ARULMIGU PALANIANDAVAR ARTS COLLEGE FOR WOMEN,

PALANI

PG DEPARTMENT OF ECONOMICS

LEARNING RESOURCES

PUBLIC FINANCE

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UNIT I

Public finance is a field of economics concerned with how a government raises money, how that money is spent and the effects of these activities on the economy and society. It studies how governments at all levels—national, state and local—provide the public with desired services and how they secure the financial resources to pay for these services.

Public finance deals with the finances of public bodies – national, State or Local – for the performance of their functions. The performance of these functions leads to expenditure. The expenditure is incurred from funds raised through taxes, fees, sale of goods and services and loans. The different sources constitute the revenue of the public authorities. Public finance studies the manner in which revenue is raised; the expenditure is incurred upon different items etc. Thus, public finance deals with the income and expenditure of public authorities and principles, problems and policies relating to these matters. We can analyse some important definitions of public finance given by some leading authorities in public finance.

Economists	Publication	Definition
Charles F. Bastable	Public Finance – 1892	For all States – whether crude or highly developed – some provisions of the kind are necessary and there for supply and application of state resources constitute the subject matter of a study which is best entitled in English as Public Finance
Dalton	Principles of Public Finance- 1922	One of those subjects which lies on the border line between Economics and Politics. It is concerned with the income and expenditure of public authorities and with the adjustment of one to the other
Harold Groves	-----	A field of enquiry that treats the income and out goes of governments –federal, state, and local
PE. Taylor	The Economics of public finance	Public Finance is the fiscal science, its policies are fiscal policies, its problems are fiscal problems
Mrs. Ursula Hicks	Public Finance	The main content of Public Finance consists of the examination and appraisal of the methods by which governing bodies provide for the collective satisfaction of wants and secure the necessary funds to carry out this purpose
CS Shoup	-----	The discipline of Public Finance describes and analyses the government services, subsidies and welfare payments and methods by which the expenditure to these ends are covered through taxation, borrowing, foreign aid and creation of new money.

According to Professor Hugh Dalton,the term 'Public authorities' refers to the Government or State at all levels –National, State, and Local.

Harold Groves' definition outlines the types of governments whose finances are studied in Public finance.

According to Taylor, public finance studies the manner in which the state through its organ, the government, raises and spends the resources required. Public Finance is thus concerned with the operation and policies of the fisc - The State treasury.

The definition of public Finance by Mrs.Ursla Hicks highlights the satisfaction of collective wants which in turn leads to the need to secure necessary resources.

The definition of CS Shoup enlarges the scope of Public Finance for modern governments to include different types of expenditure and different sources of revenue.

All the definitions stated above illustrate the scope of Public Finance. From these definitions, we can conclude that Public Finance is an enquiry into the facts, techniques, principles, theories, rules and policies which shape, direct, influence and govern the use of scarce resources, with alternative uses, of the government.

IMPORTANCE OF PUBLIC FINANCE

1) Provision of public goods: -For providing public goods like roads, military services and street lights etc. public finance is needed. Business firms will have no incentive to produce such goods, as they get no payment from private individuals.
2) Public finance enables governments to tackle or offset undesirable side effects of a market economy. The side effects are called spill overs or externalities. For example, pollution. The governments can introduce recycling programmes to lessen pollution or they can make laws to restrict pollution or impose pollution charges or taxes on activities that bring about pollution.
3) Public finance helps governments to redistribute income. To reduce the inequality in the economy, the governments can impose taxes on the richer people and provide goods and services for the needy ones.
4) Public finance provides many a programme for moderating the incomes of the rich and the poor. Such programmes include social security, welfare and other social programmes.
5) The acceptance of the principle of welfare state, the role of public finance has been increasing. Modern governments are no more police states as the classical economists viewed.
6) As the scope of state participation in the economic activity is widening, the

scope of public finance has also been increasing. Generation of employment opportunities, control of economic fluctuations like boom and depression, maintaining economic stability etc. are some of the thrust areas of the governments through fiscal operations.

SUBJECT MATTERS OF PUBLIC FINANCE (OR) SCOPE OF PUBLIC FINANCE

The subject matters of Public Finance can be broadly classified in to five categories –a) Public revenue b) Public expenditure c) Public debt d) Financial administration e) Economic stabilization and f) Federal Finance.

Public Revenue:

The income of the states is referred to as Public Revenue. In this branch, we study the various ways of raising revenue by the public bodies. We also study the principles and effects of taxation and how the burden of taxation is shared among the various classes of society etc.

Public Expenditure

It deals with the principles and problems relating to the allocation of public spending. We study the fundamental principles governing the flow of public funds in to different channels, classification and justification of public expenditure; expenditure policies of governments and the measures adopted for welfare state etc.

Public Debt

The governments borrow when its revenue falls short of its expenditure. Public debts is a study of various principles and methods of raising debts and their economic effects. It also deals with the methods of repayments and managements of public debts.

Financial Administration

It deals with the methods of Budget preparation, various types of Budgets, war Finance, Development Finance etc. Thus, financial administration refers to the mechanism by which the financial functions are carried on. In other words, financial administration studies the organizing and disbursing of the finances of the State.

Economic stabilization and Growth

The use of Public revenue and Public expenditure to secure stability in levels of prices by controlling inflationary as well as deflationary pressures is studied. Similarly the income and expenditure policies adopted by the government so as to attain full employment, optimum use of resources, equitable distribution of income etc. are also studied.

Major Fiscal Functions

According to Professor Musgrave there are three major fiscal or budgetary functions of the governments. They are a) Allocation functions b) Distribution functions and c) Stabilization functions.

The Allocation Function

There are certain cases in which the wants of all individuals cannot be satisfied through market mechanism. In such cases the public sector or the governments have to provide goods and services. The allocation branch of public finance deals with the provision of social goods. Social goods are those goods and services produced to satisfy collective wants. Collective wants are those wants which are demanded by all members of the community in equal or more or less equal amounts. The allocation branch explains the process by which the resources in use are divided between private goods and social goods by which the mix of social good is chosen.

The Distribution Function

The very important feature of a market economy is the disparity in the distribution of income and wealth. The distribution function of public finance deals with the adjustment of the distribution of wealth and income to ensure "fair or just" state of distribution. That is, the distribution function of public finance deals with the determination of taxes and transfer payments policies of the governments.

The Stabilization Function

The stabilization function explains the macroeconomic aspect of budgetary policy. In other words, the stabilization function deals with the use of budgetary policy as a means of maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth, with allowances for effects on trade and balance of payments. The major instruments of stabilization policy are monetary policy and fiscal policy. This function is otherwise known as compensatory finance.

FUNCTIONS OF PUBLIC AUTHORITY

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

1. Maintenance of internal peace and order:

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

2. Defence :

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

3. Justice:

Judiciary plays a very important role in the settlement of disputes between persons, states and governments. It is one of the three major items of expenditure for a government.

Judiciary is an independent body. It functions along with executive and legislature.

4. Regulation and control of economic enterprises:

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

5. Promotion of social welfare :

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

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

6. Conservation of Natural Resources:

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

7. Promotion of State unity:

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

8. Administration:

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

9. Financial system:

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

10. Religion:

Very occasionally certain governments perform religious functions also.

FEDERAL FINANCE

Under federal finance we study the principles and policies governing the distribution of functions and funds among the public authorities in a federal set up. In a federal set up there are different levels of governments-centre, state and local.

PUBLIC FINANCE AND PRIVATE FINANCE

The understanding and the study of public finance is facilitated by a comparison of the public or government finance with private or individual finance. Such a comparison will help us to know how the aims and objectives and methods of public Finance operation are similar or differed from the financial operations of the individual.

Similarities

1. Both the State as well as individual aim at the satisfaction of human wants through their financial operations. The individuals spend their income to satisfy their personal wants whereas the state spends for the satisfaction of communal or social wants.
2. Both the States and Individual at times have to depend on borrowing, when their expenditures are greater than incomes
3. Both Public Finance and Private Finance have income and expenditure. The ultimate aim of both is to balance their income and expenditure.
4. For both kinds of finances, the guiding principle is rationality. Rationality is in the sense that maximization of personal benefits and social benefits through corresponding expenditure.
5. Both are concerned with the problem of economic choice, that is, they try to satisfy unlimited ends with scarce resources having alternative uses.

Dissimilarities

1. The private individual has to adjust his expenditure to his income. i.e., his expenditure is being determined by his income. But on the other hand the government first determines its expenditure and then the ways and means to raise the necessary revenue to meet the expenditure.
2. The government has large sources of revenue than private individuals. Thus at the time of financial difficulties the state can raise internal loans from its citizens as well as external loans from foreign countries. In the case of private individual, all borrowings are external in nature.
3. The state, when hard pressed, can resort to printing of currency, as an additional source of revenue. In fact, during emergencies like war, it meets its increased financial obligations by printing new currency. But an individual cannot raise income by creating money.

4. The state prepares its budget or estimates its income and expenditure annually. But there is no such limitation for an individual. It may be for weekly, monthly, or annually.

5. A surplus budget is always good for a private individual. But surplus budgets may not be good for the government. It implies two things. a) The government is levying more taxes on the people than is necessary and b) the government is not spending as much as the welfare of the people as it should.

6. The individual and state also differ in their motives regarding expenditure. The individuals hanker after profit. Their business operations are guided by private profit motive. But the states expenditure is guided by the welfare motive.

7. The private individual spends his income on various items in such a manner as to secure equi-marginal utilities from them. The government on the contrary does not give as much importance to this law as a private individual does. Modern government sometimes incur cretin types of expenditure from which there do not derive any advantage but they do incur this expenditure to satisfy cretin sections of the community.

8. Individuals always seek quick returns they save only a small amount for future and spend more to satisfy their current needs. Individual tend to think more on present as they are dead in the long run. Similarly they seldom spend if it does not yield any money income. On the other hand, State has a long term perspective of its expenditure. It does not care only for immediate benefit. State spends on projects having long gestation period. The burden of taxation is borne by the present generation in the interest of long run welfare of the community. Similarly sometimes government may have to spend on schemes which may not yield any money income at all (e.g. Public Health).

6. An individual’s spending policy has very little impact on the society as a whole. But the state can change the nature of an economy through its fiscal policies.

7. The pattern of expenditure in the case of private finance is often influence by customs, habits social status etc. The pattern of government expenditures is guided by the general economic policy followed by the government.

8. Private Finance is always a secret affair. Individual need not reveal their financial transactions to anyone except for filing tax returns. But Public Finance is an open affair. Government budget is widely discussed in the parliament and out sides. Public accountability is an important feature of public finance.

9. Individuals can plan to postpone their private expenditure. But the state cannot afford to put off vital expenditure like defence, famine relief etc. Findlay Shiraz says that compulsory character is an important future of public finance.

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

One of the important principles of public finance is the so – called Principle of Maximum Social Advantage explained by Professor Hugh Dalton. Just like an individual seeks to maximize his satisfaction or welfare by the use of his resources, the state ought to maximize social advantage or benefit from the resources at its command.

The principles of maximum social advantage are applied to determine whether the tax or the expenditure has proved to be of the optimum benefit. Hence, the principle is called the principle of public finance. According to Dalton, “This (Principle) lies at the very root of public finance”

He again says “The best system of public finance is that which secures the maximum social advantage from the operations which it conducts.” It may be also called the principle of maximum social benefit. A.C. Pigou has called it the principle of maximum aggregate welfare.

Public expenditure creates utility for those people on whom the amount is spent. When the volume of expenditure is small with a slighter increase in it, the additional utility is very high. As the total public expenditure goes on increasing in course of time, the law of diminishing marginal utility operates. People derive less of satisfaction from additional unit of public expenditure as the government spends more and more. That is, after a stage, every increase in public expenditure creates less and less benefit for the people. Taxation, on the other hand, imposes burden on the people. So, when the volume of taxation becomes high, every further increase in taxation increases the burden of it more and more. People under go greater scarifies for every additional unit of taxation. The best policy of the government is to balance both sides of fiscal operations by comparing “the burden of tax” and “the benefits of public expenditure”. The State should balance the social burden of taxation and social benefits of Public expenditure in order to have maximum social advantage.

Attainment of maximum social advantage requires that;

a) Both public expenditure and taxation should be carried out up to certain limits and no more.

b) Public expenditure should be utilized among the various uses in an optimum manner, and

c) The different sources of taxation should be so tapped that the aggregate scarifies entailed is the minimum.

Assumptions of the Principle

- The public revenue consists of only taxes (and not of gifts, loans, fees etc.) and the state has no surplus or deficit budgets.
- Public expenditure is subject to diminishing marginal social benefits and the taxes are subject to increasing marginal cost or disutility.

According to Dalton, maximum social advantage is at a point where the Marginal Social Sacrifice (MSS) of taxation and Marginal Social Benefit (MSB) are equal. The point of equality between MSS and MSB is referred to as the point of maximum social advantage or least aggregate social sacrifice.

Musgrave calls Dalton's principle as "Maximum Welfare Principle of Budget Determination." He puts that the optimum size of the budget is determined at point where Net Social Benefit (NSB) of fiscal operations to the society becomes zero. The NSB is the difference between MSB and MSS. (NSB=MSB-MSS). Musgrave presented Dalton's principle of MSA with some slight differences.

Diagrammatic Representation

The curves MSS and MSB show the marginal social scarifies of taxation and marginal social benefit of public expenditure respectively. MSS curve slopes up words since taxation increases marginal social sacrifices. MSB curves slopes down wards showing that public benefit goes on declining with every increase in public expenditure. The ideal point of financial operations is where the governments collect OM taxation from the society and uses it for public expenditure. At this point , MSS is exactly equal to MSB (Point E) at OM 1 , MSS is M1 F1 which is less than MSB (M1 , E1) thus depicting a loss of welfare to the society (E1 F1). Similarly, the government is collecting OM2 taxation to finance larger public expenditure; The MSS is higher than MSB by E2 F2. So the ideal level of taxation and expenditure is at OM. According to Dalton "Public expenditure in every direction, should be carried just so far that the advantage to the community of a further small increase in any direction is just counter balanced by the disadvantage of a corresponding increase in taxation or in receipts from any other source of public income. This gives the ideal public expenditure and income".

UNIT-II

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MEANING

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

PRIVATE AND PUBLIC EXPENDITURE

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

Similarities :

Following are the similarities between private expenditure and public expenditure.

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

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

Dissimilarities :

Following are the differences between private expenditure and public expenditure.

1. The private expenditure is determined by income of the individual whereas the public expenditure determines the income of the public authority.
2. The private expenditure is optional whereas the public expenditure is compulsory.
3. An individual, while spending money, aims at striking a profit – oriented budget whereas the public authority does not aim at this.
4. An individual, while spending money, calculates the amount of benefit accruing to him due to that expenditure. But a public authority does not make any such calculation.
5. An individual calculates short - run benefits out of his expenditure whereas a public authority calculates only the long - run benefits out of its expenditure.

CLASSIFICATION OF PUBLIC EXPENDITURE

Meaning:

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

Need for classification:

Classification of public expenditure is important for the following reasons.

(i) To study the nature and effects of each kind of public expenditure

(ii) To compare the effects of one public expenditure with that of another

(iii) To study the relative importance of public expenditure under different heads

(iv) To examine and evaluate the effects and efficacy of the various matters in which the funds have been allocated and

(v) To determine the most appropriate expenditure policy of the government.

VARIOUS CLASSIFICATIONS

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

1. **Accounting classification:**

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

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

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

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

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

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

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

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

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

3. **Nicholson's Classification:**

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

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

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

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

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

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

4. Adam Smith's Classification:

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

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

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

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

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

5. Hick's Classification:

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

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

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

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

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

6. Rocher's Classification:

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

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

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

7. Shirra's classification:

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

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

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

8. Mehta's classification:

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

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

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

9. Economic classification:

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

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

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

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

EFFECTS OF PUBLIC EXPENDITURE

Introduction:

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

a. **Effects on Production.**

b. **Effects on Distribution.**

a. EFFECTS OF PUBLIC EXPENDITURE ON PRODUCTION :

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

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

i. Efficiency Effect.

ii. Incentive Effect.

iii. Allocative Effect.

i. Efficiency Effect :

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

ii. Incentive Effect :

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

iii. Allocative Effects :

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

- Public expenditure causes diversion of economic resources from one use to another. For example, the resources from private use to public use can be generated.

- Public expenditure can increase the productive power of the community. Public expenditure can create economic overheads like roads, railways, irrigation projects, etc.,

- Public expenditure can exploit the utilised and unutilised resources. In that way, a country can invest on a large number of key and basic industries like iron and steel, chemicals and fertilisers. The resources can be transferred from less productive use to more productive use. The long term efficiency of the people depends upon the desirable infrastructure facilities.

- Public expenditure promotes the future needs of the society. A better allocation of resources between the present and future can be made through public expenditure.

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

b. EFFECTS OF PUBLIC EXPENDITURE ON DISTRIBUTION

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

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

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

(i) Regressive Expenditure :

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

(ii) Proportional Expenditure :

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

(iii) Progressive Expenditure :

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

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

CAUSES FOR THE GROWTH OF PUBLIC EXPENDITURE

One of the most important features of the present century is the phenomenal growth of public expenditure. Some of the main causes of public expenditure growth are:
1. Income Elasticity and Increase in Per Capita Income 2. Welfare State Ideology and Wagner's Law 3. Effects of War and the Need for Defence 4. Resource Mobilizations and Ability to Finance 5. Inflation 6. The Role of Democracy and Socialism 7. The Urbanisation Effect 8. The Rural Development Effect 9. The Population Effect 10. The Growth of Transport and Communication 11. The Planning Effect.

1. **Income Elasticity and Increase in Per Capita Income:**

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

than the latter. Hence, the income elasticity of public expenditure (IEPE) for the U.S.A. was 4.8 for the period 1890-1963 and 4.5 for the U.K. in 1890-1955.

2. **Welfare State :**

The modern State is a welfare state. It aims at promoting the economic, political, and social well-being of its citizens. It makes every effort to improve the living standard of the common people. For this purpose, it has to undertake several functions and services never visualized before.

The 19th century state was a **'police state'** while, in 20th and 21st centuries modern state is a **'welfare state'**. Even in a capitalist framework, socialistic principles are not altogether discarded. Since socialistic principles are respected here, modern governments have come out openly for socio-economic uplift of the masses.

Various socio-economic programmes are undertaken to promote people's welfare. Modern governments spend huge money for the purpose of economic development. It plays an active role in the production of goods and services. Such investment is financed by the government.

Besides development activities, welfare activities have grown tremendously. It spends money for providing various social security benefits. Social sectors like health, education, etc., receive a special treatment under the government investment. It builds up not only social infrastructure but also economic infrastructure in the form of transport, electricity, etc.

Provision of all these require huge finance. Since a heavy sum is required for financing these activities, modern governments are the only providers of money. However, various welfare activities of the government are largely shaped and influenced by the political leaders (Ministers, MPs, and MLAs to have a political mileage, as well as by the bureaucrats (MPLAD).

3. **Effects of War and the Need for Defence:**

The tremendous growth in public expenditure may also be attributed to wars and threats of war in modern times. In the Second World War, countries like England incurred heavy war expenditures, amounting to £ 15 million per day. Wars and threats of war and the consequent defence needs compel governments to spend more and more on the production of war goods.

Due to the invention of nuclear weapons, there is always the danger of foreign aggression. International political situation is uncertain and insecure. Modern States are already facing a cold war. As such, every nation has to prepare itself for strong defence.

The defence expenditure is thus continuously rising. It contains expenditure on war

materials, maintenance and growth of armed forces, naval and air wings, expenses on the development of military art and practice, pensions to retired war personnel, interests on war debt, cost of rehabilitation, etc.

4. Resource Mobilisation and Ability to Finance:

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

5. Inflation:

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

6. The Role of Democracy and Socialism:

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

The number of ministries and executive offices has also been increasing. Further, the ruling party has to fulfill its promises and launch upon new policies and programmes to achieve socialist objectives, in order to create a favourable image in the public. This also requires increasing State expenses in order to provide new amenities and opportunities to the people at large.

7. The Urbanisation Effect:

The spread of urbanisation is an important factor leading to the relative growth of public expenditure in modern times. With the growth of urban areas, there has been an increasing tendency of expenditure on civil administration.

Expenses on water supply, electricity, provision of transport, maintenance of roads, schools and colleges, traffic controls, public health, parks and libraries, playgrounds, etc. have increased enormously these days. Likewise, the expenditure on courts, prisons etc. is increasing, especially in the urban sector.

8. The Rural Development Effect:

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

9. The Population Effect:

A high growth of population naturally calls for increase in the expenses as all State functions are to be performed more extensively. Rising population also poses various problems in poor countries.

The State will have the added responsibility of solving such problems as food, unemployment, housing and sanitation. Further, overpopulated countries like India will have to check the population growth. The State has, therefore, to spend more and more on family planning campaigns every year.

10. The Growth of Transport and Communication:

With the expansion of trade and commerce, the State has to provide and maintain a quick and efficient transport system. Transport being a public utility, the State has to provide it cheaply also. Hence, railway and passenger transport is nationalized.

Government has, therefore, to run transport services even at a loss. This obviously calls for a high expenditure for maintenance and expansion. Further, the government in a poor country has to spend a lot on constructing new railway lines, new roads, national highways, bridges and even canals to connect the different areas with a smooth transport system as a precondition of growth.

11. The Planning Effect:

In a less developed economy, the government adopts economic planning for the development of the country. In a planned economy, thus, when the public sector is expanding its role, public expenditure obviously shows an increasing trend.

12. Rise in price level:

Rises in prices have considerably enhanced public expenditure in recent years. Higher prices mean higher spending on the part of the govt. on items like payment of salaries, purchase of goods and services and so on.

13. Expansion public sector:

Counties aiming at socialistic pattern of society have to give more importance to public sector. Consequent development of public sector enhances public expenditure.

14. Public debt:

Along with debt rises the problem like payment of interest and repayment of the principal amount. This results in an increase in public expenditure.

15. Grants and loans to state governments and UTs:

It is an important feature of public expenditure of the central government of India. The government provides assistance in the forms of grants-in-aid and loans to the states and to the UTs.

16. Poverty alleviation programs:

As poverty ratio is high, huge amount of expenditure is required for implementing alleviation programmes.

CONTROL OF PUBLIC EXPENDITURE IN INDIA

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

I. Administrative Control:

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

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

II. Audit Control:

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

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

DUTIES AND POWERS OF AUDITOR GENERAL

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

- He audits and reports all transactions of the Central and States relating to debt, deposits, sinking funds, advances, etc.,
- He is responsible for keeping accounts for the centre except those relating to defence and railways.
- He prepares each year's accounts showing the annual receipts and disbursements.

III. Parliamentary Control:

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

a. Committee of Public Undertakings:

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

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

b. Public Accounts Committee :

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

c. Estimates Committee :

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

- To report the economic improvements in organizations and administrative reforms which are necessary.
- To suggest alternative policies in order to bring about Efficiency and economy in administration.
- Examines whether money is allotted within the limits of the policies.

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

Conclusion :

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

PUBLIC REVENUE

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

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

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

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

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

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

Public Revenue constitutes an important branch of Public Finance.

SOURCES OF PUBLIC REVENUE

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

1. Taxes

Meaning and Definition :

Taxes form the most important part of the revenues of any State."A tax is a compulsory contribution of wealth of person or body of persons for the services of public powers" (**Bastable**).

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

Characteristics of a Tax :

A tax possesses the following three important characteristics.

- A tax is a compulsory contribution from the citizen to the public authority. Refusal on the part of the tax payer to a particular tax to the public authority is liable for punishment by the court of law.

- A tax imposes a personal obligation on the tax payer. The tax payer has the obligation to show of all his incomes to the government and pay the eligible amount of tax to the government. He should not hide the particulars of his income and evade payment of tax.

- The tax revenues are spent for the general and common benefit.

2. Fees

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

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

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

Examples :-

- Court Fees,

- Registration fees for legal documents, Gun license fees,

- Contract fees for marriages, mortgages deeds, etc., Fees paid into the postal dept,

- Copy right of books, Issue of passports,

- State inspection of weights and measure, etc.,

3. Licenses

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

4. Fines and Forfeitures

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

5. Escheats

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

6. Special Assessments

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

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

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

- They are capable of apportionment.

7. Receipts from public property

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

8. Receipts from public enterprises

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

9. Public Borrowings

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

10. Receipts from the use of the printing press

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

11. Grants and Gifts

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

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

CLASSIFICATION OF PUBLIC REVENUE

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

1. Adam Smith's classification:

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

2. Bastable's classification:

Bastable also classified public revenue into two parts.

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

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

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

3. Adam's classification :

Prof. Adam has divided public revenue into three groups.

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

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

c) **Anticipatory revenue :** It refers to the anticipated income of the government obtained through sale of treasury bills, floating new loans, etc.,

This classification is also defective in the sense that it include both commercial and administrative revenues which are fundamentally different in nature.

4. Seligman's classification :

Seligman has divided public revenue into three parts.

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

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

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

5. Lutz's classification :

Lutz has classified public revenue into six categories.

a) Commercial revenue

b) Administration revenue

c) Taxation

d) Public debt

e) Subventions and grants

f) Book keeping revenues or transfers

The last three are not included in public revenue today.

6. Prof. Shirras's classification:

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

a)**Tax Revenue :** It is an important source of revenue and it includes fees and special assessments. It is called as "revenue from the people" by Adam Smith and as "derivative revenue" by Adam. A special assessment is defined as a "a compulsory contribution levied in proportion to the special benefits derived, to defray the cost of a specific improvement to property undertaken in the public interest". Fees refer to revenue obtained from monopoly enterprises.

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

7. Taylor's classification :

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

a) Grants and gifts.

b) Administrative revenue

c) Commercial revenues

d) Taxes

a) Grants and gifts:

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

b) Administrative Revenue:

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

c) Commercial Revenue:

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

d) Taxes:

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

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

8. Economic classification:

Since all these classifications are not suitable for making economic interpretations, comparative study of income and expenditure and for analysing various aspects, an economic classification of the budgetary transactions was adopted in India in 1957-58. This classification divides income and expenditure into Revenue Account and Capital Account.

Revenue account includes tax revenue and non-tax revenue. Market borrowings, external assistance, small savings, provident funds are all included in Capital Account.

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

FEDERAL FINANCE

PRINCIPLES OF FEDERAL FINANCE

Prof .B.P. Adarkar, mentioned three principles of federal finance in his book "Problems of Federal Finance". These and other principles which are obeyed to achieve the above objectives are analyzed below:

1. Principles of independence and responsibility

Related to this prof. B.P. Adarakar says first that federal and state both the government should be given all arrangements to do financial management through which they can not experience any obstacle to fulfil their social and economic objectives. This means that central and state government should possess their private and independent finance resources, which should be sufficient to complete their works. In other words it can be said that central and state government should be independent of the financial matter in this fields. Except this, every government should take responsibility of imposing tax, collection of debt and increasing sources of income so that they can smoothly run the development works of his area.

2. Principle of adequacy and elasticity

In regard of federal finance system Prof. B.P. Adarkar gives more importance to the principle of Adequacy and elasticity. According to this principle state and central government should have finance resources in adequate manner. So that government of every level can easily fulfill its responsibility. In other words, this means that every government should possess sufficient resources of income which can help them to fulfill their work and duties which are assigned to them. According to the Australia's high court former judge Sir John Lothem, "If one federal system wants to exist as a full independent government then state should have adequate resources to fulfill their responsibilities."

3. Principle of administrative economy

Prof. B.P. Aderkar have force third principle which is a principle of administrative economy according to them it is necessary for federal state and for their financial matter's success that in the arrangement of financial resources the cost should be minimum and there should be no tax evasion or diplomacy in it. While dividing the resources it should be seen that which resources can be prepared better by the central or state government, Corruption

and forceful entry should be popped and every resources must be used for the increase in income. Except this, taxes should be applied in the manner so that it will not affect industries and business infect it increases employment and tax evasion lowers down. Prof. Seligman said while talking about the principle of administrative economy, "No matter the planning is more useful, but if its administration is not correct then it will surely become unsuccessful."

4. Principle of uniformity

In the federal system, uniformity means to give equal part of tax to every government that work which is essential for every state, to tolerate its burden, all the states government give equal part of tax to the central government on the basis of equality or apply equal tax rate on the citizens of the states through central government which imposing taxes every citizen should be treated in an equal manner which doing public expenditure, central government should also behave equali with all the citizen. But this equality is not possible in fiscal policy as the sources of every level and their expenditure is not same. Resource and needs of every state is different. Yes, it may possible that while giving taxes every citizen of one state should not be given special facilities or discount as compared to another state.

5. Principle of equity

The principle of equity is an important principle in taxation, which Adam Smith stated. To implement this principle in federal finance system is an important things, because according to this principle the distribution of resources in federal and states create the state of inequality which can spoil the whole structure. There can be difference in level of economic development of different states of a federal, but if taxation is done according to this principle then the burden of taxes in different states will be different. Because, marginal sacrifice will be different in different states. The marginal sacrifice of taxpayers of rich states will be less in comparison to those states which are relatively poor, Therefore, the need arises that taxes of central and state government must be coordinated in such a way that marginal sacrifice must be equal or approximately equal due to both type of taxes on every taxpayer, whether they live in any state. In means that taxes of center and state governments must be included in such a way, by which the burden of taxes must be equal or approximately equal on every citizen.

6. Principle of integration and coordination

A federal finance arrangement should be like that every unit coordinated with one another and no a unit separate from whole arrangement. It is necessary for an efficient system. Regarding this one more thing is there that principle of integration and coordination is not limited only for taxes. Coordination of Budget, Assets, expenditure and other related activities must be there between union and state.

7. Principle of accountability

Federal finance system and democracy are like sisters in a federal government. Every government is responsible for applying taxes and giving accounts to his MLAs, this means about imposing by the government taxes or expenditure and MLAs have the right to take accounts. But, government has to take care of other government that what impact they have on them.

8. Principle of fiscal access

Central and state government should not be any restriction from increasing their sources of income as they have to fulfill their increasing needs. This means that with the increasing of government responsibility, their sources should also be increased.

9. Principle of transfer of resources.

This principle means that the state which is rich, their income should be given to the poor states so that every person of every state can lead a minimum life standard. Its objective is that person of a country should lead a life standard which is below of it. This means that no person can get lower life standard below the national standard. Dr. B.R. Mishra had written in his book 'Indian federal finance that the division of resources between central and state should be based on the principle of 'National minimum, this can be possible by the income transfer of rich states to the poor ones. The main objective of this transfer is to lower down the inequality because economic inequality is not beneficial to the national welfare. Activities of the Revenue can lessen down the inequality.

10. Re-allocation of resources

Every state should division their resources in a type so that centre and state can get enough money and can complete their objectives efficiently. But this kind of division is not simple. There is no solid point on the basis which can say that the division is favorable. A line between state and central government resources is not easy to draw.

When the decision takes place between centre and state then there are some resources on which central government have the rights and some resources are given to the state and some are given to both of them. These kinds of resources lie in concurrent list. In concurrent areas disputes occur which solved according to the constitution. Generally, right is given to the central government that it limits the tax, its procedure and arrangement and which the state that in government have to follow.

In this way, it is clear that in relation to the concurrent list central government forms a structure and under this, state government makes rules and applies taxes. One thing has to clear that with the time situation also changes and because of this no definite division can take place. So the solution of the division of resources cannot be limited to one changing situation can be re-divided. In the end, it can only that the division of the resources should be done in such a way from which maximum use of resources and can also increase the economic development rate and can lower down the income inequality.

STATES FINANCE

An important feature of a federal government is that in this division of power between state and central takes place, their work is also divided some work are under concurrent list like economic and social planning, Trade and industrial right, workers welfare in which their working planning is also included like – price control, education, irrigation and electricity, etc.

These taxes on which states have right are—Land Revenue, Tax on Agriculture, Tax on house and resources and on opium, alcohol and on production of alcoholic medicines and Indian Bhaang. In the British period Land administration was given the name of Land settlement and this was fixed after the survey and division of Business. Those who earn same income and are under the category of Direct taxes they should be confirmed first the source and form of their money.

Types of Division

Tax jurisdiction is clearly divided between central and state government. It has been done in this way to try to stop duplication and expiration for this tax was calculated and after that they were given to central and state governments. If any tax is left then it will be paid to the central government. Generally, these taxes which are of international level comes under legislative authority of central government and those which are of local level, come under legislative authority of states.

Functions and resources

One of the important factors of central government is that function and resources are divided between states and central government. That is why in Indian constitution some works are given to the state. The main aim of this division is to do the work independently without any struggle. In this way it is clear that centre government should be given sufficient resources. It is also essential that state should not be dependent on centre for its income and also centre should not interfere in states autonomy. So now we understand the functions and resources which are given to the states by the Constitution, to work independently and how far they are successful and what problems are they facing.

Functions

Discussions on Power and Resources are already took place but to clarify them more, here a brief description is given .

Functions of the central Government Work which are under centre are: Defence, foreign matters, trade, Railway, Currency, Post offices, and Telegraph, Regulations of international trade and Business, Regulations of international rivers and project progress, insurance, nuclear power, elections and audited account.

Functions of state Government The responsibilities which are under state government are: establishment of law and order, water, Police, administration of justice, public health, Hospitals, Production of alcohol products, construction and sales, education, Agriculture and its related problems large and small scale industries like Handicraft etc. Forest and responsibility of social welfare and its laws.

Concurrent functions

Some subjects are under concurrent list like-economic and social planning; Business and industrial Rights, Labour controversy and Welfare and work of workers are also included. Price control, education, irrigation and electricity etc. Some of the other works are also included in this list like to make law on any subject which is also a part of parliament. This means the topics which are covered in this list are the responsibility of both centre and state.

But behaviourly it is seen that mostly central government takes charge or give grants for these topics, but the responsibility of their control and progress is on the state government union taxes

The heads of union list are divided in five categories

1) Completely central head included customs duties, Corporation tax, tax on assets except individuals and Companies and Agricultural land According to the Article 271 surcharge of income tax is also a completely central head.

2) Except Agriculture income, taxes on other income. Centre imposed taxes and also collects them but it has to give apart of income tax to the states as per the finance commission recommendations

3) Except Alcohol and Drugs other taxes are collected by the federal excise duty and also collects them. But if parliament wants then it can distribute some part to the states.

4) There are also taxes which are collected by the union government and completely distributed by the parliament among and taxes like excise duty, terminal tax on products which comes or goes through Air and water ways, Train fare, Sale and purchase of newspapers and on international trade.

5) These taxes which are imposed by the centre but collected by the state and state itself keep them like cheques, stamped duty and alcohol used cosmetics excise duty.

States taxes

On those taxes which have legislative power of states and have the right to collect taxes they are Land Revenue, Agriculture tax estate duty of Agricultural land, Tax on opium Indian Bhaang and Alcoholic medicines and products and Excise duty on Investment except

this Tax on Consumer goods on local place, Tax on electricity consumption and Sales Tax, Tax on Vehicles, Animals and on Boats, Except newspaper Tax on other advertisements, on Roads or travelers, goods of internal water ways, Terminal Tax, Stamped duty and Tax on Employment, Capitation Tax, Tax on luxurious and entertainment items. States are also assessed stamped duty and Registration fee.

Land revenue

From the olden times Land Revenue is one of the important sources of income of the state. In this way in states taxes it is considered as the oldest tax. When it was applied from then onwards system of Land Revenue and debit tax had a huge difference while calculating them between states. But then also it is one of the important taxes of states as it is one of the important taxes so it creates an impact on different times.

Different System of Settlement In the British time different Systems of settlement were popular in India which were (1) Permanent settlement – in which the interest rate fixed of Land Revenue. (2) temporary settlement – In this interest rate of land Revenue was fixed for a time period. This can be further divided into three parts (a) Zamindari system – In which interest rate was fixed by the Zamindars. (b) mahalwadi system – In this interest rate of land revenue of a village or palace was different for the whole rural community.(c) raiyatwadi system – In this land revenue was fixed according to the land size.

Federal Finance

Federal finance refers to the system of assigning the source of revenue to the Central as well as State Governments for the efficient discharge of their respective functions i.e. clear-cut division is made regarding the allocation of resources of revenue between the central and state authorities.

1. **Division of Powers**: In our Constitution, there is a clear division of powers so that none violates its limits and tries to encroach upon the functions of the other and functions within own sphere of responsibilities. There are **three lists** enumerated in the **Seventh Schedule of constitution.** They are: the Union list, the State list and the Concurrent List.

2. The **Union List** consists of 100 subjects of national importance such as Defence, Railways, Post and Telegraph, etc.

3. **The State List** consists of 61 subjects of local interest such as Public Health, Police etc.

4. The **Concurrent List** has 52 subjects important to both the Union and the State, such as Electricity, Trade Union, Economic and Social Planning, etc.

CENTRAL STATE FINANCIAL RELATIONSHIP

(I) Union Sources

1. Corporation tax
2. Currency, coinage and legal tender, foreign exchange.
3. Duties of customs including export duties.
4. Duties of excise on tobacco and certain goods manufactured or produced in India.
5. Estate duty in respect of property other than agricultural land.
6. Fees in respect of any of the matters in the Union List, but not including any fees taken in any Court.
7. Foreign Loans.
8. Lotteries organized by the Government of India or the Government of a State.
9. Post Office Savings Bank.
10. Posts and Telegraphs, telephones, wireless, Broadcasting and other forms of communication.
11. Property of the Union.
12. Public Debt of the Union.
13. Railways.
14. Rates of stamp duty in respect of Bills of Exchange, Cheques, Promissory Notes, etc.
15. Reserve Bank of India.
16. Taxes on income other than agricultural income.
17. Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies.
18. Taxes other than stamp duties on transactions in stock exchanges and future markets.
19. Taxes on the sale or purchase of newspapers and on advertisements published therein.
20. Terminal taxes on goods or passengers, carried by railways, sea or air.

(II) State Sources

1. Capitation tax
2. Duties in respect of succession to agricultural land.
3. Duties of excise on certain goods produced or manufactured in the State, such as alcoholic liquids, opium, etc.
4. Estate duty in respect of agricultural land.
5. Fees in respect of any of the matters in the State List, but not including fees taken in any Court.
6. Land Revenue.
7. Rates of stamp duty in respect of documents other than those specified in the Union List.
8. Taxes on agricultural income.
9. Taxes on land and buildings.
10. Taxes on mineral rights, subject to limitations impose by Parliament relating to mineral development.
11. Taxes on the consumption or sale of electricity.
12. Taxes on the entry of goods into a local area for consumption, use or sale therein.
13. Taxes on the sale and purchase of goods other than newspapers.
14. Taxes on the advertisements other than those published in newspapers.
15. Taxes on goods and passengers carried by road or on inland waterways.
16. Taxes on vehicles.
17. Taxes on animals and boats.
18. Taxes on professions, trades, callings and employments.
19. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
20. Tolls.

(III) Taxes Levied and Collected by the union but Assigned to the States (Art.269)

1. Duties in respet of succession to property other than agricultural land.

2. Estate duty in respect of property other than agricultural land.
3. Taxes on railway fares and freights.
4. Taxes other than stamp duties on transactions in stock exchanges and future markets.
5. Taxes on the sale or purchase of newspapers and on advertisements published therein
6. Terminal taxes on goods or passengers carried by railways, sea or air.
7. Taxes on the sale or purchase of goods other than newspapers where such sale or purchase taxes place in the course of inter-State trade or commerce.

(IV) Duties levied by the Union but collected and Appropriated by the states (Art.268)

Stamp duties and duties of excise on medicinal and toilet preparation (those mentioned in the Union List) shall be levied by the Government of India but shall be collected.

1. In the case where such duties are leviable within any Union territory, by the Government of India.
2. In other cases, by the States within which such duties are respectively leviable.
3. Taxes which are Levied and Collected by the Union but which may be Distributed between the Union and the States (Arts.270 and 272)
4. Taxes on income other than agricultural income.
5. Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List and collected by the Government of India.
6. “Taxes on income” does not include corporation tax. The distribution of income-tax proceeds between the Union and the States is made on the recommendations of the Finance Commission.

FINANCE COMMISSION

What is the Finance Commission?

Finance Commission is a constitutional body, that determines the method and formula for distributing the tax proceeds between the Centre and states, and among the states.

The Finance Commission also decides the share of taxes and grants to be given to the local bodies in states. This part of tax proceeds is called Finance Commission Grants, which is a part of the Union budget.

The Finance Commission has a chairman and four members appointed by the President of India.

15th Finance Commission: Recommendations

The **Fifteenth Finance Commission** (**XV-FC** or **15-FC**) is an Indian Finance Commission constituted in November 2017 and is to give recommendations for devolution of taxes and other fiscal matters for five fiscal years, commencing 2020-04-01. The commission's chairman is Nand Kishore Singh, with its full-time members being Ajay Narayan Jha, Ashok Lahiri and Anoop Singh. In addition, the commission also has a part- time member in Ramesh Chand. Shaktikanta Das served as a member of the commission from November 2017 to December 2018.

Know the recommendations of the 15th Finance Commission.

The Finance Commission (FC) is constituted by the President of India every fifth year under Article 280 of the Constitution.

The Fifteenth Finance Commission (XV-FC) was constituted in November 2017 to give recommendations for vertical and horizontal devolution of taxes for five fiscal years, commencing 1 April 2020.

15th Finance Commission

The 15th Finance Commission was constituted by the President of India in November 2017, under the chairmanship of NK Singh. Its recommendations will cover a period of five years from April 2020 to March 2025.

Terms of Reference of XV-FC

XV- FC is mandated to give **recommendations** regarding

- The distribution between the Union and the States of the net proceeds of taxes which are to be divided between them.
- The allocation between the States of the respective shares of such proceeds.
- The principles which should govern the grants in aid of the revenues of the States out of the Consolidated Fund of India.
- The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State based on the recommendations

made by the Finance Commission of the State.

The Commission shall review the current fiscal status of the Union and the States, and recommend a fiscal consolidation roadmap. The Commission may also examine whether revenue deficit grants be provided at all.

While making the recommendations, the XV-FC may consider

- Resources of Central and State governments and their potential and fiscal capacity.
- Demand on the resources of respective governments.
- Impact of the enhanced devolution following 14th FC on the fiscal situation.
- Impact of GST and compensation for the losses in revenues for 5 years.

The Commission may consider **proposing performance-based incentives to the States** based on

- Efforts made in expansion and deepening of tax net under GST.
- Efforts and progress made in moving towards the replacement rate of population growth.
- Achievements in the implementation of flagship schemes of Government of India, disaster-resilient infrastructure, and sustainable development goals.
- Progress made in increasing capital expenditure, eliminating losses of the power sector, and improving the quality of such expenditure in generating future income streams.
- Progress made in increasing tax/non-tax revenues.
- Promoting savings by the adoption of Direct Benefit Transfers and Public Finance Management System.
- Promoting digital economy and removing layers between the government and the beneficiaries.
- Progress made in promoting ease of doing business and promoting labour-intensive growth.
- Provision of grants in aid to local bodies for basic services and implementation of a performance grant system in improving the delivery of services.
- Control or lack of it in incurring expenditure on populist measures.
- Progress made in sanitation, solid waste management and bringing in a behavioural change to end open defecation.

The Commission shall use the population data of 2011 while making its recommendations.

The Commission may review the present arrangements on financing Disaster Management initiatives regarding the funds constituted under the Disaster Management Act, 2005.

Controversies associated with the 15th Finance Commission

The Terms of Reference (ToR) of the 15th Finance Commission were **opposed by some States**. The main apprehensions were:

- Progressive states would lose heavily if the population-based on the 2011 census was considered for the devolution of central funds.
- States that have performed well on population control would be penalized.
- Previous FCs used 1971 Census numbers while the 14th commission had given weight to both the 1971 (17.5%) and 2011 (10%) censuses.
- Some states have a higher potential in expanding the GST tax base while others do not. Hence the performance on this parameter cannot be a basis for fund devolution.
- Many states run social sector schemes which are welfare-oriented. If these schemes are considered populist, these States will be penalized.
- States are already under the burden of GST and devolution based on the 2011 Census will further constrain the fund position of the States.
- States resent a devolution criterion that considers the implementation of Central schemes, as tax devolution is their constitutional right and not a largesse of the Central government.
- Since revenue deficit grants are proposed to be re-looked, there may be a reduction in the fiscal autonomy of the States and conditions for borrowing from external sources will also be reviewed.

These apprehensions were addressed by the Centre which said that there is no regional bias and that poorer States rely more on Centre’s revenue than developed ones. Regarding the shift to Census 2011 numbers, it was mentioned that efforts made towards reducing population growth rate towards replacement rate were also included which balances the equation.

REPORT OF THE 15TH FINANCE COMMISSION FOR FY 2020-21

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

- February 1, 2020. The final report with recommendations for the 2021- 26 period will be submitted by October 30, 2020.

Key recommendations in the first report (2020-21 period) include:

- **Devolution of taxes to states:** The share of states in the centre's taxes is recommended to be decreased from 42% during the 2015-20 period to 41% for 2020-21. The 1% decrease is to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the central government. The individual shares of states from the divisible pool of central taxes is provided in Table 3 in the annexure.

Criteria for devolution

Table 1 below shows the criteria used by the Commission to determine each state's share in central taxes, and the weight assigned to each criterion. We explain some of the indicators below.

Criteria for devolution (2020-21)

Criteria	14th FC 2015-20	15th FC 2020-21
Income Distance	50.0	45.0
Population (1971)	17.5	-
Population (2011)	10.0	15.0
Area	15.0	15.0
Forest Cover	7.5	-
Forest and Ecology	-	10.0
Demographic Performance	-	12.5
Tax Effort	-	2.5
Total	**100**	**100**

Sources: Report for the year 2020-21, 15th Finance Commission; PRS.

- **Income distance:** Income distance is the distance of the state's income from the state with the highest income. The income of a state has been computed as average per capita GSDP during the three-year period between 2015-16 and 2017-18. States with lower per capita income would be given a higher share to maintain equity among states.

- **Demographic performance:** The Terms of Reference (ToR) of the Commission required it to use the population data of 2011 while making recommendations. Accordingly, the Commission used only 2011 population data for its recommendations.
- The Demographic Performance criterion has been introduced to reward efforts made by states in controlling their population. It will be computed by using the reciprocal of the total fertility ratio of each state, scaled by 1971 population data. States with a lower fertility ratio will be scored higher on this criterion. The total fertility ratio in a specific year is defined as the total number of children that would be born to each woman if she were to live to the end of her child-bearing years and give birth to children in alignment with the prevailing age-specific fertility rates.
- **Forest and ecology:** This criterion has been arrived at by calculating the share of dense forest of each state in the aggregate dense forest of all the states.
- **Tax effort:** This criterion has been used to reward states with higher tax collection efficiency. It has been computed as the ratio of the average per capita own tax revenue and the average per capita state GDP during the three-year period between 2014-15 and 2016-17.

Grants-in-aid

In 2020-21, the following grants will be provided to states: (i) revenue deficit grants, (ii) grants to local bodies, and (iii) disaster management grants. The Commission has also proposed a framework for sector-specific and performance-based grants. State-specific grants will be provided in the final report.

- **Revenue deficit grants:** In 2020-21, 14 states are estimated to have an aggregate revenue deficit of Rs 74,340 crore post-devolution. The Commission recommended revenue deficit grants for these states (see Table 4 in the annexure).
- **Special grants:** In case of three states, the sum of devolution and revenue deficit grants is estimated to decline in 2020-21 as compared to 2019-20. These states are Karnataka, Mizoram, and Telangana. The Commission has recommended special grants to these states aggregating to Rs 6,764 crore.
- **Sector-specific grants:** The Commission has recommended a grant of Rs 7,375 crore for nutrition in 2020-21. Sector-specific grants for the following sectors will be provided in the final report: (i) nutrition, (ii) health, (iii) pre-primary education, (iv) judiciary, (v) rural connectivity, (vi) railways, (vii) police training, and (viii) housing.
- **Performance-based grants**: Guidelines for performance-based grants include: (i) implementation of agricultural reforms, (ii) development of aspirational districts and

- blocks, (iii) power sector reforms, (iv) enhancing trade including exports, (v) incentives for education, and (vi) promotion of domestic and international tourism. The grant amount will be provided in the final report.

- **Grants to local bodies:** The total grants to local bodies for 2020-21 has been fixed at Rs 90,000 crore, of which Rs 60,750 crore is recommended for rural local bodies (67.5%) and Rs 29,250 crore for urban local bodies (32.5%). This allocation is 4.31% of the divisible pool. This is an increase over the grants for local bodies in 2019-20, which amounted to 3.54% of the divisible pool (Rs 87,352 crore). The grants will be divided between states based on population and area in the ratio 90:10. The grants will be made available to all three tiers of Panchayat- village, block, and district.

- **Disaster risk management:** The Commission recommended setting up National and State Disaster Management Funds (NDMF and SDMF) for the promotion of local- level mitigation activities. The Commission has recommended retaining the existing cost-sharing patterns between the centre and states to fund the SDMF (new) and the SDRF (existing). The cost-sharing pattern between centre and states is (i) 75:25 for all states, and (ii) 90:10 for north-eastern and Himalayan states.

For 2020-21, State Disaster Risk Management Funds have been allocated Rs 28,983 crore, out of which the share of the union is Rs 22,184 crore. The National Disaster Risk Management Funds has been allocated Rs 12,390 crore.

Grants for disaster risk management (In Rs crore)

Funding Windows	National corpus	States' corpus
Mitigation (20%)	2,478	5,797
Response (80%)	9,912	23,186
(i) Response and Relief (40%)	4,956	11,593
(ii) Recovery and Reconstruction (30%)	3,717	8,695
(iii) Capacity Building (10%)	1,239	2,998
Total	**12,390**	**28,983**

Sources: Report for the year 2020-21, 15th Finance Commission; PRS.

Recommendations on fiscal roadmap

- **Fiscal deficit and debt levels:** The Commission noted that recommending a credible fiscal and debt trajectory roadmap remains problematic due to uncertainty around the

- economy. It recommended that both central and state governments should focus on debt consolidation and comply with the fiscal deficit and debt levels as per their respective Fiscal Responsibility and Budget Management (FRBM) Acts.

- **Off-budget borrowings:** The Commission observed that financing capital expenditure through off-budget borrowings detracts from compliance with the FRBM Act. It recommended that both the central and state governments should make full disclosure of extra-budgetary borrowings. The outstanding extra-budgetary liabilities should be clearly identified and eliminated in a time-bound manner.

- **Statutory framework for public financial management:** The Commission recommended forming an expert group to draft legislation to provide for a statutory framework for sound public financial management system. It observed that an overarching legal fiscal framework is required which will provide for budgeting, accounting, and audit standards to be followed at all levels of government.

- **Tax capacity:** In 2018-19, the tax revenue of state governments and central government together stood at around 17.5% of GDP. The Commission noted that tax revenue is far below the estimated tax capacity of the country. Further, India's tax capacity has largely remained unchanged since the early 1990s. In contrast, tax revenue has been rising in other emerging markets. The Commission recommended:
(i) broadening the tax base, (ii) streamlining tax rates, (iii) and increasing capacity and expertise of tax administration in all tiers of the government.

- **GST implementation:** The Commission highlighted some challenges with the implementation of the Goods and Services Tax (GST). These include: (i) large shortfall in collections as compared to original forecast, (ii) high volatility in collections, (iii) accumulation of large integrated GST credit, (iv) glitches in invoice and input tax matching, and (v) delay in refunds. The Commission observed that the continuing dependence of states on compensation from the central government (21 states out of 29 states in 2018-19) for making up for the shortfall in revenue is a concern. It suggested that the structural implications of GST for low consumption states need to be considered

Other recommendations

- **Financing of security-related expenditure:** The ToR of the Commission required it to examine whether a separate funding mechanism for defence and internal security should be set up and if so, how it can be operationalised. In this regard, the Commission intends to constitute an expert group comprising representatives of the Ministries of Defence, Home Affairs, and Finance. The Commission noted that the Ministry of Defence proposed following measures for this purpose: (i) setting up of a non-lapsable fund, (ii) levy of a cess, (iii) monetisation of surplus land and other assets, (iv) tax-free

- defence bonds, and (v) utilising proceeds of disinvestment of defence public sector undertakings. The expert group is expected to examine these proposals or alternative funding mechanisms.

Share of states in the centre's taxes

State	14th Finance Commission		15th Finance Commission		Devolution for FY 2020-2021
	Share out of 42%	Share in divisible pool	Share out of 41%	Share in divisible pool	(In Rs crore)
Andhra Pradesh	1.81	4.31	1.69	4.11	35,156
Arunachal Pradesh	0.58	1.38	0.72	1.76	15,051
Assam	1.39	3.31	1.28	3.13	26,776
Bihar	4.06	9.67	4.13	10.06	86,039
Chhattisgarh	1.29	3.07	1.4	3.42	29,230
Goa	0.16	0.38	0.16	0.39	3,301
Gujarat	1.3	3.1	1.39	3.4	29,059
Haryana	0.46	1.1	0.44	1.08	9,253
Himachal Pradesh	0.3	0.71	0.33	0.8	6,833
Jammu and Kashmir	0.78	1.86	-	-	-
Jharkhand	1.32	3.14	1.36	3.31	28,332
Karnataka	1.98	4.71	1.49	3.65	31,180
Kerala	1.05	2.5	0.8	1.94	16,616

GSECO20-21

Madhya Pradesh	3.17	7.55	3.23	7.89	67,439
Maharashtra	2.32	5.52	2.52	6.14	52,465
Manipur	0.26	0.62	0.29	0.72	6,140
Meghalaya	0.27	0.64	0.31	0.77	6,542
Mizoram	0.19	0.45	0.21	0.51	4,327
Nagaland	0.21	0.5	0.23	0.57	4,900
Odisha	1.95	4.64	1.9	4.63	39,586
Punjab	0.66	1.57	0.73	1.79	15,291
Rajasthan	2.31	5.5	2.45	5.98	51,131
Sikkim	0.15	0.36	0.16	0.39	3,318
Tamil Nadu	1.69	4.02	1.72	4.19	35,823
Telangana	1.02	2.43	0.87	2.13	18,241
Tripura	0.27	0.64	0.29	0.71	6,063
Uttar Pradesh	7.54	17.95	7.35	17.93	1,53,342
Uttarakhand	0.44	1.05	0.45	1.1	9,441
West Bengal	3.08	7.33	3.08	7.52	64,301
Total	**42**	**100**	**41**	**100**	**8,55,176**

Sources: Reports of 14th and 15th Finance Commission; PRS.

GSECO20-21

Some of the grants-in-aid for FY 2020-21 (in Rs crore)

State	Revenue deficit grants	Grants to rural local bodies	State's share in grants for rural local bodies	Grants to urban local bodies	State's share in grants for urban local bodies
Andhra Pradesh	5,897	2,625	4.32	1264	4.32
Arunachal Pradesh	-	231	0.38	111	0.38
Assam	7,579	1,604	2.64	772	2.64
Bihar	-	5,018	8.26	2,416	8.26
Chhattisgarh	-	1,454	2.39	700	2.39
Goa	-	75	0.12	36	0.12
Gujarat	-	3,195	5.26	1538	5.26
Haryana	-	1,264	2.08	609	2.08
Himachal Pradesh	11,431	429	0.71	207	0.71
Jharkhand	-	1,689	2.78	813	2.78
Karnataka	-	3,217	5.29	1549	5.29
Kerala	15,323	1,628	2.68	784	2.68
Madhya Pradesh	-	3,984	6.56	1,918	6.56
Maharashtra	-	5,827	9.59	2,806	9.59
Manipur	2,824	177	0.29	85	0.29
Meghalaya	491	182	0.3	88	0.3
Mizoram	1,422	93	0.15	45	0.15
Nagaland	3,917	125	0.21	60	0.21
Odisha	-	2,258	3.72	1087	3.72

GSECO20-21

Punjab	7,659	1,388	2.29	668	2.29
Rajasthan	-	3,862	6.36	1,859	6.36
Sikkim	448	42	0.07	20	0.07
Tamil Nadu	4,025	3,607	5.94	1737	5.94
Telangana	-	1,847	3.04	889	3.04
Tripura	3,236	191	0.31	92	0.31
Uttar Pradesh	-	9,752	16.05	4,695	16.05
Uttarakhand	5,076	574	0.95	278	0.95
West Bengal	5,013	4,412	7.26	2,124	7.26
Total	**74,341**	**60,750**	**100**	**29,250**	**100**

Sources: Report for the year 2020-21, 15th Finance Commission; PRS.

UNIT – III

PUBLIC DEBT

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

CLASSIFICATION OF PUBLIC DEBT

I. Internal debt and External debt:

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

II. Productive and Unproductive Debt:

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

III. Redeemable and Irredeemable Debt:

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

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

IV. Funded and Unfunded Debt :

Funded debts are long term debt the payment of those may be made at least after a year

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

V. Voluntary and Compulsory Loans:

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

CAUSES OF PUBLIC DEBT

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

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

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

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

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

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

Seventhly borrowing is also undertaken for financing public enterprises

THE BURDEN OF PUBLIC DEBT

The burden of public debt refers to the sacrifice it will impose on the community through a raise in taxation for the payment of interest. The burden of public debt may be direct and indirect. Direct money burden is measured by the extent of money involved and the raise in

taxation needed. Direct real burden is equal to the loss of economic welfare (Sacrifice of goods and services made by the tax payers) on account of the direct money burden of increased taxation. Indirect burden of public debt refers to the extent of adverse effect of increased taxation on the level of production.

Burden of Internal Debt

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

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

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

Burden of External Debt

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

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

REDEMPTION OF PUBLIC DEBT OR METHODS OF REPAYMENT

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

- First of all it saves the Government from bankruptcy,
- Secondly it discourages extravagant expenditure of the Government,
- Thirdly it maintains the confidence of the lenders,
- Fourthly it saves the future generation from the burden of debt.

METHODS OF REPAYMENT

1) REPUDIATION:

It means refusal to pay a debt by governments. This method was followed by the USA after the civil war and by the USSR after the 1917 Revolution. This method is undesirable and has not been used recently anywhere in the world. Repudiation shakes the confidence of the people in public debt and many provoke retaliation from creditor countries. But in modern democratic days this method is not possible because contracts have to be accepted and respected. If one country repudiates an external debt other countries will not have trade relationship with that country.

2) REFUNDING:

Refunding is the process of replacing maturing securities with new securities. In some cases the bonds may be redeemed before the maturing date when the government intends to rearrange the maturity of outstanding debts or when current rate of interest is low.

Generally, short-term borrowings are made in anticipation of tax collections for meeting current expenditure. However, excessive burden of new expenditure does not permit the retirement of the debt by means of revenue newly raised or by means of long term borrowing. Thus, there is necessity of refunding the loans by old lenders and renewing the loans at lower rate of interest for future period. The drawback of this method is that government is tempted to postpone its obligation of debt redemption. This leads to a continuous increase in the burden of public debt in future.

3) CONVERSION OF LOANS:

It is a special type of refunding. Conversion of existing securities into new securities before maturity. It is generally resorted to reduce the burden of debt by converting high interest loans into low interest loans. According to Professor Dalton, the conversion does not reduce the burden of public debt on the state; because a reduction in interest rates reduces the ability of the creditors to pay taxes which may mean a loss of income to the governments there by reducing its capacity to repay loans.

4) ACTUAL REPAYMENT :

a) Sinking Fund: Sinking fund is a special fund created for the repayment of public debt. There is a theoretical justification for creating this fund because it imposes a requirement on the government to pay the old debts regularly. According to this method, the government sets aside a certain amount out of the budget every year for this fund. The balances in the funds are also invested and the interest accruing on them is also credited in the fund.

Sinking fund is of two types: (i) certain sinking fund here, the governments credit a fixed sum of money annually. (ii) Uncertain sinking fund the amount is credited when government secures a surplus in the budget. The one danger of this method is that the government may not wait till the end of the period of maturity and utilize the fund for some other purpose than the one for which the fund was created originally.

The practice of sinking fund inspires confidence among the lenders and the enhancement of the creditworthiness of governments.

b) Capital levy:

Capital levy is a special type of **"once for all"** tax on capital imposed to repay war debts. All capital goods are taxed above a minimum level of assets possessed by residents of the country. Simply, capital levy refers to a very heavy tax on property and wealth. This tax was levied immediately after the First World War. This method has been advocated by economists like David Ricardo, Pigou and Dalton. Professor Dalton has suggested that capital levy as a method of debt redemption with least real burden on the society. It is useful on account of its deflationary character.

c) Surplus budget:

Quite often, surplus budget may be used to clear public debt. But in recent times due to the ever increasing public expenditure, surplus budget is a rare phenomenon.

d) Terminal Annuities :

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

e) Buying up of Loans: Governments redeems debt through buying up loans from the market.

OBJECTIVES OF PUBLIC DEBT

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

a. Revenue :

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

far exceeds government revenue.

b. National Emergencies:

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

c. Welfare State :

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

d. Revival of Economic Activity :

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

e. Control of Inflation:

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

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

f. Economic Development :

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

g. Financing Public Enterprises :

Government are running certain commercial enterprises. These are generally

productive ones and hence, should be run efficiently. Therefore, the governments borrow for financing such commercial enterprises.

h. Expansion of Education and Health Services :

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

i. Financing War:

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

EFFECTS OF PUBLIC DEBT

The following are the important effects of public debt:

1. EFFECTS ON CONSUMPTION:

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

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

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

2. EFFECTS ON PRIVATE INVESTMENT:

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

ultimately hinders private capital investment.

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

3. EFFECTS ON LIQUIDITY :

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

4. EFFECTS ON PUBLIC INVESTMENT :

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

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

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

5. EFFECTS ON COST OF PRODUCTION :

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

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

6. EFFECTS ON RESOURCES ALLOCATION AND NATIONAL INCOME :

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

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

PUBLIC DEBT IN INDIA

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

- For promoting economic development we have been borrowing both internally and externally.
- Public debt is also incurred due to the increased defence expenditure. Though we follow a policy of non- alignment, it is necessary to build a sound military and unclear- liase.
- The social and cultural development expenditure has increased plans after plan in order to build a sound education, and health. The population of India is increasing at the rate of 2.4% per annum. Hence they have to increase our investment in education and society.
- All the state Governments have to spend more on education, security and health in their respective states. They are forced to demand more and more of shares from the Central Government. The increase in debt charges is also another important reason for the growth of public debt by 20 times.
- Rise in the price level on inflation in India is also an important reason for the growth of public debt in India. Inflation affect both the private and also public sectors.
- The creation of more and more of administrative posts in India is also an important cause in the growth of public debt in India. As a result our public debt has to be increased year after year due to the growth of administrative expenditure.
- The pay-scales and allowances have increased in modern days due to the rise in prices. As a result the public debt has also increased in India.
- Deficit budgets are also responsible both at the centre and the states for the growth of public debt in India.

BENEFITS OF PUBLIC DEBT IN INDIA

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

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

PROBLEMS OF PUBLIC DEBT IN INDIA

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

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

UNIT – IV

TAXES

Meaning and Definition:

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

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

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

Characteristics of a Tax :

A tax possesses the following three important characteristics.

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

CANONS OF TAXATION

Canons of taxation refer to the administrative aspect of the tax. They relate to the rate, amount method of levy, and collection of a tax. In other words, the qualities or attributes of a good tax are called canons of taxation. It was none other than Adam Smith who gave first a detailed and comprehensive statement of the principles of taxation. According to Findlay Shirras, "No genius, however, has succeeded in condensing the principles into such clear and simple canons as has Adam Smith."

Adam Smith has given the following four canons of taxation.

1) Canon of Equity
2) Canon of Economy
3) Canon of Certainty and
4) Canon of Convenience. **(2 Es& 2Cs).**

CANON OF EQUITY

Canon of equity or equality is the most important and basic Canon of taxation. It is

based on the principle of social justice and ability to pay. Tax burden should be equally distributed among the tax payers according to their ability to pay. That is, the rich people should bear a heavy burden and the poor a less burden. Hence, the tax system should be progressive. According to Adam Smith, **“The subject of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”**

CANON OF ECONOMY

Canon of economy explains that taxes should be collected at minimum cost. The tax laws and procedures should be simple. The administrative machinery should not be elaborate and costly. According to Adam Smith, **“Every tax ought to be so contrived as little to take out and to keep out of the pockets of the people as possible over and above what it brings in to public treasury of the state.”**

Adam Smith argued that lack of economy would result when:

1) Tax administration is costly on account of complicated taxes.
2) Taxes are unduly heavy which would discourage investment, so that the income level reduces, hence the relative tax yields.
3) Taxes are having elaborate and complicated administrative supervision and
4) Taxes are unproductive in yielding sufficient revenue.

CANON OF CERTAINTY

Taxation must have an element of certainty. That is, there must be certainty about the tax which an individual has to pay. Things like the time of payment, the manner of payment, and the quantity to be paid etc. should be plain and clear to the tax payer. It should not be arbitrary. 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 to be clear and plain to the contributor and to every other person.”**

CANON OF CONVENIENCE

It explains that a tax should be levied in such manneror in such a time that it is convenient for the tax payer to pay it. In the words of Adam Smith, **“Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.”**

OTHER CANONS OF TAXATION

Besides the four canons put forward by Adam Smith, there are some other canons

given by writers like Charles F.Bastable. They are canon of productivity, canon of elasticity or flexibility, canon of simplicity, canon of diversity, canon of co- ordination etc.

CANON OF PRODUCTIVITY

Tax should be productive of large revenue. According to this canon it is desirable to have a few taxes yielding large revenue rather than having a large number of taxes yielding small revenue.It also implies that instead of imposing large number of unproductive taxes, it is advisable to have a few productive taxes.

CANON OF ELASTICITY

It means that taxation should be flexible or elastic. That is, it should be capable of increasing or decreasing the tax revenue depending on the need of the government. In other words, the tax revenue may increase automatically whenever needed by an upward revision of tax rates or by extension of its coverage.

CANON OF DIVERSITY

This implies that there should be a number of different taxes in the country. This will make every citizen of a country to pay something to the national exchequer. As the number of taxes increases it will increase the administrative costs, reducing the revenue. Hence, too many taxes are to be avoided.

CANON OF SIMPLICITY

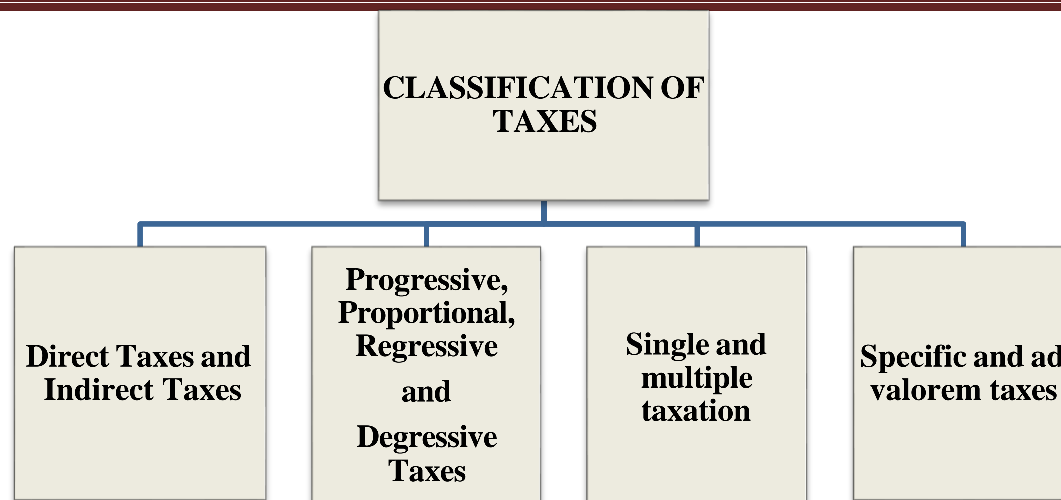
This canon implies that the tax should be simple to understand even to a layman. It should be free from all ambiguities and provisions to avoid differences in interpretation and legal disputes.

CANON OF CO-ORDINATION

There should be co-ordination among different layers of governments in imposing taxes. Especially, in a federal country like India there should be co- ordination among the central, state and local governments regarding taxes, since each of these is having legal right to impose taxes.

CLASSIFICATION TAX

Taxes are classified on different bases. Different bases adopted by the economists to classify taxes are the forms, nature, aims and methods of taxation. The various taxes may be classified under following major heads.



A) **DIRECT TAXES AND INDIRECT TAXES**

According to Dalton **' A direct Tax is really paid by a person on whom it is legally imposed, while an indirect tax is imposed on one person, but paid partially or wholly by another, owing to consequential change in the terms of some contract or bargaining between them.'**

According to J S Mill, **'A direct tax is one, demanded from the very person who is intended or desired should pay it. Indirect taxes are those which are demanded from the one person in the expectation and intention that we shall identify him at the expenses of another'.**

According to Prest, **"The distinction between direct and indirect taxes is more commonly drawn by reference to the basis of assessment rather than the point of assessment."**

Professor Antonio defines direct taxes as, "Direct taxes strikes a citizen's income at the moment of its production."

In the words of Gladstone, **"The direct and indirect taxes are like two attractive sisters between whom an exchequer should be perfectly impartial."**

According to P.E. Taylor, an authority on public finance, distinguished direct taxes and indirect taxes as follows," **The terms direct and indirect taxes are finally distinguishable in meaning only in terms of shift ability. Direct taxes are not shifted while indirect taxes are."**

From the above we can reach in a conclusion that direct taxes are those which are paid by persons on whom these are imposed and the real burden is also borne by them. The burden of such taxes cannot be transferred or shifted to some other persons. That is, **in**

the case of direct taxes both impact and incidence fall upon the same person.

Indirect taxes are imposed on one person but are paid either partly or wholly by another. The person who pays the tax in the first instance, transfers its burden on the shoulders of another person. In other words, **an in the case of indirect tax, the impact and incidence of the tax fall on different persons.**

Examples of direct taxes are income tax, wealth tax, corporation tax, gift tax etc. And examples of Indirect taxes are Sales tax, excise duty, VAT etc.

Merits of Direct Taxes:

Following are the main merits of direct taxes.

1) **Equity**: direct taxes such as income taxes, taxes on property, capital gain taxes etc. are progressive in their nature. That is, higher incomes are taxed heavily and lower incomes are taxed lightly. Hence, direct taxes are based on ability to pay of the tax payer and they ensure the canon of equity.
2) **Economy:** The administrative cost of collecting the direct taxes is low. The tax payers directly pay the tax to the state. So there is not much waste of resources and time. That is, direct taxes satisfy the canon of economy.
3) **Certainty:** Another merit of direct tax is that it is certain. The tax payers know how much tax is to be paid, on what basis tax is paid to the government etc.

   Thus, the tax payer is able to make adequate provision the payment of tax in advance. The government can also plan development activities since they can estimate the amount of revenue they receives in the form of taxes.
4) **Elasticity and revenue generation:** the yield from direct taxes increases as the country economically advances. The government gets more revenue through direct taxes automatically at higher rates.
5) **Distributive justice:** Since direct taxes are progressive in rates, tax rate increases as the income of individuals rises. The tax burden will heavily be on the richer sections of the society. The increased revenue through taxes is allocated for providing subsidized food, clothing and housing to the poor and needy people. This will bring about distributive justice in the country.
6) **Civic consciousness:** Direct taxes create civic consciousness among the tax payers. The tax payers will be vigilant in the utilization of the tax revenue and will see whether the resources are efficiently used and wastage is avoided.
7) **Absence of leakages:** since there is direct payment of taxes by tax payers to the government, there is no room for any wastage. The whole amount of direct taxes such as income taxes, property taxes, and taxes on capital gains etc., reaches the treasury without any middlemen.

Demerits of Direct Taxes

The important demerits of the direct taxes are explained below.

1) **Uncertainty:** The precise degree on needed progression cannot be estimated on account of the difficulties of measuring the ability to pay and the subjective nature of the marginal utility of income.

2) **Unpopularity:** the direct taxes are directly imposed on individuals. They have to bear both the impact and incidence of these taxes. Thus they experience their pinch directly. Consequently, direct taxes are not as popular as indirect taxes.

3) **Violation of the principle of equity:** the burden of direct taxes falls almost exclusively on the richer sections of the society while the poorer section are totally exempted from these taxes. This is unjustified and improper because the burden of state expenditure should be borne by individuals at all levels of society according to their ability to pay.

4) **Large scale evasion:** direct tax is based on honesty. The tax is not evaded only when the tax payer is honest. It is a fact that the people in the higher income groups do not reveal their full income. It is remarked that "direct taxes are a premium on honesty."

Merits of Indirect Taxes

The following are the important merits of indirect taxes.

1) **Convenience:** Indirect taxes are more convenient to pay. It is paid at the time of purchase of a commodity. Hence, the tax payer does not feel the burden of tax. The tax is hidden in the price of the commodity bought. It is paid in small amount. The government can also collect it conveniently.

2) **Indirect taxes lead to social welfare:** indirect taxes on narcotics and intoxicants reduce the consumption of them which are harmful to health. Reduction in the consumption of such goods will indirectly increase the welfare of the people.

3) **Indirect taxes are justified:** indirect taxes are justifiable and equitable. They are paid by all the individuals and when they purchase goods and services.

4) **Indirect taxes help production and investment:** Another advantage of indirect taxes is that they perform as powerful tool in moulding the production and investment activities of the economy.

5) **No evasion:** Indirect taxes are generally difficult to be evaded as they are included in the price of the commodity. A person can evade an indirect tax only when he decides not to purchase the taxed commodity.

6) **Highly revenue yielding in developing countries:** direct taxes do not yield much income in developing countries, as the income of the people is very less. Since indirect taxes cover a large number of essential commodities to be consumed by both the rich and the poor in the country, large revenue could be collected.

Demerits of Indirect Taxes

1) **Indirect taxes promote inequality:** Indirect taxes are generally imposed on the consumption goods. The poor people have to pay as much by way of indirect taxes on commodities as the rich people. This is unjust and equitable. They are regressive in nature which will promote economic inequality in society by imposing larger burden of taxes on the poor people.

2) **Uneconomical:** Indirect taxes involve high costs of collecting them. To raise desired levels of public revenue, taxes should be collected from millions of people.

3) **Element of uncertainty:** Indirect taxes are extremely uncertain. The revenue accrued to the government from indirect taxes cannot be estimated accurately. As soon as the tax is imposed, the price of the commodity is raised. This will in turn reduce the demand for the commodity. It cannot be estimated with certainty as to what extent the demand falls.

4) **Lack of civic consciousness:** Indirect taxes do not create civicconsciousness as the tax payers in most cases do not feel the burden of the tax they pay.

5) **Indirect taxes promote inflation:** another demerit of indirect taxes is that it promotes inflationary tendency in the economy, as they would increase the prices of the taxed goods.

6) **Discourage saving:** Indirect taxes discourage savings because they are included in the prices of commodities. Therefore, people have to spend more on the purchase of commodities. This will reduces the disposable income of the people and hence the savings.

B) PROGRESSIVE, PROPORTIONAL, REGRESSIVE AND DEGRESSIVE TAXES

A tax may be progressive, proportional, regressive or degressive according to the relationship between tax rate structure and tax revenue.

Progressive Tax:

A progressive tax is that in which the rate of the tax depends on change in income. That is, the rate of tax increases with the increase in the income. The higher the level of income, the higher the tax will be and vice- versa. (Table-1)

Table1. Progressive Tax Rates

Taxable income	Tax Rate%	Amount of tax
3000	10	300
4000	15	600
5000	20	1000
6000	25	1500

Proportional Taxes

A proportional tax is one in which the rate of tax remains the same irrespective of the level of income. Here, the same percentage of tax is levied on all income groups. The tax amount is simply calculated by multiplying the tax base with the tax rate. This is illustrated in Table 2.

Table-2 Proportional Tax Rates

Tax Base	Tax Rate %	Amount of tax
1000	10	100
2000	10	200
3000	10	300

Regressive Taxes

In regressive taxation, the higher the income of the tax payer, the smaller is the proportion of income he contributes to the government in the form of taxes. That is, in the regressive taxation, the tax rate declines as income increases. This type of taxation is against the objective of welfare state in modern time. (Table 3)

Table 3.Regressive Tax Rates

Tax Base in Rs.	Tax Rate %	Amount of tax in Rs.
1000	10	100
2000	8	160
3000	6	180

Degressive Taxes

Under this tax system, the tax is mildly progressive up to a certain limit. After that the tax may be charged at a flat rate. In other words, degressive tax system is a mixture of proportional as well as progressive tax system. In this, the higher income group people have to make little sacrifice in comparison with lower income group. (Table 4)

Table 4. Degressive Tax Rates

Tax Base in Rs.	Tax Rate %	Amount of Tax in Rs.
1000	10	100
2000	12	240
3000	13	390
4000	13	520

C) SINGLE AND MULTIPLE TAXATION

Single tax refers to a system in which the taxes are levied only on one item or head of tax. It is only one kind of tax. It implies a tax on one thing. That is, one class of things or one class of people. This type of tax was advocated by economists from 17th to 19th century. Such a tax is collected at regular intervals, may be monthly or annually or any other shorter or longer duration. A single tax may be progressive, proportional or regressive.

First of all, the physiocrats during the 17th and 18th century strongly advocated a single tax on land, for according to them agriculture was the only productive sector yielding surplus. Issac Sherman proposed a single tax on all real estates—on land— because it was convenient in administration and payments. Henry George also advocated a single tax on land mainly because he thought that it was not possible to shift the tax.

Merits of Single tax System

1) It is a very simple tax as it simplifies the work of the government.
2) It is less costly as lesser amount is spent to collect the revenue.
3) It is based social justice.
4) It does not discriminate against any particular work or industry.

Demerits

1) It cannot bring adequate revenue to meet the needs of the modern governments.
2) Single tax system violates the principle of ability to pay.
3) The burden of taxation is not equally distributed.
4) The tax system is not effective during the period of emergency or crisis.
5) Tax evasion is much possible.
6) It lacks elasticity.

MULTIPLE TAXATION

The multiple taxes imply that there should be all types of taxes so that every citizen can contribute to the state revenue. Similarly, modern economy has to fulfil many objectives like those of economic growth, equitable distribution of income and wealth, economic stability, full employment and so on. Since no single tax can realise all these objectives simultaneously, a multiple tax system is preferred. But at the same time, too many taxes will yield only a small amount of revenue. The cost of collection will be very high. According to Dalton, “It is better to rely on few substantial taxes for the bulk of revenue.” Thus, the burden of taxation should be widely distributed. Multiple tax system is a mixture of proportional, progressive, direct and indirect taxes.

Merits

1) It leads to equitable distribution of tax burden as it includes proportional, progressive, direct, and indirect taxes.
2) Tax evasion is very difficult under this system.
3) It is more flexible than single tax system.
4) It is based on the principle of equity.
5) It enhances the income of the governments.

Demerits

1) It is more complicated than single tax system.
2) Too much multiplicity leads to inconvenience to both the taxing authority and the tax payer.
3) It is not based on the principle of ability to pay.
4) It checks the productive process of the economy.

D) SPECIFIC AND AD VALOREM TAXES

According to the assessment, taxes on commodities can be divided in to two types—Specific tax and Ad Valorem tax.

SPECIFIC TAX

Taxes which are based on specific qualities or attributes of goods are called Specific tax. This tax is imposed on commodities according to their weights, size or volume. It is a per unit tax on commodity. For example, specific excise duty may be levied on the cloth in the length units and tax on sugar is based according to the units of weight.

Advantages

1) It is quite easy to calculate and administer.
2) The collection of the tax is very convenient.
3) It does not add to inflation, since it is fixed in amount.
4) It confirms to the canon of certainty.
5) It is difficult to evade as the tax is imposed on the basis of weight, size or measure.

Disadvantages

1) It is regressive in nature. It falls heavily on the cheaper varieties of products which the lower income groups consume.
2) It is less equitable as compared to the ad valorem tax.
3) They are less productive and less elastic.
4) They are also less economical during the period of inflation.

AD VALOREM TAX

When a tax is imposed on a commodity on the basis of its value, it is called ad valorem tax. This type of tax is levied after assessing the value of the taxable possession of a person. For example, several imported articles are taxed in terms of value and they have nothing to do with the weight, length, and size of the commodity.

Advantages

1) It imposes greater burden on the rich section of the society.
2) It is more equitable as it is imposed on the value of goods and thus the canon of ability to pay is fulfilled.
3) It is highly productive and elastic.
4) It is economical.

Disadvantages

1. It is quite difficult to administer as it is difficult to assess the value of commodities.
2. It increases inflationary pressures when there is rise in price level
3. There is wide scope for tax evasion as people may show smaller value of a particular commodity only for the sake of saving the tax amount.

MAJOR TAXES IN INDIA

The taxes of the government may be classified into three categories: 1) Taxes on income and expenditure 2) Taxes on properties and capital and 3) Taxes on commodities. First two types of taxes are direct taxes and the third type of taxes is indirect taxes.

INCOME TAX

Income tax has become the most important type of direct tax in India. The period of assessment of income tax is one year. Money income is taken as the basis of income tax in almost all countries of the world. In India income tax was introduced in 1860 by Sir James Wilson to meet the heavy expenses incurred during the Sepoy Mutiny of 1857. Though it was introduced to meet only the temporary needs of the government, it became a permanent feature of our tax system due to its revenue yield. In 1939, the rate structure was designed o n a slab System.

After Independence, the government appointed Income Tax Investigation Commission in 1947, to investigate all matters relating to taxation of income so as prevent its evasion and avoidance. The Commission recommended in its report in 1948 that all loop holes in income tax system was to be plugged. The Income Tax (Amendment) Act, 1953 incorporated a number of recommendations of the commission. The Income Tax Act, 1961,as amended from time to time through Annual Finance Acts, is the basis of Income Tax in India.

A notable feature of income taxation in India is that the whole proceeds of income tax do not go to the central government. According to the recommendations of various Finance Commissions, a large share of the total proceeds is distributed among state governments.

Merits of Income Tax

1) Income tax is based on the principle of ability to pay.
2) It is one of the most important instruments for reducing inequalities in the distribution of income, because it can be made easily progressive.
3) Income tax is one of the important tools for maintaining price stability.
4) It cannot be easily evaded.

5) A tax on income prevents the consumption of least useful items.

6) It conforms to the canons of productivity and elasticity.

Demerits

1) The main drawback of income tax is that it will tend to reduce the ability and willingness to work, save and invest.

2) Direct taxes are inconvenient because complete records and files are to be maintained up to date by each individual tax payer.

3) There is great scope for tax evasion by concealing actual income.

4) As the poor section of the community remains untouched under income tax, it fails to achieve the objective of creating civic consciousness among the people.

COPORATION TAX

A corporation tax is a tax on net income of business corporations or companies. In India, it was introduced after the First World War and since then it has become an integral part of Indian tax structure. This tax is paid by companies and is distinct from the taxes paid by shareholders on their dividends. That is, corporation tax is paid out of the taxable profits (net profit) after meeting all costs i.e., interest charges, wages and depreciation costs etc. earned by the corporation during an assessment year and the remaining is distributed among the shareholders in the form of dividends.The main feature of Corporation tax is that the entire proceeds of this form the revenue of the Union Government and no share is divided among states.

Advantages of corporation tax

1) Since the governments confer special benefits upon the companies and corporations like perpetual legal existence, limited liability and easy capital issue, they are liable to be taxed.

2) The income of the corporations constitutes an important source of accumulation of ideal income and wealth, thus it is appropriate to tax such income and wealth in order to ensure equity in the economy.

3) The undistributed income of the corporations is mainly used as reserves or for expansion of the company. All these will enhance the capital gains, which are to be taxed.

4) It is not only that the corporations have independent ability to pay, but also that their incomes are earned from supplying services. Hence, corporation incomes should be more heavily taxed than the personal incomes.

Disadvantages

1) It is argued that the imposition of a corporate income tax and a personal income tax will bring about a double taxation. This is because of the fact that shareholders of corporations are also subjected to personal income tax.
2) It discourages investment in risky enterprises.
3) The burden of such a tax falls entirely upon the ordinary shareholders and not on the preference shareholders.
4) The tax does not facilitate equitable distribution of income.
5) The ultimate burden of corporation tax is to be borne by the consumers. The corporation will deem the tax as cost of production and will include this in the prices. Hence, the final burden is rested on the consumers.

GIFT TAX

The Gift tax was also introduced in April 1958 on the recommendation of Professor Nicholas Kaldor. It covered the Gifts made by individuals, Hindu Undivided Families, companies, firms and association of persons. Initially, it was levied on the donor and not on the donee. All gifts made by a donorduring a particular year where liable for Gift tax. However, the liability of paying the tax was shifted from the donor to the done who receives the gift under the new Gift Tax Act of 1990. Thus the Gift tax was made donee-based. The reason for the major change in the taxation on the Gifts is that the mechanism of Gifts was used to split up capital and launder black money. The Gift tax was also abolished in October, 1998.

EXPENDITURE TAX

Expenditure tax is a tax on expenditure. It is levied when the income is spent. In India it was first imposed in 1958 following to the recommendations of Professor. Nicholas Kaldor. He had suggested the imposition ofthis tax to prevent the possibility of tax evasion and to discourage superfluous consumption. According to Kaldor the major advantages of expenditure tax are the following

a. It is more easily definable than income tax.
b. Expenditure is better index of taxable capacity.

The expenditure tax was abolished in 1962. It was again introduced in 1964 and was abolished in 1966. In 1987, it was again introduced under the Expenditure Tax Act,1987.

COMMODITY TAXATION IN INDIA

The Central Government of India levies two types of commodity taxes –Excise Duty and Customs Duty.

UNION EXCISE DUTY

The Constitution of India, under Articles 269 (taxes levied and collected by the Union and assigned to States) and 270 (Taxes levied and collected by the Union and distributed between Union and States), has made a provision for levying Union Excise Duties on all commodities produced anywhere in India except alcoholic liquors and opium, narcotics and narcotic drugs (these are within the jurisdiction of the State governments.) There are three types of excise duties which are imposed by the governments. They are: a) Basic Excise Duties b) Earmarked cesses and c) Additional Excise Duties

Basic Excise Duties are levied and collected by the Union Government. The proceeds are shared with the state governments under Article 272 of the Indian Constitution.

Earmarked cesses are levied under Special Act and are earmarked for special purposes. The entire proceeds of earmarked cesses are assigned to the Union Government.

Additional Duties of Excise Act, 1975 provides for the levy and collection of additional duties on sugar, tobacco, cotton fabrics, woollen fabrics and man-made fabrics. These are in addition to the basic duties. The entire proceeds of these duties, excluding those attributable to the Union Territories, are distributed among the states on the basis of recommendations of the Finance Commission. These duties are levied in lieu of sales tax.

CANONS OF EXCISE DUTIES

Indian Fiscal Commission, 1921-22 had laid down the following canons of excise duties:

1) Excise duties should ordinarily be confined to industries which are concentrated in large factories or small areas.
2) The duties are imposed for the purpose of checking the consumption of injurious articles and especially on luxuries coming under this category.
3) Otherwise they should be imposed for revenue purpose only.
4) While permissible on commodities of general consumption, they should not press too heavily on the poorer class.

ARGUMENTS IN FAVOUR OF EXCISE DUTIES

1) The burden of excise duty is not troublesome. The excise duties are paid in small instalments along with prices by the consumers at convenient times. So the burden is not felt by the consumers.
2) It helps in discriminating the rich and the poor in the society, if excise duties are levied on luxuries.
3) It checks detrimental consumption. The imposition of excise duties on injurious commodities may reduce the consumption.
4) The duties are productive and elastic.
5) The indigenous industries contribute to the public exchequer, since the excise duties are imposed on indigenous industries.

ARGUMENTS AGAINST EXCISE DUTIES

1) Equity considerations: Excise duties do not provide any exemption or deduction to individuals as in the case of other taxes. Thus, the distribution of burden of excise duties is very often, though not always, regressive in nature.
2) Distortions of Resources Allocations: There may be distortions in the allocation of resources as the excise duties tend to cause distortions in consumer preferences on account of changes in relative prices of goods and services.
3) Inflationary Potential: The excise duties have a great inflationary potential. The prices of goods will tend to rise as the burden of excise duties is shifted to the wholesalers, retailers, and ultimately to the consumers by the manufacturers. The manufacturers will include the excise duties in the cost of production and will meet this by increasing the prices for the products.
4) Conflict between Equity and Elasticity: For raising more revenue the excise duties may be elastic. In order to get more revenue by way of excise duties, the demand for the taxed commodities is relatively inelastic. Otherwise, the demand will be contracted and consequently the revenue to the governments will also decline. Generally, the demand is inelastic for such commodities which are necessaries of life and are chiefly consumed by the poorer sections of the society. Thus, the excise duties violate the principle of equity for the sake of raising revenue to the states.
5) Excess Burden: The excise duties put an excess burden on the community through a loss of consumer’s satisfaction due to higher prices and reduced availability of goods coupled with misallocation of resources.

CUSTOM DUTIES

Taxes on international trade, particularly known as custom duties, are levied and

collected by the Central Government and entirely owned by it as per Constitutional provision. Custom duties usually take the form of import duties and export duties. That is, custom duties are levied on goods imported to India (import duties) from foreign countries and goods exported from India (export duties) to foreign countries.

Custom duties applies on goods like any other tax – they are applied like ad– valorem or specific. These types of taxes are progressive which are based on ad-valorem and specific taxes are known as special taxes which applies according to the number, size and weight of the goods. Custom duties are of two types (i) Import duty and (ii) export duty. It is not definite to say that on which sector the burden of this tax lies. Actual situation is that the burden of custom duties on import duty and on flexibility of demand and supply.

Export duty: Goods which are sent to foreign countries from India, export duty applies on that. This is not only the main source of government – income infact it has some important economic effects like export duty on raw materials will lead to the availability of the cheap raw materials to the industries. On the annual budget export duty also announces.

Import duty: The aim of import duty is to discourage these items which affect the county's production. With this government also gets income. In India it is applied according to the Indian Tariff Regulation, 1934. Rates of 1934 first and second list it is applies differently on various items. Like any other Interest rate improvement had also done in the of custom duty. In 1985 policy to control the import dependence on tariff increased in 1991. Chelyah committee suggested that on ready goods tax should be applied. In the next years also improvement in custom duties continued. In 2002-03 in budget announcement was made that in the year 2004-05 the rate will be of two basic levels on raw materials and intermediate it will be 10 % and 20 % on ready goods. Because of this in 2002-03 rate will be decreased to 3% from 35%.

Objectives of Custom Duties

1) For raising revenue: custom duties are one of the important sources of revenue. For this aim, it is better to levy on goods which are largely imported rather than those which are produced at home.

2) For protecting domestic industries: Tariffs or duties may be imposed for protecting domestic industries. Protection is justified on the basis of infant industry argument. Infant industries may not be able to compete with well- developed industries. Therefore, it is argued that infant industries are to be protected till they become strong and can stand on their own legs.

3) For attaining equal status: to ensure an equal status to domestic industries and foreign industries, a countervailing duty is advocated. The imposition of an excise duty on the domestic goods will raise the price of domestic goods. This will be advantageous for the foreign goods and harmful for the indigenous goods. For attaining an equal status for both goods, a countervailing duty on

imported goods, which is equal to the excise duty in amount, is to be imposed.

4) For achieving Price stability: price stability is obtained by imposing import and export duties. A reduction in import duties may increase imports bringing about a fall in prices. Similarly, an exemption of export duties will be enlarging exports which will in turn raise prices.

TAXES ON CAPITAL TRANSACTIONS AND PROPERTY

The important taxes in this group are: (i) Estate duty (ii) Wealth tax (iii) Gift tax and (iv) Capital gains tax

ESTATE DUTY

Article 269 of the Indian constitution provides for the imposition and collection of the estate duty in respect of property other than agricultural land, by the Centre. The whole proceeds of this duty except those which are attributable to the Union Territories are assigned to the States with in which this duty is liveable and distributed among them in accordance with the law made by the Parliament, on the recommendations of the Finance Commission.

An estate duty is levied when any movable and immovable property or interest there in passes or is deemed to pass at death of its owner. The tax is payable by legal heirs on the estate of a deceased person inherited by them. It is also known as death duty or inheritance tax or succession tax. This tax came in to force with effect from October 15,1953 and was abolished from the middle of March 1985.

WEALTH TAX

Wealth tax is a tax which is levied on the net wealth of individual. It is also known as a tax on capital or property taxation. Wealth tax is different from income tax which is a tax on income and paid out of income. Wealth is a stock variable whereas income is flow variable. This tax was imposed on the recommendation of Professor NicholasKaldor in 1957. He justified the imposition of an annual tax on wealth on the ground of equity, economic effect and administrative efficiency.

Not all wealth holders where taxed. Wealth below rupees 2.5 lakh was exempted. Initially the tax rate was very high (15%). Consequently it led to wide scale evasion and avoidance. Subsequently the rate was reduced to a very moderate level ranging from 0.5 % to 2%. In 1992-93 the finance minister withdrew the wealth tax on productive assets such as guest houses, residential houses, jewellery etc. With effect from April 1993,wealth tax is chargeable in respect of the net wealth exceeding RS 15 lakh at 1% only. As a consequence of these changes, the revenue from this tax has gone down considerably. Recently the wealth tax has been recommended to be abolished.

SALES TAX

Under the Indian government Regulation Act. 1935, states were assigned the Sales Tax.

Indian Constitution also gives the rights to the states that they can impose tax on any -newspaper and also collects them. According to Article 286 states are abide for the following tax.

1. Selling and purchasing of goods of out of the boundary of India.
2. Selling of goods those given to other states for its use.
3. International Business and trade related selling except this if parliament wanted to impose tax. which term as essential, it has to take permission of the President. For this in 1952 essential Good Act was passed.

Forms of sales tax :

Sales tax is of many types like General Sales Tax and selected Sales tax, multipoint and single point Sales tax.

1.General sales tax and selective sales tax: When in sales tax law selected items are kept then it is known as selective sales tax. In other words when selective sales tax applies on selected items then it is known as Selective Sales Tax. This type of tax is imposed on high prices and luxurious goods. In opposite of this when law imposes tax and leave some goods then it is called General Sales Tax. In this way when the collection of tax is based on some sales then it is General Sales Tax.

2.multi-Point and single-Point sales tax: General Tax is of two types Multi Point and Single Point Sales Tax. Multi point is a sales tax and also known as one of the parts of single point sales tax.

under single Point sales tax: Special money add to the good which sold to the consumer this sales tax is collected on one level it is collected on that level which the producer sold to wholesaler or on that level also when retailer sold to consumer this single point sales tax imposed on producer these people gives sales tax to the government and taken back from the consumer in this way those traders who purchase goods from the producer they are not eligible for sales tax but have to give those prices in which sales tax is includes.

Multi Point sales tax: Tax applies on goods of all levels at one point it is applied when producer sold his books to the whole seller and secondly when whole seller sold it to the trader and in the end it is applied when retailer sold it to the consumer. The rate of this tax is low and taken by the consumer.

SALES TAX IN UNDER DEVELOPED COUNTRIES

In under developed countries, on one hand states needs financial settlement for their resources and on the other hand most of the population is poor and also the scope of taxes is limited. In this condition sales tax which is an indirect tax is helpful for the state government sales tax is generally included in the price of a goods and it is -to the principle of colvert scratch duck wings in this way so that it makes less noise. If sales tax is applies on luxurious items then it will indirectly encourages saving as the increasing price makes it demand down. In this way this tax lessen propensity to consume and also encourages

savings. So sales tax is one of an important source of revenue especially in under developed countries.

Effects on Production

Now, we will discuss that what are the effects of sales tax on production; means-

(a) On ability to do work

(b) On ability to save and invest

(c) On desire to work and save

(a) effect on the ability to Work: decreases when it affects negatively on the work of a person. So poor class always against it. In this way if sales tax applies on those things which are consumed by the poor class then it will affect their work and capacity. So sales tax has negative effects. But it general consuming goods will be tax free or used by the rich class like luxurious items then it will not affect negatively. This encourages saving. So it is necessary to make general consumption goods tax free or to apply low interest rate and the burden of sales tax must be on such goods which are generally used by rich category, such as the goods of luxuries then there is no possibility of adverse effect of sale tax on production. Not only this, it can also encourage more savings. Therefore, it is necessary that the goods of general consumption must be either kept tax-free or taxes must be imposed on them at lower rates and taxes must be imposed at higher rates at the goods of luxuries.

(b) effect on ability to save: As far as the question arise of capacity this is less than all the taxes. But there is a different intake of those people who don't have excess income from which they can do there saving. This type of income and burden lies on the poor class which have no extra means of savings. So sales tax lies on those sectors which don't have the capacity of savings. But being a sales tax it is included in the price of a thing, so this discourages both consumption and saving. But if its rates become low than savings can be increased and also if it applies on luxurious items then it will not create serious effects.

(c) effect on Desire to work and save: As far as the question arise of the work of the people and wish to save, discussion of goods taxes have been already done. But those people who have to earn for their dependents should do saving but become helpless with the increasing burden of the taxes. In this situation applying sales tax discourages savings as these types of people are more concern for their future and earning.

Effect on Distribution

Sales tax imposes on those items which are purchased by the poor class of the society in this way its nature become regressive. In this situation it increases the inequity between income and money distribution. But to remove this defect it can be applied on selected and luxurious items but in that condition it will not remain the source of Revenue. One of the fundamental defects of sales tax is that it is not related to the consumer's capacity. Rich and the poor pay this on the same rates. Not only this there is no discount for domestic situations and in this way it lies burden on the same income group which have large quantity dependents. In this way, general sales tax is of regressive nature one thing is there that production increase

and money distribution are parts of economic welfare. Here, this is mentionable that production growth and best distribution of money are undivided friends of economic welfare. So sales tax should be applied in a manner with which countries production increases. In the end it can only be said that in the form of revenue source sales tax performed better and also gives resources in some states it is one of the big and in some is the biggest sources.

SHIFTING AND INCIDENCE OF TAXATION

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

First of all, a tax may be imposed on a person,
Secondly it may be transferred by him to a second person,
Thirdly it may be ultimately borne by the second person or transferred to others by whom it is finally consumed.

IMPACT OF TAX

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

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

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

DIFFERENCE BETWEEN IMPACT AND INCIDENCE

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

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

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

IMPORTANCE OF INCIDENCE OF TAX

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

FACTORS AFFECTING THE INCIDENCE OF A TAX

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

1. **Price :**

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

2. **Nature of Demand :**

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

3. **Nature of Supply :**

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

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

The shorter the period of time the lesser is the scope of adjusting the supply. The supply of a commodity cannot be increased in the short period. But in the long period the

supply of the commodity will be relatively elastic because it is easy to change the capacity of a plant.

5. **Area :**

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

6. **General Business Conditions :**

During prosperous times taxes can be easily shifted while during depression taxes cannot be easily shifted. The demand for the commodity is highly elastic and the supply is inelastic.

INCIDENCE OF SPECIFIC TAXES

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

A) TAXES ON NET INDIVIDUAL INCOME

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

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

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

B) TAXES ON NET INCOMES OF THE BUSINESS FIRMS

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

C) TAX ON PURE PROFIT

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

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

D) INCIDENCE OF SALES TAX AND EXCISE DUTIES

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

- ❖ During prosperity shifting of taxes is easier.
- ❖ If a taxed product has an untaxed substitute forward shifting would be difficult.

- When people are accustomed to certain goods the forward shifting of taxes is easy.

E) INCIDENCE OF CUSTOMS DUTIES

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

FACTORS DETERMINING THE INCIDENCE OF EXPORT DUTIES:

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

FACTORS DETERMINING THE INCIDENCE OF IMPORT DUTIES:

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

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

UNIT – V

BUDGET

The term budget has been derived from a French word 'bougette' which means a leather bag or purse. The term 'budget' is commonly understood as a document presented by a government containing an estimate of proposed expenditure for a given period and proposed means of financing them for the approval of legislation. As per **Article 112 of Indian Constitution** the Government has to present in the Parliament an annual financial statement showing estimates of revenue and expenditure. This is called the Annual Financial Statement or Budget. Hence, government budget is a schedule of all revenues and expenditures that the Government expects to receive and plan to spend during the following year. A Budget includes a) financial actions of the previous year b) budget and revised estimates of the current year and c) the budget estimates for the following year. For example, in the budget 2013-14 there will be the actual estimates of 2011-12, the budget estimates and revised estimates for the year 2012-13 and the budget estimates for the year 2013-14.

The budget is presented in the parliament by the Union Finance Minister. Similarly, the State Governments have also to present the budget in the State Legislatures as per **Article 202 of the Indian Constitution.**

Definitions of Budget

"It is a document containing a preliminary approved plan of public revenue and expenditure." Prof. Rene Stourn.

"A budget is at once a report on estimates and proposals, that it is the instrument by which all the processes of financial administration are correlated and coordinated." Bastables.

"A budget is a pre-determined statement of management policy during a given period which provides a standard for comparison with the results actually achieved." Crown and Howard.

B.E Buck defines budget as, "(a) finance plan, (b) a procedure formulating, authorizing, executing and controlling this plan and (c) some government authority responsible for each successive step in this procedure."

Government Accounts

Consolidated Fund: - All sums of money, all revenues of the governments, the loans raised by it, receipts by way of repayment of

Loans constitute the consolidated fund. All expenditures are also incurred out of this fund. No amount can be withdrawn from this fund without the sanction of the parliament. [**Article 266 (1)]**

The Contingency fund:- The fund is placed at disposal of the President to enable

the government to meet the unforeseen emergencies. Prior sanction of the parliament is not required to spend from the fund.**[Article 267]**

Public Account:-Certain transactions are not included in the contingency fund. They include transactions relating to provident funds, small savings collections, other deposits etc. The money thus received is kept in public account. This money does not belong to the government. It has to be paid back to the persons and authorities who have deposited it. Hence, parliamentary approval is not required for payments.**[Article 266(2)]**

Features of Budget

1. It is a statement of expected revenue and proposed expenditure.
2. It is sanctioned by some authority.
3. It is periodicity, generally annual and
4. It prescribes the manner in which revenue is collected and expenditure is incurred.
5. Budget is prepared on cash basis.
6. Rule of lapse- All unutilized funds within the year 'lapse' at the end of the financial year.
7. Realistic Estimation.
8. Budget is on Gross/ Net basis.
9. Form of Estimate is to Correspond to Accounts.
10. Estimates to be on Departmental Basis.

Objectives of a Budget

Budget is an important tool of financial administration and an effective means of enforcing fiscal policies. The main objectives of a budget are the following.

- Re-allocation of resources
- Re-distribution of resources
- Stabilization of resources
- Sources of information to the public of the past, present and future activities, plans and programmes of the relevant governments.
- Tool of government policy
- To estimate income and expenditure
- An instrument of fiscal policies
- Basis of public welfare
- To ensure financial and legal accountability
- To serve as a tool of management for controlling administrative efficiency.

OBJECTIVES OF BUDGETING

Planning :

The process of budgeting begins with the establishment of specific targets of performance and is followed by executing plans to achieve such desired goals and from time to time comparing actual results with the target goals. These targets include both the overall business targets as well as the specific targets for the individual units within the business. Establishing specific targets for future operations is part of the planning function of management, while executing actions to meet the goals is the directing function of management. It may be explained as

- Budget plans are made in synchronisation with the overall objectives of the organisation, keeping mission and corporate strategy into account. Individual plans at unit level should be in consonance with organisational plan.
- Budgets reflect plans and that planning should have taken place before budgets are prepared.
- Budgets plans are quantified and responsibility is assigned to the persons who are responsible for execution of plan.
- Using the budget to communicate these expectations throughout the organisation has helped many a companies to reduce expenses during a severe business recession.
- Planning not only motivates employees to attain goals but also improves overall decision making. During the planning phase of the budget process, all viewpoints are considered, options identified, and cost reduction opportunities assessed. This process may reveal opportunities or threats that were not known prior to the budget planning process.

Directing and Coordinating :

- Once the budget plans are in place, they can be used to direct and coordinate operations in order to achieve the stated targets.
- A business, however, is much more complex and requires more formal direction and coordination.
- The budget is one way to direct and coordinate business activities and units to achieve stated targets of performance.
- The budgetary units of an organisation are called responsibility centers. Each responsibility center is led by a manager who has the authority over and responsibility for the unit’s performance.
- Objectives and degree of performance expected from a responsibility centres are communicated rapidly.

Controlling :

- As time passes, the actual performance of an operation can be compared against the planned targets. This provides prompt feedback to employees about their performance. If necessary, employees can use such feedback to adjust their activities in the future.
- Feedback received in the form of budget report from the responsibility centre. This report is helpful to know the performance of the concerned unit.
- Any unexpected changes into the conditions which were prevailing at the time of preparing budget are taken into account and budgets are revised to show true performance yardstick.
- Comparing actual results to the plan also helps prevent unplanned expenditures. The budget encourages employees to establish their spending priorities.

The main objective of Budgeting is to help in achieving the overall objective of the organization.

COMPONENTS OF A BUDGET

The government budget is divided into **Revenue Budget and Capital Budget**.

Revenue Budget or Revenue Account is related to current financial transactions of the government which are of recurring in nature. Revenue Budget consists of the revenue receipts of the government and the expenditure is met from this revenues. Revenue Account deals with Taxes, duties, fees, fines and penalties, revenue from Government estates, receipts from Government commercial concerns and other miscellaneous items, and the expenditure there from.

Revenue Receipts include receipts from taxation, profits of enterprise, other non- tax receipts like administrative revenue (fees, fines, special assessment etc.), gifts grants etc. Revenue expenditure includes interest-payments, defense expenditure, major subsidies, pensions etc.

The Capital Account is related to the acquisition and disposal of capital assets. Capital budget is a statement of estimated capital receipts and payments of the government over fiscal year. It consists of capital receipts and capital expenditure. The capital account deals with expenditure usually met from borrowed funds with the object of increasing concrete assets of a material character or of reducing recurring liabilities such as construction of buildings, irrigation projects etc.

Capital Receipts include a) Borrowings b) Recovery of loans and advancesc) Disinvestments and d) Small savings.

Capital Expenditure includes a) Developmental Outlay b) Non-developmental outlay c) Loans and advances and d) Discharge of debts.

TYPES OF BUDGETS

Based on the balancing of revenue and expenditure, budgets are divided into Balanced Budget and Unbalanced Budget.

Balanced Budget: - A balanced budget is that over a period of time, revenue does not fall short of expenditure. i.e., revenue is equal to expenditure (Revenue= Expenditure).

Unbalanced Budget

The Budget imbalance may be due to an excess of expenditure over income or an excess of income over expenditure. In other words, budget may either be surplus or deficit. A budget is said to be surplus when public revenue exceeds public outlay (R>E.)

A deficit budget means a budget when expenditure exceeds revenue (R<E.)

BUDGETARY PROCEDURE IN INDIA

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

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

1. PREPARATION OF THE BUDGET :

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

The prescribed form has four different columns :

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

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

2. PRESENTATION OF THE BUDGET :

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

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

3. GENERAL DISCUSSION :

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

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

4. VOTING :

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

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

- Salary and allowances of the President of India
- Salary and allowances of the Judges of the Supreme Court
- Salary and allowances of the Comptroller and Auditor-General of India
- Public debt charges including repayment of public debt
- Salary and allowances of the Chairman and Deputy Chairman of Rajya Sabha

- Salary and allowances of the Speaker and Deputy Speaker of the Lok Sabha and
- Any expenditure required to satisfy any judgment, degree or award of any court or arbitration or tribunal

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

5. EXECUTION OF THE BUDGET :

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

The execution of the budget consists of three aspects :

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

Proper distribution of grants or funds :

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

Collection of revenue :

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

Custody of collected funds :

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

BUDGETARY CONTROL

Meaning

CIMA has defined the terms 'budgetary control' as "Budgetary control is the establishment of budgets relating to the responsibilities of executives of a policy and the continuous comparison of the actual with the budgeted results, either to secure by individual action the objective of the policy or to provide a basis for its revision. "It is the system of management control and accounting in which all the operations are forecasted and planned in advance to the extent possible and the actual results compared with the forecasted and planned ones.

Budgetary Control Involves :

1. Establishment of budgets
2. Continuous comparison of actual with budgets for achievement of targets
3. Revision of budgets after considering changed circumstances
4. Placing the responsibility for failure to achieve the budget targets.

The salient features of such a system are the following:

1. Determining the objectives to be achieved, over the budget period, and the policy or policies that might be adopted for the achievement of these ends.
2. Determining the variety of activities that should be undertaken for the achievement of the objectives.
3. Drawing up a plan or a scheme of operation in respect of each class of activity, in physical as well as monetary terms for the full budget period and its parts.
4. Laying out a system of comparison of actual performance by each person, section or department with the relevant budget and determination of causes for the discrepancies, if any.
5. Ensuring that corrective action will be taken where the plan is not being achieved and, if that be not possible, for the revision of the plan.

In brief, it is a system to assist management in the allocation of responsibility and authority, to provide it with aid for making, estimating and planning for the future and to facilitate the analysis of the variation between estimated and actual performance.

In order that budgetary control may function effectively, it is necessary that the concern should develop proper basis of measurement or standards with which to evaluate the efficiency of operations, i.e., it should have in operation a system of standard costing.

Beside this, the organisation of the concern should be so integrated that all lines of authority and responsibility are laid, allocated and defined. This is essential since the system of budgetary control postulates separation of functions and division of responsibilities and thus requires that the organisation shall be planned in such a manner that everyone, from the Managing Director down to the Shop Foreman, will have his

duties properly defined.

Objectives of Budgetary Control System

1. Portraying with precision the overall aims of the business and determining targets of performance for each section or department of the business.
2. Laying down the responsibilities of each of the executives and other personnelso that everyone knows what is expected of him and how he will be judged. Budgetary control is one of the few ways in which an objective assessment of executives or department is possible.
3. Providing a basis for the comparison of actual performance with the predetermined targets and investigation of deviation, if any, of actual performance and expenses from the budgeted figures. This naturally helps in adopting corrective measures.
4. Ensuring the best use of all available resources to maximise profit or production, subject to the limiting factors. Since budgets cannot be properly drawn up without considering all aspects usually there is good co-ordination when a system of budgetary control operates.
5. Co-ordinating the various activities of the business, and centralising control and yet enabling management to decentralise responsibility and delegate authority in the overall interest of the business.
6. Engendering a spirit of careful forethought, assessment of what is possible and an attempt at it. It leads to dynamism without recklessness. Of course, much depends on the objectives of the firm and the vigour of its management.
7. Providing a basis for revision of current and future policies.
8. Drawing up long range plans with a fair measure of accuracy.
9. Providing a yardstick against which actual results can be compared.

WORKING OF A BUDGETARY CONTROL SYSTEM

The responsibility for successfully introducing and implementing a Budgetary Control System rests with the Budget Committee acting through the Budget Officer. The Budget Committee would be composed of all functional heads and a member from the Board to preside over and guide the deliberations.

The main responsibilities of the Budget Officer are:

1. to assist in the preparation of the various budgets by coordinating the work of the accounts department which is normally responsible to compile the budgets—with the relevant functional departments like Sales, Production, Plant maintenance etc.;
2. to forward the budget to the individuals who are responsible to adhere to them, and to guide them in overcoming any practical difficulties in its working;
3. to prepare the periodical budget reports for circulation to the individuals concerned;
4. to follow-up action to be taken on the budget reports;

5. to prepare an overall budget working report for discussion at the Budget Committee meetings and to ensure follow-up on the lines of action suggested by the Committee;
6. to prepare periodical reports for the Board meeting. Comparing the budgeted Profit and Loss Account and the Balance Sheet with the actual results attained. It is

necessary that every budget should be thoroughly discussed with the functional head before it is finalized. It is the duty of the Budget Officer to see that the periodical budget reports are supplied to the recipients at frequent intervals as far as possible.

The efficiency of the Budget Officer, and through him of the Budget Committee, will be judged more by the smooth working of the system and the agreement between the actual figures and the budgeted figures.

Budgets are primarily an incentive and a challenge for better performance; it is up to the Budget Officer to see that attention of the different functional heads is drawn to it to face the challenge in a successful manner.

Advantages of Budgetary Control System

	Description
Efficiency	The use of budgetary control system enables the management of a business concern to conduct its business activities in the efficient manner.
Control on expenditure	It is a powerful instrument used by business houses for the control of their expenditure. It in fact provide1`s a yardstick for measuring and evaluating the performance of individuals and their departments.
Finding deviations	It reveals the deviations to management, from the budgeted figures after making a comparison with actual figures.
Effective utilisation of resources	Effective utilisation of various resources like—men, material, machinery and money—is made possible, as the production is planned after taking them into account.
Revision of plans	It helps in the review of current trends and framing of future policies.
Implementation of Standard Costing system	It creates suitable conditions for the implementation of standard costing system in a business organisation.
Cost Consciousness	Budgets are studied by outside fund providers also such as banking and financial institutions, realising that management encourages cost consciousness and maximum utilisation of available resources.
Credit Rating	Management which have developed a well ordered budget plans and which operate accordingly, receive greater favour from credit agencies.

Limitations of Budgetary Control System

Points	Description
Based on Estimates	Budgets are based on series of estimates which are based on the conditions prevailed or expected at the time budget is established. It requires revision in plan if conditions change.
Time factor	Budgets cannot be executed automatically. Some preliminary steps are required to be accomplished before budgets are implemented.It requires proper attention and time of management. Management must not expect too much during the development period.
Co-operation Required	Staff co-operation is usually not available during budgetary control exercise. In a decentralised organisation each unit has its own objective and these units enjoy some degree of discretion. In this type of organisation structure coordination among different units are required. The success of the budgetary control depends upon willing co-operation and teamwork,
Expensive	Its implementation is quite expensive. For successful implementation of the budgetary control proper organisation structure with responsibility is prerequisite. Budgeting process start from the collection of requirements to budget and performance analysis. It consumes valuable resources for these purpose, hence, it is an expensive process.
Not a substitute for management	Budget is only a managerial tool and must be applied correctly for management to get benefited. Budgets are not a substitute for management.
Rigid document	Budgets are considered as rigid document. But in reality, an organisation is exposed to various uncertain internal and external factors. Budget should be flexible enough to incorporate ongoing developments in the internal and external factors affecting the very purpose of the budget.

Components of Budgetary Control System

The policy of a business for a defined period is represented by the master budget the details of which are given in a number of individual budgets called functional budgets. These functional budgets are broadly grouped under the following heads:

1. **Physical budgets :** Those budgets which contain information in terms of physical units about sales, production etc. for example, quantity of sales, quantity of production, inventories, and manpower budgets are physical budgets.

2. **Cost budgets :** Budgets which provides cost information in respect of manufacturing, selling, administration etc. for example, manufacturing costs, selling costs, administration

cost, and research and development cost budgets are cost budgets.

3. **Profit budgets :** A budget which enables in the ascertainment of profit, for example, sales budget, profit and loss budget, etc.

4. **Financial budgets :** A budget which facilitates in ascertaining the financial position of a concern, for example, cash budgets, capital expenditure budget, budgeted balance sheet etc.

DEFICIT FINANCING IN INDIA

The fiscal policy plays a very important role in any economy. Through its fiscal policy, the government creates and sustains the public economy consisting of the provision of public services and public investment. It is also an important instrument for the reallocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability. If the fiscal policy is not managed in a prudent way then it can create a fiscal mess. A fiscal imbalance needs to be rectified immediately through corrective measures because a large fiscal deficit is unsustainable.

Up to the mid-1980s in India fiscal imbalance was seen in terms of the overall budget deficit measured by the gap between the expenditure and the receipts under the revenue and capital accounts have been taken together. This gap was actually filled up by **deficit financing**.

What is deficit financing?

In India, it is defined as "borrowings from the Reserve Bank of India against the issue of Treasury Bills and running down of accumulated cash balances". When the government borrows from the Reserve Bank of India, it merely transfers its securities to the Bank. On the basis of these securities the bank issues more currency and puts them into circulation on behalf of the government. This amounts to the creation of money. Nowadays most governments both in the developed and developing world are having deficit budgets and these deficits are often financed through borrowing. Hence the fiscal deficit is the ideal indicator of deficit financing. In India, the size of fiscal deficit is the leading deficit indicator in the budget. It is estimated to be 3.9 % of the GDP (2015-16 budget estimates). Deficit financing is very useful in developing countries like India because of revenue scarcity and development expenditure needs.

Various indicators of deficit in the budget are:

Deficit financing is the budgetary situation where expenditure is higher than the revenue. It is a practice adopted for financing the excess expenditure with outside resources. The expenditure revenue gap is financed by either printing of currency or through borrowing

1. Budget deficit = total expenditure – total receipts
2. Revenue deficit = revenue expenditure – revenue receipts
3. Fiscal Deficit = total expenditure – total receipts except borrowings

4. Primary Deficit = Fiscal deficit- interest payments
5. Effective revenue Deficit-= Revenue Deficit – grants for the creation of capital assets
6. Monetized Fiscal Deficit = that part of the fiscal deficit covered by borrowing from the RBI

Simply budget deficit is printing money to finance a part of the budget. In India, there is no budget deficit at present. Hence one there is no budget deficit entry in Government's budget. Another absent deficit identity is monetized fiscal deficit. This is borrowing by the government from RBI to finance the budget. Such a borrowing practice is not adopted in India from 1997 onwards. Hence the monetized fiscal deficit is also not there.

The leading deficit indicator and also the best one to measure the health of the budget in the Indian context is fiscal deficit. The fiscal deficit represents borrowing by the government. This borrowing is made by the government mostly from the domestic financial market by issuing bonds or treasury bills

The root factor that cause deficit in the budget is the revenue deficit. Revenue deficit is the difference between revenue receipts and revenue expenditure in an accounting sense

In recent years, government is following another deficit term called effective revenue deficit. Actually, revenue expenditure indicates expenditure to finance day to day functions of the government. They are not productive. But according to the government some revenue expenditure creates assets and hence is productive. This revenue expenditure which creates assets is deducted to get Effective Revenue Deficit.

The last type of deficit is Primary Deficit that shows the difference between fiscal deficit and interest payments.

Underlying Rationale for Deficit Financing

In a developing country sometimes the government fails to mobilise adequate resources. In this situation, the option of deficit financing is required to meet fiscal deficit targets. If the option of deficit financing is not utilized the government ends up compromising on growth targets. A developing country has to make a decision by choosing between two difficult choices viz. a lower growth rate and an inflationary price rise. It is held that out of the two options, the price rise is a lesser evil and has to be preferred to a lower growth rate.

The recourse to deficit financing is taken largely because the government fails to mobilise enough resources from other options. Additionally, it also occurs because of the rapidly growing expenditures. At times the government has also failed to curb expenditure on unproductive non-developmental activities as it has lacked fiscal prudence.

What are the consequences of Deficit Financing?

Deficit financing can have a useful role during the phase of depression in a developed economy. During this phase, the level of expenditure falls down to a very low level and the banks and the general public are in no mood to undertake the risk of investment. They prefer to accumulate idle cash balances instead. The machinery and the capital equipment are all present there but the incentive to produce is lacking due to a deficiency in aggregate demand. It is in this scenario that the government pumps in additional purchasing power in the economy through deficit financing the level of effective demand is likely to increase.

Capital accumulation in developing countries through deficit financing is likely to generate inflation because in these countries “the propensity to consume is high, there are many market imperfections, there is little excess capacity in plant and equipment, and the elasticities of food supplies are low”.

As a consequence of deficit financing, the demand for food items is likely to be pushed up to a far higher level as compared to their supply resulting in an inflationary spiral in their prices. It is being held by economists that even if deficit financing tends to be inflationary it carries no danger as long as the inflationary pressures are mild.

Inter-linkage between Deficit financing and inflation

Deficit financing is inherently inflationary. Deficit financing increases aggregate expenditure which logically enhances aggregate demand. Consequently, the danger of inflation is always there. At times deficit financing has also resulted in hyper-inflation.

However, the critical variable is the nature of deficit financing which has a bearing on whether deficit financing is inflationary or not. If the deficit financing is unproductive in character (for example, war expenditure made through deficit financing) it is definitely going to be inflationary. However, the net consequence is different if a developmental expenditure is made via the instrumentality of deficit financing. In this case, deficit financing may not be inflationary although it results in an actual increase in money supply.

It is being held that “Deficit financing, undertaken for the purpose of building up useful capital during a short period of time, is likely to improve productivity and ultimately increase the elasticity of supply curves.” In this case, the productivity is raised which acts as an antidote against price inflation.

The most crucial thing about deficit financing is that it produces an economic surplus during the process of development. By economic logic, the multiplier effects of deficit financing will be larger if total output exceeds the volume of money supply. Consequently, the inflationary effect will be neutralized.

Deficit financing helps in meeting the liquidity requirements of the growing economies. Actually, a mild dose of inflation following deficit financing is helpful to the whole process of development. Deficit financing is not anti-developmental if the resultant inflationary spiral is only moderate. However, in most cases, deficit financing causes inflation and economic instability. It is very inflation-prone compared to other sources of financing.

Some amount of inflation is bound to happen under the following circumstances:

(a) If the economy is fully employed, the raised level of money supply enhances aggregate money income via multiplier effect. Since no excess capacity in the economy is there such increased money income leads to a raised level of aggregate expenditure. Consequently, it incentivizes inflationary rise in prices. Deficit financing immediately releases monetary resources leading to excessive monetary aggregate demand creating demand-pull inflation.

(b) It is held that the method of deficit financing is actually a vicious circle. It is very difficult to escape from the vicious circle of deficit financing once this popular method of financing is adopted. The inflationary impact becomes stronger once persistent deficit financing is adopted.

Once the prices zoom up and the government fails to stabilize the price level, rising prices lead to an increased cost which forces the government to mobilize additional revenues through deficit financing. This surely threatens price stability. Thus a vicious circle of rising price level and increased cost sets in. On the whole, deficit financing has the potential to create demand- pull and cost-push inflationary scenarios.

Pros and Cons of Deficit Financing

Deficit financing happens to be a very popular method, especially in developing countries. Its popularity is due to the following reasons:

It is beneficial:

- There has been a huge expansion in governmental activities. It has forced governments to mobilize resources from different sources. As a source of finance, tax-revenue is highly inelastic in poor countries. Also, governments in these countries are under political compulsion not to impose newer taxes. If they do so they may lose political support of the electorate. Additionally, public borrowing is also insufficient to meet the expenses of the state. In this scenario, deficit financing does not give any trouble either to the taxpayers or to the lenders who lend their surplus money to the government. Hence, this instrumentality of deficit financing is most popular to meet developmental expenditure. Deficit financing does not take away any money from the pocket of anybody and yet provides massive resources to be utilized for further development.
- In India, deficit financing is associated with the creation of additional money by borrowing from the Reserve Bank of India. Interest payments to the RBI against this borrowing come back to the Government of India in the form of profit. Thus, this borrowing or printing of new currency is virtually a cost-free method. In sharp contrast to this, borrowing involves payment of interest cost to the lenders.
- Financial resources that a government can mobilize through deficit financing are certain and the exact figures are known before. The financial strength of the government is determinable if deficit financing is made.

- Deficit financing is an inflationary method of financing. However, the rise in prices must be a short run phenomenon. In any case, a mild dose of inflation is necessary for economic development. If inflation is kept within a reasonable limit, deficit financing ends up promoting economic development. Consequently, it neutralizes the disadvantages of price rise.
- Deficit financing has certain multiplier effects on the economy. This method encourages the government to utilize unemployed and underemployed resources. This results in more incomes and actually ends up promoting employment in the economy.

Disadvantages

It is equally important to understand and critically analyse the disadvantages of deficit financing. The negative effects of deficit financing are:

- It is actually a self-defeating method of financing. This is so because it always leads to an inflationary rise in prices and proves to be a vicious cycle as some countries go for persistent deficit financing.
- Deficit financing-induced inflation helps to produce classes and businessmen to flourish. However, fixed-income earners suffer very much during inflation. This increases the gap between the two classes. Consequently, income inequality increases.
- Another significant negative fallout of deficit financing is that it creates significant distortion in investment pattern. Actually, the investors have a higher profit motive. So, they tend to invest their resources in quick profit-yielding industries. However, investment in such industries is not beneficial in the interest of a country's long-term economic development.
- Deficit financing may not produce beneficial results in the creation of employment opportunities. Generally, additional employment opportunities are not created in poor resource-deficient countries. This happens because these countries lack raw materials and types of machinery even if adequate finance is made available via the instrumentality of deficit financing.
- Under inflationary conditions, the value of money goes down. In this scenario, the purchasing power of money declines. Consequently, a country experiences a flight of capital abroad for safe returns. This leads to a scarcity of capital.
- This deficit financing method causes a larger volume of the deficit in a country's balance of payments scenario. This happens because after an inflationary rise in prices there is a decline in exports while import bill keeps on rising. In this scenario, resources get transferred from export industries to import- competing industries.

Conclusion

Despite the perils associated with deficit financing, it is quite inevitable that the governments in poor and developing countries will employ this method of financing. It is a necessary evil. It is almost like a double-edged sword. Its success is actually premised upon the way in which it is used. It can be very successful if robust anti-inflationary measures are employed to combat inflation. The key challenge lies in keeping the inflation within a reasonable limit. Most of the woes related to deficit financing can be neutralized

if inflation is kept within a reasonable limit.

It is quite interesting that deficit financing itself needs to be kept within the safe limit if we want to keep inflation within a safe limit. However, it is difficult to define a safe limit for the same. Given the fact that deficit financing is unavoidable, it must be exercised with due prudence and caution. There are contextual and differential needs of the economy and hence its use cannot be discouraged. However, it must be acknowledged that the risky option of deficit financing must be utilized in a limited way.

FISCAL POLICY IN INDIA

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

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

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

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

FUNCTIONAL FINANCE

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

FISCAL POLICY IN DEVELOPING COUNTRIES :

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

1. MOBILISATION OF RESOURCES :

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

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

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

2. PROMOTION OF ECONOMIC GROWTH :

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

3. INCREASE OF EMPLOYMENT OPPORTUNITIES :

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

4. ECONOMIC STABILITY :

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

5. REDUCTION OF INEQUALITIES :

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

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

CONCLUSION :

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

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