a part of capital receipts. However, net receipts on account of sale of 182 days and 364 days treasury bills and sales proceeds of government assets are included in capital receipts.

4. **Fiscal Deficit:**

   Fiscal deficit is the difference between revenue receipts plus certain non-debt capital receipts and the total expenditure including loans net of repayments.

   Fiscal Deficit = Total Expenditure – (Revenue Receipts + Non-debt Capital Receipts)

   In short, fiscal deficit indicates the total borrowing requirements of the government from all sources. This may also be called Gross Fiscal Deficit (GFD). It measures that portion of government expenditure, which is financed by borrowing and drawing down of cash balances.

It should be noted that in India, borrowings are net amounts (that is, gross borrowings less repayments). Similarly, loans extended by Government of India are included on the expenditure side of capital account while 'recoveries' are included on the receipts side. Therefore, the amount of loans and advances by Government of India is also reduced.

It is often stated that fiscal deficit measures an addition to the liabilities of Government of India. In 2008 -09, fiscal deficit was at a figure of Rs. 3, 26,515 crore (RE) which is 6.1 per cent of Gross Domestic Product.

Fiscal deficit was of the order of 4 per cent of gross domestic product (GDP) at the beginning of 1980s, and was estimated at more than 8 per cent in 1990-91. The growing fiscal deficit had to be met by borrowing which led to a mammoth internal debt of the government.

The servicing of this debt has become a serious problem. Public debt in India is mostly subscribed to by commercial banks and financial institutions. A judicious macro-management of the economy requires a progressive reduction in the fiscal deficit and revenue deficit of the government.

5. Primary Deficit:

It is simply fiscal deficit minus interest payments. In the 2008-09 budget, primary deficit was shown at a figure of Rs. 1, 33,821 crore (Revised estimates). This measure is also referred to as Gross Primary Deficit (GPD). Measures of deficit described above (except capital deficit) include payments and receipts of interest. These transactions, however, reflect a consequence of past actions of the government, namely, loans taken and given in years prior to the one under consideration.

Exclusion of interest transactions would, therefore, enable us to see the way the government is currently conducting its financial affairs. Accordingly, Primary deficit is defined as Fiscal Deficit less net interest payments, (that is less interest payments plus interest receipts).

Net primary deficit is obtained by subtracting 'Loans and Advances' from net fiscal deficit. It is also equal to Fiscal Deficit less interest payments plus interest receipts less loans and advances.

The primary deficit which was 4.3 per cent of GDP during 1990-91 came down to 1.5 per cent of GDP during 1997-98 and in the revised estimates for the year 2008-09 it was 2.5 per cent of GDP.

6. Monetised Deficit:

Besides ways and means advances, the Reserve Bank of India also supports the government's borrowing programme. Monetised deficit indicates the level of support extended by the Reserve Bank of India to the government's borrowing programme.

Monetised deficit is defined as net increase in net Reserve Bank of India credit to central government. The rationale for this measure of deficit flows from the inflationary impact which a budgetary deficit exerts on the economy.

Since borrowings from Reserve Bank of India directly add to money supply, this measure is termed monetised deficit. It is obvious that monetised deficit is only a part of fiscal deficit.

6.9 Conclusion

Public debt is the total amount, including total liabilities, borrowed by the government to meet its development budget. It has to be paid from the Consolidated Fund of India. The term is also used to refer to overall liabilities of central and state governments, but the Union government clearly distinguishes its debt liabilities from the states'. The central government broadly classifies its liabilities into two categories — debt contracted against the Consolidated Fund of India, and public account.

Over the years, the Union government has followed a considered strategy to reduce its dependence on foreign loans in its overall loan mix. Internal debt constitutes over 93 per cent of the overall public debt. Internal loans that make up for the bulk of public debt are further divided into two broad categories – marketable and non-marketable debt.

The sources of public debt are dated government securities (G-Secs), treasury bills, external assistance, and short-term borrowings.

In the long run, public debt that's too large is like driving with the emergency brake on. Investors drive up interest rates in return for the increased risk of default. That makes the components of economic expansion, such as housing, business growth, and auto loans, more expensive. To avoid this burden, governments need to carefully find that sweet spot of public debt. It must be large enough to drive economic growth but small enough to keep interest rates low.

Fiscal improvement can be achieved only through effective performance and good governance by the central, state and local governments. Indian public finance must be viewed as a system combining three governments. We need to view fiscal management in terms of long term perspective. Though the FRBM Act talks about Medium Term Fiscal Policy statement, it is yet to be developed. A long term approach is a must.

6.10 Questions

Q1. What is Public Debt? What are the different types of public debts?

Q2. What are the different types of burdens of public debt? Explain in detail.

Q3. What is the internal burden of public debt?

Q4. What is external burden of public debt?

Q5. Explain the framework for the management of public debt.

Q6. What is budget? What are the different components of a Budget?

Q7. Explain the different concepts of Deficits.

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Module 4

7

INDIAN PUBLIC FINANCE – I

Unit Structure:

7.0 Objectives

- To study the budget of Government of India.
- To understand the concepts of public expenditure and components of public expenditure.
- To understand the concept of public receipts and the sources of public receipts.
- To study about the introduction to Goods and Services Tax (GST).

7.1 Introduction

Public finance is branch of economics which deals with the government revenue and expenditure that means public finance studies what are ways of government revenue and government outlay or expenditure. In the other words public finance is the study of role of government in the economy. Government intervene in economy for adjustments according to need of the economy through public finance or public policy.

Definitions of public finance

According to Adam Smith, "The investment into the nature and principles of state expenditure and state revenue is called public finance".

According to Dalton, "Public finance is one of those subjects which lie on the borderline between economics and politics. It is concerned with the income and expenditure to the public authorities and with the adjustment of one to the other". Accordingly, effects of taxation, Government expenditure, public borrowing and deficit financing on the economy constitutes the subject matter of public finance.

According to F. E. Taylor, "Public finance deals with the finance of the public as organized group under the institution of the government. It therefore, deals only with the finance of the government. The finance of the government includes the raising and disbursement of government funds. Public finance concerned with the operation of the fiscal science, its policies are fiscal policies, its problems are fiscal problems. Thus, "Public Finance is the part of political economy which discusses the way in which government obtains revenue and manages them".

According to Findlay Sirras and C. F. Bastable, "Public finance is the science which is concerned with the matter in which public authorities

Obtain their income and spend it."

Thus, Public finance is nothing but the study of government revenue or income and expenditure. That means how government collect income from the various economic activity via taxation and non- taxation policy and same as with how the government expenditure occurs.

7.2 Budget of the Government of India

The financial operations of the government comprising public revenue, public expenditure and public borrowing for a year are estimated. 'The statement with estimates of planned expenditure and the expected revenues from taxes and other sources is called as budget.' In other words, 'an annual financial statement of anticipated revenues and planned expenditure of the government is called as budget.'

Thus, budget deals with how the government raises its resources to meet its ever-increasing expenditure. In this sense, a budget may be considered a description of both the fiscal policies and the financial plans of the government. Budget is an important instrument for achieving various fiscal objectives of the government.

Types of Budget:

There are three types of budget.

1. **Balanced budget:**

   'When the expected total revenues of the government are equal to its total expenditure during a given year is called as balanced budget.' The classical economists have advocated laisez faire policy, they believed that the government should follow sound finance and balanced budget.

2. **Surplus budget:**

   'When the expected total revenue exceeds the total expenditure of the government during a given year is called as surplus budget.'

3. **Deficit budget:**

   'When the total planned expenditure exceeds expected total revenues of the government during a given year is called as deficit budget.' With the emergence of Welfare State and massive increase in public expenditure, balanced or surplus budget has become a rare phenomenon. However, modern economists advocate deficit budget. Because they believe that the government should spend more than its income to maximize welfare of the people.

Components of Budget:

The budget of a government is generally divided into two accounts, namely (1) The Revenue Account or Revenue Budget, and (2) The Capital Account or Capital Budget.

1) **The Revenue Account or Budget:**

   The Revenue Account shows both revenue receipts and revenue expenditure. Revenue receipts are divided between tax revenue and non-tax revenue. The two components of tax revenue are

   1) Revenue from direct taxes, particularly tax on personal income and corporate tax, and

   2) Revenue from indirect taxes like the excise duties and customs duties are most notable.

   Non-tax revenue includes fees, fines and penalties, interest receipts and surplus or profits from public enterprises and gift and grants. Revenue expenditure is usually divided into developmental and non-developmental expenditure. Revenue expenditure of the government of India is defence expenditure, interest payments, subsidies wages and salaries, etc.

2) Capital Account or Budget: -

The Capital Account shows capital receipts and capital expenditure. Capital receipts include market borrowings, small savings, provident funds, special deposits, recoveries of loans, external loans and receipts from disinvestment.

Capital expenditure includes repayment of debts and expenditure incurred on creation of capital assets. Capital expenditure is also two types, development expenditure and non-development expenditure.

Key Point of Budget of India (2020-21)

While presenting the union budget in the parliament on February 1st 2020, Finance Minister Nirmala Sitharaman said, "In May 2019, Prime Minister Narendra Modi received a massive mandate to form the government again. People of India have unequivocally given their janaadesh for not just political stability, but have also reposed their faith in our economic policy. This is a budget to boost their income and enhance their purchasing power."

The key highlights of the Full Union Budget 2020-21 from Finance Minister Nirmala Sitharaman's speech are as follows-

DEFENCE

- The defence budget was increased to Rs. 3.37 lakh crore for 2020-21 against last year's Rs. 3.18 lakh crore.
- Rs 1.13 lakh crore has been set aside out of the total allocation for capital outlay to purchase new weapons, aircraft, warships and other military hardware.
- The revenue expenditure has been pegged at Rs 2.09 lakh crore which includes expenses on payment of salaries and maintenance of establishments.

INCOME TAX

- Upto Rs 5 lakh: No tax
- Rs 5-7.5 lakh income: reduced to 10 from 20%
- Rs 7.5 lakh to 10 lakh: reduced to 15 from 20%
- Rs 10-12.5 lakh: reduced to 20% from 30%
- Rs 12.5-15 lakh: reduced to 25% from 30%
- Rs 15 lakh: 30% (No change)
- Dividend distribution tax abolished.

- Around 70 of more than 100 income tax deductions and exemptions have been removed, to simplify tax system and lower tax rates
- To boost start-ups, tax burden on employees due to tax on Employee Stock Options to be deferred by five years or till they leave the company or when they sell, whichever is earliest
- Option to be provided to cooperative societies to be taxed at 22% plus 10% surcharge and 4% cess, with no exemptions or deductions. To also be exempted from Minimum Alternative Tax.
- Under Vivad Se Vishwas Scheme, taxpayer to pay only amount of disputed tax, will get complete waiver on interest and penalty, if scheme is availed by March 31, 2020.
- Aadhaar based verification of taxpayers is being introduced. A system to be launched soon, for instant online allotment of PAN on the basis of Aadhaar, without the need for filling any application form.
- Total allocation for Swachh Bharat is around Rs. 12,300 crore for this year.
- Central government's debt has come down to 48.7% in March, 2019 from 52.2% in March, 2014.

GDP

- GDP growth for the year 2020-21 is estimated at nominal 10%
- Receipts for 2020-21 is estimated at 22.46 lakh crore rupees
- Expenditure at is 30.42 lakh crore rupees
- Revised expenditure estimate is at Rs. 26.99 Lakh Cr for FY 21
- Estimate Fiscal deficit is at 3.8% vs target of 3.3% of GDP
- Corporate tax is at 15% lowest in the world
- Turnover threshold for audit is raised to Rs. 5 Crore from Rs. 1 Crore

SPORTS BUDGET

- The government allocated Rs. 2826.92 crore to the sports budget for the next financial year.
- The government gave a substantial hike of Rs 291.42 crore to its flagship Khelo India programme for development of sports at the grassroot and youth level.
- The highest reduction was for National Sports Federations with Rs. 245.00 crore being allocated in the Union budget.

- Incentives for sportsperson has been proposed to be slashed from Rs. 111 crore to Rs. 70 crore. The budget for National Sports Development Fund will also be reduced to Rs. 50.00 from the earlier Rs. 77.15 crore.
- The government also reduced the allocation to Sports Authority of India from the revised Rs. 615 crore to Rs. 500 crore.
- National Welfare Fund for Sports persons will continue to get the same amount of Rs. 2 crore as earlier, while, at Rs. 50 crore, there was also no change in the allocation for the enhancement of sports facilities in Jammu and Kashmir.
- Laxmi Bai National Institute of Physical Education will, however, gets Rs. 55 crore, Rs. 5 crore more than the last budget.

AGRICULTURE

- Finance Minister listed 16-point action plan for farmers, towards the goal of doubling farmers income by 2022
- Agricultural credit target has been set at Rs. 15 lakh crore. NABARD Refinancing Scheme to be further expanded.
- Will encourage state governments who implement following model laws: Model Agricultural Land Leasing Act of 2016; Model Agricultural Produce and Livestock Marketing Act of 2017; Model Agricultural Produce and Livestock Contract Farming and Services Promotion and Facilitation Act of 2018
- Pradhan Mantri Kisan Urja Suraksha evem Utthan Mahabhiyan (PM KUSUM) to be expanded to provide 20 lakh farmers in setting up standalone solar pumps
- 2.83 lakh crore rupees allocated for agriculture and allied activities, irrigation and rural development
- Encourage balanced use of all fertilizers, a necessary step to change the incentive regime which encourages excessive use of chemical fertilizers
- Village Storage Scheme run by SHGs, will provide holding capacity for farmers, women in villages can regain their status as Dhaanya Lakshmi
- Krishi UDAN will be launched by the Ministry of Civil Aviation on international and national routes, improving value realization in North East and tribal districts
- Milk processing capacity to be doubled by 2025
- Indian Railways will set up Kisan Rail through PPP arrangement, for transportation of perishable goods
- Fish production to be raised to 200 lakh tonnes by 2022-23

EDUCATION

- A medical college to be attached to a district hospital in PPP mode, viability gap funding to be set up for setting up such medical colleges.
- Rs. 3,000 crore for skill development.
- IND-SAT exam to be held in African and Asian countries, for bench-marking foreign candidates who wish to study in India.
- Degree-level full-fledged online education program to be offered by institutes in top 100 in National Institutional Ranking Framework.
- Government announces Rs 99,300 crore outlay for education sector in 2020-21.
- New Education Policy to be announced soon.
- Urban local bodies across the country to provide internships for young engineers for a period of up to one year.
- 8,000 crore rupees over five years to be provided for quantum technologies and applications.

G-20 PRESIDENCY

- Finance minister Nirmala Sitharaman on Saturday said India will host the G-20 Presidency in 2022 and Rs. 100 crore has been allocated for this purpose.
- During this meeting, India would be able to drive the global economic and development agenda, the finance minister said while presenting the Budget for 2020-21 in Parliament.
- India would be able to drive considerably the global economic and development agenda during this presidency, she said.
- The G20 (or Group of Twenty) is an international forum for the governments and central bank governors from 19 countries and the European Union.

HEALTH

- The Budget provides an additional Rs. 69,000 crore for the health sector and proposes to expand Jan Aushadhi Kendras in all districts of the country to provide medicines at affordable rates.
- Nominal health cess on import of medical equipment to be introduced, to encourage domestic industry and generate resources for health services.

FINANCE

- Deposit Insurance Coverage to be increased from 1 lakh rupees to 5 lakh rupees.
- We wish to enshrine in the statute a taxpayers' charter. I would like to reassure taxpayers that we remain committed to taking measures to eliminate tax harassment.
- To achieve higher export credit, a new scheme being launched which provides higher insurance cover, reduced premium for small exporters and simplified procedure for claim settlements.
- Rs. 27,300 crore rupees for development of industry and commerce.
- Investment Clearance Cell to set up through a portal, will provide end-to-end facilitation, support and information on land banks.
- Amendments to be made to enable NBFCs to extend invoice financing to MSMEs.
- Government proposes to sell a part of its holding in LIC by initial public offer.

ENERGY

- Rs. 22,000 crore rupees to be provided to power and renewable energy sector in 2020-21.

INFRASTRUCTURE

- 100 more airports to be developed by 2024 to support the UDAN scheme.
- 1.7 lakh crore rupees to be provided for transport infrastructure in the coming financial year.
- More Tejas-type trains to connect iconic destinations.
- Accelerated development of highways will be undertaken. Delhi-Mumbai expressway and two other projects to be completed by 2023. Monetization of 12 lots of highway bundles of over 6,000km before 2024
- National Logistics Policy will soon be released, creating single window e-logistics market.
- Project Preparation Facility to be set up for preparation of infrastructure projects, actively involving young engineers and management graduates.
- Fibre to Home connections under Bharat Net will be provided to 1 lakh gram panchayats this year itself, 6,000 crore rupees provided for Bharat Net.
- National Gas Grid to be expanded from 16,200 km to 27,000 km.

WOMEN & NUTRITION

- Gross Enrolment Ratio is now higher for girls than for boys at all levels under 'Beti Bachao Beti Padhao'.
- Rs. 28,600 crore rupees provided for programmes which are specific to women.
- Rs. 35,600 crore rupees for nutrition-related programmes in 2020-21.
- Over 6 lakh anganwadi workers have been equipped with smartphones to upload the nutrition status of 10 crore households.

OTHER SECTORS

- 85,000 crore rupees for Scheduled Castes and Other Backward Classes in 2020-21.
- 53,700 crore rupees for Scheduled Tribes.
- Enhanced allocation of 9,500 crore rupees for Senior citizens and Divyangs.
- Five archaeological sites to be developed as iconic sites.
- Rs. 2,500 crore rupees to be allocated for tourism promotion, in 2020-21.
- Rs. 3,150 crore rupees to be provided for culture ministry in 2020-21.
- Parameters and incentives to be provided to states who take measures for cleaner air in cities above 1 million population - 4,400 crore rupees allocated for this.
- India will host G20 Presidency in 2022, 100 crore rupees to be allocated for making preparations for this historic occasion, where India will drive global economic agenda.

7.3 Sources of Public Revenue

The income of the government from all possible sources is called as public revenue. Different economists have offered different classification of public revenue. Among them the classification offered by Adam Smith, Seligmen and Bastable are well known. Based on some classifications the various sources of public revenue are divided into two groups- A) Tax Revenue and B) Non-tax Revenue.

A) Tax Revenue:

The revenue from taxes is called tax revenue. Tax is the most important source of revenue to the government. ‘A tax is a compulsory contribution made by the citizens of a country to the government without expecting any benefits.’

Tax is required to meet its general expenses incurred in the common interest of all. These expenses are incurred with any corresponding benefits to the taxpayers. There are two types of taxes- i) Direct taxes and ii) Indirect taxes. Personal income tax, corporate tax, capital gain tax, wealth tax, gift tax etc. are called direct taxes. Sales tax, excise duty, custom duty etc., are called indirect taxes. Taxation has been considered to be an important source of raising revenue. However, at present, it is also used as a means to achieve various objectives of society. The important characteristics are-

1. Tax is a compulsory payment; every citizen is legally bound to pay.

2. If any person does not pay the tax, he can be punished by the government.

3. There is no direct quid- pro- quo between taxpayers and the government.

4. Tax is imposed on income, goods, and services.

Progressive taxes help to reduce the inequality of income and wealth. Taxation affects production, consumption and distribution. It can be used as an effective instrument to achieve price stability.

B) Non-tax Revenue: The revenue obtained by the government from sources other than tax is called as non- tax revenue. They may be classified as-

1. Administrative Revenue

2. Profit of Public Enterprises and

3. Gifts and Grants.

1. **Administrative Revenue:-** Government gets revenue from the public for administrative work in the form of fees, fines and penalties, special assessment.

   i) **Fees**: - Fee is the government for providing certain services to the people for e.g. court fee, license fee etc, and charges Fees. Generally, fees are charged to recover the cost of services. Those citizens who make use of certain special services by the government pay fee. There is always a definite relationship between the fee paid and the benefits received by the citizens. However, there is no relationship between tax paid and benefits received by the taxpayers. Unlike tax, there is no compulsion in case of fee. Fees are an important source of non-tax revenue to the government.

   ii) **Fines and penalties**: - Fines and penalties are levied on offenders of laws as a punishment. The main objective of the government is not to earn income but to prevent the offending of laws. Hence, they are an insignificant source of revenue. Fines and penalties are arbitrarily determined. They are not related to government activities. Like taxes, fines are compulsory payment without quid-pro-quo. They are not expected to be a major source of revenue to the government.

iii) **Special assessment**: - A special type of compulsory contribution made by the citizens of a particular locality in exchange for certain special facilities given to them by the authorities is known as special assessment. For example, if the municipal corporation in a city builds 'pucca' road or makes arrangement for the supply of electricity and water in particular locality, the value of property in that locality will inevitably go up. Therefore, the municipal corporation can levy a special tax on the residents in proportion to the increase in the value of the property, to cover a part of the cost of facilities. There is quid-pro-quo between the special taxpayer and the local public authority.

2) **Profits of public enterprises**: - Almost all countries have public enterprise involved in commercial activities. The profits of these enterprises are an important source of non-tax revenue to the government. The revenue collected in the form of profits is largely influenced by the manner in which the government determines the prices of goods and services it sells. When state has an absolute monopoly high prices are charged. There is quid-pro-quo.

3) **Gifts and grants**: -Gifts are voluntary contributions made by individuals or NGOs to the government. This is done for a specific purpose such as relief fund, war fund, draught fund, earthquake fund etc. The volume of gifts is normally small.

Grant refers to the funds provided by the central government or a state government for undertaking special activities. State governments also provide grants to the local government to carry out their functions. Grant from foreign countries is known as foreign aid. Developing countries receive military aid, food aid, economic and technical aid etc. from developed countries. Such grants are normally conditiognal. They constitute insignificant source of revenue to the government. In short, mainly tax and non-tax sources are ways and means of government revenue.

7.4 Introduction to GST

Goods and Service Tax (GST) is an indirect tax, which is levied only on the value added at each stage of supply chain comprising of manufacture, sale and consumption of taxable goods or services.

The GST provides for a comprehensive and continuous chain of tax credits beginning from the manufacture or production of goods or provision of service up to the retailer or consumer to ensure that (a) There is no cascading effect by levying tax on tax at each stage; and (b) The tax is levied only on the value added at each stage of supply.

At each stage of supply, a supplier of goods or service or both can avail input credit for the tax paid on the purchase of goods or services or both and set off this credit against the GST payable on the supply of goods and services or both made by him to the next stage. GST makes no difference between goods and services and both are treated at par and taxed at a single rate.

It is only the final consumer, who bears the GST charged by the last supplier in the supply chain, with set-off benefits at all the previous stages.

India has a dual GST model, with identical tax rate applied by the Central Government called Central GST (CGST) and State GST (SGST). For inter-state transactions, Integrated GST (IGST) is levied, which is equal to CGST= SGST.

NEED FOR GST

India had a multi-tier indirect tax regime comprising of -

- overlapping taxes
- levied by different authorities
- at different levels
- Denied credit or set off for the taxes paid at the previous stages.

Credit for the VAT paid on the inputs was denied to the manufacturer and the service provider and credit for the excise duty or the service tax paid was denied to the seller only because the excise duty and the service tax were the central taxes, but the VAT was a state tax.

These taxes were not mutually exclusive. For instance, intrastate sale of excise-paid manufactured goods attracted VAT on the gross value of the goods, which included the basic value, the excise duty charged by manufacturer and the profit by dealer.

As a result, the indirect- tax structure was a complex cobweb of rules and regulations in different parts of the country having cascading tax effect. There was no credit at all for local taxes like entry tax and octroi imposing hindrance in smooth movements of goods across the country besides creating scope for arbitrage of rates at different places, interstate smuggling and grey markets for goods and services. India needed a uniform tax regime with lower rates and stringent implementation.

The flaws in the indirect tax structure created the need for a broad- based uniform, integrated central tax with lower tax rates, efficient implementation and free credit across the board for various taxes paid and reduce the cascading effect of multiple taxes, which subsumes all the taxes levied on the sale of goods or provision of services by both the centre and the states and provide a larger pull for set off of taxes. These reasons may be summed up as under:-

a. Integration of different taxes such as excise, VAT, luxury tax, entertainment tax, Octroi and CST so as to avoid multiple taxation of a transaction as both goods and services.

b. Replacement of multiple tax levies by a uniform tax regime in respect of goods and services both.

c. Abatement of the cascading tax burden of tax on tax at different levels.

d. Introduction of an indirect, comprehensive, broad based consumption tax for any product or service throughout India

e. Provision for a continuous chain of credits from the original producer or service provider to the retailer or end consumer for taxes paid at earlier stages i.e. input credit to ensure the removal of cascading effect of multiple taxes.

f. Imposition of tax only on the value added at every stage in the supply chain instead of tax on origin or manufacture of goods.

g. Setting up an efficient tax regime free of corruption and bureaucratic red-tape to enable simplified tax compliance.

h. Creation of a national market for goods and services.

i. Safeguarding the interests of the states by opting for a dual model GST with inbuilt provisions for CGST, SGST, UGST and IGST.

Principles of subsuming taxes

Accordingly several taxes were subsumed or absorbed in the GST, based on the following principles:

a. Only indirect taxes on goods and services were to be subsumed in GST.

b. Such taxes were part of the supply chain i.e. manufacturer, service provider or retailer or consumer ;

c. The taxes resulted in free flow of tax credits in intra and inter- State levels; and

d. The taxes which were not specifically unrelated to supply of goods or services, e.g. stamp duty, municipal taxes etc. were not subsumed in GST.

e. The subsuming of the taxes maintained revenue neutrality and fairness between the central and the states.

Taxes subsumed or absorbed in GST

Based on the above principles, following taxes have been subsumed in GST:

A. Central Taxes

(a) Central Excise Duty (CENVAT)

(b) Additional Excise Duties

(c) Excise Duty under the Medicinal &Toiletries Preparations (Excise Duties) Act 1955

(d) Service Tax

(e) Additional Customs Duty, commonly known as Countervailing Duty (CVD)

(f) Special Additional Duty of Customs – 4% (SAD)

(g) Surcharges and Cesses levied by Centre wherever they are in the nature of taxes on goods or services e.g. cess on rubber, tea, coffee, national calamity contingent duty etc.

(h) Central Sales Tax phased out

B. State / Local Taxes

(a) VAT / Sales tax

(b) Entertainment tax except levied by the local bodies

(c) Luxury tax

(d) Taxes on lottery, betting and gambling

(e) State cesses and surcharges relating to supply of goods and services

(f) Octroi and entry tax

(g) Purchase tax

C. **Taxes not subsumed** in GST

(a) Basic Customs Duty levied on Import of goods into India.

(b) Exports Duty imposed on export of goods are not available in India in abundance,

(c) Road and Passenger tax ,

(d) Toll tax

(e) Property tax

(f) Stamp duty

(g) Electricity duty

D. **Treatment of Specific goods**

a) The Alcoholic Liquor for Human Consumption

Under Article 366, clause 12A, the supply of the alcoholic liquor for human consumption is outside the ambit of GST. The States will continue to impose tax on it. Moreover, CST on inter-state sales of alcohol products would also continue.

b) Tobacco Products

Tobacco and tobacco products being "Sin' goods will be subjected to GST subject to a separate excise duty by the Centre.

c) Petroleum, Crude, High Speed Diesel (HSD), Motor Spirit, Natural Gas and Aviation Turbine Fuel (ATF)

The states will continue to levy VAT on intra-state sales of petroleum products. Inter-state sales would continue to attract Central Sales Tax (CST). However, these products may be transitioned into the GST regime on a future date to be notified by the GST Council. Moreover, these products are also subject to levy of excise duty imposed by the Centre in addition to the VAT or GST.

d) Newspapers and newspaper advertisements

While there is no GST on newspaper, GST, advertisements are subject to levy of GST.

4. DUAL GST MODEL

GST is a uniform destination-based tax applicable on all transactions involving supply of goods or services, or both, for a consideration subject to specified exceptions throughout India including the State of Jammu and

Kashmir. India has followed Canada and Brazil and adopted the dual GST model, while most of the countries have a single GST model.

Under the dual GST model, both the Centre and the states/UT may concurrently levy GST on intra-State taxable supply of goods or services or both. Accordingly, the dual model of GST adopted in India comprises of the following components in respect of intra-state supply of goods or services or both :-

Type of GST Levied and collected by

a) The Central Goods and Service Tax (CGST) Centre under the CGST Act, 2017 passed by the parliament,

b) (i) The State Goods and Service Tax (SGST)

The states under the respective SGST Acts passed by the legislature of the concerned states and the union territories with their own legislatures viz. Delhi and Puducherry,

(ii) The Union Territories State Goods and Service Tax (UTGST)

The Union territories without State legislatures viz. Andaman and Nicobar Islands,

Lakshadweep, Dadra and Nagar Haveli, Daman and Diu and Chandigarh under the provisions of UTGST Act, 2017 passed by the parliament.

c. Integrate State Goods and Service Tax (IGST) Centre under the IGST Act, 2017 passed by the parliament in respect of inter-state supplies.

By and large, CGST and SGST/UTGST rates are equal and IGST is almost equal to the sum total of CGST and SGST/UTGST.

Hence, it can be said that GST in respect of intra-state supplies is equally shared by the concerned state and the Centre.

For instance, If CGST rate in case of intra state supply of goods or service or both, is 12%, then 6% will be the CGST and 6% will be the SGST/UTGST. IGST will be levied at 12% on inter-state supplies.

Further, the SGST acts of the states/UT, UTGST Act, 2017 and IGST Act, state are by and large uniform in respect of the basic features of the tax, chargeability, taxable event, taxable person, classification and valuation of goods and services, procedure for collection and levy of tax etc. to keep the concept to of dual GST in harmony.

5. GOODS AND SERVICES TAX NETWORK (GSTN)

GST regime is technology based. It seeks to avoid personal interface with taxpayers and insists on online compliance. With this objective, Goods and Service Network (GSTN) was incorporated as a special purpose vehicle as a non –profit company under section 8 of the Companies Act, 2013 with an initial equity capital of Rs. 10 crore; 24.5% contributed by the Centre, 24.5% by all States including Delhi and Puducherry, and the balance 51% equity by non-Government financial institutions.

Objects

The company set up a single portal *www.gst.gov.*in with the objects:

(a) to provide IT infrastructure and all GST related services to the Central and the State Governments, taxpayers and other stakeholders for implementation of the Goods and Services Tax (GST); and

(b) to establish a uniform interface linkage for the taxpayer and a common and shared IT infrastructure between the Centre, Union Territories and States.

The portal is accessible over Internet by taxpayers and tax professionals like chartered accountants, tax advocates, banks, accounting, tax authorities and other stakeholders and intranet by tax officials etc.

Functions of the GSTN

GSTN provides to the taxpayers three front-end services, viz. registration, payment and return through GST common portal. Its main functions are as under:-

a) To facilitate registration of the taxpayer. GSTN takes help of IT, ITeS, and financial technology companies called GST Suvidha providers (GSP), who provide mechanism to receive GST returns from the taxpayers and forward the returns to Central and State authorities;

b) To develop applications to be used by taxpayers for interacting with the GSTN and facilitate the taxpayers in uploading invoices as well as filing of returns and act as a single stop shop for GST related services with the help of GSPs;

c) To customize products that address the needs of different segment of users. GSPs may take the help of Application Service Providers (ASPs) who act as a link between taxpayers and GSPs;

d) To compute and settle IGST with the concerned states/UT;

e) To match payment of tax by the tax payers with the banking network;

f) To generate MIS reports from the information furnished by the taxpayers in the GST returns information and provide such reports to the Centre and States;

g) To analyse and provide analysis of taxpayers' profile;

h) To match reversal and reclaim of input tax credit and

i) To ensure data privacy and protection along with developing data retrieval and audit trails and other value added service.

7.5 Components of Public Expenditure

Public expenditure is the most important part of the public finance. Public expenditure refers to the expenditure incurred by public authorities for the benefit of society as a whole. There are different views regarding public expenditure. The classical definition of public expenditure indicates that, government should play limited role like protection and maintaining law and order. On the other hand, Keynes stated that, that system of public expenditure is the best which is highest in amount. It means government should spend more than its income to maximize the welfare of the society. Modern state is a welfare state economy in which government has to play different role and perform a number of functions. Hence public expenditure has increased enormously to promote maximum social welfare.

The public expenditure is defined as, 'that expenditure which is incurred by the public authorities like, central, state and local government bodies to satisfy collective social wants of the people.' The expenditure incurred by the government on defense, administration, maintenance of law and order, economic development, welfare activities etc. is called as public expenditure.

In modern welfare state, the functions of the state have been enlarged and the importance of public expenditure has increased.

The government has to spend a lot for achieving various socioeconomic and political objectives. Public expenditure is an effective measure to achieve certain objectives.

1. Price stability

2. Full employment

3. Maintenance of law and order

4. Development of industries

5. Creation of social goods

6. Provision of education and health

7. Development of transport and communication.

8. Protection from external aggression etc.

9. Promotion of economic stability

10. Elimination of socio-economic inequalities etc.

The components of public expenditure as follows.

1. **Revenue Expenditure:** Revenue expenditure refers to those items of current expenditure which reduce the usable funds of the government without reducing any debt liability. Such expenditure does not result in creation of assets. Revenue expenditure is incurred towards purposes like running of government departments, provision of various services, interest payments on government loans, subsidies etc.

2. **Capital expenditure:** Capital expenditure refers to expenditure incurred by the central government on acquisition of assets like land, building, machinery and equipment, investment on shares, loans granted to state and union territories, government companies, corporations etc.

3. **Development expenditure:** It refers to expenditure incurred by the government on programmes related to the growth and development activities of the government. It includes expenditure on education, health, industry, road, channels, rural developments, water works and power generation etc.

4. **Plan expenditure:** It refers to expenditure incurred by the government towards its planned development programmes. Both consumption and investment expenditure made by the government will be included under plan expenditure. Expenditure on power communication, industry, agriculture and health are the different types of expenditure falling under plan expenditure.

5. **Non development expenditure:** It refers to expenditure incurred on the non development activities of the government. It includes activities like maintenance of law and order, defence, tax collections, payment of interest and loan, payment of old age pension etc.

6. **Non-plan expenditure:** It refers to expenditure made beyond the preview of the plan development activities of the government. It includes expenditure on subsidies, defence, law and order, payment of loan and interest etc.

7.6 Summary

Public expenditure is the most important part of the public finance. Public expenditure refers to the expenditure incurred by public authorities for the benefit of society as a whole. There are different views regarding public expenditure. The classical definition of public expenditure indicates that, government should play limited role like protection and maintaining law and order. On the other hand, Keynes stated that, that system of public expenditure is the best which is highest in amount. It means government should spend more than its income to maximize the welfare of the society.

Modern state is a welfare state economy in which government has to play different role and perform a number of functions. Hence public expenditure has increased enormously to promote maximum social welfare.

7.7 Questions

Q1. Explain the types and components of budget.

Q2. What is the meaning of public finance? What are the sources of public revenue?

Q3. Writhe about Goods and Services Tax (GST).

Q4. Explain the components of public expenditure.

Q5. Explain the key points of budget of India (2020-21)

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Module 4

8

INDIAN PUBLIC FINANCE – II

Unit Structure:

8.0 Objectives

- To know the different sources of public borrowing and debt liabilities.
- To study the various concepts of deficits.
- To know more about Fiscal Responsibilities (FRBM) act.
- To know the concept of Financial Commission and study the recommendations of Fourteenth Finance Commission.
- To study in detail about fiscal federalism

8.1 Introduction

Public finance is one of the important branches of economics. It is the study of the financial operations of the central and state government. According to H. Dalton, 'Public finance is the study of income and expenditure of public authorities.' Public finance broadly implies the various activities undertaken by the public authorities regarding- raising resources of funds, their proper utilization and achieving various objectives namely, rapid economic development, full employment, price stability, equitable distribution of income etc. The subject matter of public finance includes public revenue, public expenditure, and public debt.

In developed countries, public finance is used to maintain economic stability through the control of inflation and recession. In developing countries, the role of public finance is different from that in developed countries. In such countries, public expenditure is directed towards economic development and public revenue, as a source of financing the development activities.

8.2 Public Borrowing / Debt

Public debt is a source to collect income by states. Public borrowing or debt is the debt the state collects from the citizens of other countries. When government borrow, then it gives the birth to public debt. Government can take debt from banks, business or organizations, business houses and the person. Government can take the debt from inside the country and from outside the country, or from both the sides.

According to Dalton, "Public debt is a way of collecting income from public officers".

According to Prof. J.K. Mehta, "Public debt is comparatively modern incident and it would come in practical form with the development of democratic governments".

According to Adam Smith, "Public debts create the conditions of war and extra expenditure".

Classification of Public Borrowing / Debt

Debt has been divided on the bases of use, target, time limit and terms of payment by the economists. The different types of public debt are as follows –

1. **Internal and External Debt**

   Internal Debt: Internal debt is a public debt taken from the country inside, but the external debt is a debt taken from foreign governments. In Dalton's words, "A debt is internal if given by those people or organizations living in that area that is controlled by the local officer of taking debt."

   External Debt: "A debt is external, if it is given by those people and organization living outside of that area".

2. Productive and Unproductive Debt

This classification of debt is depend on the use of public debt. Debts can be used for the production works and unproductive debt.

Productive debt: Productive debts are those debts which are used in those plans which provide the income, like railway, plans of electricity and the plans of irrigation. The income got from these plans can be used to the payment of yearly interest and for the payment of Principle.

Unproductive debt: - Unproductive debts are those debts which used in that plans, no income is provided, for example, war.

3. Funded and Non-Funded Debt

Government debt can also be divided in the form of funded and non-funded debt.

Funded debts: - Funded debts are long term debts. Payment of these debts can be done within one year or it can be possible, not to give any promise regarding this in other words funded debts are those debts, in which the payments are given with in, one year.

Unfunded debts: - Treasury bonds are unfunded debts, because these debts are given for three or six months and their time period is not more than one year. Even then, this is clear that in the condition of funded debts, government is responsible to pay the regular payment of interest to the debt payer; yes, their basic money payment is totally left on the government.

4. With Rate of Interest and without Rate of Interest

Debt with Rate of Interest: - On loans with rate of interest, government gives interest on a fixed rate to the loan taker after a fixed time period.

Debt without Rate of Interest: - debt without rate of interest, loans government don't have to pay any interest.

5. Purchasable and Non–Purchasable Debt

Purchasable debts: - it includes government securities; whose sale and purchase is not possible independently.

Non-purchasable debts: - In opposite, those securities are included in non-purchasable debts, whose sale and purchase is not possible in the open market and can only give back to the government on a fixed rate.

6. Total Debt and Net Debt

Total Debt: - On a fixed time, whatever debts governments have, the total of all is called total debt.

Net Debt: - If government collects any fund to pay back the debts, then the amount of that fund subtracted from the total debt and whatever left is called net debt.

7. **Short Term and Long Term Debt**

Short Term Debt: - When government takes debt for a short period, then this is called short term debt. These debts are paid back in the time period with in a year that is to be taken to complete the tenure of debts.

Long Term Debt: - When governments take debt for a very long period then this is called long term debit. The time of giving it back is not fixed. At that time the debt is paid back, the debt giver got regular interest.

8.3 Deficits

Budget deficits represent excess of all expenditure by the government over its receipts from revenue and capital accounts. This means, the government spends more than it collects through taxes and non-tax receipts. It may be noted that the deficit may occur either in the revenue account or capital account or in both.

Thus, budget deficit can be obtained as

Budget Deficit = Total Expenditure – Total Revenue.

This deficit may be financed by withdrawing cash balance of the government with the RBI or by borrowing from the public to fill up the gap between current income and expenses. Further, a budget deficit may also be financed through the creation of new money. In other words, the government may cover the deficit by borrowing from the central bank of the country.

The various concepts of deficit used in budget in modern world are as follows.

1) **Revenue Deficit:**

The deficit in revenue account of the budget is called as revenue deficit. It takes place when revenue expenditure is more than revenue receipts. It refers to the excess of revenue expenditure over the revenue receipts of the government. Revenue receipts come from direct, indirect taxes, and other sources like fees, fines, surplus of public enterprises. Revenue expenditures are made on civil administration, law and order, justice, defence, interest payments on public debt, subsidies, education, health etc.

Revenue Deficit = Revenue Expenditure > Revenue Receipts

Revenue deficit reflects the inability of the government to finance current expenses through tax and non-tax revenues. It should be noted that most of the expenditure on revenue account represents collective consumption of the society. It thus does not create income-earning assets. Prudent fiscal management requires that receipts on revenue account should be more than the expenditure on revenue account. When there is a deficit in revenue account, the borrowed funds from capital account are used to meet a part of the consumption expenditure of the government.

2. Budgetary Deficit: -

It is defined as excess of total budgetary expenditure over total budgetary receipts (both revenue and capital account) of the government. The budgetary deficit in India is met by either withdrawing cash balance kept with the RBI or by net addition to the Treasury bill issued by the central government. It is only a partial measure of budgetary imbalances, as it does not reflect the total indebtedness of the government.

Budgetary Deficit = Total Expenditure > Total Revenue

3. Fiscal Deficit: -

The fiscal deficit is an internationally used concept. It is an important and complete measure of deficit. Fiscal deficit is the excess of total expenditure (both revenue and capital account) over revenue receipt and non-borrowing types of capital receipts like

proceeds from disinvestment of public enterprises. It shows the total resource gap in the financial operation of the government. It is a comprehensive measure of budgetary imbalance as it fully reflects the total indebtness of the government.

Fiscal Deficit = Revenue Expenditure + Capital Expenditure > Revenue Receipts + Non Borrowing Capital Receipts

The government in two ways can meet fiscal deficit firstly, by borrowing – both internal and external market borrowing secondly, by borrowing from the Central Bank against its own securities. When the government borrows from the Central Bank, new money or currency is created. This is called monetizing the deficit because it leads to the creation of reserve money of high-powered money. Monetizing fiscal deficit is called deficit financing in India. In other words, Fiscal deficit is the excess of total expenditure, excluding repayment of debt, over total receipts excluding debt capital receipts.

4. Primary Deficit: -

Primary deficit is obtained by deducting interest payment from fiscal deficit. It is a measure of budget deficit, which indicates the real position of the government finance. If the interest payments on past borrowings are high the fiscal deficit is high.

Hence, fiscal deficit may be high and primary deficit may be low. If public debt is reduced b mobilizing resources and curtailing public expenditure, then fiscal deficit would be reduced.

Primary Deficit = Fiscal Deficit – Interest Payment

5. Monetized Deficit: -

It refers to the increase in net RBI credit to the government. It is the sum of net increase in holding of Treasury bill of central bank and its contribution to the market borrowing of the government.

It gives rise to the expansion of new money of currency is called Monetizing the deficit. Hence it leads to the creation of reserve money or high powered money by the RBI. When the government is monetizing the fiscal deficit, it shows the extent of

deficit financing in India. Thus monetized deficit is responsible for directly raising the general price level.

To conclude, the fiscal imbalance was attributed to a number of factors such as rapid increase in government spending, inadequate rise in revenue receipts, excessive borrowing, unproductive use of the resources etc. In fact, the large and increasing fiscal imbalance affected adversely the economy in terms of deficits because of balance of payments, large inflationary rise in the general price level, and cut in capital expenditure.

8.4 Fiscal Responsibilities Budget Management (FRBM) Act

The fiscal situation in India was deteriorated throughout 1980's and reached to a peak level of crisis in the year1990-91. The fiscal deficit in 1990-91 was 6.6 percent of GDP while revenue deficit was as high as 3.3 percent of GDP. The primary deficit was 2.8 percent in the same period. The situation did not improve significantly. This further indicates deterioration in fiscal situation due to rise in burden of interest payments. This was one of the factors responsible for the BOP crisis in 1990-91. But by the time the stock of government liabilities had become very large. It was affecting government functioning. Therefore, the central government appointed a committee on Fiscal Responsibility Legislation on Jan. 17, 2000 to look into various aspects of fiscal system and recommended a draft legislation on fiscal responsibility of the government. To ensure fiscal discipline the central government according introduced 'fiscal responsibility and budget management bill' in the parliament in December 2000 with the primary objective of reducing the central government's deficits and debts. Later on it became an act. The fiscal responsibility and budget management act was passed and came into force on 5 July 2004.

Objectives of the FRBM Act 2003

1. To set the limits on government borrowing, under a time bound programme.
2. Achieve zero revenue deficit, to achieve sufficient revenue surplus and bring down fiscal deficits.
3. Make government responsible to ensure long-term macroeconomic stability.
4. To make government responsible to reduce burden of debt repayment on future generations and to adopt prudent debt management.
5. Improve the transparency in fiscal operations of the government.

Main Features of FRBM Act 2003 and FRBM Rules 2004:

1. **Reduction in Revenue Deficit:-** The FRBM rules states that, the central government must take appropriate measures to reduce revenue deficit by 0.5 percent of GDP or more at the end of each financial year beginning with 2004-05. The FRBM Act further Stipulates that, revenue deficit should be reduced to zero within a period of 5 years ending with 31st March 2009.

2. **Reduction in Fiscal Deficit:-** The FRBM Rules states that, the central government should take appropriate measures to reduce fiscal deficit but 0.3 percent of GDP or more at the end of each financial year beginning with 2004-05. The Act further states that fiscal deficit should be reduced to 3 percent of GDP by the end of 2008-09.

3. **Borrowing from the RBI:-** The FRBM Rules states that, the central government should not borrow directly from the RBI with effect from 1st March 2006 except by way of advances to meet temporary shortage of cash. The RBI should not subscribe to the issue of government securities from 2006-07.

4. **Additional Liabilities:-** The FRBM Rules states that, the central government should limit the additional liabilities to 9 percent of the GDP in 1004-05 and should reduce this limit to by one percent point of GDP at the end of each financial year.

5. **Relaxation of Deficit Reduction Targets:-** The FRBM Act states that, the revenue and fiscal deficit may be more than the specified targets in the rules, but only on ground of national security, national calamities, or other exceptional cases relaxation from deficit reduction targets may be granted to the central government.

5. **Quarterly Reviews**: - The FRBM Act states that, the Finance Minister should take quarterly review of receipts and expenditure, and should place the outcome report of review before the parliament. He must present a statement in the parliament by explaining the reasons for changes in FRBM Act targets. Similarly, government should announce the corrective measures to be taken to overcome these changes.

6. **Fiscal Transparency**: - The FRBM Act clearly stated two important measures to ensure greater transparency in fiscal operation of the government. They are

   I) The central government should minimize secrecy in preparation of annual budget.

   II) The central government should disclose the information relating to the significant changes in accounting standards, policies and practices as well as revenue arrears, guarantees and assets by 2006-07.

7. **Government Guarantees:-** The Act states that, the central government should not provide guarantee to loans borrowed by the state governments and public sector undertakings in excess of 0.5 percent of GDP in any financial year beginning with 2004-05.

8. **Placing Reports:** - The Act further states that, the government should present three reports before the parliament every financial year.

   - **Macroeconomic Framework Statement**- This report states what is the growth rate expected to be achieved and also the macroeconomic situation in the economy.

   - **Fiscal Policy Strategy Statement-** This report states the policy measures relating to taxation, expenditure, borrowing, subsidies and administrative prices.

   - **Medium term Fiscal Policy Statements-** This report states three year rolling targets for prescribed fiscal indicators.

Evaluation of FRBM Act

The critical evaluation of FRBM Act 2003 can be done by analyzing it broadly into to groups. They are A) Achievements and B) Limitations.

A) Achievements:- The three main achievements of FRBM Act 2003 are as follows.

1. **Reduction in Revenue Deficit**:- The first major achievement of the Act is the reduction in revenue deficit from 3.6 percent of GDP in 2003-04 to 1.1 percent of GDP in 2007-08.
2. **Reduction in Fiscal Deficit**: - The second major achievement is reduction in fiscal deficit from 4.5 percent of GDP in 2003-04 to 2.7 percent of GDP in 2007-08.
3. **Reduction in Revenue Expenditure**: - The third major achievement is reduction in revenue expenditure from 3.1 percent of GDP in 2003-04 to 1.1 percent of GDP in 2007-08.

B) Limitations; - Though the government has taken credible efforts to reduce revenue and fiscal deficits FRBM Act has certain limitations. They are as follows.

1. **False expectations of revenue deficit target:** - It was expected that the revenue deficit is to be brought down to zero. Central government failed to reduce revenue deficit during the 1990s. The revenue deficit of the government rose from 2.4 percent of GDP in 1996-97 to 4.1 percent of the GDP in 223-04. This is due to a decline in tax-GDP ratio and rise in interest payment, subsidies, defence expenditure and other non-plan expenditure. If restrictions are imposed on the government to reduce revenue deficit the real possibility is that the government may cut down social sector spending especially on health and education. This will adversely affect large sections of the population.
2. **Low level of capital expenditure**:- One of the major limitations of FRBM Act is the continuous decline in capital expenditure. According to critics to reduce fiscal deficit the government has reduced capital expenditure from 5.6 percent of GDP in 1990-91 to 3.02 percent of GDP in 2002-03. This will restrict governments' investment in infrastructure in future which is vital for rapid economic growth.
3. **Neglect of equity and growth:** - According to critics one of the major limitations of the FRBM Act is the bill has not favoured investment in human resource development and infrastructure because the returns on these do not contribute directly to government revenue. But these areas are crucial for equity and economic growth. The FRBM bill has no time bound targets.

4. **Lack of seriousness about financing public expenditure: -**

   The FRMB Act does not address the problem of financing public expenditure in a serious manner. During 1990s the tax-GDP ratio declined significantly. Hence there was a need to raise this ratio, but it has not received top priority under the Act. There is no target under the Act for the tax-GDP ratio. The problem of financing public expenditure is callously dealt with by imposing a restriction on the central government borrowing from the RBI to finance government expenditure.

5. **Flawed assumptions of the FRBM Act**: - The FRBM Act is based on the following assumptions.

   i. Lower fiscal deficits lead to higher and more sustained growth.

   ii. Larger fiscal deficits necessarily lead to higher inflation.

   iii. Larger fiscal deficits increase external vulnerability of the economy.

   These assumptions have been rejected by C. P. Chandrashekhar and Jayati Ghosh who have given the following arguments.

   1. If the deficit is in the form of capital expenditure, it would contribute to future growth.

   2. Fiscal deficit is not the only cause for higher inflation. During the late 1990s, the rate of inflation has fallen even when the fiscal deficit was as high 5.5 percent of GDP.

   3. Higher fiscal deficit need not necessarily cause external crisis.

   The external vulnerability depends more on capital and trade account convertibility. In India, we have managed to build large foreign exchange reserves, though fiscal deficit has not come down.

   In short, the assumptions of the FRBM Act are theoretically incorrect.

6. **Neglect of primary deficit**: - According to critics the FRBM Act completely neglected the primary deficit because it did not determine any specific target for it despite high burden of interest payment on nation.

7. **Target for gross fiscal deficit very stringent**: - The Act states that gross fiscal deficit should be reduced to 3 percent of GDP up to March 31, 2009. This means that government borrowings would be restricted to 3 percent of GDP. According to Dr. Chelliah this target is very stringent. The ratio of gross fiscal deficit to GDP should be 4 to 5 percent of GDP to boost investment in infrastructure and accelerate the process of economic development.

To conclude, the government has introduced several measures of improving fiscal situation. The Task Force constituted under the chairmanship of Dr. Vijay Kelkar, submitted its report to the government. It has outlined measure to increase revenue and reduce revenue expenditure. It has also recommended raising capital expenditure to induce economic growth. On account of such reforms, the Task Force has estimated that the tax-GDP ratio can improve considerably in 2008-09. At the same time there would be a decline in total expenditure. As a result, revenue surplus would be 2 percent of GDP while the fiscal deficit could be brought down to 2.8 percent of GDP.

8.5 Fiscal Federalism

The fiscal federalism refers to financial relations between the country's federal government system and other units of the government. It is a study of how expenditure and revenue are allocated across the different vertical layers of government administration. Article 246 and Seventh Schedule of the Indian Constitution distributes powers and allots subjects to Union and states with a threefold classification type:

a. Union List:

The Union is responsible for functions of national importance, including but not limited to the communications, constitution, defence, elections, external affairs and organisation of Supreme Court and High Courts.

b. State List:

States are the responsible for touching on the life and welfare of the people, for instance, through public order, police force, agriculture, local government, public health and water land, etc.

c. Concurrent List:

The Concurrent list includes the administration of justice, economic and social planning, and more.

According to the lists, the Parliament has reserved exclusive powers to create laws with regards to anything from Union List. Contrarily, the Legislature of any state reserves the power to make laws for their respective states in relation to anything from State List. However, for any subject matter that falls within Concurrent List both, the Parliament and State Legislature can create laws, however, in the event of any conflict, the law made by the Parliament will prevail. Residuary functions listed in neither union list or state list are vested in the Union.

The Union and State lists also include powers of taxation. The main source of income for the Union are direct taxes, mainly income tax. However, they are also entitled to collect various other taxes such as customs and corporate tax. States normally derive their income from indirect taxes, most commonly from sales tax. Besides this, the State List also includes land revenue, excise on alcoholic liquor, estate duty, tax on vehicles and more. The Concurrent List does not comprise any tax power. The distribution of revenues and approaches for determining grants between the States and Union are legislated by various Articles of the Indian Constitution.

8.6 Fourteenth Finance Commission

Fourteenth Finance Commission of India was a finance commission which is constituted on 2nd January, 2013. The chairman of the fourteenth finance commission was the former governor of Reserve Bank of India, Y. V. Reddy and the members were Sushma Nath, M. Govinda Rao, Abhijit Sen, Sudipto Mundle, and A. N. Jha. The recommendations of the commission entered force on April 2015; they take effect for a five-year period from that date.

The government of India on 24th February, 2015 accepted the recommendations of the fourteenth finance commission to increase the share of states in central taxes to 42% ,the single largest increase ever recommended. It has recommended distribution of goods to states for local bodies using 2011 population data with weight of 90% & area with weight of 10%.

Major recommendations of Fourteenth Finance Commission (FFC) accepted by the government

- States' Share in the net proceeds of Union tax revenues increased to 42% from 32% earlier. This is the largest ever jump in percentage of devolution. In the past, changes have ranged between 1-2% increase.
- Eight Centrally Sponsored Schemes (CSS) delinked from support from the Centre. Finance Commission has identified over 30 CSS schemes to be delinked from Centre's support but all have not yet been delinked considering the national priorities and legal obligations.
- Sharing pattern under various CSS to undergo a change, with States sharing higher fiscal responsibility for scheme implementation.
- Distribution of grants to States for local bodies based on 2011 population data (90% weight) and area (10% weight)

Other key recommendations of FFC that government will examine

- Revenue compensation to States under GST should be for five years; 100% in first three years, 75% in fourth year and 50% in fifth year.
- Create an autonomous and independent '**GST Compensation Fund'** through legislative actions to facilitate the compensation process.
- Suggesting a fiscal consolidation roadmap, FFC puts a ceiling on fiscal deficit at 3% of GDP from 2016-17 onwards .
- Some flexible provisions for State's borrowings over and above the annual limit of fiscal deficit at 3% of GSDP.
- Establish an independent **Fiscal Council** to undertake ex-ante assessment of fiscal policy implications of budget proposals and their consistency with fiscal policy and rules.
- Suitably amend Electricity Act 2003 to facilitate levy of penalties for delays in payment of subsidies by the State Governments.
- Have independent regulators for road sector for tariff setting, quality regulation, among other functions.
- Several recommendations made for evaluating government's ownership, disinvestment in Central Public Sector Enterprises.

8.7 Summary

The Finance Commission is Constitutionally mandated body which is at the centre of fiscal federalism. Finance commission has been Set up under Article 280 of the Constitution, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them, lay down the principles determining the distribution of these taxes among States. Its working is characterised by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism. The first Finance Commission was set up in 1951 and there have been fifteen so far. Each of them has faced its own unique set of challenges.

The Fifteenth Finance Commission was constituted on 27 November 2017 against the backdrop of the abolition of Planning Commission (as also of the distinction between Plan and non-Plan expenditure) and the introduction of the goods and services tax (GST), which has fundamentally redefined federal fiscal relations.

8.8 Questions

Q1. What are the Sources of Public Borrowing and Debt Liabilities?

Q2. What the meaning of deficits? Explain various types of deficit.

Q3. Write about Appraisal of Fiscal Responsibility and Budget Management (FRBM) Act.

Q4. Explain the concept of fiscal federalism.

Q5. What are the measure recommendations of Fourteenth Finance Commission?

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