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Public Economics

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PUBLIC ECONOMICS
(BAECCC202)

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Unit 01: Meaning of Public Finance

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Objectives

- understand the basic concept of Public Economics
- evaluate the mechanism of Public Economics to increase public welfare.
- Study the Principles of social advantage.
- Evaluate the Principles of social advantage propounded by Prof. Dalton, A.C. Pigou and Musgrave.

Introduction

Economicsis a social science concerned with the production, distribution, and consumption of goods and services. It studies how individuals, businesses, governments, and nations make choices about how to allocate resources.Economics is the study of human efforts to satisfy what appears to be unlimited and competing wants through the careful use of relatively scarce resources. As such, it is a social science because it deals with the behaviour of people as they deal with this basic issue.

1.1 Public Economics

Public economics (or economics of the public sector) is the study of government policy through the lens of economic efficiency and equity. Public economics builds on the theory of welfare economics and is ultimately used as a tool to improve social welfare. Public economics provides a framework for thinking about whether or not the government should participate in economic

markets and to what extent it should do so. This subject encompasses a host of topics, notably market failures such as public goods, externalities and Imperfect Competition and the creation and implementation of government policy. Emphasis is on analytical and scientific methods and normative-ethical analysis, as distinguished from ideology. Examples of topics covered are tax incidence, optimal taxation, and the theory of public goods.

Public economics 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 economics 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.

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.

1.2 Importance of Public Finance

- Provision of public goods: -For providing public goods like roads, military services and streetlights etc. public finance is needed. Business firms will have no incentive to produce such goods, as they get no payment from private individuals.
- 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.
- 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.
- 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.
- 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.

- 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.

1.3 Subject Matters of Public Finance

The subject matters of Public Finance can be broadly classified in to five categories –

- Public revenue
- Public expenditure
- Public debt
- Financial administration
- Economic stabilization and
- 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 into 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.

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.

1.4 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

- 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.
- Both the States and Individual at times have to depend on borrowing, when their expenditures are greater than incomes.
- Both Public Finance and Private Finance have income and expenditure. The ultimate aim of both is to balance their income and expenditure.
- 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.
- Both are concerned with the problem of economic choice, that is, they try to satisfy unlimited ends with scarce resources having alternative uses.

Dissimilarities

- 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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).

- 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.
- 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.
- 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.
- 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.

1.5 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

1.6 Principle of Maximum Social Advantage

The 'Principle of Maximum Social Advantage' was introduced by British economist Hugh Dalton.Prof. Dalton and Prof. A.C. Pigou are the two prominent economists responsible for formulating and popularizing this fundamental principle of public finance. Pigou calls it the Principle of Maximum Aggregate Welfare.According to Hugh Dalton, "Public Finance" is concerned with the income & expenditure of public authorities and with the adjustment of one with

the other.Budgetary activities of the government result in the transfer of purchasing power from some individuals to others. Taxation causes the transfer of purchasing power from tax payers to the public authorities, while public expenditure results in transfers back from the public authorities to some individuals. Therefore, financial operations of the government cause 'Sacrifice or Disutility' on one hand and 'Benefits or Utility' on the other.

This results in changes in the pattern of production, consumption & distribution of income and wealth. So, it is important to know whether those changes are socially advantageous or not.If they are socially advantageous, then the financial operations are justified, otherwise not.According to Hugh Dalton, "The best system of public finance is that which secures the maximum social advantage from the operations which it conducts."The 'Principle of Maximum Social Advantage (MSA)' is the fundamental principle of Public Finance.The Principle of Maximum Social Advantage states that public economics leads to economic welfare when public expenditure & taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.Hugh Dalton explains the principle of maximum social advantage with reference to:

- **Marginal Social Sacrifice**
- **Marginal Social Benefits**

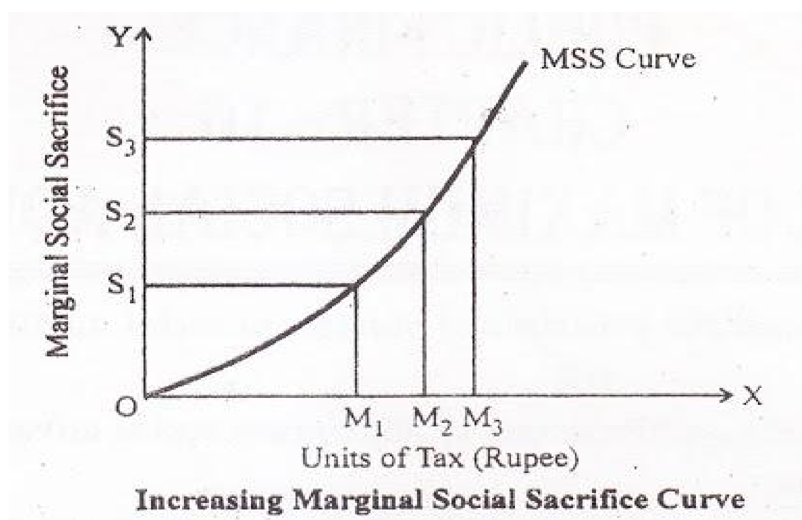
This principle is however based on the following assumptions: -

- All taxes result in sacrifice and all public expenditures lead to benefits.
- Public revenue consists of only taxes and no other sources of income to the government.
- The government has no surplus or deficit budget but only a balanced budget.
- Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

1.7 Marginal Social Sacrifice (MSS)

Marginal Social Sacrifice (MSS) refers to the amount of social sacrifice undergone by the public due to the imposition of an additional unit of tax.Every unit of government tax-imposed results in a loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing, i.e., the total social sacrifice increases at an increasing rate.This is because, when taxes are imposed, the stock of money in the community diminishes. As a result of the diminishing stock of money, the marginal utility of money goes on increasing. Eventually, each additional unit of taxation has a greater impact and requires a greater sacrifice from society.That is why the marginal social sacrifice goes on increasing.

Figure 1.1:Marginal social sacrifice



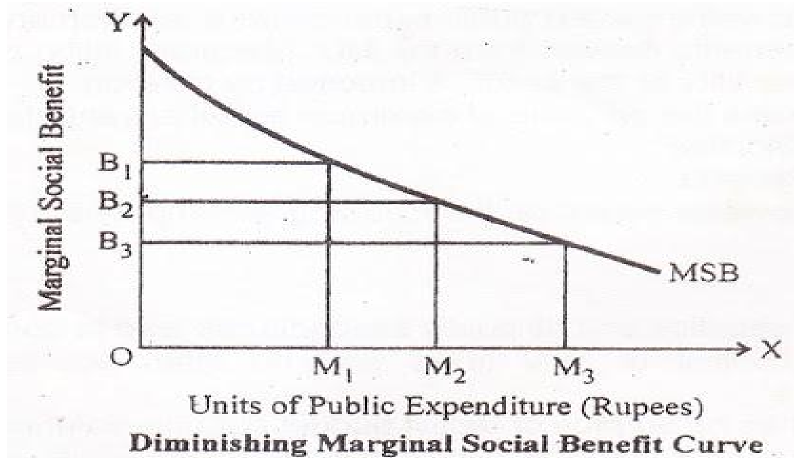
The above fig. 1.1, indicates that the Marginal Social Sacrifice (MSS) curve rises upwards from left to right. This indicates that with each additional unit of taxation, the level of sacrifice also increases. When the unit of taxation was OM_1, the marginal social sacrifice was OS_1, and with the

increase in taxation at OM_2, the marginal social sacrifice rose to OS_2.While imposition of tax puts a burden on the people, public expenditure confers benefits. The benefit conferred on society by an additional unit of public expenditure is known as Marginal Social Benefit (MSB).

1.8 Marginal Social Benefit (MSB)

In the beginning, the units of public expenditure are spent on the most essential social activities.Subsequent doses of public expenditure are spent on less and less important social activities. As a result, the curve of marginal social benefits slopes downward from left to right as shown in the figure 1.2 below.

Figure 1.2: Marginal Social Benefit

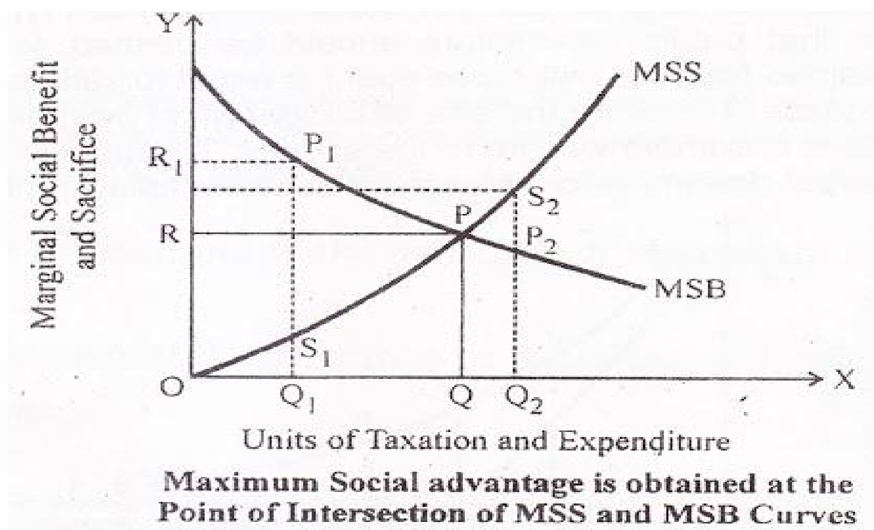


In the above diagram, the marginal social benefit (MSB) curve slopes downward from left to right. This indicates that the social benefit derived out of public expenditure is reducing at a diminishing rate. When the public expenditure was OM_1, the marginal social benefit was OB_1, and when the public expenditure was OM_2, the marginal social benefit was reduced to OB_2..

1.9 The Equilibrium of Maximum Social Advantage

Social advantage is maximised at the point where marginal social sacrifice cuts the marginal social benefits curve.This is at point P. At this point, the marginal disutility or social sacrifice is equal to the marginal utility or social benefit. Beyond this point, the marginal disutility or social sacrifice will be higher, and the marginal utility or social benefit will be lower.

Fig. 1.3: Equilibrium of Maximum Social Advantage



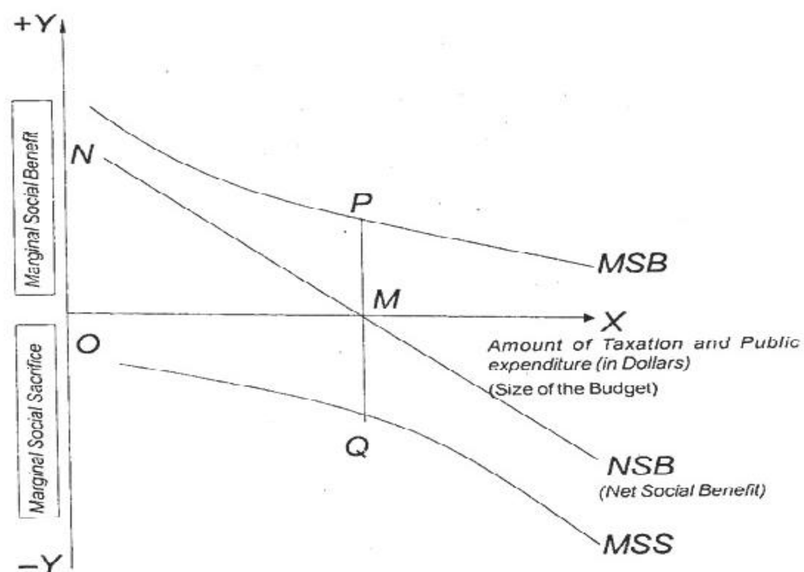
In fig. 1.3, At point P social advantage is maximum. Now consider Point P_1. At this point marginal social benefit is P_1Q_1. This is greater than marginal social sacrifice S_1Q_1. Since the marginal social sacrifice is lower than the marginal social benefit, It makes more sense to increase the level of taxation and public expenditure.This is due to additional units of revenue raised and spent by the government leading to an increase in the net social advantage. This situation of increasing taxation and public expenditure continues, as long as the levels of taxation and expenditure are towards the left of the point P.At point P, the level of taxation and public expenditure moves up to OQ.At this point, the marginal utility or social benefit becomes equal to marginal disutility or social sacrifice. Therefore, at this point, the maximum social advantage is achieved.At point P_2, the marginal social sacrifice S_2Q_2 is greater than the marginal social benefit P_2Q_2.

Beyond point P, any further increase in the level of taxation and public expenditure may bring down the social advantage. This is because; each subsequent unit of additional taxation will increase the marginal disutility or social sacrifice, which will be more than marginal utility or social benefit.This shows that maximum social advantage is attained only at point P & this is the point where the marginal social benefit of public expenditure is equal to the marginal social sacrifice of taxation.

1.10 Musgrave's Approach to Maximum Social Advantage

According to Prof. R.A. Musgrave, the principle of maximum social advantage is a logical extension of the Pigouvian Welfare approach to taxation, which is incorporated in the theory of minimum aggregate sacrifice.Musgrave is of the opinion that the optimum size of the budget should be determined at a point where the marginal net benefit is zero. Fundamentally there is not much difference between the approach of Prof. Dalton and Musgrave.Musgrave redesignate Dalton's principle of maximum social advantage as the maximum welfare principle of budget determination. Even though Musgrave pursued the line of reasoning advocated by Dalton and Pigou, his treatment is based on the valuation of individual preferences.

Fig. 1.3: Musgrave's approach to Maximum Social Advantage



In the figure 1.3, the size of the budget is measured on the horizontal axis. The marginal social sacrifice and the marginal social benefits are shown separately on the vertical axis. The marginal utility of successive dollars of public expenditure allocated optimally between public uses is shown by the line MSB in the figure 1.3. MSS indicates the marginal disutility of taxes, imposed so as to causes the least total sacrifice. The line NSB shows the net social benefit curve. It is derived by deducting MSS from MSB. Hence, it indicates the net social benefits derived from the successive expansion of the budget.MSS indicates the marginal disutility of taxes, imposed so as to causes the least total sacrifice. The line NSB shows the net social benefit curve. It is derived by deducting MSS from MSB.Hence, it indicates the net social benefits derived from the successive expansion of the budget.

We find that the optimum size of the budget is determined at OM where marginal net benefit is zero. When an amount OM is raised through taxation and spent by the state, then the marginal social benefit and the marginal social sacrifice are equated (MP = MQ).Till then the gain for society is more than the loss. The net gain to society is equal to the area OMN. Here, the state should stop expanding its activities. If the state stops its budget operation at a figure less than OM, society will be forgoing a possible gain; On contrast, if operations are expanded beyond OM, the total net benefit will again start falling.

The difficulty to determine the preference on which the values of MSB and MSS schedules are to be based and the problem of choosing between alternate solutions are the basic limitations of this approach, admitted by Musgrave himself. The fundamental problem is that of planning the budget efficiently.

1.11 Objective Test of Social Advantage

Dalton prescribes two practical tests that should be achieved by the Finance Minister who pursue his policies in accordance with the concept of optimum social welfare.These two tests are:

(a) Political test, and

(b) Economic test.

Political Test:

Preservation of the community: The first test is the provision for defense against external aggression and the maintenance of internal law and order. To preserve the community and to ensure confidentiality and promote the economic life of citizens, thereby enhancing the social advantage. These duties must be performed by every government, apart from other considerations. To maintain army, police and judiciary to meet the external threat of the enemy successfully. Economic life would be difficult if not possible, in the absence of a sense of security in the minds of the people. At the same time, as Dalton points out, a peaceful and just policy must be followed both at home and abroad. A belligerent foreign policy should increase the dangers of war, necessitating increased defense spending. Similarly, an unwise political, economic and social policy may perhaps necessitate increased expenditure on the maintenance of law and order.

Economic Test:

The Second Economic Test is divided into two:

- Improvement and expansion in the production of Wealth and
- Reduction in economic inequalities.

A sound financial policy should serve the fundamental purpose of better production and distribution.

Improvement in Production:

Increase in the amount of wealth produced per head. This in turn necessitates optimum utilization of all factors of production. Minimization of the wastage of resources, resulting from misdirection and unemployment. Improvements in the composition or pattern of production, so as best to serve the needs of the community.The distribution of wealth should be improved. The operation of public finance can bring about changes in the distribution of wealth If the purchasing power is taken away from taxpayers and transferred to others in the shape of public expenditure.If this transfer takes place from the relatively rich to the relatively poor sections of people, the distribution of wealth can be made more equal.

Other Conditions:

Stability and Full Employment: maintenance of stability in the level of economic activity and full employment. Instability is the fundamental feature of a free economy and is a cause of much misery

and suffering. Boom and depression should be properly controlled. The social advantage to the community can be enhanced if business conditions in the country are stable and when all fluctuations are eliminated.

Provision for Future:

Finally, as Dalton has pointed out, another important criterion is the effect on future generations.Individuals are mainly concerned with the present only and not with the future.The state is a permanent association and is concerned with the welfare of future generations. As a result, the operation of public finance should be designed to protect the interests of future generations as well.

Criticism of Principle of Maximum Social Advantage

Difficulties in Measuring Social Benefits: The principle of maximum social advantage is theoretically explained with the help of the marginal utility analysis. The Marginal benefits of public expenditure and the marginal disutility on sacrifice of public revenue are concepts, the objective measurement of which is extremely difficult.

Difficulties in Measuring Social Benefits: The principle of maximum social advantage is theoretically explained with the help of the marginal utility analysis. The Marginal benefits of public expenditure and the marginal disutility on sacrifice of public revenue are concepts, the objective measurement of which is extremely difficult.

Unrealistic Assumptions: It is unrealistic to assume that government expenditure is always beneficial and that every tax is a burden to society. For example, taxes on cigarettes or alcohol can provide benefit to society; expenditure on social overheads like health care will give rise to social benefit whereas. Unnecessary increase in expenditure on defense may divert resources from productive activities, causing loss of welfare to the society.

Neglect of Non – Tax Revenue: The principle says that the entire public expenditure is financed by taxation. But, in practice, a significant portion of public expenditure is also financed by other sources like public borrowing, profits from public sector enterprises, imposition of fees, penalties etc. Dalton fails to take into account all such other sources.

Lack of divisibility:The marginal benefit from public expenditure and marginal sacrifice from taxation can be equated only when public expenditure and taxation are divided into smaller units. But it is not possible practically.

Large Budget Size: The financial operations of the government involve collection of large sums of money from taxation and other sources and the disbursement of large amounts by way of public expenditure. The effects of small additional amounts of these on the community are difficult to measure. Therefore, in practice, the public authorities are not in a position to estimate the marginal benefits and the marginal sacrifice.

Change in Condition: Conditions in an economy are not static and are continuously changing. The point of maximum social advantage under some conditions may not be so under some others. For example, in times of war, government expenditure and revenue must increase, and the increase is to the advantage of the community.

Different Periods: The impact of many public projects is felt over a long period by both the present and the future generations. In order to determine maximum social advantage, it becomes necessary to calculate social benefits from public expenditure in a short period and in a long period.

Conceptual differences: Taxes are paid by individuals and the sacrifice involved is felt at an individual or micro level. However, at the macro level, all people benefit from public expenditure in a community. Many economists argue that it is neither possible nor desirable to compare micro and macro concepts by using the same criteria.

Misuse of Government Funds: The principle of maximum social advantage is based on the assumption that government funds are utilized in the most effective manner to generate marginal social benefit. However, quite often, a large share of government funds is misused for unproductive purposes which do not provide any social benefits.

Summary

The economy of public finance is related to the fulfillment of group needs specially. In this, we study those economic problems which arise in state or public sector, such as how to divide resources between private and public sectors and how allotment of resources for satisfaction of different resources of Government expenditure under public sector. The implementation of General Theory of employment by Keynes and Economic depression of 1930 became the bell of death for the policy. Keynes narrated that it is possible for the state to increase employment by fiscal operations and to maintain it on high level. in under-developed countries too, it is the main motive of the Government that the country must progress fastly economically and there must be equitable distribution of national production, and fiscal policy can become an important tool for the fulfillment of these objectives. The area and subject - matter of public finance is not static, because it is expanding continuously with the changes in functions of state and problems of economy. The basic difference is found between public finance and private finance in many matters such as objective, the methods of receiving finance and the quantity of resources etc. The classical view of public finance was based on classical economic theory but there were many revolutionary changes in this theory later. At last, modern economic theory was implemented which is called Keynes General Theory of Full Employment. Because of this theory, the classical concept of public finance changed. Keynes 'Employment Theory' is based on this basic concept that expenditure by a person is the income of another person. The concept of employment symbolizes about that special state in which working persons have more space in comparison to the number of unemployed persons. Maximum Social Advantage is achieved at the point where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equated, i.e., where MSB = MSS. This shows that to obtain maximum social advantage, public expenditure should be carried up to the point where the marginal social benefit of the last rupee or dollar spent becomes equal to the marginal social sacrifice of the last unit of rupee or dollar taxed.The marginal social benefit of public expenditure and the marginal social sacrifice of taxation must be equal.The resources of the state should be so distributed on different heads of expenditure in such a way that the marginal return of satisfaction from each of them is the samethe tax burden should be so distributed that the marginal social sacrifice of taxation to each taxpayer should be equal.

Keywords

Budget - The account of income and expenditure

Fiscal operations - The activities of fiscal

Inflation - The usage of more money than business needs of the country

Taxation - To impose tax

Self Assessment

1. If a good is a public good,

A. anyone can be excluded from enjoying its benefits.
B. consumers pay a low price.
C. no one can be excluded from enjoying its benefits.
D. economies of scale exist over the entire range of output for which there is a demand.

2. A good that is rival and nonexcludable is a

A. private good.
B. common resource
C. regulated good.
D. public good.

3. Which one of the following goods is excludable?

A. a city bus
B. a bridge that does not charge a toll
C. protection from the police force
D. the atmosphere

4. When a city street is congested, it is a
A. public good.
B. private good.
C. nonrival and excludable.
D. common resource.

5. Public goods are provided by government because
A. private firms do not consider the impact of external costs.
B. free-rider problems result in underproduction by private markets
C. governments are more efficient than private firms at producing public goods.
D. people value national defense very highly.

6. Mixed goods are those goods having benefits which are:
A. rival
B. Non – rival
C. both rival &Non – rival
D. none of these

7. Those goods whose consumption and use are to be encouraged are called
A. Private good
B. Public good
C. merit good
D. mixed good

8. A criterion by which public goods are distinguished from private goods:
A. Exclusion principle
B. Externality principle
C. Public choice principle
D. None of the above

9. The basic principle of public finance is:
A. Maximum Social advanatage
B. welfare of the Govt.
C. welfare of the Individual
D. all of the above

10. The Principle of Maximum Social Advantage is associated with:
A. Dalton
B. Pigou
C. Seligman
D. Hicks

11. The principle of Maximum Social Advantage is connected with
A. Taxation
B. Expenditure
C. Public Debt
D. None of above

12. Maximum social advantage is achieved when:
A. Total Social Sacrifice=Total Social Benefits
B. Marginal Social Sacrifice=Marginal Social Benefits
C. Net Social Sacrifice=Net Social Benefits
D. Average Social Sacrifice = Average Social Benefits

13. Maximum Welfare Principle of Budget Determination is associated with
A. Adam Smith

B. Edwin Seligman
C. Hugh Dalton
D. Richard Musgrave

14. Marginal social benefit curve ____
A. Diminishes
B. Increases
C. Remains constant
D. Does not follow fixed pattern for rise and fall

15. According to Musgrave the major functions of public finance are:
A. Allocative function
B. Distributive function
C. Stabilisation function
D. All the above

Answers for Self Assessment

1.	C	2.	B	3.	A	4.	D	5.	B
6.	C	7.	B	8.	A	9.	A	10.	A
11.	B	12.	B	13.	D	14.	A	15.	D

Review Questions

1. What is public finance? Discuss the scope or subject matter of public finance.
2. Distinguish between public finance and private finance.
3. What is the role of public finance in the economic development of a country?
4. What are the fiscal functions of governments according to Professor Musgrave?
5. Explain the principle of maximum social advantage theory.

Further Readings

- Public Finance By H.L . Bhatia, Vikas Publishing House
- Public Finance in Theory and Practice By S.K. Singh, S Chand & company
- Public Finance in Theory and Practice By Musgrave. .and P.B. Musgrave,Mcgraw Hill Education
- Public Finance-a Contemporary Application of Theory to Policy By David n. Hyman, CengageLearning.

Unit 02: Social Goods

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Summary

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Objectives

After studying this unit, students will be able to:

- learn about social goods of an economy
- evaluate the classification of goods and free rider problem
- understand the concept of market failure,
- evaluate the measures for market failure taken by government
- understand the concept and type of social goods.
- evaluate the social goods and efficiency

Introduction

The market economy, when certain conditions are met, serves to secure an efficient use of resources in providing for private goods. Consumers must bid for what they wish to buy and must thus reveal their preferences to producers. Producers, in trying to maximize their profits, will produce what consumers want to buy and will do so at least cost. Competition will ensure that the mix of goods produced corresponds to consumers' preferences. This view, of course, is a highly idealized picture of the market system. In reality, various difficulties arise. Markets may be imperfectly competitive, production may be subject to decreasing cost, consumers may lack sufficient information or be misled by advertising, and so forth. For these reasons, the market mechanism is not as ideal a provider of private goods as it might be. But even so, it does a good job and a better

one than can be done otherwise. At the same time, the market cannot solve the entire economic problem. First, and most important in the present context, it cannot function effectively if there are "externalities," by which we mean situations where consumption benefits are shared and cannot be limited to particular consumers, or where economic activity results in social costs which are not paid for by the producer or the consumer who causes them. Second, the market can respond only to the effective demands of consumers as determined by the prevailing state of income distribution, but society must also judge whether this is the distribution it wants. Third, there are problems of unemployment, inflation, and economic growth which do not take care of themselves automatically.

2.1 Social Good

Social good is an activity that aims to help the greatest number of people in the greatest possible way. It implies a positive societal impact; this could be helping to make healthcare and education readily available to everyone or taking action in the fight against climate change. A social good is something that benefits the largest number of people in the largest possible way, such as clean air, clean water, healthcare, and literacy. Also known as "common good," social good can trace its history to Ancient Greek philosophers and implies a positive impact on individuals or society in general.

Classifying Goods

What is the essential difference between?

- A city police department and Brinks security
- Fish in the Atlantic Ocean and fish in a fish farm
- A live concert and a concert on television

These, and all goods and services can be classified according to whether they are excludable or nonexcludable and rival or nonrival.

Excludable: A good, service, or resource is excludable if it is possible to prevent a person from enjoying its benefits.

Examples of excludable items are:

- The services of Brinks security
- Fish in a fish farm
- A live concert

Nonexcludable: A good, service, or resource is nonexcludable if it is impossible to prevent a person from enjoying its benefits.

Examples of nonexcludable items are:

- The services of the city police department
- Fish in the Atlantic Ocean
- A broadcast television signal

Rival: A good, service, or resource is rival if its consumption by one person decreases its consumption by other people.

Nonrival: A good, service, or resource is nonrival if its consumption by one person does not decrease its consumption by other people.Examples of rival items are:

- The services of Brinks security
- Fish both in ocean and in a fish farm
- A seat at a live concert

Examples of nonrival items are:

- The protection provided by a city police department

- A broadcast television signal

2.2 A Four-Fold Classification

Private good: A good or service that can be consumed by only one person at a time and only by those people who have bought it or own it.

Public good: A good or service that can be consumed simultaneously by everyone and from which no one can be excluded.

Common resource: A resource that is nonexcludable and rival—can be used only once but no one can be prevented from using what is available.

Natural monopoly: A good or service that is nonrival but excludable—can be produced at zero marginal cost.

Examples:

Figure 2.1:Four-fold classification of goods and services

	Excludable	Nonexcludable
Rival	Food and drink Car House	Fish in ocean Atmosphere National parks
Nonrival	Internet Cable television Bridge or tunnel	National defense The law Air traffic control

Characteristics of Social Goods

Universal distribution: members of the society can't be easily or reasonably prohibited from accessing **social goods**.

Universal consumption: one person consuming a **social good** doesn't appreciably reduce someone else's consumption.

Pooled financing: the social good is paid for predominantly by the pooled funds or labor of the entire group.

Separation of buyer and user: the user of a social good may not be the one who paid for it, and vice versa.

Social goods are also prone to several common challenges

Underproduction: the society may not produce enough of the social good to meet demand.

Overuse: the social good may be overused due to underproduction caused by the separation of buyer and user.

Degradation: the social good may become degraded through overuse, poor maintenance, accident or natural disaster.

Free ridership: individuals who bear neither direct or indirect costs for the social good may nonetheless use it.

Example:

- The public transportation in a city may not provide enough bus service for the community due to lack of funds, public resistance or other reasons.
- The buses that are in service may be overused through crowding and through running them beyond their designed parameters.
- Over time, the buses themselves and the entire related system can become run down.
- People who pay no taxes and no fare may be riding the bus.

For marketers, social goods pose several challenges

- **Design:** How can you design with, not for, your audience, when your audience is potentially everyone?
- **Distribution:** How do you effectively distribute social goods, when reaching such a broad audience is expensive?
- **Pricing:** How do you fairly price a social good when the user is not the buyer? Can you make people pay for a social good that they don't directly use?
- **Promotion:** Can social messages competitive effectively against commercial messages for society's attention?

Examples of Social Goods

- Many goods and services can be offered as social goods, but here are several of the common ones:
- Clean water
- Clean air
- Wild lands
- Fisheries
- Sanitation
- Public health
- Food and drug safety
- Energy
- Education
- Transportation
- Finance and markets
- Public spaces
- Information
- Public safety and justice

2.3 Free Rider Problem

- The free-rider problem associated with public goods was recognized by David Hume, even before the time of Adam Smith's writings.
- Each citizen who can enjoy the benefit of a public good has an incentive to try to lay the whole burden of provision on others, whenever the exclusion of nonpayers is very costly or impossible.

- Hume recommended in 1739 that government provide the goods in question, such as bridges (Musgrave 1985). The free rider problem is the burden on a shared resource that is created by its use or overuse by people who aren't paying their fair share for it or aren't paying anything at all.
- The free rider problem can occur in any community, large or small.

When the Free Rider Problem Arises?

When can everyone consume a resource in unlimited amounts?

When can no one limit anyone else's consumption?

When someone has to produce and maintain the resource?

That is, it's not a natural lake, it's a swimming pool, and someone had to undertake its construction and maintenance.Free rider problem is a phenomenon associated with public goods. It arises because public goods are non-rival and non-excludable. Non-rival means consumption of public good does not reduce or diminish the availability of others. Non-excludable means it is impossible to exclude others from consuming the good. Because of the aforementioned features, some individuals may use public goods without actually contributing to the cost of financing the good. This would encourage other consumers also to follow the suit and enjoy the public good 'free' of cost. This phenomenon is called free-rider or easy-rider problem. Eventually there comes a situation where the cost of providing the public good exceeds the benefits to the providers and the incentive to provide the good disappears even though it is needed for the welfare of the society. A person who enjoys the benefits of a good or service without paying for it.Because of the free-rider problem, the market would provide too small a quantity of a public good. To produce the efficient quantity, government action is required.

2.4 Solutions to Free Rider Problem

1. Taxation
2. Soliciting Donations
3. Make a Public Good Private

1. Taxation: One solution is to treat all beneficiaries as one consumer and then divide the cost equally.For example, if we have a public good like national defense, we can get everyone to pay for it by using tax revenue to pay for the national defense budget.

2. Soliciting Donations: This can be effective for services that a low cost. People often don't mind making a small donation towards a garden or a museum. Not everyone will pay, but the generosity of the people that will pay will make up for the free riders.

3. Make a Public Good Private: If you convert a public good into private, then you could force everyone to pay to use it. For example, by erecting a toll on the public bridge, you would force everyone who crosses it to pay for the construction cost.

2.5 Social Goods and Market Failure

Market failure refers to the inefficient distribution of goods and services in the free market.In a typical free market, the prices of goods and services are determined by the forces of supply and demand, and any change in one of the forces results in a price change and a corresponding change in the other force. The changes lead to a price equilibrium.

Market Failure: Market failure occurs when there is a state of disequilibrium in the market due to market distortion. It takes place when the quantity of goods or services supplied is not equal to the quantity of goods or services demanded. Some of the distortions that may affect the free market may include monopoly power, price limits, minimum wage requirements, and government regulations.**Market fails to produce the right amount of the product, resources may be:**

- **Over-allocated**
- **Under-allocated**

Demand-Side Failures: Impossible to charge consumers what they are willing to pay for the product. Some can enjoy benefits without paying

Supply-Side Failures: Occurs when a firm does not pay the full cost of producing its output**.** External costs of producing the good are not reflected in the supply

Efficiently Functioning Markets: Demand curve must reflect the consumers full willingness to pay**.** Supply curve must reflect all the costs of production**.** Market failure occurs when there is a state of disequilibrium in the market due to market distortion. It takes place when the quantity of goods or services supplied is not equal to the quantity of goods or services demanded. Some of the distortions that may affect the free market may include monopoly power, price limits, minimum wage requirements, and government regulations.

2.6 Causes of Market Failures

Externality: An externality refers to a cost or benefit resulting from a transaction that affects a third party that did not decide to be associated with the benefit or cost. It can be **positive or negative**. A positive externality provides a positive effect on the third party.For example, providing good public education mainly benefits the students, but the benefits of this public good will spill over to the whole society.On the other hand, a negative externality is a negative effect resulting from the consumption of a product, and that results in a negative impact on a third party.For example, even though cigarette smoking is primarily harmful to a smoker, it also causes a negative health impact on people around the smoker.

Public goods: Public goods are goods that are consumed by a large number of the population, and their cost does not increase with the increase in the number of consumers. Public goods are both non-rivalrous as well as non-excludable. Non-rivalrous consumption means that the goods are allocated efficiently to the whole population if provided at zero cost, while non-excludable consumption means that the public goods cannot exclude non-payers from its consumption.Public goods create market failures if a section of the population that consumes the goods fails to pay but continues using the good as actual payers. For example, police service is a public good that every citizen is entitled to enjoy, regardless of whether or not they pay taxes to the government.

Market control: Market control occurs when either the buyer or the seller possesses the power to determine the price of goods or services in a market. The power prevents the natural forces of demand and supply from setting the prices of goods in the market.On the supply side, the sellers may control the prices of goods and services if there are only a few large sellers (oligopoly) or a single large seller (monopoly). The sellers may collude to set higher prices to maximize their returns.The sellers may also control the quantity of goods produced in the market and may collude to create scarcity and increase the prices of commodities.On the demand side, the buyers possess the power to control the prices of goods if the market only comprises a single large buyer (monopsony) or a few large buyers (oligopsony).If there is only a single or a handful of large buyers, the buyers may exercise their dominance by colluding to set the price at which they are willing to buy the products from the producers. The practice prevents the market from equating the supply of goods and services to their demand.

Imperfect information in the market: Market failure may also result from the lack of appropriate information among the buyers or sellers. This means that the price of demand or supply does not reflect all the benefits or opportunity cost of a good.The lack of information on the buyer's side may mean that the buyer may be willing to pay a higher or lower price for the product because they don't know its actual benefits.Market failure may also result from the lack of appropriate information among the buyers or sellers. This means that the price of demand or supply does not reflect all the benefits or opportunity cost of a good. The lack of information on the buyer's side may mean that the buyer may be willing to pay a higher or lower price for the product because they don't know its actual benefits.

2.7 Market Failure and Government Interventions

To understand the role of government, it will be useful to distinguish four broad types of government involvement in the economy. First, the government attempts to respond to market failures to allocate resources efficiently. In a particular market, efficiency means that the quantity produced is determined by the intersection of a demand curve that reflects all the benefits of consuming a particular good or service and a supply curve that reflects the opportunity costs of producing it. Second, government agencies act to encourage or discourage the consumption of certain goods and services. The prohibition of drugs such as heroin and cocaine is an example of government seeking to discourage consumption of these drugs. Third, the government

redistributes income through programs such as welfare and Social Security. Fourth, the government can use its spending and tax policies to influence the level of economic activity and the price level.

The Government: If perfectly competitive markets are left on theirown, they may fail to providean e fficient and fair allocation of resources so the government stepsin.

Roles of the Government:

- Regulatory role
- Allocative role
- Distributive role
- Stabilisation role

RegulatoryRole:The rules that are established to make the market system work effectively. Employment Relations Act, Fair Trade Act and the Consumer Guarantees Act.

AllocativeRole: Thegovernmentmustdeterminehowsomeresourcesareallocated.Collectivegoodssu chasroads,educationand health.

DistributiveRole:Thefree-marketoutcomeresultsinanunfairdistributionof income,sotheywillintervenetoassureeveryonehasasufficientincome.Theydothisthroughbenefits,state housingand educationalcourses.

StabilisationRole: Thegovernmentintervenesinthemarkettoensurethereissteadygrowth. Theydothisthroughmonetaryandfiscalpolicy.

2.8 Probable corrective action for Market Failure

Using the definition of a broad perfect competition, a market failure can be usually corrected by allowing consumers and competing sellers to shove the market towards equilibrium over a period of time. Markets often tend to constantly move towards equilibrium, but never quite attaining it because of limitation to human knowledge, besides changes in global situations.

Many policy experts and economists seek possible regulations and interventions for compensating a perceived market failure. Subsidies, tariffs, punitive or redistributive taxation, trade restrictions, disclosure mandates, price ceilings and several other economic distortions were mooted to correct inefficient outcomes.

Other economic experts argue that a market is recognizably imperfect. Market failures, however, are improperly framed. Instead of asking whether market failures are related to perfect competition, they say that the question must revolve around whether a market performs better than other processes which humans may trigger.

Free market economists like Milton Friedman, FA Hayek, and others, have argued that a market is the only recognized discovery process capable to adjust correctly to all inefficiencies. They say that a regulation can interfere with the process causing inefficiencies to deteriorate than better.

Here are some actions that can be adopted to resolve a market failure.

Control of monopoly

A monopoly power in the market can be controlled by the government by passing restrictive trade practice legislation and anti-monopoly laws. These regulations are targeted to remove unfair competition in the market, prevent iniquitous price discrimination and fixing prices that equal to competitive prices.

The government may also deescalate all monopoly prices to a competitive level via taxation and price regulation. The authorities may enforce a price ceiling to bring down monopoly pricing to near or equal to a competitive price. This is usually achieved by setting up of a commission that fixes the price of a monopoly goods or service, below the monopoly price.

Taxation is another way of controlling monopoly power during a market failure. Taxes could be levied lumpsum, irrespective of the output of the monopolist. The tax could also be proportional to the output i.e. the taxable amount rising with a rise in output. In both cases, the target is to bring

down the monopoly to a competitive level.Eminent English economist, Arthur Cecil Pigou, favored nationalizing monopoly for ending monopoly power.

External factors

Pigou suggested social control measures and using subsidies and taxes to achieve an optimal allocation of resources in the face of various externalities. The government can interfere, in all cases, an external diseconomy of production for removing any divergence between social and private costs and benefits. The government in that case can ask the business owner for moving out of the residential area by extending appropriate facilities to a smoke emitting workshop. He said that in case of any external diseconomy of consumption, the government could end the noise pollution by banning loudspeakers, except during a special occasion in specific hours with prior permission.

Government Intervention

Governments intervene in markets to address inefficiency. In an optimally efficient market, resources are perfectly allocated to those that need them in the amounts they need. In inefficient markets that is not the case; some may have too much of a resource while others do not have enough. Inefficiency can take many different forms. The government tries to combat these inequities through regulation, taxation, and subsidies. Most governments have any combination of four different objectives when they intervene in the market.

Maximizing Social Welfare

In an unregulated inefficient market, cartels and other types of organizations can wield monopolistic power, raising entry costs and limiting the development of infrastructure. Without regulation, businesses can produce negative externalities without consequence. This all leads to diminished resources, stifled innovation, and minimized trade and its corresponding benefits. Government intervention through regulation can directly address these issues.

Another example of intervention to promote social welfare involves public goods. Certain depletable goods, like public parks, aren't owned by an individual. This means that no price is assigned to the use of that good and everyone can use it. As a result, it is very easy for these assets to be depleted. Governments intervene to ensure those resources are not depleted.

Macro-Economic Factors

Governments also intervene to minimize the damage caused by naturally occurring economic events. Recessions and inflation are part of the natural business cycle but can have a devastating effect on citizens. In these cases, governments intervene through subsidies and manipulation of the money supply to minimize the harsh impact of economic forces on its constituents.

Socio-Economic Factors

Governments may also intervene in markets to promote general economic fairness. Government often try, through taxation and welfare programs, to reallocate financial resources from the wealthy to those that are most in need. Other examples of market intervention for socio-economic reasons include employment laws to protect certain segments of the population and the regulation of the manufacture of certain products to ensure the health and well-being of consumers.

Other Objectives

Governments can sometimes intervene in markets to promote other goals, such as national unity and advancement. Most people agree that governments should provide a military for the protection of its citizens, and this can be seen as a type of intervention. Growing a large and impressive military not only increases a country's security but may also be a source of pride. Intervening in a

way that promotes national unity and pride can be an extremely valuable goal for government officials.

Price Ceilings

A price ceiling is a price control that limits the maximum price that can be charged for a product or service. Generally, ceilings are set by governments, although groups that manage exchanges can set ceilings as well. The purpose of a price ceiling is to protect consumers of a certain good or service. By establishing a minimum price, a government wants to ensure the good is affordable for as many consumers as possible.

An example of a price ceiling is rent control. These regulations require a more gradual increase in rent prices than what the market may demand. This regulation is meant to protect current tenants. Without rent control, there could be situations where the demand for housing in an area could cause rent prices to make a substantial jump. Unable to afford the new, significantly higher rent, a majority of the neighborhood's tenants may be forced to move out of the neighborhood. Rent controls limit the possibility of tenant displacement by minimizing the amount by which rent can be increased.

By definition, however, price ceilings disrupt the market. By setting a maximum price, any market in which the equilibrium price is above the price ceiling is inefficient. There will be excess demand because the price cannot increase enough to clear the excess.

For a price ceiling to be effective, it must be less than the free-market equilibrium price. This is the price established through competition such that the amount of goods or services sought by buyers is equal to the amount of goods or services produced by sellers. It is also the price that the market will naturally set for a given good or service. If the price ceiling is higher than what the market would already charge, the regulation would not be effective. As a result, a government will do significant research into the current market conditions for a good before setting a price ceiling.

2.9 Social Goods

A social good is something that benefits the largest number of people in the largest possible way, such as clean air, clean water, healthcare, and literacy. Social goods: are goods with non-exclusion principle and their supply is jointly made.Also known as "common good," social good can trace its history to Ancient Greek philosophers and implies a positive impact on individuals or society in general.**Social good** is typically defined as an action that provides some sort of benefit to the public. For example, fresh water, education and healthcare

Characteristics of Social Goods

- Universal distribution: members of the society can't be easily or reasonably prohibited from accessing social goods.
- Universal consumption: one person consuming a social good doesn't appreciably reduce someone else's consumption.
- Pooled financing: the social good is paid for predominantly by the pooled funds or labor of the entire group.
- Separation of buyer and user: the user of a social good may not be the one who paid for it, and vice versa.

Non-excludability: Benefits derived from **pure public goods** cannot be confined solely to those who have paid for it. Non-payers can enjoy the benefits of consumption at no financial cost to themselves – economists call this the **'free-rider' problem**

Non-rival consumption: Each party's enjoyment of the good or service does not diminish others' enjoyment– in other words the marginal cost of supplying a public good to an extra person is zero. If a public good is supplied to one person, it is available to all.

Non-rejectable: The **collective supply** of a pure public good for all means that it cannot be rejected by people, an example is a national nuclear defence system or major flood defence projects.

2.10 Quasi-Public Goods

A quasi-public good is a near-public good. It hassome of the characteristics of a public good. A public good may take on some of the features of a private good.Quasi-public goods are:

Semi-non-rival: up to a point, more consumers using a park, beach or road do not reduce the space available for others. But eventually beaches become crowded as do parks/leisure facilities. Open-access Wi-Fi networks become crowded

Semi-non-excludable: it is possible but difficult or costly to exclude non-paying consumers. E.g. fencing a park or beach and charging an entrance fee; or building toll booths on congested road routes.

Pure public goods are not normally provided by the private sectorbecause they would be unable to supply them for a profit.It is up to the government to decide what output of public goods / funding of public goods is appropriate for society.To do this, it must estimate the **net social benefits** from making public goods available.

The Free-Rider Problem

Because public goods are non-excludable it is difficult tocharge people for benefitting once a product is availablethe**free rider problem** leads to under-provision of a good and thus causes market failure

The Changing Nature of Public Goods

Advances in technology are causing a blurring of the distinction between public and private goods. Here are some examples.In some cases, **encryption allows** suppliers to exclude non-payers – although the product remains non-rivalTechnological progress reduces the cost of smart- metering used in road pricing– this makes roads more of a private (excludable) goodThe open source / creative commons movement has made much information public good in nature.

Should the Government Provide Public Goods?

- The non-rival nature of consumption provides a strong case for the government rather to provide and pay for public goods
- Many public goods are provided free at the point of use and then funded by taxation or a charge such as the BBC's licence fee
- State provision may help to prevent under-provision and under- consumption of public goods so that social welfare is improved
- If the government provides public goods, they may be able to do so more efficiently because of economies of scale.
- Providing essential public goods helps **affordability** and access to important services for lower income households and therefore help to address inequalities of income
- If the government becomes a monopoly provider, there is a danger of a lack of efficiency arising from a lack of competition
- In some cases, the state will fund, and the private sector provides public goods e.g. **Public Private Partnerships**

Global Public Goods

Global public goods are goods with benefits and/or costs that potentially extend to all countries, people, and generations. Global public goods are in a dual sense public: they are public as opposed to private; and they are global as opposed to national. Like publicness in general, globalness is in most instances a matter of policy choice. For example, capital controls or trade barriers are often being removed based on governmental and/or intergovernmental decisions. Or greenhouse gases must not rise and burden the atmosphere to the extent they do. All of this is today a matter of policy choice. **Global public goods** benefit every country, irrespective of which ones provide them – they have become more important recently

- Security from war, violence, and crime

- The rule of law, property rights, and contract enforcement
- Eradication of smallpox, Ebola and other diseases
- Non use / proliferation of nuclear weapons
- Agreements/measures towards protection of the ozone layer

2.11 Public Bads

There are also public bads in which one person experiencing some disutility does not diminish the disutility of another, such as air and water pollution. Public goods and public bads cannot be handled by the institution of private property. K. E. Boulding has explained public bads with the following example: "If someone drives his car into my living room and pollutes it, I can sue him for damages. This is a private bad. If someone congests the road or pollutes the air, however, there is not much I can do about it as an individual. This is public bad."

A public bad is any product on condition that it decreases the welfare of others in a non-exhaustive manner. For example, a factory situated in a residential area emits smoke which affects adversely health and household articles of the residents.In this case, factory benefits by producing more quantities of commodities but at the expense of residents who have to incur extra expenses to keep themselves healthy and their households clean. These are social marginal costs which are higher due to negative externalities (public bads).

A public bad has negative effects (externalities) on people and their communities leading to a significant loss of social welfare. Examples of public bads:

- Spread of infectious diseases such as Ebola
- Unauthorized / illegal surveillance by the state
- Modern slavery / human trafficking
- Environmental threats to the global commons
- Gender and other forms of discrimination in labour markets
- Disposal of household and commercial waste
- Web viruses / denial of service attacks
- High rates of global inequalities of income and wealth
- Endemic corruption within organisations and societies
- Externalities from banking crises / financial mismanagement

The Tragedy of the Commons

The pursuit of individual self-interest is often not good for socialefficiency leading to the long-term depletion of resources. Consider the example of a stock of common grazing land used by all livestock farmers in a small village.Each farmer keeps adding more livestock to graze on theCommons, because the marginal cost of doing so is zero.But because the commonly own resource is then over-using the result is a depletion of the soil, lower productivity and thus a fall in the market value of the resource for all users.The resource may become irretrievably damaged.The contribution of each agent is minute, but summed over all agents, these actions cause long term damage

Social Goods and Efficiency

To determine the efficient quantity of a social/public good, it is necessary to first determine the demand for it. Demand for public goods is represented through price-quantity schedules, which show the price someone is willing to pay for the extra unit of each possible quantity. Unlike the market demand curve for private goods, where individual demand curves are summed horizontally, individual demand curves for public goods are summed vertically to get the market demand curve.

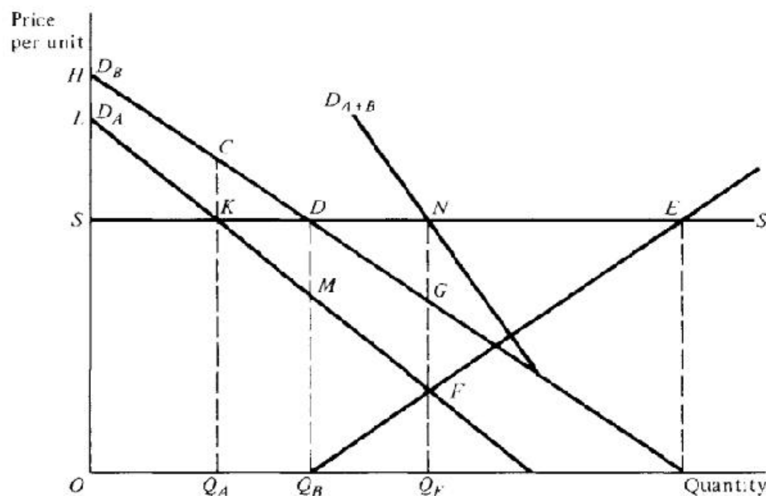

Figure: 2.2

Above Figure 2.2 depicts a situation where two consumers share in the benefit of a social good.The provision may be paid for by A or B but the quantities provided are available equally to both. D_A and D_B are A's and B's demand schedules for the social good and SS is the supply schedule. D_{A+B} is the aggregate demand schedule, obtained by vertical addition of D_A and D_B.Up to output OQ_E, the maximum prices which A and B would be willing to offer, as shown by D_{A+B} add to more than cost. This suggests that output will be bid up to OQ_E, where D_{A+B}, intersects SS at N. Both A and B pay a price equal to their marginal evaluation, Q_EF and Q_EG, respectively.As a result, the market demand curve for public goods gives the price *society* is willing to pay for a given quantity. It is equal to the marginal benefit curve. Due to the law of diminishing marginal utility, the demand curve is downward sloping.

As a result, the market demand curve for public goods gives the price *society* is willing to pay for a given quantity. It is equal to the marginal benefit curve. Due to the law of diminishing marginal utility, the demand curve is downward sloping.The government supplies the public good. The supply curve for a public good is equal to its marginal cost curve. Because of the law of diminishing returns, the marginal cost increases as the quantity of the good, produced increases. The supply curve therefore has an upward slope.

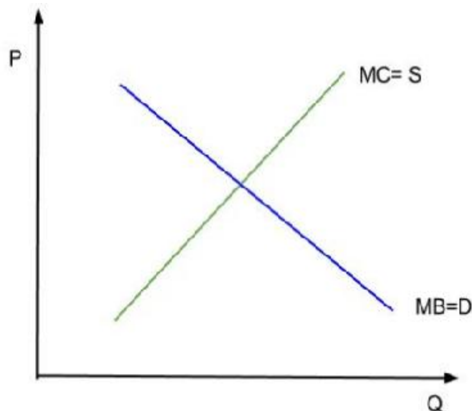

Figure: 2.3

Figure 2.3, the demand curve is equal to the marginal benefit curve, while the supply curve is equal to the marginal cost curve. The optimal quantity of the public good occurs where MB (society's marginal benefit) equals MC (provider's marginal cost), or where the two curves intersect. When MB = MC, resources have been allocated efficiently.

The public good provider uses cost-benefit analysis to decide whether to provide a particular good by comparing marginal costs and marginal benefits. Cost-benefit analysis can also help the provider decide the extent to which a project should be pursued. Output activity should be increased if the marginal benefit exceeds the marginal cost. An activity should not be pursued when the marginal benefit is less than the marginal cost. An activity should be stopped at the point

where MB equals MC. This is the MC=MB rule, by which the provider of the public good can determine which plan, will give society maximum net benefit.

Summary

The provision of social goods (the allocation function), reference is made to goods and services which must be paid for through budgetary finance. Whether the production of these goods is by a public agency or whether the goods and services are purchased from private firms is a different matter. Provision for social goods poses problems which differ from those which arise in connection with private goods. Since social goods are nonrival in consumption, consumer preferences are not revealed by consumer bidding in the market. Therefore, a political process and budgetary finance are required. The pattern of distribution which results from the existing pattern of factor endowments and their sale in the market is not necessarily one which society considers as fair. Distributional adjustments may be called for, and tax and transfer policies offer an effective means. of implementing them, thus calling for a distribution function in budget policy.Market failure is a necessary but not a sufficient condition for intervention. To be truly worthwhile, a government intervention must outperform the market or improve its functions. Second, the benefits from such intervention must exceed the costs of planning, implementation, and enforcement, as well as any indirect and unintended costs of distortions introduced to other sectors of the economy by such intervention.

Keywords

Externalities: are third party effects arising from production and consumption of goods and services for which no appropriate compensation is paid.
Common Resources: Goods or services that have characteristics of rivalry in consumption and non-excludability - grazing land or fish stocks are examples. The over-exploitation of common resources can lead to the "tragedy of the commons"

Tragedy of the Commons: When no one owns a resource, it gets over-used, for example fish stocks and deforestation - people use and benefit from it without regard to the effect on others

Public Bads: Public bads include environmental damage and global warming which affects everyone – no one is excluded from the dis-benefits.

Externalities: These occur when a third party is affected by the decisions and actions of others.

Socialbenefit: the total benefit to society =Private Marginal Benefit (PMB) + External Marginal Benefit (XMB)

Social Cost: is the total cost to society =Private Marginal Cost (PMC) + External Marginal Cost (XMC

Social Efficiency: This occurs when resources are utilised in the most efficient way. This will occur at an output where social marginal cost (SMC) = Social Marginal Benefit. (SMB)

SelfAssessment

1. Which of the following is a public good?

A. house.
B. traffic sign
C. both of the above
D. none of the above

2. Which is following characteristic of Public goods?

A. Elasticity
B. Inelasticity
C. Non-Rivalry
D. Excludable

3. A Pure private good is subject to:

A. Non exclusion
B. Low satisfaction
C. Exclusion
D. high satisfaction

4. What is the suitable commodity of Public goods:
A. Private finance
B. Education
C. Free air
D. all are above

5. Which of the following is a rival public good?
A. forest
B. hospital
C. both, forest and hospital
D. none of the above

6. Which of the following is a pure public good?
A. Police
B. highway
C. both of the above
D. none of the above

7. For a positive externality, _________________________than the social benefits.
A. private benefits of an action are more
B. social benefits of an action are more
C. private benefits of an action are less
D. social costs of an action are less

8. "Market Failure" can be described as a situation in which
A. a single seller of a good has substantial control over the price of the good.
B. the "free market outcome" is NOT efficient.
C. government intervention leads to a greater Deadweight-Loss than does the "free market outcome."
D. government imposes progressive taxes, in order to indirectly redistribute income.

9. A good is "Excludable" if
A. consumption by one person does not diminish the quantity/quality of consumption by others.
B. consumption by one person does diminish the quantity/quality of consumption by others.
C. it is difficult (or very costly) to prevent consumption by those who do not pay for the good.
D. it is easy (or relatively costless) to prevent consumption by those who do not pay for the good.

10. A good is said to be non-excludable if it is ____________________ to stop other people consuming it once it has been provided.
A. Impossible
B. Possible
C. Reasonable
D. Acceptable

11. Public goods are provided by government because
A. private firms do not take into account the impact of external costs.
B. governments are more efficient than private firms at producing public goods.
C. people value national defence very highly.
D. free-rider problems result in underproduction by private markets

12. According to ________ theory, governments make choices that result in an ________ provision of public goods. This outcome occurs in ________.
A. public choice; efficient; political markets in which voters are rationally ignorant
B. public choice; inefficient; a perfect political system in which voters are full informed about the effects of policies
C. social interest; efficient; political markets in which voters are rationally ignorant
D. social interest; efficient; a perfect political system in which voters are fully informed about the effects of policies

13. The tragedy of the commons refers to
A. the absence of incentives to prevent the overuse of a common resource that arises when its users have no incentive to conserve it and use it sustainably.
B. the inability of lower income groups to achieve a higher level of education.
C. the tendency for bureaucrats to maximize their budget.
D. farmers who allow their livestock to overgraze their fields.

14. Which of the following achieves the efficient use of a common resource?
A. property rights, individual transferable quotas, and subsidies.
B. production quotas, individual transferable quotas, and copyrights.
C. individual transferable quotas and copyrights.
D. property rights, production quotas, and subsidies

15. One way to alleviate the tragedy of the commons is to
A. make the resource private property.
B. distribute common resources among those individuals who really need the resource free of charge.
C. allow all individuals to use the common resource free of charge.
D. eliminate production quotas for using the common resource.

Answers for SelfAssessment

1.	B	2.	C	3.	C	4.	C	5.	C
6.	A	7.	C	8.	B	9.	D	10.	A
11.	D	12.	D	13.	A	14.	D	15.	A

Review Questions

1. What are some strategies for overcoming the free-rider problem in India?
2. How does the government use corrective taxes to attempt to address externalities?
3. What are the examples of market failure, and how can a government intervene to protect it?
4. How can we correct for externalities and provide public goods at an optimal level?

Further Readings

- Public Finance by H.L. Bhatia, Vikas Publishing House
- Public Finance in Theory and Practice by S.K. Singh, S Chand & company
- Public Finance in Theory and Practice by Musgrave. .and P.B. Musgrave, McGraw Hill Education
- Public Finance-a Contemporary Application of Theory to Policy by David n. Hyman, Cengage Learning.

Unit 03: Social Goods Allocation

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Objectives

After studying this unit, students will be able to:

- understand efficient provision of private and social goods,
- analyze the efficient provision of private and social goods to public in an economy.
- study the concept of budget allocation for social goods.
- evaluate the efficient allocation of budget for social goods.
- understand classification of mixed and merit goods.
- evaluate the mixed and merit goods in an economy.

Introduction

The provision for social goods, or the process by which total resource use is divided between private and social goods and by which the mix of social goods is chosen. Although social goods are available equally to those concerned, their benefits may be spatially limited. Thus, the benefits from national defense accrue nationwide while those from streetlights are of concern only to residents. This suggests that the nature of social goods has some interesting bearing on the issue of fiscal federalism centralization or decentralization. As we will see later, a good case can be made for letting national public services be provided by national government and local public services by local government.

3.1 Social Goods

Social goods, such as spaceships or military hardware, similarly may be produced by private firms and sold to government; or they may be produced directly under public management, as are

services rendered by civil servants or municipal enterprises. If we say that social goods are provided publicly, we mean that they are financed through the budget and made available free of direct charge. How they are produced does not matter.

The allocation function, concerned with the provision of social goods, inevitably departs from the market process but nevertheless poses the type of problem with which economic analysis has traditionally been concerned, i.e., the efficient use of resources given a prevailing distribution of income and pattern of consumer preferences. The issue of distribution is more difficult to handle. Yet, distribution issues are a major (frequently the major) point of controversy in the budget debate. In particular, they play a key role in determining tax and transfer policies.

Public Goods – no one wants to pay for them, but everyone benefits from them.

How does the government decide **WHICH** public goods are provided and HOW **MUCH IS** provided?

Should the ***private market*** be used to provide or produce government commodities?

A PURE PUBLIC GOOD has two features:

1) Nonrival – once provided, another person can consume it at no additional cost.
2) Nonexcludable – once provided, it is impossible or highly expensive to prevent anyone from consuming it.

What is a Private Good?

A PRIVATE GOOD has two features:

1) Rival – once consumed, another person cannot consume it
2) Excludable – others can be prevented from consuming it

Food (ie: pizza) is a good example of a private good. Once I eat it, it's gone, and you're left hungry.

Pure Public Good Issues

6 Issues arise out of Pure Public Goods:

1) Different Values
2) Public Goods Aren't Absolute
3) NONRIVAL ≠ NONEXCLUDABLE
4) Unconventional Public Good
5) Private Provision
6) Private Production

3.2 Efficiency

A given economic arrangement is efficient if there can be no rearrangement which will leave someone better off without worsening the position of others. Thus, it is impossible in this situation to change the method of production, the mix of goods produced, or the size of the public sector in a way that would help A without hurting B and C.If such a change is possible, then the prevailing arrangement is inefficient, and an efficiency gain can be had by making the change. This definition, so far as it goes, is quite reasonable. Provided only that envy is ruled out or overlooked, most people would agree that a change which helps A without hurting B and C is efficient.

Efficient Provision of Private Goods

Efficiency Rules: Economists have laid down certain conditions which must be met if the solution is to be efficient. To state the problem in simple terms, we consider an economy with two consumers, A and B, and two products, X and Y. These conditions must be met:

1. Efficiency requires that any given amount of X should be produced in such a way as to permit the largest possible amount of Y to be produced at the same time, and vice versa. The best available technology should be used. If one technique permits the production of I00 units of X and 80 units of

Y and Another permits I00 units of X combined with only 50 units of Y, the former method is obviously to be preferred.

2. The "marginal rate of substitution" in consumption between goods X and Y must be the same for consumers A and B. By this, we mean that the rate at which A and B will be willing to trade the last unit of X for additioal units of Y should be the same. If A is willing to give I unit of X for 3 units of Y and B will give 4 units of Y for 1 unit of X, it will be to the advantage of both to exchange, with A increasing consumption of Y and B consuming more of X until equality of the marginal rates of substitution is restored.

3. The marginal rate of substitution of X for Y in consumption should be the same as their marginal rate of transformation in production. The latter is defined as the additional units of X that can be produced if the production of Y is reduced by 1 unit. Thus, if the marginal rate of substitution in consumption is 3X for 2Y while the marginal rate of transformation in production is 3 X for 1 Y, it will be desirable to increase the output of X and to reduce that of Y until the two ratios are equalized.

3.3 Efficient Provision of Private Goods

To cover the efficient provision of ***public goods***, we first look at the efficient provision of ***private goods.***Consider A and B's individual demands for video games. At a market price, we add up A and B's quantity demanded for video games to find market demand. This results in a HORIZONTAL SUMMATION

Figure 3.1: Efficient Provision of Private Goods

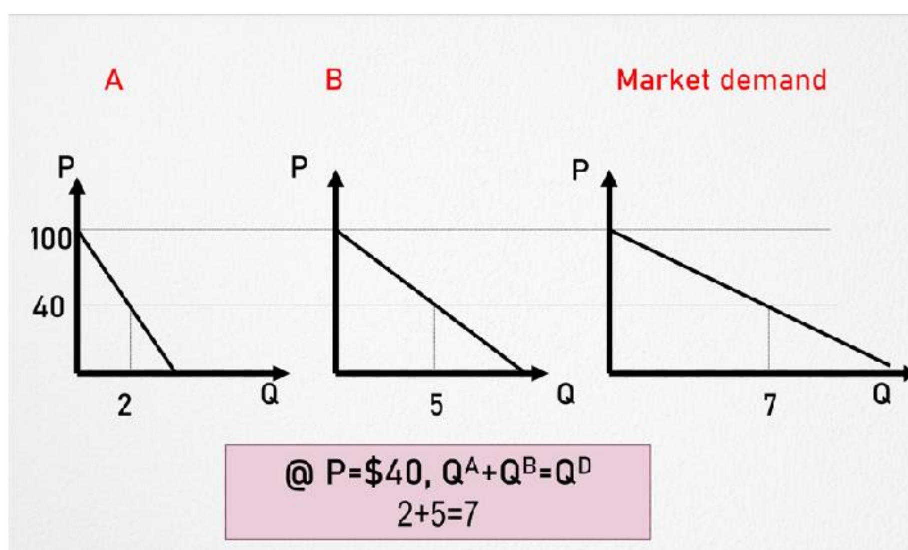
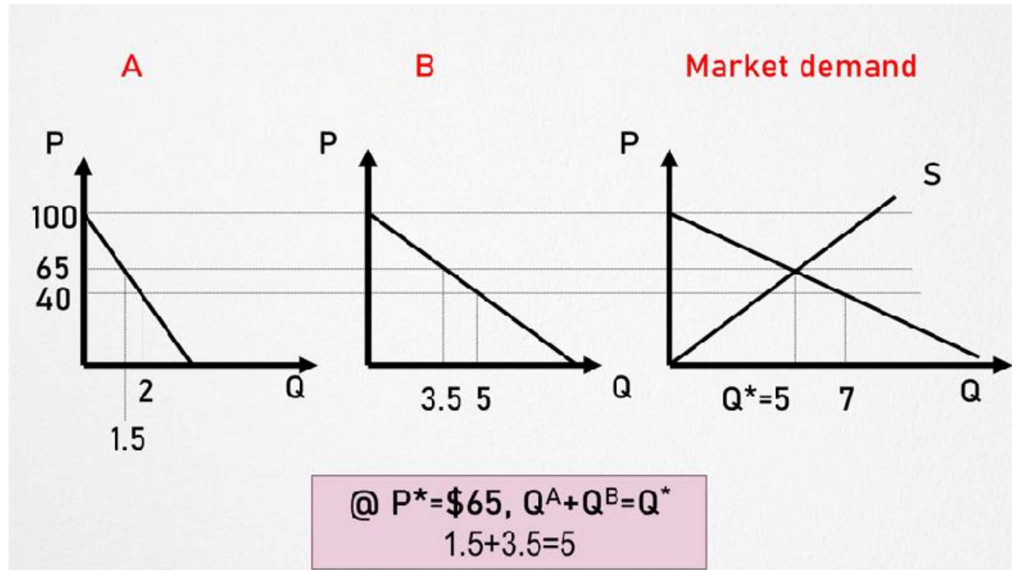


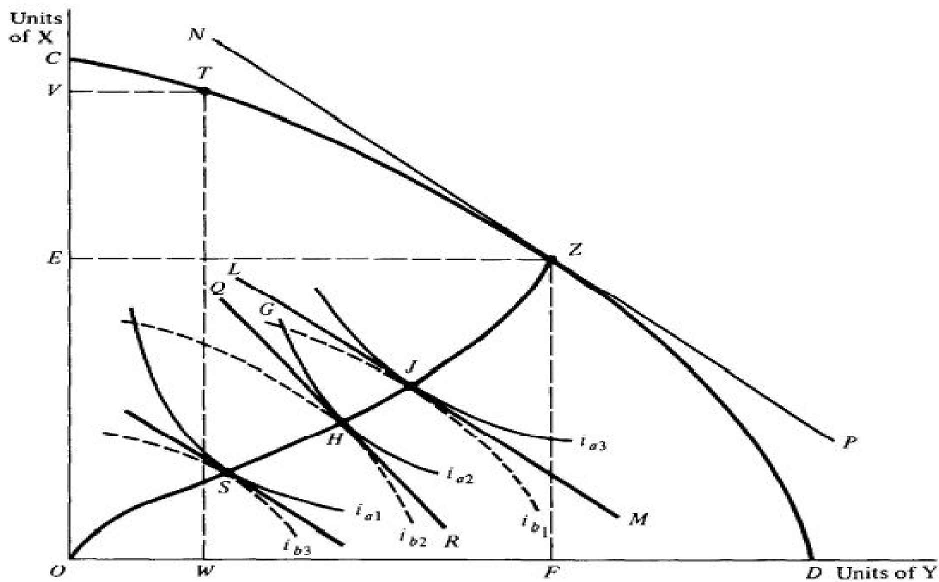
Figure 3.2: Equilibrium price and individual demand.



From microeconomic theory, we know that a consumer maximizes utility where $MRS_{xy}=P_x/P_y$. If we normalize P_y to $1, this simplifies to $MRS_{xy}=P_x$. Since price is found on the demand curve, A's (B's) demand expresses A's (B's) MRS at each level of consumption. The supply curve comes from MC-$MRT_{xy}=MC_x/MC_y$, but since $P_y=MC_y$ and P_y=$1, $MRT_{xy}=MC_x$. Therefore, the supply curve represents MRT_{xy}.Then, at equilibrium, Supply=Demand, and

$$MRT_{xy} = MRT_{xy}^{Person\,A} = MRT_{xy}^{Person\,B}$$

Figure 3.3: Pareto Efficiency

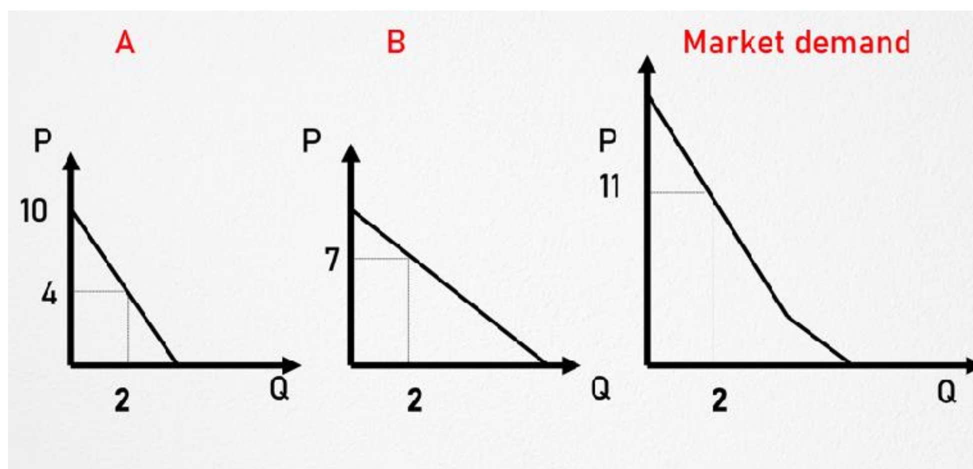


In above figure 3.3, output of private good X measured vertically and that of Y measured horizontally, CD shows the best possible combinations of both that can be produced. If all resources are put into X, the largest possible output of X equals OC; and if all resources are put into Y, the largest possible output equals OD. If OE of X is produced, the largest possible output of Y equals OF.The slope of CD thus reflects the marginal rate of substitution in production between X and Y.

3.4 Efficient Provision of Social Goods

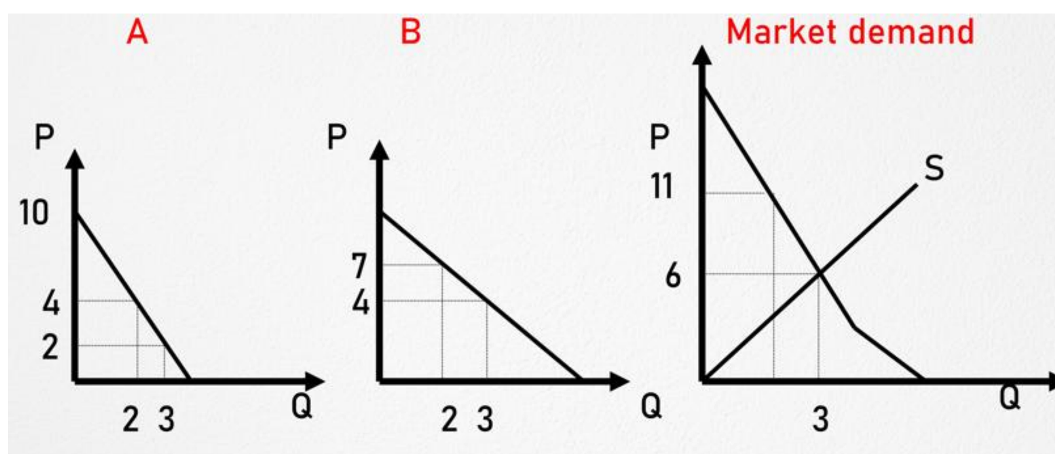
Consider A and B's individual demands for a public good, radio shows. Radio shows are nonrival and nonexcludable; one person's consumption doesn't affect the other. The key difference in a public good is that BOTH can consume a purchased good; it is not used up. This results in a VERTICAL SUMMATION to calculate willingness to pay

Figure 3.4



A is willing to pay $4 each for 2 radio shows, and B is willing to pay $7 each, therefore the market is willing to pay $11 each.

Figure 3.5



The market Supply gives an equilibrium *quantity* of 3. Here price paid in the market ($6) is the sum of A's payment ($2) and B's payment ($4).Once again, if we normalize our other good to $1, demand (willingness to pay) represents MRS for each person.The sum of both people's willingness to pay (market demand), is therefore the sum of individual MRS.The supply curve still represents MC and therefore MRT, so we have:

$$MRT_{xy} = MRT_{xy}^{Person\,A} = MRT_{xy}^{Person\,B}$$

Furthermore, again since P_y=$1,

$$MC = MB^{PersonA} + MB^{PersonB}$$

Intuitively, public goods should therefore be provided until the point where the marginal cost of the good is equal to the sum of marginal benefits. The private good equation can also be rewritten as

$$MC = MB^{PersonA} + MB^{PersonB}$$

Distortionary Taxes and Public Goods

If Public Goods are funded by distortionary taxation, we have two additional effects:

1) We have to consider the cost of raising an additional dollar through a distortionary tax, or marginal cost of public funds (MCF). Gross cost then becomes:

$$MCF * MC$$

2) The public good may encourage economic activity, which translates into new taxes, captured by:

$$MCF * MR$$

Therefore, optimal provision of a public good then occurs when:

$$MCF\ (MC - MR) = MB^{PersonA} + MB^{PersonB}$$

If MR is positive (the public good benefits the economy), benefit becomes

$$MCF * MR + MB^{PersonA} + MB^{PersonB}$$

Alternately, if MR is negative (the public good, though it may benefit people, hurts the economy (such as a free theme park hurting private theme parks), cost becomes:

$$MCF\,(MC - MR)$$

In short, public goods are always best provided whereTotal Marginal Benefit = Marginal Cost. Providing a public good through distortionary taxes may ***increase*** or ***decrease*** its provision when compared to lump-sum taxation funding.

3.5 Budget

An estimation of the revenue and expenses over a specified future period of time. A budget can be made for a person, family, group of people, business, government, country, multinational organization or just about anything else that makes and spends money.A budget is an operational plan for a definite period, usually a year. Expressed in financial terms and based on the expected income and expenditure.

Origin of budget

Derived from the French word 'Bougette' meaning 'leather bag'. Bag used by the British chancellor to keep his papers to be presented to the parliament. Present sense of the term was used for the first time in 1873.

- According to Article 112 of the Indian Constitution, the Union Budget for a year, also referred to as the **Annual Financial Statement**,
- is a statement of the estimated receipts and expenditure of the government for that particular year.
- It is presented each year on the last working day of February by the Finance Minister of India in Parliament.
- The budget speech of the finance minister is usually divided in two parts.

  (a) deals with general economic survey of the country while part.

  (b) relates to taxation proposals.

Stages Involved in the Government Budget

1. Preparation of the budget
2. Enactment of the budget
3. Execution of the budget

Preparation of the budget

The budget contains 3 types of accounts:

a. actual for the preceding year

b. revised budget estimates for the current year

c. budget estimates for the coming year

A government budget is defined as a legal document that is passed by the legislature and approved by the chief executive or President.

The government budget comprises:

(a) revenue budget

(b) capital budget

a. Revenue Budget: It deals with the revenue aspect of the government's budget. It explains how revenue is generated or collected by the government and how it is allocated among various expenditure heads.

The revenue budget is divided into two parts:

i. Revenue Receipts

ii. Revenue Expenditures

b. Capital Budget: It deals with the capital aspect of the government budget, and it consists of:

i. Capital Receipts

ii. Capital Expenditures

3.6 Social-Goods Allocation in The Budget

A social good is something that benefits the largest number of people in the largest possible way, such as clean air, clean water, healthcare, and literacy. Every State allocate the funds from their budget to provide social goods to the public.This general model integrates the properties of social goods into the theory of welfare economics, but it tells us little about how the solution is to be implemented.In a real-world setting, there is no omniscient planner who can solve the problem for us and settle the outcome.A mechanism is needed by which preferences are revealed and the corresponding allocations are made. In the case of **private goods**, this mechanism was provided through the use of a **competitive pricing system** which, based on a given distribution of income, serves to secure an efficient solution.In the case of social goods, a political process is needed, with consumers expressing their preferences through voting and on the basis of a given distribution of income.

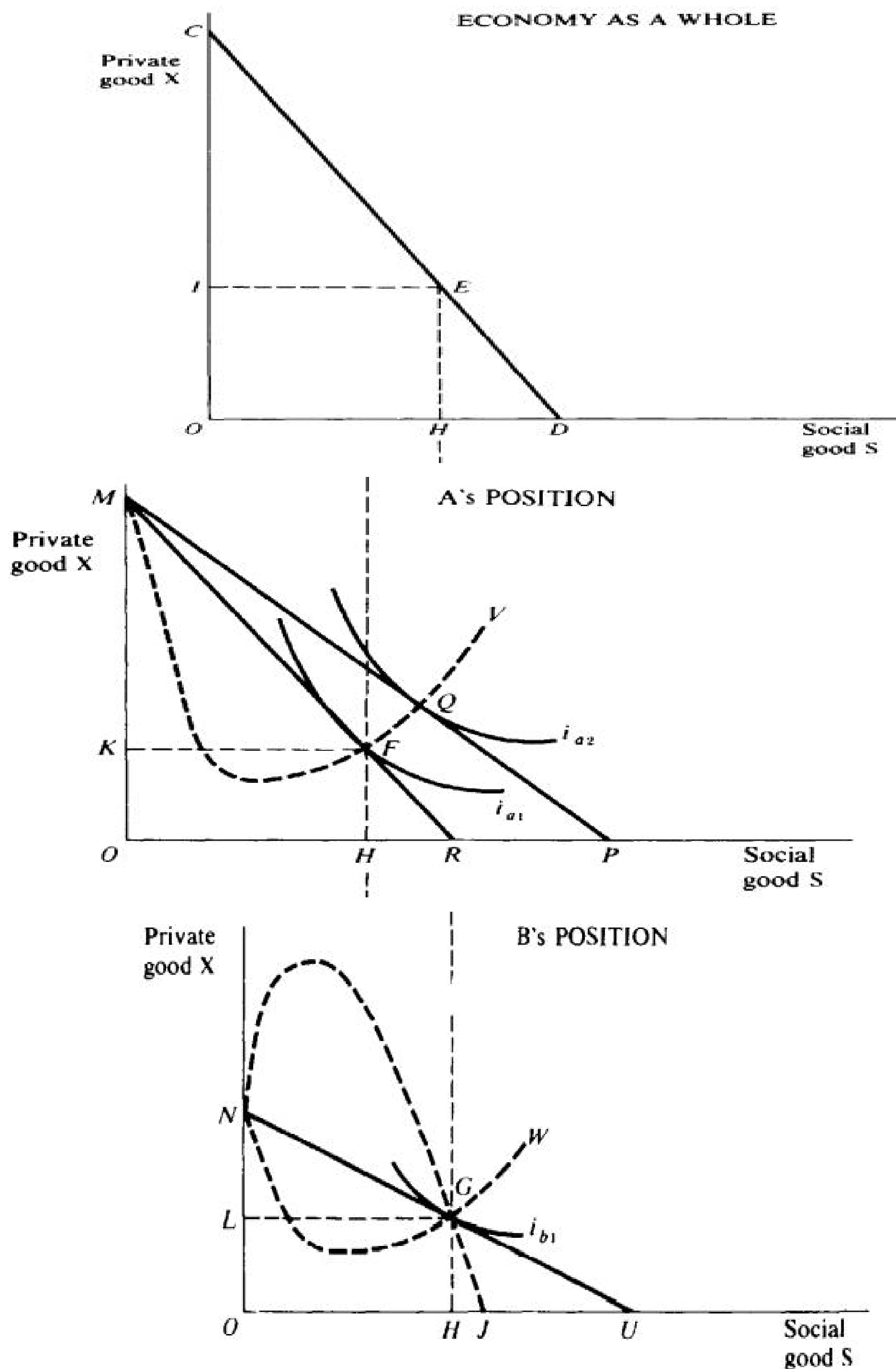
Efficient Allocation: In this process, social-goods allocation will now be restated in terms of a budget model, where the provision for social goods is decided upon in line with consumers' evaluations, based on their incomes and preferences. The cost of social goods is then covered by taxes, imposed in line with consumer evaluation-i.e., by a generalized system of benefit taxation-which moves the model in the direction of realism, but we retain for the time being the assumption that preferences are known to the planner. We assume that the tax prices are set so as to charge particular consumers for their consumption of social goods in accordance with a *pricing rule similar* to that operating in a competitive market for private goods. for each consumer, all units of a good are to be sold at the same price (there is to be no higher price on intramarginal units), and the ratio of unit prices for goods is equal to the consumer's marginal rate of substitution in consumption. All consumers will pay the same unit price for all private goods while consuming different amounts thereof, and they will pay different unit prices for social goods while consuming the same amount.

The production possibility line CD in the upper figure shows various mixes of S (the social good) and X (the private good) that can be produced and that are available to the economy as a whole. The middle figure shows the position of consumer A and the lower that of B.Suppose that income is divided between A and B so that A receives a share equal to OM/OC of potential private-good output OC and B receives ON/OC, where OM + ON = OC.

The broken line MV will then record the optimal allocation of A's income between X and Sat varying price ratios. It traces the point of tangency of a set of price lines anchored at M with successive indifference curves. Given the price ratio OM/OP, for instance, A's preferred position will be at Q, where MP is tangent to the highest attainable indifference curve *i 2* • The broken curve NW traces a similar price line for B.Following A's positions along MV, we may trace out the corresponding positions available to B, as shown by the broken curve NJ. At each pair of points, both must consume the same amount of S, while B's consumption of X is obtained by deducting A's consumption (as recorded by MV) from the total supply of X (as recorded by CD).The NW curve, in

turn, traces out the preferred positions for consumer B which would result if different price ratios were applied to B 's purchases of social and private goods. The NJ and NW curves intersect at G, and the correct pricing and output solution is thus obtained where B is placed at G while A is positioned at F and total output is divided between private and social goods, as shown by E on the production possibility curve.

Figure 3.6: Social and private goods with given distribution



Both consume OH of S, while private good output OJ is divided so that OK goes to A and OL to B where OK + OL = OJ. This solution has the following characteristics:

1. The solution conforms to the initial distribution of income, with A's share equal to OM I OC and B's share equal to ON I OC.
2. A and B both pay a tax price such that each one's marginal rate of substitution for S and X in consumption is equal to each one's price ratio, so that our pricing rule is complied with.
3. The combined tax contribution of A and B equals the cost of S to the group as a whole.
4. The solution meets the efficiency criterion of the Samuelson model-i.e., that the sum of the marginal rates of substitution equals the marginal rate of transformation.

Extension to Voting: This view of the fiscal problem takes one step toward reality since an initial distribution of money income is assumed to exist and tax shares are determined on that basis. But it remains unsatisfactory in that it is still implemented through a planner to whom preferences are known. In the real-world setting, there is no omniscient planner to whom the preferences of Figure 5-4 are revealed and who can derive an optimal solution therefrom. Nor is the case of realism helped by substituting an assumption of voluntary bidding. To provide an operational view of the budget, the model must thus be extended to incorporate a theory of the voting process.

More specifically, the task is to devise a voting system which is effective in securing preference revelation and an efficient system of tax-expenditure determination. The solution should approximate an efficient pricing rule, such as that shown in Figure 3.4. Through the voting process, the pseudo-demand schedules are revealed, the budget size is determined, and the tax prices are applied.

3.7 Mixed Goods and Merit Goods

Mixed goods

Mixed goods are those goods having benefits which are wholly internalized (rival) and others, the benefits of which are wholly externalized (non-rival). The cost of producing such goods partly covered by private contributions and partly by government subsidy. Mixed goods possess characteristics of both private and public goods. These goods and services are common in the real world and raise several vital questions about the economic role of government. Two classes of mixed goods and services can be distinguished

- Non-rival, excludable mixed goods and services:
- Rival, non-excludable mixed goods and services:

	Excludable	Non- Excludable
Rivalrous	**Private Goods** Food, clothing, cars, personal electronics	**Common Goods** Fish stocks, timber, coal
Non- Rivalrous	**Club Goods** Cinemas, private parks, satellite	**Public Goods** air, national defense

Public Goods

Public goods are those goods, the consumption of which is externalized. Public goods satisfy the collective wants or social wants in general. Public goods are those goods, which are jointly supplied. That is, the benefits from consumption of public goods, are consumed jointly by more than one person.

Private Goods

Private goods are those goods, which yield utility only to the person consuming the good. Only the person who drinks a cup of tea for example, benefits from the consumption of that cup of tea. The cup of tea consumed by one person cannot be consumed by anyone else. Therefore, private goods are carrying a price with it.A perfect **example** of this type of **good** is a local fishing hole. The fishing hole has the non-excludable element of public goods (we cannot exclude certain people from fishing in the public place), But also has the rival element of a private **good** (There is a limited number of fish in the pond).

Public vs. Private Goods

The major difference between a pure public good and quasi-public good or mixed good; is that the benefits of the former are completely indivisible and must be consumed equally by all, while the latter creates individual benefits (divisible and assignable) as well as public benefits.Many democratic countries quasi-public goods are publically financed, mixed goods can be defined in another way. The goods and services which are partly supplied by the private market and partly through the Budgetary provision can be categorized as mixed goods.A good example is the public distribution system in India. Under this system essential goods are supplied to the poor people at subsidized prices. Therefore, wheat, rice or sugar purchased from the ration-shops are charged lower prices than those prevailing in the open market, for them. Public distribution is made possible through government subsidy, which involves budgetary expense.

3.8 Merit Goods

Those goods whose consumption and use are to be encouraged are called merit goods (e.g.; education) and goods whose consumption and use are to be discouraged are called non-merit goods or demerit goods (e.g., liquor, narcotic etc.) drugs Merit goods are socially desirable goods which promote social welfare. Merit goods are rival and excludable. Governments provide merit goods in order to ensure distributional justice. These are goods which governments feel if people will under consume or produce and therefore should be subsidized or provided free. **Merit goods** are those goods and services that the government feels that people will **under-consume**, and which ought to be **subsidised** or provided **free at the point of use** so that consumption does not depend primarily on the ability to pay for the good or service. Concept of merit goods was introduced by **Prof. R. A, Musgrave in 1959.**

This is good where people underestimate the benefits of consuming. This may be due to poor information or overvaluing present happiness (e.g., going to party rather than studying.Merit goods usually have positive externalities; for example, with education, if people gain qualifications – they can earn a higher salary, but the whole economy benefits from their skills.E.g., Education is a merit good. People underestimate benefits of studying and so there is under-consumption.Note Merit goods may be provided in a free market – but in insufficient quantities.

A merit good has two characteristics:

1. People do not realise the true personal benefit. For example, people underestimate the benefit of education or getting a vaccination.
2. Usually, these goods also have a positive externality.

Therefore, in a free market, there will be under consumption of merit goods.For example, Health Care – people underestimate the benefits of getting a vaccination. If people do get a vaccination, then there will be a personal benefit in protecting against diseases. Also, there will be external benefits to the rest of society because it will help reduce the prevalence of disease in the rest of society.

Museums – the educational benefit of museums may be unappreciated.

Eating fruit and vegetables – A diet of raw fruit gives health benefits to the consumers, but we may prefer unhealthy food.

Education – People may undervalue the benefits of studying and decide to leave school early or not get good grades.

Demerit Goods

A demerit good is a good where people may be unaware of the costs or choose to ignore them. For example, people may over-consume alcohol or get addicted to cigarettes – even though this will damage their health.It requires a subjective opinion that people make 'wrong' choices. Some may see gambling as an example of a demerit good because it can lead to gambling addiction. Others may see it as 'harmless fun'.Demerit goods often have negative externalities as well. If you smoke it gives passive smoking to others.

A demerit good has two characteristics:

1. A good which harms the consumer. For example, people don't realise or ignore the costs of doing something e.g. smoking, drugs.
2. Usually, these goods also have negative externalities. If you smoke you harm yourself, but also, the smoke affects other people negatively.

   Therefore in a free market, there will be overconsumption of these goods.

Examples of Demerit Goods include:

- Smoking – People underestimate health costs or risks of getting addicted.
- Drinking – Health costs to drinkers. Costs to society include more expenditure on health care and policing.
- Taking drugs – Health costs to drug users – people underestimate the risk of getting addicted. External costs of more crime.
- Drinking sugary soft-drinks – which damage teeth and cause obesity.

The mixed goods and the merit goods are influenced by government. The public goods are entirely supplied by government, while the merit goods, intervened by government. Owing to the particular attributes, the public goods could not be privatized. The merit goods could not be totally supplied by the private sector. So there is mixture of both.

Summary

Efficient resource use occurs when there is no possibility of making a change which helps one person without hurting anyone else. There are many efficient solutions to the allocation problem, each reflecting a different state of distribution among consumers. Efficient resource use in the case of private goods requires the marginal rates of substitution in consumption to be the same for all consumers and equal to the marginal rate of transformation in production. This result from step 2 can be achieved through a competitive market where consumers reveal their preferences by bidding for goods. In such a market, all consumers would pay the same price but consume different amounts, depending upon their income and their preferences. A market demand schedule is obtained by horizontal addition of individual demand schedules. In the case of social goods, the solution to the problem differs for the following reasons: Since such goods are nonrival in consumption, the same amount is consumed by all. Efficient resource use now requires the sum of the marginal rates of substitution in consumption to equal the marginal rate of transformation in production. An omniscient planner, to whom all preferences are known, can thus arrive at an allocation of resources to the production of private and of social goods and at a distribution of private goods among consumers which is optimal. Such a solution is optimal both in the sense of meeting the efficiency conditions of Pareto optimality and of satisfying the distributional norms of the given social welfare function. This solution, however, is not operational. A political process or voting system, based on a given distribution of money income, is needed to induce the revelation of preferences. The voting process, it is hoped, approximates an efficient solution. But this solution, like that of a competitive market for the allocation of private goods, is optimal only if the underlying distribution of money income is also the correct one. The allocation choice also affects distribution, so that corrective adjustments in distribution cannot be independent of the allocation choice. Nevertheless, a separation of functions remains necessary as a practical solution.

Keywords

Free rider: those who want others to pay for the public good and then plan to use the good themselves; if many people act as free riders, the public good may never be provided.

Nonexcludable: when it is costly or impossible to exclude someone from using the good, and thus hard to charge for it.

Nonrivalrous: even when one person uses the good, others can also use it.

Public Good: good that is nonexcludable and non-rivalrous, and thus is difficult for market producers to sell to individual consumers

Self Assessment

1. Public Goods are:
A. Excludable
B. Non – excludable
C. Marketable
D. All of these

2. A criterion by which public goods are distinguished from private goods:
A. Exclusion principle
B. Externality principle
C. Public choice principle
D. None of the above

3. Public goods are non rivial if
A. Some people cannot be prevented from consuming it
B. Consumption by one person reduces consumption of other individuals
C. Some people can be prevented from consuming it
D. None of above

4. Marginal cost of providing the public goods to additional consumers is:
A. 0
B. 1
C. 2
D. 3

5. Private goods are characterized by
A. Application of exclusion principle
B. Rivalry in consumption
C. Payment of prices
D. All the above

6. The Annual Account of both the income and expenditure is called:
A. Plan
B. Budget
C. Manifesto
D. Accounts

7. Which of the following is not a fiscal instrument?
A. Open market operations
B. Public expenditure
C. Taxation
D. Budget

8. Public expenditure on education and health will have a _______ effect on people’s ability to work.
A. Negative

B. Neutral
C. Positive
D. Stagnating

9. The amount collected by the government as taxes and duties is known as _______
A. Capital receipts
B. Tax revenue receipts
C. Non-tax revenue receipts
D. All of these

10. Which is a component of the Budget Receipt?
A. Revenue Receipt
B. Capital Receipt
C. Both, Revenue Receipt& Capital Receipt
D. None of the above

11. Merit goods means:
A. Public good
B. Free good
C. Rare good
D. White good

12. Education is an example of:
A. Public good
B. Merit good
C. Social good
D. Club good

13. Those goods whose consumption and use are to be encouraged are called
A. Private good
B. Public good
C. merit good
D. mixed good

14. Mixed goods are those goods having benefits which are:
A. rival
B. Non – rival
C. Both, rival and Non – rival
D. none of above

15. Non-exclusion principle is related to:
A. Private goods
B. Public goods
C. Merit goods
D. Mixed goods

Answers for Self Assessment

1.	B	2.	A	3.	A	4.	A	5.	D
6.	B	7.	A	8.	C	9.	B	10.	C
11.	A	12.	B	13.	C	14.	C	15.	B

Review Questions

1. What are the two key characteristics of public goods?

2. Name two public goods and explain why they are public goods.
3. What is the free rider problem?
4. Explain why the federal government funds national defense.
5. Why is a football game on ESPN a quasi-public good but a game on the DD ONE and DD India is a public good?
6. Provide two examples of goods/services that are classified as private goods/services even though they are provided by a federal government.

Further Readings

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2. Public Finance in Theory and Practice by S.K. Singh, S Chand & company

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4. Public Finance-a Contemporary Application of Theory to Policy by David n. Hyman, Cengage Learning

Unit 04: Theory of Public Choice

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Objectives

- After studying this unit, students will be able to:
- Analyze the provision of social goods in an economy.
- Compare the private goods and social goods and budgetary provision.
- Understand the democracy and its type
- Evaluate the fiscal choices of people through voting
- Demonstrate the process of representative democracy
- Evaluate the representative democracy in decision making to satisfy the voters
- Demonstrate the Leviathan hypothesis
- Analyze the application and feasibility of Leviathan hypothesis

Introduction

The theory of social, or public, goods provides a rationale for the allocation function of budget policy. Although difficult to resolve, it is of central importance to the economics of the public sector, just as the theories of the consumer household and of the firm are at the core of private sector

economics. Our task in this chapter, therefore, is to extend the economic principle of efficient resource use to the public sector. Some believe this to be a hopeless task and hold that the determination of budget policy is a matter of politics only, not amenable to economic analysis, a view that is unduly pessimistic. Budget policy has difficult task and will hardly realizea perfect solution. But not all feasible policies are equally good. Efficiency of resource use, here as in the private sector, is a matter of degree, and economic analysis can help us in seeking the best answer. The task is to design a mechanism for the provision of social goods which operating in a democratic setting will be as efficient as is feasible.

4.1 Social Goods and Market Failure

The market economy, when certain conditions are met, serves to secure an efficient use of resources in providing for private goods. Consumers must bid for what they wish to buy and must thus reveal their preferences to producers. Producers, in trying to maximize their profits, will produce what consumers want to buy and will do so at least cost. Competition will ensure that the mix of goods produced corresponds to consumers' preferences. This view, of course, is a highly idealized picture of the market system. Markets may be imperfectly competitive, production may be subject to decreasing cost, consumers may lack sufficient information or be misled by advertising, and so forth. For these reasons, the market mechanism is not as ideal a provider of private goods as it might be. But even so, it does a good job and a better one than can be done otherwise. At the same time, the market cannot solve the entire economic problem. First, and most important in the present context, it cannot function effectively if there are "externalities," by which we mean situations where consumption benefits are shared and cannot be limited to particular consumers or where economic activity results in social costs which are not paid for by the producer or the consumer who causes them. Second, the market can respond only to the effective demands of consumers as determined by the prevailing state of income distribution, but society must also judge whether this is the distribution it wants. Third, there are problems of unemployment, inflation, and economic growth which do not take care of themselves automatically.

Market for Private Goods

The market can function only in a situation where the "exclusion principle" applies, i.e., where A's consumption is made contingent on A's paying the price, while B, who does not pay, is excluded. Exchange cannot occur without property rights, and property rights require exclusion. Given such exclusion, the market can function as an auction system. The consumer must bid for the product, thereby revealing preferences to the producer, and the producer, under the pressures of competition, is guided by such signals to produce what consumers want. At least, such is the outcome with a well-functioning market. This process can function in a market for private goods-for food, clothing, housing, automobiles, and millions of other marketable private goods-because the benefits derived therefrom flow to the particular consumer who pays for them. Thus, benefits are internalized and consumption is rival. A hamburger eaten by A cannot be eaten by B. At the same time, the nature of the goods is such that exclusion is readily feasible. The goods are handed over when the price is paid, but not before. But market failure occurs, and budgetary provision is needed if consumption is nonrival and exclusion is inappropriate or inapplicable.

Market Failure due to Nonrival Consumption

Exclusion is inappropriate in the case of social goods because their consumption is nonrival. That is, they are goods such that A's partaking of the consumption benefits does not reduce the benefits derived by all others. The same benefits are available to all and without mutual interference. Therefore it would be inefficient to apply exclusion even if this could readily be done. Since A's partaking in the consumption benefits does not hurt B, the exclusion of A would be inefficient. Efficient resource use requires that price equal marginal cost, but in this case marginal cost (the cost of admitting an additional user) is zero, and so should be the price. Consider, for example, benefits provided by national defense or by measures to prevent air pollution. Exclusion would be impossible and moreover inefficient, since A's partaking does not hurt B. Or take the case of a bridge which is not crowded, so A's crossing will not interfere with that of B. Charging a toll would be quite feasible, but so long as the bridge is not heavily used, the charge would be inefficient since it would curtail use of the bridge, the marginal cost of which is zero. Or consider the case of a

broadcast, which with the use of jamming can be made available only to those listeners who rent clearing devices. Again, the jamming would be inefficient since A's reception does not interfere with B's. Exclusion can be applied but should not be, because consumption is nonrival. Since the marginal cost to previous users of adding an additional consumer is zero, no admission price should be charged. But even though the marginal cost of admitting additional users is zero, the cost of providing the facility is not. This cost must be covered somehow, and it must be determined how large a facility should be provided. With exclusion inappropriate, even if feasible, the task cannot be performed through the usual market mode of sale to individual consumers. Provision through the market cannot function and a political process of budget determination becomes necessary, a process which permits consumers to express their preferences through the political process and also obliges them to contribute.

Market Failure due to non-Excludability

A second instance of market failure arises where consumption is rival but exclusion though appropriate is not feasible. Whereas most goods which are rival in consumption also lend themselves to exclusion, some rival goods may not do so. Consider, for example, travel on a crowded cross-Manhattan Street during rush hours. The use of the available space is distinctly rival and exclusion (the auctioning off or sale of the available space) would be efficient and should be applied. The reason is that use of crowded space would then go to those who value it most and who are willing to offer the highest price. But such exclusion would be impossible or too costly to be administered. We are dealing with a situation in which exclusion should but cannot be applied. Here the difficulty of applying exclusion is the cause of market failure. Public provision is required until techniques can be found to apply exclusion.

Think once more of why absence of exclusion causes market failure. If partaking in consumption is not made contingent on payment, people are not forced to reveal their preferences in bidding for social goods. Such, at least, is the case if the number of participants is large. Since the total level of provision will not be affected significantly by any one person, the individual consumer will find it in his or her interest to share as a "free rider" in the provision made by others. With all consumers acting in this fashion, there is no effective demand for the goods. The auction system of the market breaks down, and once more a different method of provision is needed.

4.2 Provision for Social Goods

The nonrival nature of social-good consumption has important bearing on

(1) what constitutes efficient resource allocation, i.e., allocation of resources to produce at least cost what consumers want most, and

(2) the procedure by which their provision is to b achieved. These implications will now be examined more carefully.

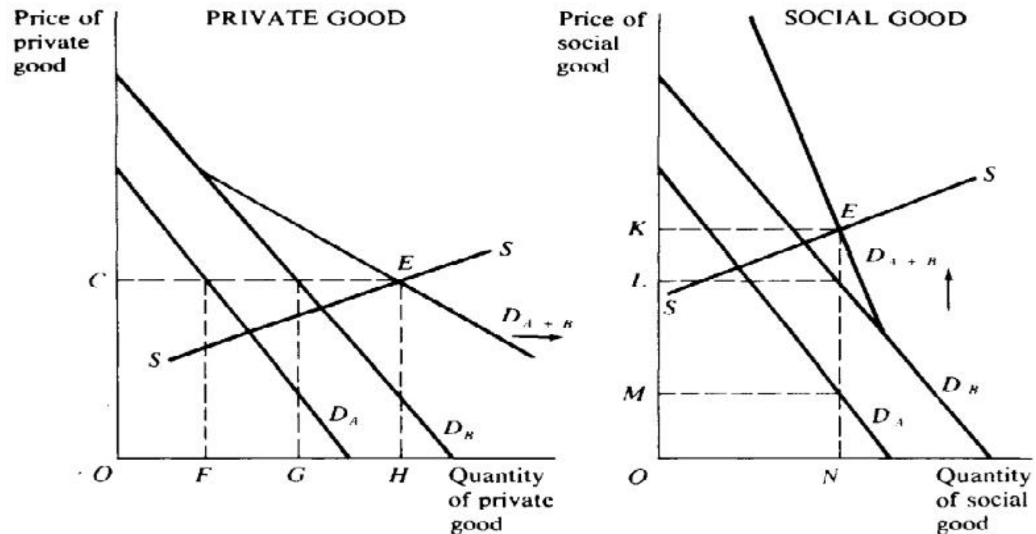
Comparison with Private Goods

To explore problem I, it is helpful to compare the familiar demand and supply diagram for private goods with a corresponding construction for social goods as they would compare in a hypothetical market setting. The latter, as we will see presently, is unrealistic, but it is nevertheless useful in noting essential differences between the two situations. The left side of Figure 4-1 shows the well-known market for a private good. D_A and D_B are A's and B 's demand curves, based on a given distribution of income and prices for other goods. The aggregate market demand curveD_{A+B} is obtained by horizontal addition of D_A and D_B, adding the quantities which A and B purchase at any given price. SS is the supply schedule, and equilibrium is determined atE, the intersection of market demand and supply. Price equals OC and output OH, with OF purchased by A and OG by B, where OF+ OG = OH.

The right side of the figure shows a corresponding pattern for a social good. We assume for this purpose that consumers are willing to reveal their marginal evaluations of the social good-say, weather forecasting installations-it being understood that daily reports will be available free of charge. As before D_A and D_B are A's and B's respective demand curves, subject to the same conditions of given incomes and prices for other goods. Since it is unrealistic to assume that consumers volunteer their preferences, such curves have been referred to as "pseudo-demand curves." But suppose for argument's sake that consumer preferences are revealed. The critical

difference from the private-good case then arises in that the market demand curve D_{A+B} is obtained by vertical addition of D_A and D_B, with D_{A+B} showing the sum of the prices which A and B are willing to pay for any given amount. This follows because both consume the same amount and each is assumed to offer a price equal to his or her true evaluation of the marginal unit.

FIGURE 4.1 Demand for Private and Social Goods



The price available to cover the cost of the service equals the sum of prices paid by each. SS is again the supply schedule, showing marginal cost (chargeable to A and B combined) for various outputs of the social good. The level of output corresponding to equilibrium output OH in the private-good case now equals ON, which is the quantity consumed by both A and B. The combined price equals OK, but the price paid by A is OM whereas that paid by B is OL, where OM+ OL =OK. Returning to the case of the private good, we see that the vertical distance under each individual's demand curve reflects the marginal benefit which derives from its consumption. At equilibrium E, both the marginal benefit derived by A in consuming OF and the marginal benefit derived by B in consuming OG equals marginal cost HE. This is an efficient solution because marginal benefit equals marginal cost for each consumer. If output falls short of OH, marginal benefit exceeds marginal cost and individuals will be willing to pay more than is needed to cover cost. Net benefits will be gained by expanding output so long as the marginal benefit exceeds the marginal cost of so doing, and net benefits are therefore maximized by producing OH units, at which point marginal benefit equals marginal cost. Welfare losses would occur were output expanded beyond OH, for marginal cost would thereby exceed marginal benefits. Now compare this solution with that for social goods. The vertical distance under each individual's demand curve again reflects the marginal benefits obtained. Since both share in the consumption of the same supply, the marginal benefit generated by any given supply is obtained by vertical addition.

Thus the equilibrium point E now reflects the equality between the sum of the marginal benefits and the marginal cost of the social good. If output falls short of ON, it will again be advantageous to expand because the sum of the marginal benefits exceeds cost, whereas an output in excess of ON would imply welfare losses, since marginal costs outweigh the summed marginal benefits. Thus the two cases are analogous but with the important difference that for the private good, efficiency requires equality of marginal benefit derived by each individual with marginal cost, whereas in the case of the social good, the marginal benefits derived by the two consumers differ and it is the sum of the marginal benefits (or marginal rates of substitution) that should equal marginal cost.

Figure 4.1 shows how application of the same pricing rule-where the price payable by each consumer equals the individual's marginal benefit-yields different results for social goods than it does for private goods. In the private-good case, A and B pay the same price but purchase different amounts, whereas in the social-good case, they purchase the same amount but pay different prices. Yet in both cases, the same pricing rule is applied. Each consumer pays a single price for successive units of the good purchased, with the price equal to the marginal benefit that the purchaser derives.

Budgetary Provision

Although the presentation of Figure 4-1 is helpful in bringing out the difference in efficiency conditions, it is misleading if taken to suggest that the provision of social goods might be implemented by a market mechanism of demand and supply, with equilibrium atE as in the case of the private good. This interpretation implies that the consumers will bid as they would for private goods and thus overlooks the crucial fact that social goods are typically nonrival in consumption, and that exclusion is not feasible Because of these factors, consumer preferences for such goods (the value which they assign to successive marginal units of consumption) will not be revealed voluntarily. Since the number of participants is usually large, any one contribution will make little difference in total provision. Knowing this, consumers will find it in their interest to act as free riders. The pseudo-demand curves of Figure 4-1 are not revealed. They do not come into play and the market mechanism cannot function.

A political process must therefore be used (1) to obtain revelation of preferences (i.e., to tell the government what social goods should be provided) and (2) to furnish it with the fiscal resources needed to pay for them. This is done through voting on tax and expenditure decisions. Individuals, knowing that they must comply with the majority decision, will find it in their best interest to vote for that solution which will move the outcome closer to their own desires, and in this way they will be induced to reveal their preferences. It is this mandatory nature of the budget decision which induces preference revelation and permits the provision of social goods to be determined. To serve as an efficient mechanism of preference revelation, the voting process should link tax and expenditure decisions. Voters are then confronted with a choice among budget proposals which carry a price tag in terms of their own tax contribution. This price tag will depend on the total cost for the community as a whole as well as on the share to be contributed by others. Voters' choices are thus contingent on their own knowledge that others must also contribute in line with the adopted tax plan. Ideally, voters will support a tax price which reflects their marginal benefit evaluation, butthis ideal solution is not achieved in practice. Tax and expenditure votes are typically taken apart from each other. The political mechanism is imperfect and can only approximate what would be the optimal budget choice. But the political mechanism is the best (or only) technique available and must be designed and used as well as it can be. As various voting rules may be designed. Majority rule, under certain assumptions regarding preference structures, may be expected to arrive at the position of the median voter. Other more complex voting rules may yield more satisfactory results. In a representative democracy, the problem is complicated further because most decisions are not made by referenda voting. Rather, the individual voters choose representatives who offer programs, with final decisions made by a representative body such as the Congress. Various hypotheses have advanced why such a process will bias the outcome in favor of overexpanding the public sector, an intriguing issue to be considered at a later point.

Mixed Goods

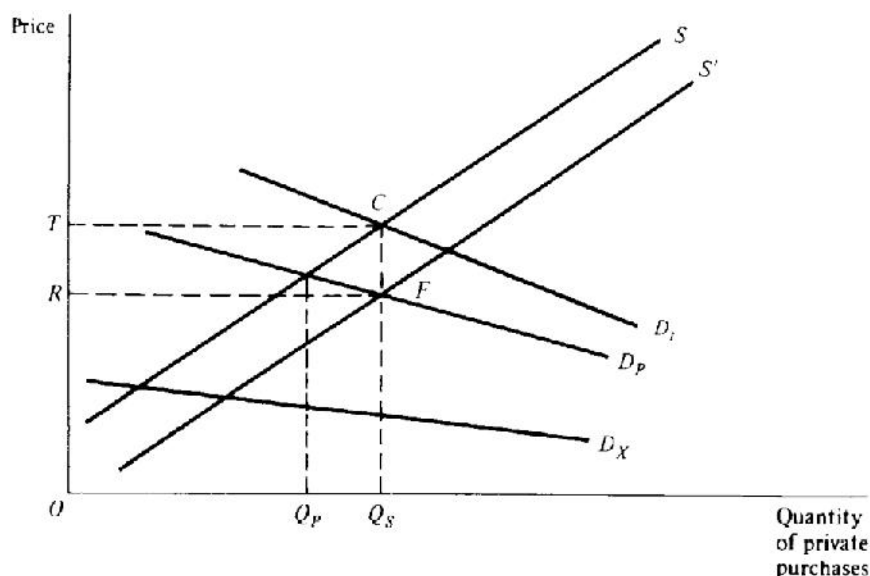
Throughout the preceding discussion, a sharp distinction was drawn between private goods, such as hamburgers, the benefits of which are wholly internalized (rival), and others, such as air purification, the benefits of which are wholly external (nonrival). This polarized view is helpful for understanding the essential difference between private and social goods, but it is not realistic. In reality, mixed situations of various kinds arise. Externalities of Private Goods Such are the case wherever private consumption or production activities generate externalities.

External Benefits

Suppose, for instance, that A derives benefits from being inoculated against polio, but so do many others for whom the number of potential carriers, and hence the danger of infection, is reduced. Or by getting educated, A not only derives personal benefits but also makes it possible for others to enjoy association with a more educated community. Since large numbers of other consumers may be affected, bargaining does not work, and a budgetary process will again be needed to secure preference revelation. But the correct budgetary intervention in this case will not involve full budgetary provision; rather, it will take the form of subsidy to private purchases.

This is shown in Figure 4-2, where D_P represents the market demand schedule, obtained by horizontal addition of demands for the private benefits which individuals derive from inoculation or from their education. Now let Dx be a supplementary schedule reflecting the evaluation (or, as noted above, pseudo-demand) by others for the external benefits generated by these activities, e.g., the reduced risk of contagion or the pleasure of a more educated society. The D_x schedule is obtained by vertical addition of individual demand curves for such benefits.

FIGURE 4-2 Adjustment for External Benefits



Adding D_P and D_x vertically, D_1 is obtained to reflect total benefits, including both the D_P and D_x components. Given this situation, the private market will result in equilibrium output OQ_P, since only the market demand schedule D_P is backed by voluntary purchases. But this is inefficient since the optimal output is at Q_s, where external or social benefits are allowed for as well.

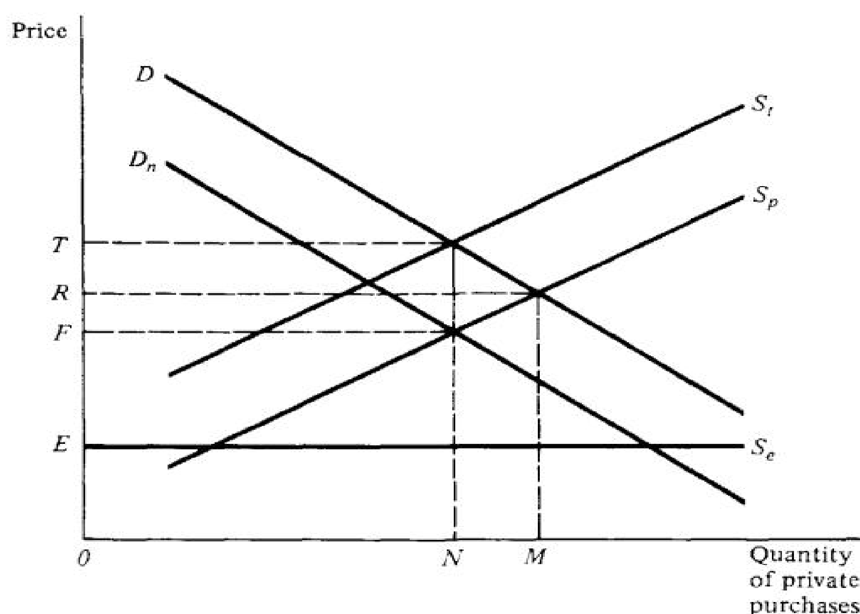
In order to expand output from OQ_P to OQ_s, the government should pay a subsidy equal to D_x. Such a subsidy raises the market demand confronting the supplier from D_p to D_t and output will be extended to OQ_s. Consumers pay a net price of OR, with the subsidy contributing the difference RT. The total cost of the subsidy equals RTCF and is paid for out of the budget, financed by taxes on A and B imposed in line with the principles that were discussed in the preceding section. Alternatively, the subsidy may be given to the producer, lowering his net supply schedule to S'.

All this would be simple enough if D_x and hence the required level of subsidy was known, but such is usually not the case. Thus, the evaluation of the external benefits-and the determination of the proper rate of subsidy-poses problems of preference revelation similar to those which arise with social goods. The polar case of social goods, examined earlier, "may thus be extended into a band of cases involving goods in which internal benefits to the individual consumer are increasingly supplemented by external benefits. At the one extreme of the purely private good, the distance FC in Figure 4-2 becomes zero, as D_s is the same as D_p and no subsidy is needed. At the other extreme of the purely social good, D_s becomes equal to D_x and the subsidy pays the entire price, i.e., benefits are wholly external. The good becomes a pure social good and is entirely provided for through the budget. In between, we have the cases of mixed goods, to be financed by a mix of private payments and of subsidies. The tax-expenditure theory of the preceding chapter may thus be restated more generally as a tax-subsidy theory, with subsidies ranking from 0 to 100 percent. Whereas the use of such subsidies is limited in practice, the frequent occurrence of external benefits suggests that a wider use might be in order.

4.3 External Costs

The phenomenon of benefit externalities has its counterpart in external costs. Private consumption or production activities may generate costs which are not "internalized" and not paid for by consumers or producers. As a result, costs are imposed on society which is not accounted for, and the activity in question tends to be overextended.

FIGURE 4.3: Adjustment for External Costs



This is shown in Figure 4-3, where D is market demand for a private good. S_P is the supply schedule, reflecting the firms' internal or private costs, with output equal to OM and price equal to OR. An efficient solution, however, calls for inclusion of external costs as given by S_e. To secure output at ON with price equal to OT, the government may impose a tax on the producer equal to EO = TF, thus raising the supply schedule to S_t, reflecting both private and social cost. Equilibrium output is now at ON. Alternatively, the tax may be imposed on the consumer, dropping the net demand schedule to D n. Whereas the case of external benefits was shown to call for a subsidy, that of external cost calls for a penalty tax, which leads to the problem of how to deal with social "bads," such as pollution and environmental damage.

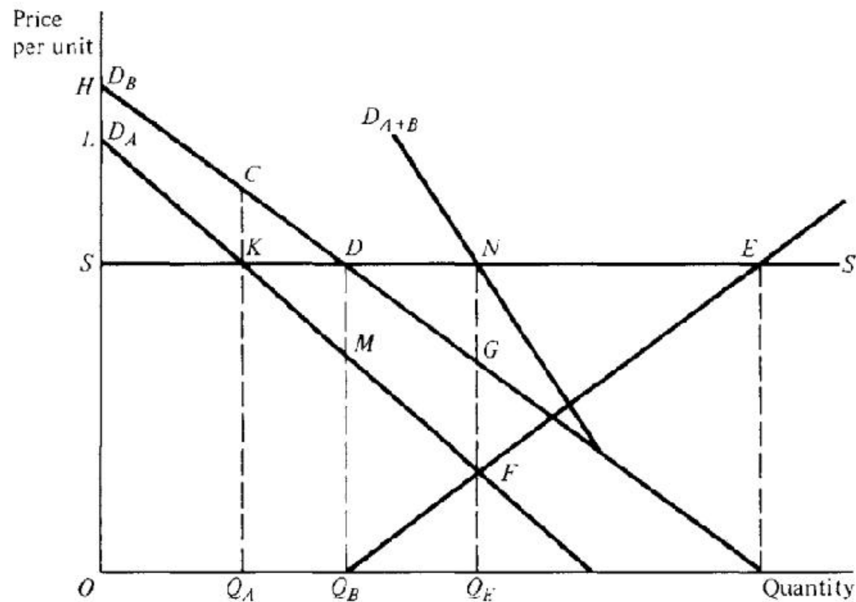
4.4 Bargaining in the Small Group

Our preceding argument has been that a political process is needed to deal with social goods or bads because voluntary payments and preference revelation will not be forthcoming in the absence of exclusion. The reason is that any one individual will not consider it worth his or her while to pay, because with large numbers involved, individual contributions will not significantly affect the total supply. Individuals find it in their interest to act as free riders. Similarly, they will not act to prevent external costs. This difficulty is less of a problem when few people are involved. Individuals will now find it worthwhile to contribute and to bargain, since individual contributions now significantly affect their own position and that of others.

4.5 External Benefits

Whereas provision for social goods occurs predominantly in a large-number setting, external benefits may accrue in situations in which only small-number conditions are involved. Neighbors, for example, may get together in a mutual effort for tree spraying, municipalities may join in building a common garbage-disposal plant, or national governments may cooperate in undertaking joint ventures, such as NATO. Moreover, budgetary decisions are typically made not by referenda which involve a large number of voters but by bargaining among elected representatives. The small-number case is thus worth considering.

FIGURE 4-4 The small-number case



The figure above depicts a situation where two consumers share in the benefit of a social good. The provision may be paid for by A or B, but the quantities provided are available equally to both.D_A and D_B are A's and B's demand schedules for the social good and SS is the supply schedule. D_{A+B} is the aggregate demand schedule, obtained by vertical addition of D_A and D_B.Up to output OQ_E, the maximum prices which A and B would be willing to offer, as shown by D_{A+B}, add to more than cost. This suggests that output will be bid up to OQ_E, where D_{A+B}, intersects SS at N. Both A and B pay a price equal to their marginal evaluation, Q_EF and Q_EG, respectively.Suppose an airplane flying at night over a city, or a chimney causing air pollution, in both situations, external cost may be imposed on many people. Yet it is impracticable for each of them to negotiate with the offender.

4.6 Market Provision of Nonrival Goods

It has also been suggested that under certain circumstances the market is capable of generating an efficient provision of social goods without involving a budgetary process. Suppose that there are goods which are social in that consumption is nonrival. At the same time, suppose that exclusion is possible. A monopoly supplier may then provide the good to various consumers at differentiated prices, exacting for successive units the maximum amount which each consumer is willing to pay. The supplier thus appropriates the consumer surplus derived by the buyer, but an efficient outcome ensues since at the margin the price paid equals the benefit derived. All this, however, assumes that exclusion can be enforced, and that the necessary information is available to the supplier, both of which are rather unlikely conditions.

4.7 Congestion

Another case of mixed goods, also of special importance in relation to local finance, arises where goods are not truly nonrival in consumption even though they are consumed in equal amounts by all members of a particular group. As more users are added, the quality of service received by all users from a given installation declines. Thus, the quality of instruction received by the individual student from a single teacher may decline as the size of the class increases, or previously empty streets may become crowded as traffic increases.

Demand schedules are still added vertically, but the marginal cost of adding an additional consumer is no longer zero. It now becomes appropriate to charge a fee, and there is the additional problem of determining how large the size of the group should be. Once more, we will take up this problem later on when we discuss local finance.

4.8 Spatial Limitation of Benefits

When speaking of social goods as "being available to all," we do not mean that the world population, or even the entire population of one country, is to be included. The spatial benefit area is limited for most social goods, and the members of the group are thus confined to the residents of that area. This restriction does not change the nature of the preceding argument. A group which is sufficiently large to require provision for social goods by political process need not be all-inclusive. Streetlights in San Francisco are a social good to residents of that city but a private good to Bostonians. At the same time, this feature of spatial limitation of benefits is central to the application of social-goods theory to local government. This being a major topic in its own right, consideration is postponed once more until the issues of fiscal federalism are examined.

Substitutability among Goods

There are some wants which may be satisfied either through the purchase of private goods or through the provision of social goods. Thus, the need for protection may be met by private locks for each house or by police protection for the entire city block. If the first route is taken, provision may be left to the market, whereas if the second is taken, budgetary provision is needed. In situations where this option exists, a choice must then be made between the two modes. Since the private mode has the advantage of permitting individuals to consume different amounts, the social-goods mode, if it is to be preferred, must more than outweigh this advantage by offering a lower cost per user.

Giving as a Social Good

The problem of social goods, by its very nature, has immediate application to the government's provision of goods and services. But it is also of interest in relation to transfers. Taxing and rendering transfer payments may be viewed simply as a process of taking by those who benefit. But this is not the entire story. To the extent that A's giving to B is based on A's desire to see B's position improved (rather than to derive pleasure from own giving), A will derive equal satisfaction from similar giving by C or D. Giving thus generates externalities not only for the recipient but also for others who see his position improved. Giving thereby assumes social good characteristics which call for budgetary implementation. In practice, it is, of course, difficult to distinguish between the taking and giving aspects of majority-based redistribution, but both elements are present. The rise of the welfare state over the past fifty years may well be interpreted as involving increased readiness to give as well as to take.

4.9 Merit Goods

In concluding this survey of the problems posed by social goods, we once more tum to their basic nature, this time focusing on the way in which wants for such goods are generated and on the nature of "merit goods."

The Premise of Individualistic Evaluation

Distinction between private and social goods was based on certain technical characteristics of social goods, i.e., the nonrival nature of consumption and the inapplicability of exclusion. It did not depend on a difference in psychological attitudes or in social philosophy regarding the two types of goods. Utilities derived from social as well as private goods are experienced by individuals and included in their preference systems. The same individualistic psychology was applied to both types of goods. The premise that all wants (private or social) are experienced by individuals rather than group entities is quite compatible with the notion that individuals do not live in isolation but in association with others. Human beings are social animals, and A's preferences will be affected by those of B and C. Dominant tastes and cultural values influence individual preferences and in tum are determined by them. Fashions are a pervasive factor in molding tastes, and not only with regard to clothing. To say that wants are experienced individually, therefore, is not to deny the existence of social interaction. Nor can it be argued that social goods differ from private goods because they satisfy the more noble aims of life.

Furthermore, the proposition that wants are experienced individually does not exclude altruism. If A is a socially minded person, he or she will derive satisfaction not only from his or her own consumption but also from consumption by B; or B, who is selfish, may enjoy only his or her own

consumption. Utilities are interdependent, and this fact broadens the range over which the economics of social goods applies. But granting all this, what matters here is that satisfaction is experienced in the last resort by A and B individually and not by a mysterious third entity called A+ B. Finally, we recognize that the quality of wants may differ. Some are concerned with the noble and others with quite ordinary aspects of life. But this does not bear on the distinction between private and social goods. The wants to be satisfied may be noble or base in either case: social goods may carry high cultural or aesthetic values, such as music education or the protection of natural beauty, or they may relate to everyday needs, such as roads and fire protection. Similarly, private goods may satisfy cultural needs, such as harpsichord recordings, or everyday needs, such as bubble gum. Clearly, no distinction between private and social goods can be drawn on this basis.

Communal Wants

The premise of wants, based on the needs and preferences of individuals, appeals to widely held values of Western culture. It also permits one to conduct the analysis of public provision within the same economic framework that applies to the analysis of private goods. The concept of communal needs, on the other hand, is hard to interpret and does not fit such analysis. Moreover, it carries the frightening implications of dictatorial abuse. Yet the concept of community also has its tradition in Western culture, from the Greeks through the Middle Ages and to date and should be given at least brief consideration. The central proposition to be examined is that there exists a community interest as such, an interest which is attributable to the community as a whole and which does not involve a "mere" addition, vertical or horizontal, of individual interests. This community interest then is said to give rise to communal wants, wants which are generated by and pertain to the welfare of the group as a whole. This raises two basic questions: one is to whom and how is the community interest revealed, and the other is over what range of needs the community concept should be applied.

Merit Goods

A more attractive interpretation is that by virtue of sustained association and mutual sympathy, people come to develop common concerns. A group of people share an historical experience or cultural tradition with which they identify, thereby establishing a common bond. Individuals will not only defend their home but will join others in defending their territory or in protecting their countryside. Such common interests and values may give rise to common wants-i.e., wants which individuals feel obliged to support as members of the community. These obligations may be accepted as falling outside the freedom of individual choice which ordinarily applies

4.10 <u>Democracy</u>

In a Democracy.... rule by the people, demos (common people) kratos (strength, rule), People Vote, Individual rights protected, Laws to protect, Majority Rule.A social contract between rational human beings who understand that their best interests lie in joining together in the mutual recognition of each individual’s right to live according to their beliefs and values. The contract contains a penal system to punish those who are guilty of breaching it. The parties of this contract recognize the rights of others to live in accordance with their values, beliefs and opinions. They are granted inalienable rights (human rights and civil rights) that neither society nor government can remove or alienate them. Democracy is a form of government in which the rulers are elected by the people.

Who are the rulers?

What kind of election?

Who are the people?

What kind of form of government?

> “Democracy is a government of the people, by the people and for the people.”
>
> - Abraham Linkon

Features of Democracy

- In a democracy the final decision-making power must rest with those who are elected by the people.
- A democracy must be based on a free and fair election where those currently in power have a fair chance of losing.
- In a democracy, each adult citizen must have one vote and each vote must have one value.
- A democratic government rules within limits sets by constitutional law and citizen's right.
- The opposition parties are allowed to function freely before and after the elections.
- The democratic governments are based on fundamental principles of political equality.

Merits of Democracy

- A democratic government is a better government because it is a more accountable form of government.
- Democracy improves the quality of decision making.
- Democracy provides a method to deal with differences and conflicts. It is suitable the countries like India. India having diversity of language, religion and cultures.
- Democracy in India made it possible to keep unity in diversity.
- In a democracy no one is a permanent winner or loser.
- Democracy is better than other forms of government because it allows us to correct its own mistakes.
- Democracy enhances the dignity of citizens, because it is based on the principle of political equality, on recognizing that the poorest and least educated have the same status as the rich and the educated.

Demerits of Democracy

- Leaders keep changing in a democracy. This leads to instability.
- Democracy is all about political competition and power play. There is no scope for morality.
- Elected leaders do not know the best interest of the people. It leads to bad decisions.
- Democracy leads to corruption for it is based on electoral competition.
- Ordinary people don't know what is good for them.

4.11 Forms of Democracy

- **Direct Democracy:** "Direct democracy," i.e., a system where fiscal decisions are made by referendum among individual voters. Voters know that group decision reached by voting will be binding on them. Therefore, they will vote so as to move the decision in a direction more compatible with their own tastes.A form of government in which the right to make political decisions is exercised directly by the whole body of citizens, acting under procedures of majority rule. Gram Sabha is the good example of direct democracy within India. Gram Sabha consists of the members registered in the electoral rolls of the village within that area.
- **Representative Democracy**: A form of government in which the citizens exercise the same right not in person but through representatives chosen by and responsible to them (representative democracy).For example: The U.S., Great Britain and India are three

examples of representative democracies.If a country holds elections, it's almost certainly a representative democracy. It's a system of government in which citizens elect representatives who propose and vote on legislation or policy initiatives on their behalf. It's a form of indirect democracy, as opposed to a direct democracy, in which people vote directly on policy initiatives.Representative democracy gives power to representatives who are elected by citizens. Political parties have become an important element of representative democracy.

Characteristics of a Representative Democracy

- **Governing framework -** Representative democracies typically have an established framework within which the government must operate. For example, in the United States, the Constitution functions as the country's governing framework. It establishes election procedures, checks and balances, separation of powers, decides which roles must be elected, and other basic principles.
- **Elected legislature -** In a representative democracy, at least part of the legislative body is elected for the people. In most, this is the case with the entire legislative body.
- **Independent judiciary** - There is generally an independent judiciary body in a representative democracy. This body has the power to determine whether or not laws enacted by the legislative body are consistent with the constitution (or other governing framework) for the country.
- **Appointment of officials** - Representative democracies provide mechanisms by which elected officials can appoint people to serve in certain roles. For example, the U.S. president can appoint cabinet members with the approval of Congress. In the event a new vice president is needed, the president can appoint one rather than holding another election.

Examples of Representative Democracy

- **United States -** The federal government of the United States of America is a representative democracy. The people elect the president, members of the House of Representatives and members of the Senate. Within each state in the U.S., citizens elect their governor and legislators.
- **United Kingdom -** The United Kingdom is a representative democracy. The Prime Minister is elected, as are members of the House of Commons. Members of England's House of Lords are appointed by the monarch (queen or king). Together, the two houses comprise the Parliament.
- **Canada** - Canada is a representative democracy, with the people electing the Prime Minister and the Members of Parliament (MPs) who serve in the House of Commons.
- **Australia** - Australia is a federation of six states. The country is led by a prime minister who is elected by the citizens.
- **India** - In India's representative democracy, the people elect both the president and the prime minister. The president commands India's military forces, while the prime minister presides over parliament. Parliament consists of The House of the People (*Lok Sabha*), which is elected by the people, and The Council of States (Rajya Sabha), which is partially elected by the states and territories and partially appointed by the president.

The Role of Politicians

Vote Maximization with Given Preferences. In economics firm's competition for consumers in the market and the politician's competition for voters in the political arena. Just as economic competition, under certain assumptions, guides producers to supply in line with preferences of consumers, political competition under certain assumptions guide representatives to act in line with the interests of the voters. The politician's objective is to maximize votes so as to stay in power.

The voter's objective is to maximize the net benefits which he or she derives from the fiscal operation, i.e., the excess of benefits derived from government expenditures over the voter's tax costs. People cast their votes for those who will best represent their interests, and politicians offer programs and support legislation which best meet the interests of their constituents. Politicians who come closest to so doing will receive the most votes and hence gain or retain political power. Politician's competition for votes resembles the producer's competition for consumers and the preferences of voters are served.

- **Leadership and Preference Formation**
  The role of the politician in the context of representative democracy may transcend that of implementing a given set of voter preferences. Political leadership may also exert an influence on preference patterns and thereby on the legislative outcome. Such leadership endeavors to advance its view of the public interest otherwise they may depart from vote maximization.
- **Parties, Platforms, and Coalitions**
  Parties and Interest Groups: Patterns of representation may differ, depending on the political system and its constitutional setting. Representatives typically seek election not only as individuals but also in the context of political parties and their platforms. These platforms try to attract particular groups of voters.
- **Platforms and Coalitions**
  Under majority rule, successful political leadership must take a position on combinations of issues acceptable to a majority. Except for referendum voting, issues are not considered in isolation but are typically combined in packages or party platforms. Coalitions are formed which combine voters with congenial views on a set of issues. Policies which would lose if considered separately, may win if considered in combination.
- **Winning Coalitions**
  In forming winning coalitions, intensity of preferences comes to be accounted for, even though a majority rule applies. Suppose there are three voters and two issues, each of which contains a pair of options. Issue 1 offer a choice between options A and B and issue 2 offers a choice between options C and D.Decision is by majority vote, but to indicate the strength of consumer preferences, numbers are used to serve as an index of the relative value which the voter attributes to various options. Each voter is given 100 points for each issue to divide between the two options. For issue 1, voter X considers option B ninety-nine times as valuable as option A; for issue 2, he or she considers option C slightly more desirable than D; and so forth.

Preferences and Party Platforms

Issues		VOTER			Total Points
		X	Y	Z	
Issue 1	option A	1	51	60	112
	option B	99	49	40	188

Issue 2	option C	51	52	20	123
	option D	49	48	80	177
Combination of A and C		52	103	80	235
Combination of B and D		148	97	120	365

A majority vote is taken on issue 1. Option A, being preferred by Y and Z, wins. The outcome is inefficient in that the aggregate valuation of option B (as measured by the point total) exceeds that of A.Similar considerations apply to issue 2, where C wins even though D carries the higher point total. But buying and selling of votes is not permitted. Instead, X and Z may make an agreement whereby X will vote for option D in issue 2 and Z will vote for option B in issue 1, leaving both with a gain across both issues. Politicians design party platforms which allow for the intensity of voter preferences. Suppose party P_1 may offer a platform combining issues A and C while P_2 offers a platform combining issues B and D. X and Z will prefer the latter platform and P_2 will win. The formation of platforms and coalitions may thus lead to superior results because it allows the intensity of preferences to enter the choice, and it does so even though majority voting rather than point voting is used.

Advantages of Representative Democracy

The people cannot be expected to have the time or interest to make important and regular decisionsrepresentatives can educate the public on political issuesrepresentatives ensure the interests of all sections of society (including minorities) are taken into account and can be held accountable for theirdecision'srepresentatives are able to 'aggregate' the differing demands of people into a more coherent and politically logical programme.

Disadvantages of Representative Democracy

Representatives may distort peoples' demands to suit their political preferences, representatives may not make themselves accountable enough between elections and can only be removed by elections if they lose the respect of the people, the electoral mandate of representatives is flawed, as voters have to accept or reject a whole manifesto, not being able to make clear which parts of it they oppose, and there is more information in this day and age for people to be able to make better decisionsrepresentatives also have to decide whether to be 'delegates' for their constituents, merely putting forward their view, or using their best judgement to 'represent' their constituents. A representative democracy should truly result in a government that is created "by the people, for the people." However, its success in doing so depends on the people's freedom to express their wishes to their representatives and the willingness of those representatives to act accordingly.

Why Vote?

Why should the rational voter bother to participate in the voting process? A rational voter knows that there is only a negligible probability that his or her vote will affect the outcome. Some people may vote because they do not realize how unlikely it is that their individual votes will decide the outcome. Others will vote because they believe that their action will encourage others to do so as well.

Voting Rules

(1) The distribution of votes, and

(2) The rules by which the. Winning vote is determined.

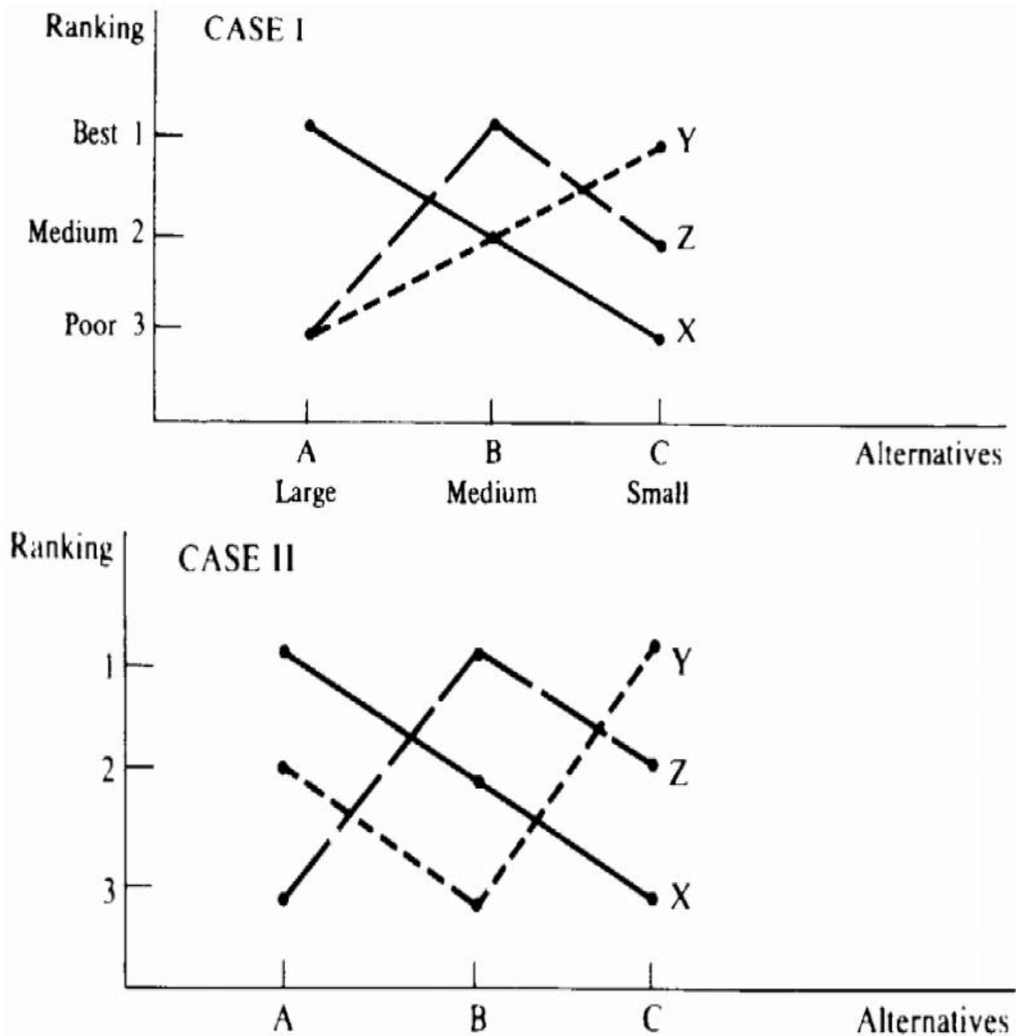
In modern democracy, it is generally agreed that each person should be given one vote. The most commonly used rule is that of simple majority. Each individual has one vote, the yeas and nays are counted, and the simple majority wins.

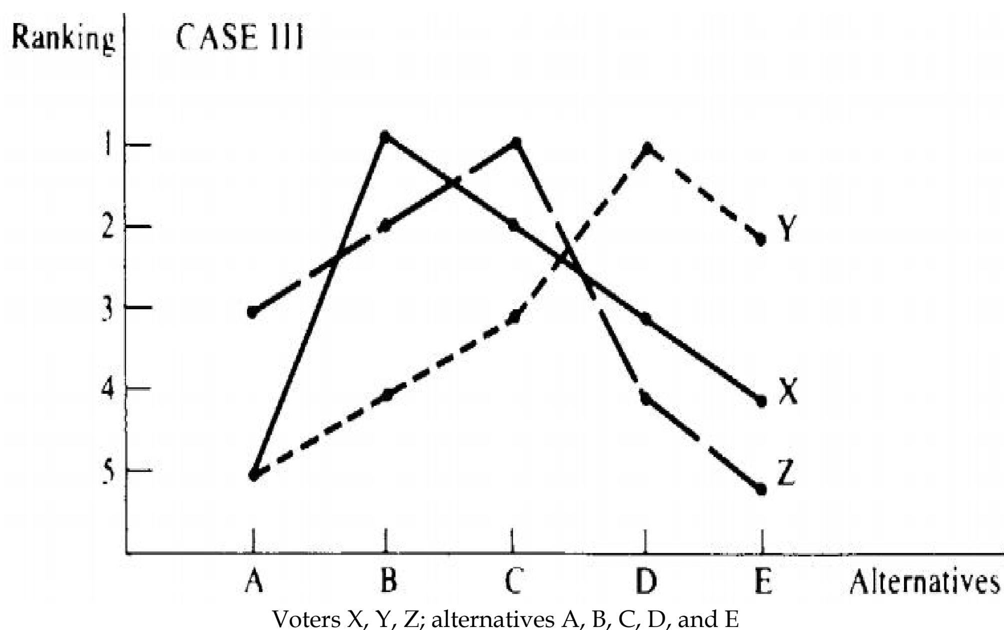
Majority Rule and the Median Voter

Voting under majority rule can be explained by Figure. Suppose that there are three levels of budget activity to choose from-large (A), medium (B), and small (C). To simplify exposition, assume that there are three voters only, X, Y, and Z, the same reasoning being applicable to the

large-number case. the cost will be spread equally among them. X is a large-budget person who prefers A to B to C; Y is a small-budget person who prefers C to B to A; and Z is a moderate-budget person who prefers B to C to A. Z is the median voter, i.e., the voter who is at the midpoint of the size scale. This pattern is plotted as case I in Figure below, where 1 is the highest and 3 is the lowest rank.

Figure 4.5: Preference patterns and majority rule





Voters X, Y, Z; alternatives A, B, C, D, and E

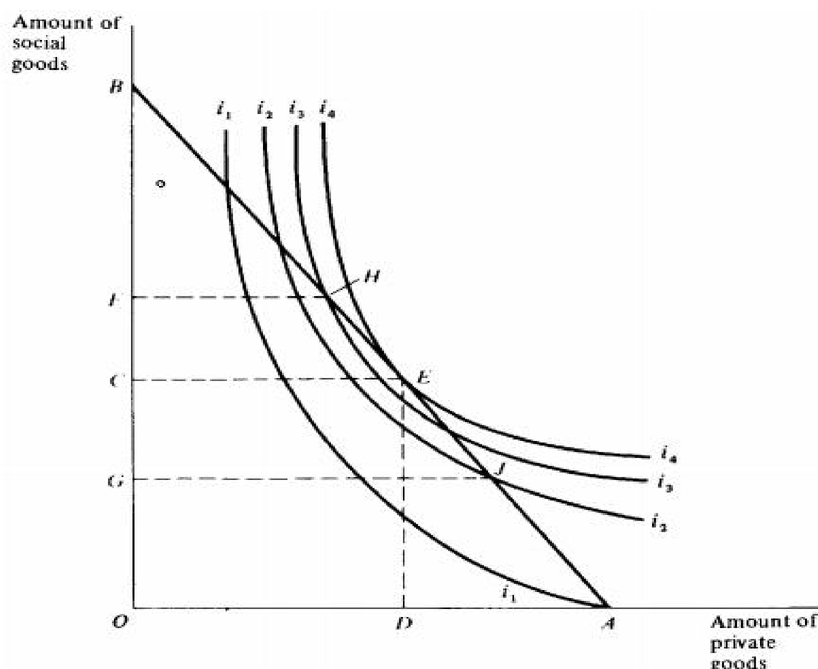
Beginning with A versus B, we find that B wins because both Y and Z prefer B to A, and only X prefers A to B. Matching B with C, B is again the winner. The same holds if we begin with A versus C followed by C versus B, or with C versus B followed by B versus A. In all instances B will win. As shown in the figure, all individual preferences, if plotted, show a single-peaked pattern, and the sequence of pairing does not matter. Voter Z, who prefers the median alternative and who is referred to as the "median voter," wins. Suppose that Y has extreme tastes and prefers C to A to B. That is to say, Y prefers both extremes to the middle solution. As plotted in case II, Y's is a multiple-peaked pattern. The final result in this case depends on the sequence in which the issues are paired. Beginning with A versus B, we find that A wins over B, and in turn C wins over A; thus **C is the winner**. However, if we begin with B versus C, then A wins; and if we begin with A versus C, **then B wins**. This is "***voting paradox***".

4.12 Fiscal Choices

The voting paradox of majority rule will not arise if preference patterns are single peaked, i.e., if there is an absence of voters with "extremist" preference patterns.The question then is whether fiscal choices will tend to be of this single-peaked type.Suppose that the budget contains only one type of public expenditure, that successive units are provided at constant cost for the group, and that the cost is to be spread equally among three consumers, each bears a "head tax" equal to one-third of total cost.

The problem is only to determine the desired amount. In this situation, there is good reason to expect that preferences will be single peaked and of the case III variety. Provided the public good is useful to the consumer, he or she will prefer some budget size to both larger and small sizes. The principle is the same as with private goods.

Figure 4.6: Choice of private and social goods



In Figure 4.6, at E on her highest feasible indifference curve i_4, with OC of social and OD of private goods being consumed. Further expansion of the budget size to OF, or reduction to OG, will place her at H or Jon indifference curves i_3 and i_2, respectively, and will leave her in less satisfactory positions. Preference schedules being single-peaked, majority rule will lead to the solution.

4.13 The Leviathan Hypothesis

The theory of representative democracy, as described in the preceding section, has been subjected to severe criticism. The theory, like that of perfect markets, establishes a normative model which does not necessarily reflect its real application. Thus, markets can function efficiently only if consumers are well-informed, if competition prevails, if prices are flexible, if no externalities are to be dealt with, and so forth. Not all these conditions prevail, and situations arise where markets do not work as the normative model suggests. Much the same holds for the model of fiscal democracy presented in the preceding pages. For the system to function efficiently, voters must be informed, the vying for votes on the part of politicians must be competitive, the formation of party platforms must be based on broad coalitions. voting systems must be sensitive to preferences, distortion through strategic behavior must be minimized, and so forth. In reality, these conditions are rarely met. Defects in the fiscal process must thus be considered and have been viewed from a variety of perspectives.

Marxist critics as noted below have seen the fiscal process as an instrument of class struggle, shaped by the diverse interests of capital and labor. In recent years, conservative critics have viewed the growth of the public sector as expressing a systematic bias in the fiscal system toward overexpansion. A modem Leviathan is said to arise and threaten free institutions. 7 Leaving the record of public sector growth and its economic determinants to the following chapter, we- here consider the reasons why such bias is said to prevail. These reasons are found to lodge in both the voting process and the way in which the agents of government (bureaucrats and politicians) impose their own wishes on the public.

4.14 Classes and Interest Groups

The critique of the democratic model, outlined in the preceding sections, derives largely from an analysis of the behavior of single individuals, whether they are voters, officials, or politicians. An alternative approach emphasizes that individual action is constrained by membership in classes and groups, so that the fiscal process is seen as a matter of group interaction. The Marxist Model Such an alternative approach is in line with the Marxist view, whereby the state (prior to the revolution) is to be seen as an instrument by which the ruling (capitalist) class exploits the subjugated (working) class. Actions of the state must be interpreted as part of the class struggle,

which transcends the political as well as the individual sphere of social relations. Fiscal history may be seen in this perspective. In the Middle Ages, the feudal lord extracted payments in cash or kind from his serfs to sustain his rule and the military establishment needed to maintain or improve his position.

Thus it was in the interest of the ruling class to have as strong and rich a state as possible. With the rise of democratic government, the ruling class lost its tight control over the state, and power went increasingly to popular majorities who shifted the costs of maintaining the state to the hitherto ruling class. As a result, the ruling class changed its view of the state. Its interests were now served better by a weak state, and it thus carne to favor small budgets, low taxes, and general noninterference with the private sector. Marx in tum advocated a highly progressive income tax, listed in the Communist Manifesto as one of the means to hasten the breakdown of the capitalist system. More recently, Marxist writers have emphasized the interdependence between "monopoly capital" and the fiscal state. The need to absorb surplus output is said to call for expanding public outlays, especially on defense; and a rising level of transfer payments is seen as necessary to maintain social peace. At the same time, monopoly capital is said to oppose the necessary financing, thus creating a fiscal crisis of the state. This view of fiscal politics reflects the Marxist framework in which the social process is seen in terms of class struggle. It is not surprising, then, that tax and expenditure decisions will be a major instrument of that struggle. Dissatisfaction with taxation has indeed been a major factor in the history of revolutions, and redistributive fiscal measures have to a degree expropriated the "capitalist class." But by the same token, the role of budgetary activity may change from a means of struggle to a tool of social accommodation once a less divisive view of society is taken. Budget policy then becomes an instrument of gradual reform and co-operation. Looking back at the history of the last century, we see that there can be little doubt that fiscal action played a key role in this growth of social cohesion. Indeed, the rise of the modem welfare state, with its emphasis on transfers and progressive taxation, has placed the public budget at the hub of the social system. The recent shift of political attitudes and critique of the welfare state in tum have focused on a critique of its fiscal components.

Summary

Majority voting may lead to arbitrary decisions, which will depend on the sequence in which issues are paired. If preferences are single-peaked, the median voter wins. As applied to various fiscal choices, the voting process is simplest when deciding the size of the budget for a single social good and with a fixed tax assignment. The problem becomes more difficult if budget composition and tax structure are allowed to vary. Plurality and point voting lead to more representative outcomes, as intensity of preferences comes to be reflected. But use of voting strategy may interfere with efficient outcomes. A system of representative democracy has been examined, and these features have been noted: Politicians may be thought of as maximizing votes by providing popular options, thereby complying with the preferences of the voters. But politicians may also exert leadership by guiding such preferences. Fiscal representation is based on a structure of interest groups, reflecting a wide variety of characteristics and concerns. By combining issues and platforms, majority voting may come to reflect intensity of preferences. Vote trading, if broadly based, may improve the efficiency of the outcome, but logrolling between a subsector of interested parties leads to inefficiency. Delegation of decision making to elected representatives introduces smallnumber bargaining at the final level of decision making, thereby helping to overcome the free-rider problem. Voting outcomes tend to be imperfect, but periodic free elections provide correction, requiring governmental policy to approximate the preferences of the voters. Critics of this model have pointed to a built-in bias in the fiscal process: The budget is said to be over expanded due to bias in the working of majority rule and deficiencies in the voting process. This bias is said to be accentuated by the role of bureaucrats and politicians who serve their own interest by expanding the budget. Various devices may be applied to limit the size of the budget, including constitutional amendments and legislative constraints. Classes and interest groups as well as individual voters enter into fiscal decision making. According to the Marxist view, the main division is between capital and labor, and the struggle over fiscal issues may be seen as reflecting a struggle between these two classes. 16. Viewed more broadly, the structure of fiscal interest groups becomes multidimensional, including groupings by income, industry, age, and region, with group formations frequently cutting across capital and labor.

Keywords

Social Goods:A social good is something that benefits the largest number of people in the largest possible way.

Market Failure: is a situation defined by an inefficient distribution of goods and services in the free market.

Mixed Goods:mixed goods possess characteristics of both private and public goods.

Democracy: Democracy is a system of government in which laws, policies, leadership, and major undertakings of a state or other polity are directly or indirectly decided by the "people

SelfAssessment

1. Pollution is an example of market failure because
A. The equilibrium price is higher than the efficient price
B. The equilibrium price is less than the efficient price
C. Property rights are poorly distributed
D. The market does not produce enough of the good

2. When there are negative externalities, the price should be adjusted so that it is equal to
A. Social cost
B. Private cost
C. The amount of the externality
D. The number of free riders

3. Government failure occurs when
A. Social cost lies to the left of private cost
B. The good it purchases has a greater negative externality than a positive one
C. The quantity of public goods it purchases is less than the socially optimal quantity
D. It pays a higher price for a public good than it would pay on the private market

4. The social cost curve lies above the supply (private cost) curve for the producer in cases of
A. Positive externalities
B. Negative externalities
C. Public goods
D. Near-public goods

5. Market failure refers to a situation when
A. Market does not function
B. Market solution occurs if government intervenes
C. Social efficiency is not achieved
D. Perfectly competitive firm experiences P > MC

6. One person, one vote means
A. One person is to be voted by all
B. One person has one vote and each vote has one value

C. A person can vote only once in his life
D. All of above

7. Democracy must be based on
A. One-party system
B. Free and fair election
C. Choice from only the ruling party
D. All the above

8. Some of the drawbacks of democracy is
A. Instability and delays
B. Corruption and hypocrisy
C. Politicians fighting among themselves
D. All the above

9. In which of these cases can democracy not provides a complete solution?
A. Removing poverty completely
B. Providing education to all
C. Giving jobs to all
D. All the above

10. Which body in Indian political system is an example of direct democracy?
A. Zila Parishad
B. Panchayat Samiti
C. Gram Sabha
D. Vidhan Sabha

11. A form of democracy in which citizens elect representatives to make governing decisions on their behalf is a:
A. Deliberative democracy
B. Liberal Democracy
C. Representative Democracy
D. Social Democracy

12. A democratic government is better than a non-democratic government because
A. It may or may not be accountable
B. It always responds to the needs of the people
C. It is a more accountable form of government
D. None of the above

13. Which of the following describes representative democracy?
A. It is not a common form of democracy in the modern age.

B. It is only found in rich and industrialized states.
C. It involves indirect participation through elected representatives.
D. It was the most prevalent form of democracy in the Colonial era.

14. _______ are supreme authority in the Representative Democracy.
A. Leaders
B. Parties
C. People
D. Kings

15. In representative democracy the process of _______ links the government and the people.
A. Judiciary
B. Election
C. Dictatorship
D. Corruption

16. Hobbes' social contract theory was written in a book called
A. Social Contract
B. Leviathan
C. Political Theory
D. Two Treatises

17. The social contract is __________.
A. An agreement among people to share certain interests and make certain compromises for the good of them all.
B. Mainly an agreement of equally selfless and unselfish persons not to commit theft or murder.
C. A choice to serve the public interest at the expense of a small number of individuals.
D. The only popular political theory.

18. Organizations that pursue the common interests of groups of people by attempting to influence the making and implementation of government policy are known as:
A. Social movements
B. Lobbyists
C. Interest groups
D. Political parties

19. A public interest group pursues policies that they believe will provide what to society:
A. Collective benefits
B. Purposive incentives
C. Solidary incentives
D. Selective benefits

20. In order to be effective in influencing government policy, interest groups require:

A. Access to media outlets

B. A permanent headquarters

C. A large number of members

D. Money and expertise

Answers forSelfAssessment

1.	B	2.	A	3.	C	4.	B	5.	C
6.	B	7.	B	8.	D	9.	D	10.	C
11.	C	12.	C	13.	C	14.	C	15.	B
16.	B	17.	A	18.	C	19.	A	20.	D

Review Questions

1. What is Public Choice? Public choice is the study of political decision making. Discuss.
2. What do you mean by democracy? Explain the advantages and disadvantages of democracy.
3. Explain the difference between direct and representative democracy.
4. What do you mean by social goods? Explain the provision for social goods.
5. Explain the Leviathan hypothesis, classes and social interest groups.

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Unit 05: Equity in Distribution

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Objectives

After studying this unit, students will be able to:

- Explore the equity in distribution of income in an economy.
- Evaluate the approaches to distributive justice for people.
- Study the mechanism of wealth redistribution system in an economy.
- Evaluate the challenges in wealth redistribution system for an economy.

Introduction

Equity means fairness or evenness, and achieving it is considered to be an economic objective. Despite the general recognition of the desirability of fairness, it is often regarded as too *normative* a concept given that it is difficult to define and measure. However, for most economists, equity relates to how fairly income and opportunity are distributed between different groups in society.The optimal use of scarce resources involves two basic issues. The first is to secure efficient satisfaction of demands that arise from a given state of distribution. Defined in terms of Pareto efficiency-the proposition that there is a welfare gain when the position of any one individual is improved without hurting that of another-this objective is generally accepted as a policy goal. Only jealousy is ruled out thereby. But there is also a second objective: how to secure a state of just or fair distribution. Since there exists an efficient solution corresponding to each and every state of welfare distribution, a question remains: Which state should be chosen as equitable or just? Here the concept of Pareto efficiency helps little, if at all. The problem of distribution is one of evaluating a change in which someone gains while someone else loses. It is one of designing the pattern of is curves of Figure 5-2. 1 As shown in that connection, the choice of the best or just solution might be found by postulating a "social welfare function,." i.e., a set of rankings in which social weights are given to gains by some and losses by others. Given such a function, technical economics can grind out the answer, as illustrated by the tangency solution B* of Figure 5-2. But there remains the more basic problem of what shape this set of values (or the social welfare function) should take. In the end, one cannot avoid the question of what should be considered a fair or just state of distribution.

5.1 Does Equity Belong in Economics?

Over the past fifty years, economists have increasingly held that a theory of just or equitable distribution is not within the purview of economics but should be left to philosophers, poets, and politicians. Indeed, when talking about the "theory of distribution," economists have traditionally referred to the theory of factor pricing and the division of national income among returns to land, labor, and capital. This theory of factor shares plays an essential role in economic analysis, but its significance lies mainly in the area of efficient allocation. For resource use to be efficient, factors of production must be applied so as to equate the value of their marginal product in all uses, a condition which holds in a socialist as well as in a capitalist society. But the theory of efficient factor use by itself is not a theory of distributive justice. For one thing, the proposition that factor allocation should be based on efficient factor pricing does not require that the final distribution of income among individuals be set equal to the proceeds from sales of their factor services in the market. The two can be separated by intervention of the distribution branch of the budget. For another thing, the ultimate concern of justice in distribution is with distribution among individuals or families and not among groups of factors. Factor shares are only loosely related to the interfamily distribution of income. While it is true that capital income accrues more largely to high-income families and wage income more largely to low-income families, there are important exceptions to the rule. The problem of distribution among individuals or families must thus be addressed directly.

Determinants of Distribution

In the market economy, the distribution of income is determined by the sale of factor services. It thus depends upon the distribution of factor endowments. With regard to labor income, this distribution involves the distribution of abilities to earn such income, as well as the desire to do so. With regard to capital income, it involves the distribution of wealth as determined by inheritance, marriage patterns, and lifetime saving. The distribution of labor and capital endowments is linked by investment in education, which in tum affects the wage rate which a person can command.

Given the distribution of endowments, the distribution of income depends further on factor prices. In a competitive market, these prices equal the value of the factor's marginal product. As such, they depend upon a wide set of variables, including factor supplies, technology, and the preferences of consumers. In many instances, however, returns are determined in imperfect markets where institutional factors, such as conventional salary structures, family connections, social status, sex, race, and so forth, play a significant role. As a result, the returns to various jobs may differ in line with status considerations rather than marginal product, and who gets the job may depend upon connections rather than superior productivity. Moreover, marriage patterns and bequests are important factors in determining the distribution of family money income. The distribution of income, as generated by the above forces, shows a substantial degree of inequality, which may be seen by comparing the percentage of income that accrues to various percentages of households as ranked by their income. Thus, below 5 percent of money income in the United States accrues to the 20 percent of families with the lowest incomes, whereas the income share received by the successively high quintiles of family groups is 11, 17, 24, and 43 percent, respectively. As among various forms of income, the distribution of capital income is less equal than that of wage and salary income. So is the distribution of wealth. The top quintile of households are estimated to own 80 percent of marketable wealth and about two-thirds of wealth if pension rights (including Social Security) are allowed for. 3 Moreover, recent decades have shown a tendency for distributional inequality to increase. How does this pattern, which is found in fairly similar form in most advanced countries, relate to what might be considered a fair or just state of distribution?

Distribution as a Policy Issue

By posing this question, the focus shifts from distribution as a market outcome to distribution as a policy issue. Although people will differ on the policies to be pursued, it is evident that distribution problems have been, are, and will continue to be a vital factor in politics and policy determination. That such is true is most apparent when it comes to the design of tax and transfer policies, but also evident is the fact that almost all policy measures, even those not immediately concerned with distributional objectives, have distributional repercussions. Thus an inflationary situation may call for a restrictive policy so as to reduce aggregate demand. Its distributional effects will differ, depending on whether the demand reduction is obtained by increasing sales taxes or income taxes, by reducing various types of public expenditure programs, or by applying monetary restriction. Policies aimed at increasing the flow of international trade will have different distributional implications, depending on which tariffs are reduced. Antitrust measures designed to render markets more efficient will affect the income of capital and labor in particular industries as well as

the real income of consumers of their products. Public investment programs, such as regional development or road construction, will affect the economic welfare of various population groups and hence the patterns of distribution. Public pricing policies, such as the pricing of publicly operated subways, similarly will affect the real income of subway riders, and so forth.

Policy design thus inevitably involves distributional judgments, but standard economic analysis unfortunately does not tell us what state of distribution should be our goal, i.e., what the criteria for distributional justice and fairness should be. As just noted, this final question tends to be considered as out of bounds for economists, whose job is taken to address efficiency issues only. But given the close bearing of distributional issues on questions of economic policy and their major or even dominant weight in economic politics, economists who are concerned with public policy can hardly detach their thinking from equity issues. They can be required only to distinguish such issues from efficiency considerations, especially with respect to the application of economics to the problems of public finance, an integral part of which is the function of our "distribution branch." The efficiency based analysis of the preceding chapter must therefore be followed by at least a brief consideration of what constitutes just or equitable distribution. Otherwise, our normative view of public-sector theory cannot be complete.

5.2 Approaches to Distributive Justice

If a choice is to be made between alternative criteria for just distribution, their implications must be understood. We first view this problem on the assumption that (1) the utility which individuals derive from their income is known and comparable, and (2) the amount of goods or total income available for distribution is fixed. Both these assumptions are reconsidered later on.

Alternative Views

Among possible criteria for what constitutes a just state of distribution, the following may be considered:

1. **Endowment-based criteria.**
    a. Keep what you can earn in the market.
    b. Keep what you could earn in a competitive market.
    c. Keep labor ("earned") income only.
    d. Keep what you could earn in a competitive market, given equal positions at the start.
2. **Utilitarian criteria.**
    a. Total welfare is maximized.
    b. Average welfare is maximized.
3. **Egalitarian criteria.**
    a. Welfare is equalized.
    b. Welfare of the lowest group is maximized.
    c. Categorical equity calls for provision in kind.
4. **Mixed criteria.**
    a. Welfare floor is set with the endowment rule applicable above it.
    b. Distribution is adjusted to maximize welfare in line with social welfare weights.

In choosing among these criteria on a self-interested basis, high-income persons will find 1 a in their best interest, while having to be altruistic in supporting the other options. Low-income persons will choose 3b. However, this is not the only way to consider the choice. An alternative perspective is offered by the philosopher's view of the problem as one of social contract. People placed in what the philosophers call the "state of nature" consider what should govern the relationship among persons in a just society, including the distribution of economic welfare. Depending on how social justice is viewed, this may mean that people are entitled to keep what they earn as suggested by endowment-based criteria, that reason calls for maximizing welfare as the utilitarian's suggest, or that some form of equal treatment is called for by egalitarian criteria. What can be said for the various views and what are their implications?

Endowment-Based Criteria

Theorists of the social contract formulated the problem in terms of certain rights and duties to which all members of society are both entitled and committed, but they differed in their views on the content of the contract. Natural-law philosophers such as Hobbes and Locke, writing in the second half of the seventeenth century and following what are here referred to as endowment-based criteria, postulated a person's innate right to the fruits of his or her labor, thereby giving ethical support to distribution by factor endowment and the pricing of factors in the market. A similar view among modem philosophers is taken by Robert Nozick. 5

This principle of entitlement may be stated without qualification, as in 1a, or it may be limited to such earnings as can be obtained in a competitive market, as in 1 b. Claims to monopoly profits would then not be legitimate, nor would claims to wage or salary incomes in excess of marginal product. Still another possibility, l c, is to apply the endowment principle only to an "earned" wage or salary but not to capital income. This may be proper because in line with Locke's thinking natural resources are held "in common" or simply because it is held that earning wages involves disutility of work whereas drawing interest does not. Some such consideration was applied by the classical British economists when they argued that "unearned" or capital income should be taxed more heavily than wage income.

A modem version, l d, of the endowment approach sanctions only such inequality as would remain if all people were given an equal position at the start. In line with a radical interpretation of the free enterprise system, this means acceptance of such inequalities as result from innate differences in earning ability, in preferences between income and leisure, and in thrift. In contrast, inequalities that arise from inheritance, different educational opportunities, or family status would not be acceptable. It might indeed be argued that this constraint on inequality is called for by the logic of a pure "enterprise" system.

5.3 Utilitarian Criteria

As distinct from supporters of these endowment-based criteria, other social philosophers rejected innate inequality in ability as a legitimate source of differences in economic well-being. The existence of such inequalities is recognized, but they should not be permitted to determine the state of distribution. To be born with a high- or low-ability level is not due to the will or action of the particular individual. Like social status, this accident of birth is considered as lacking ethical sanction as a basis for distribution. According to this view, some other principle of assignment must be sought.

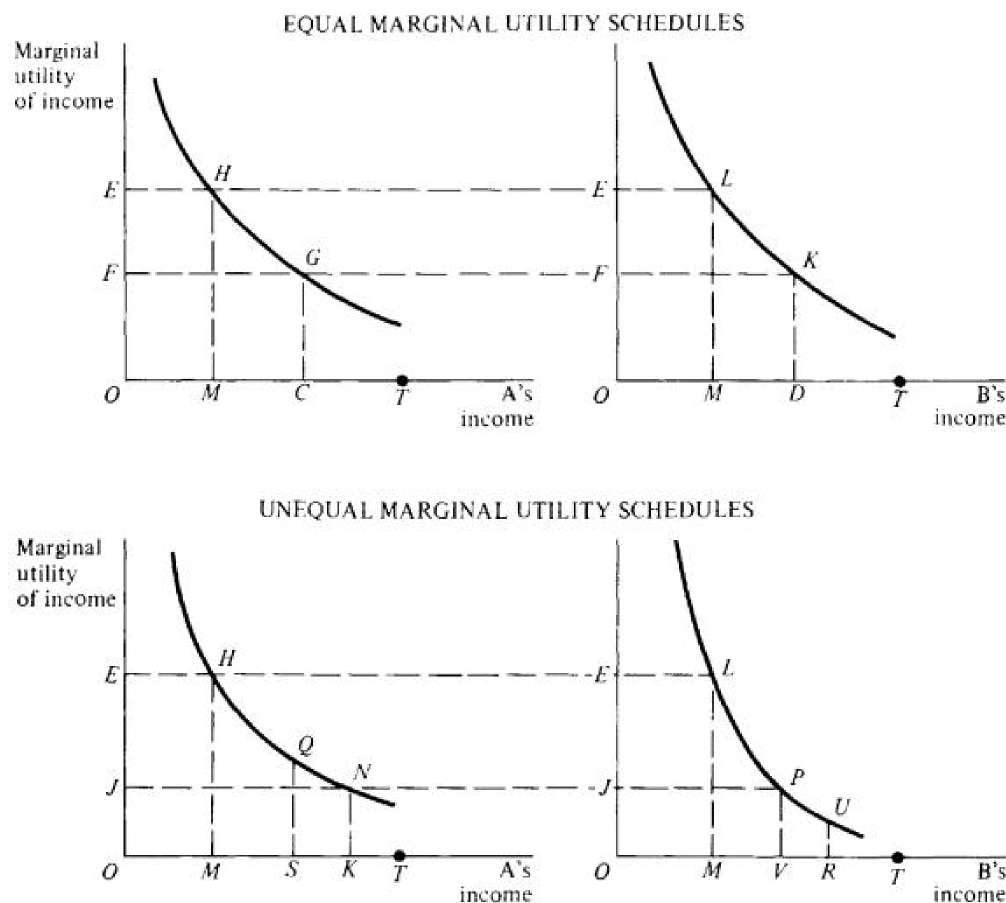
Fixed Total Income One answer was given by the utilitarian's, such as Bentham, who would have income distributed so as to achieve the greatest sum total of happiness, an objective which they thought would appeal to "all reasonable men." With respect to the division of a given total pie, A should be given more income than B if A's "utility level," or ability to derive happiness from personal income, is higher. Only if we assume that the marginal income utility schedules for all individuals are the same and are declining will an equal distribution of income be called for. The maximum satisfaction view, therefore, may or may not lead to an egalitarian solution.

This is illustrated in Figure 6-1. In each diagram, income is measured along the horizontal axis, while the vertical axis records the marginal utility of income, i.e., the increment in total utility which results as another dollar is added to income. The area under the curve thus measures the total utility derived at various income levels. To bypass the difficulty which arises because the utility of initial dollars may well be infinite, we consider the distribution of income above a certain minimum level OM. We assume, for the time being, that the utility of income can be measured in "utils" and that a utility comparison among various individuals is possible. The difficulties involved in these assumptions will be considered presently. We assume further that after providing each with OM, total income available for assignment between A and B is fixed at MT, an assumption to be reconsidered presently.

In the upper part of the figure, we postulate that two individuals, A and B, have the same marginal utility schedules. To maximize total satisfaction, this income will then be divided equally between A and B so that A receives MC and B receives MD, with MC + MD = MT. The marginal utilities of A and B are set equal at OF, as are their total utilities, reflected by MCGH and MDKL, respectively. 8 In the lower part of the figure, we assume that A's marginal utility schedule, beyond the minimum income level OM, lies above B's. A, in other words, has a higher capacity to derive additional utility from income above OM. Assuming again a total income MT to be available for distribution, total utility is now maximized by assigning the larger amount MK to A and the smaller amount MV to B, where MK + MV = MT. Marginal utilities are equated at OJ, and A's total

utility, or MKNH, now exceeds B's, or MVPL. Having a higher-lying utility schedule, A is better off for two reasons: A not only derives greater utility from the same income but, in addition, receives a larger income share.

FIGURE 6-1 Patterns of distribution



Variable Total Income Figure 6-1 has proceeded on the assumption that total income available for distribution remains unchanged thereby. As adverse effects are allowed for, maximizing welfare, as utilitarian's from Bentham on have stressed, may well fall short of equal distribution and do so even if we assume the shape of utility schedules of all individuals to be the same. Moreover, as noted below, allowance must be made for deadweight losses which arise in the process of redistribution.

5.4 Egalitarian Criteria

Viewing the problem in terms of maximum welfare (whether total or average) is a somewhat artificial construction. Society, after all, consists of individuals, not of a sum of individuals or of an average individual. This being so, why should all reasonable men agree to maximize total welfare? Is not the essential problem of distribution one of relative position among individuals and should not equality of position be the goal? This is the focus of the egalitarian formulation.

Equality as Goal

A first version (3a) postulates that equality of welfare is inherently desirable. Based on the humanistic view of the equal worth of each individual, this tenet underlies the egalitarian thought of such writers as Rousseau and Marx. It may also be seen as in line with Christian ethics, although other interpretations have pointed to the endowment-based criteria, as reflected in Max Weber's idea of the Protestant Ethic. Distribution of a given total income, moreover, depends again on whether or not individual utility schedules are the same. If they are, the upper part of Figure 6-1 applies, and income is divided equally between A and B. The utilitarian (maximum total welfare) and egalitarian precepts both call for an equal distribution of income. But if utility levels differ, as assumed in the lower part of the figure, egalitarian distribution would assign MS to A and MR to B,

where MS + MR = MT and MSQH = MRUL. The larger share of income now goes to the person whose utility scale is lower, and the pattern of income inequality becomes opposite to that achieved under the maximum total satisfaction rule.

It is doubtful, however, whether egalitarians such as Rousseau or Marx would have recognized differences in the level of utility schedules as legitimate reasons for income inequality. When Marx postulated, ''From each according to his ability, to each according to his need," he evidently referred to differences in need due to objective factors, such as family size or health, and not to subjective differentials in the capacity to enjoy income. Although enjoyment capacities may differ, most egalitarian philosophers would interpret the equal-worth doctrine as calling for society to distribute a given income total as if utility schedules were the same, thereby arriving at an egalitarian distribution, qualified only by allowance for objective differentials in need.

But once more, the level of income is not fixed. The egalitarian, no less than the utilitarian, must again allow for effects of income distribution upon the level of earnings. Taxing H in order to transfer to L may reduce the income available for distribution. If carried too far, a further rise in the tax on H may not only narrow the gap between Hand L but also lessen the position of both. The egalitarian rule carried to an extreme thus runs into difficulty, unless equality is valued so highly as to offset a decline in average levels.

5.5 Maximizing the Lowest Income

This difficulty is avoided by setting distribution policy such as to maximize income at the bottom of the scale. This rule, as suggested by Rawls, permits income inequality to the extent that it contributes to a higher level of income at the bottom. If carried beyond a certain point, a further increase in tax rates reduces yield, thus becoming counterproductive in permitting transfers to lower-income recipients.

Rawls obtains such a solution from his rule of fairness by which individuals are placed into an "initial position" where they do not know what their earnings potentials will be. They then render an "impartial" choice as to what the state of distribution should be. Knowing that equalization will reduce the level of income available for distribution but not knowing what their own position on the income scale will be, they will stop short of demanding equalization. Assuming people to be highly risk averse, they will vote for that degree of redistribution which maximizes the lowest income, thus arriving at the above result. The scope of desirable redistribution thereby becomes dependent on the degree of risk aversion.

Categorical Equity

Still another approach to equity in distribution, also concerned with entitlement to minimum levels, defines the latter not in terms of income but in terms of specific consumption items. Thus the floor may be defined as a minimum supply of food, clothing, and shelter. The cost of these items might then be taken to set the minimum income, or provision might be made in kind. This is a perspective to be noted further below when the role of giving is considered. Referred to as "categorical equity," it may be taken to link the merit-good approach to that of distributive justice. 13 That approach thus helps to explain the prevalence of public policies that offer in-kind support such as low-cost housing or that subsidize products bought by them such as the food-stamp plan.

Mixed Solutions

Whereas the premises underlying these various approaches may be explored and their consequences may be examined, choosing among them hardly permits a unique answer. The basic question of whether the design of the good society can be determined by "reason" or whether "values" must be chosen remains unresolved, a matter to be rethought as civilization proceeds.

It should also be noted that in practice the various approaches need not be implemented in pure form but more likely will be combined. Thus it may be held that equity calls for ensuring that no one suffers poverty, but that an endowment based approach should be applied once this objective is met. Such a compromise view (combined perhaps with some recognition of the equality-at-the-start interpretation of the endowment criteria) most nearly approximates the emerging mores on distribution. A few years ago it was argued in the Economic Report of the President that "those who produce more should be rewarded more; and no individual or household should be forced to fall below some minimum standard of consumption regardless of production potential. Put differently, it is held that the endowment-based approach, with entitlement to market earnings, should apply but that the resulting degree of inequality is to be limited by setting a floor to the share derived at

the bottom of the scale. Or some qualification of the endowment approach might be extended further up the scale, in line with criteria 4b above.

Equity among Generations

Those now living may affect the welfare of future generations in various ways. Thus advances in science and technology made by this generation will be at the disposal of the next. Similarly, the capital stock accumulated by the present generation is bequeathed as a legacy to the next one. In many ways the present generation thus benefits the future one. But dissaving, exploitation of irreplaceable natural resources and destruction of the environment place a burden upon the future. All these relationships-the asymmetrical fact that the present can affect the future but not vice versa-pose questions of "intergeneration equity" to which we shall return later when discussing social security finance and public debt. Now we only note that introduction of a time dimension further adds to the complexities of the distribution problem.

5.6 Limits to Redistribution

The preceding discussion has focused on the basic question of what constitutes a just state of distribution. The problem of practical policy is more limited. The issue is not so much how to establish a fair society and its de novo state of distribution, but to consider whether and how to address the problem of redistribution. The question is to what extent and how the existing state of distribution-as determined by the market and prevailing social institutions-is to be amended. To some extent this may be accomplished by way of voluntary giving, but such transfers carry minor weight as compared with policies of redistribution decided upon by the budget process. Such policies will then be met by the responses of individuals who stand to lose or gain in the process. This in tum may affect the size of the pie available for redistribution and impose costs which must be allowed for.

The Size of the Pie

Redistribution as noted throughout this discussion involves costs as well as benefits, and both must be considered. Policies to redistribute, to begin with, can shrink the size of the pie available for distribution. This is shown here with regard to effects on labor supply, but similar problems arise with regard to possible effects on saving, investment, and economic growth. Consider two individuals, H with high and L with low earnings capacity. To simplify, suppose L's earnings capacity is, in fact, zero. In the absence of intervention, H has a substantial positive income and L has none. Now a tax is imposed on Hand a transfer is paid to L. As a result of the tax, the net wage rate of H (the return in goods which H can obtain for selling leisure) is reduced. Initially H may respond by working more (H's labor supply schedule slopes backward over a range of high wage rates), but thereafter a further increase in the tax rate will induce H to retain more leisure-that is, to work less. As a result, the revenue obtainable from a given tax is not unlimited. As the tax rate is increased further, revenue will rise for some time until a point is reached beyond which further increases in the tax rate will result in declining revenue and hence in a reduction in funds available for transfer to L. This relationship is illustrated by the following table, showing H's response to rising rates of tax with a wage rate of $10

Tax Rate (Percentage) (I)	H's Hours Worked (II)	H's Income Before Tax (Dollars) (III)	Tax Revenue from H Transferred to L (Dollars) (IV)	H's Income After Tax (Dollars) (V)	L's Income (Dollars) (VI)
0	6.0	60.0	0	60.0	0
15	7.0	70.0	10.5	59.5	10.5
30	5.0	50.0	15.0	35.0	15.0
50	2.5	25.0	12.5	12.5	12.5
80	1.0	10.0	8.0	2.0	8.0
100	0	0	0	0	0

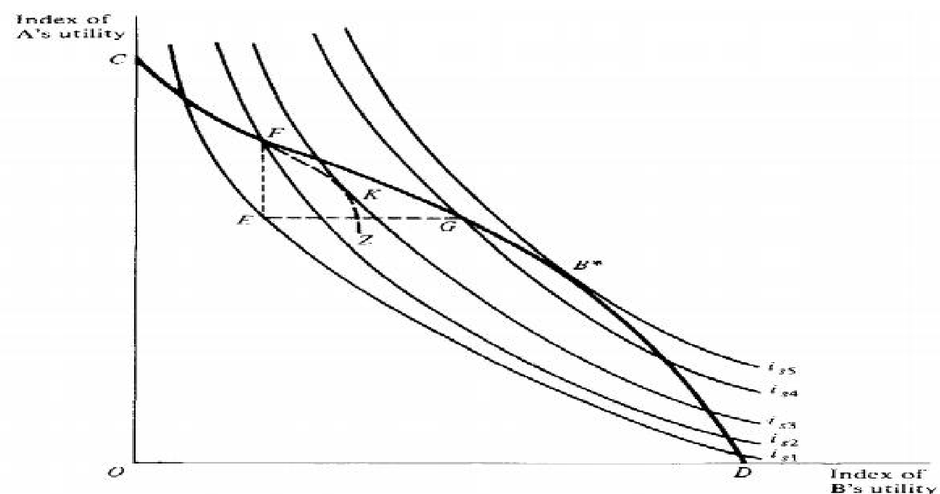
As the tax is introduced, H increases his working hours initially so as to recoup some of the lost income. He does so until a tax rate of 15 percent is reached, above which his working hours will be reduced. In moving from 15 percent to 30 percent, revenue still rises as the increase in tax rate more than offsets the decline in the taxable base, but as the tax rate is increased still further, revenue begins to fall. Whereas the goal of maximin would be served by stopping at 30 percent, a 50 percent rate would be needed for full equalization.

5.7 Efficiency Costs

The potential scope for redistribution may thus be limited because a further increase in tax rates eventually hits a revenue ceiling. But this is not the entire story. There is another and subtler cost to redistribution which becomes effective from the outset. This arises because withdrawing one dollar of income tax from H leaves H with a welfare loss in excess thereof, and because receipt by L also imposes a deadweight loss that must be taken into account. As noted below, this factor poses a major problem in the design of welfare programs.

The fact that the donor loses more than the recipient gains, however, does not mean that the transaction must involve a social loss. Much depends on the weight to be attributed per dollar of loss and per dollar of gain, so that a low-income gain of 90¢ may, as placed under a social weight, more than outweigh a loss of $1.10 higher up. The nature of the efficiency-equity tradeoff is illustrated in Figure 6-2 for an economy containing two persons, A and B. As shown previously in Figure 5-2, the vertical and horizontal axes measure A's and B 's utility levels, with utility rising when moving from 0 to C or from 0 to D. CD is the utility frontier as derived in Figure 6-2, and i_{s1}, i_{s2} ,i_{s3} , • • • are social indifference curves reflecting the distributive judgment of the community. B* is the bliss point, reflecting the best of all possible solutions.

FIGURE 6-2 Equity-efficiency tradeoff



If prevailing arrangements place the economy at E, movement to points between F and G on the utility frontier is efficient (Pareto-optimal), since at least one gains and none loses. But the Pareto criterion of efficiency does not tell us how to choose among points between F and G. From the social point of view, however, G is best, since it reaches the highest possible social indifference curve, i_{s4} . Now suppose that the functioning of the market leads to point F. Given the is curves of Figure 6-2, a social gain results by moving from F to B*, raising social welfare from i_{sl} to i_{s5}. This gain results even though A loses, so that the move is not sanctioned by the criterion of Pareto efficiency. Moreover, moving to a point off the utility frontier, such as K, may be superior from the social point of view to remaining at F. Introduction of a social welfare function, as reflected in i_{s1}, i_{s2}, ... thus suggests a broadened concept of efficiency, i.e., one by which the outcome is assessed and ranked in terms of social welfare weights.

To see how this bears on the efficiency cost of redistribution, we might imagine CBD to trace the utility frontier as it would look if redistribution could be achieved without an efficiency cost. But given this cost, and beginning at F, the actually available frontier may be given by the dotted line FKZ. By moving from F to K (but not farther!), redistribution still pays in social welfare terms, but the gain is less (involving a shift from i_{s2} to i_{s3} only) than it would be without an efficiency cost of redistribution. Although society may thus accept some efficiency loss to obtain an equity gain,

distributional adjustments should be made so as to minimize this cost. This is considered further when the efficiency cost of various types of taxes is compared.

Summary

The problem of just distribution, along with that of efficiency, is an essential part of the broader problem of optimal resource use. The distribution of income as determined in the market depends on the distribution of factor endowments and the prices which the services of these factors will fetch. This process has important bearing on efficient resource use, but it does not constitute a theory of distributive justice. The distribution as determined by factor incomes need not coincide with what is considered socially desirable, thus calling for adjustment by fiscal and other policy measures. Various approaches to distributive justice have been distinguished, and their implications for the distribution of income have been considered. Endowment-based views sanction the distribution of income as determined by factor ownership and returns. Utilitarian views call for a distribution of welfare so as to maximize total satisfaction. An equal distribution of income is required if individuals are assumed to have similar utility functions. Egalitarian views would distribute income so as to equalize the welfare position of all individuals, or so as to maximize that of the lowest. Equity considerations may be applied across generations as well as across individuals. Redistribution policy is subject to certain limitations, which must be allowed for in policy design. The higher-income person, in response to being taxed, may substitute leisure for income, thus setting a limit to the feasible scope of redistribution. Redistribution policies involve an efficiency cost which must be taken into account.

Keywords

Equality:ensuring that every individual has an equal opportunity to make the most of their lives and talents.

Distribution: · the division of the aggregate income of any society among its members, or among the factors of production.

Utilitarianism: is a theory of morality that advocates actions that foster happiness or pleasure.

Egalitarian: is a belief that everyone should be treated the same or equally and all should have the same rights

SelfAssessment

1. Assume that society has a utilitarian social welfare function. Under what condition does maximizing the social welfare function call for an equal distribution of income?

A. Utilitarian social welfare function always calls for an equal distribution of income
B. Marginal utility of income is higher for low incomes.
C. Marginal utility of income is higher for high incomes.
D. Individual utility functions are identical

2. Which theory of justice would promote the use of sentencing circles to achieve justice?

A. Ideological justice
B. Restorative justice
C. Libertarian justice
D. Transitional justice

3. Which of the following statements would best describe utilitarian theory of justice?

A. What is just is what is proportionate.
B. What is just is under the veil of ignorance.

C. What is just is what is fair.
D. Justice is the greatest good for the most people

4. Rawls believed that the only starting point to develop fair public policy would be from the
A. Subservient position.
B. Postmodern framework.
C. Original position.
D. Uneducated position.

5. According to Aristotle's Nicomachean Ethics, justice is achieved when
A. The punishment is in proportion to the crime.
B. Most citizens agree with the punishment.
C. The punishment is just under the veil of ignorance.
D. The costs of crime outweighed the benefits.

6. Nozick is doubtful about…
A. The notion of distribution in a free society
B. The notion of entitlement
C. The notion of justice
D. Historical accounts of justice.

7. Nozick holds that the principle of justice in transfer of holdings…
A. Doesn't necessarily preserve justice.
B. Preserves justice.
C. Is a matter of making sure things are transferred in a way that makes society better off
D. None of the above

8. Which of the following best describes Nozick's entitlement theory?
A. Structural
B. Time-slice
C. Historical
D. Patterned

9. Equals treated equally in taxation leads to:
A. Vertical equity
B. Real equity
C. Horizontal equity
D. None

10. When individuals with unequal tax paying ability should be taxed unequally in order to equal sacrifice is called:
A. Horizontal equity
B. Vertical Equity

C. Tax paying ability
D. None of these

11. The least able person in a society will prefer:
A. Minimum redistribution
B. Maximum redistribution
C. Optimal distribution of income
D. Allocative efficiency.

12. The degree of redistribution is limited by:
A. The economy's capital stock
B. The market.
C. Autocracy.
D. The government's ability to identify the poor and the rich.

13. The distribution of income in a market economy is determined by:
A. Inheritance.
B. Individuals' productivities.
C. Hours worked
D. Bargaining.

14. The principle that states that we should strive to achieve the greatest happiness for the greatest number is called
A. Efficiency.
B. The symmetry principle.
C. The big tradeoff.
D. Utilitarianism.

15. The requirement that peoples in similar situations be treated similarly is called
A. Utilitarianism.
B. The symmetry principle.
C. The big tradeoff.
D. Efficiency

16. If there are no external costs or benefits, no price ceilings or price floors, and the good is not a public good or a common resource, then efficiency is
A. Achieved when the good is produced in a competitive market.
B. Achieved when the amount of output exceeds the amount produced in a competitive market.
C. Achieved when a monopoly produces the good.
D. Unrelated to the amount produced in a competitive market.

Answers for SelfAssessment

1.	D	2.	B	3.	D	4.	C	5.	A
6.	A	7.	B	8.	C	9.	C	10.	B
11.	B	12.	D	13.	B	14.	D	15.	B
16.	A								

Review Questions

1. Equity is important for social welfare. Discuss.
2. Explain the different approaches to distributive justice.
3. What do you mean by Utilitarian Criteria? Explain.
4. Write and explain the Egalitarian Criteria of equal distribution.

Further Readings

- Public Finance By H.L . Bhatia, Vikas Publishing House
- Public Finance in Theory and Practice by S.K. Singh, S Chand & company
- Public Finance in Theory and Practice by Musgrave. .and P.B. Musgrave, McGraw Hill Education
- Public Finance-a Contemporary Application of Theory to Policy by David n. Hyman, Cengage Learning

Unit 06: Economics of Taxation

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Objectives

After studying this unit, students will be able to:

- Understand the taxation and its principle for public welfare.
- Evaluate the benefit principle and ability to pay principle of taxation.
- Explore the concept and taxable capacity of tax payers
- Evaluate the incidence of tax under different elasticity of demand and supply.
- Explore the concept of tax burden and shifting of tax.
- Demonstrate the concept of tax burden and theory of tax shifting.
- Explore the Linthal solution for tax and public goods.
- Evaluate the Linthal equilibrium position for tax and public goods.

Introduction

The most important source of revenue of the government is taxes. The act of levying taxes is called taxation. A tax is a compulsory charge or fees imposed by government on individuals or corporations. The persons who are taxed have to pay the taxes irrespective of any corresponding return from the goods or services by the government. The taxes may be imposed on the income and wealth of persons or corporations and the rate of taxes may vary.Is the inherent power of the sovereign, exercised through the legislatureto impose burdens upon subjects and objects within its jurisdiction for the purpose of raising revenues to carry out the legitimate objects of governmentthe action, process, or system of taxing people or thingsTAXES are the enforced proportional contributions from persons and property levied by the law-making body of the state by virtue of its sovereignty for the support of the government and all public needs.

6.1 Taxation

Taxes are levied by governments on their citizens to generate income for undertaking projects to boost the economy of the country and to raise the standard of living of its citizens. The authority of the government to levy taxes in India is derived from the Constitution of India, which allocates the power to levy taxes to the Central and State governments. All taxes levied within India need to be backed by an accompanying law passed by the Parliament or the State Legislature.The payment of tax is beneficial on multiple levels including the development of the nation, betterment of infrastructure, the upliftment of the society, and even for welfare activities for the nation.Taxes are mandatory contributions levied on individuals or corporations by a government entity—whether local, regional, or national. Tax revenues finance government activities, including public works and services such as roads and schools, or programs such as Social Security and Medicare.In economics, taxes fall on whoever pays the burden of the tax, whether this is the entity being taxed, such as a business, or the end consumers of the business's goods. From an accounting perspective, there are various taxes to consider, including payroll taxes, federal and state income taxes, and sales taxes.

Essential elements of a tax

1. It is enforced contributions which signify that it is compulsory on the part of the government and obligations of the citizen.
2. Generally payable in money.
3. It is proportionate in character which means it is largely based on the ability to pay principle.
4. It is levied on persons, property, or the exercise of a right or privilege.
5. It is levied by the state which has jurisdiction over the subjects or objects of taxation.
6. It is levied by the law-making body of the state which is deemed to be the direct representatives of the taxpayers themselves, the people.
7. It is levied for public purpose or purposes which takes the form of benefit for the greater majority.

Purposes of taxation

1. **Revenue or fiscal:** the primary purpose of the taxation on the part of the government is to provide funds or propertyto promote the general welfare and the protection of its citizens and to enable it to finance its multifarious activities without which the government cannot function.
2. **Non-revenue or regulatory:** taxation may also be employed for purposes of regulation or control. This takes the form of the following measures;
   a. imposition or tariffs on imported goods to protect local industries
   b. The adoption of progressively higher tax rates to reduce inequalities in wealth and income
   c. The increase or decrease of taxes prevent inflation or ward off depression.

Public Purpose in Taxation

This is one of the inherent limitations of the power to tax and is synonymous to "governmental purpose", a tax must always be imposed for a public purpose otherwise, it will be declared as invalid. The term "public purpose" has no fixed connotation.It has been said that the best test of rightful taxation is the proceeds tax must be used:

a. For the support of the government; or
b. Some of the recognized objects of government; or
c. To promote the welfare of the community.

Effects of Incidental Benefit to Private Interest

The purpose to be accomplished by taxation need not to be exclusively public although private individuals are directly benefited, the tax would still be valid provided such benefit is only incidental. The test is not as to who receives the money, but the character of the purpose for which it is expended; not the immediate result of the expenditure, but rather the ultimate results.

Inherent limitations:

1. Purpose must be public in nature
2. Prohibition against delegation of the taxing power
3. Exemption of government entities, agencies and instrumentalities
4. International comity
5. Limitation of territorial jurisdiction

Nature of the Power of Taxation

1. It is inherent in sovereignty; hence, it may be exercised although it is not expressly granted by the constitution.
2. It is legislative in character; hence, only the legislature can impose taxes.
3. It is subject to constitutional and inherent limitations; hence, it is not an absolute power that can be exercised by the legislature anyway it pleases

6.2 Principle of Taxation

1) Benefit Principle and

2) Ability to Pay Principle

The Benefit Principle

The ***benefit principle*** states that the individuals who receive the benefit of the good or service should pay the tax necessary to supply the good.The principle recognizes that the purpose of taxation is to pay for government services. If taxes are imposed according to the benefit principle, people pay taxes in proportion to the benefits they receive from government spending.If taxes are imposed according to the benefit principle, people pay taxes in proportion to the benefits they receive from government spending. Therefore, those who derive the maximum benefits from government services such as roads, hospitals, public schools and colleges should pay the maximum tax. However, if the benefit principle of taxation is followed, the government will be required to estimate how much various individuals and groups benefitand set taxes accordingly.According to the benefit principle of taxation those who reap the benefits from government services should pay the taxes. The benefit principle holds that people should be taxed in proportion to the benefits they receive from goods and services provided by the government. This principle is based on the feeling that one should pay for what one gets. One clear example is road tax. Receipts from road taxes typically are set aside for maintenance and construction of roads. Thus, those who drive on the roads pay the tax.The principle also leads to an economically efficient solution to the questions of how much government should provide and who should pay for it. However, using the benefit principle has several practical difficulties that render it impossible to apply it for many publicly supplied goods and services. When a good or service supplied by the government has the exclusive and rival characteristics of a private good, benefits can be computed rather easily, and users can be charged accordingly.Examples include road tax, toll tax and transit fees. When a publicly provided service is non-rival and non-exclusive (a pure public good) the benefit principle is just a theoretical concept because the benefits cannot be measured.

Problems

Let us suppose taxes are based on one's reported assessment of the benefits one receives from the good. In essencetaxation is voluntary. Some taxpayers might assert that they want little or none of the public good (like a road, or a public park or a bridge) in question. If most people want to enjoy the good or service free of cost (or, they attempt to 'free ride'), the public good may not be available at all. Most people will enjoy the benefits of public expenditure but will be reluctant to pay taxes.To

overcome this problem, an alternative principle has been suggested, viz., the ability to pay principle.

The Ability-to-Pay Principle

The *ability-to-pay principle* states that individuals who are most able to bear the burden of the tax should pay the tax. Those who have higher incomes can afford to pay a greater proportion of their income in taxes, regardless of the benefitsIf the objective of the government is to redistribute income, it should set taxes according to the ability-to-pay principle. However, it is difficult to measure ability. There are, in general, three measures of ability: income, expenditure and property.

Income:Income is said to be a better measure of ability than wealth. But here also some difficulties are encountered. All work do not involve the same sacrifice. A man earning Rs.500 through toil and trouble will not be a position to pay taxes as one earning the same amount without any effort (from paternal property) or gambling or through chance (lottery). One with the same level of income as another may have more dependents and more liability and thus lower ability to pay. Moreover, the marginal utility differs from man to man. It is higher to a man with lower income and vice versa

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

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

If taxes are imposed on the basis of the ability to pay principle, higher taxes will be paid by those with greater ability to pay, as measured by income and/or wealth.Let us consider the three alternative income tax plans listed in Table. OPINION

Table 1: Three Alternative Income Tax Plans

	Tax Payments (in Rs.)			Average Tax Rate (%)		
Income(Rs.)	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
1000	100	100	100	10	10	10
10000	2000	1000	500	20	10	5
100000	40000	40000	2500	40	10	2.5

In table above, all these plans may be said to be operate on the ability to pay principle of taxation. Yet they have different distributive consequences. Plan 1 is a progressive tax: the average tax rate is higher for richer families. Plan 2 is a proportional tax; every family pays 10% of its income. Plan 3 is quite regressive: since tax payments rise more slowly than income, the tax rate for richer families is lower than that for poorer families.It appears that under plan 3 the principle of 'fairness' is violated. However, the modern system of progressive personal income tax seems to be based on the notion of vertical equity. Other things being equal, progressive taxes are seen as 'good' taxes in some ethical sense while regressive taxes are seen as -bad'. On these grounds, advocates of greater equality of income support progressive income taxes and oppose sales taxes. However, progressivity in taxation is not necessary for vertical equity. A proportional income tax system could well satisfy the equity principle.

Advantages of Ability-To-Pay Taxation

1. **Pool more resources for government services**: With an ability-to-pay taxation system, individuals with more resources are able to provide more funding for services needed by all. Societies rely on government services, either directly or indirectly, such as police, scientific research, schools, and more.
2. **Government revenue scales with earnings:** A different tax system may give rise to some "taxation deadweight loss." For example, if a flat tax system was implemented, then the

tax rate would need to be high enough to ensure enough government revenue for services, but low enough to accommodate low-income earners.Taxation revenue is "left on the table" and that can lead to reductions in services. In addition, low-income earners most likely need a majority of their income, so an ability-to-pay taxation system allows them to keep a larger percentage of their income to help stimulate the economy.

Disadvantages of Ability-To-Pay Taxation

1. **Reduces incentive to increase income**: Because an individual will pay more tax as their income increases, critics of the ability-to-pay taxation system argue that individuals will lose the incentive to earn more. In a sense, the critics argue that high incomes are penalized, even though the funds might have been accumulated through hard work and ingenuity.
2. **No government spending accountability**: When a government taxes its citizens, it makes decisions about how to best spend that money to benefit its citizens. Individuals argue that the services they receive don't benefit them individually, so their taxes should be put towards services that benefit them (benefit-received taxation).For example, the government would collect taxes from gasoline to service items, such as roads. All tax revenue that is collected from gasoline should be put towards roads, but it isn't necessarily the case with ability-to-pay taxation.

6.3 Taxable Capacity

Taxable Capacity means the maximum capacity of the people of a country to bear the burden of taxation without much hardship. It is nothing but the maximum limit that a government can tax the people. If the government exceeds this red signal, namely the maximum limit, it will result in over-taxation.As a result of over-taxation, the country experiences imbalance not only in the economy but also in the government itself. The purpose of finding out the taxable capacity of any country or people is to know the limit of taxation to which it could be subjected for raising public revenue.

According to Dalton, the term "taxable capacity" is a dim and confused conception. He says that the term "absolute capacity" is a myth and a discussion on it must be banned.

"Taxable Capacity is of great practical importance. It is useful for a government to know in general the maximum amount that people of the country can contribute by way of taxation."

Findlay Shirras

According to **Joshia Stamp,** "Total production minus the amount required to maintain the population at subsistence level".

Indian Taxation Enquiry Commission, "Taxable capacity is a relative concept. It is the degree of taxation beyond which productive effort and the efficiency as a whole begin to suffer".

The term absolute refers to the maximum amount of tax that a community can pay without experiencing any unpleasantness. It represents the maximum number of taxes that can be levied and maximum revenue collected from the people of a country.Taxable capacity at any rate is a relative concept and it cannot be measured with any mathematical precision. It may change between peace time and war time.The term taxable capacity is used in two senses:

- **The Absolute sense and**
- **The Relative sense**

Absolute Taxable Capacity

Absolute taxable capacity refers to whatever could be taken away by the State after allowing for the barest of subsistence to the citizens, or as **Shirras** has stated, "Absolute taxability is the limit of squeezability".The main difficulty in this explanation is to ascertain the subsistence level of the country.It is very difficult to quantify the minimum subsistence level. If the entire amount so obtained after deducting the subsistence level from the total production is taken away in the form of taxes, it will affect not only the well-being of the people, but also the productivity and efficiency

of the community.After realizing these difficulties, Sir Josiah Stamp suggested an alternative measure, namely, the difference between the **total production** and **total consumption**.There are other indicators of absolute taxable capacity. If the additional taxation results in lower production or lower productivity or if it does not increase the revenue of the State, it then indicates that the absolute taxable capacity of the people has already been reached.

Relative Taxable Capacity

This terminology refers to the respective contribution made by two communities for the common expenditure of the government. That is it is the capacity of the community to some common expenditure in relation to the capacities of other communities. For example, there are two communities, namely the rich and the poor communities. The rich-people can be made to contribute more to a common expenditure than the poor people. The rich people have the ability to pay in view of their higher income.Prof. Musgrave relates the notion of taxable capacity with the concept of income per capita.The higher the per capita income higher is the capacity to pay tax.

Dr. Dalton says that absolute taxable capacity is a myth, while relative taxable capacity is a reality.The criticism leveled against absolute taxable capacity by Dr. Dalton cannot be accepted completely. Though it is not possible to measure the absolute taxable capacity accurately, but it cannot be ignored completely. It serves as a useful guideline for the government when it levies new taxes on its citizen.

6.4 Factors Influencing Taxable Capacity

The concept of taxable capacity is not very rigid. It is a moving concept. As the prosperity of nation increases, the taxable capacity of the people also increases. The taxable capacity of the people of a country is influenced by several factors. They are as follows:

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

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

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

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

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

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

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

8. Size of National Income: The taxable capacity of any community will depend upon the size of national income which itself will depend upon such factors as the volume of natural and other resources, the degree of utilization of resources, the state of technology, and so on. The richer a community, the higher is its capacity to pay taxes.

Thus, all these factors taken together determine the upper limit of taxation. As the economy goes on achieving prosperity and affluence, the taxable capacity also increases. Taxable capacity varies from country to country and from time to time in the same country. But there is no mathematical formula to measure taxable capacity.The well-known economist Colin Clark has laid down 25 percent of the national income as a safe upper limit for taxation. But this is applicable to developed countries only. It is possible to increase the tax revenue every year by 10 to 15 percent without causing unpleasantness to community.

Significance of the Concept of Taxable Capacity

The knowledge of the taxable capacity of the community is bound to be of great use to the government in many ways and under different circumstances.

1. The information will be useful for the mobilization of economic resources for purposes of economic planning.

2. During periods of war, it is essential for the government to know the maximum amount which the people can contribute for the prosecution of the war.

3. Even in normal times, it will prevent government from imposing unnecessary taxes which may prove irritating than productive which may result in discontent among people.

4. The concept is of value in federal finance.

In federal finance, comparison has to be made between the different contributors in order not only to allocate the burdens of taxation but also to facilitate to the solution of the various problems connected with the financial relations between the constituent state and the federal government.

6.5 Tax Incidence

Tax incidence (or incidence of tax) is an economic term for understanding the division of a tax burden between stakeholders, such as buyers and sellers or producers and consumers. Tax incidence can also be related to the price elasticity of supply and demand. When supply is more elastic than demand, the tax burden falls on the buyers. If demand is more elastic than supply, producers will bear the cost of the tax.

The division of the burden of a tax between the buyer and the seller. If the price rises by the full amount of the tax, then the burden of the tax falls entirely on the buyer. If the price rises by a lesser amount than the tax, then the burden of the tax falls partly on the buyer and partly on the seller. If the price doesn't change, then the burden of the tax falls entirely on the seller.

Tax Incidence and Elasticities of Demand and Supply

For a given elasticity of supply, the buyer pays a larger share of the tax the more inelastic is the demand for the good.For a given elasticity of demand, the seller pays a larger share of the tax the more inelastic is the supply of the good.The incidence of a tax depends on the relative elasticity of supply and demand.If supply is more elastic than demand, more of the economic burden of the tax will be borne by customers than by suppliers. If demand is more elastic than supply, more of the burden will be borne by suppliers than by customers. If demand and supply are equally elastic, the economic burden of the tax will be divided equally.

6.6 Tax Shifting

Tax shift is a kind of economic phenomenon in which the taxpayer transfers the tax burden to the purchaser or supplier by increasing the sales price or depressing the purchase price during the process of commodity exchange. Tax shift is the redistribution of tax burden.Shifting means the process of transfer, i.e., the passing of the tax from the one who first pays it to the one who finally bears it. It is through this process of shifting that the incidence of a tax comes finally to rest somewhere. The process of shifting may be slow or may be only partially effective so that the burden of a tax may not fall entirely on the person, who is intended to bear it.The term shifting refers to the transfer of some or all of the burden of the tax from the one on whom tax is imposed to another person.

Shifting of Tax: The process of transfer of a tax, while its impact lies on the person who pays it at first instance. Or, shifting is a process through which a taxpayer escapes the burden of a tax.

There are two types of Shifting of taxation-

- Single point shifting.
- Multi point Shifting.

Factors determining the shifting of tax

1. Elasticity of Demand:Elasticity of demand affects the shifting process. If the taxed commodity is having perfectly elastic demand price cannot be raised at all.Hence the incidence will be wholly on the seller. On the other hand, when the demand is perfectly inelastic, the incidence will be wholly on the buyer. In between these two extremes, the incidence of tax will be shared by the buyer and seller.

2. Elasticity of Supply: Price is determined by the interaction between demand and supply of a commodity. Hence incidence of a tax will be fully borne by the buyer, when the taxed commodity is having perfectly elastic supply. Likewise, when the supply of a commodity is perfectly inelastic, the whole incidence will be on the seller.

3. Price acts an Engine of Shifting:Price act as a media of shifting. It is the vehicle, which carries money burden of tax from the point of view of legal liability. If the tax is shifted through a raise in price, it is called forward shifting. If the price cannot be rise, tax cannot be shifted. Hence the character of price flexibility is the most important factor that determines the shift- ability of a tax.

4. Tax Area:The nature of the area in which the tax is imposed also affect shifting of a tax. If the tax is imposed on a commodity, having local market, it will be difficult to shift the tax by raising the price.In such a case, people can avoid the tax by purchasing a commodity from neighborhood market, where it is cheap. This also gives rise to smuggling of commodities from non-tax levying locality to avoid taxes.

5. Time Period: Time factor influence the shift ability of a tax. In the short period supply is inelastic. Hence, during this period greater part of tax burden will be borne by the seller.In the long-run, supply is more elastic. Hence, there is a better scope for shifting tax burden upon the buyers. Therefore, in the short period, shifting of a tax is difficult, where as in the long period it is easy to do.

6. Coverage of Tax:If the tax is general in character, falling on wide range of commodities, it is easy to shift the burden.For example, if the tax levied on tooth paste is general in nature, covering all brands and kinds, it will be readily shifted. However, if a tax is imposed on one brand of tooth paste, excluding the other brands, it is not possible to shift the tax burden. So we can say that shifting of a tax is rendered easier in general tax than in non-general taxes.

7. Availability of Substitutes:Taxes imposed on a commodity having no close substitutes, can be easily shifted to the buyer. Here the buyer cannot find an alternative product as substitute to satisfy his demand.Hence, he will be ready to purchase the taxed commodity by giving higher prices. On the other hand, if the taxed product has close substitute, shifting the money burden to buyers, is difficult.Any rise in price due to tax will be opposed by the buyer, and he will go for the non-taxed substitutes. So the seller will himself bear the burden of tax, instead of attempting to shift it.

8. Nature of Demand for Commodities:By this, we mean whether the taxed commodity is falling under the category of necessaries, comforts or luxuries. The nature of demand is different for different commodities. In the case of necessary goods, demand is inelastic.Hence the burden of tax is higher upon the buyer, than on seller. In the case of comforts, demand is more elastic, hence burden of tax will be divided between buyer and seller. Coming to the case of luxuries, demand is elastic. Hence the burden of tax is more on the seller. It cannot be easily shifted to the consumers.

9. Business Conditions:Shifting of a tax is influenced by the existing business condition in the economy. During periods of rising prices and economic prosperity, taxes can be shifted more easily. However, during periods of depression, forward shifting of tax liability is very difficult. Depression is a situation of falling prices. Seasonal changes also will affect the shifting of tax.

10. Types of Tax:Shifting depends upon nature or type of tax imposed. If a tax is imposed on the excess profits of a firm under monopoly or imperfect competition, the incidence will not be shifted. On the other hand, if the tax is levied on the output of the firm, a part of incidence can be shifted on to the consumers.

11. The Policy of the Government:Shift ability of a tax is determined by the tax laws and public policy. In India, a tax law clearly indicates the price to be charged and to be printed on the product cover. For example, sales tax legislation stipulates that the burden of sales tax is to be borne by the consumers.Likewise, government fixes maximum retail price and through law makers it binding to print it on the product. Then those who charge higher prices are legally punished. Hence, whenever a tax is imposed the law-abiding citizen will pay it rationally.On the other hand, if prices are increased due to the attempt to shift some taxes to be paid by the seller; awareness of tax laws helps the consumer to resist it.

6.7 Process of Tax Shifting

Forward shifting- Tax shifted from the seller to the purchaser. If a tax incidence is shifted through a sales transaction, it is called forward shifting. For example, an excise duty imposed on a producer may be shifted to a consumer, or a value added tax (VAT)imposed on a seller may be shifted to a buyer. In case of multi-stage forward shifting of tax incidence, a tax incidence shifted from a seller to an intermediate purchaser.Who will also shift it to another buyer and so on until the tax finally settles on the ultimate purchaser or consumer, 'It may be called that the tax is being shifted onward.

Backward shifting-Backward shifting is that shifting in which the tax is shifted from purchaser to the seller. If a tax incidence is shifted through a purchase transaction, it is called backward shifting. If a VAT imposed on a consumer and he can shift it to the producer, or a VAT imposed on a buyer and he can shift it to the seller, then it will be backward shifting. Backward shifting may be through tax capitalization when a tax affects the capital value of assets. If a tax changes the expected yield of an asset, then it will also change its market price. In other words, the tax has been capitalized. Say, a durable good is subject to a periodic tax (e.g., equivalent to previous annual license fee on TV) and an equivalent of the future tax payments is found in terms of the present value (PV) of the periodic tax discounted on the basis of interest rate. If the purchase price of the durable item is reduced by a part or full amount of this PV by the purchaser, then it is called tax capitalization.

6.8 Concentration Theory

This approach maintains that there is an inherent tendency for the taxes to be absorbed by certain income classes (e.g., tax on wage or tax on land income only). According to the physiocrats, the shifting process involves friction and waste. It is better to impose all taxes on land directly or rather on the net product of landlord, than indirectly through other source. The physiocrats, advocated that the government should concentrate on a single tax on economic rent earned by landlord. They also stood in favor of abolishing the diversified tax structure. Even if a tax was levied on these sterile classes, it will be shifted and re-shifted and ultimately fell on the landlords, who extracts a surplus. Only a tax imposed on landlords can't be shifted further because tax fall upon surplus income and it is paid out of it.

DIFFUSION THEORY

PROPOUNDED BY FRENCH ECONOMIST N.F. CANARD. According to ***diffusion theory of taxation***, under perfect competition, when a tax is levied, it gets automatically equitably diffused or absorbed throughout the community. This theory describes that: "When a tax is imposed on a commodity by state, it passes on to consumers automatically. Every individual bear burden of tax according to his ability to bear it". For instance, a specific tax is imposed on say, cloth. Manufacturer raises prices of commodity by the amount of tax. Consumers buy commodity according to their capacity and thus share burden of tax.

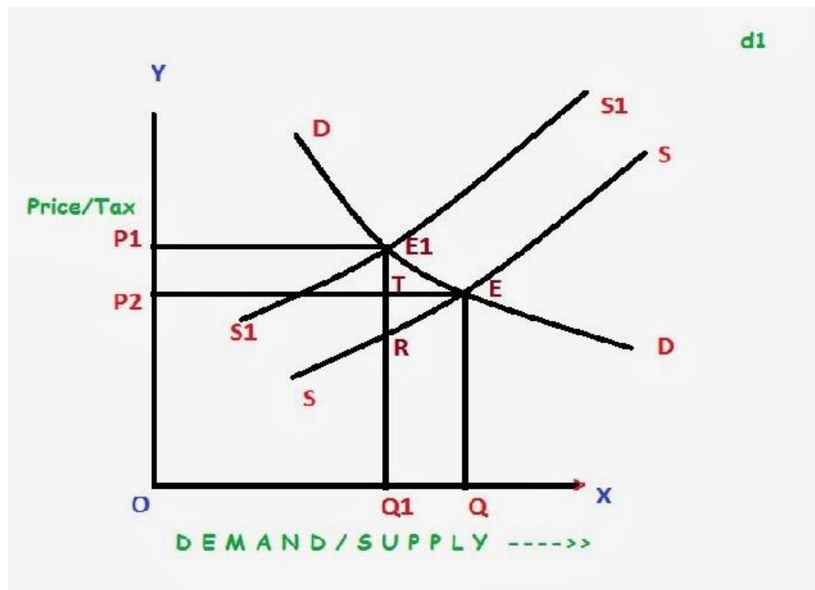
Mansfield, "It is true that a tax laid on any place is like a pebble falling into a lake and making circles till one circle produces and gives motion to another." This quotation has been given to explain to readers that just as a pebble gets diffused in a lake, similarly a tax imposed on a commodity is also absorbed and its burden is felt equally among various sections of community.

THE MODERN THEORY

Modern theory of taxation is one of the important contributions of Dalton to economics. This theory is also known as the Modern theory of shifting and incidence. In this theory Dalton shows the relationship between the burden of taxation with elasticity of demand and supply.**This theory is based on the assumption of "ceteris- paribus" means other things being unchanged.**According to this theory

1. There is direct relationship between the elasticity of demand of the taxed good and the burden borne by the seller.
2. There is negative relationship between the elasticity of demand of the taxed good and the burden borne by the buyer.
3. There is positive relationship between supply elasticity of the taxed good and the burden borne by buyer.

Elasticity of demand and supply of the taxed good has effect on the tax burden of both the seller and the buyer. It can be explained with the help of the following diagram.In the diagram below, DD is demand and SS is supply curve.



At the point E, the demand and the supply of the commodity is equal and thus this point represents the market equilibrium of the commodity. Hence, the equilibrium price is OP and equilibrium quantity is OQ.Now, because of the imposition of tax at E1R, the supply curve shifts to S1S. The price also shifts to OP1. Therefore, the burden borne by buyer is E1T and the rest TR is borne by seller.

Propositions of the Theory

1. If elasticity of demand and supply of the taxed good is equal, then the burden of tax is also equal on both the seller and buyer.

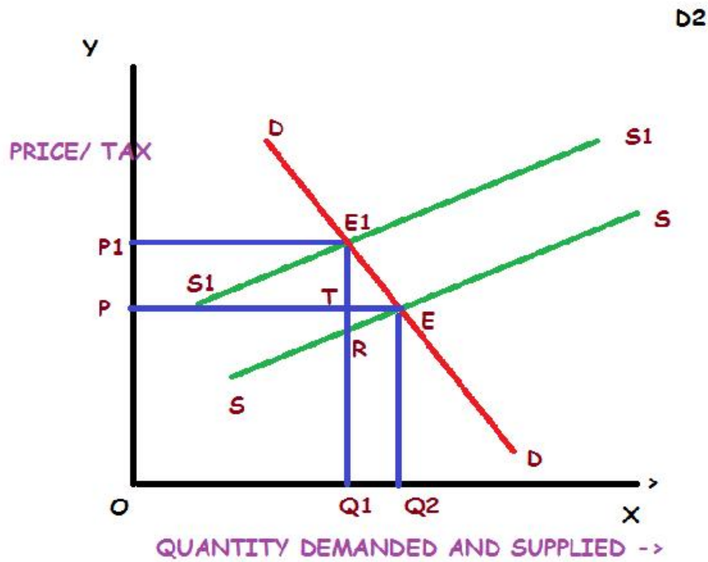
2. In case of elasticity of supply> elasticity of demand, the burden falls on buyer>burden falls on seller.

In the following diagram, 6.1, burden of tax is ER.

Burden borne by seller= TR.

Burden borne by buyer= E1T.

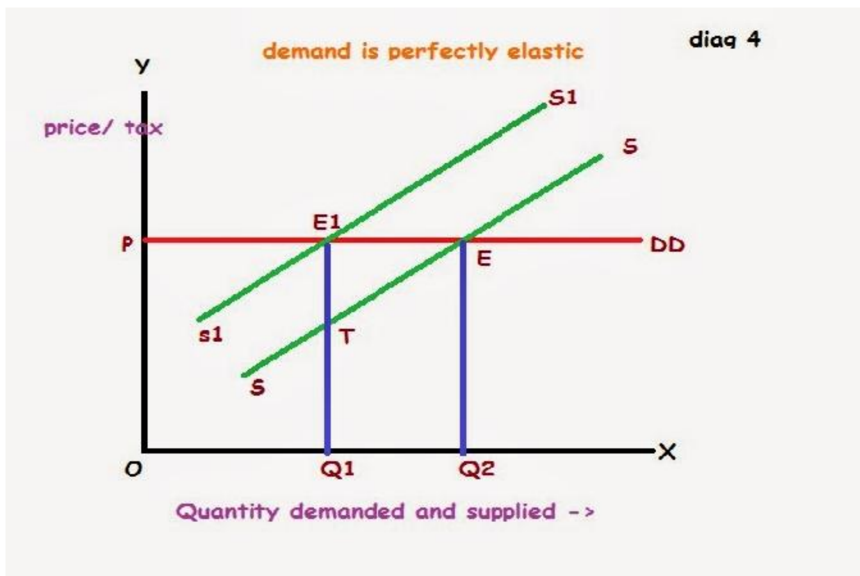
E1T> TR.



3. If elasticity of demand> elasticity of supply, the burden borne by seller> burden borne by buyer.

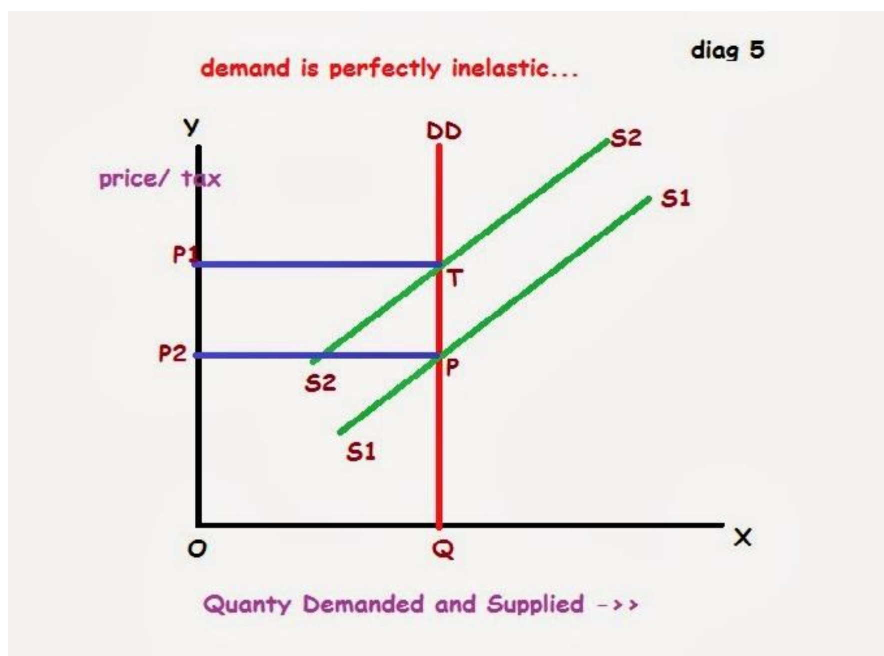
4. If demand is perfectly elastic, the whole burden of tax is borne by the seller.

In the following diagram 6.2, we see that the price is unchanged. Therefore, buyers don't bear any burden. The whole burden has to be borne by the seller.



5. If demand if perfectly inelastic and supply is elastic, then the whole burden of tax is borne by the buyer.

In the diagram 6.3, DD is the inelastic demand curve. We see that demand of a commodity remains the same. So price of the commodity rises. Therefore the whole burden of tax has to be borne by the buyer.



6.9 Lindahl Equilibrium

Lindahl equilibrium is a state of equilibrium in a quasi-market for a pure public good. Like a competitive market equilibrium, the supply and demand for the good are balanced, in addition to the cost and revenue to produce the good. Lindahl equilibrium depends on the possibility of implementing an effective Lindahl tax, first proposed by the Swedish economist Erik Lindahl.Lindahl equilibrium is a theoretical state of an economy where the optimal quantity of public goods is produced, and the cost of public goods is fairly shared among everyone.Achieving Lindahl equilibrium requires the implementation of a Lindahl tax, which charges everyone an amount proportionate to the benefit they receive.Lindahl equilibrium is a theoretical construct because various theoretical and practical issues prevent an effective Lindahl tax from ever actually being implemented.

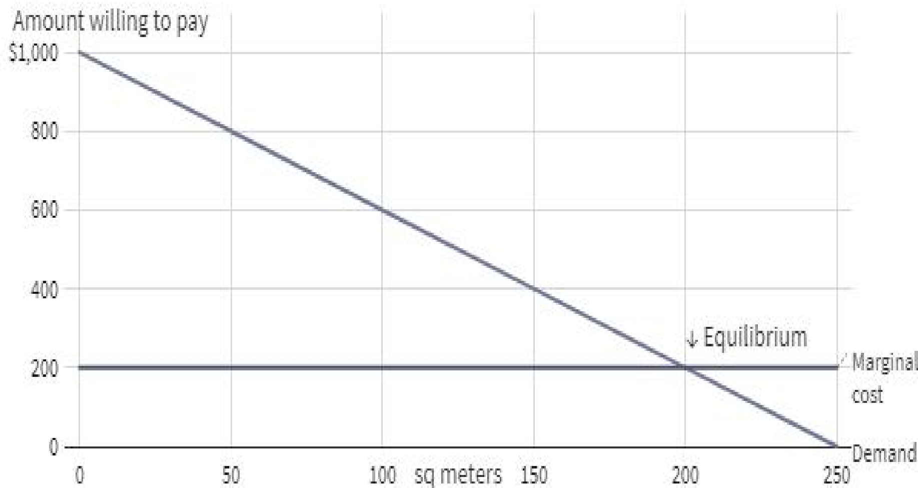
At Lindahl equilibrium, three conditions must be met:Every consumer demands the same amount of the public good and thus agrees on the amount that should be produced.Consumers each pay a price (known as a Lindahl tax) according to the marginal benefit they receive.The total revenue from the tax covers the full cost of providing the public good.A Lindahl tax is a type of taxation proposed by Swedish economist Erik Lindahl in 1919, in which individuals pay for the provision of a public good. According to the marginal benefit they receive to determine the efficient level of provision for each public good.In the equilibrium state, all individuals consume the same quantity of public goods but will face different prices under the Lindahl tax because some people may value a particular good more than others.

Under this paradigm, each individual's relative share of the total tax revenue is proportional to the level of personal utility they enjoy from a public good. In other words, the Lindahl tax represents an individual's share of a given economy's collective tax burden. The actual amount of the tax paid by each individual is this proportion times the total cost of the good.The equilibrium quantity will be the amount that equates the marginal cost of the good with the sum of the marginal benefits to consumers (in monetary terms).The Lindahl price for each individual is the resulting amount paid by an individual for their share of public goods.

Lindahl prices can thus be viewed as individual shares of the collective tax burden of an economy, and the sum of Lindahl prices equals the cost of supplying public goods—such as national defense and other common programs and services—that collectively benefit a society.

Lindahl Equilibrium

A city wants to build a public pool, a public good. The marginal cost to build the pool is $200 per sq meter. The residents of the city are willing to pay $1000 for the first sq meter and $0 for the 250th sq meter. Thus, the city should build a 200-sq meter pool and levy a tax according to how much each resident is willing to pay.



Problems with the Lindahl Tax

The Lindahl equilibrium has more of a philosophical application than a practical use due to various issues that restrict the Lindahl equilibrium's real-world function. Due to the infeasibility of actually implementing a Lindahl tax to achieve Lindahl equilibrium. Other methods such as surveys or majority voting are normally used to decide the provision and financing of public goods. In order to implement a Lindahl tax, the taxing authority must know the exact shape of every individual consumer's demand curve for each public good. However, without a market for the good there is no way for consumers to communicate what these demand curves look like. Because it's not possible to evaluate how much each person values a certain good, the marginal benefit cannot be aggregated across all individuals. Even if consumers could communicate their preferences and the taxing authority could aggregate them.

Consumers might not even be aware of their own preferences regarding a given public good, or how much they value it depending on whether. How much, or how often any given consumer actually consumes the public good. Even if consumer preferences are known, communicated, and aggregated, they may not be stable at the individual level or in the aggregate. Estimates of consumer demand curves might need to be continuously updated in order to adjust both the total quantity of each public good produced and the rate charged to every single individual.Problems of the equity of a Lindahl tax have also been raised. The tax charges each individual an amount equal to the benefit they receive from the good.For certain public goods, such as social safety nets, this obviously makes no sense.

For example, it would require charging welfare beneficiaries a tax at least equal to the transfer payments they receive, which would seem to defeat the entire purpose of the program. It might also be the case that some consumers receive negative utility from a given public goodand providing the good actually causes them harm. For example, a devout pacifist who deeply opposes the very existence of an armed military for national defense.A Lindahl tax for this individual would necessarily be negative. This would lead to a lower equilibrium quantity (since total demand is lower) and a higher Lindahl price for everyone else in society (since the total revenue required would include the price of "buying off" the pacifist).

In the extreme, this could even lead to a case where a small minority group or even a single individual with strongly contrary preferences could completely prevent the production of a given public good regardless of how much it would benefit the rest of society—if the price to buy them off is higher than the amount that others are willing to pay.In this case, it might make more sense to simply ignore the interests of the contrarian minority, to divide the political body along the lines of preferences for public goods, or to physically remove the contrarian minority from the economy.

Summary

The benefit principle has the advantage of linking the expenditure and tax sides of budget policy, but it is not readily implemented, since consumer evaluation of public services is not known to tax authorities but must be revealed through the political process. However, in some instances, benefit taxation can be applied. The benefit principle as applied to the financing of public services excludes redistributional considerations and presumes them to be dealt with in another part of the budget

process.The ability-to-pay principle calls for a distribution of the tax burden in line with the economic capacity of the taxpayer. It has the advantage of permitting inclusion of distribution considerations but the disadvantage of dealing with the tax problem in isolation, the provision of social goods being left out of the picture. The ability-to-pay principle calls for a distribution of the tax burden in line with horizontal and vertical equity. To obtain horizontal equity, taxpayers with equal ability to pay should contribute equally. To secure vertical equity, taxpayers with unequal capacity should contribute correspondingly different amounts.There is no reason to think that Lindahl equilibrium can be embodied by any working political process.

There is some reason to think that the core is a meaningful political concept. If a group of people find themselves able, using only their own resources, to achieve a better life, it is not unreasonable to suppose that they will try to enforce this threat against the rest of the community. They may find themselves frustrated if the rest of the community resorts to violence or force to prevent them from withdrawing. In the absence of some assumption about the reaction of the part of the society not in the coalition to the coalition threat, detailed predictions of the equilibrium situation are not possible.But if a society stays inside the core as it is defined here, there is a minimal rationale for everyone to continue to participate. The conflicts that will naturally arise over the redistribution of initial endowments will still be there. But no group will have the power to alter the situation in its own favor unilaterally. This is a very crude and intuitive argument for the relevance of the core to political reality, but the whole theory of political equilibrium is in its infancy.

Keywords

Tax:A tax is a compulsory financial charge, or some other type of levy imposed on a taxpayer by a government.

Taxable capacity: Taxable capacity is the ability of individuals and businesses to pay taxes

Forward Shifting: when the seller shifts the tax to the consumer.

Backward Shifting:when the price of the article taxed remains the same but the cost of the tax is borne by those engaged in producing it.

SelfAssessment

1. Income tax is based on the principle of:

A. Ability to pay
B. Willingness to pay
C. Benefits received
D. None of these

2. The Benefit Principle of taxation states that tax should be paid in proportion to:

A. Income
B. Expenditure
C. Benefit
D. Utility

3. Which of the following tax is best example of ability to pay principle of taxes

A. Excise tax on cigarettes
B. Highway tool tax
C. Proportional sales tax
D. Personal income tax

4. The Indian tax system is:

A. Proportional
B. Progressive
C. Regressive
D. Digressive

5. The equity principle of taxation was propounded by:
A. Adam Smith
B. Dalton
C. J.B. Say
D. Marshall

6. A tax either on consumers or on producers
A. Creates a dead weight loss for society as a whole
B. Creates a loss only to consumers.
C. Creates a loss only to producers.
D. Creates a net gain for the society as a whole

7. A tax can be fully borne by consumers if
A. The demand is elastic.
B. The supply is elastic.
C. The demand is perfectly inelastic.
D. The supply is perfectly inelastic.

8. The incidence (split) of sales tax is determined by the
A. Level of government which imposes the tax
B. Federal government in all cases
C. Greed of the seller
D. Price elasticities of supply and demand.

9. With a perfectly elastic demand and a normal supply (upward-slopping)
A. Consumers will bear the entire tax burden
B. Consumers will not bear any tax burden
C. Consumers and producer will split the tax burden in half
D. Producers will not bear any tax burden.

10. Impact of a tax refers to –
A. Final money burden
B. Immediate money burden
C. Indirect real burden
D. None of the above

11. Which factor has no role in the shifting of a tax?
A. Change in prices

B. Elasticity of demand and supply

C. Nature of Demand

D. Income of the consumer

12. The shared burden of taxation on consumer and producer implies

A. Inelastic Supply and Elastic Demand

B. Elastic Supply and Demand

C. Inelastic Supply and Demand

D. Elastic Supply and Inelastic Demand

13. The following is a characteristic of a direct tax –

A. Incidence may be shifted

B. Imposes more burden on poor

C. The impact and incidence are on the same person

D. All of the above

14. Lindhal model depends on:

A. Social cost

B. Tax distribution ratio

C. Excess tax

D. Tax deficit

15. Which is main objective index to measure ability to pay approach:

A. Equal sacrifice

B. social welfare

C. Able to pay

D. Public wants

16. The objective of taxation by the Government are:

A. Raising revenue for the state

B. To maintain economic stability

C. To remove disparities in the distribution of income

D. All of the above

Answers for Self Assessment

1. A	2. C	3. D	4. C	5. A
6. A	7. C	8. D	9. B	10. B
11. D	12. B	13. C	14. B	15. A
16. D				

Review Questions

1. What is tax incidence? How it can be determined?
2. "The Income-tax Act gives absolute exemptions in respect of certain income, while some income is included in the total income for determining the rate only". Discuss.
3. Describe the factors which determine taxable capacity
4. Explain the principles of tax.

Further Readings

- Public Finance By H.L . Bhatia, Vikas Publishing House
- Public Finance in Theory and Practice by S.K. Singh, S Chand & company
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Unit 07: Indian Tax System

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Objectives

After studying this unit, students will be able to:

- Explore the Features and Assessment of Indian Tax System
- Evaluate the difference between direct and indirect taxes
- Evaluate the Indian tax structure and its characteristics
- Explore the Goods and Service Tax in India.
- Evaluate the issues and challenges in Indian taxation system
- Understand the nature of state and local finances.
- Analyze the sources of state and local finances.

Introduction

Taxes are an important and largest source of income for the government. The government uses the money collected from taxes for various projects for the development of the nation. The Indian tax system is well structured and has a three-tier federal structure. The tax structure consists of the central government, state governments, and local municipal bodies. When it comes to taxes, there are two types of taxes in India - Direct and Indirect tax. The direct tax includes income tax, gift tax, capital gain tax, etc while indirect tax includes value-added tax, service tax, Good and Service taxm, customs duty, etc.The Central Government of India imposes taxes such as customs duty, central excise duty, income tax, and service tax. The state governments impose income tax on agricultural income, state excise duty, professional tax, land revenue and stamp duty. The local bodies are allowed to collect octroi, property tax, and other taxes on various services like water and drainage supply.

7.1 Indian Tax Structure

Tax structure in India is a three-tier federal structure, central government, state governments, and local municipal bodies make up this structure. Article 256 of the constitution states that "No tax shall be levied or collected except by the authority of law." Hence, each and every tax that is collected needs to backed by an accompanying law.Interestingly, the tax system in India traces its origin to the prehistoric texts such as Arthashastra and Manusmriti. As proposed by these manuscripts, the taxes paid by farmers and artisans in that era would be in the form of agricultural produce, silver or gold. Based on these texts, the foundation of the modern tax system in India was conceptualized by the Sir James Wilson during the British rule in India in the year, 1860. However, post-independence the newly-established Indian Government then soldered the system to propel the economic development of the country. After this period, the Indian tax structure has been subject to a host of changes.

Tax System in India

A tax is a compulsory charge or fees imposed by government on individuals or corporations.The persons who are taxed have to pay the taxes irrespective of any corresponding return from the goods or services by the government. The taxes may be imposed on the income and wealth of persons or corporations and the rate of taxes may vary.The **tax system in India** allows for two types of taxes—Direct and Indirect Tax.The **tax system in India** for long was a complex one considering the length and breadth of India. Post GST implementation, which is one of the biggest tax reforms in India, the process has become smoother. It serves as an all-inclusive indirect tax which has helped in eradicating the cascading effect of tax as a whole.It is simpler in nature and has led to upgrade the productivity of logistics.

7.2 Types of Taxes in India

Taxation in India is majorly divided into Central and State Govt taxes with two types of taxes:

1. Direct Taxes

2. Indirect Taxes

While direct taxes are levied on your earnings in India, indirect taxes are levied on expenses. The responsibility to deposit the direct tax liability lies with the earning party, whether individual, HUF or a company.Indirect taxes are collected majorly by the corporate and businesses providing services and products. Thus, the responsibility to deposit indirect taxes lies with these entities.

What is Direct Tax?

A direct tax is that tax whose burden is borne by the same person on whom it is levied. The ultimate burden of taxation falls on the person on whom the tax is levied. It is based on the income and property of a person.Direct taxes are imposed on corporate entities and individuals. These taxes cannot be transferred to others. For individual taxpayers like you, the most important type of Direct tax is the income tax. This tax is levied during each assessment year (1st April to 31st March). As per the Income Tax Act, 1961, it is mandatory for you to make income tax payments if your annual income is above the minimum exemption limit. You can get tax benefits under various sections of the Act. Before we talk about tax benefits, it is important for you to understand the income tax slab.

What are the Different Types of Direct Tax?

Direct taxes account for almost 50% of the government's revenue in India. However, income tax is not the only direct tax. Here are the types of direct taxes applicable in India:

1. Income Tax
2. Capital Gains Tax
3. Corporate Tax

Income tax applies to any income of an Individual and HUF except capital gains and profits from business and profession. Income tax is calculated as per the applicable slab rates for the Assessment Year.The central government announces the slab rates in the annual budget.You also have the provision to reduce your taxable income using the tax-saving investments and expenses under section 80C.

What other Taxes come under Direct Tax?

Individuals in India, earn an income in a diverse range. Therefore, it is important to levy a tax on you based on your income and if someone earns more, the tax percentage should be different. The Income Tax Act segregates the income range and charges different rates as per the segregation. The different groups are known as tax slabs. Your income tax slab can vary not only based on your income but also your age. Every year during the Central Government's Budget Session, amendments are made in the income-tax slabs.

1. Capital Gains Tax

Capital gains tax applies to the profits from the sale of a capital asset only. The rate of tax on capital gains depends on the type of capital gain. Income Tax Act, 1961 divides the capital gains tax into the following two types:

Short-Term Capital Gains Tax

Long-Term Capital Gains Tax

Short-term capital gains are when the assets are sold within a specified period, for example:

a. Equity stocks sold within 12 months of purchase
b. Debt mutual fund units sold within 36 months of purchase
c. Real estate property or gold sold within 36 months of purchase

If the asset is sold after the specified period, the gains or losses will become long-term capital gain or loss.Depending on the type of asset your gain may receive indexation benefit on long-term capital gains. Indexation allows you the benefit of inflation to your capital gains, reducing your tax liability.

Advantages of Direct taxes

(i) It is easy to determine the incidence of the tax – a person or institution that actually pays and suffers the burden of tax.

(ii) Direct taxes tend to be progressive – people in the higher income group pay a greater percentage than poorer people, e.g., income tax is graduated so that high income earners pay a larger percentage; also a selective wealth tax would only apply to those owning more than a certain level of wealth.

(iii) Direct taxes are easy to collect. Consider, for example, the PAYE system which is used to collect income tax from most wage and salary earners.

(iv) Direct taxes are important to the government's economic policy. If the government is fighting inflation it can impose, for example, high levels of income tax to restrict consumer demand. If the government is concerned about unemployment it can reduce the levels of income tax to increase consumer demand and increase production.

Disadvantage of direct taxes

(i) Direct taxation may be a disincentive to hard work. High rates of income tax, for example, may discourage people from working overtime or trying to gain promotion at work. Some economists blame the 'brain drain' (i.e., the emigration of highly qualified persons, such as scientists and doctors) on India's high levels of taxation.

(ii) Direct taxation discourage savings because, after paying tax, individuals and companies have less income available to save. This means that investment, which relies on the level of savings, is low and this could cause less production and employment.

(iii) This type of taxation encourages tax evasion – to avoid paying so much tax.

(iv) There is no element of choice about paying the tax – it is unavoidable.

7.3 Indirect Tax

Indirect taxes are taxes which are indirectly levied on the public through goods and services.The sellers of the goods and services collect the tax which is then collected by the government bodies.Value Added Tax (VAT)– A sales tax levied on goods sold in the state. The rate depends on

the government.Indirect taxes are taxes which are indirectly levied on the public through goods and services. The sellers of the goods and services collect the tax which is then collected by the government bodies.Indirect taxes are those whose burden can be shifted to others so that those who pay these taxes to the government do not bear the whole burden but pass it on wholly or partly to others. Indirect taxes are levied on production and sale of commodities and services and small or a large part of the burden of indirect taxes are passed on to the consumers. Excise duties on the product of commodities, sales tax, and service tax, and customs duty, tax on rail or bus fare are some examples of indirect taxes.

Value Added Tax (VAT)– A sales tax levied on goods sold in the state. The rate depends on the government.

Octroi Tax– Levied on goods which move from one state to another. The rates depend on the state governments.

Service Tax– Government levies the tax on service providers.

Customs Duty– It is a tax levied on anything which is imported into India from a foreign nation.

Tax Collection Bodies - The three bodies which collect the **taxes in India** have clearly defined the rules on what type of taxes they are permitted to collect.

The Central Government: Income tax, custom duties, central excise duty.

The State Governments: tax on agricultural income, professional tax, value- added tax, state excise duty, stamp duty.

Local Bodies: property tax, water tax, other taxes on drainage and small services.

7.4 Goods Service Tax

In India, the three government bodies collected **direct and indirect taxes** until 1 July 2017 when the Goods and Services Act (GST) was implemented. It is a single indirect tax for the whole nation, one which made India a unified common market. It is a single tax on the supply of goods and services, right from the manufacturer to the consumer.GST incorporates many of the indirect taxes levied by states and the central government.

What does the GST mean for your money?

Goods and Service Tax is a tax on goods and services. It is leviable at each point of sale or provision of service. At the time of sale of goods or providing the services the seller or service provider can claim the input credit of tax which he has paid while purchasing the goods or procuring the service.This is simply very similar to VAT. It can be termed as National level VAT on Goods and Services. Only difference in this system is that not only goods but also services are involved. The rate of tax on goods and services are generally the same.

Some of the taxes GST replaced include:

Sales Tax.

Central Excise Duty.

Entertainment Tax.

Octroi.

Service Tax.

Purchase Tax.

It is a multi-stage destination-based tax. Multi-stage because it is levied on each stage of the supply chain right from purchase of raw material to the sale of the finished product to the end consumer whenever there is value addition and each transfer of ownership.Destination-based because the final purchase is the place whose government can collect GST. If a refrigerator is manufactured in Delhi but sold in Mumbai, the Maharashtra government collects GST.A major benefit is the simplification of **taxation in India** for government bodies.

The state taxes proposed to be subsumed under GST are:

CGST: CGST is a tax levied on Intra State supplies of both goods and services by the Central Government and will be governed by the CGST Act.**Governed by the Central Government.**It will include following taxes-

1. Central Excise Duty.
2. Service tax.
3. Countervailing duties.
4. Surcharge,education &Secondary/Higher Education Cess.
5. Additional excise Duty.

SGST: SGST is a tax levied on Intra State supplies of both goods and services by the State Government and will be governed by the SGST Act.Governed by the Central Government.It will include following taxes-

1. VAT/Sales Tax.
2. Purchase tax.
3. Entertainment tax.
4. Luxury Tax.
5. Lottery Tax.

IGST: IGST will be applicable on any supply of goods and/or services in both cases of import into India and export from India.IGSTisdesignedtoensure seamless flowofinputtaxcredit from one state to another.It is designed so that a state doesn't have to deal with every other state to settle the tax amounts.Therefore if inter-state sales (i.e., sale from one state to another state) is made then the seller will charge IGST in place of CGST + SGST.For example:A dealer in Maharashtra sells goods to its dealer in Rajasthan worth Rs.1,00,000. The GST rate is 18% comprising of CGST rate of 9% and SGST rate of 9%. In such a case the dealer has to charge Rs.18, 000 as IGST.

UTGST: The UTGST bill is presented in respective states government to implement as UTGST Act.The Main purpose of UTGST bill is to apply a collection of tax on every Intra UT supply of goods and service in the union territories in absence of legislature and has similar properties as that of SGST.

Advantages

1. Convenient Indirect taxes are more convenient to pay. These taxes, generally being on commodities, are wrapped up in prices.

2. Disguised: The effect of indirect taxes does not provoke resentment, because they cause less annoyance to the public as these taxes are not felt directly.

3. Not Easily Evadable: Indirect taxes are difficult to evade as they are usually merged with prices.

4. Broad-based: Indirect taxation usually being commodity taxes has a broader scope. The low-income strata of society which are exempt from direct taxes can be easily caught in the net of such tax.

5. Social Value: Indirect taxes have a high social value. They can serve to improve social morale and public health by discouraging consumption of such harmful commodities as intoxicants, tobacco, etc.

6. Forced Savings: Indirect taxes are an effective means of mopping up consumer's surplus and thereby diverting the saving potential of the community at large into the hands of the government.

7. Complementary: Additional revenue can be easily obtained by introducing an indirect tax. Indirect taxes in fact can serve as complementary to direct taxes.

8**. Progressive**: Indirect taxes on luxuries and semi-luxuries are progressive in effect, as they fall on the rich people's consumption outlays.

Disadvantages

1. In equitability: Indirect taxes are unjust and inequitable as they are regressive in effect. Since they are charged at a proportional rate on commodities of general consumption.

2. Less Productive: Indirect taxes do not conform to the canons of economy and productivity. As these taxes involve many stages, the cost of collection is usually high in relation to the revenue yielded.

3. Inflationary Potentiality: Indirect taxes prove to be inflationary when excessively relied upon. In India, for instance, excessive indirect taxation on commodities of mass consumption may be blamed as being an important factor contributing to the inflationary price spiral in the country.

4. Disincentive Effect on Savings Indirect taxes discourage savings when the people have to spend more with a rise in the prices of commodities.

5. No Educative Value: Indirect taxes being invisible, and as they are collected through middlemen like traders, hence, they do not promote any civic sense.

Differences between Direct and Indirect Tax

1. **Direct tax** is levied and paid for by individuals, Hindu undivided Families (HUF), firms, companies etc. whereas **indirect tax** is ultimately paid for by the end-consumer of goods and services.
2. The burden of tax cannot be shifted in case of **direct taxes** while burden can be shifted for **indirect taxes**.
3. Lack of administration in collection of **direct taxes** can make tax evasion possible, while **indirect taxes** cannot be evaded as the taxes are charged on goods and services.
4. **Direct tax** can help in reducing inflation, whereas **indirect tax** may enhance inflation.
5. **Direct taxes** have better allocative effects than indirect taxes as direct taxes put lesser burden over the collection of amount than indirect taxes, where collection is scattered across parties and consumers' preferences of goods is distorted from the price variations due to **indirect taxes**.
6. **Direct taxes** help in reducing inequalities and are considered to be progressive while **indirect taxes** enhance inequalities and are considered to be regressive.
7. **Indirect taxes** involve lesser administrative costs due to convenient and stable collections,while **direct taxes** have many exemptions and involve higher administrative costs.
8. **Indirect taxes** are oriented more towards growth as they discourage consumption and help enhance savings. **Direct taxes**, on the other hand, reduce savings and discourage investments.
9. **Indirect taxes** have a wider coverage as all members of the society are taxed through the sale of goods and services, while **direct taxes** are collected only from people in respective tax brackets.
10. Additional **indirect taxes** levied on harmful commodities such as cigarettes, alcohol etc. dissuades over-consumption, thereby helping the country in a social context.Direct and indirect taxes are defined according to the ability of the end taxpayer to shift the burden of taxes to someone else.

GST HAS THREE COMPONENTS

CGST-Stands for **Central Goods and Services Act**. The central government collects this tax on an intrastate supply of goods or services.

SGST: Stands for **State Goods and Services Tax**. The state government collects this tax on an intrastate supply of goods or services.

IGST: Stands for **Integrated Goods and Services Tax**. The central government collects this for inter-state sale of goods or services.

For a smooth implementation of the **Indian tax system**, there are bodies dedicated to it. Popularly known as the revenue authorities.

CBDT: The Central Board of Direct Taxes is a part of the revenue department under the Ministry of Finance. It has a two-fold role.

One, it provides important ideas and inputs for planning and policy with regard to direct tax in India.

Second, it assists the Income Tax department in the administration of direct taxes.

CBEC: The Central Board of Excise and Customs deals with policy formulation with regard to levy and collection of customs and central excise duties and service tax.

CBIC: Post GST implementation, the CBEC has been renamed as the Central Board of Indirect Taxes & Customs (CBIC).

The main role of CBIC is assisting the government in policy-making matters related to GST.

7.5 Benefits of Taxes

While paying taxes may not be a pleasant feeling, however, it is prudent to understand that tax paid by every single individual contributes towards the country's administration and resources required for its economic progress.

It promotes savings as well as investments. If an individual makes certain set of investments, a part amount of the same would be tax exempted, thereby enabling him or her to pay reduced amount of taxes.

Paying tax also works as a proof that you are not only disciplined in filing your tax returns but also helps at the time of loan application.

This is because at the time of purchasing a home loan, the bank requires proof of whether the applicant has filed his or her taxes regularly.

Features of Indian Tax Structure

1. The Scientific Division of Tax Powers: India being a federation, there is the existence of a multi-level finance system.

The constitution of India forms the basis of division of powers into:

Union,

State, and

Concurrent.

Based on this the constitution has also made a provision for division of tax powers between the centre and the states.The area and sphere of taxation of centre and state is clearly demarcated as per constitutional provision. Taxes which are in the purview of central government accounted for 50 percent of its revenue. Some taxes are again levied by the Central government and the proceeds of such taxes are divided between the centre and the state governments.

2. Multiplicity of Tax Structure: India is having a broad based and extensive tax structure. Its main feature is the existence of multiplicity of taxes. There are both union government taxes and state government taxes. The tax structure includes both dried and indirect taxes.In the case of states indirect taxes play a dominant role, in the composition of tax revenue. Among the direct taxes imposed in India, the most important is income tax. Other prominent taxes are wealth tax capital gains tax, gift tax etc.The indirect taxes in India Consists of excise duties, customs duties, etc.The important taxes levied by the union government are income tax, corporation tax, central excise duties, wealth tax, gift tax, custom duties etc.The state governments main taxes are land revenue, sale tax, state excise duties, entertainment tax, stamp and registration duties etc.

3. Larger share of Indirect Taxes: In India in the total tax revenue there is the domination of indirect taxes over direct taxes.If shows that because of the undeveloped character of the economy and glaring inequality in income, the scope of direct taxes are limited.

4. Insufficient Tax Revenue: In-spite of rising trend in tax revenue, the total revenue remained small when compared to developed countries. The tax GDP ratio generally remained in the range of 8 percent to 10 percent in India (E. Survey 2020-21) where as it is very high in countries like Sweden, France, West Germany, UK, USA, etc. where the share ranges between 30 to 42 percent.

5. Greater Importance to Sate Government in Federal Fiscal System: In Indian fiscal federalism much importance is assigned to state governments. The field within which tax revenue, are raised and spend regularly is very wide in India when compared to many federal governments.This is because of the growing responsibilities of the state government in the discharge of developmental activities.

6. Incidence of Taxation: In India the incidence of taxation is much higher in urban areas than in rural areas this is because of the predominance of agriculture in rural area and low income of rural households.The urban population depends more on service and business sector and enjoys comparatively higher income and taxpaying capacity.

7. Progressiveness in Tax Structure: Indian tax structure is framed in such a way that all indices of ability to pay is taxed. The direct tax is framed in such a way that as tax base increases, tax rate also rises sharply. Excise duties are levied and collected discriminately, depending on the type of commodity and the class of consumers.

8. Narrow Base and Others: Fiscal experts opine that the tax base is very narrow in India in the case of both direct and indirect taxes. A planning commission estimate shows that only one percent of working population comes under the preview of direct tax.

9. Complexity of Indian Tax Laws: With the intension of broad based tax system, a plethora of changes have been introduced in the tax structure. However both direct and Indirect tax laws are highly complex, with a lot of loopholes which enable the people to avoid as well as to evade taxes.

10. Integration between Centre and Sate Revenue: After independence concrete efforts were made to organize the tax structure scientifically in tune with the requirements of a federal set of government. At present there is well-organized machinery for the collection distribution and expenditure of the revenue.Now the tax system is well structured to generate sufficient revenue to meet the requirements of development objectives.

7.6 Major Defects in the Tax Structure of India

Indian tax system is unscientific because it doesn't provide any stimulation for production investment and saving activities of the government. This unscientific base of tax system is pin pointed as a factor responsible for generating black money and encouraging tax evasion. Compared to developed countries like Japan, Australia USA etc.

1. High Rate and Low Yield of Direct Taxes: In India, as in other LDCs, the rate of direct tax is very high but the contribution to the total tax revenue is very low.In the 1950s, the rate of income tax in India was one of the highest in the world but the revenue was very insignificant. This is because high tax rates encouraged tax evasion and avoidance on a large scale.

2. Low Contribution of Income Tax: Although the rate of income tax is the highest in India, the contribution from such is very low. Tax evasion seems to be the primary reason. Another reason is the high exemption limit in a country where per capita income is very low. In India, the exemption limit has been raised from time to time, but the levels of national and per capita incomes have failed to increase proportionately.

3. Double Taxation of Dividends: Due to double taxation of dividend, the rate of domestic saving and capital formation has failed to increase appreciably. Companies pay corporation and other taxes (such as excess profit tax or surtax) to the Government. A portion of net profit after tax is usually distributed among shareholders in the form of dividend.A portion of such dividend income is again taxed away in the form of personal income tax.

4. Absence of Agricultural Income Tax: Another feature of India's tax system is that there is no tax on agricultural income. Agriculture is the dominant sector of the Indian economy. Planned investment on agriculture has also increased over the years. But agriculture has failed to make any contribution to the introduction of the Government's tax revenue.

5. Importance of Indirect Taxes: Importance of indirect taxes has increased over the years which imply that the importance of direct taxes has diminished. In absolute terms (i.e., in terms of rupee)

the contribution of direct taxes has increased but the percentage contribution of such taxes in total tax revenue has declined.

6. Progressive Taxes on Income: The Government has made the system of direct tax progressive and progressiveness is considered desirable in the interest of equity and for reducing the disparities in the distribution of income and wealth. But progressive taxes encouraged tax evasion and avoidance and have failed to reduce inequalities of income and wealth.

7. Widening the Indirect of Tax Net: Over the years, the indirect tax net has been spread wide. Almost all the commodities that we buy bear high indirect taxes as sales tax, excise duty, customs duty, octroi, cess and so on. At present, Central Government revenue from two main taxes, viz., union excise duties and customs accounts majority of the total revenue.

8. Regressive Nature: Indirect taxes have become more and more regressive over the years. Such taxes are usually imposed on consumption goods.Poor people have a high propensity to consume than the rich people. Marginal propensity to consume gradually decreases with an increase in income.Thus poor people, who spend the major portion of their small income on consumption goods, pay the maximum amount of indirect taxes. Over the years, the direct tax system has become less and less progressive due to gradual reduction in the personal income tax rate, while indirect taxes have become more and more regressive due to the inclusion of more and more items in the excise net.

7.7 State and Local Finances

State and local governments collect tax revenues from three primary sources: income, sales, and property taxes. Income and sales taxes make up the majority of combined state tax revenue, while property taxes are the largest source of tax revenue for local governments, including school districts. Tax revenues fluctuate in response to changes in economic conditions and tax policies. The states' revenues comprise broadly two categories —

- **Tax Revenue and**
- **Non-Tax Revenue.**

Tax revenue: It is divided into two further categories: State's Own Tax Revenueand Share in Central Taxes.Again, Own Tax Revenue comprises three principal sources:Taxes on Income (taxes on professions, trades, callings and employment).Taxes on Property and Capital Transactions (land revenue, stamps and registration fees, urban immovable property tax).Taxes on Commodities and Services (sales tax, state sales tax/VAT, central sales tax, surcharge on sales tax, receipts of turnover tax, other receipts, state excise).**Non-tax revenues**, State GST, VAT (mainly fuel), Excise (mainly on liquor), Property & capital transactions and Tax on vehicles.

Local Finance: Local Finance, as a branch of public finance, is concerned with the income and expenditure of local bodies (local self-govt.) and with the adjustment of the one to the other. Its principles are fundamentally the same as those of public finance.

Principle of local finance

According to the **principle of local financial** autonomy, administrative units are entitled to sufficient **financial** resources that **local** authorities can use in their duties on the basis and within the limits provided by law. **Local** authorities have the power to establish levels of **local** taxes under the law.The **sources** of revenue for **local** governments discussed include taxes, user fees, andintergovernmental transfers, as well as investment Income, property sales, and licenses and permits.

Borrowing — by issuing bonds — is a tried-and-true **way for states and local governments** to finance the cost of building and maintaining infrastructure. Projects financed with bonds can give a **state's** economy both a short- and long-term boost.

Structure of Local Finance: By local finance we mean finance of local bodies in India. There is a large variety of local bodies in India. Different states have different types of local bodies with different functions. There are municipalities, taken in the sense of municipal committees or boards, in towns in all parts of the country.Some of the large cities have municipal corporations. Further, there are important trusts and development boards in a number of big cities, but as they do not enjoy any power of taxation, they may not be considered as local bodies for one purpose. In rural

areas, we have district boards and rural boards. Rural boards operate over areas smaller than a district.

District boards operate in a full district. In villages, in most states, we have village panchayats which have special functions assigned to them and have their own sources of revenue. Following main four local bodies:

1. Village Panchayats:A village panchayat is an institution in the village with large variety of function. The jurisdiction of a panchayat is usually confined to one revenue village. In some cases, though not very frequently, two or more small villages are grouped under one panchayat. The establishment of panchayat raj is an avowed policy of most states in India, the panchayats have to establish in all villages.

The functions of panchayats range over a wide area including judicial, police, civil, economic and so on. Small disputes disposed of by panchayats on the sport. Roads, primary schools, village dispensaries etc. are to be managed by panchayats. Supply of water, both for drinking and irrigation, falls within their field of responsibility, and in some cases even productive and unproductive activities, such as, farming, marketing, storage, etc. are entrusted to them.Village panchayats in almost all the states have been given powers to levy taxes. However, they differ from state to state.The lists of tax powers of the panchayats are quite large, the taxes which have been widely adopted by them are: - (i) general property tax, (ii) taxes on land, (iii) profession tax, and (iv) tax on animals and vehicles. Other taxes are, such as service tax, octroi, theatre tax, pilgrim tax, tax on marriage, tax on birth and deaths, and labor tax. As a matter of fact, taxes are levied by the panchayats only with the sanction of the state government, and there are certain limits in respect of tax rates which have to be observed.

2. District Boards or Zila Parishads: In rural areas, district boards or Zila Parishads are established on a district level. The territorial jurisdiction of a district board is generally a revenue district. Some of the functions of the district boards are being taken up by the State and by the village panchayats.The district boards have been replaced by Zila Parishads in most of the states, the district-level body is known as the Zila Parishad in Andhra Pradesh, Bihar, Maharashtra, Orissa, Punjab, Rajasthan, Uttar Pradesh and West Bengal, as the district panchayat in Gujarat, Zila Panchayats in Madhya Pradesh and as the District Development Council in Tamil Nadu and Karnataka.

Zila Parishad has scientific executive functions in the establishment, maintenance and expansion of secondary, vocational and industrial schools. Zila Parishad is the strongest of the panchayat raj bodies and is vested with the executive functions in various fields including Planning and Development and advising the state government.The tax powers of district boards or Zila Parishads are extremely limited. They derive a substantial part of their revenues from the government grant-in-aid. The sources of revenue of district boards, or Zila Parishads, are as follows:

i. Gran t-in-aid from the state government.
ii. Land Cesses.
iii. Total, fees etc.
iv. Income from the property and loans from the state governments.
v. State non-plan help.
vi. Grants for the central sponsored schemes relating to development work.
vii. Income from fairs and exhibitions.
viii. Property tax and other taxes which the state governments may authorise the district boards.

3. Municipalities: The municipalities are bodies or institutions which are established in urban areas for looking after local affairs, such as, sanitation, public health, local roads, lighting, water supply, cleaning of streets, maintenance of parks and gardens, maintenance of hospitals, dispensaries and veterinary hospitals, provision of drainage, provision of primary education and organizing of fairs and exhibitions etc. However, all these functions are performed subject to the control of the state government.The main sources of revenue of municipalities consist of

i. taxes on property,
ii. taxes on goods, particularly octroi and terminal tax,
iii. Personal taxes, taxes on profession, trades, callings and employment.

iv. taxes on vehicles and animals,

v. theatre or show tax, and

vi. Grant-in-aid from state government.

However, the average income of municipalities is quite low and thus they cannot perform their functions efficiently.

4. Municipal Corporations: The municipal corporation, as a distinct type of municipal organization, is confined to only a few large cities. The municipal corporations as a class have wider functions and large powers than is usually the case with the municipalities. The pattern of municipal corporations in regard to structure and organization is more or less the same in all the states.The municipal corporations have wide powers and enjoy greater freedom as compared to municipalities. The municipal corporations are usually entrusted with the functions, such as, water supply and drainage,lighting, roads, slum clearance, housing and town planning etc. the rapid increase in the population of cities has definitely added to the functions of municipal corporations.The taxes levied by corporations generally include

i. taxes on property,

ii. taxes on vehicles and animals,

iii. taxes on trades, calling and employment,

iv. theatre and show tax,

v. taxes on companies,

vi. taxes on goods brought into the cities for sale,

vii. taxes on advertisements,

viii. octroi and terminal tax etc.

The corporations have a fair degree of freedom in respect of their choice and modification of these taxes, subject of course to the maximum and minimum rates laid down by the law.

Summary

After independence Indian government established investigation commission and committee to improve Indian tax system. In 1953 under the chairmanship of Dr John Mathai an investigation committee was set up to improve the tax system and to abolish the in equality of income. To make direct taxes move simple 'Bhutlingam committees' was appointed in March 1968. To stop the tax evasion Vanchu committees was also established in 1970. To improve the indirect taxes in July 1976 investigation committee was made under the leadership of Shri L.K. Jha after that to simplify the rules of direct taxes another investigation committee was established under the chairmanship of Shri C.C. Chowki: y After the independence, socialism was established in Indian tax system to lower the gap of income inequality for this objective Indian tax system was centralized on tax action structure.The aim of Indian tax system was not only to earn revenue but to establish socialist economy. It was also kept in mind in Indian tax system that taxation has no reverse effect on appropriation, saving and production and state governments were also given rights to impose certain taxes. y In India both direct not affect and indirect taxes applies by which every individual affected in one or the other way. In India there is a union finance arrangement. In constitution there are some lights given to the state and central government for applying taxes. y If income tax is very progressive then it affects opposite on savings and investigate and because of that production level lower down. y Like in developed countries in India also Income tax is not the main source of Revenue. In total population even 1% did not pay the tax. Of the realm in that the people who are capable of giving taxes cannot be identified and they are involved in tax evasion. y Corporation tax is that which applies a corporation and Company's profit in 1959-60 it is known as the super tax. After that it included in the tax of income and named as corporation tax. In 1959-60 through Coldar committee in 1956 the corporation tax which was adapted is as same as 'classical thought – according to this approached identify of co. or corporation is different and for this reason different corporation tax can be applied on the total profit of the co. Wealth tax is applied on individual's wealth or money every year. This is applicable on business commercial Company's and on corporations. One of the main sources of the income of Indian government is central Excise duties – central government can apply taxes on all the production except alcohol drugs and other alcoholic things in India. All the alcoholic things come under the state government. y Central Excise duty

expanded in 1960 and 1970 in 1944-75 around 128 goods came under the tax which included ready goods, raw materials and intermediate goods. On raw materials and intermediate goods tax effect is cascading which is not right according to economy. Tax improvement committee (Cheliyah Committee) recommended service tax in its last part (1991) The reason the tax only to increase economic development but also to increase percentage of gross domestic production tax and revenue production will start decreasing to increase the production service tax should be included. With this many weakness can be ended while choosing goods by the consumer. In 1956 Indian government passed the central sales tax Regulation and applied tax on these goods which is exported internationally. From which state, goods go out only that state can apply the tax andalso gets revenue State tax is a controversial topic and it is always opposed. It also becomes an electoral topic but then also it is not ended because state opposed this as it is their one of the main sources of income. In local government Municipality, Gram Panchayat and district board improved. After looking at their expense state government has given then right to apply some taxes.

Keywords

Surcharge – Extra tax

Cascading – A rock whose edge is sharp and standing

Lagaan – land revenue

SelfAssessment

1. Which of the following "tax" is levied at every stage of production?

A. VAT
B. Income tax
C. Custom duty
D. None of the above

2. Which of the following is indirect tax?

A. Income tax
B. Wealth tax
C. Corporation tax
D. Sales tax

3. If 'Tata Company' imports a product from abroad, then which tax will be levied on it?

A. VAT
B. Custom duty
C. Income tax
D. Corporation tax

4. Which of the following tax is imposed by the Central Government but the state government collects it?

A. VAT
B. Income tax
C. Corporation tax
D. Stamp Duty

5. Which tax cannot be shifted to others?

A. Excise duty
B. Sales tax
C. Entertainment tax
D. Wealth tax

6. An increase in tax rate when tax base expands represents:

A. Progressive taxation
B. Regressive taxation
C. Proportional taxation
D. None of these

7. The direct violation of Tax law is called:

A. Tax evasion
B. Tax avoidance
C. Tax Rebate
D. None of these

8. If the rate of tax falls with an increase in income, it is called:

A. Proportional tax
B. Progressive tax
C. Regressive tax
D. None of these

9. Which of the following commodities is not kept outside the previewof GST?

A. High speed Diesel
B. Natural Gas
C. Supply of liquor for human consumption
D. Aviation turbine fuel

10. Whichof the following taxes have been subsumed in GST?

A. Central Sales Tax
B. Central Excise Duty and Service Tax
C. Value Added Tax
D. All of Above

11. Whoshall be empowered to levy and collect GST on supplies in the course ofInter state Transactions of trade or commerce?

A. Central Government
B. State Governments
C. Union Territories
D. All of the above

12. Tax rate on goods under GST are determined by
A. Union budget
B. State budget
C. GST council
D. Central Govt in consultation with state Govt

13. The most important source of revenue to the states is
A. Sales tax
B. Service tax
C. Excise duty
D. None of the above

14. The tax levied on the interstate trade of goods is
A. Sales tax
B. Excise tax
C. Service tax
D. Central sales tax

15. Which of the following taxes is/are withdrawn or abolished?
A. Interest tax
B. Estate duty
C. Gift tax
D. All the above

16. The tax levied by the union government on income of individuals is known as
A. Personal income tax
B. Interest tax
C. Wealth tax
D. Corporation tax

Answers for SelfAssessment

1.	A	2.	D	3.	B	4.	D	5.	A
6.	A	7.	A	8.	C	9.	C	10.	D
11.	A	12.	C	13.	A	14.	D	15.	D
16.	A								

Review Questions

1. Explain the features of Indian tax system.
2. What are the good qualities of Indian tax system?
3. Write the sources of income of central government.
4. Comment on the following. (a) Corporation tax (b) Property tax (c) Service tax
5. What is income tax? Write its merits.
6. Explain the main taxes of state government.
7. Describe main taxes of the local agencies.

Further Readings

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Unit 08: Public Expenditure

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Objectives

After studying this unit, students will be able to:

- To understand the concept of Public Expenditure,
- Evaluate the objectives, types and role of Public expenditure.
- Understand the Adolph Wagner's Law of Increasing State Activity.
- Explain critically the Wagner's Law of Increasing State Activity
- Study the Canons of Public Expenditure,
- Evaluate the Canons of Public. Expenditure for public welfare and Economics Development.

Introduction

Public expenditure is that expenditure, which is spent for the fulfilment of community needs of citizens or to improve their economic and social welfare. These days the amount of government expenditure is increasing in almost all countries. Its reason is that the works of government and other local bodies are continuously increasing on different areas and fields. The principle of government expenditure was not considered impotent in 19th century because the area of works of government was very limited, but in 20th century the works of state have expanded in the area of social matters like education and public health and commercial and industrial matters like—railway irrigation, electricity and other plans, therefore government expenditure has increased due to this. Due to nature and amount of government expenditure and for this reason that it affects economic life of country in many types, its importance has been increased. For example, government expenditure affects general level of economic activities and level of production and distribution.

8.1 Public Expenditure

Classical economists had given less importance on public expenditure. Due to limited area of work of then state, they didn't understand the need of the principle of public expenditure, classical economists used to give emphasis, on personal economic freedom. They didn't like that state could unnecessary interference in state economy. That's the reason by which classical economists wanted to keep the area of state limited. According to J.B. Say- "The best of all plans of finance is to spend less."1. Adam smith believed that the works of state must be limited to justice, security and some public services' management. As quoted by an American critic, "the ancient English writer did not need a theory of expenditure because the theory of government which they held implied a fixed limit to government works."2. According to Sir Parnail – "Every particle of expenditure beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack it waste and an unjust and oppressive imposition of the public,".3. This type of, classical economists wanted to keep the functions of state limited, because they considered the government works unproductive and unbeneficial to society. Modern Views These days, the above-mentioned view of classical economists cannot be considered appropriate, because the states of present time are welfare states which is different from Police state of classical time. Welfare state has to do more welfare works of public in which government has to spend in bulk quantity for fulfilling many objectives for social welfare and economic development. That's the reason that the tasks of present states have been increased.

These days, public expenditure is done normally for following tasks—

(a) For security,

(b) For the safety of backward groups of society,

(c) For the development of society,

(d) For establishment of public industries,

(e) To reduce the effect of business – circles,

(f) To reduce the ill–effect of natural calamities,

(g) For public services,

(h) For administrative services.

8.2 Reasons for the Growth of Public Expenditure

(1) Increase in the Activities of the State—Government provides services on low cost value or free to consumers, their area has been increased. Education, health of public and arrangement of entertainment for public are their examples. The arrangement of house and health services are those new areas in which governments have entered. Government arranges these services keeping the principle in view that if the benefactors can avail these cases by their money more by the Government in comparison by them self then it will be in favor of them. The expenditure on works of public construction like rails and roads by government have been increased, so that the difficulties of people can be reduced and useless labor and resources can be used. The expenditure of this type can be considered desirable from the view to overcome the state of depression of country. In this regard, it can be considered that Wagner's law is a suitable option in regard of increase in activities of state in current time. Wagner said that a permanent nature is found of expensive and intensive increase in tasks of state. States are taking new tasks in their hands continuously and are completing new tasks with more accuracy at greater level. Therefore, for completing these increasing tasks, government expenditure is used.

(2) Industrial Development – there is no change in industrial structure in list countries of the world due to industrial revolution but their political and social structure have changed. There were many changes in the methods of production due to long list of inventions after industrial revolution in these change the social and political reasons gave their contribution. With the increase in industrial production, the income and life–standard of people raised, a big part of population got aid and they got capability to fulfill their new needs. With all these changes, problems developed, as a result of which laborers relations regulations of trade and commerce, conservation of consumers, distribution of money and income and the tasks and expenditures, of government related to economic insecurity increased.

(3) Increase in Social Security – At present time states has been transformed in welfare states and they provide social security in any form to their laborers in whole country. It is the responsibility of governments is that they watch that whether industrialists are giving actual wages to laborers or not and whether they have been provided social security appropriately or not. In this way present government spend in bulk on social security of their citizens like old–age pension for industrial laborers, dependent benefits, free education, aid in sickness, accidental benefit, health facility etc. In addition to this; many governments have started unemployment benefit plans and help in house construction. These days government expenses are bulk on health and medical facilities for their citizens. Different type of facilities is being provided to employees under state Act in 1948 in India also.

(4) Nationalization of Industries and Trade—Nationalization of industries and trades is an effort by government by which government manages for services provided on goods on commercial basis for public. Government can take such responsibilities on it for many reasons such as in order to solve major problem of regulating monopolize or half-monopolize, provide goods or services on subsidized rate to the consumers or determine the limitations of non-governmental economic activities. There is a possibility of improvement in the conditions of labor and distribution of income. But, for the payment of fulfilment of loss of nationalized industries and for the establishment of those industries and for their conduction, government has to spend in bulk. In addition to this, government can take custody of private trade and commerce so that it can solve the problems and can earn more profit for treasury.

(5) Development of Agriculture—Development of agriculture of a country specially developing country like India is the centre of development of her economy. It is essential to provide facilities for the development of both sectors – agriculture and non-agriculture because both depends on each other. For example, with the increase in agricultural income, the consumption of industrial goods also increases as a result of which industrialization got encouragement. In this way, there is mutual dependency between agriculture and industries. This dependency can be shown as follow – The raw material of agricultural sector is used as inputs in industries. In this ways output of industries is used as input of agricultural sector. In this way, it inessential to strengthen agricultural structure to provide speed to social and economic development in country like India. Therefore developing countries are spending in bulk for their agricultural development. Government spends on facilities like to provide debt to farmers on low interest rate, to provide facilities of contribution, sale of agricultural goods at fixed prices to exporters. In addition to this, government spends in bulk on contraction of agricultural research and agricultural resources.

(6) Rising Trend of Prices – The nature of raising trend of prices which is found in each country of the world, government expenditure increases due to this. Governments are forced for this aspect that they must pay more money for those goods and services which are liked by them and the wages and dearness allowance of government servants must be increased. This state extends government expenditure more, it is not essential for this extension whether increase in government activities. In this way, the increment in government expenditure appears more in comparison to actual.

(7) Problem of Defense – There are no two opinions that the problem of security of country has become a main reason of increment of government expenditure. One country wants to make armies powerful for their security and another's are forced to draw such step for self-defense only. Heavy amount of money has to be spent on maintenance of army and production of artilaries, due to day by day change in methods of fighting, there is a need of new weapons for army also. The burden of expense increases again due to this. Security expenditure not only includes expenditure of armies and army goods but also includes of debt for pension of armies and war. There has been much progress in science and art of war that the weapons of today became old and useless tomorrow because of which war system became very expensive. Many countries are spending in bulk on security.

(8) Urbanization – There is no doubt that increasing urbanization of population is an important reason of increment in government expenditure also. The rule of increasing costs in cities applies completely. With the increase in size of city, per person cost of expenditure spent on services like water supply transport service and its control police security health and hygiene etc. In addition to this due to construction and maintenance of hospitals, roads streets, lights, playground and community hall etc. and duets distribution of life saving, essential goods and due to control also there is additional burden of expenditure on governments.

(9) Change in Attitude towards Government – Some increment in government expenditure is due to this reason because there are many changes in general view towards government in last years.

Before one century people got scared even from the name of government and considered it as a symbol of autocratic and licentious powers. But today's, the general view in this regard is that good thing for common person and more comfortable life for all people couldn't be available until we must not depend in more on government. There are many reasons of this change in regard of government. Some important reasons are given below:

(a) Technical change – The sentiment of dependency has been increased due to technical changes and due to this, many people remain incapable to work between such powers which are out of their control completely.

(b) When there were small units of business and production—Economic system seemed to work efficiently as a self-working machinery, the same economic system seems trapped in the marsh of single system control and appears to impose exploitation. As a result of this, there has been demand from government that they must appose commercial depression and make balance in half trades. Some people insist that government has to take the responsibility of maintaining economic stability on itself, but it is possible only when government expenditure has to be increased.

(c) Human welfare—Due to the development of sentiments of humanity on present times, the extensive poverty in any country is considered very bad and aggregative steps are suggested to eradicate it. In that condition, the cooperation of government becomes essential and they have to take shelter in heavy expenditure for the works of public welfare and public construction.

(d) Economic and political complexions – it is also felt that these days, complexities of political and economic problems have been increased. It is also a reason out of other reasons thatpromotes the increment of expenditure in bulk for education and other many such welfare activities such as medical house, police and home administration etc.

(10) Economic Development – Government expenditure is increasing rapidly in under – developed countries. Many countries out of these countries implement the programmes of rapid economic development. The management of basic financial services like transportation, communication and electricity are managed under these programmes. It is essential for the state that it must manage for best economic and social services so the industries can develop rapidly. In addition to this, it has been become a policy of many modern governments that private persons have to be helped in that efforts of production. They can do so by giving bounties, loans and grant–in–aid to farmers and industrialists. Not only is this, by providing different type of aids, help given to them by government such as help of technical guidance and raw material etc.

(11) Economic Planning – all countries have started their economic development in planned way by getting affected by the success of economic planning of Russia. This type of efforts are done in economic planning that available resources must be consumed in such a way that standard of living of people can be developed with multidimensional economic development and national income must be increased. Government has to make big plans for economic planning, for completing them, capital is required in bulk. After taking loan from country and foreign countries, if expenditure is not fulfilled then have to manage deficit financial system. For example, six five–year plans have been completed in India till date and there has been much expenditure on them.

(12) Increase in Population – An important reason for increase in public expenditure is population increment rate also. Government has to spend in much quantity for comfort and facilities of increased population. There has been rapid increment in population in last years. According to World Health Organization, the population of the world has been increased to 415 crore from 155 crore in last 45 years. The population of India has become 68.38 crore according to census of 1981. There has been approximately 2.5 per cent yearly increase in the population of India. There has been increment in expenditure of administration of state not only but also the expenditure of state also increases with the increase in their comfort and facilities. Government has to spend in bulk on education, health, entertainment, dwelling etc. for increasing population.

(13) Other Reasons – (i) Increase in costs – After Second World War, costs have been increased in every country. As a result of increment in price level, government has to spend more in comparison to earlier. Government has to buy many goods and services and secondly, government assumes for that expenditure for production, government has to spend more in comparison to earlier on that production due to increment in costs.

(ii) Increase in national income and standard of living—As a result of economic development in last year's, national income increased as a result of which standard of living of people increased. Government has to spend more with the increase in this standard of living.

(iii) The Burden of Democracy – There are democratic government in many countries of the world. Government has to conduct by polls and midterm polls for this and government has to spend more for completing them. In addition to government has to spend more on ministers and other selected representatives. Governments have to maintain diplomatic relations also with other countries. Governments have to open embassies in other countries on which government has to spend more.

(iv) International Cooperation – Each country has to economically cooperate with other countries in present age. Each government gives loan, contribution and other economic aid to any country. In addition to this, international financial organizations such as – International Monetary Fund, International Reconstruction and Development Bank, International Development Federation, Asian Bank etc. have to give membership fee to government from time to time. In this way, government are spending more for maintaining international cooperation.

8.3 Principles of Public Expenditure

The principle of public expenditure has been already discussed when public finance's principles was studied and in principles of maximum social benefit were described. In that first principle indicates that limit where net public expenditure should have been increased and second principle indicates towards the distribution of resources so that net social profit can be maximized. Their brief description is given again:

1. Public expenditure should be done in every direction at the limit when in any area, a small amount of increment for the welfare of the society, or in public expenditure loss, in the area of increment can be adjusted. This rule presents an ideal limit in both public income as well as expenditure. Prof. Pigou also describes almost the same "in every directions public expenditure should be increased at that point on which satisfaction occurs even after the spending of last shilling, that satisfaction should be equal to those public services which are destroyed by that last shilling." In this way this principle allows public expenditure to continue at that point of time till every last penny is spent on social welfares and it should be equal to left over limit.

2. "Public expenditure should be done in every direction at the point when in any area, a small amount of increment for the welfare of the society or in public expenditure loss in the area of increment can be adjusted." It means the expenditure between battle ships and poor relief should be distributed like this that with every last shilling one gets the same satisfactory return. This means that government should distribute all at its resources in a way that it should be equal to the limit of every aspect. In this way it is clear that if government distributes its resources and keep in view this principle then it can get maximum satisfaction. This can also be termed as 'maximum satisfaction rules. Thus , it is clear that if this principle is keep in view the government at the time of distribution of his resource in between different expenditure then the government can get maximum satisfaction. It is already mentioned that the measurement of marginal social welfare is very tuff but not impossible.

According to Prof. G. Pigou – If we assume society a living thing and government its brain then expenditure should be stretched in all directions to that point where satisfaction from the last shilling is equal to the loss of satisfaction from the same. In this way for the state it really become difficult to maintain a balance between the marginal social welfare of minimum money equal to that marginal social welfare which is receiving by the tax payer from his last one penny. We can look deeply with an example – for example, public expenditure and taxation are done by different government departments. So it makes more difficult to make a comparison of marginal profit obtained by minimum money and it obtained by receiving last penny by taxation. Above all public expenditure is affected with other factors also like non-economical reason political pressure, strikes processions etc. It is concluded that public expenditure which is mentioned above are only ideals and true only in the theoretical form. If the question of business then it is difficult to implement them.

8.4 Guidelines for Public Expenditure

Prof. Alfred G. Bulcher mentions some of the public expenditure's Guidelines which should be applied in day to day life by the Public authorities. According to him, "Till now the principle of expenditure did not rises as that of taxation. But still there are some basic principles which can work as the guidelines for both government and it are not founds people, till that period of time. Some of the guidelines are as follows:

1. Increase in social welfare: Through public expenditure social welfare should increased but it may possible that sometimes government expenditure happens for welfare of a particularsection of society. So it should be ensured that while working for the betterment of a particular section of society, whole society should not be neglected.

2. Profit is more than cost – Government officers and elected representatives should ensure that the expenditure should be less than the profit and the expenditure is less than the welfare of the society. And this goal cannot be achieved until or unless expenditure done by the private companies people.

3. Preference to social welfare activities – Firstly those services should be attended by which increase in social welfare takes place maximum. These service through which social welfare is less expected to expenditure should be taken later.

4. Results of profit – Conclusions from the expenditure can only be done after the calculation of adverse effects of taxes and receiving income any other source.

5. Administrative expenditure –The expenditure which is incurred for Public administration it should assume that this amount is also a part of social welfare expense. If abundant administrative expense becomes abundant then it seems that there are some deficiencies in the methods of management or selection of secrecies.

6. Availability of resources –Government services can handled only when there are enough resources available. Through loan only temporary receipts can be managed because this type of loan can be refunded by other sources of income in which taxes are important.

7. Expectations of income – Some services are transferable nature, for example, Public work. By spending on these, it should be seen that what are the possibilities of income in and future whether they are completing through common business situations? To complete these services proper time should be selected which is better according to the society so that the effects of these services can turn towards increases of economic stability.

8. Limitations of expenditure –There are some limitations on expenditure not in the initial stage but at the final stage. These limitations are: while looking at the population—income of society or money area, other resources and specially distribution of money and income.

9. Service coordination –There should be coordination between different government services so that maximum benefit should be given to the society and no duplication produce.

10. Administrative ability –Administration should be able and honest. Only legally expenses should incurred. All the records should be kept of all the expenses and through reports etc. Another record should be maintained of government finances so that comparison can be done between cost and gain by government for governmental officials as well as public.

8.5 Wagner's law of Increasing State Activities

Wagner's Hypothesis: Adolf Wagner a noted German political economist (1835-1917) propounded an empirical law to analyses and explains the trend in the growth of public expenditure. Wagner argued that a functional, cause and effect relationship exists between the growth of an industrializing economy and the relative growth of its public sector. According to Wagner, relative growth of the government sector is an inherent characteristic of industrializing economies. He illustrates this with the examples of Great Britain, U.S.A, France, Germany and Japan. He came to the conclusion that as per capita income and output increases in industrializing nations, the public sectors of these nations necessarily grow as a proportion of total economic activity. Wagner hypothesized a functional relationship between industrialization and the relative importance of public sector activity. He then set out to test his hypothesis by examining the industrialization process in various European countries and Japan. His observations led to what is now called as Wagner's Law of Increasing State Activity.

The German Economist Adolf Wagner, systematically observed the historical facts of increasing expenditure activities of public authorities particularly of Germany, He then tried to explain the cause of growth in public expenditure in terms of his famous "Law of Increasing State Activities". According to Wagner there are inherent tendencies for the activities of different layers of a government (such as center and state) to increase both intensively and extensively. Wagner presented his law in the following words "Comprehensive comparisons of different countries and different times show that among progressive people, with which we alone are concerned an

increase regularly takes place in the activity of both the central and the local governments. This increase is both extensive and intensive. The central and local governments constantly undertake new functions, while they perform both old and new functions more efficiently and completely."

Wagner's law of increasing state activities is a universal truth in recent years. It is a fact that economic growth of a country has always been accompanied by increasing state activities and hence increasing public expenditure. Empirical evidence indicates the hypothesis of continuous upward trend in government activities. F.S. Nitty made an empirical study of the expenditure trend of public authorities of varying countries of the world and concluded with empirical evidence that Wagner's law was not only applicable to Germany but to various governments which differ widely from each other. Nitty states all kinds of government, irrespective of their layers (say central, state or local) intensions (peaceful or warlike) and size etc., had shown similar tendencies towards increasing public expenditure. Wagner's law was based upon historical facts. His law was applicable to modern progressive governments only in which the state was interested in expanding the public sector of the economy. Wagner observed that there was a persistent tendency towards an 'extensive' and 'intensive' increase in the functions of the state. Intensive increase means expansion of traditional functions of the state on a large scale. Extensive increase relates to coverage of new welfare functions.

According to Wagner's law, the expenditure of public authorizes has a continuous increasing trend due to three reasons, they are:

a. Expansion of Traditional Functions: Traditional functions mainly include defense, administration of justice, maintenance of law and order and provision of social overheads. The coverage and variety of such functions have gradually increased. Defense expenditure has expanded rapidly because of a change in military arts and sciences. In modern times military activities has become sophisticated. From simple aggression, the modern warfare shifted to prevention of attack and use of sophisticated weapons. Defense outlays on men, materials and maintenance have been on a rising trend in modern times. Similar is the case with expenditure on internal protection and administration. Increasing areas of administration and spread of government machinery with expertise have become more and more expensive.

b. Coverage of New Functions: Secondly the activities of the state were increasing in their coverage. Traditionally the state activities were limited to only defense, justice, law and order, maintenance of the states over heads etc. But with the growing awareness of its responsibilities to the society, the governments started expanding its activities in the field of various welfare measures to enrich the cultural life of the society. Along with this new welfare programmes were designed to provide social security to the people. This required increasing government expenditure on education, public health, low cost housing, subsidized provision of food, agricultural inputs, old age pension, sickness benefit etc.

c. Expanding Sphere of Public Goods: Almost all modern democratic governments have increasingly recognized the need to provide and expand the sphere of public goods. The need and necessity to provide social and merit goods through budgetary allocation was increasingly recognized by the modern state. The state was trying to shift the composition of national product more in favor of public goods. As a result state activities expanded to areas like irrigation and flood control projects, construction and maintenance of public parks, provision of education and health care facilities, creation of economic overhead capital etc., Provision of these public goods and merit goods means heavy investment in public enterprises. Apart from the above-mentioned factors, Wagner also examined the forces that operate on both the demand and supply side of public sector activity and explained how they interact. Changing production and marketing arrangements of public sector activity affect and are affected by social organizations in different ways.

They are given:

i. Factors that affect both demand and supply of public expenditure activities:

(a) Per capital income and wealth exert a positive impact on the demand as well as cost of government services.

(b) Coupled with this rate of growth of population and density also affect the demand for public goods such as transport, communication, hospitals etc., in addition to the cost of supply of these services.

ii. Factors affecting the demand side of public expenditure activities. The major factors under this category are:

(a) Urbanization and industrialization.

(b) Structure and composition of the population which determine the demand for educational facilities, old age pension, old age homes etc.

(c) Specialization of labor and centralization of administration in both private and public activities.

iii. Factors affecting the supply side of public expenditure activities. On the supply side, the major factors affecting public sector activities are:

(a) Changing scale of production of government activities.

(b) Quality of production.

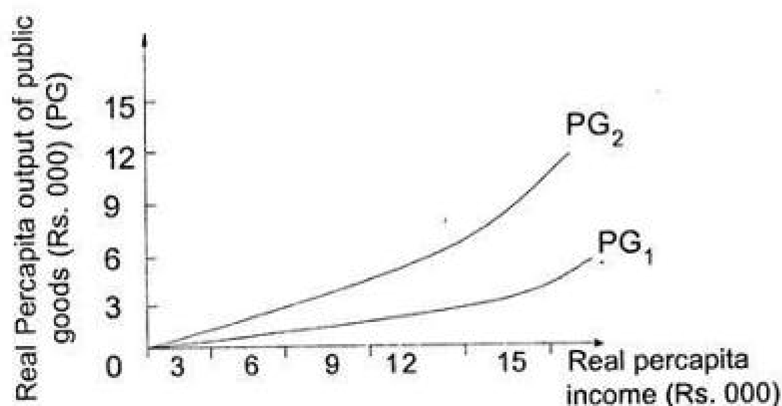
(c) Intergovernmental grants.

Obviously the functional relationships Wagner sought to trace are complex. Adolf Wagner believed that increased public expenditure was the natural result of economic growth and the continued pressure for social progress. Wagner held that the income elasticity of government services is greater than unity. In other words public expenditure will increase faster than the increase in per capita income of the people.

Graphic Presentation of the Wagner Hypothesis:

The modern formulation of Wagner's law is that "as per capita income rises in industrializing nations, their public sector will grow in relative importance" (Bird, 1971, p.2). The Wagner's hypothesis of increasing state activity is illustrated in Figure No.8.1.

Figure No.8.1.



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

In other words, as real per capita income increases, due to economic development of the society, the real per capita output of public goods remains at the same proportion of total economic activity. The constant proportion line, PG^1, can be used as a reference point to the graphical presentation of Wagner hypothesis as depicted by the line PG^2. All along the PG^2 the proportion of resources devoted to the output of public goods is expanding overtime. The implication of Wagner's law can be stated in the following equations. When the real per capita output of public goods remains at the same proportion of total economic activity, i.e. PG^1, the equation is

$$PGa/Ya = PGo/Yo$$

In other words the income elasticity of expenditure for public goods (Ye) is elastic. Wagner's hypothesis provides the most suitable frame work for explaining economic factors, as the most important determinant of a relatively expanding public sector during industrialization and economic growth. The functional relationships, Wagner sought to trace are complex. Wagner believed that increased public expenditure was the natural result of economic growth and the continued pressure for social progress.

Criticism of Wagner's Hypothesis:

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

i. Wagner's hypothesis deals with inter-disciplinary phenomenon. But it lacks interdisciplinary approach in its analytical framework.
ii. Lacks comprehensiveness in analysis Wagner's law lacks comprehensiveness. Political science, economics and sociology are among the several disciplines to be incorporated in any theory of public expenditure. The Wagner's hypothesis excludes all these characteristics.
iii. It is based on an organic self-determining theory of the state, which is not the prevailing theory of the state in most western countries.
iv. The theory ignores the influence of war on governmental spending, and
v. It stresses a long term trend of public economic activity, which tend to overlook the significant 'time pattern' or process of public expenditure growth.

8.6 Canons of Public Expenditure

According to Prof. Shiraz there are four principles of public expenditure which are as follows:

(1) Cannon of Benefit – The main motive of this principle is to achieve maximum social welfare, which means the strategy of public expense should be done in such a way that it will be profitable (as a whole) for the society and no for a particular sector of the society., "if other things remain the same then public expenditure can bring many social achievements like increase in production protection from external attack and internal violence. With these achievements protection can be done of society and if possible lessen income discrimination". In short it can be said that public expenditure should be done in the social welfare area. In other words, maximum satisfactory gain should be received from the public expenditure and this can be possible only while the government spends this type of expenditure distributes resources equally so that the marginal satisfactory result obtained by uses will equal. This can be possible only when maximum satisfaction rule applies this in turn means distribution should be done according to above polices so that:

(a) Increases total production of the whole country.

(b) In order to protect society from internal and external dangers it could be maintained adequate armies and police.

(c) Difference of income between citizen could be lessen.

(d) Not only for one section, but it can maximize the welfare of whole society.

In other words, maximum profit of maximum people, is the only target of the principle. This is one of the useful principle of public expenditure and no students of economics can go against this principle in the form of ideal which is adopted by the government apart from this principle if only come to the Question of Practical then it has be notable that through state it is difficult to achieve aim. This is on one hand it is not possible for the government to make every gain of every resource equal and on the other hand to calculate profit of the whole society – In the end it is concluded that the objective of every public expenditure should be the improvement in production and distribution.

(2) Canon of Economy – Means of principle of canon of economy is that the state should maintain economic view about economy. There two things are important. At firstly government should spend minimum amount on every aspect. Secondly it should make increment in production power of society this is the positive aspect of economy. First thought is related to present while the second one is related to the future. Its only objective of this principle is to get rid of production of extravagance and corruption. The social welfare can be maximized only when there do not exist extravagance and corruption in expenditure. This principle is such practical rule which can followed by the government. One of the important aspects of this principle is that whenever government planned its expenses then it should also be adopted.

(3) Cannon of Sanction – The principle of sanction means that without the sanction of officials or government no public expenses can occur. This means that not even a small amount can be used without sanction of related officials. Every government department should have freedom to spend till a secured limit but beyond the limit expenses occurs only when the related officials gives a nod. So the objective of this principle is to keep a ton on extravagance because people experiences that unauthorized expenditures encourage extravagance. In this principle one of the thing should be ensured that the sanctioned money should be used in right direction. In the end of the financial area government accounts are guided and inspected. Prof. Siraz's principle represents the proper work system for determining public expenses.

In the current phase this principle of sanction developed e.g., in democratic countries government itself required to take approval of parliament or legislation before spending. Every government department or ministry required take approval from finance ministry. Within one department also it is essential to take permission from the Head of the department approval like this process continues of taking approval. Because of the permission taking sometimes it becomes late in completing work and it gives birth to red tapism. But it has to be tolerated so that in the expense administration honesty and economy stays and it can be stop extravagance.

(4) Canon of Surplus –According to surplus principle in public expenditure one should avoid loss. In Prof. Shiraz words, "In the matter of income received and expense governments should behave like common citizens. Like a 'private person who does not exceed his expense by his income government should also make a habit of balance budget. Yearly expense should be balanced without any new loan. "This principleseems solid and safe. This principle tells that like a private person government should also expand in its periphery but this does not means that government can never take loans. If actually if the required he should borrow the loan. But its income has to be more so that it can pay interest and also made a sinking fund for the return of loan.

But modern economist not always likes the balance budget. How to make budget is totally depends on county's economic condition. Surplus budget seems more likeable in inflation as it lessen the purchasing power of the people which intern make the effective demand low and in this way it maintains a balance between current demand and current production in its opposite, in deflation deficit budget seems good because it increases the purchasing power of the people and also effective demand and in this way balance current demand and production. Like this way balanced budget becomes proper when in economic there is a stability in employment and prices. Except this in a developing country deficit budget is seems as a weapon to increase the rate of capitalization to see whether losses are more or less otherwise inflationary any tendencies will be create in economy. So it is to be concluded that principle of surplus or budget does not hold that position or importance which it held in olden times

5. Canon of Elasticity – According to this principle state's expenditure policy should be like this that it can change according to the situation it can be possible to increases or decreases in public expenditure. Actually the objective of this principle is to maintain elasticity in the public expenditure so that in the case of emergency like war or overall development finance arrangement cannot become unsuccessful. In other words the arrangement of public expenditure should be like that, if in emergency mutual transfers of resources take place then the country's economic life should not get effected for example, in war time there should not be any difficulty if expense done on war instead of house construction.

6. Canon of Equitable Distribution – This principle states that public expenditure should be done in such a way so that the difference of the distribution of income is low. In other words public expenditure gives satisfaction of equitable distribution of income between different sectors of society. This aim can only be achieved when the more gain reaches to the poor people by public expenditure. This gain can be given in the form of medical help, education, house construction and old age pension. This principle is more beneficial in those countries where a huge disparities is found in income distribution. This is the reason that this principle is implemented in developing countries like India implementing economic activities and tregory policies of states. For example, in such countries priority in employment is give to the backward section of society and also scholarships and other education related facilities are also gives. Like this some agencies works only for small farmers for their upliftment. For example, Small farmers, development agency.

7. Canon of Productivity – According to this principle expenditure and policy of state should encourages country's production. It is clear that according to this principle maximum public expenses should be done for production and development work. Underdeveloped countries can gain a lot from this principle because in these countries, "For the increment in social and government services and for consume facilities of community public expenditure has to be

elaborated, " so the objectives of public expenditure are to provide maximum employment production and income.

8.7 India's Public Expenditure: On the Basis of Principles

If we look Public expenditures of India at the principles we find that it is according to some but again improvement is required thereafter the independence lot of expense have done on public expenditure like setting up of heaves industries, increase in formation of financial and social capitalization, increasing of planning of social welfare etc. and this is the reason in last two decades India's economy become stable. The regional development Policy which was adopted underplaying was according to the 'principle of benefit, because in this beneficiaries were the backward class especially rural population. But due to administrative laxity the principles of economy and sanction are not to be obeyed. Deficit budget has been traditional weakness of our government and the situation becomes so critical that not only central government but also state government do most of its work on deficit budget. The reality is that the capacity of the people of paying taxes is almost finished, and public expenditure is increasing day by day. To solve this problem government regulate new currency but it led to inflation. For the last decade the problem became more serious. But on the other hand it is remarkable that the expenditure policy of production and distribution was quite success full. In this way it is clear that India's expenditure policy has scope to improve.

Summary

According to Wagner a permanent instinct of extensive and intensive increase are found in state's work. The state is taking new works slowly and gradually and completing its previous one efficiently.With Industrial Revolution not only the structure of industries changed but in fact its, political and social forms has also changed. In any developing country like India can develop with the development of agriculture. For economic development it is needed to provide facilities for development of both agricultural and non-agricultural areas. One of the reasons of increase in public expenditure is increasing of population. Government would have expanded a huge amount to fulfill their needs of increased population. Normally the problem of public and private expenditures is same. Both of them tries to balance between Income and expenditure and the economy policy applies on both of them public expenditure can affect economy of any county life in many ways. To improve the level of production and distribution level and for economic stability, support can be taken from public expenditure. Public expenses should do in every area till the limit when its benefit goes to the society and the opposite of this i.e., a small increase in public sources and loss takes place because of it. This can balance the situations. This principle represents an ideal limit for both public and private income. If we assume society a living thing and government, its brain then expenditure should be stretched to that point where satisfaction from the minimum money is equal to the loss of satisfaction from the last penny. Till now expenditure principles are not developed as that of taxation. But again, also there are some basic principles which are still working as the guidelines for public and the government and there is need to innovate new proper levels. The record should properly keep of an expenditure and in easy and proper way of financial activities of government should be done through reports for that Public as well as government official can compare the costs of government services gains. If other things remain proper then public expenditure can bring social achievements like increase in production, as external attack and internal violence and possible as lessen the inequity of income protections. The meaning of economy is to protection of the benefits of taxpayers – not only by effecting expenditures but also to increase public income. To increase the facilities of social and government services and increase in community consume it is essential to increase or expand public expenditure.

Keywords

- **Expenditure** – spending
- **Commission** – authority granted for a particular action
- **Taxation** - To impose tax
- **Income Tax** - Tax on income

Self Assessment

1. The Classical economists asserted that public expenditure is:
A. Unproductive
B. Productive
C. Stagnant
D. All of these

2. The Annual Account of both the income and expenditure is called:
A. Plan
B. Budget
C. Manifesto
D. Accounts

3. The controlling authority of Government expenditure is:
A. RBI
B. Planning Commission
C. Ministry of Finance
D. Finance Commission

4. Expenditures incurred on civil administration, defense forces is in the nature of
A. Capital Expenditure
B. Revenue Expenditure
C. Transfer Expenditure
D. Productive Expenditure

5. Public Expenditure increases
A. Interest rate
B. Employment
C. Exports
D. Imports

6. Who is the exponent of the law of increasing state activities?
A. Dalton
B. Wagner
C. Seligman
D. Musgrave

7. According to Wagner's law, the expenditure of public authorizes has a continuous increasing trend due to…………………..
A. Expansion of Traditional Functions
B. Coverage of New Functions
C. Expanding Sphere of Public Goods

D. All of above

8. During the process of economic development, the share of public expenditure to Gross Domestic Product tends to expand. This is called:
A. Keynes Law
B. Adam Smith's Theory
C. Brettonwoods Law
D. Wagner's law

9. The expenditures which do not create assets for the government is called:
A. Revenue Expenditure
B. Capital Expenditure
C. Both (a) and (b)
D. None of the above

10. Which type of expenditure is made in bridge construction?
A. Revenue Expenditure
B. Capital Expenditure
C. Both (a) and (b)
D. None of the above

11. The principle of public expenditure that requires that Government should avoid shortfall of revenue in comparison with its expenditure is termed as
A. Canon of Deficit
B. Canon of Surplus
C. Canon of Elasticity
D. Canon of Sanction

12. The canon of neutrality in public expenditure refers to which one of the following?
A. The principle of public expenditure which requires that public expenditure before it is incurred should be sanctioned by a competent authority and should not be incurred for the benefit of only one section of the people
B. The principle of public expenditure which requires that it should be possible for public authorities to vary the expenditure according to the need and circumstances and not on the basis of any political or bureaucratic influence
C. The principle of public expenditure which requires that public expenditure should have no adverse affect on production and consumption instead it should lend a helping hand to the production process and bring about equality of income and wealth distribution
D. The principle of public expenditure which requires that every government must try to keep its budgets well balanced. There should be neither ever recurring surpluses nor deficits in the budgets.

13. The principle of public expenditure which requires that public expenditure before it is incurred should be sanctioned by a competent authority is
A. Canon of Economy
B. Canon of Sanction
C. Canon of Elasticity
D. Canon of Maximum Social Benefit

14. Which of the following principles of public expenditure propounded by Prof. Findlay Shirras is considered irrelevant in a modern government?
A. Canon of Economy
B. Canon of Sanction
C. Canon of Maximum Social Benefit
D. Canon of Surplus

15. The principle of public expenditure that requires that it should be possible for public authorities to vary the expenditure according to the need and circumstances is:
A. Canon of Economy
B. Canon of Sanction
C. Canon of Elasticity
D. Canon of Maximum Social Benefit

Answers for SelfAssessment

1.	A	2.	B	3.	C	4.	C	5.	B
6.	B	7.	A	8.	D	9.	A	10.	B
11.	B	12.	C	13.	B	14.	D	15.	C

Review Questions

1. Public expenditure provides for which works?
2. What are the reasons of increasing in public expenditure?
3. What is the difference between private and public expenditures?
4. Explain principles of public expenditure.
5. Write notes on the following: (a) Administrative expenditure (b) Service coordination.

Further Readings

- Public Finance By H.L . Bhatia, Vikas Publishing House
- Public Finance in Theory and Practice by S.K. Singh, S Chand & company
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Unit 09: Theories of Public Expenditure

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Objectives

After studying this unit, students will be able to:

- Understand the Wiseman Peacock Hypothesis for Public expenditure.
- Evaluate the Wiseman Peacock Hypothesis for Structure and Growth of Public Expenditure.
- Study the theory of Public expenditure.
- Evaluate the Colin Clark's Critical Limit Hypothesis of Public expenditure
- Explore the concept and process of Zero-Base Budgeting
- Evaluate the Zero-Base Budgeting and other provision of budgeting

Introduction

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

9.1 Wiseman Peacock Hypothesis

Peacock and Wiseman emphasize the time pattern of public spending trends rather than striving for a genuine positive theory of public sector growth. The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner, but in jumps and jerks or step

like fashion. Their analysis involves three related elements. These are displacement, inspection and concentration effects. Using empirical data for the British economy after 1890, Wiseman and Peacock observe that the relative growth of the public sector in the United Kingdom has followed a discrete step like pattern rather than a continuous growth pattern. During the period under study they found that, government fiscal activities, in the country have risen step by step to successive new plateaus.

Moreover the absolute and relative increases (steps upward) in taxing and spending activities by the British government have generally taken place during periods of major social disturbance or crisis such as war or depression. These kinds of changed fiscal situation cause the previous lower tax and expenditure levels to be replaced by new, higher, budgetary levels. This movement from the older level of expenditure and taxation to a new and higher level is called the displacement effect after the social disturbance has ended; the new level of tax is tolerated by the society. The emerged new levels of tax tolerance make the society willing to support higher levels of public expenditure. In other words the lax threshold has increased.

Thus there is no strong motivation to return to the lower pre-crisis level of taxation. Over the secular period, 1890 -1955, this displacement procedure occurred several times in Great Britain. Thus when the major social disturbance ends, no strong motivation exists for the society to return to the lower pre-disturbance level. The higher government revenues are used to support permanently higher levels of public sector allocation. Figure No. 9.1 clearly shows the displacement effect, as explained by Wiseman and Peacock.

Figure No. 9.1The displacement effect

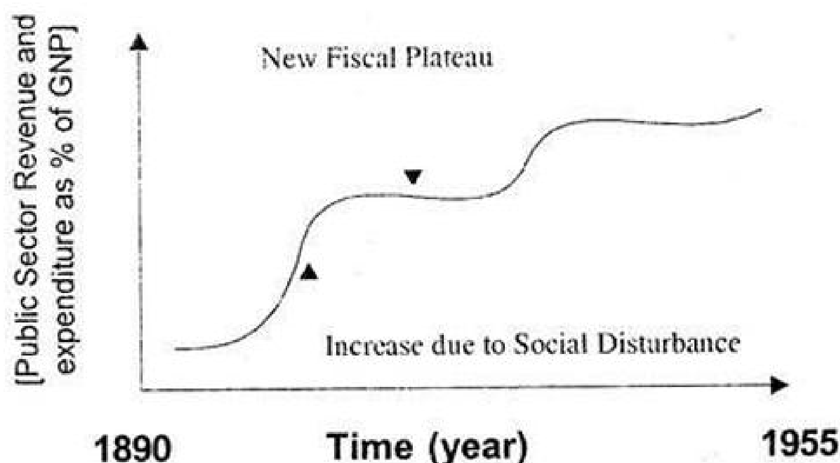

Figure No. 9.1 demonstrates the displacement effect, tax threshold behavior. Time (years) is measured along the horizontal axis, while public sector revenues (mostly taxes) and public expenditures as a percentage of gross national product are measured along the vertical axis.

The figure reveals that as the social disturbance cause a relative expansion of the public sector, the displacement effect which occurs helps to explain the time pattern by which the government growth takes place. This displacement effect does not require that the new higher plateau of expenditure, continue the same expenditure composition that was created by the social disturbance. Some of the increased expenditures like debt interest are the direct results of the social disturbance. While other expenditures arose as a result of technological development and expansion of government activity into new areas. For instance, war and 'other social disturbance, frequently force the people and their government to find out a lasting solution to the long standing and pending problems, which were previously neglected.

This is known as "inspection effect". Inspection effect is the inadequacy of revenue in comparison with the 'required' public expenditure. In addition to the displacement and inspection effect, Peacock and Wiseman, also give narration about a concentration (scale) effect. It refers to the apparent tendency for the central government economic activity to become an increasing proportion of total public sector economic activity, when a society is experiencing economic growth. This occurs, because central government has to initiate a number of measures to sustain higher economic activity. Since each major disturbance leads to a situation in which, the central government assuming a larger proportion of the total national economic activity, the net result is "the concentration effect". Wiseman – Peacock hypothesis appears to be quite relevant. At the

outlet, the hypothesis looks quite convincing. It emphasizes jerks and jumps in public expenditure, on account of unusual and abnormal situations.

According to Prof. Aronson, for Peacock and Wiseman expenditure growth is sporadic rather than constant and revenues create their own expenditures. However, we must not forget the fact that, an account of the advance of the economy and the structural changes therein, there are constant and regular increments in public expenditure and revenue. Public expenditure has a tendency to grow on account of a systematic expansion of government activities, both in terms of intensity and quality.

The regular and dynamic changes in state activity and public spending caused by macro variables like population growth, urbanization, awareness of civic rights on the part of citizens and political and social commitments on the part of democratic governments voted to power are major factors giving a big push to upward trend in public expenditure. However, the influences of these factors on government spending were not systematically analyzed by Wiseman and Peacock in their hypothesis. However, Bernard. P. Herber sincerely argues that the Peacock – Wiseman hypothesis of governmental spending trends, is much more modest in what it intend to explain than in Wagner's hypothesis. The fact is that, both the Wagner's and Peacock. Wiseman narrations contribute a lot in understanding the process of public sector growth in industrialized nations.

9.2 Colin Clark's Critical Limit Hypothesis

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

The hypothesis draws conclusion from the empirical data drawn from several western countries for inter-war period. Clark wants to point out that in an economy; inflation emerges when the share of the government sector, as measured in terms of taxes and other receipts, exceeds 25 per cent of the aggregated economic activity in the country.

When public expenditure reaches 25 percent of the total economic activity or aggregate amount of expenditure in the country, the tax payers, ability to pay more tax is exhausted. Public expenditure beyond this limit, means, disincentive to producers and fall in production due to taxation beyond tolerance level.

The hypothesis rest upon the following two institutional factors:

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

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

Even though Colin Clark's critical minimum effort thesis is well accepted by the business community, its significance in the academic circle is very limited. Colin Clark gave undue emphasis on his critical limit of 25 percent.

In the modern world a number of countries are incurring public expenditure much beyond their limit, without facing worse situation of inflationary pressure. Impact of budgetary spending on generation of inflationary situation; depend upon the manner and nature in which public expenditure is incurred.

Inflation is a complex economic phenomenon influenced and characterized by a number of mutually exclusive and inter-dependent factors. Hence we can only fairly conclude that in a marked economy, increasing state activity may create inflationary pressure.

9.3 Structure and Growth of Public Expenditure

There has been a phenomenal increase in public expenditure in almost all the countries of the globe.This tendency which was noted in the previous century has become crystallised in the presentcentury. The classical economists assumed the state has very limited functions under the

laissez faire policy. The functions of the state were restricted to justice, police and arms. According to J.B. Say —the very best of all plans of finance is to spend a little . But today the role of the state has changed under the welfare criterion and there is a persistent trend towards an extensive and intensive increase in the scale of governmental performance.

Causes of Increase in Public Expenditure:

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

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

(c) Welfare State: The 19th century state was a 'police state' while, in 20th and 21st centuries modern state is a 'welfare state'. Even in a capitalist framework, socialistic principles are not altogether discarded. Since socialistic principles are respected here, modern governments have come out openly for socio-economic uplift of the masses. Various socio-economic programmes are undertaken to promote people's welfare. Modern governments spend huge money for the purpose of economic development. It plays an active role in the production of goods and services. Such investment is financed by the government. Besides development activities, welfare activities have grown tremendously. It spends money for providing various social security benefits. Social sectors like health, education, etc., receive a special treatment under the government patronage. It builds up not only social infrastructure but also economic infrastructure in the form of transport, electricity, etc. Provision of all these require huge finance. Since a hefty sum is required for financing these activities, modern governments are the only providers of money. However, various welfare activities of the government are largely shaped and influenced by the political leaders (Ministers, MPs, and MLAs to have a political mileage, as well as by the bureaucrats (MPLAD)).

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

(e) Price Rise: Increase in government expenditure is often ascribed to inflationary price rise.

9.4 Types of Public Expenditure

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

Public expenditure may also be classified as **plan expenditure and non-plan expenditure**. **Non-plan expenditure** falls under two broad heads, viz., revenue expenditure and capital expenditure. The former comprises interest payments, defense expenditures, subsidies, pensions, other general services (like health, education), economic services (like agriculture, energy, industry, transport and communication, science, technology and environment, etc.) Expenditures on agriculture, rural development, irrigation and flood control, energy, industry and mineral resources, etc., are included in plan expenditure.

9.5 Importance of Public Expenditure

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

i. **Economic Development:** Without government support and backing, a poor country cannot make huge investments to bring about a favorable change in the economic base of a country. That is why massive investments are made by the government in the development of basic and key industries, agriculture, consumable goods, etc. Public expenditure has the expansionary effect on the growth of national income, employment opportunities, etc. Economic development also requires development of economic infrastructures. A developing country like India must undertake various projects, like road bridge-dam construction, power plants, transport and communications, etc. These social overhead capital or economic infrastructures are of crucial importance for accelerating the pace of economic development. It is to be remembered here that private investors are incapable of making such massive investments on the various infrastructural projects. It is imperative that the government undertakes such projects. Greater the public expenditure, higher is the level of economic development.

ii. **Fiscal Policy Instrument:** Public expenditure is considered as an important tool of fiscal policy. Public expenditure creates and increases the scope of employment opportunities during depression. Thus, public expenditure can prevent periodic cyclical fluctuations. During depression, it is recommended that there should be more and more governmental expenditures on the ground that it creates jobs and incomes. On the contrary, a cut-back in government's expenditure is necessary when the economy faces the problem of inflation. That is why it is said that by manipulating public expenditure, cyclical fluctuations can be lessened greatly. In other words, variation of public expenditure is a part of the anti- cyclical fiscal policy. It is to be kept in mind that it is not just the amount of public expenditure that is incurred which is of importance to the economy. What is equally, if not more, important is the purpose of such expenditure or the quality of expenditure. The quality of expenditure determines the adequacy and effectiveness of such expenditure. Excessive expenditures may cause inflation. Moreover, if the government has to impose taxes at high rates there will be loss of incentives. So, it is necessary to avoid unnecessary expenditure as far as practicable, otherwise benefits of better economic development may not be reaped. As a fiscal policy instrument, it may be counterproductive.

iii. **Redistribution of Income:** Public expenditure is used as a powerful fiscal instrument to bring about an equitable distribution of income and wealth. There are good much public expenditure that benefit poor income groups. By providing subsidies, free education and health care facilities to the poor people, government can improve the economic position of these people.

iv. **Balanced Regional Growth:** Public expenditure can correct regional disparities. By diverting resources in backward regions, government can bring about all-round development there so as to compete with the advanced regions of the country. This is what is required to maintain integration and unity among people of all the regions. Unbalanced regional growth encourages disintegrating forces to rise. Public expenditure is an antidote for these reactionary elements. Thus, public expenditure has both economic and social

objectives. It is necessary to ensure that the government's expenditure is made solely in the public interest and does not serve any individual's interest or that of any political party or a group of persons.

9.6 Effects of Public Expenditure

Public expenditure is an important fiscal instrument to secure many fold social objectives in an economy. The traditional economist held the view that state should not incur more expenditure. Adam Smith and other classical economists considered public expenditure as 'unproductive' and private expenditure was considered 'productive'. This mistaken notion of the classist arose out of their false belief in the efficacy of Laissez-faire capitalism, in mitigating cyclical fluctuations and preserving full employment. Adam Smith advocated minimum activities for the state. That is preservation of the community from aggressions and maintenance of law and order. Hence classical economists were in favor of minimum public expenditure. However, the world wide depression of 1930's and the two global wars, proved faulty the classical faith on Laissez-faire. With the advent of Keynes general theory, public expenditure came to be looked upon as an indispensable fiscal instrument of securing social welfare and correcting economic instability. Moreover, there are areas of economy like provision of basic infrastructures, where market mechanism completely fails to distribute the cost of output production among expenditure beneficiaries through the pricing system. Only the public sector can supply these welfare increasing facilities through budgetary allocation. Hence in the modern world public expenditure influence the national economy in a manifold manner. It is important therefore to examine how public expenditure affects the economy in various ways and secure social welfare.

1. Effects of Public Expenditure on Production:

According to Dalton the level of production and employment in any country depends upon three factors namely:

(a) Ability of the people to work, save and invest,

(b) Willingness to work save and invest, and

(c) Diversion of economic resources as between different uses and localities.

Public expenditure influences all these factors either positively or negatively. Production depends upon the employment of resources by human labor assisted with capital. The capital stock of a country depends upon savings or the surplus over consumption. Thus the way in which public expenditure effects production is determined by its influence on the willingness and ability of the laborers to work, on the allocation of resources and on the amount of savings. We shall now explain these effects in detail;

(a) Ability to Work, Save and Invest:

Public expenditure can influence ability to work, save and invest either favorably or unfavorably. If public expenditure is used as an instrument to promote the efficiency of a person to work, it will promote production and national income. For example, public expenditure on education, medical services, cheap housing facilities etc. can increase the efficiency of a person to work. At the same time, public expenditure can promote saving on the part of the lower income group by providing additional income to them, for, all the persons who has larger income can be normally expected to save lower amounts. It improves their standard of living and efficiency and thereby their ability to work and save enhances.

Finally public expenditure, particularly repayment of public debt, will place additional funds at the disposal of those who can invest. Likewise expenditure incurred on the maintenance of law and order, will create confidence in the minds of the people, thereby creating a favorable investment climate in productive activities. In this way public expenditure can promote ability to work, save and invest and thereby production and employment. On the other hand, if larger portion of public expenditure is channelized into wasteful social functions, on the production of intoxicants, harmful drugs etc. it will adversely affect ability to work, save and invest. Similarly, if heavy public expenditure is made on the construction of film studios, cinema houses, hotels and bars, rather than on the construction of roads, and other means of transport and communication, public expenditure creates unfavorable effect on ability to work, save and invest.

(b) Willingness to Work, Save and Invest:

The effect of public expenditure on the willingness to work, save and invest depends considerably on the expectation of future benefits. It also depends upon the character of public expenditure and the policy of the government. For example, pension, interest on loans, provident fund, sickness benefit etc. provide security and safety to a person. Therefore it reduces his willingness to work and save. The underlying principle is why should a person work hard and save, when he knows fully, that he will be looked after by the government when he is not in a position to earn any income. He finds his future fully secured. In the absence of any saving, investment will notarise. Hence public expenditure should be regulated in such a way that it may not adversely affect the incentive to work of the people.

(c) Diversion of Economic Resources:

Public expenditure diverts resources from private to public use in many ways. Public expenditure has far reaching effects on the utilization of resources as between alternative uses. In the first place, there are such diversions of resources from private to public use, about which there is some doubt. Dalton talks about government expenditure on armaments and armed forces. To meet such expenditure, the government diverts economic resources from the general public to the government. It is thought by many that these economic resources could have contributed to economic welfare, if they have been allowed to remain with the people themselves. But it is also true that defense expenditure is essential for the safety and security of the nation without which no country can flourish economically. Hence in this context, defense expenditure is important from the national point of view. Alternatively, public expenditure may bring about a better allocation of economic resources between the present and the future.

In a free capitalist society, very little provision is made for the future. This is because people prefer the present rather than the future. The state on the other hand is the custodian of the interest of the future generation. It is the duty of the state to make adequate provision for the future generation. Unlike private individuals, the government can make investments in railways, irrigation projects, afforestation etc., which do not yield immediate returns, but can provide social and economic benefits to the future generation. The government also spends money in the conservation of economic resources. Hence the diversion of resources from private to public sector for the construction of basic infrastructure and for preservation and conservation of scarce resources is very essential for economic development. These kinds of expenditure exert a positive impact on production and economic activity of a nation. Public expenditure can result in increased production in the society through changes in pattern and composition of production. Private sector is interested in maximization of profit and is not concerned with efficient allocation of resources. Public expenditure can induce diversion of resources from less essential products to more essential products by offering subsidies and other concessions. Hence public expenditure in the form of subsidies and grants is helpful in directing the resources of the people to establish new industries as well as to accelerate production of existing industries. Similarly, public expenditure on social overheads like education, training, public health etc., produce favorable effect on production. It will increase social welfare and efficiency of production. Likewise government spends money for encouraging and developing research and development activities and inventions and innovations. The diversion of economic resources here will greatly increase production and enhance productive capacity. Government expenditure on public works programmes has also favorable effect on production and employment. Sometimes public expenditure may result in diversion of economic resources as between localities. This is done through central government grants to state governments to provide certain services more efficiently. This will help to increase productive capacity and to reduce regional inequalities in development. For example, special expenditure in the form of grants incurred to the development of backward region help to reduce regional imbalance and to enhance production and economic development. Prudently planned public expenditure can certainly bring about diversion of resources as between regions which will improve the economic position of backward areas, and thereby increase production and employment. Further, public expenditure can also modify the allocation of resources and thus influence the composition of GNP. For example, an increase in public investment in highway construction may stimulate automobile and allied industries and this expansion in turn may retard railway expansion. Similarly, subsidies given for the assistance of particular industries may develop them at the expense of others. For example, if grants are given for building houses for middle or poor income groups, resources might flow to construction industries. On the whole, public expenditure exerts a wholesome influence on production. Dalton's conclusion on the question of the effects of public expenditure on production and employment is that "whereas

taxation taken alone, may check production, public expenditure, taken alone, should almost certainly increase it". It is possible that production will definitely be checked if carelessly planned, but it will stimulate production, if carefully planned.

1. Public Expenditure and Distribution:

In most communities and countries of the world, inequality in the distribution of income and wealth exists in different forms. This social problem is undesirable on many grounds ethical, economic and political, among others. The removal of or reduction in inequality in the distribution of wealth has now universally been recognized as an important objective of state policy. India also envisages a more equitable distribution of wealth. The tools of fiscal policy are directed towards achieving a fair distribution of income among the different classes of people in the society. The state tries to achieve this object partly by means of taxation or leveling down the wealth of the rich and partly by means of public expenditure or leveling up the wealth of the poor. Both fiscal activities are ultimately linked with each other. They are complementary rather than competitive in character.

There are certain items of public expenditure which benefit individuals and those which benefit society as a whole, in the list of expenditure which benefits individuals, the expenditure on social services, in the form of free medical aid and free education out of state funds will benefit the poor more than the rich. Such services imply a net addition to the income of the poorer classes. Expenditure which benefits the society as a whole is those relating to general improvement. For example, good roads, free water supply in urban areas etc. However, any attempt to redistribute wealth by public expenditure, may reduce savings, firstly of those who are taxed and secondly of those who receive the benefits of such expenditure. In this context Colwyn Committee remarked "the effect of public expenditure on production seems to be in conflict with that on distribution. But up to a certain point, this is not the case. The difficulty is to know where the balance should be struck".

Regressive, Proportional and Progressive Public Expenditure: Regarding the distributive impact of public expenditure much depends on the nature of public expenditure and the policy underlying it. Just as there are proportional progressive and regressive taxes, in the same manner, government grants may be proportional, progressive and regressive. Public expenditure must be on the principle of 'ability to receive' (corresponding to ability to pay of taxation), if it has to secure an equitable distribution of wealth. Corresponding to the principle of minimum sacrifice in taxation, there is the principle of maximum benefit in public expenditure. Broadly, the principle of maximum social advantage should be the underlying criteria of public spending. From this point of view, expenditure on debt services is regressive because it gives more income to those who are rich. Old age pension and expenditure on social insurance are progressive. In this context, it should be noted that a government grant reduces the desire to work and save, it lead to reduction of income of beneficiaries. In this case inequalities of wealth distribution are reduced. A grant or public expenditure is regressive, if the addition it makes to the income of a beneficiary is smaller in the case of people with small income and higher in the case of people with high income. The best example is subsidy and interest offered by the government on public debt. The provision of free residence only to higher paid government employees and not to low paid employees is a typical example of regressive expenditure. In this case benefit of public expenditure is reaped by the richer income group. This only helps to aggravate inequality of income.

The public expenditure or grant will be proportional, when the proportion of additional benefit provided by the grant or public expenditure is the same, whatever the size of the recipient income. In such case, there is no change in existing inequalities of income distribution. For example, if all categories of employees were given a house allowance at the same rate, say 10% of their salaries, it would be a case of proportional expenditure. A grant or public expenditure would be progressive, when the additional benefit provided by the grant or public expenditure is larger in the case of low income people and lower in the case of high income people. The expenditure on social security like free medical aid, free education, subsidized houses etc. is progressive in nature. For example, if only the lower salaried employees were given free residential quarters, it is a case of progressive expenditure. Such expenditure helps to reduce the glaring inequality existing in the distribution of income. Dalton observes that system of public expenditure is the best, which has the strongest tendency to reduce the inequalities of income.

Hence progressive public expenditure is the best anti-dot to reduce income inequality existing in the society. Progressive expenditure can assume different forms. It may be in the form of cash grants-old age pensions, unemployment benefit, sickness and accident benefit. This act as a sort of

timely help. Progressive redistributive expenditure may also take the shape of provision of cheap or free services and commodities. Free primary education, free medical aid, subsidies to food and housing and the provision of free meals to school children are examples of this type of progressive grant. Such expenditure benefits the poorer among the poorest and helps to raise the living standards of the weaker sections. Reduction of glaring inequalities in the distribution of income, provision of certain minimum basic facilities to the weaker sections of the community is now rightly regarded as the primary social functions of any modern government. Public expenditure has therefore become an important instrument in the fiscal policies of modern governments to achieve certain social and economic objectives oriented towards the welfare of the community.

9.7 Zero-Based Budgeting

Zero-based budgeting (ZBB) is a mechanism that contributes to aligning a country's expenditure with strategic targets. The concept of ZBB requires organizations to build their annual budget from zero every year to verify all elements of the annual budget are cost-effective, less time taking, and relevant.**"Zero-based budgeting"** is an approach to planning and preparing the budget from the beginning.

As the name suggests, it refers to planning and preparing the budget from scratch or '**zero bases**'.

Plays a vital role as an emerging budgeting concept that is introduced with the aim of subsisting with the demerits of the traditional budgeting system.

It is a reverse chronology of traditional planning and decision-making with respect to budgeting.

Zero-based budgeting (ZBB) is basically a **systematic cost management** process that prioritizes the efficient allocation of income to fixed expenditure, variable expenses, and savings in order to nullify the difference between income and expenditure. A method of budgeting in which all **expenses must be justified** for each new period. The process of zero-based budgeting involves the review and justification of each and every ministry's expenditure to receive funding at the beginning of each financial year.

Zero-based Budgeting - Background

British budget authority **Edward Hilton Young** introduced the Zero-based budgeting concept in 1924.He supported complete justification of every item requested in a budget. In the 1960s, ZBB was formally initiated in the **Department of Agriculture of the USA** and turned out to be more popular in the 1970s.The Zero-Based Budgeting applicable today was developed at **Texas Instruments Inc. in 1969 by Peter Pyhrr.**

Features of Zero-Based Budgeting

- The budget allowance to any decision unit should be first **sanctioned by the manager** of the said unit.
- Decisions are based on what each unit can offer at the given cost.
- The manager should **justify his request without making any citation** to the previous level of expenditure under his decision unit.
- Sudden or instant adjustments in the budget are possible if required.
- Activities are identified as **decision packages**, and then the latter are ranked in order of priority.
- Individual units' objectives are aligned with the corporate goals.

Traditional vs Zero Based Budgeting

Traditional Budgeting	Zero-Based Budgeting
It is when the budget is prepared by taking the immediately preceding year's budget as a base.	It is a method of budget preparation that involves that whenever the budget is set, the activities are re-evaluated.
It focuses on previous levels of expenditure.	It focuses on new economic appraisal.
It is an accounting-oriented method of budget preparation.	It is a decision or project-oriented method of budgeting.

Priority is given to mainly past levels of spending, then to demand inflation and new programs.	Priority is given to comprehensive decision packages and ranked according to their relevance.
It has lower clarity and responsiveness.	It has higher clarity and responsiveness.
It is a simple method of budgeting.	It is a complex method of budgeting.

Advantages of Zero-Based Budgeting

Profitable Analysis: When each and every item has to be justified, it gets easier for organizations to produce and eliminate the ones that are not performing in generating an adequate return on investments.

Resource Intensive: Zero-based budgeting is also resource-intensive. It invests proper time and effort to have an accurate review and justification of every budget element rather than modifying an existing budget and reviewing only present factors.

Detailing of expenses: Through the Zero-Based Budgeting mechanism, there's a focus of efforts on both the factors - 'How much a unit will incur' and 'why it is incurred'.

Minimizing the redundant activities: It leads to the detection of opportunities and more economical ways of doing things by removing all the unproductive or redundant activities.

In control of every budget: Every penny has a job when you are using the zero-based budgeting method as it controls mindless spending effectively. Zero-based budgeting encourages initiative and responsibility so that your spending gets coordinated.

Limitations of Zero-Based Budgeting

Compensate Short-Term thinking: One of the major drawbacks of zero-based budgeting is that it can reward short-term thinking by transferring resources in the direction of companies that will produce assets over the coming budgeting period.

Excessive Paperwork: It is a major shortcoming responsible for the failure of the said concept. ZBB process requires too much paperwork, which makes it laborious sometimes for the organizations.

Complex and Expensive: Zero-based budgeting can be very costly, as well as time-consuming and complicated, to implement. For companies operating on thin budgets, the strain may be prohibitive.

High Manpower Requirement: Making an entire budget from Zero requires the participation of many employees, but many departments may not have the proper time and workforce for the same.

Lack of Experience: Explaining every line item and every cost is a difficult task and requires trained experienced managers.

Zero Based Budgeting in India

The zero-Based Budget in India was introduced in the **Department of Science and Technology in 1983**.

In 1986, the Indian government adopted this process as a technique for the **systematic regulation of the expenditure budget**.

The ZBB was promoted during the **Seventh Five-Year Plan.**

The government made it mandatory for all ministries to review their programs and activities and prepare expenditure estimates based on the ZBB concept.

However, we have **limited application of Zero-Based Budgets in India** at this point.

Summary

Wiseman-Peacock hypothesis emphasizing the recurrence of abnormal situation which cause sizable jumps in public expenditure and revenue.But historical facts indicate that onaccount of advancement of the economy and structural changes therein, there are constant and regular increment in public expenditure and revenue. Public expenditure theories are dealing with the role of public expenditure for the economic growth and development. As mentioned above, there are three basic theories in public expenditure. Each of them agreed with the necessity of public

expenditure to push a country in to the path of development.Zero-based budgeting targets at presenting true expenses to be incurred by a department. Although this budgeting method is time-consuming, this is a more appropriate way of budgeting. This includes all-inclusive analysis of the budget proposal and if the employees make irrelevant variations so as to achieve what they want, they are probably exposed.Zero-based budgeting has a different work process from traditional budgeting wherein the companies that use it create a budget for each new budgeting session. They are benefited from this procedure because it is cost-effective and takes less time. It rewards short-term thinking, is resource-intensive, and could be manipulated, which proves to be a drawback of the Zero-Based Budgeting concept. It must be noted that the zero-based budgeting mechanism is entirely based on activities, where the budget is prepared for every action instead of a functional department and the allowances or funding are based on needs and program efficiency and not on the history of the budget.

Keywords

Zero-based budgeting: The process of zero-based budgeting starts from a zero base.

Budget:A budget is an estimation of revenue and expenses over a specified future period of time and is usually compiled and re-evaluated on a periodic basis

Budgeting Mechanism:budgeting mechanism is a company management tool promoting achievement of strategic objectives on the basis of balanced financial performance

Excessive expenditure: means the portion of expenditure incurred that significantly exceedsthe budgets.

Review Questions

1. Explain the Wiseman-Peacock theory.
2. Explain the pure theory of public expenditure.
3. Explain the characteristics of Good Tax system.
4. Explain the concept of zero-base budgeting indetails.
5. What does the reasons for increasing Public expenditure?

SelfAssessment

1. Public Expenditure refers to...........

A. Government Expenditure

B. Private Expenditure

C. Private Expenditure

D. None of the above

2. Wiseman   Peacock hypothesis supports in a much stronger manner the possibility of:

A. An upward trend in public expenditure

B. A downward trend in public expenditure

C. A constancy of public expenditure

D. A mixed trend in public expenditure

3. According to Peacock Wiseman hypothesis, A discontinuity in the growth pattern which produces expenditure peak during social disturbances is referred to as:

A. Concentration Effect

B. Displacement Effect

C. Inspection Effect
D. Substitution Effect

4. The increase in public expenditure doesn't follow any smooth and continuous trend but the increase in public expenditure occurred in step like manner. This hypothesis is called
A. Caldor's model
B. Peacock and Wiseman Hypothesis
C. Wagner's Law of Public Expenditure
D. Keynes Law of Public Expenditure

5. Peacock and Wiseman Hypothesis on public expenditure consists of three concepts which are:
A. Subscription Effect, Tax Effect, Expenditure Effect
B. Tax Effect, Expenditure Effect, Consumption Effect
C. Displacement Effect, Concentration Effect, Inspection Effect
D. Consumption Effect, Labor Effect, Income Effect

6. Critical Limit Hypothesis was associated with the name of
A. Dalton
B. Colin Clarke
C. J.M. Keynes
D. Musgrave

7. According to Colin Clark maximum limit of the tolerance level is _________ of GNP
A. 24%
B. 25%
C. 26%
D. 27%

8. Expenditure Tax for India was recommended by:
A. Kaldor
B. Colin Clarke
C. Adam Smith
D. Adolph Wagnor

9. How the government can meet its expenditure:
A. By taxing people
B. By borrowing from banks and other governments
C. By printing new money
D. By all the three methods

10. Expenditures incurred on civil administration;defense forces is in the nature of

A. Capital Expenditure
B. Revenue Expenditure
C. Transfer Expenditure
D. Productive Expenditure

11. The Zero-based budgeting was first adopted in:
A. India
B. USA
C. France
D. Germany

12. Who proposed the Zero-based budgeting for the first time:
A. David Ricardo
B. Alfred marshall
C. Adam Smith
D. Peter Phyrr

13. Functional budget is subsidiary to
A. Variable budget
B. Fixed budget
C. Master budget
D. All of the above

14. Production and Manufacturing budget is prepared after receiving the
A. Material and purchase budget
B. Sales budget
C. cash budget
D. None of the above

15. The merit of zero-based budgeting is that
A. Tax liability is reduced
B. Profit goes up
C. Deficit financing becomes zero
D. Expenditure is rationalized

Answers for SelfAssessment

1.	A	2.	A	3.	B	4.	B	5.	C
6.	B	7.	B	8.	A	9.	D	10.	B
11.	B	12.	D	13.	C	14.	B	15.	D

Further Readings

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Unit10: Government of India Finances

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Objectives

After studying this unit, students will be able to:

- Study the Revenue Account and Capital Account in public expenditure.
- Analyze the different aspect of public expenditure for welfare.
- Explain the Public Expenditure and its different types.
- Evaluate the importance of public expenditure for any economy
- Understand the concept and causes of deficit financing
- Analyze the role and limitation of deficit financing
- Understand the concept of government budget
- Evaluate the features and reforms of government budget

Introduction

There is a need of income for fulfillment of a person's needs, in the same way government needs income for successfully completing its tasks. Income of all types received by government is called public income. In the study of public finance, the government income has the same place which is gained by production in study of economy. The production is necessary for the fulfillment of consumption, in the same way, for the fulfillment of the government expenditure, government income is essential. Income received from different sources of government is called government income or government revenue. But, Dalton has used government income in both meanings - broad and limited. He named them public receipts in Broad Meanings and named them public income or public revenue in Limited Meaning.

10.1 Public Revenue

In public revenue, taxes, the cost of commodities and services received by government industries, income of administrative operations like fees and penalty and gifts and contributions are included. But, in public receipts, all those incomes of government can be included which they receive during a particular duration. In other words, public receipts = public revenue + income of all other sources such as individuals, debts from banks and issue new money letter. In the age of economic planning, the importance of origin in economy has same importance as public revenue of public finance. In current time, due to increment in tasks of states, the amount of public expenditure is also increasing. For the fulfillment of this increased expenditure, it has become necessary to increase public income. In modern times the objective of income related sources is not only receive income, but to affect production, employment, planning and other economic operations as a form of an effective fiscal tool. An arrangement of powerful resource for fulfillment of desired objectives by deciding a definite policy in regard of public revenue as well as public expenditure and public debt policy in every economy is done. Therefore, in current age, public income for each economy, whether developed or undeveloped has been proved important. The familiarity and success of government depend on whole public income. In the same way, for both private individuals and government, the practical importance of methods of public revenue and study of its nature has been increased.

Sources of Public Revenue

Different sources or forms of government revenue. These resources are following-

(1) Taxes

(2) Commercial Revenues

(3) Administrative Revenues

(4) Gifts and Grants

1. Taxes

Taxes are those compulsory payments which are used without any such hope towards government by tax payers that they will get direct benefit in return of them. According to Bartable, ′′ Tax is that compulsory contribution of money present with person or individuals which is given in lieu of service in government tasks.′′ According to Prof. Seligman, ′′ Tax is that compulsory contribution given to Government by individuals which is paid in the payment of expenses in all general favors and no special benefit is given in lieu of that.′′ According to Trussing, ′′The special thing is that in regard of tax in comparison to all amounts taken by government, quid pro quo is not found directly between taxpayer and government administration in it.′′

Characteristics of a Tax

It is clear by above mentioned definitions that some specialties are found in tax which are as follows :-

(1) Compulsory Contribution—Tax is a contribution given to state by people living within the premises of country due to residence and property etc. or by citizens and this contribution is given for general use only. Though it is a compulsory contribution, therefore, no individual can deny from the payment of tax. For example, no person can say that he is not getting benefit from some services provided by that state or he didn't get the right to vote, therefore, he is not bound to pay tax. Therefore, tax must be paid by each individual which is imposed by state, whether he is adult or minor and citizen or foreigner. If a person denies paying tax, he must be prosecuted. But, there are some limitations of taxes. For example, if tax is imposed on some special product then he can escape tax by not using that product. Suppose if tax is imposed on wine then government can force some person to pay tax only when he uses wine. But, if he doesn't drink, then he cannot be forced to pay tax imposed on wine. In addition to these limitations, tax is compulsory payment and its specialty separates it from other types of government revenue.

(2) Personal Obligation —Tax casts personal obligation on taxpayer. Its meaning is that if tax has been imposed on some person then it is his duty or obligation to pay it and don't try to avoid it in any condition. For example, tax is imposed on incomes of persons then there can be many sources

of income of persons, therefore it is possible that government may not be aware of all sources of income of people. In that condition, it is the duty of taxpayer that he must declare all his income and pay tax according to it.

(3) The Tax is Imposed for the General and Common Benefit — The contribution that is received from taxpayers in the form of taxes, it can be possible that it cannot be spent for their profit only, but it must be spent in favor of common people. It can be possible that a person is not capable to fulfill all his needs specially to fulfill those needs where huge amount is spent there such as construction of hospital. In that condition the state arranges for such services for the benefit of all people. Therefore, for bearing this general burden, the tax is imposed on all those people who are capable to pay it.

(4) No Relation between Taxation and State Services — Payment of taxes not done by state for the payment of any special service given to a person and tax is not paid for this purpose that some special benefit has been given to taxpayer by state. In this way, tax are not paid because taxpayer has received benefit from state or state has provided service for it. But, there is some limitations also of this specialty. For example, land tax is paid by those individuals only who have land or those who get benefit from land. In the same way, entertainment tax is given by those individuals only who get benefit from entertainment. By highlighting on this condition, Prof. De Marco has said about the limitation of tax that the law of taxation in modern state is based on the assumption of an exchange relationship that is the exchange of a payment of the state for the provision of public services by the state. Therefore, according to De Marco, "The tax is the price which citizen pays to the state to cover his share of the cost, the general public services which he will consume.

But, here, this is mentionable that contribution is received in form of land tax by farmers, it can be possible that it is not only use for their benefits only by the state, but also it must be given for the benefit of all society. In the same way, government receives contribution in lieu of the profit received from entertainment by people; it is possible that it must be used for the benefit of whole community instead of the benefit of only those. In this way, the amount paid in the form of tax by individual and benefit received from the government service have no relation between them. Therefore, it is a compulsory contribution and this contribution is for the benefit given to general public and there is no relation between service given by government and tax paid by them.

2. Commercial Revenues

Commercial revenues are those incomes which are received in the form of produced goods by them or cost of services. In other words, that revenue is called commercial revenue which it received by selling goods of public enterprises or services by government. This revenue is called price and it is so because it is received in the form of goods provided by Government and cost of services, payment of postal expenditure, toll tax, interest of money given on debt by government approved corporations, costs paid for the beer of government godowns, costs of electricity distributed by government, payments of rail services etc, are included in commercial revenues. Sometimes, government generates revenue from the production of goods like steel and mineral oil. But, in spite of this, savings or surpluses from commercials enterprises are not considered an important source of revenue in most countries of the world

3. Administrative Revenues

Those receipts which are placed in the category of administrative revenue are fees, license, penalty, receipts from mortgaged property and control on property in absence of heir and special assessments. One characteristic of this receipt is that a person gets relaxations that he can pay them or not. Secondly, these receipts give direct benefit to the person or impose fine on him. But, in that state it is not essential that there must be a relation between money paid or cost of benefit and cost of benefit received. There is a special characteristic of administrative income that it is received in the form of byproduct of administrative works of government. And this is the reason that these are called 'administrative income'.

Fees

The definition of Prof. Seligman is as follow - "Fee is that amount which is given to pay the cost of each such recurring service provided by government which is mainly in favor of public but which provides such special benefit to fee payer that can be measured." In this way, fee is that payment which is given to government to fulfill the costs of those administrative services which are completed in the favor of whole public but provide special benefit to individuals. Therefore, fee is paid by those individuals only which get special benefit from the services provided by government.

For example, if a student wants to get benefit of education by studying in government school, then he must have to pay fees

License Fees

The nature of license fees match with fees up to some extent but there is some difference in it and fees. "License fee is paid in that condition when government administration is requested that it must provide permission or privilege instead of providing service of definite kind and more clear." Registration fees of motor vehicles, payment of permit of driving motors and license fee for keeping revolver are such examples. No one can be forced to pay fees in these matters, but any person who wants to use revolver or motorcar then essential fees have to be paid for that. The benefit which a fee payer gets after paying fees, that is in the form of practical facility and law to use motorcar or keeping revolver. The objective of that fee is sometimes that the implementation or control of activities and operation of different type, for example, responsible individuals must be given license of revolver for the establishment of law and order. In this way, for controlling the sale of wine, licenses are given to run wine shops. In the favor of public-security, motor driver are instructed to get license for driving and these licenses are given only when a person is found fit to drive a vehicle. Therefore, the factor of control which is found in license fee separates it from fee and tax both.

Special Tax Assessment

In the words of Prof. Seligman, "Special assessment is that compulsory contribution which is paid in the ratio of special benefits provided and whose objective is to pay the cost of special reform in property purchased." When government takes the tasks of public reforms like road construction, arrangement of sewer and arrangement of light in roads and streets in its hand, then the whole public get general benefit whose property like shop, house etc. is on that road. As a result of these reforms, the costs and rents of these properties increase. So, it is possible that government may impose some special tax on the people of that area to pay back some part of such expenditure. Such special tax imposition is done in the ratio of increment in the cost of property and it is different from this view.

Fines and Penalties

Fines and penalties are not an important source of government revenue. Fine is related to punishment and penalty is given on breaking the law. The objective of both of them is to avoid crimes and to punish for any wrong doing.

Forfeitures

The meaning of bails or bond or forfeitures of property is related to those penalties which are imposed on people by courts so that they failed to appear in court in a definite date or they didn't complete prior contracts. It is clear that the importance of the source of revenue of government is very less.

Escheat

This source of government revenue is the symbol of claim of government on property of such person who died without appointing a successor or without making a will. In this state the amount deposited in bank of that person go in the custody of government. Under escheat, government can take over dissolved educational institutions or unclaimed property of trusts also. It is not an important source of government income.

4. Gifts and Grants

Gifts are those optional contributions which are given to government for such special tasks by private persons or non-governmental donors such as relief fund at the time of war or defense fund. These contributions are given to freedom fighters, kind hearted and other individuals at war, natural disaster or other such emergency situations. In modern government system, there is no mentionable place for these gifts excluding war time or emergency. It had important place definitely in classical government system but king, Nawab and Jageerdar etc. take gifts from their people. These days the total amount of gifts is so less that it has nominal place in revenue system. The characteristic of receiving's in the form of gifts and grants that are optional in nature and in return of this, it does not hope for any direct benefit. In the state of grants, donor government gives financial help for completing government task at any level. In unitary countries, central government gives grants-in-aid to state governments and state governments give grants-in-aid to local governments so that they can be made capable so that they can do their work successfully or

with uniformity or can handle some special tasks such as construction and maintenance of highways. Therefore, these contributions can be unconditional also or can be given to complete some special tasks too.

10.2 Public Expenditure

Public expenditure is expenditure incurred by the government (e.g. central government, state governments, lower level governments like district office, gram panchayat, etc.). Such expenditures are made for social welfare of people and to run the government administration. The importance attached to public expenditure has varied between different schools of thought. During the laissez-faire polices of 19th century, the role of government was minimum. Over time, with the evolution of theories of public expenditure, the importance of public expenditure has come into limelight as an important tool of fiscal policy. The failure of market mechanism to ensure social welfare, income equality and full employment has contributed to the insights developed into the potentials of public expenditure. In view of these, the role of the government in public expenditure is considered crucial across the globe.

Factors of Influence

Several factors of demographic, political and public significance influence public expenditure. These may be stated as follows.

Growth of Population:A large and growing population is one of the main reasons behind growing public expenditure. A country with large population will have to create more schools, hospitals, transport facilities, roads and other amenities to meet the needs of its large population as compared to countries with smaller population. In order to control the population growth, the government intervenes with policies on family planning creating necessary infrastructure to administer such policies.

Growth of Democracy: The structure of the democratic form of the government is such that it will require more public expenditure. It requires regular and continuous maintenance of the political institutions. For instance, periodic conduct of elections would be required at all levels of the government. Countries with a democratic form of government will always therefore have a higher level of public expenditure. Additionally, to increase their chances of re-election local politicians will be more responsive to demands of the people in their jurisdiction. This requires the setting up of large scale 'public goods' in all jurisdictions which require funds on regular basis for their maintenance (called non-plan or revenue expenditure). Therefore, the political and governing structure of country always serves as a significant factor behind a large scale public expenditure.

Welfare State: The role of the state during the laissez-faire policies of 19th century was termed as a 'police state' where the role of public expenditure in the economic life of the people and community remained neglected. Various positive effects of public expenditure on increasing production and employment, reducing income inequality, etc. were ignored. In successive decades, the understanding of the term 'modern state' evolved over time. This changed the concept of 'police state' to 'welfare state' under which large emphasis is placed on the welfare related measures required to uplift the social welfare of the marginalized sections of people. For instance, creation of employment opportunities, social security measures, creation of welfare related infrastructure, etc. would all require greater role by the government. The 'theory of public expenditure' has therefore recognized distortions created by 'market mechanism' in ensuring full employment of job seeking population. Due to these factors and increased sensitization for the welfare of people, the extent of public expenditure incurred has increased enormously over the years.

Defense Expenditure: In modern society, every country wants to protect its borders. The possibility of wars require the nations to equip themselves with arms. This process, in turn, requires large scale public expenditure to equip their defense sector.

Expansion of Public Sector and Administrative Set up: Creation of large-scale administrative set up requires large scale public expenditure. This is more likely for countries with large geographic area with decentralized government systems Patterns of Public Expenditure in India 21 (e.g. Canada, Australia, India). This entails expenditure on large scale police and public services machinery in every nook and corner of the country to maintain internal security, public administration, public sector enterprises, etc.

Poverty Alleviation Programmes: Countries which have chronic poverty have to incur large scale expenditure in the form of poverty alleviation programmes. This is especially so for countries like

India (and other developing countries) which rely heavily on public programmes to improve the well-being of their poorest so as to bring them up to join and benefit from the mainstream development process of the country.

Urbanization: Countries with a larger, and especially growing, urban population also require growing public expenditure to expand their urban amenities (such as establishment of better-quality schools, drainage system, hospitals, drinking water facilities, better law and order condition in the society, etc.).

Income Re-distribution: Policies targeted for income re-distribution collect taxes from richer states and spend them in poorer states leading to transfer of funds. For instance, government collects taxes from richer areas with proceeds from certain taxes earmarked to be spent for the development of poorer regions. This is needed because such regions cannot raise enough funds from their own jurisdiction due to lower level of development. The extent of public expenditure is therefore large in such a federal set up.

10.3 Revenue Expenditure and Capital Expenditure

The Union budget in India classifies the total public expenditure into two components: revenue expenditure and capital expenditure. The former is committed expenditure and less productive. Expenditure categories such as pensions, salaries, subsidies, interest payment, etc. come under revenue expenditure. These do not lead to the creation of productive assets but have to be incurred in a recurring manner year after year. Capital expenditure, on the other hand, leads to creation of assets. These are expenditures incurred on creation of real capital assets or financial assets (e.g. expenditure on purchase of land, buildings or machinery, expenditure on building schools and hospitals, government investment in shares or expenditure which reduces liabilities such as repayment of loan). Capital expenditure is, thus, generally a long-term expenditure.

The capital expenditure is always outweighed by revenue expenditure. This is despite the emphasis of the government towards increasing the share of capital expenditure (CE) relative to revenue expenditure (RE). The ratio of RE to CE (RE/CE) for central government was close to 2 until 1985. This was indicative of the fact that the share of revenue expenditure in total expenditure was nearly double that of capital expenditure. The gap between RE and CE for the centre widened post-1985 to touch a high of 8+ by 2009. This indicates that the share of capital expenditure relative to revenue expenditure has been steeply declining over time. A similar picture is evidenced for state government accounts where the RE/CE ratio (which was above 2 even in 1970s) has been increasing post-1980 to touch a peak of more than 5 around the year 2000. This indicates that the share of capital expenditure in total expenditure for all state governments is also declining as compared to the share of revenue expenditure.

10.4 Plan Expenditure and Non-Plan Expenditure

The expenditure categories of revenue and capital expenditure are further divided into plan and non-plan expenditure. Plan expenditure refers to the part of expenditure which is incurred on planned schemes or projects designed under the five-year plans. It includes current development outlays and investment outlays on two main accounts: first, it comprises of ‘central plans’ on agriculture, irrigation projects, rural development, transport, communications, etc.; and second, it includes ‘central assistance’ (i.e. grants) provided by the central government to the 28 States and Union Territories for their development plans. Non-plan classification refers to that part of expenditure which is incurred outside the five-year plan schemes. These are expenditures on items which are more or less committed.

A High-Level Expert Committee on Efficient Management of Public Expenditure (HLEC, 2011) observed that the Plan/Non-Plan bifurcation of expenditure has contributed to a fragmented view of budget allocation hindering the process of estimating the cost of delivery and hampering the linking of budget allocation to the outcomes. The HLEC has further observed that ‘out of total expenditure, the plan expenditure constitutes only 30 percent’. Since the outcome of a scheme depends on total expenditure and not just on plan expenditure, the HLEC has held that the plan and non-plan classification is not providing a clear picture of development and non-development dimensions of government expenditure. It has, therefore, recommended to remove the plan and Non-plan classification from both central and state budgets.

10.5 Capital Expenditure

Expenditure that acquires a capital asset is capital expenditure. If it acquires stock-in-trade, then it is revenue expenditure. A capital asset is one that is used in or for the purposes of the business and not meant for sale in the ordinary course of business of the enterprise. Purchase of stock-in-trade is not capital expenditure as it is sold in the ordinary course of business. Expenditure on the purchase and installation of machinery is a capital expenditure. Further when expenditure is made with a view to bringing into existence an asset or advantage for the enduring benefit of trade is a capital expenditure in the absence of special circumstances leading to the opposite conclusion.

Asset or advantage of enduring nature means that it must not be fully consumed or used up in the accounting period in which it is incurred. Capital expenditure increases the earning capacity or reduces the operating expenses of a business. According to Kohler the term capital expenditure is "generally restricted to expenditures that add fixed asset units or that has the effect of increasing the capacity, efficiency, life span, or economy of operation of an existing fixed asset."

Capital expenditures represent significant investments of capital that a company makes to maintain or, more often, to expand its business and generate additional profits. Capital expenditures consist of the purchase of long-term assets, which are assets that last for more than one year but typically have a useful life of many years.Capital expenditures are often used for buying fixed assets, which are physical assets such as equipment. As a result, capital expenditures are typically for larger amounts than revenue expenditures. However, there are exceptions when large asset purchases are consumed in the short term or the current accounting period. Capital expenditures are often used to undertake new projects or investments by a company. Typically, the purpose of CAPEX is to expand a company's ability to generate revenue and earnings. Conversely, revenue expenditures are the operational expenses for running the day-to-day business and the maintenance costs that are necessary to keep the asset in working order.

Companies often use debt financing or equity financing to cover the substantial costs involved in acquiring major assets for expanding their business. Debt financing can involve borrowing money from a bank or issuing corporate bonds, which are IOUs to investors who buy them and get paid interest periodically. Equity financing involves issuing shares of stock or equity to investors to raise funds for expansion and capital improvements.

10.6 Revenue Expenditure

If an expenditure is made not for the purpose of bringing into existence any capital asset or advantage of enduring nature but for running the business or working it with a view to produce the profits is revenue expenditure. Such expenditure benefits the current period only. It is incurred to maintain the existing earning capacity of the business. For example, the amount spent on purchase of stock-in-trade is of revenue nature. Administrative expenses and selling and distribution expenses are other examples of revenue expenditure.

Rules for Determining Revenue Expenditure: The following are the rules for determining revenue expenditure:

1. An expenditure incurred for the purpose of acquiring goods purchased for resale, consumable items, etc. is revenue expenditure. For example, purchase of raw material in the case of manufacturing unit and purchase of merchandise meant for the purpose of resale. At the end of the year, closing stock and opening stock of these items adjusted to match cost with revenue for calculating profit.
2. Expenditures incurred on other direct expenses, e., expenses on production and purchase of goods such as wages, power, freight etc. are revenue expenditure.
3. Expenditure incurred for maintaining fixed assets in working order is revenue expenditure. For example, amount spent on repairs and renewals is revenue expenditure.
4. Depreciation on fixed assets is revenue expenditure.
5. Expenditures incurred on office and administrative and selling and distribution departments (not covered above) in the normal course of business are revenue expenditures.

These include salaries, rent, telephone expenses, electricity, postage, advertisement, travelling expenses, commission to salesmen.

6. Expenditures incurred on non-operating expenses and losses are revenue expenditures. For example, interest on loan taken after commencement of commercial production, loss on sale of a long-term asset, loss by theft, loss by fire are revenue expenditures.
7. Expenditure incurred by an enterprise to discharge itself from recurring liability is of revenue nature. For example, a lump sum amount paid to a pensioner by the employer is revenue expenditure.
8. Expenditure incurred for protecting the business is revenue expenditure. For example, the amount spent on propaganda campaign to oppose the threatened nationalization of industry is of revenue nature.
9. Expenditure incurred to maintain the existing efficiency, or the earning capacity is of revenue type.

Distinction between Capital Expenditure and Revenue Expenditure: The following are the points of distinction between capital expenditure and revenue expenditure:

1. Enduring benefit: Capital expenditure is meant for enduring benefit, e., for more than one accounting period. Revenue expenditure benefits one accounting period only.
2. Nature of asset: Capital expenditure relates to the acquisition of fixed asset and revenue expenditure relates to the acquisition of stock-in-trade.
3. Effect on net profit: Capital expenditure is capitalized while revenue expenditure is transferred to the Trading or Profit and Loss Account. Unexpired portion of the capital expenditure is shown as an asset in the Balance Sheet. Revenue expenditure is expired cost.
4. Nature of liability discharged: Expenditure incurred by an assessed to free himself from a capital liability, for instance, disadvantageous lease is a capital expenditure, while the amount spent in discharging himself from a recurring liability is of revenue nature.
5. Periodicity of occurrence: Capital expenditure is usually of non-recurring nature while revenue expenditure is usually of recurring nature.
6. Earning capacity: Capital expenditure helps to increase the earning capacity of the business or to reduce the operating cost. Revenue expenditure is incurred to maintain the existing earning capacity of the business.
7. Matching: Capital expenditure are not matched against capital receipts. Revenue expenditures are matched against revenue receipts for income determination.
8. Commencement of business: Capital expenditures may be incurred even before the commencement of business. Revenue expenditures are incurred only after the commencement of business.

10.7 Deficit Financing

When a government spends more than what it currently receives in the form of taxes and fees during a fiscal year, it runs in to a deficit budget. When the budget deficit is financed by borrowing from the public and banks, it is called deficit financing. Deficit financing refers to the borrowing undertaken by the government to make up for the revenue shortfall. It is the best stimulant for the economy in short term. However, in the long term it becomes a drag on the economy and becomes the reason for rise in interest rate There is no precise definition of the term deficit financing. It is a method used to finance the overall or net budget deficit. Deficit financing is said to have been practiced when the expenditure of the government both development and non- development exceeds its current revenue and capital budget and the deficit is met through government borrowing.

Deficit financing is an important source of capital formation in the developed and under developed countries of the world. In advanced countries, the newly created money is used to finance public investments which increase economic growth. The government invests borrowed money in improving the quality and reliability of infrastructure i, e, railways, roads, air service, social overheads such as schools. Hospitals etc. The deficit financing is mostly employed to boost up economic activity in the private sector, raising effective demand for goods and services, increasing employment opportunities etc,. etc. In developing countries, the governments are faced with persistent deficits in the budgets. They are liberally using the delicate tool of deficit financing for paying back the domestic and foreign loans, meeting the government consumption expenditure etc

Concept and Meaning

Deficit financing refers to means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowings. The term is also generally used to refer to the financing of a planned deficit whether operated by a government in its domestic affairs or with reference to balance of payment deficit. In the West, the phrase "Deficit financing" has been used to describe the financing of a deliberately created gap between public revenue and expenditure or a budgetary deficit. This gap is filled up by government borrowings which include all the sources of public borrowings viz., from people, commercial banks and the Central Bank. In this manner idle savings in the country are made active. This increases employment and output.

But according to Indian budgetary documents government resorting to borrowing from the public and the commercial banks does not come under deficit financing. These are included under the head of 'Market Borrowings' and government spending to the extent of its market borrowings does not result in or lead to deficit financing. In the Indian context, public expenditure, which is financed by borrowing from the public, commercial banks are excluded from deficit financing. While borrowing from the central bank of the country, withdrawal of accumulated cash balances and issue of new currency are included within its purview.

Deficit financing in Indian context occurs when there are budgetary deficits. Let us now discuss the meaning of budgetary deficit. Budgetary deficit refers to the excess of total expenditure (both revenue and capital) over total receipts (both revenue and capital). In the words of the First Plan document, the term 'deficit financing' is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on revenue or on capital account. The essence of such a policy lies, therefore, in government spending in excess of the revenue it receives in theshape of taxes, earnings of state enterprises, loans from the public, deposits and funds and other miscellaneous sources. The government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system (mainly from the Central Bank of the country) and thus 'creating money'. Thus, the government tackles the deficit financing through approaching the Central Bank of the country i.e. Reserve Bank of India, and commercial banks for credit and also by withdrawing its cash balances from the Central Bank.

10.8 Deficit Financing and Economic Development

Deficit financing has been resorted to during three different situations in which objectives and impact of deficit financing are quite different. These three situations are war, depression and economic development.

Deficit financing during war

Deficit financing has its historical origin in wlr finance. At the time of war, almost every government has to spend more than its revenue receipts from taxes and borrowings. Government has to create new money (printed notes or borrowing from the Central Bank) in order to meet the requirements of war finance. Deficit financing during war is always inflationary because monetary incomes and demand for consumption goods rise but usually there is shortage of supply of consumption goods.

Deficit financing during depression

The use of deficit financing during times of depression to boost the economy got impetus during the great depression of the thirties. It was Keynes who established anExpositive role for deficit financing in industrial economy during the period of, depression. It was advocated that during depression, government should resort to construction of public works wherein purchasing power

would go into the hands of people and thereby demand would be stimulated. This will help in fuller utilization of already existing but temporarily idle plants and machinery. Deficit spending by the government during depression helps to start the stagnant wheels of productive machinery and thus promotes prosperity.

Deficit financing and economic development

Deficit financing for development, like depression deficit financing, provides stimulus to economic growth by financing investment, employment and output in the economy. On the other hand "development deficit financing7' resembles "war deficit * financing" in its effect on the economy. Both are inflationary though the reasons for price rise in both the cases are quite different. When government resorts to deficit financing for development, large sums are invested in basic heavy industries with long gestation periods and in economic and social overheads. This leads to immediate rise in monetary incomes while production of consumption goods cannot be increased immediately with the result that prices go up. It is also called the inflationary way of financing development. However, it helps rapid capital formation for economic development.

Advantages of Deficit Financing

Uptill now, we have seen that deficit financing is inflationary and it destroys its own purpose of aiding economic development. But it is not always so. Secondly inflation is not always harmful for economic development. On the contrary, to a certain extent inflation is conducive to economic development and hence deficit financing is beneficial.

During the process of development, increase in national production is bound to give rise to the demand for increased money supply for transactions. This can be met by injecting new money in the economy through deficit financing. If deficit financing is resorted to for productive purposes especially for the production of consumer goods and that too for quick results then deficit financing is not that inflationary. For example, if any land reclamation activity is to be undertaken which would lead to agricultural production, resort to deficit financing for this activity will not be inflationary. Even if there is a moderate price increase of 4 to 5% per annum, its impact on the economy will not be too severe. Besides, deficit financing will not be inflationary if it is matched by a balance of payment deficit. To the extent to which past savings of foreign balances can be used to pay for such imports, it would be deflationary. But much reliance cannot be put on balance of payments deficit because balance of payments deficit depends on our foreign exchange reserves and our credit worthiness in the world market. Moreover, a developing country aims at reducing this deficit by increasing exports and reducing imports.

Deficit financing will be non-inflationary if the government is able to mop up the additional money incomes, created by deficit financing, through taxation and saving schemes. Properly controlled and efficiently managed programme of deficit financing may help the process of economic development. In fact a certain measure of deficit financing is inevitable under planned economic development to activate unutilized or dormant resources especially when one of the objectives of planning is to step up the tempo of economic process.

Inflationary impact of deficit financing is helpful for economic development to a certain extent and under certain circumstances like :

a) Under developed countries, with their low incomes, low or negative savings, inadequate investment and traditional resistance to change and modernization, will remain stagnant or develop at an intolerably slow pace unless they are restructured and activised. This can be done with the stimulus of inflation.

b) Inflation stimulates economic activities and rising prices induce more ' investments. In a developing economy the major goal is rapid economic development through speedy capital formation. The additional income that is earned through inflation can be ploughed back and if the same process is repeated there is every possibility of a rapid rate of capital formation in the country. For this, inflation may be tolerated to a certain extent.

c) Inflation is said to be a useful method of increasing saving in a forced way. There will be redistribution within the private sector of the economy, from the personal sector to corporate sector. Inflation reduces real consumption and provides resources for investment purposes.

Thus, deficit financing is a necessary and positive instrument to accelerate the rate of economic growth in countries suffering from acute shortage of capital. But any deficit financing has to be undertaken in the context of an efficient and well executed plan for economic development.

Limitations of Deficit Financing

Deficit financing can be regarded as a necessary evil which has to be tolerated, at least in the developing economies; only to the extent it can promote capital formation and economic development. This extent of tolerance is called the safe limit of deficit financing. This safe limit shows the amount of deficit financing that the economy can absorb and beyond which inflationary forces may be set in motion. Though it is not possible to quantify it, yet it is desirable to identify the factors that affect it.

Factors that affect deficit financing can be put under two categories: (a) factors related to demand for money and (b) factors related to supply of money. If the demand for money is low in the economy, the safe limit of deficit financing will be low. Then creation of new money or deficit financing must be kept at a low level otherwise evil consequences will follow. Reverse will be the case when demand for money is high. On the supply side of money, if due to some factors the supply of money or purchasing power with the public increases, other things being equal, it will have an inflationary tendency and the safe limit of deficit financing will be low. However, safe limit will be high in the opposite situation.

The concept of 'safe limit' of deficit financing can be reduced to the age old theory of demand and supply. The point at which demand for and supply of money are equal is the point of safe limit of,deficit financing. Unfortunately conditions in a developing country are not so simple. Various factors simultaneously exert contradictory effects on each side.

Factors Affecting Safe Limit

i. The safe limit of deficit financing depends on the supply elasticity of consumption goods in the country. Usually, the supply of consumption goods, specially food grains, cannot be increased to any extent for a long time due to many constraints in a developing economy. Under such circumstances even a little deficit financing would be inflationary and the safe limit of deficit financing will be very low.

ii. Safe limit of deficit financing also depends on the nature of government expenditure for which new money is created, i.e., the purpose of deficit financing. If the newly created money is used for unproductive purposes, the use of deficit financing will be inflationary and the safe limit of deficit financing will be lower than if the newly created money is to be used for industrial development or for intensive farming.

iii. If the foreign exchange reserves are increasing the scope of using deficit financing will increase because that way the country will be able to import more goods which will have deflationary effect.

iv. Time lag between the initial investment and the flow of final products also determines the safe limit of deficit financing. If this time lag is long, then inflation will set in from the very initial stage of investment and it will not be possible to control the rapidly rising prices.

v. Low safe limit of deficit financing is required if the economy consists of large speculative business community.

vi. If government is not in position to implement successfully its economic policies accompanying the policy of deficit financing, low safe limit of deficit financing is prescribed.

vii. If a country is already passing through inflationary phase, low deficit financing is advised.

viii. If the rate of growth of population is high then low deficit financing is good and vice versa.

Safe limit deficit financing also depends on a country's tax structure and the borrowing schemes through which the government can take away at least a portion of additional incomes thereby reducing the purchasing power with the public. But all this is not easy in a developing economy where there are rigidities in the tax system. There is large scale tax

evasion so that government is not able to take away any substantial part of additionalincomes. The country is, therefore, more prone to inflation and the safe limit of deficit financing is low.

In a developing economy, all the aforesaid factors exert their influence simultaneously. The effect of each factor may be favorable or unfavorable for the use of deficit financing and sometimes the effects of some factors may counter effect each other and, thus, be cancelled out. This safe limit of deficit financing will be different for different countries because conditions vary from country to country. The safe limit of deficit financing also depends on the measure of popular cooperation which the government gets and the willingness of the people to submit to austerity. Even if this limit is calculated, it will go on changing with every change in the economic conditions of the country. With efforts in the right direction this limit can be shifted upwards so that a larger amount of deficit financing\ can be resorted to by a government which is conducive to economic development and not inflation.

Summary

The popularity and success of government depends on whole public revenue. In the same way practical importance of study of nature and methods of public revenue for both private individuals and government has been increased. Taxes are those compulsory payments which are given by taxpayer to government in this hope that they will get direct benefit in lieu of this. According to Bastable, a tax is that compulsory contribution of money with individuals or group of individuals which is given to government tasks in lieu of service. Tax is contribution given to state by citizens living in the radius of a country due to residence or property etc, or by citizens that this contribution is given for common use only. It is a compulsory contribution so no person can deny from the payment of tax. Payment of tax is not done for the payment of any special service for individual by state and neither paid because the taxpayer got some special benefit by state. Tax is the cost given to government by each citizen which he pays in lieu of that part of cost of those public services which are used by him. Commercial revenues are those revenues which are received to government as costs of services or goods produced by them. Tax is a compulsory contribution which is paid by each such person on which it is imposed but the cost is paid by those individuals who buy goods or services produced by government. Tax doesn't give guarantee that benefit will be received in return of that payment and if happens so then what will the amount and nature of that, but costs are direct payments in lieu of goods and services and the amount of those payments depend on amount of services and goods purchased. The receipts which are kept in the category of administrative revenue, these are - fee, license, penalty, receipts in forfeitures and escheat etc. and special assessments. Special assessment is those compulsory contribution which are paid in proportion to special benefits provided and whose objective is to pay cost of special reform in property seized in view of public favor.Deficit financing as a method of resource mobilization has assumed an important place in public finance in recent times. It refers to the means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowing. In this unit, we have discussed the meaning of deficit financing, its role as an aid to financing economic development in various situations. Deficit financing in a developing country becomes inflationary and it has varied effects on economic development which have been highlighted in the unit. We have also examined the impact of deficit financing on price behavior in India during the plan period. It shows that, apart from other factors, there has been a close relationship between rate of growth of money supply resulting from deficit financing and rate of increase in prices. But to a certain reasonable extent, deficit financing has proved to be conducive to economic development, especially in countries with acute shortage of capital. The advantages of deficit financing in this context have been dealt with in the unit. As we have discussed in the unit deficit financing in developing economies can be regarded as a necessary evil which can be tolerated only to the extent it promotes capital formation and economic development. This extent of tolerance is known as safe limit of deficit financing. To minimize the inflationary effects of deficit financing during the process of development, certain measures have to be taken like proper channelizing of investment in areas with low capital output ratio, adoption of policies of physical control like rationing, import of only necessary capital equipment etc. In economies with low capital formation, deficit financing becomes a necessary and positive instrument if used with efficient and well executed plan of economic development.

Keywords

- Land tax —Tax to be paid for land
- Cost — Expenditure
- Legal — Related to law
- Surplus — In large quantity

SelfAssessment

1. Expenditures incurred to acquire fixed assets:

A. Revenue expenditures
B. Prepaid expenses
C. Capital expenditure
D. Outstanding expenses

2. Expenditures which provide benefit in future period are called:

A. Revenue expenditures
B. Capital expenditures
C. Outstanding expenditures
D. Current expenditures

3. An expenditure is a Capital expenditure because:

A. Amount is paid in lump sum
B. It is intended to benefit current period
C. Amount is large
D. It is intended to benefit in future period

4. Salaries and pensions paid by governments are called:

A. Capital expenditure
B. Development expenditure
C. Revenue expenditure
D. Plan expenditure

5. The major objectives of public expenditure are

A. Economic Growth
B. Maintenance of Defense
C. Social Welfare
D. All of the above

6. Which of the following is not non-plan expenditure?

A. Centralassistance for states and UT plans
B. Subsidies
C. Defense expenditure
D. Interest payment

7. Bharat Nirman, MGNREGA are examples of –

A. Non-Plan Expenditure

B. Plan Expenditure

C. Capital Expenditure

D. None of the above

8. Consider the following statements regarding plan and non-plan expenditure

   1. Plan expenditure is believed to be under the discretion of the central government, whereas non-plan expenditure is not part of discretion of the central government
   2. The distinction between plan and non-plan expenditures has been eliminated from Budget 2017-18 onwards.

   Which of the statements given above is/are correct?

A. 1 only

B. 2 only

C. Both 1 and 2

D. None of above

9. The fiscal deficit excluding the interest liabilities for a year is called as

A. Revenue deficit

B. Capital deficit

C. Budget deficit

D. Primary deficit

10. Generally, deficit financing can create inflation. However, it can be checked if _________.

A. Government expenditure increases the aggregate supply in the aggregate demand ratio.

B. All the investment is indicated as payment on national debt only.

C. Only the aggregate demand is increased.

D. All of the above

11. Deficit financing may lead to:

A. Poverty

B. Unemployment

C. Inflation

D. Deflation

12. Defict financing includes

A. Borrowing from the Central Bank

B. Issues of new currency by the Government

C. Withdrawal of past accumulated cash balance by the government

D. All the above

13. An annual statement of the estimated receipts and expenditure of the government over the fiscal year is known as
A. Budget
B. Income estimates
C. Account
D. Expenditure

14. Which objectives government attempts to obtain by Budget
A. To Promote Economic Development
B. Balanced Regional Development
C. Redistribution of Income and Wealth
D. All the above

15. Which of the following budget is suitable for developing economies?
A. Deficit Budget
B. Balanced Budget
C. Surplus Budget
D. None of these

16. According to Budget 2020-21, What is the highest source of Income to Union Government?
A. Borrowing and Other Liabilities
B. Corporation Tax
C. Income Tax
D. Union Excise Duties

Answers for SelfAssessment

1.	C	2.	B	3.	D	4.	C	5.	D
6.	A	7.	B	8.	C	9.	D	10.	D
11.	C	12.	D	13.	A	14.	D	15.	A
16.	A								

Review Questions

1. How government receipts are decided?
2. Describe briefly about different sources of public revenue.
3. Describe the characteristics of tax.
4. What do you understand by administrative revenue?
5. What is the difference between fee and cost?

Further Readings

- Public Finance By H.L . Bhatia, Vikas Publishing House
- Public Finance in Theory and Practice by S.K. Singh, S Chand & company
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Unit 11: Economics of Public Debt

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Summary

Keywords

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Objectives

After studying this unit, students will be able to:

- Explain the concept of public debt and its importance.
- Evaluate the causes and purpose of public debt.
- Understand the concept of on an economy.
- Evaluate the types of public debt burden
- Explore the concepts of fiscal balance, public debt, and fiscal deficit.
- Evaluate the fiscal balance, public debt, and fiscal deficit of a government.
- Explore the concepts of fiscal balance, public debt, and fiscal deficit.
- Evaluate the fiscal balance, public debt, and fiscal deficit of a government.

Introduction

Public debt is the total amount, including total liabilities, borrowed by the government to meet its development budget. It has to be paid from the Consolidated Fund of India. The term is also used to refer to overall liabilities of central and state governments, but the Union government clearly distinguishes its debt liabilities from the states. The central government broadly classifies its liabilities into two categories — debt contracted against the Consolidated Fund of India, and public account.Over the years, the Union government has followed a considered strategy to reduce its dependence on foreign loans in its overall loan mix. Internal debt constitutes over 93 per cent of the overall public debt. Internal loans that make up for the bulk of public debt are further divided into two broad categories – marketable and non-marketable debt.The sources of public debt are dated government securities (G-Secs), treasury bills, external assistance, and short-term

borrowings.According to the Reserve Bank of India Act, 1934, the RBI is both the banker and public debt manager for the government. The RBI handles all the money, remittances, foreign exchange and banking transactions. The Union government also deposits its cash balance with the RBI.The Union government's liabilities account for a little over 46 per cent of India's gross domestic product (GDP). However, if the public debt is calculated as general government liabilities, which also includes the liabilities of states, this goes up to 68 per cent of the country's GDP.

11.1 Public Debt

In the Indian context, public debt includes the total liabilities of the Union government that have to be paid from the Consolidated Fund of India. Sometimes, the term is also used to refer to the overall liabilities of the central and state governments. However, the Union government clearly distinguishes its debt liabilities from those of the states. It calls overall liabilities of both the Union government and states as General Government Debt (GGD) or Consolidated General Government Debt.Public debt is a source of collecting income by state collects from the citizens of country.

When government borrows, then it gives birth to public debt. Government can take debt from banks, business or organizations, business houses and the person. Government can take debt from inside the country and from outside the country, or from both the sides.According to**Dalton, "Public debt is a way of collecting income from public officers"**.

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

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

Causes of Increase in Public debt:

Government can borrow because it can possible that local income was not enough for their expenditure due to incidental expenditure government could have to borrow because it is not possible to increase the tax income at that point. Government can borrow finance arrangement of capital expenditure because current revenue will not be enough to fulfill the target.Government can borrow because it can possible that local income was not enough for their expenditure due to incidental expenditure government could have to borrow because it is not possible to increase the tax income at that point. Government can borrow finance arrangement of capital expenditure because current revenue will not be enough to fulfill the target.At the time of depression, when private demand is not enough then government borrow, the extra savings of people which is not in use and spends it to increase the effective demand and by this gives birth to the extra income and employment in the society. These extra amounts from government taxes are supplementary to each other.

i. The most important cause of increase in public debt is war of war-preparedness. Nations attach a great importance to their territorial integrity and they consider no sacrifice too much to defend their country. Every war, therefore, leaves the country under greater debt.

ii. The increase is also due to fairly frequent budget deficits or current account. The deficits arise from the necessity of maintaining full economic activity in the economies which may have ceased to expand.

iii. Increase in public debt is also due to the undertaking of welfare schemes by governments in modern times.

iv. In Public utilities, where there is no convenient profit check, no right control over cost can be maintained and there are more losses than gains. They also add to the weight of public debt.

v. In recent years, urge for economic growth has induced the underdeveloped countries to contract debts both internally and externally. The volume of public debt has consequently swollen.

Purposes of Public Debt:

(i) Bridging Gap between Revenues and Expenditure:

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

(ii) Financing Public Works Programme:

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

(iii) Curbing Inflation:

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

(iv) Financing Economic Development:

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

(v) Financing the Public Sector:

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

(vi) War Finance:

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

11.2 Classification of Public Debt

Economists have divided debt on the bases of use, target, time limit and terms of payment. The different types of public debt are following –

i. **Internal and external debt:**Internal debt refers to the government loans floated in the capital markets within the country. Such debt is subscribed by individuals and institutions of the country.If a public loan is floated in the foreign capital markets, i.e., outside the country, by the government from foreign nationals, foreign governments, international financial institutions, it is called external debt.

ii. **Short term and long-term loans:**Most government debt is held in short term interest-bearing securities, such as Treasury Bills or Ways and Means Advances (WMA). Maturity period of Treasury bill is usually 90 days.Government borrows money for such period from the central

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

iii. **Funded and unfunded debt**Funded debt is the loan repayable after a long period of time, usually more than a year. Funded debt is long term debt for the repayment of such debt government maintains a separate fund;floating or unfunded loans are those which are repayable within a short period, usually less than a year.

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

v. **Redeemable and irredeemable debt:Redeemable public** debt refers to that debt which the government promises to pay off at some future date. After the maturity period, the government pays the amount to the lenders. In the case of **irredeemable debt,** government does not make any promise about the payment of the principal amount, although interest is paid regularly to the lenders and the society will have to face the consequence of burden of perpetual debt.

vi. **Productive and unproductive debt/deadweight debt:Public debt is productive** when it is used in income-earning enterprises. **Productive debt** refers to that loan which is raised by the government for increasing the productive power of the economy. **Publicis unproductive debt** when it is spent on purposes which do not yield any income to the government, e.g., refugee rehabilitation or famine relief work.

11.3 Methods of Debt Redemption

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

The following are some of the methods adopted:

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

(ii) Purchase of Government Bonds: The government may buy its own stock in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the conditions are favorable.

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

(iv) Conversion: Conversion of Debts means change of old debts into new debts.According to this theory, the payment of debt is not done in reality, but only the form of debt is changed. The, process of conversion of debts means to change high interest rate debt into low interest rate debt. It is possible that when government has taken debt, at that time the rate of interest is very high. But, when the rate of interest is lowered then government changes old debts into new debts so that the burden of taxes on government must be minimum. Then, low interest rate on public debt means low unequal distribution of income.

(v) Sinking Fund: A fund is created for the repayment of every loan by setting aside a certain amount every year out of the current revenue. The sum to be set aside is so calculated that over a

certain period, the total sum accumulated, together with the interest thereon, is enough to pay off the loan.

(vi). Capital Levy: Capital levy is an indicator of very heavy taxes on property and wealth.It is imposed only once on properties of capital of more from a definite value. Capital levy has been instructed to be imposed just after war so that wartime proportional debts can be paid. They are imposed serial wise on single property.

11.4 Advantages of Public Debt

1. Increase in Origin in Money: - Public debts encourage industries in country, production increases, national income increases by which the life standard of citizens of the country increases.

2. Suitable Repayment Balance: - Business and repayment balance become in favor of taking debt and the problem of foreign investment solves.

3. Economic Development: -Undeveloped countries become capable to do their economic development by public debts.

4. Control on Natural Calamities:-Government takes the help of public debts to control natural calamities.

5. Successful War Conduction: - Wars have become very expensive today. Therefore, taking debt is essential for conduction of war.

6. Harmony: - Equal and suitable distribution debts take place by which harmony and cooperation increase.

7. Secure Investment: - Public debts are secure sources of investment and every individual considers it profitable to invest money in it.

8. Public Works: - With the help of public debts public works and plans like building of roads, water-electricity, canals, bridges etc. can be implemented by government.

9. Non-economic Benefits: - Friendly relations develop between countries taking and giving debts from public debts.

11.5 Disadvantages of Public Debt

1. Misuse of Resources of Country: - Such conditions must be laid while taking public debts that the industries on which debt is used, that must have partial control on country debtor.Misuse of sources of country takes place in favor and a big part of money goes to foreign countries as interest.

2. Fear of Government's Bankruptcy: - If government receives debt easily then there is a fear that whether government may receive such a large amount of debt whose repayment may become impossible.

3. Nature of Extravagancy: - When public debt begins to receive easily then there is a fear of its extravagancy.

4. Political Burden: - Debt-giver country intervenes in the policies of debtor country for the defense of capital of their citizens and debtor country loses its political freedom.

5. Emergency: - There is a fear of emergency like political controversy and war from public debts.

6. Burden on Public: - When debts are taken for non-productive works then the burden of tax is increased on public for its repayment.

7. Economic Backwardness: - Foreign debt makes the economy of the country weak and country begins to depend on other for their economic development.

11.6 Burden of Public debt

Real burden of public debt refers to the distribution of tax burden and public security among the people. It is the hardship sacrifice and loss of economic welfare shouldered by the taxpayers on accountof increased taxation imposed for repayment of public debt.According to Prof. Taylor, "the

nature and severity of the burden have, however, frequently been improperly understood, largely because of the temptation to think of public debt in terms of private debt and to apply identical standards to both". Further, Taylor points out, "the liability of the debtor to the creditor is matched by the asset value of the creditors' claim.Public debt constitutes the financial obligation or liabilities of the government. Debt burden is measured as ratio of outstanding debt to GNP, Debt= Outstanding Debt/ GNP. Burden of Public Debt consists of the sacrifice that tax payers have to make for financial repayment of principle and interest.Increases inequality: Purchasing power transfers from the poor to the rich. Adversely affects the ability and desire to work, save and invest. Transfer purchasing power from the younger to the older generation. Burden of unproductive debt: not self-liquidating to reduces private investment.

Direct money burden: The size of the burden depends on the rate of interest and the amount of the loan incurred.

Direct Real burden: It is measured in terms of the loss of welfare suffered by the people of the debtor country due to repayment of debt.

Indirect money burden and Indirect Real burden: This is measured in terms of the effect on the production and allocation of resources.

Burden of unproductive foreign debt: The magnitude depends upon whether the debt is incurred for productive or unproductive purposes. If incurred for unproductive purposes, it will create a greater burden on the community. Foreign currency burden increases.

Burden of Public debt: The Keynesian approach disagreed with the classical burden thesis.The Keynesian approach strongly advocates that public borrowing for the purpose of generating effective demand will not generate any burden. It will help to activate idle savings in the private sector and generate income and employment. Different Views on Burden of Public debt…………

1. Traditional Views: The traditional view is that public debt, as in the case of private debt, imposes a real burden on the community. The classical view maintains that if government expenditure is financed through taxation, the current generation bears the burden. But if government spending is financed through public borrowing, The present generation gets relieved of the cost and the burden is shifted to the future generation.The future generation suffers when the present generation reduces its saving in-order to meet the debt finance and leave a smaller amount of capital resources for the future. This will reduce the productive capacity of the future generation and, accordingly, they will stand to lose. If savings are reduced, the future generation suffers on account of reduced inherited capital.According to the classists; public debt necessitates a transfer of resources from the private sector to the government in the form of additional taxation. Secondly, the classists held the view that public debt is a more-costly method of financing public expenditure than taxation. Thirdly, as stated earlier, public debt tends to transfer the burden of a particular outlay to future generations.Excess borrowing and mounting public debt of the government may undermine the creditworthiness of the government. Hence, traditional economists strongly argue that public debt should be kept to a minimum and should be redeemed as early as possible.

2. Modern Views: Economists like J.M. Keynes, Harris, Buchanan, Musgrave, and Modigliani are the chief supporters of the modern version of debt burden. The modem theory of public debt is put as “the new orthodoxy” by Prof. Buchanan. The worldwide depression of 1930’s and the emergence of Keynesian economics paved the way for the development of the new theory of public debt.Modern theory firmly advocates that large volume of public debt is a national asset rather than a liability. This theory recognizes that persistent deficit spending is a tonic to the economic development of nations.During periods of depression, the technique of deficit budget financed through borrowing can be fruitfully utilized to improve employment situation and generating effective demand and thereby raising the level of economic activity.The modern theories strongly believe that public expenditure is not at all wasteful. Public expenditure can be made productive and an important means to increase employment in the economy. Prof. A.H. Hansen, the chief advocate of modern theory, states that public debt is an essential means of increasing employment.Prof. James Buchanan in his book “Public principles of public debt”, states that debt burden implies a compulsory sacrifice. Buchanan argues that when government debt is serviced there is a burden in the form of claim on the taxpayer’s income. When the debt is repaid; the future generation has to pay tax. This will reduce either their consumption or saving.The existence of large debt is neither a blessing nor an evil. It produces both favorable and adverse effect on the economy.Public debt should be treated as an important instrument of fiscal policy.

3. Direct Money Burden: Repayment of public debt involves payment of interest and the principle by the government. Government will have to raise the necessary resources by way of taxation. The

direct money burden of public debt consists of the tax burden imposed on the public and it is equal to the sum of money payments for interest and the principle components.Dalton observes, "thus all transactions connected with an internal debt resolve themselves into a series of transfers of wealth within the community. It follows that there can never be any direct money burden or direct money benefit of an internal debt". In the case of external debt, money payments by the debtor nations to the creditors constitute a clear direct money burden.

4. Direct Real Burden: Real burden of public debt refers to the distribution of tax burden and public securities among the people. It is the hardship sacrifice and loss of economic welfare shouldered by the taxpayers on account of increased taxation imposed for repayment of public debt. People hold public debt and they also pay taxes towards the cost of debt service.If the proportion of taxation paid by the rich towards the cost of debt service is smaller than the proportion of public securities held by them, If the proportion of taxation paid by the poor and middle-income group towards the cost of debt service is larger than the proportion of public securities held by them, there is a direct real burden from public debt.Suppose government bonds and securities are held by the working classes, while the taxation towards the cost of debt service is paid by the rich only, then public debt will help to reduce the inequalities of income in the community. In such a circumstances there is no direct burden; instead there is a direct real benefit to the community.

5. Indirect Money Burden and Real Burden: It is argued that heavy taxation to meet debt service charges may reduce taxpayers ability and willingness to work an save. In turn this will check production. Moreover, heavy debt charges may also force the government to curtail and economies some desirable social expenditure, which may promote economic development.If it is possible to neutralize the adverse effect of taxation resulting from the problem of debt service by some favorable effect of public expenditure, the indirect burden of public debt can be cancelled out. Dalton observes that practically this is not possible. In the case of external debt, indirect money and real burden arise from its bad effect on production because of additional taxation to pay for debt charges.

6. Burden of Internal Debt: Internal debt involves no significant burden on the community as a whole. The payment of interest and increased taxation to meet the servicing and principle component of debt involves a transfer of purchasing power from one section of the community to another. the people owe themselves the debt and the question of the burden need not be treated as raising any major issue.If the creditors (bond holders) and the taxpayers belong to different income strata's, there may occur a change in the distribution of income among different sections of the community. But Dalton observes that while estimating the burden of public debt, we should consider the purpose for which the loan is raised.

Suppose if the public debt is floated specifically for raising investment funds for a productive activity, the profit generated from it can be used to pay off the debt, there is no burden as such.where as a debt raised for financing a war may be a dead weight and it will have to be paid out of increased taxation. burden imposed by taxation upon the taxpayers.The repayment process of public debt should be managed in such a way that, it may not exert any adverse effect on production and distribution. So it maybe concluded that if not planned and utilized scientifically, internal debt can practically impose a burden on the community, even though theoretically it is not correct.

7. Burden of External Debt: External debts differ from internal debt in the case of burden of debt, both share some similar characteristics. For the payment of internal and external debt, imposition of additional taxation is imperative.According to Prof. Dalton "as a general rule, an internal debt is likely to involve an additional and indirect burden on a community; an external debt does the same".External debt involves greater burden than internal debt. In the case of internal debt there is no resource transfer to outside the country. The repayment of principle and interest charges doesn't lead to the transfer of resources from the country to another country.It merely results in the transfer of income from one section of the community to another section.

Moreover, the taxpayers and receivers of interest constitute the same class of people. Whereas external debt specifically involves resource transfer to foreign nation.In case of external debt, interest charges and repayment of principle, resources are transferred to the creditors abroad. Therefore, payment of interest on foreign debt reduces the net income of the debtor country.Internal debt carries with it no such evil effect. External debt involves a greater burden than internal debt.

11.7 Debt Management and Redemption

The burden of public debt refers to the sacrifice imposed on the taxpayers with the increase in taxation to serve the debt, the adverse effects on the economy as a whole like reduction in capacity to consume, reduction in production of high quality goods and services by private sector, increase in price level, increase in inequality of income, inter-generation transfer of burden, outflow of national assets in case of foreign debt, etc.It is concerned with forms of public debt in terms of which new bonds are sold, maturing debts are redeemed or refunded, proportion in which different types of public debt should be issued, the pattern of maturities of debts & their ownership,In India, public debt management is coordinated through the RBI.The burden is interpreted as financial or direct and real or indirect. Increase in tax levels transfers some income of people to the government, and the loss in income of people is a financial or direct burden. The other adverse effects on the economy, as mentioned above, are the real or indirect burden.

Debt Management

Debt management is concerned with the determination of the structural characteristics of public debt. They are the size, types, proportions, terms, maturities, ownership patterns of public debt and the methods of its redemption. Debt management should help to achieve the economic objectives and should not have adverse effects on the economy.The objective of Public Debt Management means that there must not be any adverseaffect on the economic condition of the country on debt and the methods of its return by the government. Taking debt and the method of its return by the government must be such that there must be less effect on the economy, by inflation and deflationary effects and the government get money for its requirements. all those rules and regulations must be included in public debt management. If the government reduces its public debt, then it can cause inflationary or deflationary effects. If the government gets the return of public debt by deficit financing or by last savings, then its effects are inflationary. If taxes are increased to repay the debts of banks, then their effects are deflationary.Public debt management contributes in such a way that such methods must be adopted which do not encourage the condition of inflation or deflation.During the days of inflation, government increase the amount of their debt and increasing the rate of interest. Budget surpluses collected as taxes can be used for debt return during the days of deflation and additional taxes can be imposed during the days of inflation for economic stability.

Definition and Significance

Public Debt Management is related to some such decisions in regard of debt that what must be the structure of public debt issued, what must be the conditions for selling new bonds, how to return matured debts, what must be the ratio of issues different types of public debts, what must be the structure of maturation of debts and ownerships of debts etc.

Framework for Public debt management

Debt Management objectives: Ensure payments obligation and financial needs are met at lowest possible cost.

Transparency and Accountability: Objectives of the Debt management should be clearly defined and publicly disclosed.

Institutional Framework: Legal framework which clarify the authority to borrow and issue new debt.

Debt security and Risk Management: Effective debt strategy should be implemented and risk in portfolio should be mitigated.

Efficient Market for Government Securities: To ensure the policies and operations are consistent with an efficient market for government securities.

Principles of Public Debt Management

1. The Interest Cost of Servicing Public Debts must be Minimized: According to this theory, government must be in such condition that it can take public debt and can return it. But, all this work must be on minimum interest – cost. This must be an important objective of public debt management because government has to either impose additional taxes for the payment of interest or has to increase current rate of taxes.If the cost on debts is minimum additional taxes in lesser

quantity otherwise it happens reverse and if taxes are imposed in less quantity then their adverse affects are also caused less on different economic motivations of desire to work save more.The interest-cost of public debts is kept minimum in that condition whereas central bank of the country can be motivated to reduce the rate of interest through their monetary operations. When the rates of interest are low in the market then the government becomes capable to issue their bond at low rates of interest.The burden related to inflation in the policy of interest-rate is possible and it occurs especially when the economy is already working in the directions of whole employment. Low interest debt policy, which creates burden related to inflation and economic instability, cannot be considered desirable

2. Satisfaction of the Needs of Investors: The management of government debts must be in such a way that they can fulfill the desires and needs of investors.If the needs of investors cannot be fulfilled, then difficulties occur in managing public debt.When the needs of investors are not satisfied through the management of public debt, then it is possible that due to the sale of securities or debt-letters, the mismanagement will happen in security markets and the bond holder will begin to sell their debt-letters and begin to receive cash.If the interest of investors is kept on priority then the cost of public debt for the government will increase.But, if debts are paid by issuing new currency then it will generate inflation and if its payment is paid by imposing additional tax, then it will generate deflation.

3. Funding of Short-term Debt into Long-term: Debt: Management of public debts must be in such a way that it must be more helpful in determining short term debts in the form of long-term debts.Funding operations must be done in such a way that it does not cause any harm to economic stability. Benefits which can be counted for this policy can be considered not much, because private short-term debt is present in the country and it make unsolved all monetary management.The rate of long-term interest increases with the increase in demand of long-term funds,therefore, the budget-expenditure of the future increases because of it. The rate of short-term interest decreases due to the reduction in demand of short-term funds. Due to this unsuitable increase in the rates of long-term interest, the amount of private investment and interest decreases, leads to recession and unemployment.It is necessary that funding operations must be done in such a way that there must not be inappropriate increment in the rate of long-term interest, which causes adverseaffect on amount and rate of non-governmental investment. So non-government investment must be reduced then government has to determine short-term debt into long-term debt. If the rates of short-term debt are low then it can encourage the short term capital that must flow in such countries where the rates of short term interest are high. But, it is not in country favor. Therefore, the funding of short-term debts into long term debts must be in such a way that it can fulfill the needs of investors

4. Public Debt Policy must be Co-ordinate with Fiscal and Monetary Policy: Co-ordination of Public debt with monetary and fiscal laws is necessary for maintains of economic stability and economical development. For example, if government forces central bank to impose low rate of interest policy,Cost of interest payment on public debt can be reduced, then it can create inflation and economic instability can occur.By maintaining suitable co-ordination between public debt and monetary fund policies, such economic instability can be avoided.The conduction of public debt policy with fiscal and monetary fund must be in such a way that these three policies must contribute for economic stability and economic progress.

5. Maturity Distribution and Kinds of Debt Holders: If a big ratio of total debt is in the form of short-term debts and a big portion of total debt is kept by banks then a big amount of debt remains in cash form. In that condition, the burden related to inflation can occur whereas to impose the policy against inflation is desirable, high liquidity of debts make difficult to control inflation.If debts are purchases even they are not much affective against inflation. The usage of high liquidity debt kept by persons can be used as a form of anti-deflationary.By increasing the costs of such debentures and encourage people to transform debt into cash. In this way, it may not be possible to achieve all objectives of arrangement of public debt.

11.8 Redemption of Public Debt

Redemption of debt means – return payment of debt. Excluding permanent investment in self dependant industries, all public debts must be returned as possible. Regarding control and the regular transfer of debt provision of their payment must be done when they are issued. Government searches opportunities to postpone the payment of their debts.It must be done that being confident about the regular payment of debts; each possible caution must be treated.

Advantages of Debt Redemption

1. It avoids bankruptcy of government.
2. It discourages extra useless expenditures of government.
3. It encourages faith of debters in government.
4. To issue debt by the government becomes easy in future.
5. It reduces the cost of debt-management.
6. If debt is paid early then it saves future payment from the burden of tax.
7. When the payment of public debts is done then these sources are transferred towards private investment. In that condition, an environment creates for private investment.
8. Reimbursement may work as the deflationary measure.

Methods of Repayment

1. Debt Repudiation: Debt Repudiation means to deny the payment of debt by government.In 1917 it had done by Soviet govt. whereas he denied to-pay Czarian debts. In this way, in some states of United States of America, before domestic war of 1861-1865, same thing had done who denied to pay debts from English citizens.When government denies to pay debt then the faith of people and banks in government shattersgovernment has to face difficulty in issuing new debentures to government in near future.This step of government is considered very inconsistent and discriminative because this affects only that group who buys debentures debt consistent and it leaves other groups ineffective.It all agreements related to refunding are denied then many serious problems will generate for that country.Foreign governments take the steps like economic security and army operation for receiving their debts. It is not a wise thing that debt repudiation policy has to be followed by government because it is considered an immoral and dishonest step.

2. Refunding: If government issues new bonds for the payment of its current debts then it is called refunding. Refunding is a name of that process by which new bonds are changed in place of maturing bonds. Sometimes, payment is done before maturing date of bonds. It happens when the rate of interest is low or government wants to change the maturity date of remaining debts.The meaning of refunding is considered so that the needs related to maturity of debt can be fulfilled.Generally short-term debts which are spent for the fulfillment of current expenditure which are paid from the money received by sale of long term debts in public latter so that the place of short-term debts can be taken from long-term debts.

3. Conversion of Debts: Conversion of Debts means change of old debts into new debts. According to this theory, the payment of debt is not done in reality, but only the form of debt is changed. The, process of conversion of debts means to change high interest rate debt into low interest rate debt. It is possible that when government has taken debt, at that time the rate of interest is very high.when the rate of interest is lowered then government changes old debts into new debts so that the burden of taxes on government must be minimum. Then, low interest rate on public debt means low unequal distribution of income.There is a need of management of public debt. Dalton said in this regard that conversion of debts do not reduce burden of debt, because by the reduction in rate of interest, the ability to pay tax of bond holders decreases which becomes the reason in reduction of government revenue and by the reduction in government revenue, the government's capacity to pay debt decreases.

Repayment of External Debt

Sinking of foreign debts can be only when foreign currency is earned for their repayment and foreign currency can be earned only when export surpluses are created in comparison to import. If foreign debts are invested in such trade which increase the completion of substances of export then foreign debts can be repaid easily. If foreign debt are used for unproductive works then export surpluses can only be created when there must be reduction in domestic consumption. In this condition, people bear the burden of foreign debt.

Importance of Public Debt Management

- Helps to reduce the cost of borrowing.

- Helps to develop the domestic financial market
- Facilitates economic development
- Make countries less vulnerable to financial risks.

Public Debt Management Policy of GOI

1. Greater reliance on domestic borrowing over external debt.
2. Preference for market borrowing over instruments carrying administered interest rate
3. Consolidation of the debt portfolio
4. Development of deep and wide market for government securities to improve liquidity in the secondary market.

Management of Public Debt

Institutions responsible for management of public debt

- Reserve Bank of India
- Ministry of Finance, Office of Aid and Accounts Division
- Ministry and Finance, Budget Division and Reserve Bank of India.

11.9 Fiscal Balance and Public Debt

Fiscal balance, sometimes also referred to as government budget balance it is calculated as the difference between a government's revenues (taxes and proceeds from asset sales) and its expenditures. It is often expressed as a ratio of Gross Domestic Product (GDP). If the balance is positive, the government has a surplus (it spends less than it receives). If the balance is negative, the government has a deficit (it spends more than it receives).Fiscal balance as a percentage of GDP is used as an instrument to measure a government's ability to meet its financing needs and to ensure good management of public finances.

The fiscal balance is the difference between general government revenues and expenditures showing how much in a given year government spending is financed by the revenues collected. A surplus occurs if, in a given year, government collects more revenues that it spends. Conversely, when the government spends more than it receives in revenues, there is a deficit. Consecutive deficits will lead to increasing debt levels and consequently to higher interest payments.A country's fiscal balance is measured by its government's revenue vis-a-vis its expenditure in a given financial year.

Fiscal deficit, the condition when the expenditure of the government exceeds its revenue in a year, is the difference between the two. Fiscal deficit is calculated both in absolute terms and as a percentage of the country's gross domestic product (GDP).The fiscal deficit of a country is calculated as a percentage of its GDP or simply as the total money spent by the government in excess of its income. In either case, the income figure includes only taxes and other revenues and excludes money borrowed to make up the shortfall.

Fiscal balance and public debt:A government experiences a fiscal deficit when it spends more money than it takes in from taxes and other revenues, excluding debt, over some timeperiod.This gap between income and spending is subsequently closed by government borrowing, increasing the national debt.Surpluses, Deficits, and Debt, when revenues exceed expenditures, governments enjoy a budget surplus. If revenues are less than expenditures, governments are faced with a budget deficit. They then have to borrow money to meet expenditures and incur debt.

Budget Surpluses and Deficits: Reducing tax revenues and increasing federal government spending throws the budget out of balance.Creates a budget deficit through deficit spending.

Deficit spending is the use of borrowed funds to finance government expenditures that exceed tax revenues.

Budget deficit is the amount by which government spending exceeds government revenue in a given time period.If the government spends less than its tax revenues, a budget surplus is created.

Budget Surplus is an excess of government revenues over government expenditures in a given time period.

Discretionary vs. Automatic Spending: At the beginning of each year, government put a budget blueprint for next fiscal year.Fiscal Year (FY) is the twelve-month period used for accounting purposes – begins on April 1 for the federal government.To a large extent, most current revenues and expenditures are a result of decisions made in prior years.

Discretionary fiscal spending are those elements of the federal budget not determined by past legislative or executive commitments.If most of the budget is uncontrollable, fiscal restraint or fiscal stimulus are less effective.

Fiscal restraint – tax hikes or spending cuts intended to reduce (shift) aggregate demand.

Fiscal stimulus – tax cuts or spending hikes intended to increase (shift) aggregate demand.

Automatic Transfers: Most of the uncontrollable line items in the federal budget *change* with economic conditions.Examples include unemployment compensation and other income transfers.*Income transfers* are payments to individuals for which no current goods or services are exchanged, such as social security, welfare, unemployment benefits.Acting as automatic stabilizers, transfer payments increase during recessions.*Automatic stabilizers* are federal expenditure or revenue items that automatically respond counter-cyclically to changes in national income.Automatic stabilizers also exist on the revenue side of the budget.Income taxes move up and down with the value of spending and output.Being progressive, personal taxes siphon off increasing proportions of purchasing power as incomes rise.

Cyclical Deficits: The size of the federal deficit is sensitive to expansion and contraction of the macro economy.The *cyclical deficit* is that portion of the budget deficit attributable to unemployment or inflation.The cyclical deficit widens when GDP growth slows or inflation decreases.The cyclical deficit shrinks when GDP growth accelerates or inflation increases.

Structural Deficits: To isolate effects of fiscal policy, the deficit is broken down into cyclical and structural components.

Total budget deficit = Cyclical deficit + Structural deficit

The *structural deficit* is federal revenues at full-employment minus expenditures at full employment under prevailing fiscal policy.

Fiscal policy is categorized as follows:

Fiscal stimulus is measured by the increase in the structural deficit (or shrinkage in the structural surplus).Fiscal restraint is gauged by the decrease in the structural deficit (or increase in the structural surplus).

Crowding Out: If government borrows funds to finance deficits, the availability of funds for private sector spending may be reduced.*Crowding-out* is the reduction in private-sector borrowing (and spending) caused by increased government borrowing.Chances of crowding-out rise when the economy gets closer to full employment.

Crowding In: There are four potential uses for a budget surplus:

- Cut taxes.
- Increase income transfers.
- Spend it on goods and services.
- Pay off old debt (“save it”).

The first two options effectively wipe out the surplus but give consumers more disposable income and change the public-private mix of output.The third option, spending the surplus, wipes out the surplus and enlarges the relative size of government.A reduction in debt takes pressure off market interest rates.***Crowding in*** is the increase in private sector borrowing (and spending) caused by decreased government borrowing.As interest rates drop, consumers are willing and able to purchase more big-ticket items like cars, appliances, and houses.

Cyclical Sensitivity: Crowding in depends on the state of the economy.In a recession, a decline in interest rates is not likely to stimulate much spending if consumer and investor confidence is low.**The Accumulation of Debt**: The United States has accumulated a large national debt.The ***national debt*** is the accumulated debt of the federal government.

Debt Creation: When the Treasury borrows funds it issues treasury bonds.***Treasury bonds*** are promissory notes (IOUs) issued by the U.S. Treasury.The national debt is a stock of IOUs created by annual deficit flows.Whenever there is a budget deficit, the national debt increases.

Liabilities = Assets: National debt represents a liability as well as an asset in the form ofbonds.**Liability** – An obligation to make future payment; debt.**Asset** – Anything having exchange value in the marketplace; wealth.The national debt creates as much wealth (for bondholders) as liabilities (for the U.S. Treasury).The national debt creates as much wealth (for bondholders) as liabilities (for the state Treasury).

Refinancing: The debt has historically been refinanced by issuing new bonds to replace old bonds that have become due.*Refinancing* is the issuance of new debt in payment of debt issued earlier.

Debt Service: *Debt service* is the interest required to be paid each year on outstanding debt.Interest payments restrict the government's ability to balance the budget or fund other public sector activities.

Opportunity Costs: Opportunity costs are incurred only when real resources (factors of production) are used.The process of debt servicing uses few resourcesand has negligible opportunity costs.The true burden of the debt is the opportunity costs of the activities financed by the debt.

The Real Trade-Offs: Deficit financing tends to change the mix of output in the direction of more public-sector goods.The burden of the debt is the opportunity costs (crowding out) of deficit-financed government activity.The primary burden of the debt is incurred when the debt-financed activity takes place.The real burden of the debt cannot be passed on to future generations.

Economic Growth: Future generations will bear some of the debt burden if debt-financed government spending crowds out private investment.The debate about the burden of the debt is an argument over the optimal mix of output.External Debt: External debt presents some special opportunities and problems.

No Crowding Out: External financing allows us to get more public-sector goods without cutting back on private-sector production.As long as foreigners are willing to hold bonds, external financing imposes no real cost.

Repayment: Foreigners may not be willing to hold bonds forever.External debt must be paid with exports of real goods and services.

Deficit Ceilings: ***Deficit ceilings***are an explicit, legislated limitation on the size of the budget deficit.Deficit Ceilings: A debt ceiling is another mechanism for curbing the national debt.A debt ceiling is an explicit, legislated limit on the amount of outstanding national debt.Like deficit ceilings, debt ceilings are just political mechanisms for forging political compromises on how to best use budget surpluses or deficits.

Summary

Public debt can be used productively for capital formation, increase in national income which eventually leads to increased revenue generation, employment generation and overall growth of the economy.The increasing amount of public debt and the corresponding rise in net interest payments would be something to worry,because as the burden of interest payments increase, the government will have less money to spend on other necessary expenditure thus cutting costs on required investments

Keywords

Liability – An obligation to make future payment; debt.

Asset – Anything having exchange value in the marketplace

Direct money burden: The size of the burden depends on the rate of interest and the amount of the loan incurred.

Debt Creation: When the Treasury borrows funds it issues treasury bonds.

Deficit Ceilings:A debt ceiling is another mechanism for curbing the national debt.

SelfAssessment

1. Public Debt means
A. Borrowing by a Government from abroad and does not include borrowing from within the country
B. Borrowing by a Government from within the country or from abroad, from private individuals or association of individuals or from banking and non-banking institutions
C. Borrowing by general public, private individuals or association of individuals from the Government which they need to repay to Government under the prescribed terms and conditions
D. Borrowing by General Public in the form of loans or advances from the Government, Local Bodies, Government owned financial institutions

2. Which of the following factors contribute to public debt of a country?
A. To undertake public welfare
B. Urge for economic growth
C. Inefficiencies of public organizations and corruption
D. All of the above

3. A one-time tax on all wealth holders with the goal of retiring public debt is generally referred to as
A. Indirect Tax
B. Capital Levy
C. Orthodox Tax
D. Socialist Tax

4. Which of the following are the causes of public debt of a country?
A. War or war-preparedness, including nuclear programmes
B. To cover the budget deficits on current account
C. To undertake public welfare schemes
D. All of the above

5. The debts which the government promises to pay off at a specified date are called
A. Irredeemable debts
B. Funded debts
C. Redeemable debts
D. Unfunded debts

6. Unfunded debts are also known as

A. Funded debts
B. Floating debts
C. Irredeemable debts
D. None

7. Debt obligations of the government that have maturities of one year or less is normally called
A. Commercial Papers
B. Commercial Deposits
C. Treasury Bills
D. Certificate of Deposits

8. Which of the following could be a purpose for raising public loans?
A. Financing economic development esp. in under-developed countries.
B. Financing the public sector for expanding and strengthening the public enterprises.
C. War, arms and ammunition financing
D. All of the above

9. Public Debt Management refers to
A. Terms of new bonds
B. Proportion of different components of public debt
C. Maturity
D. All the above

10. Redemption of public debt means:
A. Repayment of debt
B. Repayment of FDI
C. Additional borrowing
D. Deficit financing

11. Which one of the following is not a method for redeeming public debt?
A. Sinking fund
B. Capital levy
C. Terminal annuities
D. Grants in aid

12. When the government raises revenue by borrowing from within the country is known as
A. Voluntary debt
B. Compulsory Debt
C. Internal debt
D. External debt

13. Fiscal deficit in the union budget is equal to
A. Net increase in internal and external borrowings
B. The difference between current expenditure and current revenue
C. The sum of monetized deficit and budgetary deficit
D. Net increase in the union government's borrowing from the Reserve Bank of India

14. Fiscal Responsibility and Budget Management Act (FRBMA) was passed to keep check on
A. Fiscal deficit only
B. Revenue deficit only
C. Both fiscal deficit and revenue deficit
D. Neither fiscal deficit nor revenue deficit

15. The fiscal deficit is the difference between the government's total expenditure and its total receiptsexcluding ______
A. Interest
B. Borrowings
C. Taxes
D. Spending

16. The primary deficit in a government budget will be zero, when _______
A. Revenue deficit is zero
B. Net interest payments are zero
C. Fiscal deficit is zero
D. Fiscal deficit is equal to interest payment

Answers for SelfAssessment

1.	B	2.	D	3.	C	4.	D	5.	C
6.	B	7.	C	8.	D	9.	D	10.	A
11.	D	12.	A	13.	A	14.	C	15.	B
16.	D								

Review Questions

1. What is public debt? What are the reasons for incurring public debt?
2. What are the types of public debt?
3. What are the methods of redemption of public debt?
4. What do you mean by a budget? Explain the objectives of budget.
5. Explain different concepts of budget deficits? What are the implications different deficits?
6. Distinguish between sound finance and functional finance.
7. How far is deficit financing beneficial for an economy?

8. What do you mean by fiscal policy? Explain the major fiscal tools used to check depression and boom.
9. Explain the different stages of central government budget in India

Further Readings

- Public Finance By H.L . Bhatia, Vikas Publishing House
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Unit 12: Public Debt in India

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Objectives

After studying this unit, students will be able to:

- Understand the concept of Composition of Government Debt
- Evaluate the different Composition of Government Debt
- Explain the types of public expenditure for welfare.
- Evaluate the causes of public expenditure for welfare

Introduction

Public debt occupies a centre stage in public financial management. Public debt is the total financial obligations incurred by the entire public sector of a nation, including guarantees and implicit debt. Public debt would include obligations evidenced by a legal instrument issued by the Central, State, Municipal, or Local Government or Enterprises owned or controlled by the Government; and other entities considered public or quasi public. The public debt portfolio is often the largest financial portfolio in the country and can have a far-reaching impact on financial stability. Most governments have large financial needs as they seek to grow their economies and expand social services in their countries. A country is required to borrow both for consumption as well as investment to promote growth which would help in improving the living standards of its population. In theory, public borrowing is an effective tool for generating economic growth by expanding the production and consumption choices of current and future generations and fairly distributing the debt burden between current and future generations of taxpayers. Without public borrowing, Governments may have to reduce the number and amount of productive investments or impose high taxes on current taxpayers or reduce current spending on services to its citizens or choose a mix of these choices. 1.2 Public Debt Management Public debt, while giving an opportunity to the country to fuel economic growth and ensure inter–generational equity, also places onus on the country for being responsible in its use of the borrowed funds. Borrowing for this purpose, when not justified by a national need, could be inconsistent with sustainable economic policy.

12.1 Public Debt

Public debt is the total amount, including total liabilities, borrowed by the government to meet its development budget. It has to be paid from the Consolidated Fund of India. The term is also used to refer to overall liabilities of central and state governments,but the Union government clearly distinguishes its debt liabilities from the states. The sources of public debt are dated government securities (G-Secs), treasury bills, external assistance, and short-term borrowings.According to the Reserve Bank of India Act, 1934, the RBI is both the banker and public debt manager for the government. The RBI handles all the money, remittances, and foreign exchange and banking transactions. The Union government also deposits its cash balance with the RBI.Investors come in various shades; they prefer high-risk-high-reward investments, while others are more comfortable investing in low-risk, fixed-income investment options. For the latter category of investors, there are many types of government securities in India that may be ideal investment choices.They bear exceptionally low risk, and in addition to this, they also come with the advantage of guaranteed income or returns on investment. For risk-averse investors who seek low-risk investment products, there are different types of government securities available in the Indian financial markets.

12.2 Government Securities

Government securities or G-Secs are essentially debt instruments issued by a government.These securities can be issued by both the central government and the state governments of India. When you invest in such options, you generally gain a regular interest income. Since these investment products are backed by the government, the risk associated with them is almost negligent.

Types of government securities: If you're interested in investing in such low-risk products, there are many types of government securities in India for you to choose from. They can broadly be classified into four categories, namely

- **Treasury Bills (T-bills),**
- **Cash Management Bills (CMBs),**
- **Dated G-Secs, and**
- **State Development Loans (SDLs).**

Treasury bills (T-bills): Treasury bills or T-bills are issued only by the central government of India.They are short-term money market instruments, which mean that their maturity period is less than 1 year. Treasury bills are currently issued with three different maturity periods: 91 days, 182 days, and 364 days. T-bills are quite unlike other kinds of investment products available in the financial markets.Most financial instruments pay you an interest on your investment. The Treasury bill, on the other hand, is what is commonly known as zero coupon securities. These securities do not pay you any interest on your investment. However, they're issued at a discount and are redeemed at face value on the date of maturity.

Dated G-Secs: Dated G-Secs are also among the different types of government securities in India.Unlike T-bills and CMBs, G-Secs are long-term money market instruments that offer a wide range of tenures, starting from 5 years and going all the way up to 40 years. These instruments come with either a fixed or a floating interest rate, also known as the coupon rate. The coupon rate is applied on the face value of your investment and is paid to you on a half-yearly basis as interest.There are around 9 different types of dated G-Secs currently issued by the government of India. These are listed below.

1. Fixed Rate Bonds
2. Floating Rate Bonds
3. Capital Indexed Bonds
4. Inflation Indexed Bonds
5. Bonds with Call/Put Options
6. Special Securities
7. STRIPS
8. Sovereign Gold Bonds

1. **Fixed Rate Bonds:** A fixed-rate bond is a debt instrument with a level interest rate over its entire term, with regular interest payments known as coupons.Upon maturity of the bond, holders will receive back the initial principal amount in addition to the interest paid.Typically, longer-term fixed-rate bonds pay higher interest rates that short-term ones.
2. **Floating Rate Bonds:** FRS bonds are fixed income instruments offered by the Government of India which come with a lock-in period.Unlike regular bonds that pay a fixed rate of interest, floating rate bonds have a variable rate of interest.The rate of interest of a floating rate bond is linked to a benchmark rate and is reset at a regular interval.The interest rate risk is largely mitigated as these bonds will pay higher return when prevailing rates are high.There is **no certainty of the future stream of income** when investing in a floating rate bond.The **best time** to buy floating rate bonds is when **rates are low and are expected to rise.**The FRBs are **not listed on any secondary exchange** which means that it **does not offer any interim exit** to the investor.The FRS bonds are a **100% risk free investment option** as interest payments on these are guaranteed by the Government of India.

   The interest earned on FRBs will be taxed as per the existing tax slab.TDS will be deducted on interest payment similar to an Fixed Deposit, the same can be claimed back while filing Income Tax returns.All residents of India and Hindu Undivided Family (HUF) are eligible to invest in FRBs.The minimum amount that a person can invest is INR 1,000 and in multiples of INR 1,000 thereof and there is no cap on investments that a person can make.A Non-Resident Indian (NRI) cannot invest in the scheme.
3. **Capital Indexed Bonds:** Capital indexed bond (CIB) are a bond whose base payment rises and falls with the Consumer Price Index (CPI).CIBs have their capital, or the principal amount of the bond, indexed (usually quarterly) with the revised capital amount due for repayment at maturity. As indexation increases the principal value of the security over time, the amount due at maturity becomes greater so your capital is protected against the perils of inflation.
4. **Inflation Indexed Bonds:** Inflation-linked bonds, or ILBs, are securities designed to help protect investors from inflation. Inflation Indexed Bonds (IIBs) were issued in the name of Capital Indexed Bonds (CIBs) during 1997 in India.ILBs are indexed to inflation so that the principal and interest payments rise and fall with the rate of inflation.Inflation-index-linked bonds can help to hedge against inflation risk because they increase in value during inflationary periods.The United States, India, Canada, and a wide range of other countries issue inflation-linked bonds. **Treasury Inflation-Protected Securities (**TIPS) and many of their global inflation-linked counterparts do not offer very good protection during times of deflation.
5. **Bonds with Call/Put Options:** Options are interesting for several reasons. Puts and calls on underlying securities are widely traded and allow investors to transfer risk.Many types of bonds have options embedded in the underlying security, including callable bonds and putable bonds. In addition, many corporations give their employees options on the company's stock as a part of their compensation.
   1. **Put Bonds Options:** A put option allows the investor to force the company issuing the bond to pay back the principal at any point in time before the bond matures. If an investor is worried about interest rates increasing after they purchase a bond, they might consider investing in a put option. This allows the investor to move their money from a lower interest paying security to one offering greater returns.
   2. **Call Bonds Options:** A Call option allows the issuer to redeem the bond before it matures. Under most circumstances, the call price will be greater than the par

value of the bond. Since the bondholder assumes the risk the security will be redeemed before it matures, the issuer will pay a premium in the form of a higher coupon rate (interest rate).Companies are willing to pay this premium because it gives them the right to refinance debt if interest rates decline.Unfortunately for the bondholder, when a security is redeemed, they may need to find an alternate investment at an inopportune time.

6. **Special Securities:** Government of India has also issued Bank Recapitalization Bonds to specific Public Sector Banks in 2018.These securities are named as Special GoI security, non-transferable and are not eligible investment in pursuance of any statutory provisions or directions applicable to investing banks.Special securities **allow govt to borrow endlessly, maintaining the facade of being fiscally prudent**. The banks, in turn, used the money to invest in special government bonds of same value. This deal suited everyone, banks were not looking for immediate liquidity and no cash changed hands.
7. **STRIPS:** Separate Trading of Registered Interest and Principal of Securities (STRIPS).Treasury STRIPS are bonds that are sold at a discount to their face value. The investor does not receive interest payments but is repaid the full-face value when the bonds mature. These types of bonds are generally known as zero-coupon bonds since they pay no interest or coupon.Treasury STRIPS are U.S. bonds that are sold at a discount to their face value and pay full face value at their maturity.No interest payments are received by STRIPS holders.The coupons are sold as separate investments.STRIPS are a popular choice for fixed-income investors. They have extremely high credit quality because they are backed by U.S. Treasury securities.
8. **Sovereign Gold Bonds:**Sovereign Gold Bond Scheme was launched by Govt in November 2015, under Gold Monetization Scheme. Under the scheme, the issues are made open for subscription in tranches by RBI in consultation with GOI. RBI Notifies the terms and conditions for the scheme from time to time. SGBs are government securities denominated in grams of gold. They are substitutes for holding physical gold. Investors have to pay the issue price in cash and the bonds will be redeemed in cash on maturity. The Bond is issued by Reserve Bank on behalf of Government of India.

12.3 Features of Sovereign Gold Bonds

The Government of India introduced the Sovereign Gold Bond (SGB) Scheme in November 2015, to offer investors an alternative to physical gold. Over the years, the market has witnessed a considerable decline in the demand for physical gold. SGB not only tracks the export-import value of the asset but also ensures transparency at the same time.SGBs are government securities and are considered safe. Their value is denominated in multiples of grams of gold. SGBs have witnessed a significant increase in investors, with it being considered a substitute for physical gold.If you are looking to purchase an SGB, all you have to do is approach a SEBI authorized agent or broker. Once you have redeemed the bond, the corpus (as per the current market value) will be deposited into your registered bank account. Features of SDGs are:

- SDB issued by Reserve Bank India on behalf of the Government of India.The Bonds will be denominated in multiples of gram(s) of gold with a basic unit of 1 gram.
- The tenor of the Bond will be for a period of 8 years with exit option in 5th, 6th and 7th year, to be exercised on the interest payment dates.
- Minimum permissible investment will be 1 gram of gold.
- The maximum limit of subscribed shall be 4 KG for individual, 4 Kg for HUF and

- 20 Kg for trusts and similar entities per fiscal year (April-March) notified by the Government from time to time.
- A self-declaration to this effect will be obtained. The annual ceiling will include bonds subscribed under different tranches during initial issuance by Government and those purchase from the Secondary Market.
- In case of joint holding, the investment limit of 4 KG will be applied to the first applicant only.
- Price of Bond will be fixed in Indian Rupees on the basis of simple average of closing price of gold of 999 purity published by the India Bullion and Jewellers
- Payment for the Bonds will be through cash payment (up to a maximum of Rs. 20,000/-) or demand draft or cheque or electronic banking.

12.4 State Development Loans (SDLs)

State Development Loans (SDLs) are dated securities issued by states for meeting their market borrowings requirements. In effect, the SDL are similar to the dated securities issued by the central government. Purpose of issuing State Development Loans is to meet the budgetary needs of state governments. Each state can borrow up-to a set limit through State Development Loans.As the name implies, SDLs are issued only by the state governments of India to fund their activities and to satisfy their budgetary needs. These types of government securities are very similar to dated G-Secs. They support the same repayment methods and come with a wide range of investment tenures. The only difference between dated G-Secs and SDLs is that the former is issued only by the central government, while the latter is issued solely by the state governments of India.

SDL securities are eligible securities for SLR and LAF of the RBI: The SDL securities issued by states are credible collateral for meeting the SLR requirements of banks as well as collateral for availing liquidity under the RBI's LAF including the repo.

SDL as a market based borrowing arrangement for states: One remarkable feature of SDL is that it is a market-oriented instrument for states to mobilize funds from the open market. Higher the fiscal strength of a state, lower will be the interest rate (yield) it has to pay for the SDL borrowings.RBI facilitates the issue of State Development Loans securities in the market. SDL securities are considered as superior to loans mobilized or bonds issued by state government entities. The RBI as the facilitator to the issue of SDLs, has the power to make repayments to SDLs out of the central government allocation to states.

Issue and marketability of SDLs: SDLs are basically securities and they are auctioned by the RBI through the e-Kuber which is dedicated electronic auction system for government securities and other instruments. RBI holds SDL auctions once in a fortnight.The SDLs doesn't have any credit risk and in this respect, they are similar to central government securities. This means that under the CRAR prudential norm, the risk weight of SDL is zero and banks need not keep any capital for investing in SDLs. Such a treatment and the higher yield (interest rate) of SDLs have encouraged banks to invest in them in recent years and states are hence able to meet their borrowing requirements.

Trading of SDLs: SDL's are traded electronically on the RBI managed NDS-OM (Negotiated Dealing System-Order Matching) and traded in the voice market (NDS).

Interest rate or yield on SDLs: The rate of interest or yield of SDL securities is determined through auction. Still the interest rate will be slightly higher than that of Central Government securities (G-secs) of matching tenure.The investors in SDL are basically commercial banks, mutual funds, insurance companies who are attracted by the slightly higher interest rate of SDL (compared to central government securities). In 2015, Government allowed Foreign Portfolio Investors (FPIs) to buy SDLs up to 2% of outstanding SDLs in the market.

12.5 Objectives of Public Debt

In India, most government debt is held in long-term interest bearing securities such as national savings certificates, rural development bonds, capital development bonds, etc. In industrially advanced countries like the U.S.A., the term government or public debt refers to the accumulated

amount of what government has borrowed to finance past deficits.In such countries the government debt has a very simple relationship to the government deficit the increase in debt over a period (say one year) is equal to its current budgetary deficit. But, in India, the term is used in a different sense.

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

(a) To meet budget deficit,

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

(c) To finance development activity.

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

*(b) Public Debt to Meet Emergencies like War:*In many countries, the existing public debt is, to a great extent, on account of war expenses. Especially after World War II, this type of public debt had considerably increased. A large portion of public debt in India has been incurred to defray the expenses of the last war.

*(c) Public Debt for Development Purposes:*DuringBritish rule in India public debt had to be raised to construct railways, irrigation projects and other works. In the post-independence era, the government borrows from the public to meet the costs of development work under the Five Year Plans and other projects. As a result the volume of public debt is increasing day by day.

12.6 Causes of Borrowing / Public Debt

Government can borrow because it can possible that local income was not enough for their expenditure due to incidental expenditure government could have to borrow because it is not possible to increase the tax income at that point. Government can borrow finance arrangement of capital expenditure because current revenue will not be enough to fulfill the target. At the time of depression, when private demand is not enough then government borrow, the extra savings of people which is not in use and spends it to increase the effective demand andby this gives birth to the extra income and employment in the society. These extra amounts from government taxes are supplementary to each other.

1. Concept of Welfare State: Modern states are not police states, but welfare states. The belief of the classical economists, in the efficacy of Laissez-fair capitalism in maintaining full employment and economic stability has been falsified.This led to the adoption of a welfare state concept by the Nations of the world. The main objective of the welfare state is to promote the economic, political and social well-being of citizens. Modern governments spend huge amounts on generation of employment, provision of basic service like educational facility.Health care facilities, social security measures, low cost housing to the poor, protection of environment etc.These welfare functions require enormous spending on the part of the government.This substantially contributed towards increasing the volume of public expenditure over years.

2. War and National Defense: In most countries the heaviest increase in public expenditure has been on account of cost of war and preparedness for war.The larger the country, the greater the percentage of resources allocated to national defense. The cost of defense has phenomenally increased overtime, due to the use of new and sophisticated equipment's. With the emergence of electronic and nuclear warfare, the nature and dimensions of war technology became much costly.Coupled with this, the provision of better living condition for defense personal,provision of pension and other social security measures, interest on war debt increased the defense expenditure of almost all countries.

3. Population Growth: Another important factor responsible for increase in public expenditure is the growth of population.Population growth and the consequent concentration of people in towns have necessitated increased levels of many governmental activities.Along with growth in numbers, the responsibilities of government relating to the provision of basic services have increased.The state will have to bear additional responsibility of solving problems like food, unemployment, housing, sanitation, street lighting, drinking water, drainage etc.Moreover, modern society is

becoming complex with increasing needs such as higher levels of education, growth of network of roads and railways and other transport system and provision of public welfare.

4. Growth of Democratic Institutions: Democratic institutions exert structural compulsions on public expenditure. The growth of democracy in the political system of any country requires maintenance of political institutions, like periodic elections, at different layers of government, the legislatures, advisory council, local boards etc. and other grass root level administrative units.A modern government thus has been compelled by the democratic forces to assume more and more functions. Under the shadow of democracy, state activities have expanded and the functions of government have increased both intensively and extensively. The government expenditure on account of these institutions and activities has been on a continuous rise**.**

5. Provision of Economic Over Head: For the development of a nation, creation and maintenance of economic overhead facilities is imperative.Provision of these facilities like well-developed transport and communication, generation of electric power etc. requires heavy capital investment. These investments are not highly profit induced, the private sector will be shy to invest in these areas.Government has to assume these responsibilities, to fulfill the basic requirements of development. Public expenditure on account of economic infrastructure is huge in size in developing countries.

6. The Problem of Urbanization: Population explosion leads to urbanization and resulted in the growth of metropolitan centers throughout the world. Urbanization is creating major hurdles to the all-round development of the economic system. Urban settlements are creating a number of socio-economic problems to the state, which need huge investment by the central, state and municipal bodies to address these problems.

7. Rising Trend in Price Level: Another factor pushing public expenditure ahead, at present, is the inflationary trend in price level. Rise in price level affect government expenditure in two ways.Firstly as a purchaser, the government has to pay higher prices for all goods and services it purchases.Secondly government, which is the single largest provider of employment, has to find out larger financial resources to meet its inflated administrative expenditure. That is when prices rise, the salary and allowances of government employees and other expenditures also increases correspondingly.

8. Adoption of Planning: Economic planning is considered as a panacea for all economic evils like poverty, deprivation, unemployment etc.planning is considered as an instrument to achieve certain socio-economic objectives. Planned economic development involves increasing state activities in many spheres of socio-economic life of the community.Eradication of poverty, equitable distribution of income and wealth, provision of increased employment opportunities, development of backward classes etc. are the major objectives of planned economic development. This require large sum of money leading to a consistent increase in public expenditure.

9. Education and Human Capital Formation: The overall development of a country depends on the quality of human capital. In developing countries, responsibilities of human capital formation are primarily on the government. The government provides educational services, both general and technical and training of manpower. These facilities are provided either free of charge or at subsidized rate.Government launched programmes to eradicate illiteracy. Large amounts of grants of varying type are given to educational institutions at different levels.Investments in the field of science and technology, to cope with the advancement in the field also pushed up government spending. The net result is a substantial increase in public expenditure at different layers of government.

10. Modernization of Agriculture: Most of the developing countries are basically agrarian economics. Growth of agriculture is necessary, not only to achieve self-sufficiency in food production, but also to provide adequate support to agro-based industries by providing required raw-materials.The governments of most of these economics have realized the interdependence of agriculture and industry. The expansion of agricultural sector provides impetus to industrialization by supplying raw-materials and wage goods to industrial sectors.In order to modernize agriculture; the government has to undertake expensive programmes for improving irrigation facilities, providing flood control methods, provision of fertilizer and other scientific agricultural inputs. All these programmes needs huge public expenditure.

11. Industrial Development: Industrialization leads to increase in national income and promotes the standard of living of the people. For rapid industrialization, the involvement of the public sector is crucial. To industrialize the country the government has to develop basic and key industries. Government offers various incentives and concessions to private sector to attract

industries in backward regions.The incentives are provided in the form of establishment of industrial estates, provision of cheap credit, subsidized raw materials, tax holidays and concessions, improved transport system and marketing facilities. Further government takes measures to control monopolies and to provide consumer goods and services at reduced price.

All these resulted in an increase in public expenditure.

12. Provision of Public Goods and Utility Services: Public goods are those, the consumption of which is externalized. It is consumed equally by all. These goods have no private market.Defense, and police service, justice, roads, irrigation, flood control projects, public parks etc. are all examples of public goods.These require huge investments and have to be provided by the government. The provision of major public utilities like railways, post and telegraph, electricity services etc. are coming under government sector. The provision and maintenance of these public goods and general utility services involve heavy expenditure.

13. Servicing of Public Debt: Public debt constitutes a substantial part of the government revenue; a major part of mounting government expenditure is met from public borrowing.

Internal and external debt obligation of the government has increased considerably. This leads increase in public expenditure in the form of increasing cost of debt servicing and repayment of loans.

14. Protection from the Problems of Market Mechanism: Modem governments consider it a part of its duty to protect the economy from the failures of market mechanism. Government adopts regulatory measures to check the imperfections in-the market system.Government usually makes arrangements for buffer stock creation, and distribution of essential goods at reduced rates through a network of public distribution system.Government makes earnest efforts to reduce the income and wealth inequalities and to achieve social and economic justice.

This necessary involves huge government expenditure through budgetary provisions.

15. Economic Depression: Public expenditure as a compensatory factor to overcome the deficiencies in trade and employment caused by reduced private investment. Public expenditure has been found as the best anti-dot to fight against and for preventing economic depressions.

The government is expected to play an active role in maintaining the level of trade and employment.Government expenditure on public works and other projects directly provides employment to large numbersby increasing the effective demand for goods and services helps to raise the level of business activity.Government expenditure is considered as compensatory factors in maintaining the level of trade and employment especially during economic depression.

16. Maintenance of Law and Order: The responsibilities of the government, to protect the people from internal conflict and breach of peace by antisocial elements have now become a crucial component of government activity. This requires large amount of funds for maintaining the law and order machinery in constant vigil with full preparedness to meet any adversities.

Summary

Given that there are many different types of government securities in India, it's easy to choose the best alternative for your portfolio. Since the investment tenure is one of the main points of difference between these G-Secs, you can choose the product that aligns best with your investment timeline. In addition offering guaranteed income or returns, investing in government securities also help you balance the risk factor in your investment portfolio.Apart from these the maintenance and preservation of historical places, monuments and forest resources, populist policies adopted by the ruling parties under pressure from democratic institutions andopinions and lethargy of the bureaucracy also contribute towards increasing the nature and volume of public expenditure in recent years.

Keywords

Revenue – Income

Expenditure – To spend.

Self Assessment

1. Which among the following does not fall under the category of government securities?

A. Dated securities

B. Treasury bills

C. State Development Loans

D. Certificate of Deposits

2. Identify the correct purpose behind issuing the government securities?

A. To finance the government expenditure and managing cash mismatch of the government

B. To decrease the fiscal deficit of government

C. To improve cash flow in market

D. None of the Above

3. Name the account that is maintained with RBI in which government securities are held?

A. Nostro Account

B. Vostro Account

C. Subsidiary General Ledger (SGL)

D. Escrow Account

4. Which of the following are called 'gilt edged securities'?

A. Shares of Public Limited companies

B. Stocks of Mutual Funds

C. Government Securities

D. Shares of Private Limited companies

5. Which of the following is a long-term source of finance?

A. Commercial Paper (CP)

B. External Commercial Borrowings (ECB)

C. Factoring

D. Line of Credit (LOC)

6. The certificate which evidences an unsecured corporate debt of short-term maturity, is known as:

A. Certificate of Deposit

B. Short-term loan certificate

C. Treasury Bill

D. Commercial paper

7. Government Securities with terms of more than one year are called?

A. Bills of exchanges

B. Government bonds

C. Treasury bills

D. Capital bills

8. The government can collect funds from
A. Taxes
B. Fees
C. Prices of public goods
D. All the three

9. A country's repayment obligations of principal and interest for a particular year on its external debt as a percentage of its exports of goods and services (i.e., its current receipt) in that year are generally referred to as:
A. Real burden
B. Money burden
C. Debt-service ratio
D. Export Earnings Ratio

10. Which of the following are the causes of public debt of a country?
A. War or war-preparedness, including nuclear programmes
B. To cover the budget deficits on current account
C. To undertake public welfare schemes
D. All of the above

11. Which operation is considered Government borrowing by modern economists?
A. Complete
B. Incomplete
C. Important
D. Total

12. Funds required for purchasing current assets is an example of
A. Fixed capital requirement
B. Ploughing back of profits
C. Working capital requirement
D. Lease financing

13. Public debt leads to extravagance, encouraged resort to war and induced bad economic conditions. This statement is of:
A. Dalton
B. Adam Smith
C. J.K. Mehta
D. Findley Shirras

14. ---------- is a special type of "once for all" tax on capital imposed to repay war debts.

A. Repudiation
B. Refunding
C. Conversion
D. Capital levy

15. It is a source of revenue for the Local Government bodies:
A. Corporation tax
B. Value added tax
C. Excise tax
D. Property tax

16. The main source of revenue of federal government is:
A. Property taxes
B. Token tax
C. Custom duties
D. Sales tax

Answers for SelfAssessment

1.	D	2.	A	3.	C	4.	C	5.	B
6.	D	7.	B	8.	D	9.	C	10.	D
11.	C	12.	C	13.	D	14.	D	15.	D
16.	D								

Review Questions

1. What is the role of public debt in regulating economy?
2. Throw light on public debt and economic development.
3. Write merits and demerits of public debt.
4. Write the policies of refunding.
5. Define the theory of management of public debtSelf-Assessment

Further Readings

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Unit 13: Fiscal Federalism

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Summary

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Objectives

After studying this unit, students will be able to:

- Understand the Federal Set up and Rationale of Fiscal Federalism.
- Evaluate the function and Rationale of Fiscal Federalism.
- Understand the Division of Functions and Financial Resources Between Centre and state Governments
- Evaluate the Division of Functions and Financial Resources Between Centre and state Governments
- Understand the concept of financial imbalance in an economy,
- Evaluate the types of financial imbalance and their correction in an economy.
- Understand the concept of Federal Finance Adjustments.
- Evaluate the principles and Methods for Adjustments of Federal Finance.

Introduction

The field of fiscal federalism studies how to divide responsibilities (including finances) among federal, state, and local governments to improve economic efficiency and achieve various public policy objectives. Determining the optimal division of responsibilities is difficult because of varying subjective views about what the role of government should be. As a result, fiscal federalism research generally renders no judgment on the proper level of total government intervention or what types of services governments should provide. The research focuses instead on how responsibilities are assigned across multiple layers of government once policymakers have decided to implement a given policy, and what trade-offs may be involved in administering it. For example, a more prominent federal government role may improve efficiency when taxpayers can easily move among localities and states to minimize taxes, or when there are substantial spillover

effects from providing goods and services. A more active state and local role may be beneficial in other cases, such as when there is a high level of variation among constituents in the desired amount of government-provided services, or when obtaining enough information to effectively administer a program is difficult (e.g., public education or local housing initiatives). Theories of fiscal federalism can be useful to policymakers when analyzing policies that could involve several layers of government.

13.1 Fiscal Federalism

Fiscal federalism - the devolution of taxing and spending powers to lower levels of government.It has become an important theme of governance in many developing countries in recent years.Accordingly, restructuring of governmental functions and finances between the national andlower levels of government has entered the core of the development debate.Intergovernmental fiscal relations are that sub national governments need to be given access to adequate resources to do the job with which they are entrusted.At the same time they must also be accountable for what they do with these resources.Moreover, like all public policies,Intergovernmental fiscal policies must take into account both the political constraints facing policy makers, such as the strength of different provinces and groups in political decisions, and economic constraints such as the stage of development of financial markets.

Fiscal federalism consists primarily of devolving revenue sources and expenditure functions to lower tiers of government. By bringing the government closer to the people, fiscal federalism is expected to boost public sector efficiency, as well as accountability and transparency in service delivery and policy-making.Four questions that must be answered with respect to intergovernmental functions and finances in any country:

(1) Who does what? This question is about assignment of functions between levels of government.

(2) Who levies what taxes? This question is about revenue assignment.

(3) How to resolve the imbalance between the revenues and expenditures of sub national governments?

This question has to do with vertical imbalances between levels of government.

(4) How to adjust for the differences in capacities and needs among different governmental units at the same level of government?

This question is about horizontal imbalances or equalization.

A key issue in intergovernmental fiscal relations is the assignment of functions and finances to different levels of government. This can also be described as the allocation of the authority and responsibility for the public sector decisions among different power centers.The traditional theory of fiscal federalism identifies three major functions for the public sector:

(1) Macroeconomic stabilization,

(2) Income distribution and

(3) Resource allocation (Oates, 1972 and 1999).

(1) Macroeconomic stabilization: The two main instruments of macroeconomic policy are monetary policy and fiscal policy.Fiscal policy, i.e., control over the amount and structure of taxes and expenditures, and the management of the budget deficit or surplus, is a powerful instrument for stabilizing the economy. The stabilization function is usually considered to be inherently national in nature, partly because subnational authorities have few or no incentives to undertake economic stabilization polices, lower levels of government often are very dependent on the national government for finance, it sometimes makes more sense to think of them as part of the national government rather than as independent actors. However, in some federal countries where a substantial share of national revenues is diverted to lower-levels, the existence of several tiers of government may give rise to difficulties in macroeconomic management (Bird, 1990). In contrast, studies from other countries, including the United States and Western Europe, conclude that decentralization has not undermined stability (World Bank, 2000). Findings from Canada even suggest that the growth of sub-national budgets has had a stabilizing effect on the economy (Sewell, 1996).This is explained by the observation that the major expenditure responsibilities which often are assigned to larger sub-national governments – such as public funding of health and education – act as automatic stabilizers because they are recurrent and not very flexible.

Increased reliance on direct taxes, such as personal income taxes in sub-national financing in some countries has also been found to have stabilizing effects.

(2) Income distribution: A substantial share of the public finance literature holds that the redistribution of income is primarily a national government concern. Some scholars even argue that attempts by local governments to redress income differences are likely to be unfair (Prud'homme, 1995).If a jurisdiction adopts policies to redistribute income by imposing high taxes on the rich and giving high benefits to the poor, the rich will tend to 'vote with their feet' and leave for more lightly taxed areas, and the poor will move in from areas that tend to offer lower benefits.Some regulatory policies allocated to local authorities in many countries, such as land use and rent controls, have profound distributional implications. Public health care, primary education, water supply, housing and public transportation which are assigned to subnational levels in many countries, also have important re-distributional functions.

(3) Resource allocation: The fiscal federalist model assigns a significant role to sub-national governments in allocating resources. The classic argument provided by the theory of fiscal federalism (Oates, 1972) is that in a democratic society decentralization will result in a better match of supply and demand for local public goods.Being closer to the people, it is claimed, local authorities can more easily identify people's needs, and thus supply the appropriate form and level of public services

A decentralized or federal system of government is not only a mechanism of power sharing between the different levels of government, but also of distributing the public revenues of the country between them. This distribution is necessary in order to enable the different levels to fulfill their respective functions. The fiscal design in decentralized states has to answer to three essential questions:

i. How are revenues shared and imbalances between lower levels equalized (intergovernmental transfers)?
ii. Which level pays (expenditure responsibility)?
iii. Which level has the command over the revenue sources (revenue-raising responsibility)?

The assignment of expenditure responsibility: The responsibility for expenditure can only be assigned if one has first looked into the question of which level should provide which public services. In this respect, it is argued that resources are spent most efficiently if the level of government that most closely represents the beneficiaries of the public service is responsible for it. This fosters transparency since citizens recognize more easily who spends their money. For certain public services, such as national defense or foreign affairs, the level that most closely represents the beneficiaries of the service will be the national level. Typical lower level expenditure responsibilities on the other hand include local infrastructures such as police, fire prevention and sanitation. Another factor determining which level should provide a certain public service is the efficient size of the program: some programs might only function efficiently if provided for the whole country by the national level of government.Regional preferences also affect the question which level should deliver a certain public service.For example, many sub-levels and their respective populations might want primary education to include the teaching of local languages. Here, a nationwide program that defines the curriculum for primary education might not serve them well citizens should have equal access to some public services, regardless of their origin, for reasons of equity.Such programs (e.g. retirement pensions, unemployment benefits, health care, the curriculum of the education) would have to be provided by the national level.The demand for minimum standards throughout the country concerning certain public services (e.g. health, education) might call for national regulation of policy guidelines for the implementation of public service programs at a lower level but does not require the central administration of these services.In order to prevent the expenditure responsibility of the sub-levels from causing economic instability or imbalances, the constitution should confer the responsibility for expenditures that have a particularly strong impact on demand or are particularly sensitive to changes in the economic cycle (such as unemployment benefits) to the national government.

The assignment of revenue-raising responsibility: Constitutional provisions that assign all or most taxing powers to local or sub-units 'governments would deprive the national government of tax instruments for macro-economic management and hinder it in redistributive policies.

For these reasons, it is usually recommended that each level of government be provided with its own sources of revenue, and, additionally, that intergovernmental transfers be used to overcome the remaining gaps between the revenue sources assigned to a certain level and its expenditure

responsibilities.Two principles should guide constitutional provisions that assign revenues to sub-national governments:

(1) The revenues assigned to the sub-national governments should suffice for at least the richest subnational government to finance all locally provided services that primarily benefit local residents from its own resources.

(2) The sub-national revenues should be collected from local residents and should be related to the benefits they receive from local services.

Taxes with the following characteristics should be assigned to the national government because sublevel competences in these fields typically cause economic imbalances between the sub- national governments of a federal state.

I. Taxes levied on the more mobile tax bases, such as income taxes on enterprises: The latter may easily move from one state to another in order to avoid the heavier tax load in the first state**.**

II. Taxes that are especially sensitive to changes in income, such as income tax on individuals: This is to provide the federal government as the protector of the federal state with economic stabilization instruments and to shelter the subnational governments from fluctuations in their income base.

III. Taxes that are levied on tax bases that are distributed unevenly across regions, such as taxes on natural resources: By assigning this type of taxes to the national government, one avoids that subnational levels differ greatly in income and thereby in their standards of living. On the other hand, where the exploitation of natural resources causes damage to the environment of the state of origin, much can be said for a sharing of revenues between the national government and that state.

Cost recovery through user charges: Taxes are not the best mechanism to obtain a better relation between demand and supply of public services. Better links can be achieved through cost-recovery charging systems.In some countries, including South Africa, charges on trading services such as electricity, water, sanitation and solid waste, are the major sources of urban and metropolitan revenues.

Vertical imbalances: The general nature of intergovernmental fiscal relations is surprisingly similar across a wide range of countries. Almost without exception countries assign more expenditure functions to sub-national governments than can be financed from the revenue sources allocated to those governments.The result of this mismatching of functions and finances – often referred to as 'vertical imbalances'is that sub- national governments are generally dependent upon transfers from higher levels of government. Thus, Bird (1990) argues that 'money is at the heart of intergovernmental matters.

Horizontal imbalances: The problem of 'horizontal balance' has to do with the fact that geographical areas usually differ with respect to resource capacity and needs. For instance, the tax base per capita often differs substantially between urban municipalities and district councils. Furthermore, the needs for public services may differ because some areas, for example, have a higher percentage of school children and/or elderly people than others.Designing fiscal institutions to cope with this complex reality is often problematic, and may be further exacerbated by political imperatives of treating even the most unequal jurisdictions uniformly, and by historically rooted conflicts and rivalries between regions and population groupsWhether fiscal decentralization aggravates income differences among sub-national jurisdictions or becomes a positive force in efforts to alleviate poverty depends on two factors (World Bank,2000:110): The first is horizontal equity, which is the extent to which sub-national governments have the fiscal capacity to deliver an equivalent level of services to their population. The second can be described as within-state equity, which is the ability or willingness of sub-national governments to improve income distribution within their borders

Economics of intergovernmental grants: Macroeconomic stabilization studies from other countries, including the United States and Western Europe, conclude that decentralization has not undermined stability (World Bank, 2000). Findings from Canada even suggest that the growth of sub-national budgets has had a stabilizing effect on the economy (Sewell, 1996).This is explained by the observation that the major expenditure responsibilities which often are assigned to larger sub-national governmentssuch as public funding of health and education – act as automatic stabilizers because they are recurrent and not very flexible.Increased reliance on direct taxes, such as personal income taxes in sub-national financing in some countries has also been found to have stabilizing effects.

Intergovernmental transfers (grants): Grants are intergovernmental transfers from higher to lower levels of government, especially from the national level to the state level.

i. Conditional grants
ii. Unconditional grants
iii. Equalization grants
iv. Special grants

Techniques and regulations of intergovernmental: Intergovernmental regulation was not a wholly new phenomenon, but most of the earliest requirements imposed on state and local governments were conditions of aid, designed to ensure fiscal and programmatic accountability in the use of federal funds.They were not used ordinarily to achieve policy goals beyond the specific scope of the funding or beyond the constitutional reach of the Congress.1964 Civil Rights Act, which guarantees nondiscrimination in federally assisted programs, and the National Environmental Policy Act of 1969, which requires environmental impact statements.Education for All Handicapped Children Act, which requires that all handicapped children be provided education opportunities, and the Emergency Highway Energy Cooperation Act of 1974, which withheld a portion of federal-aid highway funds if states failed to establish a 55-mph speed limit on roads in their jurisdictions.

13.2 Division of Functions and Financial Resources Between Governments

Generally, in a typical federation along with the distribution of legislative and administrative powers, the financial resources of the country are also so distributed to ensure the financial independence of the units. However, the Indian Constitution does not make a clear-cut distribution of the financial resources and leaves much to be decided by the Central Government from time to time.The financial resources which have been placed at the disposal of the state are so meager that they have to look up to the Union Government for subsidies and contributions.

Taxes Exclusively Assigned to the Union: Income from certain subjects like customs and export duties, income tax, excise duty on tobacco, jute,' cotton, etc., corporation tax, taxes on the capital value of assets of individuals and companies; Estate duty and succession duty in respect of the property and other than agricultural land; and income from the earning departments like the railways and postal departments have been exclusively assigned to the Union Government by the Constitution.

Taxes Exclusively Assigned to States: Income from land revenue, stamp duty except on documents included in the Union List; succession duty and Estate duty in respect of agricultural land; income tax on agricultural lands; taxes on goods and passengers carried by road or inland water; taxes on vehicles used on roads, animals, boats, taxes on the consumption or sale of electricity, tolls, taxes on lands and buildings;taxes on professions, traders, calling and employment; duties on alcoholic liquors for human consumption, opium, Indian hemp, and other narcotic drugs, taxes on the entry of goods into local areas,

taxes on luxuries, entertainments, amusements, betting and gambling, etc. has been assigned to the States.

Taxes Levied by Union but Collected and Appropriated by the State: The taxes on the following items are levied by the Union Government but the actual revenue from them is collected and appropriated by the States; (i) stamp duties on bills of exchange, cheques, promissory notes, bills of landing, letters of credit, policies of insurance, transfer of shares, etc.; (ii) Excise duties on medicinal toilet preparation containing alcohol or opium or Indian hemp or other narcotic drugs.

Taxes Levied and Collected by the Union but assigned to States: The taxes in this category are levied and collected by the Union Government although they are subsequently handed over to the states where from they have been collected. Such taxes included duties in respect of succession to property other than agricultural land; state duty in respect of property other than agricultural landterminal taxes on goods or passengers carried by railways, sea or air, taxes on railway freights and fares; taxes other than stamp duties on transactions in stock exchanges and futures markets; taxes on the sale or purchase of newspapers and advertisements published therein; taxes on purchase or sale of goods other than newspapers where such sale or purchases take place in the course of interstate trade or commerce.

Taxes Levied and Collected by the Union but Shared: Taxes on income other than agricultural income and excise duties other than those on medicinal and toilet preparations are levied and collected by the Union Government but shared with the states on an equitable basis. The basis of distribution is determined by the Parliament through a law.

Central State Relation - Legislative, Administrative and Financial: In India, before the formation of the federation the States were not 'sovereign' entities.As such, there was no need for safeguards to protect 'States'. On account of the exigencies of the situation, the Indian federation has acquired characteristics which are quite different from the American model.The residuary powers under the Indian Constitution are assigned to the Union and not to the States. However, it may be noted that the Canadian Constitution does the same mode of distributing the powers cannot be considered as eroding the federal nature of the Constitution.

(ii) Though there is a division of powers between the Union and the States, the Indian Constitution provides the Union with power to exercise control over the legislation as well as the administration of the States. Legislation by a State can be disallowed by the President, when reserved by the Governor for his consideration.The Governor is appointed by the President of the Union and holds office "during his pleasure". Again these ideas are found in the Canadian Constitution though not in the Constitution of the U.S.A.

(iii) The Constitution of India lays down the Constitution of the Union as well as the States; andno State has a right to determine its own (State) Constitution.

(iv) When considering the amendment of the Constitution we find that except in a few specific matters affecting the federal structure, the States need not even be consulted in the matter of amendment of the Constitution. The bulk of the Constitution can be amended by a Bill in the Union Parliament being passed by a special majority.

(v) In the case of the Indian Constitution, while the Union is indestructible, the States are not.It is possible for the Union Parliament to reorganize the States or to alter their boundaries by a simple majority in the ordinary process of legislation.The 'consent' of the State Legislature concerned is not required; the President has only to 'ascertain' the views of the Legislatures of the affected States. The ease with which the federal organization may be reshaped by an ordinary legislation by the Union Parliament has been demonstrated by the enactment of the States Reorganization Act, 1956. A large number of new States have, since, been formed.

(iv) Under the Indian Constitution, there is no equality of representation of the States in the Council of States. Hence, the federal safeguard against the interests of the lesser States being overridden by the interests of the larger or more populated States is absent under our Constitution.Its federal nature is further affected by having a nominated element of twelve members against 238 representatives of the States and Union Territories.

13.3 Centre State Relations

The Constitution of India provides a dual polity with a clear division of powers between

The Union and the States, each being supreme within the sphere allotted to it. The Indian federation is not the result of an agreement between independent units, and the units of Indian federation cannot leave the federation.Thus the constitution contains elaborate provisions to regulate the various dimensions of the relations between the centre and the states.

The relations between centre and state are divides as:

1. Legislative relations
2. Administrative relations
3. Financial relations

1. Centre State Legislative Relations: Articles 245 to 255 in Part XI of the Constitution deal with the legislative relations between the Centre and the State.Extent of laws made by Parliament and by the Legislatures of States.The Parliament can make laws for the whole or any part of the territory of India. Territory of India includes the states, UTs and any other area for the time being included in the territory of India.Whereas, the state legislature can make laws for whole or any part of state.The Parliament can alone make 'extra territorial legislation' thus the laws of the Parliament are applicable to the Indian citizens and their property in any part of the world.

Subject-matter of laws made by Parliament and by the Legislation of States.

The Constitution divides legislative authority between the Union and the States in three lists-

i. the Union List,
ii. the State List and
iii. The Concurrent List.

The Union list consists of 99 items. The Union Parliament has exclusive authority to frame laws on subjects enumerated in the list. These include foreign affairs, defense, armed forces, communications, posts and telegraph, foreign trade etc. The State list consists of 61 subjects on which ordinarily the States alone can make laws. These include public order, police, administration of justice, prison, local governments, agriculture etc.The Concurrent list comprises of 52 items including, criminal and civil procedure, marriage and divorce, economic and special planning trade unions, electricity, newspapers, books, education, population control and family planning etc.Both the Parliament and the State legislatures can make laws on subjects given in the Concurrent list, but the Centre has a prior and supreme claim to legislate on current subjects. In case of conflict between the law of the State and Union law on a subject in the Concurrent list, the law of the Parliament prevails.Both the Parliament and the State legislatures can make laws on subjects given in the Concurrent list, but the Centre has a prior and supreme claim to legislate on current subjects. In case of conflict between the law of the State and Union law on a subject in the Concurrent list, the law of the Parliament prevails.

Residuary powers of legislation: The constitution also vests the residuary powers (subjects not enumerated in any of the three Lists) with the Union Parliament. The residuary powers have been granted to the Union contrary to the convention in other federations of the world, where the residuary powers are given to the States. However, in case of any conflict, whether a particular matter falls under the residuary power or not is to be decided by the court.

Parliament's Power to Legislate on State List: Though under ordinary circumstances the Central Government does not possess power to legislate on subjects enumerated in the State List,

But under certain special conditions the Union Parliament can make laws even on these subjects.

a) In the National Interest (Art.249): If the Rajya Sabha declares by a resolution supported by not less than 2/3 of its members present and voting, that it is necessary or expedient in the national interest that the Parliament should make laws with respect to any matter enumerated in the State List (Art.249).After such a resolution is passed, Parliament can make laws for the whole or any part of the territory of India. Such a resolution remains in force for a period of 1 year and can be further extended by one year by means of a subsequent resolution.

b) Under Proclamation of National Emergency (Art.250): Parliament can legislate on the subjects mentioned in the State List when the Proclamation of National Emergency is in operation. However, the laws made by the Parliament under this provision shall cease to have effect on the expiration of a period of six months after the Proclamation has ceased to operate, except as respects things done or omitted to be done before the expiry of the said period.

c) By Agreement between States (Art. 252): The Parliament can also legislate on a State subject if the legislatures of two or more states resolve that it is lawful of Parliamentto make laws with respect to any matter enumerated in the State List relating to those State.Any act passed by the Parliament shall apply to such states and to any other state which passes such a resolution. The Parliament also reserves the right to amend or repeal any such act.

d) To Implement Treaties (Art. 253): The Parliament can make law for the whole or any part of the territory of India for implementing any treaty, international agreement or convention with any other country or countries or any decision made at any international conference, association or other body. Any law passed by the Parliament for this purpose cannot be invalidated on the ground that it relates to the subject mentioned in the State list.

e) Under Proclamation of President's Rule (Art.356): The President can also authorize the Parliament to exercise the powers of the State legislature during the Proclamation of President's Rule due to breakdown of constitutional machinery in a state. But all such laws passed by the Parliament cease to operate six months after the Proclamation of President's Rule comes to an end.

13.4 Center's Control over State Legislation

The Constitution empowers the centre to exercise control over the state's legislature in following ways:

1. The governor can reserve certain types of bills passed by the state legislature for the consideration of the President. The President enjoys absolute veto over them.
2. Bills on certain matters enumerated in the State List can be introduced in the state legislature only with the previous sanction of the President as imposing restrictions on freedom of trade and commerce.
3. The President can direct the states to reserve money bills and other financial bills passed by the state legislature for his consideration during a financial emergency.

Centre State Administrative Relations: The administrative jurisdiction of the Union and the State Governments extends to the subjects in the Union list and State list respectively.The Constitution thus defines the clauses that deal with the administrative relations between Centre and States.

Centre State Financial Relations: Indian Constitution has made elaborate provisions, relating to the distribution of the taxes as well as non-tax revenues and the power of borrowing, supplemented by provisions for grants-in-aid by the Union to the States. Article 268 to 293 deals with the provisions of financial relations between Centre and States.The Constitution divides the taxing powers between the Centre and the states. The Parliament has exclusive power to levy taxes on subjects enumerated in the Union List, the state legislature has exclusive power to levy taxes on subjects enumerated in the State List,

Both can levy taxes on the subjects enumerated in Concurrent List whereas residuary power of taxation lies with Parliament only.

Distribution of the tax-revenue:

1. Duties Levied by the Union but Collected and Appropriated by the States: Stamp duties on bills of Exchange, etc., and Excise duties on medical and toilet preparations containing alcohol. These taxes don't form the part of the Consolidated Fund of India, but are assigned to that state only.
2. Service Tax are Levied by the Centre but Collected and Appropriated by the Centre and the States.
3. Taxes Levied as Well as Collected by the Union, but Assigned to the States:These include taxes on the sale and purchase of goods in the course of inter-state trade or commerce or the taxes on the consignment of goods in the course of inter-state trade or commerce.
4. Taxes Levied and Collected by the Union and Distributed between Union and the States: Certain taxes shall be levied as well as collected by the Union, but their proceeds shall be divided between the Union and the States in a certain proportion, in order to effect on equitable division of the financial resources. This category includes all taxes referred in Union List except the duties and taxes referred to in Article 268, 268-A and 269; surcharge on taxes and duties mentioned in Article 271 or any Cess levied for specific purposes.
5. Surcharge on certain duties and taxes for purposes of the Union: Parliament may at any time increase any of the duties or taxes referred in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part the Consolidated Fund of India.

Grants-in-Aid: Besides sharing of taxes between the Center and the States, the Constitution provides for Grants-in-aid to the States from the Central resources. There are two types of grants: -

1. Statutory Grants: These grants are given by the Parliament out of the Consolidated Fund of India to such States which are in need of assistance.

- Different States may be granted different sums.

- Specific grants are also given to promote the welfare of scheduled tribes in a state or
- To raise the level of administration of the Scheduled areas therein (Art.275).

2. Discretionary Grants: Center provides certain grants to the states on the recommendations of the Planning Commission

- Which are at the discretion of the Union Government?
- These are given to help the state financially to fulfill plan targets (Art.282).

Effects of Emergency on Center-State Financial Relations: -

1. **During National Emergency:** The President by order can direct that all provisions regarding division of taxes between Union and States and grants-in-aids remain suspended.However, such suspension shall not go beyond the expiration of the financial year in which the Proclamation ceases to operate.
2. **During Financial Emergency:** Union can give directions to the States: To observe such canons of financial propriety as specified in the direction.To reduce the salaries andallowances of all people serving in connection with the affairs of the State, including High Courts judges.To reserve for the consideration of the President all money and financial Bills, after they are passed by the Legislature of the State.

13.5 Fiscal Imbalance

Fiscal imbalance refers to the mismatch between own revenue raising capacity and expenditure needs at different governmental unitsthis implies the gap between revenue and expenditure when both revenue sources and functions are allocated between various units of the government optimally. Empirical estimates of fiscal imbalances are difficult to derive on the basis of such definitions, for, estimates of revenue capacity or expenditure needs in an absolute sense will depend heavily on the relevant value judgments made and in practice,it is difficult to find an allocation of revenue sources and responsibilities which is strictly optimal in any sense.Fiscal imbalance occurs when a government's future debt obligations are not in balance with its future income streams. Fiscal imbalance generally occurs when a government's spending (and resulting debt) outstrips its long-term ability to raise revenue to finance its spending and debt. This often occurs when a government takes on long-term spending obligations based on overly optimistic estimates of the cost of the obligations, orthe ability or willingness of taxpayers to finance them.One common example is when governments commit to expensive defined-benefit pensions for public employeeswithout considering the possibility of future economic downturns that might impact tax revenue and the value of pension fund investments. This scenario has played out at some state and municipal governments, leading to budget cuts to basic public services such as policing, demands for state or federal bailouts for fiscally mismanaged government units, or in some cases bankruptcy proceedings.

Types of Fiscal Imbalance

There are two types of imbalances that can impact a government's expenditures and revenue: vertical fiscal imbalance and horizontal fiscal imbalance.Obligations and income streams are measured at their respective present values and discounted at the risk-free rate plus a certain spread. If a government incurs a sustained fiscal imbalance, then tax burdens will likely increase in the future, causing current and future household consumption to fall.Fiscal imbalance occurs when there is a mismatch between a government's future debt obligations and future income streams.Vertical and horizontal fiscal imbalance is the two types of imbalance that can impact a government's expenditures and revenues.A vertical fiscal imbalance occurs when revenues do not match expenditures for different government levels.A horizontal fiscal imbalance occurs when revenues do not match expenditures for different regions of the country.

A vertical fiscal imbalance occurs when revenues do not match expenditures for different government levels.

A horizontal fiscal imbalance occurs when revenues do not match expenditures for different regions of the country.

13.6 Measurement of Fiscal Imbalances

Measurement of fiscal imbalances involves, of necessity, actual elements of federalism as opposed to normative ones, although the very concept of fiscal imbalance has a built-in normative consideration; the general presumption would be that the less of imbalance there is, the better it is. The concept almost axiomatically implies that if there are imbalances, they need to be corrected.The imbalances at different levels of the government (inter-governmental) are known as vertical fiscal imbalances, while those at different units at the same level of government (interjurisdictional) are known as horizontal fiscal imbalances.Although these two concepts are identifiable by themselves, they are, except under very special circumstances, related.If the distribution of revenue sources and expenditure responsibilities between the Centre and the States is such that the Centre raises more than it spends while the States spend more than they raise, the extent of this vertical fiscal imbalance can affect the horizontal fiscal imbalance (i.e., between different States) through the non-neutral incidence of Central revenue and expenditure package. When the benefits from the Central expenditure (or grant) exactly match the tax (revenue) collections in each Statethe incidence of Central fiscal policy neutral. It is only under such a condition that the vertical and horizontal fiscal imbalances are fully independent. A certain amount of redistribution involved in the fiscal policy of the Centre, and this links vertical imbalances with the horizontal imbalances.Larger the horizontal imbalances, greater is the need for federal intervention to correct these imbalances. Such interventions can take the form of direct Central expenditure, or equalizing transfers. In both the cases, a centralizing tendency in revenue raising becomes unavoidable. However, the expenditure responsibilities of the States do not decrease, leading to vertical fiscal imbalance.

Horizontal Fiscal Imbalance:

A horizontal fiscal imbalance describes a situation in which revenues do not match expenditures for different regions of the country. Horizontal fiscal imbalances are often used to justify equalization transfers or payments to a state or province from the federal government to offset monetary imbalances between different parts of the country.These benefits are also often used as part of the justification to require transfer payments and redistribution of wealth from some regions to others.Horizontal fiscal imbalance is corrected, and the principle of fiscal equity is achieved through equalization of fiscal residue. Prof. J. M. Buchanan defines fiscal residue as:"net benefits from tax-expenditure programme i.e., benefit from expenditures minus disutility from tax payment."Due to difference in resource endowment, level of development and Variation in the implementation of tax expenditure programmes among different states in a federation, the central and state taxes generate unequal fiscal residue for their citizens. A gap in fiscal residue arises and the some must be equalized to achieve, what is called horizontal fiscal balance.This gap in fiscal residue can be filled by interstate transfer of resources. There should be a federal arrangement for transferring resources from richer states to poor states.This will help to reduce interpersonal fiscal inequality. Musgrave put it as realization of horizontal equality however it is unlikely that rich states within a country will voluntarily agree to transfer adequate resources to poor states.Another problem in federal set up is the tax competition, in order to attract more capital and trade from other parts of the country,one state government may reduce or abolish certain type of taxes,this policy may sometimes benefit for backward states. However this type of competitive tax reduction may hinder the smooth flow of interstate trade.

Vertical Fiscal Imbalance

A vertical fiscal imbalance describes a situation in which revenues do not match expenditures for different levels of government. A vertical fiscal imbalance is a structural issue that can be resolved if revenue and expenditure responsibilities can be reassigned. For example, if a state requires its towns and cities to provide educational services but leaves responsibility for funding up to local property or other taxes, this can create a vertical imbalance unless the state also contributes funding to help meet the fiscal obligation it created for its towns and cities. Expenditures on activities like education public health, social welfare, urban management,welfare schemes for weaker sections rural development activities etc. are on a continuous increase.Majority of revenue source under the control of state and local governments is inelastic in nature. This creates a situation of imbalance between growing expenditure requirements and poor yield of revenue source for state and local governments.The central government always possesses surplus revenue owing to control over more elastic sources of revenue. These occurs a situation of greater expansion of financial resources

of central government, and shrinking of resources bases of state and local governments, coupled with increasing responsibilities of state and local governments due to growth of welfare activities.Fiscal federalism tries to bridge this gap and attain a balance through vertical co-ordinations between the centre, state and local level public expenditure and resources needed to finance them.The important methods adopted to achieve vertical fiscal equality between the centre and regional governments in a federation are:

1. Tax sharing:Under tax sharing arrangement a tax is levied and collected by single administration. But the proceeds are shared either wholly or partly with two or more units. The allocation of the share to constituent units require some criteria which may be either within in the constitution orleft to be determined by the national governmentor it may be determined by periodical agreement between the centre government and constituent units.

2. Tax credit: Under the tax credit, a superior government unit allows a credit against its tax to anyone who pays the same kind of tax to subordinate units. This method eliminates tax competition problem and thereby increases the capacity of the subordinate units.

3. Tax deductibility:Tax deductibility is another method to correct vertical imbalance.Under the method permission is granted by one government to deduct tax paid from the tax payers upon which another government levies taxes.

4. Tax denial:Under the tax denial the government may put restrictions on state and local government taxing powers. It includes denial of power to subordinate jurisdictions to levy certain taxes, putting a ceiling on the tax rule used by the lower level governmental units;Any upward change in the tax rate requires the approval of the central legislature. These methods of tax co-ordination are known as tax denial or tax restrictions.

5. General grants-in-add:Another method of correcting vertical imbalance in fiscal resources is transfer is grants-in-aid. Three types of grants are used to transfer revenue to lower level of government viz. General (Block or unconditional) grant, selective grant (restrictive or conditional grant) and matching or non-matching grants**.**

13.7 Federal Financial Adjustment

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.It is a form of political association in which two or more states constitute a political unity with a common government, but in which the member states retain a measure of internal autonomy. Encyclopedia Britannica defines federation "as a form of government in which the essential principle is that there is a union of two or more States under the central body for certain permanent objectives."

Sir Robert Garran defined federation as foam of government in which Sovereignty or political power is divided between the central and the local governments, so that each of them within its own sphere is independent of the other.As far as functions and resources are concerned the two sets of government are independent. Actual federations are however of different forms. For example, India is more a unitary than federal type, where there is large concentration of power in the hands of central government.Whereas USA is more of a federal than unitary type Country, where there is lesser concentration of power with centre and larger exercise of power by provincial and local governments.So, depending on the type of federation fiscal responsibilities is shared between central, state and local governments. Therefore, federal finance means divisions and coordination of different items of income and expenditure between central, state and local governments. This multilevel decentralized fiscal system is known as fiscal federalism.

Federation is characterized by certain basic principles

(a) Division of power and functions,

(b) Supremacy of the constitutions,

(c) Constitutional independence of the constituent units, and

(d) Federal predominance.

Principles of Federal Finance:

In a federation functions are distributed among different layers of government. Since each government is responsible for its own sphere of activity there should be adequate provision for source of revenue and its efficient administration for discharging the assigned functions independently and satisfactory.The pool of total revenue source should be divided between the centre, state and local governments scientifically and reasonably. This warrants some mutually beneficial and sound principles, for the division of revenue source.

Prof. Seligman prescribed three principles on the basis of which revenue sources i.e., taxes should be divided between the different layers of government.

i. Efficiency,
ii. Suitability, and
iii. Adequacy.

Efficiency:Efficiency norms insist that tax allocation among different layers of governmentshould be decided by the capacity of feasibility to administer the tax effectively. There will be taxes, which can be best administered by the centre. Such taxes should be assigned to the central government. For example, income tax in India.

Suitability:Suitability criterion insists that the nature of tax is an important aspect determining allocation. There are some taxes which can be administered by the state government. Such taxes should be assigned to the state government. Best example is agricultural income tax. Taxes with narrow jurisdiction should be allocated to regional or local governments rather than central government.

Adequacy:The adequacy norms insist that revenue assigned to a particular layer of government should be sufficient to carry out the functions and responsibilities assigned to them. The non-coordination between functions of government and revenue allocated to discharge the functions generate crucial problem in federal finance. Prof. Seligman in his Essays in Taxation observes" no matter how well intentioned a scheme may be or how completely it may harmonies with the abstract principles of Justice, if the tax does not work administratively, it is doomed to failure".

Therefore, there are no uniform principles which determine the resource allocation in federal finance.Prof. B.P Adarkar in his master piece "Principles and Problems of Federal Finance." laid down three principles governing the working of Federal Finance. Later economists added a few more principles based on certain practical situations.These principles are briefly explained below:

1. Independence and Responsibilities:

The success of fiscal federalism is conditioned by the two fundamental requisites- Financial independence and financial responsibility. Central and state government must be financially independent within their own spheres. Each government should possess separate and independent sources of revenue. Government at different layers should have full power to tax, to incur expenditure and to borrow to perform the assigned functions effectively.Prof. Adarkar observes, "Taxing autonomy and spending autonomy should go hand in hand. In the broader interest of the nation the centralization of revenue in the hands of the central government seems to be good. However too much dependence of state government on central government for resources is not a healthy practice in federal finance."Prof. Adaekar Says, "full freedom of financial operations must be extended to both federal as well as state governments in-order that they may not suffer from a feeling of Cramp in the discharge of their normal activities and in the achievements of their legitimate aspirations for the promotion of social and economic advancement."

2. Adequacy and Elasticity:

Adequacy implies that allocation of resources should be based on distribution of functions.The sources of revenue assigned to each layer of government, should be sufficient enough to discharge the functions efficiently and effectively.For achieving this financial structure should be elastic, flexible and adaptable to the changing conditions of economy.The resources should be capable of expression in response to the rapidly growing needs and responsibilities of government otherwise the federal finance system will create rigidities during times of economic stress and strain.

3. Administrative Efficiency and Economy:

Tax resources should be assigned to different layers of government considering efficiency and economy in administration. The administrative Cost should be minimized. There should be no scope for fraud and evasion.While allocating resources the administrative efficiency should be

adhered.For example, it is better and economical to allocate land tax to local bodies, excise tax on alcohol to state government and income tax to central government.Here each layer of government is assigned such sources of revenue which it can administer efficiently.As point out by prof. Seligman, the nature of tax and character of administration determine the effectiveness of different taxes. This will ensure optimum utilization of revenue potential and help to prevent corruption and evasion in revenue mobilization and realization.

4. Principle of Uniformity and Equity:

In a federation there may be regional variation in the level of economic development, owing to a number of economic and non-economic factors. Therefore, contribution of each state in federal resources structure should be based according to its ability or economic condition. The principles of equality in the distribution of tax burden are another guiding principle of federal finance.Principles of uniformity insist that there should be no discrimination between citizens of different states in a federation. Adequate provision should be there to protect the interest of backward regions and states and even weaker sections of the community. Under conditions of difference in resource endowments, tax burden should be distributed on the basis of marginal sacrifice principle.For the success of fiscal federalism there should be proper integration and co-ordinations of the financial system of different layers of government. Judicious uses of scarce resources are affected by well-coordinated and integrated intergovernmental fiscal policy.

5. Principles of Accountability:

In a federal form of political set up federation and democracy are considered as sister institutions. In a federation, each layer of government should be accountable to its own legislature for its taxing and spending decisions.Utmost transparency should be retained in all financial and administrative matters. Each government spending and taxing decisions should be done with regard to their effect on other governments.

6. Principle of Financial Access:

This principle implies that there should be no bar on centre and state governments in exploring new source of resources, to meet the growing financial requirements. In a sense resource should grow along with growth in responsibilities.To develop healthy financial relation between different units in a federation each government unit will have to work under certain self-imposed discipline.A number of problems arises and exist in federal finance. A pragmatic approach towards finding solutions to problem is needed. Socio-economic conditions differ from time to time and from state to state the division of resources should be subjected to flexibility and adaptability. In a federal fiscal system, there is only scope for adjustment in the light of changing circumstances.

13.8 Methods of Adjustments of Federal Finance

The essential methods of adjustments of Federal Finance are:

1. Tax Sharing:Under this method, the proceeds of certain selected taxes, imposed and realized by the Centre, are apportioned between the Centre and the different states. In India, the income tax and some union excise duties are taxes which are shared. This method of sharing the tax yield is, however, confronted with various difficulties such as;

What should be the criteria for determining the share of states out of the total tax yield of the Centre?

What portion of the total national share should be assigned to each state?

Basically, the share of the Centre should be reasonably large to meet its nationwide functions.The share of each state can, however, be determined on the basis of actual yield from a particular state, its population, total revenue and its total expenditure needs.Adjustments to the complete satisfactionof the different states may not be possible and states are bound to feel a sense of frustration. In India, for instance, a Finance Commission is appointed every five years by the President to determine the share of each state in the division of taxes.

2. Reallocation of Functions:Sometimes, when it is found that certain functions, though assigned to the state government, can very well be carried out by the central government with the same efficiency, it is desirable for the Centre itself to take over such functions, thus, relieving the state governments of the administrative burden.

3. State Contribution:There may be a provision for contribution or payment from state governments to the Centre, when the latter is in need of large resources. This was practiced in the U.S.A., at the time of its first Constitution when the national government had no powers of taxation and was solely dependent on the states' assistance.Such a system had been discarded in modern times, It will not only make the Centre weak and subordinate to the states, but hinder the progress of national wellbeing and create immense difficulties for the Centre in meeting emergencies.

4. Supplementary Levies: Supplementary levies may be of two types: imposition of additional levies by the Centre on state taxes. the states have their own rates of taxation, the second method may not be a practicable proposition. The first method is more desirable and practicable, because in all federations the states which need additional revenues to meet their growing commitments and as such, they should be authorized to impose supplementary levies on federal taxes.

5. Grants-in-aid:For making the necessary adjustments in state resources, the central government has the constitutional power to make grants to the state governments in most federations of today. Undoubtedly the grants-in-aid from the Centre constitute a more definite anddependable source of revenue to the state governments than the method of sharing tax yields of the Centre.In India, a finance commission is appointed every five years to recommend to the Centre the allocation of grants.Moreover, the allocation of federal grants should be determined well in advance and should be valid for a period of time; otherwise, a great deal of uncertainty and dissatisfaction may be caused to the states.

Conditional and Unconditional Grants:

Federal grants may be conditional or unconditional.

1. **Conditional grants:**Conditional grants are made for certain specific purposes. Therefore, the state governments have perforce to use such funds only for the purposes for which they are allocated. Conditional grants are provided on the basis of expenditure needs of each state, irrespective of its financial capacity.For instance, educational grants may be made according to the number of students in school-going age in each state.Under conditional grants, the states lose their freedom of action, such grants are justified on the grounds that the receiving states are made conscious of their financial responsibilities and functions and observe financial discipline and check unwise spending.
2. **Unconditional grants:** Unconditional grants are generally made on the basis of per capita income and relative poverty of the different states. They are devised to bridge the gap between revenues and expenditures of the state governments. Under unconditional grants, there is no check or supervision by the Centre; the receiving states have full authority to use them in any way they like.It will be observed from what has just been said that conditional and unconditional grants have their own merits and demerits. However, a combination of both the systems seems to be desirable and practical.However, the state governments do not use them for projects which benefit the nation as a whole; they are used only for local purposes.

Summary

In India, the Centre-States relations constitute the core elements of the federalism. The Central Government and State Government cooperate for the well-being and safety of the citizens of India. The work together in the field of environmental protection, terror control, family control and socio-economic planning.Imbalance between central and state's financeremoved by two methodstransfer of work of state government to central government or to transfer some sources of income of central government to state government. Imbalance between central and state government can be removed by transfer of some capital from centre to state in federal system.The main problem of federal finance is the distribution of financial resources between centraland states because they can't do their financial and future development programmes withoutthe arrangement of finance. In this way, this is the main problem for them.Every government should take responsibility of imposing tax, collection of debt and increasingof income from other sources so that they can smoothly run their development work.In federal, government every govt. should remain free in the field of

economy, state govt.should have right to have money for their work, so that they can apply taxes and can takeloans. These should be independent.Division of economic resources should be done in an elasticity form because no matter thatplanning is better but it will be not suitable every time.Imbalance between income of sources and needs is because of important elastic resourcesgiven to the central government for the country's betterment.To remove the imbalance between Income and resources, second method is supplementarylevies or taxes. In this, mostly one government (mainly central government) imposes principaltax, and other government applies extra taxes.In present situation central government should be given enough power, so that it can fulfillsocial and economic responsibilities of a modern center government.In central government's index there are 12 items on which taxes are imposed. Although, allthese taxes are included in the central index, but this does not mean that the all revenue receivedfrom their usage only by the central government.In the area of finance, constitution had adopted an expensive method. This type of procedurecannot be found in any other federal constitution.

Keywords

Fiscal federalism: Fiscal transfers from the central government to subnational governments.

Vertical imbalances: a situation in which revenues do not match expenditures for different levels of government.

Horizontal imbalances:when sub-national governments do not have the same capabilities in terms of raising funds from their tax bases to provide public services.

Conditional grants:an allocation to a province or municipality from the national government's share of revenue raised nationally for a specific purpose.

SelfAssessment

1. The theory of fiscal federalism assumes –

A. A federal system of government can be efficient and effective in solving problems.

B. A federal government will be able to bring about economic stability allocation of resources.

C. Since states and localities are not equal in their income, federalism is helpful.

D. All of the above

2. The term Fiscal Federalism was introduced by

A. Musgrave

B. Oates

C. Dalton

D. None of the above

3. Fiscal federalism deals with.............

A. The division of governmental functions

B. Financial relations among levels of government

C. Proper allocation of Resources

D. All of the above

4. The main pillars of institutional framework to deal with centre-state financial relations in India are.........

A. Finance Commission

B. Planning Commission

C. National Development Council
D. All of the above

5. In India's federal system, the state governments have the power to legislate on all those subjects which are included in the:
A. Union list
B. State list
C. Concurrent list
D. Residuary subjects

6. The Constitution of India
A. Divided powers between centre and states in three lists.
B. Divided powers between centre and states in two lists.
C. Listed the powers of the states and left the undefined powers to the state.
D. Specified the powers of the states and left the residuary powers with the centre.

7. Which of the following taxes are imposed and collected by the state government?
A. Estate duty
B. Sales tax
C. Land revenue
D. All the above

8. Which of the following is a union tax?
A. Corporation tax
B. Taxes on agricultural income
C. Capitation taxes
D. Land revenues

9. The horizontal fiscal imbalance that arises in a fiscal federation is also called:
A. Problem of Equalization
B. Problem of Efficiency
C. Problem of Effectiveness
D. Problem of Economy

10. Tax revenue sharing between the federal and sub-national governments is aimed at correcting which of the following type of imbalances?
A. Vertical imbalances
B. Horizontal imbalances
C. Diagonal imbalances
D. Criss-cross imbalances

11. Fiscal Responsibility and Budget Management act was enacted, to get the ________ effectively

A. Fiscal balance
B. Fiscal imbalance
C. Frictional balance
D. Frictional imbalance

12. Fiscal Responsibility and Budget Management act tries, to ensure greater _________ in the fiscal operations of the central government
A. Translucent
B. Opaque
C. Transparency
D. Colour

13. The principle of federal finance which envisages that the resources should be distributed among the different states of the federation so that each state receives a fair share of revenue is referred to as
A. Principle of Equity
B. Principle of Uniformity
C. Principle of Fiscal Access
D. Principle of Independence

14. Which is the method of financial adjustment between Centre and States?
A. Grant in aid
B. Tax sharing
C. Public debt
D. Federal Finance

15. Which one of the following taxes is levied by the State Government only?
A. Entertainment tax
B. Corporation tax
C. Wealth tax
D. Income tax

16. The methods of restoring resource balance between different governments in a federal set up is based on
A. Tax sharing
B. Grants-in Aid
C. Loans
D. All the above

Answers for SelfAssessment

1.	D	2.	A	3.	D	4.	D	5.	B
6.	A	7.	D	8.	A	9.	A	10.	A
11.	A	12.	C	13.	A	14.	B	15.	A
16.	D								

Review Questions

1. To establish balance between state and federal what are the main factors?
2. In how many parts, taxes of central index can be divided?
3. What is the meaning of supplementary levies or taxes?
4. What is the procedure of transferring financial resources between governments?
5. What are the reasons of imbalance in financial resources?

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Unit 14: Fiscal Federalism in India

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Objectives

After studying this unit, students will be able to:

- understand the concept of Fiscal Federalism under the Constitution.
- evaluate the allocation of tax and revenue under Fiscal Federalism.
- understand the Allocation of Revenue Resource between Centre and state.
- evaluate the allocation of power to impose and collect the tax between Centre and state.
- explain the Finance Commission, working process and powers.
- evaluate the functions and recommendations of fourteenth finance commission.
- study the fifteenth finance commission of India.
- evaluate the recommendations of fifteenth finance commission.
- explore the concept of fiscal policy of an economy.
- evaluate the role fiscal policy in economic development

Introduction

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

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

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

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

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

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

14.1 Fiscal Federalism under the Constitution

India has a federal form of government, and hence a federal finance system. The essence of federal form of government is that the Centre and the State Governments should be independent of each other in their respective, constitutionally demarcated spheres of Action. Once the fundamentals of the government are spelt out, it becomes equally important thateach of the government should be provided with sources of raising adequate revenue.For the successful operation of the federal form of government's financial independence and adequacy for the backbone.Sales taxes are most important revenue for the states in India. Taxes vary in their design, they are generally levied in the first point of sale within the State.Multileveled government permits various functions to be assumed by different levels, potentially improving efficiency since different activities have different optimal scales in India with respect to Sales Tax Federalism, The Constitutional amendment in 1956, gave the States power to impose sales tax,the Central Sales Tax Act, 1956,enacted by the Sixth Constitutional Amendmentwhich introduced Entry 92A in List I of the Seventh Schedule authorizing Parliament to levy tax on the sale or purchase of goods (other than newspapers) in the course of inter-State trade. The revenue from this tax was assigned to the States by amending Article 269 of the Constitution.Sale within the State (Intra-State sale) is within the authority of State Government, while sale outside State (Inter-State sale) is within the authority of Central Government. Accordingly, the Central Sales Tax (CST) is levied on sale or purchase of goods in the course of inter-State trade and commerce.The power to levy the CST and revenue from this tax is assigned to the State occasioning the movement of goods from one State to another. An attempt has been made hereby to study the Distribution of Power and Tax federalism in India with respect to Sales Taxation in India Keeping in view the Central Sales Tax Act and the Individual States Sales Tax Acts.

Fiscal Federalism in India

Fiscal Federalism refers to the division of responsibilities with regards to public expenditure and taxation between the different levels of the government. Fiscal Federalism mechanism allows the government to optimize their costs on economies of scale, because in this manner, people will get public service which they prefer, andthere will be no unnecessary expenditure. Article 246 of the Constitution lays down the list of subjects on which different levels of government can make laws. There are three lists mentioned under Article 246. The Union can make laws relating to the subject matter given under list I. The Sates has the authority to make laws relating to subjects given under list II, and list III, also known as the Concurrent List, allows both the Union and the States to make laws, relating to subjects provided by the list.The Union List (I) includes taxes like Customs and Excise duties, Corporation Tax, taxes on income other that agricultural income, etc. List II includes taxes like taxes on vehicles, taxes on liquors, land revenue, taxes on stamp duties, taxes on

entertainment and luxuries, taxes on sale or purchase of goods, etc. List III, or the Concurrent List does not contain any major tax as such.The Constitution has provided provisions which enable the Union and the States to work in coordination and to levy and collect these taxes through systematic arrangements, for instance, provisions like-Taxes levied and collected by the Centre but assigned to the States.Taxes levied by the Centre but collected and kept by the States.Sharing of proceeds of income from some taxes.Grant-in-aid provided by the Centre to the States.Grants provided for any public purpose.By dividing the powers of levying and collecting tax between the Centre and the state, the Constitution has allowed the States to share the resources which are accumulated by the Centre. Any amendment of the list through which the States and the Centre derive their power of regulating the taxation system is governed by Article 368 of the Constitution.These amendments require the consent of at least half of the State Legislatures. But if any provision of Part XII of the Constitution is to be amended it can be done by invoking Article 368 (2) which requires the assent of only 50 % members of each House of the Parliament, and the share which the States are entitled can be altered by the Parliament.When administrative convenience and national policy is looked into, they require that some elastic taxes are assigned to the Central Government, but the nature of these considerations is such that these are regulated by the States.

14.2 Sales Taxation in India

Sales Tax is one of the primary sources of revenue for the States in India. Sales Tax can be defined as a tax on sales of goods, and the liability arises when the goods or the commodity is sold for the first time. If a product is sold subsequently, without being subjected to any process, then it is exempted from Sales Tax.

Sales Tax can be categorized into Three classes-

1. **Single Stage Tax-** This tax is applied to the commodity only once in the entire channel of production and distribution.
2. **Multiple Stage Tax-** This kind of tax apply at all the levels in the production-distribution channel.
3. **Value Added Tax (VAT)** – VAT possesses the characteristics of both, Single Level Tax and Multiple Level Tax.

The Central Sales Tax Act, 1966 governs the levy of Sales Tax in India. The Act applies to the whole of India. The main objectives of this Act are-

Formulation of principle for determining when purchase or sale takes place in the course of inter-state commerce, intra-state commerce, and in cases of export and import of goods.

i. Declaration of certain goods as special goods for the purpose of inter-state trade and commerce.
ii. To provide a procedure for the levy, collection and distribution of tax on the sale of goods.
iii. Specifying conditions and restrictions on state laws which impose a tax on sale or purchase of special goods.

Tax Federalism and Central Sales Tax

The Central Sales Tax Act was introduced in the year 1956, and it authorized the Parliamentto levy taxes on sale or purchase of foods (other than newspapers) In the course of inter-state commerce.Thus, the Centre had the power to levy taxes in case of inter-state trade and commerce. States were granted the authority to levy the CST, and the amount of revenue procured from the levy of CST was also assigned to the States.Section 15 of the CST Act puts certain restrictions on the power of the states with regards to the levy of a tax on "special goods" or goods which have been declared having special importance in that particular area. Apart from this, since 1975, the Union Government has also entered into a agreement with a few states to abolish levy of sales tax on goods like sugar, tobacco, and textile.

Division of Taxing Power

Under Article 246 of our Constitution, it is mentioned in Part XII there are some taxes which are completely under the purview of the Union Government but can be divided between the Centre

and the States under this Article. The various procedures for framing the Rules under CST can be categorized under three heads-

- Rules framed by the State Governments.
- Rules framed by the Central Government.
- Rules which are given under the State Sales Tax Act of each State.

As stated above, it may be noted that, although the Union levies the Sales Tax, it is administered by the States.Section 13 (1) of the CST authorizes the Central Government to make certain Rules.Section 13 (3) confers the power upon the State Governments to make certain Rules, but these Rules shouldn't be in contravention to the Rules made by the Central Government, or the CST Act as a whole.Section 9 (2) states that if in any State, there are no General Sales Tax law is in force, then the Central Government has the authority to govern the matters relating to sales tax or any other matter provided under the CST Act.Originally, inter-state trade and commerce were included under Article 269 of the Constitution,the power to administer the taxation and retain the revenue was delegated to the origin States. The original provision was based on "destination" principle, but the Constitutional amendment under the CST Act displaced this rule, making way for exportation.Sometimes some goods are not subjected to the CST, but some special excise duty may be levied on them by the Union Government. It is very important to determine whether the sale of goods has taken place within or outside the State because CST is applicable only on inter-state trade or commerce.In the case of intra-state trade and commerce, the State Sales Tax Law applies. Section 9 (1) of the CST Act states that the tax will be levied by the Union but collected and retained by the state in which the movement of the goods or the commodities have begun.

Procedure for Imposition of Sales Tax

Under the CST Act, Section 6 is the charging section, puts a liability on the seller to pay sales tax on the sale of all goods (other than the sale of electrical energy) in the course of inter-state sales. Goods and Services which fall under the CST Act have been divided into different categories and sales tax is levied according to the category of the good.The tax is levied on a single point, but in several states assesses have been divided into different categories like the dealer, manufacturer, agent, etc. and the tax is levied on the basic of the category to which the assessed belongs. A quarter returns of sales or purchases are insisted upon, and the assessed is required to furnish the return in the prescribed form.

14.3 Allocation of Revenue Resource

India follows a federal structure where the powers are shared between both the centre and the states. Though however, the distribution of these powers are not equal, and we often find states raising constant concerns about their extreme dependence on the Union Government for all the matters, thus limiting their powers and autonomy.In the financial field, the Union Government is more powerful than the states and though there have been various reforms in fiscal federalism from time to time still there exists a wide variety of issues that needs to be addressed. As in the present situation also the states have to rely heavily on the centre for financial resources.

Government revenue refers to **all the income of the government from taxes and non-tax sources**. These funds are used for government expenditure. Revenue refers to all the receipts of the government from taxes, custom duties, revenue from state-owned enterprises, capital revenues and foreign aid.The Indian Constitution has elaborate provisions regarding the distribution of revenues between the Union and the States.Article 268 to 293 in Part XII deal with the financial relations. The financial relations between the Union and the States can be studied under the following heads:

Taxes and duties levied by the Unionbut collected and appropriated by the States: Stamp duties and duties of excise on medical and toilet preparations are levied by the Government of India, but collected and appropriated by the States, within which such duties are leviable, except in the Union Territories, where they are collected by the Union Government **(Art. 268)**. The proceeds of these duties levied within any State are assigned to that State only and do not form a part of Consolidated Fund of India.

Service tax levied by the Centre but collected and appropriated by the Centre and the States: Taxes on services are levied by the Centre, but their proceeds are collected and appropriated by both the Centre and the States.Principles of their collection and appropriations are formulated by the Parliament.

Taxes levied and collected by the Unionbut assigned to the States within which they are leviable (Art.269): Succession duty in respect of property, other than agricultural land.Estate duty on property, other than agricultural land. Terminal taxes on goods or passengers carried by railways, sea or air.Taxes on railway fares and freights taxes on transactions in Stock Exchanges.

Taxes levied and collected by the Union and distributed between the Union and the States (Art.270): Certain taxes are levied as well as collected by the Union, but their proceeds are divided between the Union and the States in a certain proportion in order to effect an equitable distribution of the financial resources.This category includes all the taxes and duties referred to in the Union List, except the three categories mentioned above, any surcharge and any cess levied for specific purposes. The manner of distribution of net proceeds of these taxes is prescribed by the President, on the recommendation of the Finance Commission.

Surcharge on certain taxes (Art.271): The Parliament is, authorized to levy surcharge on the taxes mentioned in the above two categories (Art.369 and Art.370) and the proceeds of such surcharges go to the Centre exclusively and are not shareable.

Taxes levied and collected and retained by the states: These are the taxes enumerated in the State List (20 in number) and belong to the States exclusively.

Grants-in-Aid: The Parliament may make grants-in-aid from the Consolidated Fund of India to such States as are in need of assistance **(Art.275)**, particularly for the promotion of welfare of tribal areas, including special grant to Assam.These are called **statutory grants and made on the recommendation of the Finance Commission**. **Art.282** provides **for discretionary grants by the Centre and States both, for any public purposes**.The Centre makes such grants on the recommendation of the Planning Commission (an extra-constitutional body).

Loans: The Union Government may provide loan to any State or give guarantees with respect to loans raised by any State.

Previous sanction of the President (Art 274): No Bill or amendment can be introduced or moved in either House of Parliament without the previous sanction of the President, if:

1. It imposes or varies any tax in which the States are interested; or
2. It varies the meaning of the expression "Agricultural Income" as defined in the Indian Income-Tax Act; or
3. It affects the principles on which money are distributed to the States; or
4. It imposes a surcharge on the State taxes for the purpose of the Union.

According to **Article 301, Freedom of Trade,** Commerce **and Intercourse throughout the territory of India is guaranteed**, but Parliament has the power to impose restrictions in public interest.Although taxes on income, other than agricultural income, are levied by the Union, yet the **State Legislatures can levy taxes on profession, trade, etc**.

Distribution of non-tax revenues: Non-tax revenues from post and telegraph, railways, banking, broadcasting, coinage and currency, central public sector enterprises and escheat (death of a person without heir) and lapse (termination of rights) go to the Centre, while State receives non-tax revenues from irrigation, forests, fisheries, state public sector enterprises and escheat and lapse (if property is situated in that state).Provision has been made for the constitution of a **Finance Commission** to recommend to the President certain measures **for the distribution of financial resources between the Union and the States (Art.280)**.Under the situation of emergencies, these financial relations also undergo changes according to the situation and the President can modify the constitutional distribution of revenues between the Centre and the States.

Article 246 – Subject Matter of Union and States to make laws on Taxation:

Article 246 of **The Constitution of India, 1949** provides a list of subjects giving power to the different levels of government to make laws on them.Essentially speaking there are three kinds of lists mentioned under Article 246 that are as follows:

Union list:The Union Government has the authority to make laws relating to the subject matter given under the list I, called the Union list. It includes taxes like Corporation Tax, Customs and Excise duties and taxes on income other than agricultural income, etc.

State List:The State Government is vested with the power to frame laws on the subjects mentioned under list II, called the state list. It includes taxes on vehicles, liquors, land revenue, entertainment,luxuries, stamp duties and sale or purchase of goods, etc.

Concurrent List: Concurrent List gives power to both the centre as well as state government to make laws with regards to the subjects provided by the list III. List III does not include any major tax.This helps in avoiding the competitive exploitation of the same source by both the authorities and the overlapping of tax-jurisdictions under the Indian Constitution. In the case of conflict, the central government decision will prevail over the State government decision.

Distribution of powers – Levying and collection of taxes

Article 268 to 281 of the Indian Constitution has made elaborate provisions that provide directions to the centre relating to the distribution of financial resources amongst the states. It lays down principles for the centre and states to work in coordination for levying and collection of taxes through systematic arrangements.

The provisions Taxes

1. Taxes levied by the Union but collected and kept by the States (Article 268).
2. Taxes levied and collected by the Union but assigned to the States (Article 269).
3. Taxes levied and distributed between the Union and the States (Article 270).
4. Grant-in-aid from the Centre to the States (Article 273, Article 275 and Article 282).
5. Sharing of proceeds from other taxes.

14.4 GST Regime – 101st Amendment

The 101st Amendment in the constitution and the introduction of GST in the Indian Economy has significantly changed the landscape of financial relations between the centre and states.Therefore, it is extremely important to have a basic knowledge of what GST is, its application and its different forms.

Position before GST:Before the introduction of GST, there were multiple taxes imposed by the centre and states separately and the distribution of which was confusing and non-uniform. It included Service Tax, Central Excise, Customs duty and State VAT etc. But after the GST, the principle of one nation one tax was adopted.

Position after GST: GST is categorized into CGST, SGST or IGST depending on whether the transaction is Intrastate or Interstate supplies. Let's understand what does this means:

Inter-state and Intra-state Supplies

i) Intra-State supply of goods or services: In these kinds of transactions, the location of the supplier and the place of supply are in the same state.

ii) Inter-State Supply of Goods and Services: As per the Section 7 of The Integrated Goods, and Services Tax Act 2017 it can be understood that "Inter-state" trade or commerce basically means: when the supplier is located in some other state or union territory and the place of the supply is in another state/UT, or when the supply of goods or services is made to or by a Special economic zone (SEZ) unit.

Central Goods and Services Tax (CGST)

1. CGST is a tax imposed on Intra-state supplies of goods and services and is governed by the CGST Act. Along with this SGST/UTGST will also be levied on the same transaction and shall be governed by the SGST/UTGST Act.
2. It implies that in the case of Intra-state supplies of goods and services both CGST and SGST are combined which are collected simultaneously; where CGST goes to the centre and SGST goes to the state.
3. The proportion of SGST and CGST is equal.

State Goods and Services Tax (SGST)

1. The SGST is a tax levied by the state on the Intra State supplies of goods and/or services by the State Government.
2. It is governed by the SGST Act.
3. As already mentioned above it is levied and collected simultaneously with the CGST.
4. In the case of Union territories, it is called UGST and governed by the UGST Act.

Integrated Goods and Services Tax (IGST)

1. IGST or Integrated Goods and Services Tax is a tax levied on all Inter-State supplies of goods and/or services.
2. It is governed by the IGST Act.
3. IGST applies on any supply of goods and/or services in case of both import into India and export from India.
4. Tax obtained under IGST is shared between centre and states as per Article 269A.

The biggest achievement of GST is that it introduced a single uniform tax system with dual tax features where the revenue is shared between both centre and state.The GST council as mentioned under Article 279 A, shall make decisions in relation to the GST rate, inter supply transactions and other matters related to GST etc.

Article 265- Taxes: According to Article 265 of the Constitution of India, the union and state cannot levy or collect any tax except authorised by law. The power of the centre or state government to levy and collect tax is not absolute power; as Article 265 of the Constitution of India imposes certain general and specific limitations on it.

Article 266- Consolidated Funds: The Constitution of India focuses on the "Consolidated Funds and public accounts of India and of the States". It lays down the definition of consolidated funds and public accounts.Consolidated Funds : As per the clause (1) of Article 166, Consolidate funds is a fund consisting of all the:

1. The revenue received by the Government of India.
2. Loans raised by the Government through issuing of treasury bills, advances, recovery of loans etc.

Article 268: Article 268 refers to stamp duties levied by the Union but collected and appropriated by the States. It includes stamp duties on bills of exchange, cheques and promissory notes as levied by the Government of India. These taxes are not included in the consolidated fund of India and appropriated by the same state in which it was levied thus do not contribute to the Consolidated Fund of India, While in the case of Union territories the fund shall be appropriated to the Government of India.

Article 269: Article 269(1) includes all the taxes on the "sale or purchase of goods" and "taxes on the consignment of goods" except those included in Article 269 A.These taxes are assigned to States as provided by the law but are collected and levied by the Government of India.It is a tax levied on all the Inter-state sale, purchase and consignment of goods. The tax is collected and levied by the Central Government but appropriated by the State Governments.The amount collected from the Inter-state trade is appropriated to the consuming state.The power to lay down laws regarding the Inter-state and commerce and the distribution of share rests with the parliament only.

Article 270: Article 270 of the Indian Constitution basically deals with the subject of how the taxes are levied and distributed between the Union and the states. **Clause (1) of Article 270**, It lays down the procedure of the appropriation for certain taxes i.e. all the taxes except those mentioned under Article 268, 269 and 269A and any surcharge on taxes and duties mentioned in Article 271 or,any cess levied for a specific purpose, other than these the provision holds true for every other tax.

1. These taxes are levied and collected by the Union.
2. The tax shall be distributed between the States and the Central Government.
3. It may include taxes such as:
   - Excise Duty on Non-GST products
   - Income Tax
   - Basic Customs Duty etc.

Borrowing powers of Centre and State:Article 292 and Article 298 of the constitution confer both the Centre and the States the power to borrow. However, there is a huge disparity between the scope of powers of the State and Centre. The borrowing powers in the constitution are similar to what was defined in the Government of India Act 1919 and Government of India Act, 1935.

Borrowing power of the Central Government:The Central Government has almost unlimited powers in terms of borrowing. The law imposes no restrictions on the Centre in relation to both national and international borrowing. It is subject to only some restrictions which are to be fixed by the parliament by the law (Article 292).

Borrowing Power of the State Government: In India, the borrowing powers enjoyed by the state government are much less in comparison to the Central Government. As there are various kinds of territorial and other limitations on the borrowing powers of the state.The Indian States are not allowed to raise loans outside India and only have the option to raise loans either from the Government of India or through public loans.

14.5 Finance Commission

Finance Commission is important commission in composition of India and serves as a constitutional body for allocation of certain resources of revenue between the Union and the State Governments. It was set up under Article 280 of the Indian Constitution by the President of India. It was formed to describe the financial relations between the centre and the state.Finance Commission of India was framed basically to assign resources between the Union and the States. It is constituted by the President and all appointments to the commission are made by him as well. Finance Commission of India was formed in the year 1951 under Article 280 of the Constitution of India. The Commission was structured according to the world standards. The intent of forming the Finance Commission was to allocate resources of the revenue between the Union and the State Governments in India sufficiently.

The historical outlook of Finance Commission:

In Indian set up, it is signified that numerous factors unexpectedly necessitated for the formation of the finance commission of India.The historical standpoint of Finance Commission India also specifies that the need for such financial commission of India was realized by the British rulers to protect its trade and commerce from the mounting threats from the other European business rivals such as the Dutch, Portuguese and the French. The basic draft of the provisions of finance commission of India was made in the early 1920s, to combine the business dominance of the British Rule in India. The first structured draft of the finance commission was a hollow structure and it drew intense criticisms from different Indian leaders of India. A commission was formed to look into the ambiguities of the drafted provision of the Finance commission and make necessary changes to it.

Finance Commission India after independence:

The Finance Commission of India was established according to the drafted Acts and Rules in the year 1951. The President of India is authorized with the selection and responsibilities of the finance commission of India. Furthermore, the President of India assigns the term of their office of the Finance commissioner and the four other member of the commission. The commissioner and the four members of the Finance Commission of India are accountable, directly to the President of India. The President of India constitutes a Finance Commission within maximum of two years from the commencement of the draft and thereafter completion of every fifth year or at earlier time.

Structure of Finance Commission:

- The Finance Commission consists of a chairman and four other members, appointed by the President himself.
- The qualification of the commissioner and the four members are determined by the elected parliament and by formulating appropriate law.

Establishment of Finance Commission of India:

The comprehensive set up and of the Finance Commission has been provided in Article 280 of the Constitution of India. The Article states:The President shall, within two years from the initiation of this Constitution and thereafter and at the expiration of every fifth year or at such time earlier as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.Parliament may by law determine the qualification which shall be requisite for appointment as members of the Commission and the manner in which they shall be selected.It shall be the duty of the Commission to make recommendations to the President as to the distribution of the net proceeds of taxeswhich are to beor may be divided between them under this chapter and the allocation between the States of the respective shares of such proceeds. It is also the responsibility of the Finance Commission to describe the financial relations between the Union and the State and it also caters to the purpose of devolution of non-plan revenue resources.One of the major tasks of a Finance Commission as specified in Article 280 (3) (a) of the Constitution is to make recommendations regarding the distribution between the Union and the states of the net proceeds of taxes. This is the most vital task of any Finance Commission, as the share of states in the net proceeds ofUnion taxes is the predominant channel of resource transfer from the Centre to states.

14.6 Composition of Finance Commission of India

The Finance Commission of India has a Chairman along with four other members and a Secretary. The Chairman is the person who heads the Commission and presides over its activities. The Indian Parliament is approved to determine by law the qualifications of the members of the Commission and method of their selection.The Chairman of the Finance Commission is designated among persons who have had the experience of public matters, and four other members are selected among persons who are qualified as judges of High Courts of India, or have knowledge of finance, or have vast experience in financial matters and are in administrationor have knowledge of economics. All the appointments are made by the Indian President. A member can be disqualified on the following grounds: when a member is found to be of unsound mind, is involved in a vile act or if his interests are likely to affect the functioning of the Commission.The tenure of the office of the Member of the Finance Commission is stated by the President of India and in some cases the members are also reappointed. The members shall give part time or whole-time service to the Commission as scheduled by the President. The salary of the members of the Finance Commission is according to the provisions laid down by the Constitution of India.

Powers, Functions and Responsibilities of finance commission:

Under the Indian Constitution, the basis for sharing of divisible taxes by the Centre and the States and the principles governing grants-in-aid to the states have to be decided by the Commission every five years. The President can refer to the Commission any other matter in the interest of sound financethe recommendations of the Commission together with a descriptive memorandum as to the action taken by the Government on them are laid before each house of Parliament. The Commission has to assess the increase in the Consolidated Fund of a state to affix the resources of the Panchayat in the state. It also has to appraise the increase in the Consolidated Fund of a state to affix the resources of the Municipalities in the state.The Commission has been given sufficient powers to operate within its area of activity. It has all the powers of the Civil Court as per the Code of Civil Procedure, 1908. It can call any witness, or can ask for the production of any public record or document from any court or office. It can ask any person to give information or document on matters as it may feel to be useful or pertinent. It can function as a civil court in discharging its duties.

Functions of Finance Commission:

Major functions of finance Commission is to make recommendations to the president of India on the following affairs:The distribution of the net proceeds of taxes to be shared between the Centre and the states, and the allocation between the states of the respective shares of such proceeds.The principles that should govern the grants-in-aid to the states by the Centre.The measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and the municipalities in the state on the basis of the recommendations made by the state finance commission.Any other matter referred to it by the president in the interests of sound finance.Till 1960, the commission also recommended the grants given to the States of Assam Bihar Orissa and West Bengal in lieu of assignment of any share of the net proceeds in each year of export duty on jute and jute products. These grants were to be given for a transitory period of ten years from the commencement of the Constitution.The commission submits its report to the president. He lays it before both the Houses of Parliament along with an explanatory memorandum as to the action taken on its recommendations.

Powers of Finance Commission:

The Commission shall have all the powers of the Civil Court as per the Code of Civil Procedure, 1908.It can call any witness, or can ask for the production of any public record or document from any court or office.It can ask any person to give information or document on matters as it may feel to be useful or relevant.It can function as a civil court in discharging its duties.The Constitution of India foresees the Finance commission as synchronizing fiscal federalism in India. Though, its role in the Centre-state fiscal relations has been destabilizedby the emergence of the Planning Commission, a non-constitutional and a non-statutory body.Dr P V Rajamannar, the Chairman of the Fourth Finance commission, emphasised the overlapping of functions and responsibilities between the Finance Commission and the Planning Commission in federal fiscal transfers as "the reference in Article 275 to grants-in aid to the revenues of states is not confined to revenue expenditure only. There is no legal warrant for excluding from the scope of the Finance Commission all capital grants; even the capital requirements of a state may be properly met by grants-in-aid under Article 275, made on the recommendations of the Finance Commission".The legal position is that there is no provision in the Constitution to avert the finance commission from taking into consideration both capital and revenue requirements of the states in formulating a scheme of devolution and in recommending grants under Article 275 of the Constitution. But the creation of Planning Commission inexorably has led to a duplication and overlapping of functions, to avoid that a practice has grown which has resulted in the curtailment of the functions of the finance commission.Complete plan, with respect to both policy and programme, comes within the purview of the Planning Commission as the assistance to be given by the Centre to plan projects either by way of grants or loans is practically dependent on the recommendations of the Planning Commission.It is understandable that the Finance Commission cannot operate in the same field. The main functions of the Finance Commission consist in determining the revenue gap of each state and providing for filling up the gap by a scheme of devolution, partly by a distribution of taxes and duties and partly by grants-in-aid.

Significance of Finance Commission:

There is immense importance of the Finance Commission in constitution of India. It is a constitutional instrument capable of settling many complicated financial glitches that affect the relations of the Union and States. This is evident from the recommendations of the last 14 finance Commissions appointed so far.Report of Finance Commission in Parliament Article 281 states that President shall cause every recommendation made by the Finance Commission under the provisions of this Constitution together with a descriptive memorandum as to the action taken thereon to be laid before each House of Parliament.

Recommendations:

Finance Commission does not communicate with the Union Government in the matters of increasing its funds. Its work is to make recommendations on distribution between the Union and the States of the net proceeds of taxes and the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues. With respect to States Finance Commission, it suggests the actions needed to increase the Consolidated Fund of a State to supplement the resources of the Panchayat and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

On Panchayat and Municipalities:

The role of the Finance Commission has expanded after the 73rd and 74th Constitutional amendments to identify the rural and urban local bodies as the third tier of government. Article 280 (3) (bb) and Article 280 (3) (c) of the Constitution command the Commission to recommend measures to increase the Consolidated Fund of a State to supplement the resources of Panchayats and Municipalities based on the recommendations of the respective State Finance Commissions. This also includes enhancing the resources of Panchayat and municipalities.

14.7 14TH Finance Commission of India

FC-XIV was constituted by the President on 2 January 2013 to make recommendations for the period 2015-20.Dr. Y. V. Reddy was appointed the Chairman of the Commission. Ms. Sushama Nath, Dr. M. Govinda Rao and Dr. SudiptoMundle were appointed full time Members. Prof. Abhijit Sen was appointed as a part-time Member. Shri Ajay Narayan Jha was appointed as Secretary

RecommendationsMade by the 14th Finance Commission Of India:

The Major Recommendations of 14th Finance Commission headed by Prof. Y V Reddy are given below: The standout recommendation of the 14th Finance Commission (FFC) that the share of states in the net proceeds of the shareable Central taxes should be 42% against 32% recommended in the 13th Finance Commission,Revenue deficit to be progressively reduced and eliminated. Fiscal deficit to be reduced to 3% of the GDP by 2017–18, which is a carbon copy of the 13th Finance Commission.A target of 62% of GDP for the combined debt of centre and states; an improvement over the 13th Finance Commission which targeted 68% debt of GDP for the combined debt of centre and states.The Medium Term Fiscal Plan (MTFP) should be reformed and made the statement of commitment rather thanstatement of intent. FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation. Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act (GST).Initiatives to reduce the number of Central Sponsored Schemes (CSS) and to restore the predominance of formula based plan grants.States need to address the problem of losses in the power sector in time bound manner.Owing to this increase in the states’ share, it was envisaged that the increase in their shares to be utilized in accumulating capital assets. The FFC has also proposed a new horizontal formula for the distribution of the states’ share in divisible pool among the states.There are changes both in the variables included/excluded as well as the weights assigned to them. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables: 2011 population and forest cover; and excluded the fiscal discipline variable.

Implications of 14th Finance Commission

With greater fiscal space there has been a 10% increase in the states’ share of the shareable of the central taxesstates can meaningfully contribute to the overall growth and development in their regions, Huge tax devolution could put some strain on center’s finances. To ensure that the Centre’s fiscal space is secure, the suggestion is that there will be commensurate reductions in the Central Assistance to States (CAS) known as “plan transfers”.

With regards to the new horizontal formula proposed by the 14th Finance Commission for the distribution of states’ share, all states stand to gain from FFC transfers in absolute terms.to assess the distributional effects, the increases should be scaled by population, Net State Domestic Product (NSDP) at current market price, or by states’ own tax revenue receipts. The biggest gainers in absolute terms under General Category States (GCS) are Uttar Pradesh, West Bengal and Madhya Pradesh while for Special Category States (SCS) it is Jammu & Kashmir, Himachal Pradesh and Assam.A better measure of impact is benefit per capita. The major gainers in per capita terms turn out to be Kerala, Chhattisgarh and Madhya Pradesh for GCS and Arunachal Pradesh, Mizoram and Sikkim for SCS.The 14th Finance Commission reinforced the idea of the 13th Finance Commission to reduce or if possible, eliminate revenue deficits; 13th Finance Commission was failed in this case, or that the government has not been able to raise its revenue efficiently.India’s high fiscal deficit is clearly pictured by the recommendation of this commission to reduce fiscal deficit again by 3%.The far-reaching recommendations of the 14th Finance Commission, along with the creation of the NITI Adyog, The Government’s vision of cooperative and competitive federalism. The necessary, indeed vital, encompassing of cities and other local bodies within the embrace of cooperative and competitive federalism is the next policy challenge.

14.8 Fifteenth Finance Commission

The Finance Commission is a Constitutionally mandated body that is at the centre of fiscal federalism.Under Article 280, of the Constitution, the President of India is required to constitute a Finance Commission at an interval of five years or earlier, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them, lay down the principles determining the distribution of these taxes among States.Its working is characterized by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism.Its recommendations are also geared towards improving the quality of public spending and promoting fiscal stability.The first Finance Commission was set up in 1951 and now there have been fifteen.The **Fifteenth Finance Commission** was constituted on 27 November 2017 against the backdrop of the abolition of the Planning Commission (as also of the distinction between Plan and non-Plan expenditure) and the introduction of the goods and services tax (GST), which has fundamentally redefined federal fiscal relations.

The Finance Commission (FC) the method and formula for distributing the tax proceeds between the Centre and states, and among the states as per the constitutional arrangement and present requirements.The 15th Finance Commission was constituted by the President of India in November 2017, under the **chairmanship of NK Singh**.Its recommendations will cover a period of five years from the year 2021-22 to 2025-26.

The Fifteenth Finance Commission (15th FC)'s ToR was unique and wide-ranging in many ways.The Commission was asked to recommend performance incentives for States in many areas like the power sector, adoption of DBT, solid waste management etc.Another unique ToR was to recommend a funding mechanism for defence and internal security.

15th Finance Commission Recommendations: Recommendation of the 15th Finance Commission of India that was tabled on 1st February 2021 are:

1. Maintaining vertical devolution at 41%:

1. It has recommended maintaining the vertical devolution at 41% the same as in the report for 2020-21.
2. It would help in maintaining predictability and stabilizing the resources, especially during COVID times.
3. It is at the same level of 42% of the divisible pool as recommended by 14th FC.
   - However, it has made the required adjustment of about 1% due to the changed status of the erstwhile
   - State of Jammu and Kashmir into the new Union Territories of Ladakh and Jammu and Kashmir.

2. **On GST:**

1. GST accounts for 35% of the gross tax revenue of the Union.
2. GST accounts for around 44% of own tax revenue of the States.

3. **On Gross Tax Revenue:**

1. There is a drop of 1.7% points in the gross tax revenue after excluding GST cess collection in comparison to 2016-17 figures.
2. The impact of this drop could be seen in the tax devolution to states.

4. **Gross Tax Revenue Assessment 2021-26:**It is expected to be 135.2 lakh crore, out of which the divisible pool is estimated to be 103 lakh crore.

5. On Horizontal Devolution:

1. The criteria and the weights assigned for horizontal devolution are:
   a. Population: 15%
   b. Area: 15%
   c. Forest & Ecology: 10%
   d. Income Distance: 45%
   e. Tax and Fiscal Efforts: 2.5%
   f. Demographic Performace: 12.5%
2. The commission has also re-introduced the tax effort criterion to reward fiscal performance.

6. On Revenue Deficit Grants (RDG):

Revenue deficit grants emanate from the requirement to meet the fiscal needs of the States on their revenue accounts that remain to be met, even after considering their own tax and non-tax resources and tax devolution to them.Revenue Deficit is defined as the difference between revenue or current expenditure and revenue receipts, which includes tax and non-tax.It has recommended post-devolution revenue deficit grants amounting to about Rs. 2.94 lakh crores over the five-year period ending FY26.The number of states qualifying for the revenue deficit grants decreases from 17 in FY22, the first year of the award period to 6 in FY26, the last year.

7. Sector-specific grants

Sector-specific grants of Rs 1.3 lakh crore will be given to states for eight sectors:

- health,
- school education,
- higher education,
- implementation of agricultural reforms,
- maintenance of PMGSY roads,
- judiciary,
- statistics, and
- aspirational districts and blocks. A portion of these grants will be performance-linked.

8. State-specific grants:

1. The Commission recommended state-specific grants of Rs 49,599 crore. These will be given in the areas of:
    - social needs,
    - administrative governance and infrastructure,
    - water and sanitation,
    - preservation of culture and historical monuments,
    - high-cost physical infrastructure, and
    - tourism.
2. The Commission recommended a high-level committee at the state-level to review and monitor utilisation of state-specific and sector-specific gran

9. Fiscal Space for Centre:

Total 15th Finance Commission transfers (devolution + grants) constitutes about 34% of estimated Gross Revenue Receipts to the Union, leaving adequate fiscal space to meet its resource requirements and spending obligations on national development priorities.

10. On Local Governments

1. Rs. 4,36,361 crore is the total grant given to the local governments for the period of 2021-26. Out of the total grant; Rs.450 crore is dedicated to the shared municipal services. The grants to local bodies will be made available to all three tiers of Panchayat- village, block, and district.
2. Grants to Rural Local Bodies:A total sum of Rs. 2,36,805 crore is a grant for the rural local bodies.
3. Grants to Urban Local Bodies:
    1. Rs.1,21,055 crore is the total grant for the urban local bodies.
    2. Of these total grants, Rs. 8,000 crore is performance-based grants for incubation of new cities and Rs. 450 crore is for shared municipal services.
    3. Urban local bodies have been categorised into two groups, based on population, and different norms have been used for the flow of grants to each, based on their specific needs and aspirations.
    4. Basic grants are proposed only for cities/towns having a population of less than a million. For Million-Plus cities, 100% of the grants are performance-linked through the **Million-Plus Cities Challenge Fund (MCF).**
    5. MCF amount is linked to the performance of these cities in improving their air quality and meeting the service level benchmarks for urban drinking water supply, sanitation and solid waste management.

4. Grants for Health to be Channelised through Local Governments:
    1. Rs. 70,051 crore stands for the Health grant to the local governments.
    2. The health grants will be provided for:
        - conversion of rural sub-centres and primary healthcare centres (PHCs) to health and wellness centres (HWCs),
        - support for diagnostic infrastructure for primary healthcare activities, and
        - support for urban HWCs, sub-centres, PHCs, and public health units at the block level.
        - Grants to local bodies (other than health grants) will be distributed among states based on population and area, **with 90% and 10% weightage, respectively.**
        - The Commission has prescribed certain conditions for availing these grants (except health grants).

11. On Higher Education:

1. The 15th finance commission has recommended two subtypes of higher education grants:
2. Promotion of online education:
    1. Rs. 5,078 crore is a total sum of grant for the promotion of online education.
3. Development of professional courses in regional languages:
    1. The commission's recommendation is in line with the New Education Policy 2020. Rs. 1,065 crore has been allocated for the development of these courses from 2021-26.
    2. Two colleges in each state should convert their learning material and pedagogy into the recognized regional language.

12. On Defence:

1. Keeping in view the extant strategic requirements for national defence in the global context, 15th FC has, in its approach, re-calibrated the relative shares of Union and States in gross revenue receipts.
2. This will enable the Union to set aside resources for the special funding mechanism that 15th FC has proposed.
3. The Union Government may constitute in the Public Account of India, a dedicated non-lapsable fund, Modernisation Fund for Defence and Internal Security (MFDIS).
4. The total indicative size of the proposed MFDIS over the period 2021-26 is Rs. 2,38,354 crore.

13. On Disaster Risk Management:

1. The fifteenth finance commission recommended maintaining the contribution of states to the State Disaster Risk Fund (SDRF) to be 25% except by the NE States (10%)
2. It has seen no changes since the 13th Finance Commission recommended the same arrangement.
3. Creation of Mitigation Funds both at central and state levels. The Mitigation Fund should be used for those local level and community-based interventions which reduce risks and promote environment-friendly settlements and livelihood practices.
4. The 15th FC has recommended the total corpus of Rs.1,60,153 crore for States for disaster management for the duration of 2021-26, of which the Union's share is Rs. 1,22,601 crore and States' share is Rs. 37,552 crore.
5. It has recommended six earmarked allocations for a total amount of Rs. 11,950 crore for certain priority areas, namely,two under the NDRF (Expansion and Modernisation of Fire Services and Resettlement of Displaced People affected by Erosion) andfour under the NDMF (Catalytic Assistance to Twelve Most Drought-prone States, Managing Seismic and Landslide Risks in Ten Hill States, Reducing the Risk of Urban Flooding in Seven Most Populous Cities and Mitigation Measures to Prevent Erosion).

14.9 Recommendations for Fiscal Roadmap

1. **Fiscal deficit and debt levels**

    1. The Commission suggested that the *centre bring down fiscal deficit to 4% of GDP by 2025-26*. For states, it recommended the fiscal deficitlimit (as % of GSDP) of:
        1. 4% in 2021-22,
        2. 3.5% in 2022-23, and
        3. 3% during 2023-26.

2. If a state is unable to fully utilise the sanctioned borrowing limit as specified above during the first four years (2021-25), it can avail the unutilised borrowing amount (calculated in rupees) in subsequent years (within the 2021-26 period).
3. Extra annual borrowing worth 0.5% of GSDP will be allowed to states during the first four years (2021-25) upon undertaking power sector reforms including
   1. reduction in operational losses,
   2. reduction in revenue gap,
   3. reduction in payment of cash subsidy by adopting direct benefit transfer, and
   4. reduction in tariff subsidy as a percentage of revenue.
4. The Commission observed that the recommended path for fiscal deficit for the centre and states will result in a reduction of total liabilities of: the centre from 62.9% of GDP in 2020-21 to 56.6% in 2025-26, andthe states on aggregate from 33.1% of GDP in 2020-21 to 32.5% by 2025-26.
5. It recommended forming a high-powered inter-governmental group to: review the **Fiscal Responsibility and Budget Management Act (FRBM)**,recommend a new FRBM framework for the centre as well as states, and oversee its implementation.

2. Revenue mobilisation:

1. Income and asset-based taxation should be strengthened.
2. To reduce excessive dependence on income tax on salaried incomes, the coverage of provisions related to a tax deduction and collection at source (TDS/TCS) should be expanded.
3. Stamp duty and registration fees at the state level have large untapped potential.
4. Computerised property records should be integrated with the registration of transactions, and the market value of properties should be captured.
5. State governments should streamline the methodology of property valuation.

3. GST:

1. The inverted duty structure between intermediate inputs and final outputs present in GST needs to be resolved.
2. Revenue neutrality of GST rate should be restored which has been compromised by multiple rate structure and several downward adjustments.
3. Rate structure should be rationalised by merging the rates of 12% and 18%.
4. States need to step up field efforts for expanding the GST base and for ensuring compliance.

4. Financial management practices:

A comprehensive framework for public financial management should be developed. An independent Fiscal Council should be established with powers to assess records from the centre as well as states. The Council will only have an advisory role. A time-bound plan for phased adoption of standard-based accounting and financial reporting for both centre and states should be prepared while eventual adoption of accrual-based accounting is being considered. The centre as well as states should not resort to off-budget financing or any other non-transparent means of financing for any expenditure. A standardised framework for reporting contingent liabilities should be devised.Both centre and states should strive to improve the accuracy and consistency of macroeconomic and fiscal forecasting.States should amend their fiscal responsibility legislation to ensure consistency with the centre's legislation, in particular, with the definition of debt. States should have more avenues for short-term borrowings other than the ways and means of advances and overdraft facility from the Reserve Bank of India. States may form an independent debt management cell to manage their borrowing programmes efficiently.

14.10 Fiscal Policy

Fiscal policy, measures employed by governments to stabilize the economy, specifically by manipulating the levels and allocations of taxes and government expenditures.Fiscal policy relates to decisions that determine whether a government will spend more or less than it receives.

According to Semuelson: "Fiscal policy is concerned with all those activities which are adopted by the government to collect revenues and make the expenditures so that economic stability could be attained without inflation and deflation"

According to Arthur Smith, "Fiscal policy refers to the policy under which government uses its expenditure and revenue program to produce the desirable effect of national income, production and employment".

Objectives of Fiscal Policy

1. Effective Mobilization of Resources: The principal objective of fiscal policy is to confirm fast economic process and development. The objective of economic growth and development is achieved by mobilisation of economic resources.
2. Reduction in inequalities of Income and Wealth: Fiscal policy aims at achieving equity or social justice by reducing financial gain inequalities among totally different sections of the society. The direct taxes like income tax are charged additional on the wealthy individuals as compared to lower financial gain groups. Indirect taxes are additional within the case of semi-luxury and luxury things, that are largely consumed by the higher middle class and also the upper class.
3. Price Stability and Control of inflation: One of the main objective of economic policy is to manage inflation and stabilize value. Therefore, the government, perpetually aims to manage the inflation by Reducing fiscal deficits, introducing tax savings schemes, productive use of economic resources, etc.,
4. Employment Generation: The government is creating every potential effort to extend employment within the country through effective business enterprise measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage additional investment and consequently generates additional employment.
5. Balanced Regional development: Another main objective of the economic policy is to achieve a balanced regional development. There are numerous incentives from the government for fixing projects in backward areas like money subsidy. Concession in taxes and duties within the form of tax holidays, Finance at concessional interest rates, etc.

Instrument or Tools of Fiscal Policy

- Implementing the Fiscal policy of the Nation
- Govt revenue
- Expenditure
- Budget
- The Budget of the Govt is main instrument of the Fiscal Policy

LEGISLATIVE MANDATES: In The Employment Act of 1946, State proclaimed the role of government in promoting maximum employment, production, and purchasing power. The Act created the CEA (Council of Economic Advisers) to advise the President on economic matters. It also created the Joint Economic Committee of Congress to investigate economic problems of national interest.
FISCAL POLICY AND THE AD/AS MODEL: **Discretionary fiscal policy** refers to the deliberate manipulation of taxes and government spending to alter real domestic output and employment, control inflation, and stimulate economic growth. "Discretionary" means the changes are at the option of the Federal government.
B. Simplifying assumptions:
1. Assume initial government purchases don't depress or stimulate private spending.
2. Assume fiscal policy affects only the demand, not supply, side of the economy.

Fiscal Policy Choices

1. Expansionary fiscal policy: used to combat a recession.
2. Contractionary fiscal policy: used to combat demand-pull inflation, due to excess spending.
Expansionary Fiscal Policy: Expansionary Policy needed: a decline in investment has decreased AD, so real GDP has fallen, and also employment has declined. A possible fiscal solution may be:

a. An increase in government spending, which shifts AD to the right by more than the change in G, due to the multiplier.
b. A decrease in taxes (raises income, and consumption rises by MPC times the change in income). AD shifts to the right by a multiple of the change in consumption.
c. A combination of increased G spending and reduced taxes.

d. If the budget was initially balanced, expansionary fiscal policy creates a budget deficit.

Contractionary Fiscal Policy: Contractionary Policy needed: When demand-pull inflation occurs, a shift of AD to the right in the vertical range of AS, then contractionary policy is the remedy.

a. A decrease in G spending shifts AD back left, once the multiplier process is complete. Here price level returns to its pre-inflationary level, but GDP remains at full-employment level.
b. An increase in taxes will reduce income, and then consumption at first by the MPC times the decrease in income, and then the multiplier process leads AD to shift leftward still further.
c. A combined G spending decrease and tax increase could have the same effect with the right combination.
d. If the budget was initially balanced, a contractionary fiscal policy creates a budget surplus.

Financing Deficits

The method used to finance deficits or dispose of surpluses influences fiscal policy:

A. Financing deficits can be done 2 ways:

1. Borrowing: ("crowding out" effect) The government competes with private borrowers for funds, and could drive up interest rates; the government may "crowd out" private borrowing, and this offsets the government expansion.

2. Money Creation: When the Federal Reserve loans directly to the government by buying bonds, the expansionary effect is greater since private investors are not buying bonds. (Monetarists argue that this is monetary, not fiscal, policy that is having the expansionary effect in this situation).

Disposing of Surpluses

B. Disposing of surpluses can be done in 2 ways:

1. Debt reduction is good, but may cause interest rates to fall and stimulate spending, which could then be inflationary.
2. Impounding or letting the surplus funds remain idle would have greater anti-inflationary impact. The government holds surplus tax revenues which keeps these funds from being spent.

POLICY OPTIONS: G OR T?

Economists have mixed views about whether to use government spending or tax changes to promote stability, depending on their view of the government:

1. If economists are concerned about unmet social needs or infrastructure, they tend to favor higher government spending during recessions and higher taxes during inflationary times.
2. When economists think that government is too large or inefficient, they tend to favor lower taxes for recessions and lower government spending during inflationary periods.

BUILT-IN STABILITY

Built-in stability arises because net taxes (taxes minus transfers and subsidies) change with GDP.

Remember that taxes reduce incomes, and therefore, spending.

It is desirable for spending to rise when the economy is slumping and to fall when the economy is becoming inflationary.

1. Taxes automatically rise with GDP because incomes rise and tax revenues fall when GDP falls.
2. Transfers and subsidies rise when GDP falls; when these government payments (welfare, unemployment, etc.) rise, net tax revenues fall along with GDP.

BUILT-IN STABILITY

The size of automatic stability depends on responsiveness of changes in taxes to changes in GDP: The more progressive the tax system, the greater the economy's built-in stability.

1. Marginal tax rates on personal income can be changes, such as in 1993, when it was increased from 31% to 39.6% to prevent demand-pull inflation.
2. Automatic stability reduces instability, but does not correct this economic instability.

EVALUATING FISCAL POLICY

A. To evaluate the direction of discretionary fiscal policy, adjustments need to be made to the actual budget deficits or surpluses.

1. The standardized budget is a better index than the actual budget in the direction of government fiscal policy because it indicates when the Federal budget deficit or surplus would be if the economy were operating at full employment. In the case of a budget deficit, the standardized budget:
    a. Removes the cyclical deficit that is produced by swings in the business cycle, and
    b. Reveals the size of the standardized deficit, indicating how expansionary the fiscal policy was that year.

Importance of Fiscal Policy in India:

In a country like India, fiscal policy plays a key role in elevating the rate of capital formation both in the public and private sectors.

Through taxation, the fiscal policy helps mobilise considerable amount of resources for financing its numerous projects.

Fiscal policy also helps in providing stimulus to elevate the savings rate.

The fiscal policy gives adequate incentives to the private sector to expand its activities.

Fiscal policy aims to minimise the imbalance in the dispersal of income and wealth.

Summary

For the successful operation of any form of government, it is very necessary that they have the adequate financial resources. Through tax federalism, the State Governments have been provided with enough resources so that they do not over depend on the Union for financial aids and resources.In the interest of national economy, some restrictions have also been placed on the powers of the State, which becomes necessary for a country like India. Therefore, it can be said that a proper balance has been maintained between autonomy and dependence.Finance Commission is a Constitutional body framed under Article 280 of the Indian Constitution. It is established every five years by the President of India to assess the state of finances of the Union and the States andsuggest strategies to maintain a stable and sustainable fiscal environment.It also makes recommendations regarding the devolution of taxes between the Centre and the States from the divisible poolwhich includes all central taxes excluding surcharges and cess which the Centre is constitutionally mandated to share with the States.A pair of balanced scales representing the Union of India and the States, the cover visual of the Fifteenth Finance Commission's report for the period 2021-22 to 2025-26, seeks to highlight the Commission's endeavour to maintain an equitable approach at a time when the Centre and States are facing unprecedented revenue stress and fiscal demands.The Centre has accepted much of the Commission's broad recommendations, including giving States a 41% share of the divisible pool of taxes and revenue deficit grants of nearly 2.95-lakh crore for 17 States over the next five years.It has also acceded to the Commission's suggestion to make grants towards urban and rural local bodies conditional upon States setting up their own finance commissions and publishing online the accounts of local bodies.And 60% of these grants will be further linked to these bodies' providing sanitation and water services.There is an 'in-principle nod to the panel's suggestion to set up a non-lapsable dedicated fund to support defence and internal security modernisation- a response to the Centre's belated request to examine if such a fund can be considered for funding defence Capex beyond normal Budget allocations.While the panel has suggested moving 1.53-lakh crore out of the Consolidated Fund of India over five years to partly finance this, the Centre has said the funding nitty-gritty will be examined later.States would monitor how the modalities here evolve, even as they have reason to fret about the Centre's non-committal response to the Commission's recommendations of sector-specific and other grants for them adding up to about 1.8-lakh crore.

The fiscal policy is the first step towards an efficient and profound nation. It is a jest and planning of all the sectoral development along with it carter the need of common people and inducing social justice. It's a great tool in the hands of government and if effective fiscal policy is applied then the growth of any nation is inevitable. The proper investment in different program and policy can bring great results in the long terms. In the context of developing nation, the importance of fiscal policy is just too much because a developing nation has limited resources and many responsibility and needs that require urgent attention. Mobilization of resources towards most urgent requirement, is the prerequisite of any developmental action.India has achieved to utilize benefit with help of fiscal policy but certain gaps in the implementation still exist which need a corrective measure to bring overall sustainable economic growth.

Keywords

Federalism: is a system of government in which the same territory is controlled by two levels of government.

Taxation: is the practice of collecting taxes (money) from citizens based on their earnings and property.

Finance Commission: is a constitutional body for the purpose of allocation of certain revenue resources between the Union and the State Governments.

Revenue deficit: is that which occurs when the government's total revenue expenditure exceeds its total revenue receipts.

A grant-in-aid: is the transfer of national funding to state, local, private, or individual entities for a project.

SelfAssessment

1. Which of the following is not a feature of the Constitution of India?
A. It is democratic
B. it is republic
C. it is federal
D. it is Presidential

2. In the Indian federal system, residuary powers rest with the
A. Local government
B. State
C. Judiciary
D. Centre

3. Unequal representation of states in the Council of States in India indicates
A. The Federal nature
B. the unitary features
C. the bicameral features
D. none of these

4. The classification of government as unitary and federal is on the basis of…………..
A. Centralization of power
B. division of power
C. delegation of powers
D. separation of powers

5. GST is a matter of jurisdiction of ______ Government
A. Union
B. State
C. Union & State
D. None of these

6. What is true about Tobacco products under GST regime?

A. Tobacco will be brought under GST later
B. Tobacco is subject to GST in addition to Central Excise Duty
C. Tobacco is out of the purview of GST
D. None of the above

7. Where the location of the supplier and the place of supply are in two different States –
A. IGST is applicable
B. CGST is applicable
C. SGST plus CGST is applicable
D. CGST plus IGST is applicable

8. GST registration is not compulsory in the case of
A. Casual taxable persons making taxable supply
B. Persons under reverse charge
C. Non-resident making taxable supply
D. Person dealing in exempt goods alone

9. Which of the following is a Statutory Body?
A. Finance Commission
B. Planning Commission
C. State Planning Board
D. None of these

10. Which of the following recommends to the President the basis for distribution of the net proceeds of taxes between the centre and states?
A. Finance Ministry
B. RBI
C. Finance commission
D. Parliament

11. Recommendations of first Finance Commission covered which of the following periods?
A. 1951-56
B. 1952-57
C. 1953-58
D. 1954-59

12. The Finance Commission does all the following functions except one, which is that?
A. Works out allocation of taxes in the divisible pool
B. Looks into financial relations between the Centre and the States
C. Allocates grants in-aid to the States and Union Territories
D. Assist the Planning Commission in making 5 year plans.

13. Fiscal policy in India is formulated by
A. Reserve Bank of India
B. Planning Commission
C. Finance Ministry
D. Securities and Exchange Board of India

14. Which of the following is part of fiscal policy of the govt?
A. sale of securities
B. government spending & taxation
C. credit rationing
D. none of the above.

15. Consider the following statements regarding Fiscal Policy:
1. It helps to maintain the economy's growth rate so that certain economic goals can be achieved.
2. It aims to achieve full employment, or near full employment, as a tool to recover from low economic activity.

Which of the statements given above is/are correct?

A. 1 only

B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

16. Fiscal consolidation is one of the objectives of India's economic policy. Which of the following would help in fiscal consolidation?
1. increasing taxes
2. getting more loans
3. reducing subsidies

Select the correct answer using the codes given below.
A. 1 and 2 only
B. 1 and 3 only
C. 2 and 3 only
D. 1, 2 and 3

Answers forSelfAssessment

l.	D	2.	D	3.	B	4.	B	5.	C
6.	B	7.	A	8.	D	9.	A	10.	C
11.	B	12.	D	13.	C	14.	B	15.	C
16.	B								

Review Questions

1. Assess the role of the Finance Commission in maintaining fiscal federalism in India. Do you agree that it should be given a permanent status?
2. Examine the challenges of fiscal federalism in India.
3. How is fiscal federalism different from cooperative federalism?
4. What are the three expansionary fiscal policy tools the government can use to expand an economy that is in a recession?
5. What role did automatic stabilizers and discretionary fiscal policies have in the emergence of budget surpluses during the late 1990s?

Further Readings

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3. Public Finance in Theory and Practice by Musgrave. .and P.B. Musgrave, McGraw Hill Education

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