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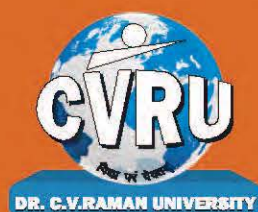
Faculty of Commerce

Public Finance

Public Finance



3BCOM3



Dr. C.V. Raman University

Kargi Road, Kota, BILASPUR, (C. G.),

Ph. : +07753-253801, +07753-253872

E-mail : info@cvru.ac.in | Website : www.cvru.ac.in



DR. C.V. RAMAN UNIVERSITY

Chhattisgarh, Bilaspur

A STATUTORY UNIVERSITY UNDER SECTION 2(F) OF THE UGC ACT

3BCOM3
Public Finance

Subject Expert Team

Dr. Supriya Singh, Dr. C.V. Raman
University, Kota, Bilaspur,
Chhattisgarh

Dr. Abhinav Awasthi, Dr. C.V. Raman
University, Kota, Bilaspur,
Chhattisgarh

Dr. Niket Shukla, Dr. C.V. Raman
University, Kota, Bilaspur,
Chhattisgarh

Dr. Sumona Bhattacharya,
Department of Commerce at Atal
Bihari Vajpayee Vishwavidyalaya,
Bilaspur, Chhattisgarh

Dr. S. Jabir Hussain, Dr. C.V. Raman
University, Kota, Bilaspur,
Chhattisgarh

Dr. R.P. Chaudhary, Dr. C.V. Raman
University, Kota, Bilaspur,
Chhattisgarh

Course Editor:

- **Dr. Indu Santosh, Associate Professor**
Disha Institute of Management and Technology Collage, Raipur, Chhattisgarh

Unit Written By:

1. Dr. Rahul Sharma

(Associate Professor, Dr. C. V. Raman University)

2. Dr. Preeti Shukla

(Associate Professor, Dr. C. V. Raman University)

3. Dr. Anshul Shrivastava

(Assistant Professor, Dr. C. V. Raman University)

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BLOCK I

UNIT -1

AN INTRODUCTION TO PUBLIC FINANCE

CONTENTS

- 1.0 Aims and Objectives
- 1.1 Introduction
- 1.2 What is Public Finance?
 - 1.2.1 Concept of Functional Finance
- 1.3 Features of Public Finance
- 1.4 Scope of Public Finance
- 1.5 Importance of Public Finance
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- 1.9 Let Us Sum Up
- 1.10 Unit End Activity
- 1.11 Keywords
- 1.12 Questions for Discussion
- 1.13 References & Suggested Readings

1.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain public finance and its needs
- Discuss the concepts of public finance
- Explain the importance of public finance
- Discuss the characteristics of public finance
- Describe the differences of private finance and public finance

1.1 INTRODUCTION

Finance is the study that deals with savings and investments in terms of money. Finance is also known as science of Money Management. Finance aims to value assets based on their level of risk level and their expected rate of return. Finance can be divided into three different sub-categories: Public Finance, Corporate Finance and Personal Finance.

1.2 WHAT IS PUBLIC FINANCE?

Public finance deals with the way in which the state or the government collects and spends its revenue and resources. Public finance deals with the income and expenditure of public authorities along with adjustment to one another. In economics, it is defined as the science which deals with the activities, how the government raises and spends its money and defines the effects of these activities in obtaining and fulfilling proper functioning of the state. In this context, government refers to the individual who are responsible for running public institutions, local, state, national, office of the president, national assembly, senate, courts, etc. who is "elected" or is appointed by someone who is elected.

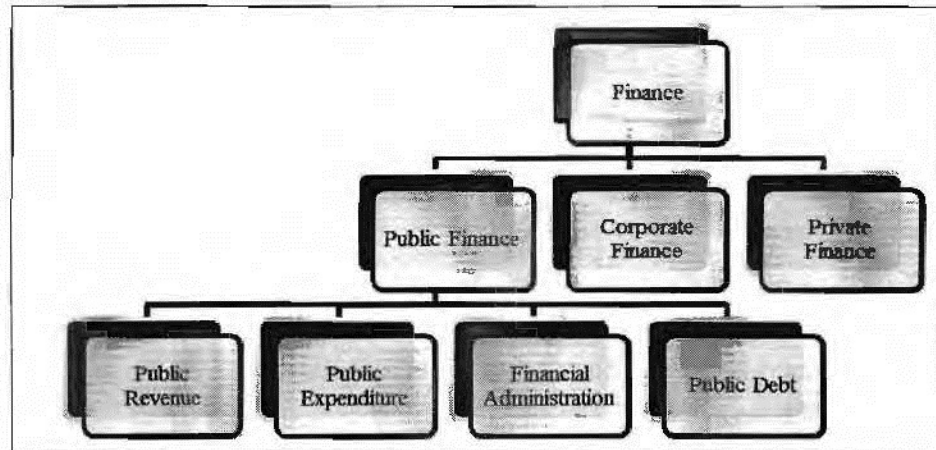


Figure 1.1: Division of Finance

According to Bastable, "Public finance deals with expenditure and income of public authorities of the states and their mutual relation and also with the financial administration and control".

According to Harold M. Grooves, "Public finance is a field investigation that takes care of issue of the income and spending of governments (federal, state and local)".

Public finance refers to the study of the financial activities of governments and public authorities. It defines and examines the expenses of government and the methods used by governments to finance its expenses.

There are various outlooks with regards to the role the government should play within the economy. With reference to this subject, the Mercantilist's view is "Economic nationalism" which tends to advocates favorable balance of trade, thus, they say that the government should actively promote trade and industry. However, the doctrine of laissez advanced by "Adam Smith, John Stuart Mill, Nassau Senior and others" suggested that government should not have any interference in the private sector and it should not effort to control or regulate enterprises. "Karl Marx, Sismondi and Robert Owen" with their socialist view proposed reorganization of the society to address inequalities in income and condition of the working class. They supported that the government should take superior role for the state in controlling the means in production.

Despite the opinion and schools of thought on the issue of the level of intervention of the government, the modern market system of the "20th century" could not survive without the intervention of the government, thus, governments and scholars agrees that the government needs to complements market and private enterprises generally accept it.

Therefore, public finance deals with the question on how the Government raises its funds to meet its ever-rising expenditure. As Dalton states, public finance is "concerned with the income and expenditure of public authorities and with the adjustment of one to the other".

Consequently, effects of taxation, Government expenditure, public borrowing and deficit financing on the economy constitutes the substance of public finance. Thus, Prof. Otto Eckstein writes "Public finance is the study of the effects of budgets on the economy, particularly the effect on the achievement of the major economic objects — growth, stability, equity and efficiency".

Additionally, it also deals with fiscal policies which should be adopted to achieve certain objectives such as price stability, economic growth, more equal distribution of income. The role that public finance in the economics point of view has changed from time to time according to the changes in economic situation.

Before the Great Depression that gripped the western industrialized countries during the 30's, the role of public finance was considered to be raising sufficient resources for carrying out the Government functions of civil administration and defense from foreign countries. During this period, the classical economists considered it practical to keep expenditure to the minimum so that taxation of the people can be avoided as far as possible.

Further, it was also considered that Government budget must be balanced. Public borrowing was recommended mainly for production commitments. During war, public borrowing was considered legitimate but it was thought that the Government should repay or reduce the debt as soon as possible.

1.2.1 Concept of Functional Finance

But under the impact of the Great Depression of 30's and the Keynesian explanation of it, the thinking about and role of public finance underwent a deep change. The classical opinion of public finance could not meet the requirements of the prevailing situation then.

Public finance was called upon to play an active role, in order to raise aggregate effective demand and thereby raise the level of income and employment in the country. During the Second World War and post war, the Western economies suffered from serious inflationary pressures which were attributed to the excessive aggregate demand.

So, in such inflationary conditions, the public finance was expected to check prices through reducing aggregate demand. Thus, the budget which was previously meant to raise resources for limited activities of the Government assumed a functional role to serve as an instrument of economic regulation.

It was realised that government's taxing and spending policies could go a long way in mitigating economic fluctuations. Balanced budgets are no longer considered sacrosanct and the governments can spend beyond their resources without offending canons of sound finance to restore the health of the economy.

Public borrowings as well as resulting in increase in public debt during depression raises aggregate demand and thereby helps in raising the level of income and employment. Hence, deficit budget and increase in public debt at such times is a thing to be welcomed.

It was further validated by Keynes that deficit financing by the Government could activate a depressed economy, by creating income and employment more than the actual amount of deficit financing through the process of multiplier.

Thus, after Keynesian revolution public finance expected a functional role of maintaining economic stability at full employment level. Therefore, the present view of public finance is not one of mere resource-raising for the Government but one of serving as an instrument for maintaining stability through management of demand. Therefore, this present view of public finance has been described by A.P. Lerner as one of "Functional Finance".

In developing countries, public finance has to fulfill other important roles too. Whereas in the developed industrialized countries, the basic problem in the short run is to ensure stability at full employment level and in the long run to ensure steady rate of economic growth, that is, growth without fluctuations, the developing countries confront a more difficult problem of how to generate a higher rate of economic growth so as to tackle the problems of poverty and unemployment.

Therefore, public finance plays a significant role in promoting economic growth in the developing countries besides maintaining price stability. Further, for developing countries sheer economic growth is not enough; the composition of growing output and distribution of additional incomes must be such, which will ensure removal of poverty and unemployment in the developing countries.

Therefore, public finance has not only to augment resources for development and to achieve optimum allocation of resources, but also to promote fair distribution of income and expansion in employment opportunities.

1.3 FEATURES OF PUBLIC FINANCE

1. Public finance is a science that deals with the public needs: the general need is the collective demand for goods, products and services, and the state through the general budget.
2. Knowledge of public finance is a branch of the common in the law: because the public finances consists of a set of legal rules governing the financial relationship of the state with others on the basis of authority and sovereignty. Public finance in this sense must be subject to a special legal regime to ensure that state agencies to ensure the delivery of public service and public interest investigation.
3. Public finances aware of the rules and procedures for public funds: public finance vary so for their own financial, since the first look at the state revenues and expenditures and its organs, the second shall discuss in the wealth that people behave and companies subject to the provisions of the law.

1.4 SCOPE OF PUBLIC FINANCE

The scope of public finance covers a study of the influence of government fiscal operations on the level of overall state activity, employment, prices and growth process of the economic system as a whole. As per Prof. Dalton, the scope of public finance is categorised into four areas which comprises of Public Income, Public Expenditure, Public Debt and Financial Administration.

- (a) **Public Income:** Public income refers to various sources of government's income. The important source includes taxes, fees, sales of public good and services, donation, etc.
- (b) **Public Expenditure:** Public expenditure refers to the expenses made by the government on people's needs and wants. This comprises of pensions, infrastructure, provision, etc. These expenditures are made to bring out the social benefits and maximum welfare.

- (c) **Public Debts:** Public debts refers to the borrowing of the union government issued by Reserve Bank which includes loans, special bearer bonds, loans and securities, treasury bills, etc. Public debt is also known as sovereign debt.
- (d) **Financial Administration:** This refers to preparation, passing and implementation of the budget, writing financial reports, budgetary policies and their socio-economic impact, inter-governmental financial relations, fiscal management and fiscal responsibility.

1.5 IMPORTANCE OF PUBLIC FINANCE

The importance of public finance was not popular in the 19th century as the Government in those days did not intervene in economic condition of a country. However, time has taken a leap and in the 20th century, every Government ensures the social welfare and development to its citizens and therefore, the scope of governmental activities has been increasing day by day. Modern Governments do not restrict themselves to law and order but they actively get involved in economic matters to justify themselves as, 'welfare states'. The governments require money for the welfare of citizens and the nation. Hence, the importance of public finance has increased in recent years.

1. **Taxation:** The governments levy high taxes to discourage the consumption of any harmful commodities such as consumption of cigarette, alcohol and other commodities.
2. **Provision Public Goods:** Governments provide public good, the self-financed services such as roads, forces, lighthouses and streetlights. Any private citizen would not pay for these services.
3. **Redistribute of Income:** Governments redistribute income by collecting taxes from the citizens to provide resources for their needy ones. The taxes fund programs helps support people with low incomes.
4. **Equity:** Public finance plays a great role in reducing the inequalities of income and wealth in a capitalist economy. This is achievable by transferring the purchasing power from the rich to the poor. Government impose taxes on the wealthier parts of the society and provides various facilities such as subsidized food, housing, free medical aid and education to the less privilege members of the society is called equity.
5. **Optimum Utilisation of Resources:** The natural resources in developing countries are underutilised or generally overutilised. The proper utilisation of natural resources is important not only for the present generation, but also for the unborn generations. The state can direct the flow of production, consumption and distribution in the economy by framing a suitable budget policy.
6. **Providing Employment Opportunities:** The government spends huge amount of public expenditure to deliver the purchasing power to its citizen and decrease unemployment issues in the economy.

1.6 FUNCTIONS OF PUBLIC FINANCE

The activities with regards to the revenue collection and expenditure by the government on several activities for the state is the main function of public finance. Earlier theories of public finance focused on narrow definition of the functions to be carried out by public authorities. It is now distinct that the area of state activity has

spread over the past two decades which has enlarged the functions and scope of public finance.

1. **Economic Activities of the State:** The scope of public finance was limited to the traditional functions of the state, i.e., the provision of defense, law and order, justice and civic amenities. But with the development of welfare states, the scope of public finance was broadened and public finance now includes the use of the budget as a tool to correct distortion in the economy, to mobilise resources, to maintain price stability create employment prevent market failure, achieve growth equity and maximise social welfare.
2. **Functional Finance:** The government should maintain a rational level of aggregate demand at all times by using the budget. Most developed economies had followed such functional financial policies in order to control trade cycles. Developing countries follows such policies to promote economic growth and welfare.
3. **Fiscal Operations:** Fiscal operations of public finance refers to raising public revenue, spending to achieve certain goals and financial administration. For such operations, the government uses fiscal tools like taxation, public expenditure and public debt. The objectives of fiscal operations are as follows:
 - (a) **Allocation of Resources:** The most important objective of fiscal operations is to determine how the country's resources will be allocated to different sectors of the economy in order to achieve predetermined goals.
 - (b) **Economic Stabilisation:** Economic stabilisation refers to a set measures to stabilise the financial system of the economy. To bring about such stability, officials supervises the business cycle, and makes necessary adjustments to fiscal and monetary policy in an attempt to create stable and sustainable growth and reduce the damage caused by downturns.
 - (c) **Economic Growth:** In developing and underdeveloped economies, the objectives of fiscal operations are more positive in nature. The basic focus of fiscal operations in such economies is the use of budgetary operations to achieve growth and development. These activities are carried out by encouraging capital formation and investments through public expenditure and tax incentives to private sectors.

1.7 DIFFERENCES BETWEEN PUBLIC FINANCE AND PRIVATE FINANCE

1. **Nature of the Budget:** In private economy, they aim at surplus budget. Having a surplus is considered economically prudent. However with government budgets in countries they need to grow and develop rapidly, deficit budgets need to be followed. A long term surplus budget indicates that the government may not be fulfilling some of its compulsion.
2. **Magnitude:** The most significant difference between the two types of finances is in terms of size and magnitude. The budget of public finance is larger as it is meant for the economy or a state or a country, whereas households and the businesses have relatively smaller amount of resources available to them and hence their budgets are smaller in size.
3. **Public Inspection:** Personal budgets of households are a private affair and in business finance, the budget is made for the stakeholders and general public for information and inspection. However in public finance, every budgetary decision has to be made for the people of the nation.

4. **Source of Revenue:** The households and business in private economy earn their income by using own assets. Their sources of income includes salaries, wages, interest, rent and profits which rise out of businesses, whereas in case of public finance, the source of income includes taxes and non-tax revenues.
5. **Sources of Borrowing:** In private economy, people may borrow from formal sources like banks and financial institution as well as informal sources like friends, relatives, moneylenders, etc. whereas public bodies can borrow almost on a continuous basis from internal and external sources. Internal borrowings are those which are floated within the country, while external borrowing refers to loans floated outside the country.
6. **Motive:** In case of public finance, the decisions are reached through political and administrative procedure and are based on common social objectives. However private finances are governed by profit motive for businesses or satisfaction of wants of an individual and households.
7. **Income Expenditure Adjustment:** In private economy, individuals adjust its expenditure to income, but in public bodies the income is adjusted to expenditure. Private finance manages to adjust expenditure according to income and to do so they may even waive fulfillment of certain wants. Whereas the governments are directed by welfare and growth for which expenses have to be predetermined.

1.8 ROLE OF STATE IN PUBLIC FINANCE

Public finance means the financial transactions of the government. Under the federal structure, the financial relationship between the union government and the state governments are based on the principle of federal Finance. The Indian constitution provides a three-fold distribution of legislative powers between the centre and the states. The Seventh schedule of the constitution consists of the Union List, the state list and the concurrent List. Union List includes the taxes which are levied, collected and retained by the central government, while the State List includes those taxes which are levied, collected and retained by the state governments

Those taxes which are not specified in the first two lists are included in concurrent list. To avoid any dispute between the centre and states in the field of tax revenue, some constitutional provisions have been made. The division of powers between the centre and states in respect of the imposition and collection of tax revenue and the appropriation of that revenue can be shown in the following:

1. Taxes levied, collected and appropriated by centre: (i) Customs duty, (ii) Corporation tax.
2. Taxes levied and collected by centre but appropriated by both centre and states: (i) Income tax, (ii) Union excise duty.
3. Taxes levied and collected by centre but appropriated by states: (i) Taxes on railway freight and fares, (ii) Estate and succession duty other than agricultural land.
4. Taxes levied by centre but collected and appropriated by states: (i) rates of stamp duties on financial documents, (ii) taxes other than stamp duties on transactions in stock exchanges.
5. Taxes levied, collected and appropriated by states: (i) sales tax, (ii) land revenue.

The Indian constitution provides for the appointment of a finance commission, by the president of India on five yearly bases to determine the basis of distribution of the tax proceeds between centre and states.

In the context of resource mobilization for economic development during planning period, public finance in India has assumed an altogether new significance with renewed objectives. The objectives of taxation were revenue regulation and economic control. The efficiency of public finance network can be assessed from the standpoints of equity, economic consequences and simplicity.

However in view of the less-developed country like India, the functions of public finance, apart from its traditional functions should be to:

- curtail national consumption,
- reallocate resources to more beneficial investments,
- provide funds for Government business, and
- provide incentives to alter behavioral patterns in order to facilitate economic growth.

Check Your Progress

Fill in the blanks:

1. Finance is also known as science of _____.
2. The present view of public finance has been described by A.P. Lerner as one of _____.
3. According to Prof. Dalton, the scope of public finance is categorised into four areas which comprises of _____, _____, _____ and _____.
4. Public debt is also known as _____.
5. A set measures to stabilise the financial system of the economy is known as _____.

1.9 LET US SUM UP

- Finance is the study that deals with savings and investments in terms of money. Finance is also known as science of money management.
- Finance can be divided into three different sub-categories: public finance, corporate finance and personal finance.
- Public finance deals with the way in which the state or the government collects and spends its revenue and resources. Public finance deals with the income and expenditure of public authorities along with adjustment to one another.
- As per Prof. Dalton, the scope of public finance is categorised into four areas which comprises of public income, public expenditure, public debt and financial administration.
- Economic stabilization refers to a set of measures to stabilise the financial system of the economy.
- The activities with regards to the revenue collection and expenditure by the government on several activities for the state is the main function of public finance.
- Public income refers to various sources of government's income.

- Public expenditure comprises of pensions, infrastructure, provision, etc.
- Public debts refers to the borrowing of the union government issued by Reserve Bank which includes loans, special bearer bonds, loans and securities, treasury bills, etc.
- Modern governments do not restrict themselves to law and order but they actively get involved in economic matters to justify themselves as, 'Welfare States'.

1.10 UNIT END ACTIVITY

Critically evaluate the role of state in public finance.

1.11 KEYWORDS

Public Finance: Public finance is the study of the role of government in the economy.

Public Sector: The public sector is that portion of an economic system that is controlled by national, state or provincial, and local governments.

Public Revenues: The income of the government through all sources is called public income or public revenue.

Public Expenditures: Public expenditure is spending made by the government of a country on collective needs and wants such as pension, provision, infrastructure, etc.

Collectivism: A political or economic theory of advocating collective control especially over production and distribution.

Allocation: The action or process of allocating or sharing out something.

Redistribution Function: Redistribution of income and wealth are the transfer of income and of wealth from some individuals to others by means of a social mechanism such as taxation, charity, welfare, public services, land reform, monetary policies, confiscation, and divorce or tort law.

Stabilisation Function: Stabilisation of the economy is one of the goals that governments attempt to achieve through manipulation of fiscal and monetary policies.

Market Failure: This is a situation, where the allocation of goods and services are not efficient.

1.12 QUESTIONS FOR DISCUSSION

1. Define public finance. Why do you think public finance is important?
2. Discuss the features of public finance.
3. Describe the functions of public finance.
4. Explain the differences between public finance and private finance.

Check Your Progress: Model Answer

1. Money Management
2. Functional Finance
3. Public Income, Public expenditure, Public Debt, Financial Administration
4. Sovereign Debt
5. Economic Stabilisation

1.13 REFERENCES & SUGGESTED READINGS

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UNIT-2

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

CONTENTS

- 2.0 Aims and Objectives
- 2.1 Introduction
- 2.2 Principle of Maximum Social Advantage (MSA)
- 2.3 Marginal Social Sacrifice (MSS)
- 2.4 Marginal Social Benefit (MSB)
- 2.5 Point of Maximum Social Advantage
- 2.6 Conclusion on Dalton's View
- 2.7 Musgrave's Approach to Maximum Social Advantage
- 2.8 Objective Test of Social Advantage
- 2.9 Limitations of the Principle of Maximum Social Advantage
- 2.10 Let Us Sum Up
- 2.11 Unit End Activity
- 2.12 Keywords
- 2.13 Questions for Discussion
- 2.14 References & Suggested Readings

2.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Describe principle of maximum social advantage (MSA)
- Describe marginal social sacrifice (MSS)
- Define marginal social benefit (MSB)
- Understand the point of maximum social advantage
- Define Musgrave's approach to maximum social advantage
- Discuss the limitations of the principle of maximum social advantage

2.1 INTRODUCTION

The budgetary operations of the state have various effects on the economy. The revenue collected by the state through taxes and the distribution of public expenditures can have significant impact on the consumption, production and distribution of the national income of the country.

Hence, it is necessary to position some standards to evaluate the suitability of any operation of public finance — the government's revenue and expenditures. In a modern welfare state, such standard are referred as economic welfare of the people. Hence it is important to have a specific financial activity of the state which leads to an increase in economic welfare.

The guiding principle of state policy has been technically necessary as the principle of maximum social advantage by Hugh Dalton. According to Hugh Dalton, "Public finance is considered to be the best fundamental principle which ensures the maximum social advantage concerned with income & expenditure of public authorities from its fiscal operation."

Taxation is a loss of utility to the people, while public expenditure is a gain of utility to the community. When the state levies taxes, we can experience dissatisfaction in the society. This dissatisfaction is expressed in form of sacrifice involved in the tax payment. Likewise, when the state spends money, we can experience satisfaction among the individuals in the society. This is referred as the social benefit of welfare of the public expenditure.

According to the principle of maximum social advantage, the public expenditure is related to decreasing marginal social benefits and taxes are related to increasing marginal social costs. Thus, an equilibrium is reached when the size of the budget is such that marginal social benefits of public expenditures are equal to the marginal social sacrifice of taxation.

Dalton states, "Public expenditure in every direction should be carried just so far, that the advantages to the community of a further small increase in any direction is just counter-balanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other sources of public expenditure and public income".

Thus, a rational state seeks to maximise the net social benefits of its budgeted operations. The social net advantage is maximum when the aggregate social benefit resulting from public expenditure is maximum and the aggregate social sacrifice involved in raising the public revenue is minimum. As per the principle of maximum social advantage, "the public expenditure should be carried on up to the marginal social sacrifice of the last unit of rupee taxed".

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

2.2 PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE (MSA)

The fundamental principle of public finance is the "principle of maximum social advantage". The principle of maximum social advantage states that public finance leads to economic welfare when public expenditure and taxation are carried out upto 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 describes the principle of maximum social advantage with reference to:

1. Marginal social sacrifice.
2. Marginal social benefits.

However, this principle is based on the following assumptions:

1. All taxes result in sacrifice and all public expenditures lead to benefits.

2. Public revenue consists of only taxes and no other sources of income to the government.
3. The government has no surplus or deficit budget but only balanced budget.
4. Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

2.3 MARGINAL SOCIAL SACRIFICE (MSS)

Marginal Social Sacrifice states to the expanse of social sacrifice undertaken by public due to the additional unit of tax imposition on them.

Every unit of tax levied by the government leads to 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 with the community diminishes. As a result of diminishing stock of money, the marginal utility of money goes on increasing. Eventually every additional unit of taxation creates greater amount of impact and greater amount of sacrifice on the society. That is why, the marginal social sacrifice goes on increasing.

The marginal social sacrifice is illustrated in the following figure:

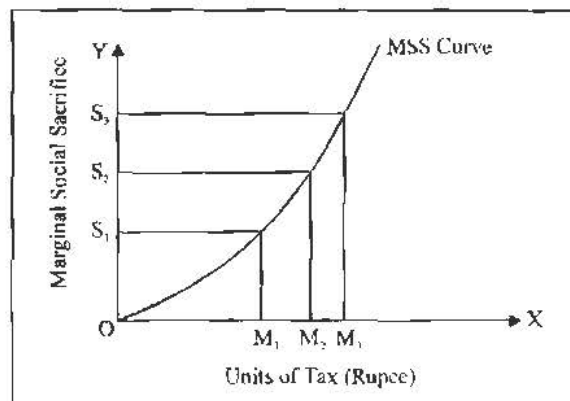


Figure 2.1: Increasing Marginal Social Sacrifice Curve

The above figure indicates that the marginal social sacrifice curve rises upwards from left to right. This indicates that, with each added unit of taxation, there is an increase in the level of sacrifice. For example, when the unit of taxation is OM_1 , the marginal social sacrifice lies in OS_1 , and as the taxation increased to OM_2 , we can see the rise in marginal social sacrifice to OS_2 and so on.

2.4 MARGINAL SOCIAL BENEFIT (MSB)

Public expenditure conveys benefits when there is an imposition of taxes on the people. The benefit conferred on the society, by an additional unit of public expenditure is known as Marginal Social Benefit.

The social benefit from each additional unit of public expenditure declines with the increase of public expenditure. Initially, the units of public expenditure are spent on the most essential social activities. Later public expenditure are spent on less important social activities.

As a result, the curve of marginal social benefits slopes downward from left to right as shown in figure below:

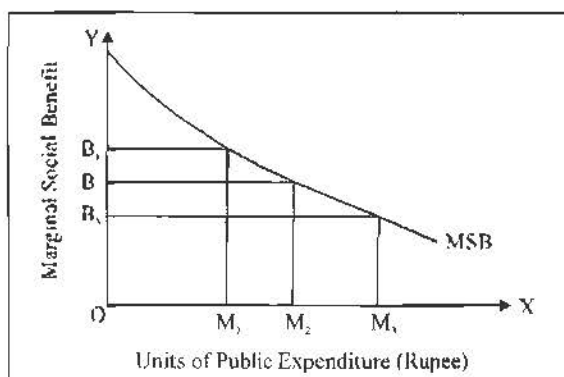


Figure 2.2: Diminishing Marginal Social Benefit Curve

In the above figure, the marginal social benefit curve slopes downward from left to right. This indicates that the social benefit derived out of public expenditure is decreasing at a diminishing rate. When the public expenditure was OM_1 , the marginal social benefit was at OB_1 , similarly when the public expenditure is at OM_2 , the marginal social benefit comes down at OB_2 .

2.5 POINT OF MAXIMUM SOCIAL ADVANTAGE

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

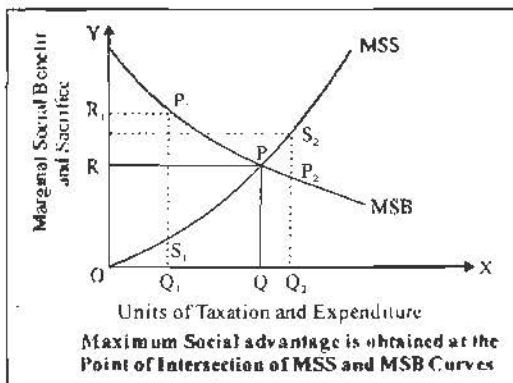


Figure 2.3: Point of Intersection of MSS and MSB Curves

At "P" social advantage is at maximum. Now let us 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, the level of taxation and public expenditure can be increased. This is because the additional unit of revenue raised and spent by the government leads to increase in the net social advantage. This situation of increasing taxation and public expenditure remains, as long as the levels of taxation and expenditure are in 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 attained.

At point P_2 , the marginal social sacrifice S_2Q_2 is greater than marginal social benefit P_2Q_2 . Therefore, 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 and this is the point where marginal social benefit of public expenditure is equal to the marginal social sacrifice of taxation.

2.6 CONCLUSION ON DALTON'S VIEW

It can be concluded as maximum social advantage is achieved where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equal, i.e., $MSB = MSS$.

This shows that to obtain maximum social advantage, the public expenditure should be carried upto the point where the marginal social benefit of the last rupee spent becomes equal to the marginal social sacrifice of the last unit of rupee taxed.

2.7 MUSGRAVE'S APPROACH TO MAXIMUM SOCIAL ADVANTAGE

Prof. R.A. Musgrave states that the principle of maximum social advantage is a logical extension of the Pigouvian welfare approach to taxation incorporated in the theory of minimum aggregate sacrifice.

Musgrave is of the opinion that 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 re-designate 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 valuation of individual preferences.

Musgrave's approach is illustrated in the following figure:

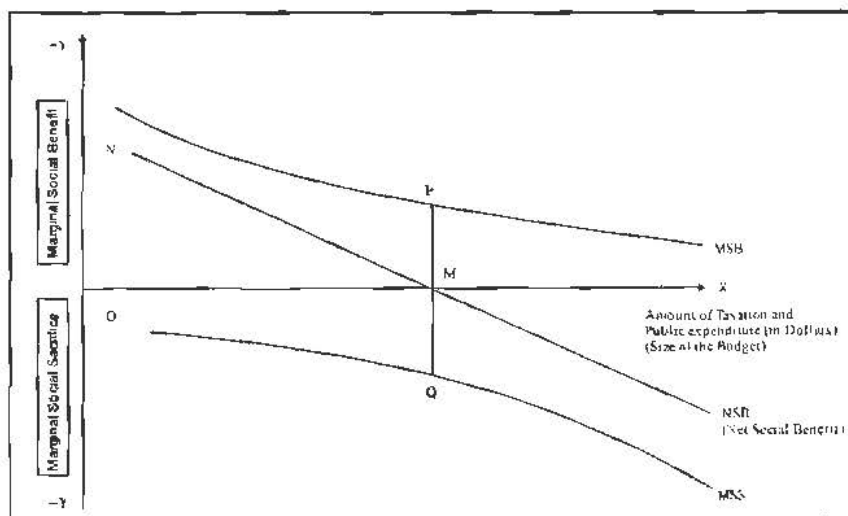


Figure 2.4: Musgrave Approach Curve

In the above figure, 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.

MSS indicate the marginal disutility of taxes, imposed so as to cause 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 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 spend by the state, then the marginal social benefit and the marginal social sacrifice are equated ($MP = MQ$).

Till then the gain to the society is more than the loss. The net gain to the society is equal to the area OMN.

It is here that the state should stop expanding its activities. If the state stops its budget operation at a figure less than OM, the society will be forgoing a possible gain; on the contrary, 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.

The following three fundamental principles of budget operations help the state to achieve the principle of maximum social advantage:

1. The marginal social benefit of public expenditure and the marginal social sacrifice of taxation must be equal.
2. 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 same.
3. The tax burden should be so distributed that the marginal social sacrifice of taxation to each tax payer should be equal.

2.8 OBJECTIVE TEST OF SOCIAL ADVANTAGE

How far we have to apply this doctrine of optimum social welfare in the field of actual administration of financial policies? According to Dalton, there are 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. That is to preserve the community and to ensure confidence and promote the economic life of citizens, thereby enhancing the social advantage.

These duties must be performed by every government, apart from other considerations. It is therefore essential 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. For this reason, adequate sum spent on the armed forces, the police and judiciary may be justifiable.

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 the war and thus necessitates increased expenditure on defense.

Similarly an unwise political, economic and social policy may perhaps necessitate increased expenditure on the maintenance of law and order.

Economic Test

The second test - Economic test is divided into two:

- (i) Improvement and expansion in the production of wealth, and
- (ii) Reduction in economic inequalities. A sound financial policy should serve the fundamental purpose of better production and distribution.

- (a) *Improvement in Production:* It means increase in the amount of wealth produced per head. This in turn necessitates optimum utilisation of all factors of production.

It also implies minimisation of the wastage of resources, resulting from misdirection and unemployment. It also means improvements in the composition or pattern of production, so as best to serve the needs of the community.

- (b) *Improvement in Distribution:* Another important consideration is that 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 tax payers 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. Taxation and public expenditure can be very useful instruments for bringing about redistribution. Hence proper distribution of income and wealth is essential for increasing the economic welfare.

According to Dalton, improvement in distribution resolves themselves into:

- (1) Reduction in the glaring inequality, which is found in most civilized communities, in the incomes of different individuals and families and
- (2) A reduction in the great fluctuations, between different periods of time, in the incomes of particular individuals and families especially among the poorer sections of the community.

Other Conditions

- (a) *Stability and Full Employment:* Still another consideration is the maintenance of stability in the level of economic activity and full employment. Instability is the fundamental feature of free economy and is a cause of much misery and sufferings.

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.

Less fluctuation means more stability, through time, in the economic life of the community, and particularly in the income and employment of individuals. More stability is another aspect of the better organisation of production.

However it should be stable at a high level of employment, not merely a less fluctuations around a lower level. Full employment is now generally accepted as one of the first economic aims of a well-organised society. It is favoured, because it helps to increase production and to promote a greater equality of income.

- (b) *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. Therefore, the operation of public finance should be such as to safeguard the interest of the future generation also.

In the words of Dalton, "it should be added that the statesman is a trustee for the future, no less than for the present. Individuals die, but the community, of which they form part, lives on. The statesman, therefore, should prefer a larger social advantage in the future to a smaller one today".

2.9 LIMITATIONS OF THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

There is no doubt that the principle of maximum social advantage occupies a pivotal position in the domain of states fiscal activities.

Its theoretical significance cannot be under estimated. Yet there are certain difficulties in the application of this principle.

It has to be noted that a fiscal operation promoting production and better distribution cannot be easily reconciled with one another. A policy that favours investment and increased production might not be promoting the welfare distribution. For example, taxation that encourages investment, profit and risk taking cannot be progressive to a sharp extent.

At the same time inadequacy of progressive taxation widens economic inequalities and hampers distribution of income and wealth. Similarly a policy that favours distribution might be inimical to production.

For example, steeply progress we taxes on income and wealth discourages capital formation and investment, though it helps distribution of wealth and income. A lot of practical difficulties may emerge in the execution of this principle in governments fiscal operations.

The important difficulties are summarized below:

1. It is impossible to make a comprehensive estimate of the resources that will have to be raised and spend by government, before it obtains the point of optimum social welfare. The theory of optimum social welfare is no doubt attractive, but it does not suggest a practical code of conduct, for a government in its financial activity.
2. The point of optimum social welfare is an elusive concept. Even if this point is wanted to become a tangible reality, it is a moving point subject to endless

fluctuations. Therefore, the finance minister is not comfortably placed to formulate his policies on the basis of such a rapidly variable factor.

3. It is very difficult for the state to measure and balance the marginal utility and marginal disutility arising from expenditure and taxation policies. Utilities as we know are highly subjective phenomenon, which cannot be measured precisely.

It is very difficult to compare and measure the marginal utility and disutility of so many individuals in a society. Likewise it is not possible to measure social benefit and social sacrifice in fiscal operations of the state.

4. Seligman doubts the wisdom contained in the concept of optimum social welfare. He points out that war and other emergencies may compel a country to use up a larger amount of her resources that it can normally afford.

A government may be given by circumstances to increase its allowances to certain spending department at the expense of other departments, whose place may be not less important, but may not be so urgent. The conception of a point of maximum social advantage is thus relative to the prevailing circumstances and it is admitted by in our present state of knowledge more of theoretical than of practical significance.

But Dalton himself realizes the practical difficulties inherent in the process of determining the point of optimum social welfare. But this difficulty, Dalton points out, does not take away the substance of truth from the theory.

Dalton quotes the old Greek saying "it is not the easy thing, but the difficult things, which are beautiful". Therefore whatever might be the practical difficulty in regard to the implementation of the theory of optimum social welfare, it provides an excellent basis for the conduct of the financial activities of the government.

Check Your Progress

Fill in the blanks:

1. The guiding principle of state policy has been technically necessary as the Principle of Maximum Social Advantage by _____.
2. _____ is a loss of utility to the people.
3. The fundamental principle of Public Finance is the _____.
4. _____ is achieved where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equal.
5. _____ doubts the wisdom contained in the concept of optimum social welfare.

2.10 LET US SUM UP

- "Public Finance" is considered to be the best fundamental principal which ensures the Maximum Social Advantage concerned with income and expenditure of public authorities from its fiscal operation.
- Taxation is a loss of utility to the people, while public expenditure is a gain of utility to the community.

- An equilibrium is reached when the size of the budget is such that marginal social benefits of public expenditures are equal to the marginal social sacrifice of taxation.
- The fundamental principle of Public Finance is the 'Principle of Maximum Social Advantage'.
- Marginal Social Sacrifice (MSS) states to the expanse of social sacrifice undertaken by public due to the additional unit of tax imposition on them.
- 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.
- The social benefit from each additional unit of public expenditure declines with the increase of public expenditure.
- Maximum Social Advantage is achieved where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equal, i.e., $MSB = MSS$.
- Seligman doubts the wisdom contained in the concept of optimum social welfare.

2.11 UNIT END ACTIVITY

Do you think that for a public good, the marginal social benefit will be higher than any individual's marginal benefit of consumption? If yes, give answer to support your question.

2.12 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.

2.13 QUESTIONS FOR DISCUSSION

1. Explain the principle of maximum social advantage defined by Hugh Dalton.
2. $MSB = MSS$. Discuss.
3. Discuss the limitations of the principle of maximum social advantage.
4. What are the difficulties that are faced in maximum social advantage?

Check Your Progress: Model Answer

1. Hugh Dalton
2. Taxation
3. Principle of Maximum Social Advantage
4. Maximum Social Advantage
5. Seligman

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UNIT-3

CLASSIFICATION OF PUBLIC REVENUE

CONTENTS

- 3.0 Aims and Objectives
- 3.1 Introduction
- 3.2 Sources of Revenue
 - 3.2.1 Tax Revenue
 - 3.2.2 Non-tax Revenue
- 3.3 Classification of Public Revenue
 - 3.3.1 Seligman's Classification
 - 3.3.2 Dalton's Classifications
 - 3.3.3 Taylor's Classification
- 3.4 Canon of Tax
- 3.5 Let Us Sum Up
- 3.6 Unit End Activity
- 3.7 Keywords
- 3.8 Questions for Discussion
- 3.9 References & Suggested Readings

3.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Know about sources of public revenue
- Discuss the classification of public revenue
- Define canon of taxation

3.1 INTRODUCTION

Classification of public revenue given by writers on public finance reflects their prejudice in regard to the functions of the state. The champions of Laissez-fair philosophers would not consider profit form public enterprises as normal source revenue, whereas the socialist writers would regard such profit as a fruitful source of revenue. For example in the erstwhile USSR, non-tax revenue account for about 90 percent of the total revenue of the state.

While discussing the question of classification of public revenue, Prof. Seligman remarked "among the unsettled questions of the science of finance few are more troublesome than that of classifying the different kinds of public revenue".

The same view is also held by Prof. Dalton when he expressed "the utter futility of a discussion on classification of public revenue". However the aim of classification of revenue is to clarify the nature of revenue and to help us in a scientific study of the subject.

3.2 SOURCES OF REVENUE

The income of the government through all sources is known as public income or public revenue.

Dalton explains, "Public Income" has two senses — wide and narrow. In its wider sense it includes all the incomes or receipts which a public authority may secure during any period of time. In its narrow sense, however, it includes only those sources of income of the public authority which are ordinarily known as "revenue resources". To avoid ambiguity, thus, the former is termed "public receipts" and the latter "public revenue".

Generally, receipts from public borrowings and from the sale of public assets are mainly omitted from public revenue. For example, the budget of the Government of India is classified into "revenue" and "capital". "Heads of Revenue" include the heads of income under the capital budget are termed as "receipts". Thus, the term "receipts" includes sources of public income which are excluded from "revenue".

In a modern welfare state, public revenue is classified into two types,

1. Tax Revenue,
2. Non-tax Revenue.

3.2.1 Tax Revenue

Tax revenue are those funds raised through the various taxes. Taxes are necessary contributions levied by the government on its citizens to meet its general expenses incurred for the common good. As Taussig puts it, "the essence of a tax, as distinguished from other charges by government, is the absence of a direct quid pro quo between the tax payer and the public authority".

Seligman defines a tax as: "A tax is a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to specific benefits conferred".

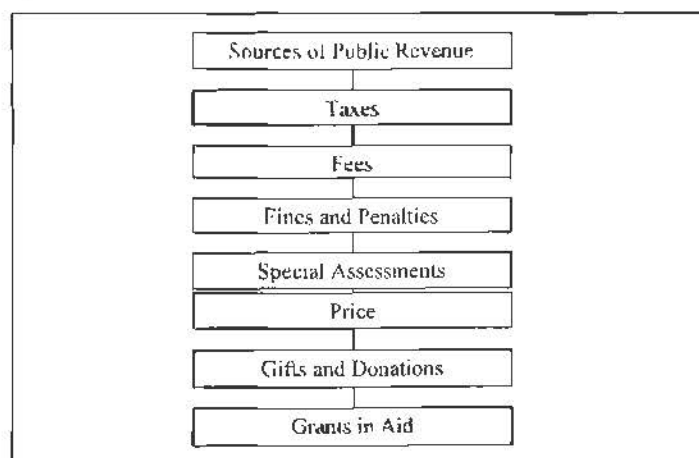


Figure 3.1: Sources of Tax Revenue

Characteristics of Tax

The main characteristic features of a tax are as follows:

1. A tax is a compulsory payment to be paid by the citizens who are liable to pay. Hence, denial to pay tax is a punishable offence.
2. There is no direct exchange of goods or services between the tax-payers and the public authority. In other words, the tax payer cannot claim mutual benefits against the taxes paid. However, as Seligman states that the state has to do something for the community as a whole for what the tax payers have contributed in the form of taxes.
 “But this reciprocal obligation on the part of the government is not towards the individual as such, but towards the individual as part of a greater whole”.
3. Taxes are levied to meet public spending incurred by the government in the general interest of the nation. It is a payment for an indirect service to be made by the government to the community as a whole.
4. Taxes payable regularly as well as periodically as determined by the taxation authority.

In modern public finance taxes represents a significant part of public revenue. Taxation can affect the size and mode of consumption, pattern of production and distribution of income and wealth or we can also say that taxes have macro-economic effects.

Inequalities of income and wealth by lowering the high income group's disposable income can be reduced by the help of progressive taxes. The income left in the hands of the tax payer for disbursement after tax payment is known as disposable income. Taxes imply a compulsory saving in a developing economy. Hence, taxes constitute an important source of development of public finance.

3.2.2 Non-tax Revenue

Non-tax revenues of the government includes public income received through the administration, commercial enterprises, gifts and grants.

Non-tax revenue includes:

- (i) Administrative revenue
- (ii) Profit from state enterprises
- (iii) Gifts and grants
- (iv) Loans

Administrative Revenues

Under public administration, public authorities can raise some funds in the form of fees, fines and penalties, and special assessments.

- **Fees:** The government or public authorities charge fees for rendering services to the payees. Seligman says, “A fee is a payment to defray the cost of each recurring service undertaken by the government, primarily in the public interest, but conferring a measurable advantage to the payer”.

Court fees, passport fees, etc., are categorised as fees. Similarly, license fees are charged to confer a permission by the controlling authority, e.g., driving license fee, import license fee, liquor permit fee, etc. Fees are to be paid by receiver who

receives special advantages. The amount of the fee usually depends upon the cost of services extracted.

Fees are non-technical charges of the administrative activities of the government and not a payment for a business. Thus, fees are different from prices. Prices are always voluntary payments, but fees are compulsory contributions, though both are made for special services. Fees, sometimes contains an element of tax when it is charged high, in order to get revenue to the exchequer e.g., a licenses fee.

- **Fines and Penalties:** Fines and penalties are charged and collected from offenders of laws as punishment. The main objective of these charges is not to earn as an income, but to prevent the commission of offences and breach of laws of the country. Fines and penalties are randomly determined and have no relation to the cost of administration or activities of the government. Hence, collections from such charges are irrelevant as a source of public revenue.
- **Special Assessments:** Seligman explains "Special assessment" as, "a compulsory contribution levied in proportion to the social benefits derived to defray the cost of a specific improvement to property undertaken in the public interest". When the government undertakes certain types of public improvements such as construction of roads, provision of drainage, street lighting, etc., special benefits may be conferred to those who owning properties nearby. Hence, values of rents of these properties may increase. The government, therefore, may impose some special taxes or charges to recover a part of the expenses incurred consequently. Such special assessment is levied commonly in proportion to the increased value of the properties which makes it different from a tax. In India, these special assessments are referred to as "betterment levy". Betterment levy is imposed on land when its value is enhanced by the construction of social overhead capital such as roads, drainage, street-lighting, etc. by the public authority in any area.

Profits of State Enterprise

With regards to the expansion of the public sector, profits of state undertakings also are an important source of revenue these days. For instance, the central government runs railways and the surplus from railway earnings can be normally contributed to the revenue budget of the central budget.

Similarly, profits from the state transport corporation and other public undertakings can be important sources of revenue for the budgets of state governments. Likewise, other commercial undertakings in the public sector such as Hindustan Machine Tools, Bokaro Steel Plant, State Trading Corporation, etc. can make profits to support the central budget.

Earnings from state enterprises depends upon the prices charged by the public sector for their goods and services and the surplus derived. Thus, the pricing policy of state undertakings should be self-supporting and reasonably profit-oriented. Again, prices charged are directly proportionate to the benefits conferred by the services rendered.

Forms of revenue derived by the government by selling goods and services of public enterprises are known as price. Public enterprises like postal services are run on cost-to-cost basis. The prices charged are just to ensure the cost of rendering such services.

However, in certain cases, when the state has an absolute monopoly, prices having a high profit element are charged. Such monopoly profits of a state enterprise are in the nature of a tax. Hence the major difference between price and fee can be stated as the price usually can never be less than the cost of production or service, while fees may or may not necessarily cover the cost of service.

Gifts and Grants

These forms are generally a very minor part of public revenue. These are purely voluntary or charitable contributions. In modern times, grants from one government to another have a greater importance. Local governments receive grants from state governments and state governments from the central government. The central government gives grants-in-aid to state governments in order to enable them to carry out their state functions. Grants, those are made by one country's government to another country's government is termed as "foreign aid". Usually such aid are received by the poor countries from developed countries, which may be in the form of military aid, economic aid, food aid, technological aid and so on.

Loans

This largest non-tax source of Central Government's revenue receipts is the interest it earns mainly on the loans it has advanced to State Governments, to financial and industrial enterprises in the public sector. Borrowings from the public are another source of government revenue. It includes loans from the public in the form of deposits, bonds, etc. and also from the foreign agencies and organizations. In India, capital receipts of the government budget are classified as following:

- **Market Loans:** Open market borrowings through auctions and other investments.
- **External Assistance:** Loans from friendly foreign countries and international organisations.
- **Recovery of Loans and Advances:** Recoveries from different levels of government and PSUs.

3.3 CLASSIFICATION OF PUBLIC REVENUE

Different economists have classified the sources of public revenue differently. A scientific classification enables us to know the various sources of resemblance with one another and the ways they differ. There are various classifications of public revenue available in economic literature, however we shall review a few important ones.

3.3.1 Seligman's Classification

Seligman classifies public revenue into three groups:

- (i) **Gratuitous revenue** includes revenues received by the public authorities or the state without any cost, e.g. gifts. They are entirely of a voluntary nature. However, these are very insignificant in the total revenue.
- (ii) **Contractual revenue** includes revenue received by sale of goods and services between the public authority and the people. For example, any prices fall under this category.
- (iii) **Compulsory revenue** includes income derived by the government from administration, justice and taxation. Taxes, fines and special assessments are regarded as compulsory revenue. It is the most significant type of public revenue in modern times.

3.3.2 Dalton's Classifications

Dalton provides a very systematic, comprehensive and instructive classification of public revenue. In this opinion, there are two main sources of public revenue — (i) taxes and (ii) prices.

Taxes are compulsory charges imposed by the public authorities whereas prices are paid voluntarily by individuals, who enters into agreement with the public authority.

Taxes can be sub-divided into:

- (i) Taxes in the ordinary sense;
- (ii) Tributes and indemnities;
- (iii) Compulsory loans; and
- (iv) Pecuniary penalties for offences.

Prices can be sub-divided into:

- (i) Receipts from public property passively held such as rents received from the tenants of public lands;
- (ii) Receipts from public enterprises charging competition rates;
- (iii) Fees or payments charged for rendering administration services such as birth and death registration fees; and
- (iv) Voluntary public debt.

3.3.3 Taylor's Classification

Taylor divides public revenue into four categories:

- (i) Grants and gifts
- (ii) Administrative revenues
- (iii) Commercial revenues
- (iv) Taxes

Grants and Gifts

Grants are financial assistance provided by one government to another to enable it to perform certain specified functions, for example, education and health grants made to the states by the central government.

Gifts are voluntary contributions from individuals or institutions for specific purposes. Grants and gifts are voluntary in nature and it lacks in quid pro quo to the donor.

Administrative Revenues

Revenue received via fees, licenses, fines and special assessments by the state by performing administrative activities. Most of these are voluntary in nature and are based upon the providing direct benefits to the payer.

Commercial Revenues

Commercial revenues are receipts received by the government in the form of prices paid for government produced goods and services. This includes postal charges, tolls, interest on loans of state financial institutions or nationalised banks, tuition fees of public educational institutions are included.

Taxes

These are compulsory payments made to government without any expectation of direct return.

3.4 CANON OF TAX

The administrative aspect of a tax is referred as Canons of taxation. They are related to the rate, amount, method of tax and collection of a tax. Regardless of the modern development of economic sciences, Adam Smith's Canons of Taxation, still continues to be widely accepted as providing a good basis to judge taxes and its principles are still applied.

Adam Smith in his book the Wealth of Nation, published in 1776, has suggested certain principles known as Canons of Taxation. The canons of Adam Smith are although not free from objections. The fundamental canons of taxation are as follows:

1. Canon of equity.
2. Canon of certainty.
3. Canon of convenience.
4. Canon of economy.

The basic principle of taxation has remained unchanged for almost 220 years. Since then, there has been a lot of changes in the economic activities, so modern economists like Charles F Bastable, H Dalton have added some canons to the existing one to update and expand them.

1. **Canon of Equity:** This canon suggests that tax system should be based on the principle of social justice. Equity refers to both horizontal and vertical equity. Horizontal equity describes the concept that, taxpayers with equal abilities to pay should the equal tax overall. However vertical equity refers that taxpayers with a greater ability to pay more tax.
2. **Certainty:** There should be clear specification about tax rules and when & how the tax is to be paid. This canon is an agreement between two parties, first, the taxpayer who is to pay the tax and second, the authority who receives the tax.
3. **Convenience of Payment:** Paying taxes should be made convenient for the taxpayer. Convenience in paying a tax helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability and the level of difficulty to collect the tax.
4. **Economy in Collection:** This canon suggests decrease in the administrative cost of collection of the tax at the lowest level. The costs to collect a tax should be kept to a minimum for both the government and taxpayers.
5. **Simplicity:** The tax law should be kept simple so that taxpayers can understand the rules and comply with them efficiently. A tax should be simple in nature so that the tax-payer is able to calculate it and pay it conveniently. Simplicity in a tax system reduces the number of errors.
6. **Transparency and Visibility:** Taxpayers should know the existence of tax and how and when it is to be imposed upon them and others. Transparency and visibility in a tax system enable taxpayers to know the true cost of transactions. This also enables a taxpayers to know when a tax is being assessed or paid and to whom.
7. **Neutrality:** The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum. The principle of neutrality stands for the proposition, that taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to the tax law.

8. **Appropriate Government Revenues:** The tax system should enable the government to determine the amount and a time duration of tax revenue will be collected. Mostly, a government realizes better stability with a mix of taxes.
9. **Economic Growth and Efficiency:** The tax system should not reduce the productivity of the economy. A tax system should be aligned with the economic goals of the jurisdiction imposing the tax. Generally, the system should not favor one industry or type of investment at the expense of others. The principle of economic growth and efficiency might seem to be in conflict with the principle of neutrality.
10. **Canon of co-ordination:** In some countries taxes are levied by central and state governments, therefore, it is desirable to have the co-ordination between different taxes that are imposed by different tax authorities. Governments should incorporate those canons for increasing taxes revenue.

Check Your Progress

Fill in the blanks:

1. The income of the government through all sources is known as _____.
2. In a modern welfare state, public revenue is classified into two types— _____ and _____.
3. Taxes payable regularly as well as periodically as determined by the _____.
4. Public authorities can raise some funds in the form of fees, fines and penalties, and special assessments can be raised under _____.
5. In India, these special assessments are referred to as _____.
6. _____ are related to the rate, amount, method of tax, and collection of a tax.

3.5 LET US SUM UP

- The income of the government through all sources is known as public income or public revenue.
- Generally, receipts from public borrowings and from the sale of public assets are mainly omitted from public revenue.
- In its narrow sense, however, it includes only those sources of income of the public authority which are ordinarily known as "revenue resources".
- Taxes are necessary contributions levied by the government on its citizens to meet its general expenses incurred for the common good.
- A tax is a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to specific benefits conferred".
- Inequalities of income and wealth by lowering the high income group's disposable income can be reduced by the help of Progressive taxes.
- Non-Tax revenues of the government includes Public Income received through the administration, commercial enterprises, gifts and grants.

- Regardless of the modern development of economic sciences, Adam Smith's canons of taxation, still continues to be widely accepted as providing a good basis to judge taxes and its principles are still applied.

3.6 UNIT END ACTIVITY

Give the sources of public revenue for the national government.

3.7 KEYWORDS

Transference: From one hand to another hand.

Contribution: Little charity.

Public Revenue: Revenues earned by the government are received from sources such as taxes levied on the incomes and wealth accumulation of individuals and corporations.

Taxation: Taxation refers to compulsory or coercive money collection by a levying authority, usually a government.

3.8 QUESTIONS FOR DISCUSSION

1. Discuss the source of public revenue.
2. Highlight the characteristics of tax.
3. Define non-tax revenue. Discuss the types of non-tax revenues.
4. Discuss the classification of public revenue.
5. "Canon of Tax". Discuss

Check Your Progress: Model Answer

1. Public Income or Public Revenue
2. Tax Revenue, Non-tax Revenue
3. Taxation Authority
4. Administrative Revenues
5. Betterment Levy
6. Canon of Tax

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BLOCK II

UNIT-4

THE TAX SYSTEM

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- 4.3 Objectives of Taxation
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4.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Discuss the objectives of taxation
- Describe the classification of taxation
- Explain the merits and demerits of taxes
- Elaborate the impact of taxation
- Discuss the factors of tax
- Define Indian tax system

4.1 INTRODUCTION TO TAXATION

Taxation has existed since the birth of early civilization. The first known system of taxation was in ancient Egypt around 3000 BC-2800 BC in the first dynasty of the old kingdom. But the taxes were either material or money like goods or services in the primitive society. The subjects used to pay a share of their income to the Head of a tribe or to the King who in return provided them with the administration security from foreign aggression and other civic amenities. Feudalism was founded in the medieval centuries and so the origin of modern tax system also was founded. Feudal market dues, tolls for protection and use of road, bridges, ferries, land rent, and other payment in goods and services were gradually transferred into money payment with the rise of money economy. Kings liked to receive money and the people preferred to pay money instead of goods and services. Gradually, the old feudal revenue system transformed into taxation. With the development of economic sciences and passage of time, the functions of modern state appeared and taxation slowly became a tool of usage with more than one goal and converted into an important source of revenue. During 19th and 20th centuries there has been both qualitative and quantitative change in the public expenditures. Taxation has passed through the stages with passage of time, and tax's functions and objectives also have changed from the ancient communities to medieval societies to modern societies also, so the tax system has evolved with the evolution of the functions of the modern state. Taxation is a form of payment from individuals or legal entity and it is imposed by government, for which there are no goods or services received directly in return, so taxes is that amount of money they the people pay but it has no direct relation to the benefit obtained by the people from the provision of a particular good or service. Until the early 1930s, it was universally accepted in principle that governments should balance their budgets. Thus, the principle reason for taxation was to pay for government expenditures. Of course, governments had from time to time resorted to borrowing in order to pay for their expenditures and government borrowing was relatively quite large during some war periods. Government borrowing may be from the private sector or from abroad.

Alternatively, governments may borrow from the central bank of the country. Money provided by taxation has been used by the government and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order, protection of property, economic

infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself.

Governments also use taxes to fund welfare and public services. A portion of taxes also goes to pay off the state's debt and the interest this debt accumulates. These services can include education systems, health care systems, and pensions for the elderly, unemployment benefits, public transportation, energy, water and waste management systems, and they also include common public utilities. Governments have also financed expenditures in recent years through the sale of publicly owned assets. Although asset sales were an important source of funds to the UK government in the 1980s, they are necessarily limited since assets can only be sold once. Thus, governments still had to raise most of the revenue needed to finance their expenditures through taxation or by charging directly for government services (user charges). Governments use different kinds of taxes and vary the tax rates, this is done to distribute the tax burden among individuals or classes of the population involved in taxable activities such as business or to redistribute resources between individuals or classes in the population.

Modern social security systems are intended to support the poor, the disabled, or the retired by taxes on those who are still working. In addition, taxes are applied to fund foreign aid and military ventures, to influence the macroeconomic performance of the economy or to modify patterns of consumption or employment within an economy, by making some classes of transaction more or less attractive. Thus, there is no doubt that most of the government expenditures must be paid for through the taxation system and it is reasonable to see this as the principle function of taxation.

In the modern time, taxation is not only a means of transferring money to the government to spend for meeting the public expenditures or raise revenue to the government, but taxes have become a tool to reduce demand in the private sector, redistribution of income and wealth in the societies in the countries. It is also a means for economic development for playing a very important role in the case of stabilisation of income, protection industrial home from foreign industrials. Taxation helps to find out solution for some economic problems that face the state like unemployment, inflation and depression cases, it has become as a stake in the election between the competing parties in the side of state. The researcher, Dr. A. Senthilrajan have mentioned that, taxation finds out solution for some economic problems, but not alone, but there are also a lot of another fiscal instruments. It is also mentioned that, countries are practicing sovereignty authority upon its citizens, through levying of Taxes.

Definition of Tax: After brief introduction, the researcher's have stated some tax definitions. Although, there is no precise and accurate definition for the tax and its concept, but it has been defined differently by different economists. So there are a many definitions of taxes, and some definitions go back to the oldest sciences Economists in the world like Prof. Seligman, Bastable, Deviti de Marco and Hugh Dalton and so on.

The researcher has searched for some of definitions from various sources.

According to Prof Seligman, "A tax is compulsory contribution from the person to the government to defray the expense incurred in the common interest of all without reference to special benefits conferred".

Bastable defines it as "A tax as a compulsory contribution of the wealth of a person, or body of persons for the service of public powers. Taxation is the act of levying a tax. i.e., the process or means by which the sovereign, through its law making body, raises income to defray the necessary expenses of government. It is merely a way of

apportioning, the cost of government among those who in some measure are privilege to enjoy its benefits, therefore must bear its burden".

Deviti De Marco defines "A tax as a share of the income of citizens which the state appropriate in order to procure for itself the means necessary for the production of general public services".

According to *Hugh Dalton* "A tax is a compulsory charges imposed by a public authority irrespective of the exact amount of service rendered to the tax payer in return and not imposed as a penalty for legal offence".

JomBouvier defined a tax as "A pecuniary burden imposed for support of the government, the enforced proportional contribution of persons and property of the government and for all public needs".

Australian Justice Dwyer wrote "A tax a compulsory contribution, or an imposed, may be nonetheless a tax, though not so called. Contribution imposed by a sovereign authority on, and required from the general body of subjects or citizens as distinguished from isolated levies on individuals".

From the researcher's point of view definition of tax is "A tax is compulsory contribution, levied by government from owner of income without direct benefit but for public benefit, and taxes should be arranged by the law".

From all definitions mentioned above, it is now clarified that, there is not one formula for definition.

4.2 CHARACTERISTICS OF TAXES

The researcher's have also discussed characteristics of tax. The researcher's have also identified that, public revenue is divided into tax revenue and non-tax revenue. Non-tax revenue like revenue received from administrative activities like fines, fees, gifts and grants, surplus from public enterprises, special assessment of betterment levy, and deficit financing, however the tax revenue has some other characteristics which has been mentioned below:

1. **Tax is compulsory payment:** A tax is levied by law and hence is a compulsory element existed by legislation. So tax is compulsory payment to the governments from its citizens. Tax is duty from every citizen to bear his/her share for supporting the government. The tax is a compulsory payment, refusal or objection for paying tax may lead to punishment or is an offence of the court of law.
2. **Tax is contribution:** Contribute means order to help or provide something. Tax is contribution from members of community to the Government. A tax is the duty of every citizen to bear their due share for support of government; these contribute to help the government to face its expenditures.
3. **Tax is an amount of money:** Tax is used as a tool for exchange and measure for prices and efforts.
4. **Tax is for public benefit:** Tax is levied for the common good of the society without any direct to benefit to any special individual. Government profits are spent to extend common benefits to all the people during natural disaster - like floods, famine - defense of the country, maintenance of law and establish infrastructure and order. Such benefits are given to all people.
5. **Tax is paid according to income or wealth of the tax payer:** Income means money received, especially on regular basis, for work or through investment. Tax is paid out of income as long as the income becomes realised.

6. **Government's impose taxes:** Government is practicing sovereign authority on its citizens through levying of taxes, because the tax is sovereign revenue. Only the government has all the power to collect tax. Tax is transferring resource from the private sector to the public sector.
7. **Tax is not the cost of the benefit:** Tax is not the cost of benefit conferred by the government on the public. The benefits of tax payers are related however payment of taxation is of course designed for conferring of benefits on general public.

A tax is levied for the economic growth and public welfare of the country. The major objectives for the government are to maximise economic growth and social welfare. Development activities of a nation generally involves two operations, firstly, raising of revenue and secondly, spending of revenue, so that the government can spend taxes for economic benefit of entire community and for aggregate welfare of the society.

4.3 OBJECTIVES OF TAXATION

Objectives of taxes have been developed as and when the functions of the Government are developed. In the primitive communities a member was to pay his share to the Head of the tribe, who in return provided them with administration, security from foreign aggression and other civic amenities. But today taxation besides being the main resource for supporting government has become a tool for economic growth, social welfare; attract foreigner investment, economic stability, and income distribution. The researchers have explained the objectives of taxes in brief.

1. **Revenue:** This is one of the oldest, uppermost and primary objectives. The taxes are imposed so as to produce the necessary amount of revenue to meet the requirement of the government since the public expenditures is increasing in scope and size day by day. So the main objective of taxes is to raise revenue to meet the expenditures adequately. The provision of public services and infrastructure is a key for any economic development and growth, so the Government pursues to secure a huge amount for protection, education, public health, etc.
2. **Social objectives:** Taxes are one of the main goals for some of social objectives:
 - (a) **Redistribution of income and wealth:** Redistribution of income and wealth income is different from one person to another in the society. Inequity in income leads to many issues and the government aims to reduction of inequalities between members of the society to secure social justice.

For the achievement of these goals government follows these ways
a) Imposition of high rate tax upon luxury commodities. b) Applying progressive tax system when levying taxes from taxpayers. c) Imposition of tax exemption to basic goods.
 - (b) **Social welfare:** Social welfare is the basic need of the society in the modern age. The government functions have become very important to the society, because the society needs saving, protection, education, health, and so on. All these functions are necessary to make social welfare, so the government levies revenue from tax, and expends it for those functions. Therefore, revenue from taxes is fuel to the government for social welfare. Social welfare is indicator of development of the countries, so almost all the countries have competition to introduce these services in the societies.
 - (c) **Safety of society from bad and injurious customs:** Fighting the bad customs in the society is the primary task of the government, so tax is a tool for fighting some of those customs. From this angle tax imposition of very high

percentage on the goods like tobacco and alcohol is an effort to reduce. Those habits have reaction on.

3. **Economic significance of taxes:** Taxes, if discussed from economic point of view, taxation helps to inspire some economic activities and as a tool to resolve some economics problems. Tax is also a means for directing of scarce economic activities. Taxation helps to accelerate economic growth, and taxation plays a very important role in economic stability
 - (a) *Economic growth.* Taxes are considered as a tool for economic growth and it helps at to accelerate growth of economic development. Economic development has placed considerable emphasis on objectives of taxation policy. Economic development is the main objective in all the countries of the world. Economic development depends on mobilisation of resources and efficient use of resources between different sectors of the economic activities.
 - (b) *Enforcing government policy:* Government policy can be easily enforced by adopting of suitable tax policy. The Government encourages investment, saving, consumption, export, protection of home industry, employment, production, protection of society from harmful customs, and economic stability through suitable tax policy. Therefore, the government provides tax exemption and benefits to certain investments and saving.
 - (c) *Directing limited resources into effective and essential channels.* Tax policy plays crucial role for direction scarce resources into essential commodities. This is achieved by giving tax exemption to certain industries and imposition of heavy duties on other industries, so with the adoption of suitable tax policy, economic resources may be diverted to the production of necessary articles and investors will go to the exemption industries.
 - (d) *Economic stability:* To maintain economic stability is one of the major tax objectives. Economic stability is a very significant factor for the economic growth. Government can use taxes in the case of inflation and depression. Here taxation has different roles in times of inflation and depression, in the case of inflation when the prices are rising. Tax can play very important role, which the government reduces, the purchasing power in the hands of people. Thus arise in the rates of existing taxes and the imposition of new taxes would check consumption, decrease the level of effective demand and therefore help in bringing up stability in prices. Heavy taxation transfer purchasing power from the hand of people to the government which if used for productive purpose will increase the level of economic activity and employment.

Thus the researcher have identified that there are three main objectives of taxes - revenue objective, social objective and economic objective. Revenue objective is the primary objective for supporting government for enforcing its functions of public goods and services. Taxes raise money to spend on armies, roads, schools and hospitals, and on more indirect government functions like market regulation or legal systems. Social objective is redistribution of income and wealth between rich class and poor class in the community. Social welfare also ensures welfare to the member of society and keeps society safe from bad and injurious customs. Lastly economic objective of taxes are to use more in the economic field, economic growth, enforcing government policy, direction limited scarce resources into effective and essential commodities and economic stability.

4.4 CLASSIFICATION OF TAXATION

Tax is the main source for the government revenue. The government businesses are unable to perform without funds and hence it needs money. Previously we have known that the government income sources divides into tax revenue and non-tax revenue. There is one fact that, revenue of tax represents majority from total public revenue. There is more than one classification of taxation.

A study of the classification of taxes helps us to understand the nature and significance of different taxes. Hence, taxes are generally classified on the basis of nature, form, aim essence and methods of taxation.

The following classification is commonly found in modern tax system:

1. As who bears the burden are direct taxes and indirect taxes.
2. As to subject of matter are personal, property and excise.
3. As to determination of account are specific and Ad-valorem duties.
4. As basis of method are progressive, proportional, regressive and regressive taxes.
5. As to purpose are single and multiple taxes.
6. As to scope are national tax and local tax.

One classification does not contradict the other but they are complementary and supplementary to one another and all classifications don't come out from one, that who bears the burden, so the researcher will discuss only one classified tax according to who bears the burden of tax (direct and indirect taxes).

Direct and Indirect Taxes

This is the best classification for revenue tax and it is well known among scientists of public finance. The main source of revenue for the government is tax revenues (direct and indirect taxes). The common difference between direct and indirect taxes is that a direct tax is one for which the formal and economic incidence are essentially the same—that is, the taxpayer is not able to pass the burden on to someone else. Thus, income tax counts as a direct tax but VAT counts as an indirect tax because the tax burden may be easily be passed on to other. Direct taxation is defined as the tax which is directly levied on the citizens of a country.

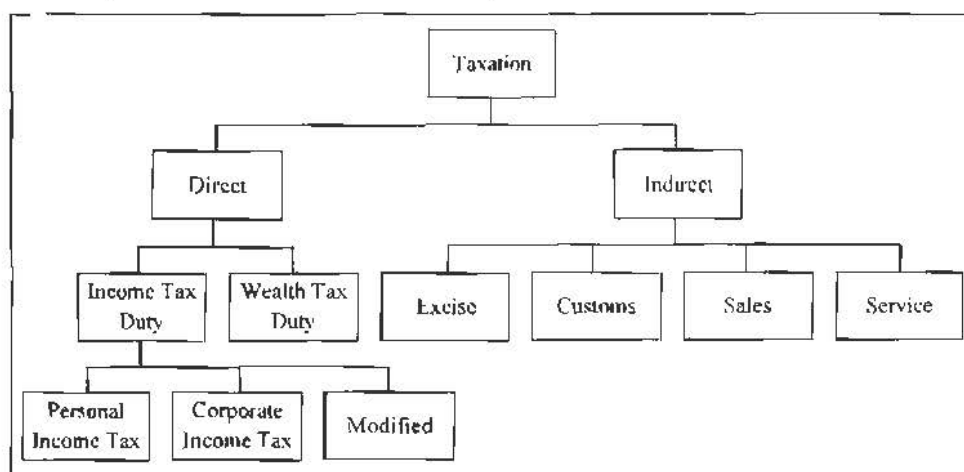


Figure 4.1: Structure Taxes Revenue According to Who Bears the Burden

The above figure defines the structure taxes revenue. Every individuals and concerns have to pay direct taxes to the government on a regular basis. These direct taxes are calculated on every source of income that accumulates to the business of an individual. On the other hand, the individuals of a country are also charged certain taxes indirectly. For examples, sales tax, excise tax and service tax. These taxes are known as indirect tax. The classification of taxes has been defined from scientists of economics, but the distinction between direct and indirect taxes is not always satisfactory or a consistent one.

Direct and indirect tax according to Dr. Dalton, depends upon who bear the impact and incidence. As a person bears impact and incidence that is direct taxes, while the impact and the incidence are not different persons, the tax is indirect. Thus, income and property taxes are direct taxes, while customs and excise duties are indirect taxes. Taxation on direct income, tax duty, personal income tax, corporate income tax, modified wealth tax, indirect Excise Duty, customs sale (VAT) services.

According to Dr. Nicholas Kaldor, there are taxes which are levied on persons and corporation and taxes levied on transactions. Thus income tax or the ownership of property would be direct taxes and taxes on the purchase or sale of property like stamp duties would be indirect tax.

According to J.S M, taxes are direct or indirect depending upon whether the ultimate burden of the tax fall upon the person who actually pays the tax or not.

Prof. P.E Taylor, thinks in terms of shift ability. When the tax don't shifted is direct, but when tax is shifted, it is indirect tax. Thus, there seems to be no scientific or logical basis for the distinction of taxes into direct and indirect and there is a lot of confusion and vagueness regarding the basis of classification of direct and indirect taxes. There is no precise scientific or logical criterion to decide whether a tax is direct tax or an indirect.

4.4.1 Direct Taxes

Direct taxes are those which are paid once for all by the persons from whom they are collected and not passed on to another. In the direct taxes, the impact and the incidence of a direct tax are on the same person. Direct taxes do not lead to increase in prices of commodities. They are progressive in nature and have satisfied the canons of economy, convenience and finally, direct taxes are taxes on income, so all incomes from various sources are direct taxes, for example, personal income, corporate income, income from land, properties income, income from capital, income from investment, wealth tax and gift tax.

Merits of Direct Tax

1. **Equity:** Direct taxes have equity of sacrifice, depending upon the volume of income. They are based on the principle of progressive, so rates of tax increase as the level of income of a person rises.
2. **Elasticity and productivity:** Direct taxes have elasticity because when the government faces some emergency like earthquake, floods and famine, the government can collect money for facing those problems by direct tax.
3. **Certainty:** Direct taxes have certainty on both sides' tax-payer and government. The tax payers are aware of the quantity of tax. They have to pay and rate, time of payment, manner of payment, and punishment from the side of government is also certain about the total amount they are getting.

4. **Reduce inequality:** Direct taxes follow progressive principles so it is taxing the rich people with higher taxation and the poor people with a lower level of taxation.
5. **Good instrument in the case of inflation:** Tax policy as fiscal instrument plays important role in the case of the inflation, so government can absorb the excess money by arising in the rate of existing taxes or imposition of new taxes.
6. **Simplicity:** Direct taxes are simplified, while levy the rules, procedures, regulations of income tax are very clear and simple.

Demerits of Direct Taxes

1. **Evasion:** Direct tax is generally a large amount and therefore tax payers try evasion.
2. **Uneconomically:** Expenses of collection are larger in the case of indirect taxes, because they require widely-spread staff for collection.
3. **Unpopular:** Direct tax is required to be paid in lump sum for the whole year, so the tax payers feel the painful payment, these taxes are therefore unpopular.
4. **Little incentive to work and save:** In direct taxes, rates are of progressive nature. A person with higher earnings are taxed more, in turn he is left little amount. So the tax payer feels disincentive to work hard and save money after reaching a certain level of income.
5. **Not suitable to a poor country:** Direct taxes are not enough to meet its expenditure.
6. **Arbitrary:** Due to absence of logical or scientific principle to determine the degree of progression in the taxation, the direct taxes are arbitrary.

4.4.2 Indirect Taxes

Another type of tax revenue is indirect taxes. Indirect taxes are paid by the producer or importer and passed on to the consumer. The impact and incident of tax are on different persons. Indirect taxes are taxes on commodities and services other than personal services. Relationship between tax payer and tax authority is absent. All people whether rich or poor are charged fixed rate. These taxes shift to another person, effect in income of poor people more than rich people. Indirect tax like excise duties, customs duties, sales tax and service tax.

Merits of Indirect Taxes

1. **High Revenue Production:** The nature of indirect taxes is imposition on the commodities and services. Here indirect taxes cover a large number of essential goods and luxurious goods which are consumed by the mass both rich and poor people, these help in collecting a large revenue.
2. **No Evasion:** Indirect tax is included in the price of commodity, so tax evasion or tax avoid is difficult.
3. **Convenient:** Indirect taxes are generally less in amount and they are hidden in the price of goods or service, hence the burden of these taxes is not much felt by the tax-payers, and it is not lump sum like direct taxes.
4. **Economy:** Indirect taxes are economical in collection and the administrations costs of collection are very low, also the procedure of collection of these taxes is very simply.

5. **Wide Coverage:** Indirect taxes cover almost all commodities like essential commodities, luxuries and harmful ones.
6. **Elasticity:** Since indirect taxation covers a large number of commodities and services there is great scope for modification of taxes, goods and tax rate, much depends on nature of good and on its demands.

Demerits of Indirect Taxes

1. **Regressive in Effect:** Essential commodities are used from all members of community. While taxing these commodities the burden would be equal, and no distinction is made between the rich and poor people.
2. **Uncertainty in Collection:** Discourage savings and increase inflation: Indirect taxes are payable when people spent their income or when people buy goods and services, so tax authorities cannot accurately estimate the total yield from different indirect taxes.
3. **Discourage Savings:** Indirect taxes are included in the price of commodity, so people have to spend more money on essential commodities, when levied indirectly. In this case that means the customers cannot save some of their money.
4. **Increase Inflation:** Indirect taxes increase the cost of input and output, increase in production cost, push the price of goods, etc. These reflect an increase in the wages of the workers.

Direct and indirect taxes represent taxation system in modern times, a combination of both the taxes would be very necessary to streamline the financial aspects of the government. The impact and the incidence of a direct tax are on the same person. In the case of indirect taxes, the impact and incident of tax are on different persons. These two taxes are complementary to each other, as they remove the financial forces operating in the economic system.

4.5 DIFFERENCES BETWEEN DIRECT TAX AND INDIRECT TAX

There are some differences between direct tax and indirect tax. They are as follows:

1. **Allocation Effect:** The allocation effects of direct taxes are superior to those of indirect taxes. When a particular amount is raised through a direct tax like income tax, it would imply a lesser burden than the same amount raised through an indirect tax like excise duty. An indirect tax involves excessive burden as it distorts the consumer's preference regarding goods due to price changes. Thus an indirect tax has an adverse effect on the allocation of resources than a direct tax.
2. **Distributive Effect:** Direct taxes are progressive and they help to reduce inequalities. But indirect taxes are regressive and they widen the gap of inequalities. Hence, direct taxes are regarded to be superior to indirect taxes in effecting a more equitable distribution of income and wealth. But this is not always true. Even indirect taxes can be made progressive by levying them on luxuries and exempting them on necessities. Both direct and indirect taxes are alternative methods of achieving any particular redistribution of income.
3. **Administrative Costs:** The administrative costs of direct taxes are more than that of indirect taxes. Direct taxes are narrow based and have many exemptions. Indirect taxes can be conveniently collected and cost of collection is constant overtime. Indirect taxes are easier to administer than direct taxes. From the point of view of efficiency and productivity, indirect taxes are better. Indirect taxes are wrapped up in prices and hence they cannot be easily evaded. They are more

productive as their cost of collection is the least. Thus, from the point of view of administrative costs, indirect taxes are relatively superior.

4. **Built-in Flexibility and Stability:** Direct taxes are more flexible than indirect taxes. During a period of prosperity, direct taxes fetch more revenue as they are progressive. But indirect taxes are proportional and they do not fetch as much revenue as direct taxes. Direct taxes help to reduce the inflationary pressure by taking away the excess purchasing power and hence they promote stability. But indirect taxes are inflationary. Hence, from the point of stability, direct taxes are more preferred to indirect taxes.
5. **Growth Orientation:** Indirect taxes are more growth oriented than direct taxes. Direct taxes being progressive reduce savings. When savings and investments are discouraged, economic growth is adversely effected. Indirect taxes however discourage consumption and increase savings. Indirect taxes on luxuries reduce conspicuous consumption and channelise resources into growth oriented program. Conclusion Thus from the above points, allocation, distribution and stability, direct taxes are superior. From the view of productivity and economic growth, indirect taxes superior. But the use of both direct and indirect taxes is indispensable in modern public finance.

4.6 SHIFTING, INCIDENCE AND IMPACT OF TAXATION

As we know, tax is sacrifice from taxpayer to government and tax is transfer money from private sector to public sector, but when tax transfer to the government is passing through some stages and here no one knows who will pay the tax and who will be the last person to pay the tax, so three concepts are involved. Firstly bears the impact of the tax which a tax imposed on some person, Secondly the incidence of the tax it may ultimately be borne by this second person or transferred to another by whom it is finally assumed. Thirdly the shifting of tax here, it may be transferred by him to second person.

Impact

The impact of tax is on the person, who has to find the money and deposit it with the state treasury. Impact of tax is on the person who pays it in the first instance, hence there is person have a businesses and the impact find by reason that's business, in other words, the man who pays the tax to the government in the first instance bears its impact. Impact of tax therefore refers to the immediate burden of the tax and to the ultimate burden of the tax.

Incidence of Taxation

Incidence of a tax is on person who finally bears burden of a tax. Tax incidence research about that bears the cost of taxation, incidence is the ultimate result of the shifting tax incidence and also it refers to the final resting place of tax burden as against the impact which means the first place where a tax is imposed. Incidence of taxation which is one of the effects of the tax system, which incidence refers to the burden of a tax, the incidence of tax is on the person who ultimately pay it, who cannot shifted it any further.

Shifting of Tax

It means the transfer of the tax burden from the original payer to some other. Tax shifting is the study of a way in which the burden of taxation is shifted among person and organization in the economy. Shifting is process of transferring money burden of tax to someone else. Shifting finally ends in incidence, shifting of a tax refers to the

process by which the money burden of a tax is transferred from one person to another, wherever there is shifting of the tax the tax may be shifted forward or backward, may be full or partial, if the tax shifted the price of the taxed commodity increases. The incidence of personal income-tax cannot be shifted to another and the burden always remains where it is imposed. In the case of direct taxes there is no shifting of the tax burden but in the case of indirect taxes, the tax burden may be shifted from one person to another person, the tax can be shifted. It depends on some factors, including, elasticity of demand and supply, coverage of the tax and the time period allowed for adjustment.

Conclusion

Impact of a tax is on person from whom government collects money in first instance. While incidence of a tax is on person who finally bears burden of a tax, while shifting is process of transferring money burden of tax to someone else. Shifting finally ends in incidence.

4.7 TAX EVASION

One of the major obstacle before India Government is Tax evasion. Tax evasion is the way people evade tax by illegal and unfair means. They may claim lesser profit, gains or turnover than actual. Even if there is huge amount of tax to be paid, evaders get refund by making misrepresentations before tax authorities. Huge amount of revenue is lost through this way for government so that we cannot climb from economic stagnation. Most of the welfare activities for poor are put on hold due to lack of money while some people who can buy even the government with black money are growing daily.

Different Ways of Tax Evasion in India

Ways through which people evade tax are Smuggling, Evasion of Sales and Value Added Tax, Evasion of Income Tax, Evasion of Wealth Tax, Evasion of Customs Duty and Evasion of Excise Duty. Also, officials take bribery and helps in making misrepresentations and fabricated financial statements instead of reporting to tax authorities. Evaders willfully fails to file return, submits false returns, submits false certificates to get deductions, exemptions and claim low income, charging personal expenses to revenue, fails to pay dues within due date and so on to evade tax.

Effect of Tax

Evasion in India Taxes are the major source of revenue of India government. Tax evasion causes economic inequality that is how some people are getting richer and others are getting poorer. Many reform measures and initiatives of government have to be set aside and welfare activities are getting affected. Black money causes inflation and value erosion.

Measures taken by India Government to Curb Tax Evasion

Several steps as below have been taken by India government to avoid tax evasion. In India, tax evasion is regarded as a crime. Prosecution and penalties are imposed under different acts by government. Income tax reward scheme has been introduced by Income Tax Department which gives rewards to informers about tax evasion. Recently, India has entered into pact with US to avoid tax evasion by Americans through Indian financial organizations. Special Bearer Bond Scheme (Immunities and Exemptions Act, 1981) enable person in possession of black money to invest in special bonds. Voluntary Compliance Scheme (Amnesty Scheme) was another one. Government increased the tax slab, reduced deduction rate, and increased legal tax avoidance measures. Most recently, Tax Administration Reform Commission was set

up by Government to make structural reform to tax matters to simplify and streamline tax procedures. Earlier India had set up several committees like Taxation Enquiry Committee, Indian Tax Reforms Committee, and Direct Taxes Enquiry Committees etc. Transfer Pricing Audit was introduced by Finance Bill to audit undisclosed transactions to curb tax evasion.

Limitations of Indian Tax Structure

Limitations of Indian Tax Structure which result in tax evasion are:

1. ***High rate of taxation:*** High rate of taxation cause a burden to tax payer. So, they find ways to avoid tax.
2. ***Failure to curb bribery:*** There should be adequate system to curb bribery and corruption among officials. They help taxpayers to avoid tax by taking an agreed share of profit out of evaded tax.
3. ***Lack of simplified procedures:*** Tax structure in India is complex and people find it hard to go to different departments for a single matter.
4. ***Existence of large number of taxes:*** Existence of large number of different type of taxes causes burden on taxpayers.
5. ***Complex tax laws and loopholes to avoid tax in laws:*** Indian tax law is complex. In the same law, people find provisions to escape from tax liability.
6. ***Lack of organized and systematic:*** Administration structure.
7. ***Frequent changes in Government and Political instability:*** Frequent changes and political instability is another reason of non-implementation of well-defined tax system. Different governments implement different tax system and it becomes difficult to follow.
8. ***Frequent changes in tax policies:*** Tax policies in India are changed frequently by government. It creates confusion among tax payers and officials about the relevant provisions.

4.8 TAXABLE CAPACITY

After the study of shifting, incidence and impact of taxation, in this section, we will study tax capacity, factors of taxable capacity and kinds of taxable capacity. The term “taxable capacity” refers to the maximum capacity of the burden of tax that a country can bear and contribute to the expenses of the national exchequer during normal and abnormal situation.

The concept of taxable capacity has been defined differently by different economists. According to Sir Josiah Stamp, “Taxable capacity is that maximum amount which the community is in a position to bear towards the expenses of public authorities without having a really unhappy and down-trodden existence and without dislocating the economic organization too much”.

According to Findlay Shiraz, “It is the optimum tax ability of a nation, the maximum amount of taxation that can be raised and spent on the economic welfare in that community”.

Dalton calls it a dim and “confused conception”. He writes in his book “Principles of Public Finance”: “Absolute taxable capacity is a myth and should be banished from all serious discussions of public finance”.

For the various definitions of taxable capacity given by eminent writers on Public Finance, we understand that taxable capacity means the maximum amount which a

nation can contribute towards the support of the government without inflicting damage on the power and produce. The amount of tax burden which the citizens of a country are ready to bear is not rigidly fixed. It can be increased or decreased with a change in the distribution of wealth, the size of population, method of taxation, etc. In other words, we can say that the limit of taxable capacity is a relative and not an absolute quantity. Taxable capacity is different in different countries. therefore as a first step, it is necessary to identify variable which influence taxable capacity, list of such variable including, per capita capital, composition of gross domestic product, degree of openness of the economy and so on.

4.8.1 Kinds of Taxable Capacity

There are two types of taxable capacity:

1. **Absolute Taxable Capacity:** The absolute taxable capacity refers to the maximum amount of tax paying capacity of the economy or country as a whole or a region or industry or a group of individuals, which can be raised from a community without effecting the productive effort and efficiency.
2. **Relative Taxable Capacity:** Relative taxable capacity is a comparative term. relative taxable refers to the comparison between the absolute taxable capacity of different tax payer, industries or groups of tax payers or between two countries.

4.8.2 Importance of Taxable Capacity

There are some points of importance for taxable capacity:

1. It helps the country to estimate the amount of money it could collect by way of taxation.
2. It helps the country to mobilise revenue from different sources.
3. It shows the participation of each section to share the provider of government revenue.
4. It helps to the government to develop the economy of the country as a whole.
5. It helps the country to identify those taxes that are very harmful and highly detrimental to the state.
6. It is useful for the purpose of comparison of the burden of taxation as between different state of federal government.

4.8.3 Factors of Taxable Capacity

There are various factors of economic and non-economic nature that influence the taxable capacity of the country:

1. **Size of Population:** Taxable capacity is very much affected by the increase in national income and by the rate of growth in population. If the increase in national income is greater than the growth in population, the per capita income goes up. The taxable capacity of the individuals rises. If the rate of growth of population is higher than the national income, the taxable capacity decreases.
2. **Distribution of National Income:** Taxable capacity is also influenced by the distribution of national income within a country. If there is unequal distribution of wealth in the country, the taxable capacity of the nation will be high, but if the income is equally distributed, then the taxable capacity will be low. A man earning an income of 50,000 a month is able to pay more to the government than thirty persons earning 300 per month.

3. **Standard of Living of People:** If the standard of living of people is high, they work more efficiently so that they may enjoy a better standard of living. When they work enthusiastically, they receive higher wages from their employers. Taxable capacity tends to increase then.
4. **Characteristics of Taxation:** If taxes are devised wisely, then they give less resentment from people and bring forth a large yield.
5. **Purpose of Taxation:** Purpose of taxation has a direct bearing on taxable capacity of a nation. If citizens of a country are satisfied with purpose, of taxation i.e., the increase in welfare of people, then they show greater willingness to pay taxes to government, whereas, if they find that revenue will be spent for unproductive purposes, they hesitate to pay taxes.
6. **Psychological Factor:** Psychological factor is a very important factor in determining taxable capacity of a nation. If people are satisfied that government is doing its utmost to raise standard of living of masses and in maintaining prestige of country, then they try to sacrifice their lives, not only money for the government. A simple approach to patriotism brings forth tons of gold.
7. **Nature of Public Expenditure:** When the revenues collected by way of taxation are spent on the social and economic overheads or on the economic development, the taxable capacity will increase, and on the other hand, if the revenues are used on unproductive projects the taxable capacity will not increase.
8. **Stability of Income:** When the state is in the good condition stability helps to mobilise more taxes and increase the taxable capacity of the national. Besides that the industrial sector has more taxable capacity from agriculture.
9. **Pattern of Taxation Adopted:** The taxable capacity is greater where multiple tax system is adopted. If there is a single tax system, when new source of taxes are tapped, a progressive tax system yields large revenue.
10. **Administrative Efficiency:** If the administration of taxation has plans for increasing efficiency of employees and its collection machinery is efficient, here the tax evasion may be reduced and the taxable capacity will increase.
11. **Economic Situation:** Taxable capacity depends upon the economic case. During the period of boom or prosperity and when manufacturers make huge profits, the taxable capacity will be high, contrary to this in the period of depression taxable capacity will be low.
12. **Political Conditions:** A stable government and peaceful conditions have a favourable effect on the taxable capacity of a country. Tax yield is low where the government is unstable or where the government is undemocratic.
13. **Effect of Inflation:** If the country is in grip of inflation, purchasing power of people is reduced, taxable capacity of nation shrinks considerably. But if value of money is high and country is not faced with unemployment, then taxable capacity of people is quite high.

4.8.4 Measurement of Taxable Capacity

The taxable capacity mostly depends upon the national dividend or national income. There are two methods available for measuring taxable capacity and they are:

1. **Personal or Aggregate Income Method:** Under this method, all the income of all individuals are added, that is income from land, building, profits from business enterprises, income from employment to get the national income if the national income increase the taxable capacity increases and vice versa.

2. **Production Method:** This method, the net produce in terms of money from various sources is estimated and added up. The produce from agriculture, industry and trade, is estimated in terms of money and is added to get the national income. If net production increases, taxable capacity also increases and vice versa.

The researchers discussed in the above definition of tax capacity and kinds of taxable capacity (Absolute taxable capacity and Relative taxable capacity), various factors on which taxable capacity of a nation depends. We cannot single out any factor and say that taxable capacity is determined solely by this factor alone. The fact is that various factors influence taxable capacity and we have to take them all into consideration while judging maximum amount which citizens of a country can pay. In the end, taxable capacity is of great importance to the theory of public finance in view of its contribution in estimating the capacity of the nations to bear the burden of taxation to help the state to estimate the amount of money.

4.9 DOUBLE TAXATION

After our discussion on the topic of tax capacity in the previous section, we should study double taxation; therefore we will single out this section to the issue of double taxation. Double taxation is a problem in the modern times. It is one from the unequal taxation. It consists either of taxing some source of wealth twice in the same country or in the different countries. Double taxation is considered as obstacle before the tax-payer and it also hurdles the mobility of capital from one country to another. It is inconsistent with the canon of equity laid down by Adam Smith, therefore from time to time efforts have been made to avoid internal and international double taxation.

4.9.1 Definition of Double Taxation

A situation may arise where a person is subject into two different tax regimes in two countries with respect to the same subject matter for the same period. Double taxation is the imposition of two or more taxes on the same income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes). It refers to taxation by two or more countries of the same income, asset or transaction. Double taxation means that the taxing authority taxes the same base in more than one way. Double taxation means the taxing of a person twice by one or two authorities in the same way that is on the same income or taxing the same base twice. From our point of view, double taxation is imposition tax of any income, on the same source of wealth twice or more in the same period of time. This levy of taxation may be in the inside the country or may be outside the country.

4.9.2 Characteristics of Double Taxation

1. **Income is there:** That means there is increase in the wealth of somebody, for that no taxation in the case of loss, which means the wealth of people increased as before.
2. **Same tax-payer:** That means the tax-payer paid twice taxation on his income. For instance, if somebody has income from his businesses but his income is objected to central & state authorities. In this case, the same person objected his income two taxation.
3. **Same Source of Wealth:** That means two taxations are done on same income.
4. **Same period:** That means levying two taxes in the same period, for example, if the central government levies tax in the profits of businesses and the state also levies once in the same period, that means twice taxation in the same period.

5. **Same Taxation:** That means same taxation is imposed on the same base, in other words, the twice same taxation. If the taxpayer paid taxation for his business and taxation of his professional here double taxation is not available because there are two types from income.
6. **Twice Taxation may be Inside the State or Outside the State:** Either imposition of twice taxation inside the country or outside the country means the income is objected twice inside the country like some of the federation country or as between the different independent countries.

4.9.3 Disadvantages of Double Taxation

1. Double taxation plays an artificial impediment on the free flow of capital and another resource such as services of technicians and expert between the different countries.
2. The tax system does not secure equity between the various tax payers and it is inconsistent with the canon of equity.

4.9.4 Kinds of Double Taxation

1. **Internal Double Taxation:** Double taxation by the same taxing authorities is as internal double that is all conditions of double taxation are in existence inside the country, for example, in a federation country, there are two taxations, first by central government and second by state government.
2. **International Double Taxation:** This double taxation appears in which two taxes authorities impose taxes in the same base, in the same period, the same tax-payer but in the two independent countries. This type of double taxation is fighting by double taxation avoidance agreement between countries.

There are two types of double taxation, internal and external, whatever the type of double taxation, but it doesn't fulfill the principle of tax equity, also double taxation is an obstacle to the transfer of technology between countries and capital, so most of the countries resort to sign bilateral agreements to prevent double taxation.

4.10 OVERVIEW OF INDIAN TAX SYSTEM

Post discussing about tax definition, characteristics of taxation, canons of taxation, kinds of taxes, and objectives of taxation, shifting, incidence, impact of taxation, taxable capacity, double taxation, the researchers have briefly described the Indian tax system and the important features of the tax system in India. The Indian tax system has become comprehensive and complicated since independence in 1947. Besides being one of the main sources of revenue, both for the central and state government, it is an effective instrument to realise various socio-economic objectives of national policies. India has a well-developed tax structure with clearly defined authority between central and state governments and local bodies. Central government levies taxes on income (except tax on agricultural income, customs duties, central excise and service tax). Value Added Tax (VAT), sales tax, stamp duty, state excise, land revenue and tax on professions are levied by the state governments. Local bodies are empowered to levy tax on properties, octroy and for utilities like water supply, drainage etc. In the last 15 years, Indian taxation system have undergone tremendous reforms. The tax rates have been rationalised and tax laws have been simplified resulting in better compliance, ease of tax payment and better enforcement. The process of rationalisation of tax administration is ongoing in India.

Since April 1, 2005, most of the State Governments in the country have replaced sales tax with VAT. Comparing the country's indicators of effective tax rates and tax

revenue productivity with other countries displays that the Indian tax system is characterised by:

1. A high dependence on indirect taxes,
2. Low average effective tax rates and tax productivity, and
3. High marginal effective tax rates and large tax-induced distortions on investment and financing decisions. While the ratio of tax revenue to GDP in India is low by international standards marginal rates are high. Economic theory suggests that high tax rates may depress employment, investment and growth.

4.11 CONSTITUTIONAL DIVISION OF FINANCIAL POWER BETWEEN THE UNION AND STATES

The constitution of India is the supreme law; it is the foundation and source of power to all laws in India. Power to charge and collect tax by union or state is derived from constitution, articles 245 to 255 provide for the distribution of taxation powers between the union and the states. It may be recalled at this stage that India is having a quasi-federal constitution in which the powers of legislation are shared between the union and the states. Briefly, the parliament has exclusive power to make laws with respect to any of the matters enumerated in list I in the seventh schedule of the constitution; this list is referred to usually as union list. The legislature of every state has exclusive power to make laws for such state or any part with respect to any of the matters counted in the seventh schedule to the constitution. This list is popularly called as state list. Both the parliament and the legislature of any state have power to make laws with respect to any of the matters enumerated in the seventh schedule to the constitution. This list is referred to as the concurrent list.

4.12 DIRECT AND INDIRECT TAXES IN INDIAN TAX SYSTEM

There is no legal definition of direct and indirect taxes in India. Taxes under the charge of central board direct taxes are direct taxes while those administered by the central board of excise, customs and services are indirect taxes.

Direct taxes at central level are income tax, corporation tax, capital gains tax, wealth tax, gift tax, estate duty, expenditure tax, tonnage tax, securities transaction tax, banking cash transaction tax, fringe benefit tax direct taxes at state level, land revenue, agricultural income tax, etc.

However indirect taxes at central level are central excise duties, customs duties, service tax, central sales tax, indirect taxes at state level are state sales tax, state excise duty, entertainment tax, motor vehicle tax, passenger tax, professional tax, electricity duty, etc.

Table 4.1: Direct and Indirect Tax

Nature of Tax		Government Act	Authority
Direct	Income Tax	Income Tax Act, 1961	Central Board of Direct Tax
	Wealth Tax	Wealth Tax Act, 1957	Central Board of Direct Tax
	Gift Tax	Gift Tax Act, 1958	Central Board of Direct Tax
Indirect	Central Excise	Central Excise & Salt Act, 1944	Central Board of Excise and Customs (CBEC)
	Customs	Customs Act, 1962	CBEC
	Central Sales Tax	Central Sales Tax Act, 1956	Union Government
	State Sale Tax	Respective State Sales Tax Acts	Respective State Sales

Direct Taxation in India

Direct taxation in India is taken care of by the Central Board of Direct Taxes (CBDT); it is a division of Department of revenue under Ministry of Finance. CBDT is governed by the Revenue Act, 1963. CBDT is given the authority to create and control direct taxes in India. The most important function of CBDT is to manage direct tax law followed by Income Tax department. In India, the tax structure is divided amongst the central government and state government. The central government levies taxes on income, custom duties, central excise and service tax. While the state government levies tax like state excise, stamp duty, VAT (Value Added Tax), land revenue and professional tax.

4.13 INCOME TAX IN INDIA

Income tax in India is levied by the central government and is monitored and controlled by Central Board of Direct Taxes under Ministry of Finance in allay with the provisions of the Income Tax Act. Income earned in any given financial year is subject to tax as per the rates prescribed for that year. A tax that is imposed on income individuals/corporations/legal entities is known as Income Tax. The Central Board for Direct Taxes (CBDT) governs the Indian Income Tax department. Income tax is imposed by Govt. of India on taxable income of 45 individuals, Hindu undivided families (HUFs), companies, firms, co-operative societies and trusts (identified as body of individuals and association of persons) and any other artificial person. Levy of tax is different for different entities and it is governed by the Indian Income Tax Act, 1961

4.13.1 Heads of Income

Income tax is an annual tax on income. The Indian Income Tax Act (Section 4) provides that in respect of the total income of the previous year of every person, income tax shall be charged for the corresponding assessment year at the rates laid down by the Finance Act, for that assessment year. Section 14 of the Income tax act further provides that for the purpose of charge of income tax and computation of total income. All income shall be classified under the following heads of income:

- (a) Salaries
- (b) Income from house property
- (c) Profits and gains of business or profession
- (d) Capital gains
- (e) Income from other sources

The total income from all the above heads of income is calculated in accordance with the provisions of the act as they stand on the first day of April of any assessment year. In the discussion to follow we will explain everyone mentioned above.

Income from Salary

Income received as salary under Employer-Employee relationship is taxed. Salaries: It covers those monetary gains that are obtained for services performed and would include wages, pension, fees and commission. Standard deduction is taken from the salary and the amount of deduction depends upon the income received. If income exceeds minimum exemption limit, then employers must withhold tax compulsorily as Tax Deducted at Source (TDS). The employees should also be provided with a Form 16 which shows the tax deductions and net paid income.

Income from House Property

As per Section 22 for taxation of annual value of a property consisting of any buildings or lands for apartment, of which the assessee is the owner, under the head — income from House Property.

Tax imposed under section 22 is a tax on the annual value of house property and is not a tax on — House Property.

Income from Business or Profession

Income arising from profits and gains of any Business or Profession: income derived by a trade/professional/similar association by performing specific services for its members; any benefit from business whether convertible into money or not, incentives for exporters; any salary, interest, bonus, commission or remuneration received by partner of a firm; any amount received under a Key man insurance policy which also covers bonus; income from managing agency and speculative transactions; is taxable.

Income from Capital Gains

Under section 2(14) of the I.T. Act, 1961, Capital asset is defined as property of any kind held by an assessed such as real estate, equity shares, bonds, jewelers, paintings, art, etc. but does not consist of items like stock-in-trade for businesses or for personal belongings. Capital gains arise by transfer of such capital assets. Long term and short term capital assets are considered for tax purposes. Long term assets are those assets which are held by a person for three years except in case of shares or mutual funds which becomes long term just after one year of holding. Sale of long term assets gives rise to long term capital gains which are 47 taxable as below: As per Section 10(38) of Income Tax Act, 1961 long term capital gains on shares/securities/mutual funds on which Securities Transaction Tax (STT) has been deducted and paid, no tax is payable. Higher capital gains taxes will apply only on those transactions where STT is not paid. For other shares and securities, person has an option to either index costs to inflation and pay 20% of indexed gains, or pay 10% of non-indexed gains. For all other long-term capital gains, indexation benefit is available and tax rate is 20%.

Income from other Sources

There are some specific incomes which are to be taxed under this category such as income by way of dividends, horse races, winning of bull races, winning of lotteries, amount received from key man insurance policy. So as we can see the Indian Income Tax law is a subject which is filled with legal jargons and complexities that keep on changing every new financial year and the importance of this law in our routine life simply cannot be ignored. Whether it is filing of Income Returns on due dates or whether it's a financial investment decision to be taken, everywhere the Income Tax provisions play a major role in driving of the cost factor.

Corporate Tax

A company has been defined as a juristic person having an independent and separate legal entity from its shareholders. Income of the company is computed and assessed separately in the hands of the company. However the income of the company which is distributed to its shareholders as dividend is assessed in their individual hands. Such distribution of income is not treated as expenditure in the hands of company, the income so distributed is an appropriation of the profits of the company. The tax levied on a company's income is based on its legal residence. Companies of Indian origin are levied tax in India, while international companies are levied tax on earnings from their Indian operations. For international companies 'royalty, interest, gains from sale of capital assets within India, dividends from Indian companies and fees for technical

services are all treated as income arising in India. Companies resident in India are taxed on their worldwide income arising from all sources in accordance with the provisions of the Income Tax Act. Non-resident corporations are essentially taxed on the income earned from a business connection in India or from other Indian sources. A corporation is deemed to be resident in India if it is incorporated in India or if its control and management is situated entirely in India.

Partnership firms and Domestic companies (for the F.Y ending 31.3.2009 and 31.3.2010)

Table 4.2: Tax Rate for Partnership Firms and Domestic Companies

Type of Company	Partnership/ LLP	Domestic company with Income of Less than one Crore	Domestic Company with Income of more than one Crore	Foreign Company with Income of Less than one Crore	Foreign Company with Income of more than one Crore
Basic tax rate	30%	30%	30%	40%	40%
Surcharge	-	-	10%	-	2.50%
E.Cess	2%	2%	2%	2%	2%
S & H E.Cess	1%	1%	1%	1%	1%
Effective tax rate	30.90%	30.90%	33.99%	41.20%	42.23%

Wealth Tax in India

The wealth taxation in India is known as the Wealth Tax Act, 1957. It applies to all the citizens of the country. It is one of the most important direct taxes. It is paid on the property ownership benefits. It extends to the whole of India. It shall be deemed to have come into force on the 1st day of April, 1957. Wealth tax is an annual tax like income tax. It is charged for every assessment year for net wealth of corresponding valuation date on every individual, Hindu undivided family and company at the rate of 1% of the amount by which net wealth exceeds ₹ 15 lakhs. The Wealth Tax Act is important direct tax legislation. Wealth tax is tax on the benefits derived from property ownership. The tax is to be paid year after year on the same property on its market value, whether or not such property yields any income. Till a person retains the ownership of a property, he or she has to pay wealth tax based on the prevailing market rate. Even if the property is not yielding any income, wealth tax would have to be paid.

Gift Tax in India

A gift tax can be simply defined as the tax imposed upon the individual giving any value to the other individual. It may be defined as a tax imposed on the value of a gift. The person who gives the gift generally pays the gift tax in most cases. So it is a tax on the monetary gifts to another person. Gift tax in India is regulated by the Gift Tax Act which was constituted on April 1, 1958. It came into effect in all parts of the country except Jammu and Kashmir. As per the Gift Act 1958, all gifts in excess of ₹ 25,000, in the form of cash, draft, check or others, received from one who doesn't have blood relations with the recipient, were taxable. However, with effect from October 1, 1998, gift tax got demolished and all the gifts made on or after the date were free from tax. But in 2004, the act was again revived partially. A new provision was introduced in the Income Tax Act, 1961 under section 56 (2). According to it, the gifts received by any individual or Hindu undivided family (HUF) in excess of ₹ 50,000 in a year would be taxable. According to the law, individuals can receive gifts from the following sources: Relatives or blood relatives, at the time of marriage, as inheritance, in contemplation of death, gifts exempted from tax gifts are exempted

from India gift tax in the following cases: The gift was given by a blood relative, irrespective of the gift value Immovable properties located outside the country.

4.13.2 Indirect Tax System in India

Charge levied by the state on consumption, expenditure, privilege, or right but not on income or property. Customs duties levied on imports, excise duties on production, sales tax or value added tax (VAT) at some stage in production-distribution process, are examples of indirect taxes because they are not levied directly on the income of the consumer or earner.

Indirect Taxes Pre Reforms

The indirect tax structure was extremely irrational between the reforms. The constitution gives the permission to levy a multitude of indirect taxes. But the most important ones are customs and excise duties charged by the central government and sales tax excepting inter state sales tax to be charged by the state government. The indirect taxes levied by the centre like customs, excise and central sales tax and the major indirect taxes levied by the states and civic bodies like passenger and goods tax, electricity duty and octroi when taken together did not present a rational system.

Indirect Taxes Post Reforms

Even after reforms, the indirect tax command in India is still in the early stages of growth. The Central and State governments charge a multitude of indirect taxes. The central government imposes tax (Custom Duty) on goods at the point of import, manufacture (Excise Duty), interstate sales (Central Sales Tax or CST) and on provision of services (Service Tax). The state governments charge tax on goods sold within the state (Sales Tax Value Added Tax or VAT), and on the goods that enter the state (Entry Tax). In the present scenario corporate would have to analyze the tax cost involved in a transaction, have enough backup documentation to support their tax positions and keep looking for ways for tax maximisation.

Custom Duties

The Central Board of Excise and Customs under the Ministry of Finance manages the customs duty process in the country. Customs duty in India falls under the Customs Act 1962 and Customs Tariff Act of 1975. Usually, the goods that are imported to the country are charged customs duty along with educational cess. For industrial goods, the rate has been slashed to 15%. The customs duty is evaluated on the value of the transaction of the goods. It came into existence to check illegal imports and exports of goods. All imports into the country would be charged a duty, to give protection to the Indian industries and to check the amount of imports with a view to secure the exchange rate of the country. The Central government has the authority to inform the ports and airports for the unloading of the imported goods and loading of the exported goods, the location for clearance of goods imported or exported, the routes by which above goods may pass by land or inland water into or out of Indian ports. According to the custom laws, the following are the various types of duties which can be charged.

Excise Duty

Manufacture of goods in India attracts Excise Duty under the Central Excise Act, 1944 and the Central Excise Tariff Act, 1985. Herein, the term Manufacture means bringing into existence a new article having a distinct name, character, use and marketability and includes packing, labeling, etc. Most of the products attract excise duties at the rate of 16%. Some products also attract special excise duty and an additional duty of excise at the rate of 8% above the 16% excise duty, 2% education

cess is also applicable on the aggregate of the duties of excise. Excise duty is levied on Ad valorem basis or based on the maximum retail price in some cases. Central Excise Duty is an indirect tax which is charged on such goods that are manufactured in India and are meant for domestic consumption. The taxable fact is "manufacture" and the liability of central excise duty arises as soon as the goods are manufactured. The tax is on manufacturing, it is paid by a manufacturer, which is then passed on to the customer. The term "excisable goods" means the goods which are specified in the First Schedule and the Second Schedule to the Central Excise Tariff Act, 1985. The term "manufacture" refers to any process, related or supplementary to the combination of a manufactured product, which is specified in relation to any goods in the section of the First Schedule to the Central Excise Tariff Act, 1985 as amounting to manufacture or in relation to the goods specified in the Third schedule involves packing or repacking of such goods in a unit container or labeling or relabeling of containers including the declaration or alteration of retail sale price on it or adoption of any other treatment on the goods to render the product marketable to the consumer. In the recent budget, a number of tax exemptions have been initiated. Tax relief has been created in sectors which create jobs like small scale industries, cottage industries, food processing sectors, bio diesel and so on. In order to provide access of electricity and purified water, the water plants and purification technology sectors are also exempt from tax. Excise duty has been increased by around 5% on cigarettes and other tobacco products. Three different types of Central Excise Duties exist in India. They are: (a) Basic Excise Duty in India, (b) Additional Duty of Excise, (c) Additional Duty of Excise.

Sales Tax in India

Sales Tax in India is a form of tax that is imposed by the government on the sale or purchase of a particular commodity within the country. Sales Tax is imposed under both, Central Government (Central Sales Tax) and State Government (Sales Tax) Legislation. Generally, each state follows its own sales tax act and levies tax at various rates. Apart from sales tax, certain states also impose additional charges like works contracts tax, turnover tax and purchaser tax. Thus, sales tax acts as a major revenue-generator for the various State Governments. Sales Tax is an indirect form of tax, wherein it is the responsibility of the seller of the commodity to collect and recover the tax from the purchaser. Generally, sale of imported items and sales by way of export are not included in the range of commodities which requires payment of sales tax. Moreover, luxury items (like cosmetics) are levied heavier sales tax rates. Central Sales Tax (CST) Act that falls under the direction of the Central Government takes into account all the interstate sales of commodities. Thus, sales tax is to be paid by every dealer on the sale of any commodity, made by him during interstate trade or commerce, irrespective of the fact that no liability to pay tax on the sale of goods arises under the tax laws of the appropriate state. He is to pay Sales Tax to the sales tax authority of the state from which the movement of the commodities commences. However, from April 1, 2005, most of the states in India have supplemented Sales Tax with a new Value Added Tax (VAT). The practice of VAT executed by State Governments is applied on each stage of sale, with a particular apparatus of credit for the input VAT paid. VAT in India can be classified under the following tax slabs:

- (a) 0% for essential commodities
- (b) 1% on gold ingots and expensive stones
- (c) 4% on industrial inputs, capital merchandise and commodities of mass consumption
- (d) 12.5% on other items variable rates (state-dependent) are applicable for petroleum products, tobacco, liquor, etc.

Dr. Manmohan Singh, the Union Finance Minister, in his budget speech for the year 1994-95 introduced the concept of Service Tax. The Service Tax assessee is the person or firm who provides the service. Hence, the Service Tax must be paid by the person or firm providing the service. Service tax is levied at the rate of 10% (plus 2% education cess) and 1% secondary and higher education cess. On certain identified taxable services provided in India by specified service providers. Service tax on taxable services rendered in India are exempt, if payment for such services is received in convertible foreign exchange in India and the same is not repatriated outside India. The Credit Rules allow a service provider to avail and utilise the credit of additional duty of customs/excise duty for payment of service tax. Credit is also provided on payment of service tax on input services for the discharge of output service tax liability.

Analytical Study of Tax Revenue for Ten Years in India

In this section, the researcher will study the trends of tax revenue for ten years from 2000-2001 to 2009-2010, first step he collected data for tax revenue. The researcher used excel windows for processing the data, then he analyzed and interpreted tables and graphs, compared between direct tax and indirect tax revenues. The sources of data (amounts for direct taxes and indirect taxes) are from website from Revenue Department, Finance Ministry in India.

Analytical total revenue for ten years from the year 2000-2001 to 2009-2010

Table 4.3: Total Revenue for Ten Years from 2000-01 to 2009-10

(crore rupees)

Fin. Year	Total Revenue	Total Tax Revenue (Direct and Indirect Tax)	Proportion of Tax Revenue into Total Revenue
2000-2001	98018.82	87723.28	89.49%
2001-2002	347111.19	305320.24	87.96%
2002-2003	417353.50	356638.23	85.45%
2003-2004	490183.05	414084.77	84.47%
2004-2005	579940.86	494370.10	85.24%
2005-2006	687018.87	587687.81	85.54%
2006-2007	861198.47	736707.71	85.54%
2007-2008	1000171.65	870329.09	87.01%
2008-2009	1045034.83	915449.99	83.28%
2009-2010	1173934.31	987509.75	84.20%

4.14 PROBLEM OF JUSTICE IN TAXATION

It is often assumed that tax is a bad thing; that government want to deprive citizens of their hard-earned money. But from an economic justice and human rights perspective, taxes are crucial for four reasons, which can be summarised as the four 'Rs':

- Revenue: funding to deliver the services citizens need
- Redistribution: to address poverty and inequality
- Representation: building accountability of governments to citizens and reclaiming policy space
- Repricing: limiting public 'bads'; encouraging public 'goods'.

In evaluating taxes today, we continue to apply Adam Smith's maxims—equity, certainty, convenience and efficiency. Today, justice in taxation is often discussed in

terms of so-called horizontal and vertical equity. Horizontal equity requires that like cases be treated alike in taxation. For instance, if two citizens of the same taxing jurisdiction have the same income and make similar relevant choices, they should pay the same income tax. Or, if they consume the same amount of the same goods, they should pay the same consumption taxes. Vertical equity, on the other hand, requires that taxpayers who are situated differently be treated differently to an appropriate degree. Although horizontal and vertical equity are two sides of the same coin, vertical equity tends to be more contentious. There is broad disagreement about what counts as relevant differences in how a person ought to be taxed.

4.15 DEFECTS AND STEPS OF REFORM

The tax structure in India is complex and burdensome. In India, GST tax will replace almost all the indirect taxes and bring a common market for easy tax structure and simple tax payment.

There is a fundamental problem with India's current tax system. India simultaneously has a tax base for direct taxes that is too small; and a tax base for indirect taxes that is too large. Consequently, too little tax revenue is raised; and too much of the tax burden is paid by the poor. This limits the state's ability to provide the infrastructure and manpower required for good governance.

According to the December 2017 report of the income-tax department, only 1.6% of Indians pay income tax. This is unsurprising since agricultural income is not taxed in India and the wealthy have mastered the art of tax avoidance and evasion. Despite the small base for income tax, most Indians contribute to tax revenue because India relies heavily on indirect taxes. However, the Indian version of taxing consumption is not very efficient. Even the relatively incentive-compatible goods and services tax (GST) is fraught with high compliance costs, too many rates and classifications.

Further, taxes on consumption tend to be regressive, because poor people spend a greater proportion of their income on consumption—and consumption is taxed at high rates in India. The regressive nature of a consumption tax is exacerbated by the current GST system, where biscuits are taxed at 18% but gold is taxed at only 3%. For instance, the smallest packets of Parle-G biscuits, a snack for the middle class, and often a meal substitute for the poor, are priced at ₹ 2 and ₹ 5, with an 18% tax. While the price is unlikely to increase, the quantity available to the buyer will likely reduce at that price—with tax burden partly passed on to the consumer.

So, what can be done to resolve this problem? I propose that Indian states should rely more on property tax, which is economically efficient, incentive compatible and progressive. Property tax has four key benefits.

First, it is difficult to evade. Property cannot be moved or hidden easily and lasts long. There is an additional incentive to correctly declare the full extent of one's property. Property owners will not understate the amount of property owned, because it might adversely affect their wealth, future sales, disputes, inheritance, etc. Since property often forms a large proportion of total assets/wealth, there is a built-in incentive to declare property honestly, unlike incentives to understate income or sales.

Second, property tax is efficient because it creates fewer distortions. Typically, a tax on something results in less of it. High levels of income tax may create a disincentive to work. High sales taxes may lead to lower consumption, and, in certain situations, an informal economy, with goods sold off-the-books, etc. In this regard, property taxes are quite efficient. Typically, existing buildings, land, etc. don't reduce or disappear because of a tax. The main response available to the property owner is to sell the property, and as long as there is a buyer willing to take on the tax burden, revenue tends to be stable.

Third, property taxes tend to be more progressive than consumption taxes (but less progressive than income tax) because the wealthy, relatively, own more property. India has a very high percentage of home ownership, especially in rural areas. It will be important to design a progressive property tax system by classifying plot sizes, accurate land values and zoning data.

Finally, and most importantly, property taxes tend to be levied by local governments. This creates a very direct feedback mechanism between voters/taxpayers and their elected representatives, unlike income and sales taxes, which are levied centrally and spent far from where they are collected. In India today, the urban rich and middle class are able to exit the consequences of state dysfunction by buying into gated communities and private developments. Within these communities, individuals pay maintenance fees, which provide the same services that would be provided by a functional municipal system.

A property tax system makes such exit costlier — which might lead the rich and middle class, who have political and social capital, to participate in governance decisions and demand better public goods and services. Unlike income taxes (often withheld at source by the employer) or sales tax, where the tax is hidden in the retail price, taxpayers typically have to write a cheque to the government while paying property tax. This has the advantage of revealing the extent of the tax explicitly, which may lead taxpayers to demand low tax rates as well as exert pressure on local governments for better services.

Property taxes may also have other consequences specific to India, with its 24.7 million vacant homes. Much of the black money in India is channelled towards owning multiple homes, and poorly designed tenancy laws coupled with a slow dispute resolution system incentivise owners to leave additional homes vacant. Property taxes make it costlier for owners to have additional vacant properties that are purely speculative. In rural India, property tax may also be an avenue to tax wealthy farmers without unduly burdening poor farmers, since agricultural income is not taxed at all.

Currently, India barely relies on property taxes, with a property tax to Gross Domestic Product (GDP) ratio of 0.2%. For other developing countries, though data varies greatly, the rough estimate is 0.7%. By comparison, the average property tax to GDP ratio for OECD countries is almost 2%. India should actively consider exploring property taxes as an important source of revenue to develop increased citizen participation for public goods infrastructure.

Major Defects in Present Structure of Indirect Taxes

Following can be summarized as major defects in present structure of indirect taxes:

- Central Sales Tax (CST) is payable for every movement of goods from one State to other. If the sale is direct, CST is payable. Even in case of stock transfers or branch transfers, there is incidence of tax as input service credit (set off) of input taxes is not fully available.
- Central Sales Tax is an orphan. Hence, if there is any difficulty, there is no authority to sort it out and find solutions. This creates numerous problems in CST.
- Cascading effect of taxes cannot be avoided due to CST and Entry Tax.
- Movement of goods in European Union (EU) is free across all countries without any incidence of tax. However, in India, movement of goods from one State to other is not tax free.
- India does not have a national market due to invisible barriers of central sales tax, Entry Tax and State Vat and visible barriers of check posts.

- Millions of man-hours and truck hours are lost at check posts. Besides, huge corruption is involved.
- Central Government cannot impose tax on goods beyond manufacturing level [CST though levied by Central Government is collected and retained by State Government only].
- State Government cannot impose service tax.
- Over the years, distinction between goods and services has become hazy, due to which there is overlapping of State Vat and Central Service Tax on transactions like works contract, food related services (restaurants, outdoor catering, mandap services), Software, IPR Related services, lottery, SIM cards, renting of movable property etc.
- Same transaction is taxed both by Central and State Government which creates confusion, litigation and double taxation in many cases.

Steps to Improve Tax Reform in India

India is a nation of a thousand divides. But if the country's recent progress in reforming its tax code is any indication, it may be slowly overcoming its penchant for political fragmentation. On March 29, the lower house of the Indian Parliament passed a new Goods and Services Tax (GST) intended to broaden the country's tax base, boost the government's revenue and increase the Indian tax-to-GDP ratio. The comprehensive measure is merely the latest sign to consolidate power are beginning to bear fruit, providing the clout he needs to push through policies that have otherwise stalled in the face of lawmakers' squabbles.

The Legacy of the License Raj

The GST, a levy applied to all production stages of goods and services consumed in India, is only one part of a decadeslong project to liberalize the Indian economy. Initiated in the 1980s, the effort gained momentum in 1991 when India's balance of payments crisis came to head just as the inspiration for its planned economy — the Soviet Union — collapsed. After securing an emergency loan from the International Monetary Fund, New Delhi moved quickly to dismantle the country's elaborate and overbearing system of regulations, business licenses and bureaucratic red tape known as the "license raj."

Tax reforms were a crucial part of this overhaul. The government hoped that by imposing a fiscal policy that prioritized savings and investment, it could breathe new life into an economy struggling to ensure that its output outpaced a rapidly expanding population.⁵ And in some ways New Delhi was right: Its structural adjustments bolstered economic growth, and the country's corporate services sector reaped the rewards.

Even so, the legacy of India's convoluted tax system lived on. Holdover issues such as cascading (double taxation), low compliance rates, a small tax base and the uneven distribution of taxation powers between the central and state governments continue to hobble the Indian economy to this day — problems the GST is meant to stamp out once and for all.

The Solution: Simplicity

The primary goals of the GST are twofold: to simplify the Indian tax code and heal the rifts it has created. As it stands, a raft of indirect taxes at the central and state levels have led to cascading, a problem that arises when a buyer pays a tax on the total value of a purchase, despite the good having already been taxed at earlier stages in the supply chain. In effect, this creates a system of double taxation.

The GST will replace this complicated collection of taxes with a single value-added tax and an accompanying system of tax credits, in which each buyer in the supply chain receives a credit for taxes previously paid on the items in question, thereby reducing the buyer's tax burden. Since claiming these credits would require documentation from earlier sellers, the new system also creates a self-policing mechanism that will promote better compliance with the nation's tax laws among Indian companies. And thanks to multiple stages of documentation, tax authorities will have more complete information to consult. This, in turn, will help to formalize India's economy through the construction of a modern, efficient and digitized tax system. Better compliance will also generate more revenue for the government in New Delhi, which hopes to bump up India's current tax-to-GDP ratio of 16 per cent to levels seen in other emerging markets. (South Africa, China and Turkey boast ratios of 26, 28 and 21 per cent respectively.)

Simplification is certainly important, but it isn't an end unto itself. The unity it enables in the Indian market, however, is. Goods in India are currently subject to a complex division of taxes at the central and state levels. For instance, New Delhi can legally levy taxes on the manufacture of goods and services, but states can tax only the sale of the former. Moreover, goods that cross state borders are slapped with a 2 per cent surcharge and are ineligible for tax credits, a setup that has discouraged trade among Indian states and undermined supply chain efficiency. (Even if it is more efficient to build plants in several states, for example, a non-refundable tax on interstate trade can result in the clustering of facilities in a single state.)

The new tax bill aims to address these problems. Under the GST's Integrated Goods and Services Tax, which regulates financial transactions among states, buyers in importing states can claim tax credits. In theory, this should bolster the Indian manufacturing industry by driving interstate commerce.

The Path Forward is Clearer Than Ever

Of course, in a country as big as India, ambitious initiatives like the GST will never please everyone—a reality that has led to the downfall of many reform attempts before it. Disputes have already broken out over several points of the GST, including the need for a four-tier tax rate instead of a single-tier structure, confusion over how products are distributed among the proposed tiers, and the exclusion of petroleum and alcohol (both major revenue generators). The GST council, moreover, has yet to decide how the new tax revenue will be split between the central and state governments.

Then there's the digital infrastructure underpinning the new system to consider. The overhaul will require governments and businesses alike to transition to an online system of tax administration called the GST Network, which is bound to result in setbacks as each side adapts to the unfamiliar scheme. What's more, tax reform is only one piece of a larger package of measures that India will need to implement to achieve its economic goals, such as boosting the country's meager GDP per capita through manufacturing-led growth and eradicating the mass poverty India inherited upon gaining its independence in 1947.

Check Your Progress

Fill in the blanks:

1. _____ is a form of payment from individuals or legal entity and it is imposed by government.
2. The researcher, _____ have mentioned that, taxation finds out solution for some economic problems, but not alone, but there are also a lot of another fiscal instruments.

Contd.

3. _____ is one of the oldest, uppermost and primary objectives of taxation.
4. _____ has placed considerable emphasis on objectives of taxation policy.
5. The _____ and the _____ of a direct tax are on the same person.
6. _____ are more flexible in nature.
7. _____ is one from the unequal taxation.

4.16 LET US SUM UP

- Taxation is a form of payment from individuals or legal entity and it is imposed by government, for which there are no goods or services received directly in return. so taxes is that amount of money the people pay but has no direct relation to the benefit obtained by the people from the provision of a particular good or service.
- Governments may borrow from the central bank of the country.
- Taxes are applied to fund foreign aid and military ventures, to influence the macroeconomic performance of the economy or to modify patterns of consumption or employment within an economy, by making some classes of transaction more or less attractive.
- In the modern time, taxation is not only a means of transferring money to the government to spend for meeting the public expenditures or raise revenue to the government, but taxes have become a tool to reduce demand in the private sector, redistribution of income and wealth in the societies in the countries.
- Today taxation besides being the main resource for supporting government has become a tool for economic growth, social welfare; attract foreigner investment, economic stability, and income distribution.
- Tax (Direct and Indirect Tax) is the main source for the Government revenue.
- Direct taxation is defined as the tax which is directly levied on the citizens of a country.
- Indirect taxes are taxes on commodities and services other than personal services.
- The study of a way in which the burden of taxation is shifted among person and organisation in the economy is known as Tax shifting.
- Taxable capacity is different in different countries, therefore as a first step, it is necessary to identify variable which influence taxable capacity, list of such variable including per capita capital, composition of gross domestic product, degree of openness of the economy and so on.
- Value Added Tax (VAT), Sales Tax, stamp duty, State Excise, land revenue and tax on professions are levied by the State Governments.

4.17 UNIT END ACTIVITY

Examine the impact of tax evasion on Indian economy.

4.18 KEYWORDS

Land tax: Tax to be paid for land

Cost: Expenditure

Legal: Related to law

Surplus: In large quantity

4.19 QUESTIONS FOR DISCUSSION

1. Define taxation. Mention the characteristics of taxation.
2. Discuss the objective of the taxation.
3. Differentiate between direct tax and indirect tax.
4. Discuss the Indian taxation system. Also mention the heads of income.
5. Discuss about pre and post reforms of indirect tax.

Check Your Progress: Model Answer

1. Taxation
2. Dr. A. Senthilrajan
3. Revenue
4. Economic Development
5. Impact, Incidence
6. Direct Tax
7. Double Taxation

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UNIT-5

INTRODUCTION TO PUBLIC EXPENDITURE

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5.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Define public expenditure
- Discuss the public expenditure issues in India
- Describe the classification of public expenditure
- Explain the role of public expenditure
- Define public debt and its classification

5.1 INTRODUCTION

Government expenditure such as government spending which is incurred by central, state and local governments of a country is referred to as public expenditure.

Public expenditure can be defined as, "The expenditure incurred by public authorities like central, state and local governments to satisfy the collective social wants of the people is known as public expenditure".

In the functions of economy at almost all stages of economic development, public expenditure plays a significant role. The government resorts to expenditure and revenue programs to produce desirable effects on the national income, production and employment. The main aim of the public expenditure is at the expansion of the volume and rate of investment in both public and private sectors and the increase in the production of agricultural and industrial sectors. Additionally, a planned scheme of public expenditure provides for an optimum resource allocation which is not guaranteed by the market, and also reduces the inequality in the distribution of resources by properly directing the expenditure towards education, medical and health care of the low income section of the community. Besides, public expenditure counteracts inflationary pressures and helps to stabilise the economy by formulating suitable fiscal policies such as drawing up the budget, providing surpluses in deficit and boom in recessions by accelerating the rate of development expenditure in the public sector steadily. The attainment of these goals of the state governments depends on the fiscal policy of the central government and the autonomy of the state governments in raising revenue and spending it.

The division of functions and revenue raising powers between the central and state governments is governed by the constitution, largely influenced by the Government of India Act, 1935. Functions like defense, external affairs, foreign trade, railways, national highways, ports, interstate trade, currency and coinage having national significance are assigned to the centre. In order to carry out these functions, the centre has been endowed with powers to levy major taxes like income tax, customs including export duties, and corporation tax. But the states are provided with functions like public order, police, administration of justice, agriculture, water supply, irrigation and canals, education, public health and other social security services. They are conferred with powers to levy less important taxes like land revenue, agricultural income tax, sales tax, excise on alcoholic liquors, entertainment tax, motor vehicles tax and stamp duties.

The state governments' own sources of revenue are inadequate to meet their expanding responsibilities. Hence, there arises a gap between the fiscal needs and the revenue resources of the state. The framers of the constitution anticipated these vertical imbalances and provided for a fiscal re-adjustment in the constitution itself. The constitution proposes a transfer of resources from the centre to the states such as assignment of the entire proceeds of certain taxes levied by the Union Government, mandatory sharing of the proceeds of income tax, participation in the proceeds of Union excise duty and statutory grants-in-aid to the states. In addition, it has also provided for an independent statutory body of finance commissions to regulate the transfer of resources from the centre to the states periodically, every five years.

5.2 PUBLIC EXPENDITURE ISSUES IN INDIA

It is convenient to group the public expenditure issues into one of the five categories that relate to five important aspects of the topic at hand: First, the macroeconomic questions relating to public expenditures and their sustainability; the issues here are often empirical and even the questions (certainly the answers) can vary from time to time.

The second set of issues has to do with the normative questions that often cross the boundaries of economics; these have to do with the appropriate size of the public expenditures, or, by implication, the role of the government.

The third set of issues relates to the priorities in public expenditure on different services or different groups of people. This obviously connects with the distributional issues.

The fourth set of issues involves the form of public expenditure. Given the priorities in terms of target groups or services, the production/provision of the relevant service can normally be made in different ways with different combinations of inputs; how, why, and which combinations are chosen would obviously be an important set of questions.

The fifth and final set of considerations relates to the mechanics of public expenditure control and the political economy questions. Institutional setup is an important ingredient in the determination of public expenditure; how exactly it works in a particular context forms the subject matter of a number of erudite enquiries across the world.

It hardly needs to be mentioned that even this quick cataloguing of issues clearly shows the futility of trying to cover all important issues relating to public expenditures, even in a superficial fashion, in a small survey paper like the present one. Instead, we outline below a sample of issues that have been raised in India. Not all of them have arisen in the context of public expenditures per se: research in the area of public expenditure in India has not been all encompassing.

5.3 CLASSIFICATION OF PUBLIC EXPENDITURE

The systematic arrangement of different items on which the government incurs expenditure is known as classification of public expenditure.

Different economists have observed public expenditure from different point of view. The following classification is based on these different views:

1. **Functional Classification:** Economists classifies public expenditure on the basis of their functions for which they are incurred. Various functions like social welfare, agriculture, infrastructure, defense and industrial development are being performed by the government. The expenditure incurred on such functions fall under this classification. These functions can be further divided into subsidiary functions. This kind of classification provides a clear idea about how the public funds are consumed.
2. **Revenue and Capital Expenditure:** Revenue expenditure are current expenditures incurred on civil administration, defense forces, public health and education, maintenance of government machinery. The type of expenditure which is recurring in nature is known as revenue expenditure.

On the other hand, capital expenditures are those which are incurred on building durable assets like highways, multipurpose dams, irrigation projects, buying machinery and equipment. They are non-recurring expenditures and are in the form of capital investments. Such expenditures are expected to improve the productive capacity of the economy.

3. **Transfer and Non-transfer Expenditure:** According to A.C. Pigou, the British economist has classified public expenditure as:

- (a) **Transfer expenditure:** The expenditure against which there is no corresponding return is known as transfer expenditure.

Such expenditures includes public expenditure on:

- (i) National Old Age Pension Schemes,
- (ii) Interest payments.
- (iii) Subsidies,
- (iv) Unemployment allowances,
- (v) Welfare benefits to weaker sections, etc.

By incurring such expenditure, the government does not get anything in return, but it adds to the welfare of the people, especially who belongs to the weaker sections of the society. Such expenditure basically results in redistribution of money incomes within the society.

- (b) *Non-transfer expenditure*: Expenditure which results in creation of income or output is referred to as the non-transfer expenditure.

The non-transfer expenditure includes development as well as non-development expenditure which results in creation of direct or indirect output.

- (i) Economic infrastructure such as power, transport, irrigation, etc.
- (ii) Social infrastructure such as education, health and family welfare.
- (iii) Internal law and order and defense.
- (iv) Public administration, etc.

By incurring such expenditure, the government creates a healthy conditions and environment for economic activities in the country. Due to this economic growth, the government may be able to generate income in the form of duties and taxes.

4. *Productive and Unproductive Expenditure*: This classification was made by Classical economists on the basis of formation of productive capacity.

- (a) *Productive expenditure*: Productive expenditure are those expenditures which generates income for the government. For example, expenditure on infrastructure development, public enterprises or development of agriculture increase productive capacity in the economy and bring income to the government.

- (b) *Unproductive expenditure*: Expenditures which do not create any productive asset that can generate income or returns to the government are termed as Unproductive expenditure. For example, defense, interest payments, expenditure on law and order, public administration, etc.

5. *Development and Non-development Expenditure*: All the modern economists have modified this classification into distinction between development and non-development expenditures.

- (a) *Development expenditure*: Expenditures that promote economic growth and development are termed as development expenditure. These are the same as productive expenditure.

- (b) *Non-development expenditure*: Non-development expenditures are termed as unproductive expenditures.

6. *Grants and Purchase Price*: This classification has been recommended by economist "Hugh Dalton".

- (a) *Grants*: Payments made by a public authority for which there may not be any quid-pro-quo, i.e., there will be no receipt of goods or services are known as Grants. For example, old age pension, unemployment benefits, subsidies, social insurance, etc. Grants are transfer expenditures.

- (b) *Purchase prices*: Expenditures for which the government receives goods and services in return are termed as purchase prices. For example, salaries and wages to government employees and purchase of consumption and capital goods.

5.3.1 Classification According to Benefits

Public expenditure can be categorised on the basis of benefits they confer on different groups of people.

1. **Common Benefits to All:** Expenditures that gives common benefits on all the people, for example, expenditure on education, public health, transport, defense, law and order, general administration, etc.
2. **Special Benefits to All:** Expenditures that gives special benefits for all, for example, administration of justice, social security measures, community welfare, etc.
3. **Special Benefits to Some:** Expenditures that gives direct special benefits to certain people and also add to general welfare. For example, old age pension, subsidies to weaker section, unemployment benefits, etc.

5.3.2 Hugh Dalton's Classification of Public Expenditure

Hugh Dalton categorised public expenditure as follows:

1. **Expenditures on Political Executives:** E.g.: maintenance of ceremonial heads of state, like the president.
2. **Administrative Expenditure:** This is to maintain the general administration of the country, like government departments and offices.
3. **Security Expenditure:** This is to maintain armed forces and the police forces.
4. **Expenditure on Administration of Justice:** This includes maintenance of courts, judges, public prosecutors, etc.
5. **Developmental Expenditures:** To promote growth and development of the economy like expenditure on infrastructure, irrigation, etc.
6. **Social Expenditures:** Expenses on public health, community welfare, social security, etc.
7. **Public Debt Charges:** This includes payment of interest and repayment of principle amount.

5.3.3 Role of Public Expenditure Management

The budget of a country should be a financial mirror of society's economic and social choices. In order to perform the roles assigned to it by its people, the state needs, among other things, to: (i) collect resources from the economy, in sufficient and appropriate manner; and (ii) allocate and use those resources responsively, efficiently and effectively.

Public expenditure management pertains only to "allocate and use those resources responsively, efficiently and effectively", and is thus only one instrument, although a key instrument, of government policy.

Also, close co-operation between tax and budget officials is a must for many areas, e.g., budget forecasting, macroeconomic framework formulation, trade-offs between outright expenditures and tax concessions.

It is said that, public expenditure management is instrumental in nature. There is a necessary distinction between the expenditure policy question of "what" is to be done, and the expenditure management question of "how" it is to be done. It is true that attempts to set hard boundaries between policy and implementation eventually lead to unrealistic policies, ad hoc implementation and, over time, both bad policy and bad

implementation. However, the distinction between the soundness of PEM procedures and processes and the goals that they are meant to achieve remains very important. Among other things, the mechanisms, techniques, skills and data required for good public expenditure management are different from those needed to formulate good policy. Accordingly, the analysis and discussion herein is generally applicable regardless of the economic orientation, strategic priorities or policy choices of the government in question.

At the same time, however, it is fundamental to realise that public expenditure management is country-specific. Public expenditure management approaches and recommendations must be solidly grounded on the economic, social, administrative and implementation capacity realities of the specific country.

The policy context and the objectives of Public Expenditure Management (PEM)

- (a) **The Policy Context:** The key goals of overall economic policy are usually defined as growth, equity and stability. It has been understood that these three goals are complementary over the long-term. Economic growth provides the resources needed for poverty reduction, but if it is not accompanied by sufficient stability and equitable policies, it cannot be sustainable. Unstable economic and financial circumstances are hostile to growth and typically hurt the poor. But stability in a context of determined economic stagnation and poverty is hardly a desirable outcome. In the short-term, however, these goals may be mutually conflicting, and a sound resolution is required that takes all three into consideration in a clear policy package.
- (b) **The Three Key Objectives of PEM:** It is observed that the nature of public expenditure management is instrumental. As a central instrument of policy, it must pursue all the three overall economic policy goals. Financial stability calls, among other things, for fiscal discipline; economic growth and equity are pursued partly through allocation of public money to the various sectors; and, most obviously, all three goals need efficient and effective use of resources into practice. Hence, the three goals of overall policy translate into three key objectives of good public expenditure management: fiscal discipline (expenditure control); allocation of resources consistent with policy priorities ("strategic" allocation); and good operational management. In turn, good operational management calls for both efficiency (minimizing cost per unit of output) and effectiveness (achieving the outcome for which the output is intended). But in addition, as stressed earlier, attention to proper norms and due process is essential as well. This book shall return again and again to these three key objectives, but a few general considerations are advanced below.

There are associations between the three key objectives of PEM, their corresponding major function and the government level at which they are mostly operative. Fiscal discipline requires control at the aggregate level; strategic resource allocation requires good programming, which entails appropriate cabinet-level and inter-ministerial arrangements; and operational management is largely an intra ministerial affair. It should be stressed, however, that fiscal discipline and operational management are amenable to "technical" improvement than is the strategic allocation of resources.

According to Petrei, 1998 puts it: "Resource distribution among programs is perhaps the least technical part of the budget process. With the exception of investment projects, spending decisions are rarely based on technical principles or on detailed work to determine the population's preference. The allocation of funds results from a series of forces that converge at different points of the decision-making process, with an arbitrator who ruled according to an imperfect perception

of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want. In any event, the effort made at this stage of the budget process to collect and analyze information is less than at any other stage”.

Our focus on public expenditure management should not lead us to let go the essential link between revenue and expenditure. The three of PEM objectives can easily be expanded into a trio of fiscal objectives. Fiscal discipline results from good forecasts of revenue as well as expenditure; strategic allocation has a counterpart in the tax incidence across different sectors; and tax administration, of course, is the revenue aspect of good operational management of expenditure.

- (c) *Complicating the Issue:* Although fiscal discipline, strategic resource allocation, and operational efficiency are in general the three key objectives of PEM, in most countries the budgeting system is expected to achieve a variety of aims. A. Premchand lists eleven dimensions of public expenditure management. Most of these dimensions can be readily reconciled within the triad of PEM objectives, and some are in effect different formulations of the same objective. However, the reality is that all these dimensions—duplicative or not—have come to be associated with public budgeting at various times. Because it is manifestly impossible for any budget system to conform to all these dimensions at the same time, a strategic decision is needed regarding which one or two or three of these dimensions to focus at a given time in the specific country concerned. Thus, although we will continue to refer throughout this book to the triad of PEM objectives, the inevitable simplification should be kept in mind.
- (d) *A Word about Sequencing:* If you cannot count the money, you cannot allocate it, and if you cannot allocate it you cannot manage it. Fiscal discipline comes first in many ways and next is resource allocation and operational efficiency. It is true that in those few developing countries that have extremely weak revenue forecasts and cash management systems in those countries, improving expenditure control is first and foremost, and any effort at addressing the other two objectives of PEM would be futile and possibly counterproductive. However, it is also essential to: (i) design and implement improvements in expenditure control in ways that do not jeopardize the improvements in sectoral allocation and resource management which must eventually follow; and (ii) have a clear ex-ante sense of how far to push improvements in expenditure and cash control before it becomes timely and necessary to address strategic allocation and management issues.

The Institutional Context

Several developing countries have accepted technical advice for decades and introduced innovations in their budgeting systems, to the point where the formal PEM system appears robust and coherent in every respect. Yet, efficiency of public expenditure remains poor, corruption is endemic, and public services are of worse quality and even less accessible than they were at the start of the “reforms”.

The term “institution” is used as a synonym for “organisation”. However, institutions are best understood as rules, and are thus distinct from the organizations that function under them.

For example, the tendency to overestimate revenues may stem from concrete incentives to do so rather than from technical weaknesses. Or, in a multi-ethnic country, a performance bonus scheme for budget officials may be perfectly designed on the surface but fail to produce improvements if it is inconsistent with the informal rule that demands that managers use their power to help members of their own ethnic

group. Indeed, under these circumstances, the "innovation" may lead managers to manipulate expenditure forecasts and outturns in the interest of "their" people, and thus to a less efficient system.

The total stock of institutions is always larger than it is visible on the formal surface, especially in developing countries. This leads to four basic points, among others:

1. A design failure to take into account key informal rules is likely to lead to a failure of the budgeting reform itself.
2. Durable institutional change, in general, and public budgeting, in particular, take a long time to be implemented successfully.
3. One way to improve the overall institutional framework is to make the informal rules more visible.
4. Budget organisations and new units can be merged, restructured, recombined and created, but no change in behaviour will result unless the basic rules, procedures and incentives changes.

For example, simply merging a Ministry of Finance and a Ministry of Planning will not do much by itself to improve coordination of current and investment budgets.

The Governance Context

- (a) *The Link between Governance and Development:* The risk of relativism inherent in the earlier statement that PEM "technology" is country specific is obviated by the universal relevance of certain fundamentals of governance. The link between good governance and economic development has long been understood by many scholars, development practitioners, and above all, the average man and woman in the developing countries themselves. However, a variety of considerations (primarily, the Cold War) kept governance away from the official concern of development institutions, and hence outside the technical advice and financial support for PEM improvements. Since the end of the 1980's, however, perceptions and policies have changed dramatically. Even the remaining alleged exception to the link between governance and development (the East Asian "miracle") collapsed under the weight of the financial crisis that began in Thailand in July 1997 and quickly spread to Indonesia, Korea and to a lesser extent to other Asian countries. It is now clear that fundamental public and corporate governance weaknesses were among the structural causes of the crisis. Since then, references to "Asian values" to justify practices inimical to good governance have been conspicuous for their absence.

- (b) *The Components of Good Governance:* There is a general consensus that good governance rests on "four pillars": accountability, transparency, predictability and participation. Accountability means the capacity to call public officials to task for their actions; transparency entails the low-cost access to relevant information; predictability results primarily from law and regulations that are clear, known in advance, and uniformly and effectively enforced; and participation is needed to supply reliable information and to provide a reality check for government action.

It is clear that none of these four components can stand by itself; each is instrumental in achieving the other three; and all four together are instrumental in achieving sound development management.

For example, accountability mechanisms in the budget process are hollow if there is no reliable financial information, and meaningless without predictable consequences. Furthermore, all governance concepts are universal in application but relative in nature. Accountability is a must everywhere, but does not become

operational until one defines accountability “of whom”, “for what” and “to whom”. Transparency can be problematic when it infringes on necessary confidentiality or privacy. Full predictability of inefficiency or corruption is not a great advantage. And it is evidently impossible to provide for participation by everybody in everything, and unwise to use participation as an excuse to avoid taking tough but necessary decisions.

- (c) *Governance and Public Expenditure Management*: The relevance of these concepts to the various aspects of public expenditure management will be brought out throughout this volume. A few generally applicable considerations are provided below.

Lack of predictability of financial resources undermines of strategic prioritization and makes it hard for public officials to plan for the provision of services (and is an excellent alibi for non-performance to boot). Predictability of government expenditure in the aggregate and in the various sectors, is also needed as a signpost to guide the private sector in making its own production, marketing and investment decisions.

Transparency of fiscal and financial information is a must for an informed executive, legislature, and the public at large. It is essential not only that information be provided, but that it should be relevant and in understandable form. Dumping on the public immense amounts of raw budgetary material does nothing to improve fiscal transparency. The IMF assembled in 1998 a Code of Good Practices on Fiscal Transparency, which underlines the importance of clear fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information and accounts. While not all the specifics of the code necessarily apply to all countries, its principles are generally applicable to developing and transition economies as well as developed countries.

Appropriate participation by concerned public officials and employees and by other stakeholders is required for the sound formulation of expenditure programs; participation by external entities, for the monitoring of operational efficiency; and feedback by users of public services, for the monitoring of access to and quality of the services.

Accountability is needed both for the use of public money and for the results of spending it. Because, through overuse, the term “accountability” has acquired mantra-like qualities (and has no exact translation in many languages), it is helpful to unbundle it at the outset. Effective accountability has two components: (i) answerability and (ii) consequences. First, answerability is the requirement for central budget officials and sector ministry personnel to respond periodically to questions concerning where the money went and what was achieved with it. The conversation itself matters, much more than any bean counting or mechanistic recitation of outputs. Second, there is a need for predictable and meaningful consequences. A budget law or administrative framework, covering budgetary as well as extra budgetary activities and specifying fiscal management responsibilities should be in place. Taxation should be under the authority of law and the administrative application of tax laws should be subject to procedural safeguards. Public availability of information, extra budgetary activities should be covered in budget documents and accounting reports. Original and revised budget estimates for the two years preceding the budget should be included in budget documents.

- ❖ The level and composition of central government debt should be reported annually with a lag of no more than six months. Open budget preparation, execution and reporting.
- ❖ A fiscal and economic outlook paper should be presented with the budget, including among other things, a statement of fiscal policy objectives and priorities, and the macroeconomic forecasts on which the budget is based.
- ❖ A statement of "fiscal risks" should be presented with the budget documents. All general government activities should be covered by the budget and accounts classification. The overall balance should be reported in budget documents, with an analytical table showing its derivation from budget estimates.
- ❖ A statement of accounting standards should be presented with the budget.
- ❖ Final central government accounts should reflect high standards, and should be audited by an independent external auditor. Independent assurances of integrity.
- ❖ Mechanisms should be in place to ensure that external audit findings are reported to the legislature and that remedial action is taken.
- ❖ Standards of external audit practice should be consistent with international standards.
- ❖ Working methods and assumptions used in producing macroeconomic forecasts should be made publicly available.

Source: International Monetary Fund.

This should be self-evident. However, the need for consequences of some sort is so often disregarded in practice that one must make the elementary point that without consequences, "accountability" is only an empty and time consuming formality.

Largely because the PEM system, must be accountable both for the use of the public money and for the results of spending it, accountability in public expenditure management has two dimensions. Stronger internal accountability of budget system personnel to their superiors may be necessary, but is more applicable to "overhead" PEM activities (e.g., policy advice, macroeconomic forecasting, etc.) than to sector ministries responsible for services to the public. For the latter, external accountability is needed as well. Particularly with the dramatic improvements in information and communication technology, feedback from service users and the citizenry can now be obtained at low cost and for a greater variety of activities, and is an essential adjunct for improving efficiency and effectiveness of service delivery. Strengthening external accountability is especially necessary in the context of initiatives for greater decentralization or managerial autonomy, when new checks and balances are required to assure that access to and quality of public services is not compromised as a result.

- (d) *A word about "performance"*: All accountability must be for performance. But "performance", too, is a relative and culture-specific concept. Government employees could be considered "well performing" if they always stick to the letter of the rules, in a system where rule of compliance is the dominant goal; if they account precisely for every cent of public money, in a system where protection of resources is the dominant goal; if they obey without question a superior's instructions, in a strictly hierarchical system; if they compete vigorously for individual influence and resources, in a system where such competition is viewed positively; if they cooperate harmoniously for group influence, in a system where conflict is discouraged; and so on. Whenever the word "performance" is heard, the

immediate question should be: "In terms of what?" It is essential to understand that administrative cultures are not inherently superior or inferior (so long as they abide by the governance fundamentals discussed earlier), and that they evolve in response to concrete problems and incentive structures. Even when an administrative culture has become badly dysfunctional, it is still necessary to understand its roots if one wishes to improve it in a durable way.

Corruption and Public Expenditure Management

Although corruption in government is often identified with large procurements and major public works projects, public expenditure is barely the only source of potential corruption. Tax administration, debt management, customs, ill-designed privatization, the banking system, etc., can be equally troublesome in that respect. But certainly, one major route to improving PEM (and, of course, improving the quality of governance as well) is to reduce the opportunities for corruption in the process and punish corruption when it occurs. The reverse is also true: a major way of reducing corruption is to strengthen PEM. Quite aside from any moral or legal consideration, corruption weakens fiscal discipline; distorts the allocation of resources; harms operational efficiency and effectiveness; and, obviously, is antithetical to due process.

Definitions of corruption can be exceptionally complex. The simplest definition is as powerful as it is short: "corruption is the misuse of public or private office for personal gain". "Misuse" (unlike abuse) covers both "sins of commission" (i.e., giving illegal favours), and "sins of omission" (i.e., deliberately turning the other way). And the presence of the term "private" in the definition of corruption underlines the fact that there cannot be a bribe received without a bribe given. In the context of developing countries, this points out that much corruption is externally generated. Clearly, attention needs to be paid to the "imported corruption" as well as to the homegrown variety.

A remarkable, indeed historic, convergence of actions and policies has occurred in this area in just two years, 1997 and 1998, as a natural outgrowth of the earlier recognition of the governance-development nexus. The World Bank enacted an official policy against corruption in September 1997. Other Multilateral Development Banks (MDBs) followed suit rapidly. The anticorruption policy of the Asian Development Bank was approved in July 1998, and anti-corruption cooperation among the MDBs has been strengthening since then. At the same time, as noted earlier, the IMF promulgated the code for Fiscal Transparency. Finally, the organisation for Economic Cooperation and Development (OECD — the "developed countries' club") succeeded in negotiating in December 1997 a landmark convention against bribe-giving, which entered into force at the end of 1998. For the first time in history, the convention makes the bribing of foreign officials a crime at par with national laws concerning bribery of national officials in all member countries of the OECD.

Thus, although many economists, country officials, and development professionals had always been aware of the inefficiencies and inequities of corruption, it is only recently that the taboo on even mentioning the "C word" has been removed and a clear consensus has emerged: in the long run, corruption (i) is bad for economic efficiency and growth; and (ii) hurts the poor most. Corruption is increasingly being seen as neither beneficial ("grease for the machine"), nor inevitable ("the way the system works"), nor respectable. This new consensus has been translated into actual policies of international organisations and governments around the world. Although the process is only beginning, and most of the implementation lies ahead (and corruption will of course never entirely disappear), for the first time in contemporary history there is a concrete opportunity to reduce substantially "the cancer of corruption".

The Macroeconomic Programming Context

Macroeconomic and financial programming has been dominated for well over a generation by the simple but powerful model developed by Jacques Polak. Change in government revenues and expenditures has always been important in that model, partly through its (monetary) impact on domestic credit and money creation, and partly through its (Keynesian) influence on national income and the demand for imports. Furthermore, since the early 1990's, the Semantics of Corruption, the definition of corruption is clear, but one must beware of assuming that the same term reflects the same reality in different developing countries. While in some countries the word "corruption" may be reserved only for million dollar bribes, inch-deep highway surfaces, and non-existent schools, in other countries the word is used to include minor irregularities or minuscule conflicts of interest. In one South Asian country, for example, a major newspaper reported in a front-page article of September 1998 that: The government is to work out a modality next week to take action against parliamentarians who are engaged in business activities with state or public institutions, the minister announced. He cited the Supreme Court judgment on the case. The court decided that one parliamentarian was not suited since he was managing a petrol shed. "We know about several others who have fixed the official telephone to their business places in a way that Parliament has to pay for their telephone charges (equivalent to tens of dollars). We cannot allow this situation to continue anymore", the minister said. Clearly, these practices are inappropriate and do fit into the strict definition of corruption. There is also a "slippery slope" argument that zero tolerance is required if corruption is not to eventually become a large problem. But, in comparison with the level of corruption in other countries, such practices as quoted above are trivial. The terms used however, are often identical. Therefore, a finding that corruption is widespread must be interpreted carefully in the light of just what is meant by corruption in the specific country's context. The rediscovery of the economic costs of excessive fluctuations in exchange rates has reduced the emphasis on currency devaluation as an instrument of economic and financial adjustment. As under the Bretton Woods system operating in the postwar period until 1973, the IMF has come back again to regard the exchange rate as a nominal "anchor", and the burden of adjustment has correspondingly shifted to the fiscal side.

The degree of fiscal adjustment is normally measured by the reduction in the overall government deficit. The fiscal deficit, obviously, is determined by both revenue and expenditure. Hence, by definition, a fiscal policy focused entirely on public expenditure adjustment would be incomplete. But in practice, the change in macroeconomic programming emphasis towards fiscal adjustment has coincided with a major rethinking of the role of the state towards downsizing and the shedding of many earlier functions. Measures on the revenue side do remain important in most developing countries but away from short-term tax increases and towards actions that broaden the tax base and raise the elasticity of the tax system with a view to long-term revenue expansion. However, the downsizing of the role of the state has naturally led to greater reliance on public expenditure reductions as an instrument of fiscal adjustment. In turn, sustainable expenditure reduction is a chimera unless the expenditure management system is in reasonable good shape. Hence, the current emphasis is on public expenditure management and its key role in macroeconomic programming.

The Genie Outside the Bottle: Information and Communication Technology (ICT)

It is impossible to provide a good overview of the context of PEM without some reference to the informatics revolution. The monumental change wrought in every field by the new information and communication technology is still only in its initial phase. The subject of ICT is too vast to be adequately discussed in this volume.

Nevertheless, as an eventual objective to aim for when and where country needs and capabilities permit. But a few general considerations should be raised here.

First, ICT is a tool, immensely powerful yet essentially no different from a photocopier or a car, in the sense that user needs and requirements must come first and dictate whether and how the ICT tool should be used. For certain functions, pencil and paper, or a telephone, or a face-to-face meeting, or a visit to the library, are far more effective than computers or the internet. This obvious point must be stressed because there are frequent instances when governments, consultants, or donor agencies encourage computerising anything in sight. Indeed, many would argue that IT innovation is now largely supply and marketing driven rather than dictated by the needs and requirements of the users. It is essential to assess realistically and compare the costs of a given ICT change with the actual benefits expected from it.

Second, neither the ICT "technic" nor the "public manager" should work in isolation from each other. As noted, improvements in effectiveness stem largely from better rules and procedures in the sector concerned. To apply advanced ICT to obsolete or inefficient rules and processes means in effect to computerise inefficiency. Doing the wrong thing faster is not progress. On the other hand, the absence of relevant ICT knowledge risks either costly mistakes or missed opportunities for dramatic service improvements.

Third, ICT cannot substitute for good management and internal controls. Indeed, the introduction of computers can give a false illusion of tighter expenditure control, in cases where a large part of the expenditure cycle occurs in parallel outside the computerised system.

Fourth, faster and integrated public financial management information systems carry correspondingly greater potential risks for the integrity of the data and can even jeopardize the financial management system in its entirety if developed carelessly and without sufficient checks, controls, security and virus protection. Also, it is often argued that ICT reduces the corruption. In fact, computer technology eliminates almost all opportunities for corruption for those who do not understand fully the new technology but opens up new corruption vistas for those who understand the new systems well enough to manipulate them.

To sum up, the adoption of more advanced ICT should meet the following criteria: (i) Always fit the user requirements and the real objectives of the activity; (ii) assure that the more advanced ICT goes hand in hand with improved rules and processes; (iii) protect data and systems integrity; and (iv) aim at an integrated strategy and avoid a piecemeal approach (which can fit specific needs but adds up to a ramshackle and even dangerous system). Note that an integrated approach requires compatibility and coordination, but not necessarily a single system.

5.4 PUBLIC DEBT: MEANING, CLASSIFICATION AND METHOD OF REDEMPTION

5.4.1 Meaning of Public Debt

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

However, since debt has to be repaid along with interest from whom it is borrowed, it does not constitute income. Rather, it constitutes public expenditure. Public debt is

incurred when the government floats loans and borrows either internally or externally from banks, individuals or countries or international loan-giving institutions.

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

5.4.2 Classification of Public Debt

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

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

- (i) Internal and external debt
- (ii) Short term and long term loans
- (iii) Funded and unfunded debt
- (iv) Voluntary and compulsory loans
- (v) Redeemable and irredeemable debt
- (vi) Productive or reproductive and unproductive debt/deadweight debt
- (i) **Internal and External Debt:** Amount owed to the citizens and institutions are called internal debt and amount owed to foreigners comprise the external debt. Internal debt refers to the government loans floated in the capital markets within the country. Such debt is subscribed by individuals and institutions of the country.

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

- (ii) **Short term and Long term Loans:** Loans are classified according to the duration of loans taken. Most government debt is held in short term interest-bearing securities such as treasury bills or ways and means advances (WMA). Maturity period of a treasury bill is usually 90 days.

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

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

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

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

- (v) **Redeemable and Irredeemable Debt:** Redeemable public debt refers to that debt which the government promises to pay off at some future date. After the maturity period, the government pays the amount to the lenders. Thus, redeemable loans are called terminable loans.

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

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

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

Hence, productive loans are an addition to the total productive capacity of the country.

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

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

5.4.3 Methods of Redemption of Public Debt

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

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

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

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

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

- (ii) **Conversion:** By debt conversion it is meant that reduction of interest burden by converting old but high interest-bearing loans into new but low interest-bearing loans. This method tends to reduce the burden of interest on the taxpayers. As

the government is enabled to reduce the burden of debt which falls, it is not required to raise huge revenue through taxes to service the debt.

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

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

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

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

- (iv) **Capital Levy:** In times of war or emergencies, most governments follow the practice of raising money necessary for the redemption of the public debt by imposing a special tax on capital.

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

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

- (v) **Terminal Annuity:** It is something similar to sinking fund. Under this method, the government pays off its debt on the basis of terminal annuity. By using this method, the government pays off the debt in equal annual installments.

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

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

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

- (viii) **Compulsory Reduction in the Rate of Interest:** The government may pass an ordinance to reduce the rate of interest payable on its debt. This happens when the government suffers from financial crisis and when there is a huge deficit in its budget.

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

Check Your Progress

Fill in the blanks:

1. Government spending which is incurred by central, state and local governments of a country is referred to as _____.
2. The _____ of different items on which the government incurs expenditure is known as classification of public expenditure.
3. Expenditure which results in creation of income or output is referred to as the _____.
4. Expenditures which do not create any productive asset that can generate income or returns to the government are termed as _____.
5. The _____ of a country should be a financial mirror of society's economic and social choices.
6. The degree of fiscal adjustment is normally measured by the _____ in the overall government deficit.

5.5 LET US SUM UP

- Public expenditure can be defined as, "The expenditure incurred by public authorities like central, state and local governments to satisfy the collective social wants of the people is known as public expenditure".
- In the early 20th Century, John Maynard Keynes advocated the role of public expenditure in determining of level of income and its distribution.
- The division of functions and revenue raising powers between the central and state governments is governed by the constitution, largely influenced by the Government of India Act, 1935.
- Revenue expenditure are current expenditures incurred on civil administration, defense forces, public health and education, maintenance of government machinery, etc.
- There is a necessary distinction between the expenditure policy question of "what" is to be done, and the expenditure management question of "how" it is to be done.
- The key goals of overall economic policy are usually defined as growth, equity and stability.
- The three goals of overall policy translate into three key objectives of good public expenditure management: fiscal discipline (expenditure control); allocation of resources consistent with policy priorities ("strategic" allocation); and good operational management.

- Effective accountability has two components: (i) answerability and (ii) consequences.
- By making a surplus budget, the government can pay off its debt to the people.

5.6 UNIT END ACTIVITY

Critically examine how public debt is managed in India.

5.7 KEYWORDS

Shifting: Roll down

Elasticity: Flexibility

5.8 QUESTIONS FOR DISCUSSION

1. Discuss the methods of redemption of public debt.
2. Describe the classification of public debt.
3. Explain the role of PEM.
4. Define public expenditure. Discuss the classification of public expenditure.

Check Your Progress: Model Answer

1. Public Expenditure
2. Systematic arrangement
3. Non-transfer Expenditure
4. Unproductive Expenditure
5. Budget
6. Reduction

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UNIT- 6

PUBLIC EXPENDITURE IN INDIA

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6.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain about effects of public expenditure
- Describe the public debt in India
- Discuss the objectives of public debt
- Explain the limit to public debt

6.1 INTRODUCTION

Rapid economic development requires huge expenditure to be incurred in the various sectors of the economy. As the private sector is usually hesitant and unwilling to invest huge amounts because the returns from such investments are either uncertain or long delayed, it is public expenditure which plays the crucial role in economic development (especially) in underdeveloped economy. The public expenditure can be used as a lever to raise aggregate demand and thereby to get the economy out of recession. On the other hand, through variation in public expenditure, aggregate demand can be managed to check inflation in the economy. Throughout the 19th

Century, most governments followed laissez faire economic policies & their functions were only restricted to defending aggression & maintaining law & order. The size of public expenditure was very small. But now the expenditure of governments all over has significantly increased. In the early 20th Century, John Maynard Keynes advocated the role of public expenditure in determination of level of income and its distribution. In developing countries, public expenditure policy not only accelerates economic growth & promotes employment opportunities but also plays a useful role in reducing poverty and inequalities in income distribution.

6.2 EFFECTS OF PUBLIC EXPENDITURE

Public expenditure has a great bearing on economic development and social welfare of a country. The following observations may be noted in this regard:

6.2.1 Effect on Production

According to Dr. Dalton, "public expenditure tends to affect the level of production in the following manner"

1. **Capacity to work and save:** As a result of public expenditure, capacity to work and save tends to rise. Government expenditure provides various kinds of social and economic facilities stimulating the capacity to work with the people. Increased capacity suggests increased efficiency and greater employment. Level of income and saving tends to rise facilitating greater investment and adding to the pace of growth.
2. **Desire to work and save:** Expenditure incurred by the government promotes the will to work and save. As a result, their income and standard of living tend to rise.
3. **Productive utilization of resources:** Public expenditure restores a balance in the economy by focusing on those areas of production which generate maximum linkages effect. Public expenditure acts as pump-priming factor attracting idle resources to their productive utilisation. Accordingly, production level tends to raise the resources from unproductive activities to productive ones. This results in increase in production.

6.2.2 Effect on Distribution

Public expenditure affects distribution in the following possible ways:

1. **Regional Inequality:** This is how public expenditure can promote equality across different regions of a country:
 - (i) The government expenditure should focus on development of backward areas, increasing the level of production and income of the people of those areas. Their standard of living will increase to catch up with the living standards in developed regions of the country.
 - (ii) Public expenditure should include financial help to the small-scale and cottage industries. These industries have the merit of easy-diversification across different parts of the country. Accordingly, regional inequality is expected to improve.
2. **Distribution of the dividends of industrial development:** As a consequence of public expenditure, there are public sector industries in the country. The workforces employed in these industries are paid higher wages. They get some special facilities also which are comparatively better than others. Following the public sector industries, private sector industries also provide higher wages and other facilities to the workers. Increase in the workers' wages will lead to reduction in economic inequality.

3. **Benefit to the weaker section:** If the government makes public expenditure on social services like education, medical care, unemployment allowance, labour welfare, etc. after collecting resources by way of taxes from the rich class, it will result in the increase in real income of the poor people, thus tilting the distribution further in their favour.
4. **Increase in the ability to work of the poor:** Distribution of income can also be influenced by increasing the ability to work of the poor with the help of public expenditure. This objective can be achieved in two ways:
 - (i) **Direct help:** The government can provide direct help to the poor people in the form of cash, commodities and service.
 - (ii) **Indirect help:** The government can provide loans to the poor at a low rate of interest. It can provide them food at fair price. It can provide more social services to them. As a result of it, their efficiency will be increased. With rise in their income level their standard of living will improve.

6.2.3 Public Expenditure and Economic Stability

Cyclical changes are an inherent character of a market economy. These changes are called Trade Cycles and are manifested as the state of recession, depression, recovery and boom. The states of recession and depression are particularly dangerous for restricting the pace of growth. Inflation is equally bad when it tends to be galloping or hyper. Note the following observations to understand how public expenditure facilitates economic stability:

1. **Public expenditure and depression:** During depression, the prices of commodities tend to fall. Accordingly there is a fall in production and employment. Unemployment increases both the producers and the consumers become pessimistic. Producers reduce output because of the lack of demand. Consumers, hoping for a further fall in prices, suspend their existing consumption needs. Accordingly, reduction in demand is compounded. As a consequence, the vicious circle of reduced demand, reduced production and reduced employment sets in. Here comes the significance of public expenditure.

According to Keynes, "in the state depression, the government should plan for a comprehensive increase in public expenditure". It can be of two types:

- (i) **Compensatory expenditure:** It includes those spending which the government makes on public works so as to increase employment and aggregate demand. Such spending generate multiplier effect on income. Income rises in consonance with increased employment, acting as an antidote the situation of depression.
- (ii) **Pump priming expenditure:** During the depression periods, investment is low. If investment is made in public sector, it will prompt private investment as well. Public expenditure thus made is called pump priming. Initial expenditure by the government particularly on infra-structural facilities, tends to be conducive for an all-round growth of private investment.

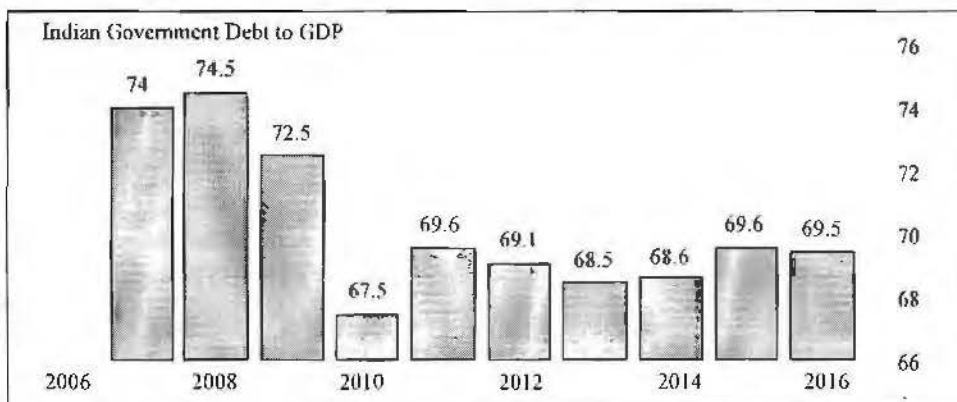
Taylor categories public expenditure during depression as:

- (a) Home relief,
 - (b) Unemployment compensation plans, and
 - (c) Work projects.
- (a) Home relief is provided to the poor so as to increase their consumption without getting their services. This is a kind of transfer payments expected to raise consumption expenditure.

- (b) Unemployment compensation fund is set with the help of the employers, employees and the government. Help is provided to the workers during the period of unemployment out of this fund.
 - (c) Work projects include public works like construction of roads, bridges and dams, etc. Expenditure on such projects will generate income to combat deflation through increased demand.
2. **Public expenditure and inflation:** Public expenditure can be used as a policy instrument to curb inflation. It should focus on the following areas:
- (i) **Increase in production:** Public expenditure should be utilised for increasing production. Increase in production during inflation implies increased flow of goods and services in the economy. In the backdrop of rising prices, increased flow of goods and services will help strike a balance between demand and supply.
 - (ii) **Reduction in consumption:** In a state of price-rise, the government should reduce its consumption expenditure. This will reduce the pressure of demand on the goods and services. Accordingly prices are expected to fall, or atleast their pace of rise will be arrested.

6.2.4 Public Debt in India

India recorded a government debt equivalent to 69.50 per cent of the country's Gross Domestic Product in 2016. Government Debt to GDP in India averaged 73.42 per cent from 1991 until 2016, reaching an all-time high of 84.20 per cent in 2003 and a record low of 66 per cent in 1996.



Source: Tradingeconomics.com | Ministry of Finance, Government of India.

Figure 6.1: Indian Government Debt to GDP for the Year 2006 to 2016

In India, public debt refers to a part of the total borrowings by the Union Government which includes such items as market loans, special bearer bonds, treasury bills and special loans and securities issued by the Reserve Bank. It also includes the outstanding external debt.

However, it does not include the following items of borrowings:

- (i) Small savings,
- (ii) Provident funds,
- (iii) Other accounts, reserve funds and deposits.

The aggregate borrowings by the Union Government comprising the public debt and these other borrowings are generally known as 'net liabilities of the Government'.

6.3 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 USA, 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:** It is not always proper to effect a change in the tax system whenever the public expenditure exceeds the public revenue. It is to be seen whether the transaction is casual or regular. If the budget deficit is casual, then it is proper to raise loans to meet the deficit. But if the deficit happens to be a regular feature every year, then the proper course for the state would be to raise further revenue by taxation or reduce its expenditure.
- (b) **Public debt to meet emergencies like war:** In many countries, the existing public debt is, to a great extent, on account of war expenses. Especially after World War II, this type of public debt had considerably increased. A large portion of public debt in India has been incurred to defray the expenses of the last war.
- (c) **Public debt for development purposes:** During British rule in India public debt had to be raised to construct railways, irrigation projects and other works. In the post-independence era, the government borrows from the public to meet the costs of development work under the five year plans and other projects. As a result the volume of public debt is increasing day by day.

6.4 THE BURDEN OF PUBLIC DEBT

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

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

The burden of external debt is measured by the debt-service ratio which returns to a country's repayment obligations of principal and interest for a particular year on its external debt as a percentage of its exports of goods and services (i.e., its current

receipt) in that year. In India, it was 24% in 1999. An external debt imposes a burden on society because it represents a reduction in the consumption possibilities of a nation. It causes an inward shift of the society's production possibilities curve.

Three Problems:

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

It creates three problems:

1. Distorting effects on incentives due to extra tax burden,
2. Diversion of society's limited capital from the productive private sector to unproductive capital sector, and
3. Showing the rate of growth of the economy.

These three problems may now be briefly discussed:

1. **Efficiency and welfare losses from taxation:** When the government borrows money from its own citizens, it has to pay interest on such debt. Interest is paid by imposing tax on people. If people are required to pay more taxes simply because the government has to pay interest on debt, there is likely to be adverse effects on incentives to work and to save. It may be a happy coincidence if the same individual were tax-payer and a bond-holder at the same time.

But even in this case one cannot avoid the distorting effects on incentives that are inescapably present in the case of any taxes. If the government imposes additional tax on Mr. X to pay him interest, he might work less and save less. Either of the outcome or both must be reckoned a distortion from efficiency and well-being. Moreover, if most bondholders are rich people and most tax-payers are people of modest means repaying the debt money redistributes income (welfare) from the poor to the rich.

2. **Capital displacement (crowding-out) effect:** Secondly, if the government borrows money from the people by selling bonds, there is diversion of society's limited capital from the productive private to unproductive public sector. The shortage of capital in the private sector will push up the rate of interest.

In fact, while selling bonds, the government competes for borrowed funds in financial markets, driving up interest rates for all borrowers. With the large deficits of recent years, many economists have been concerned in the competition for funds; also higher interest rates have discouraged borrowing for private investment, an effect known as crowding out.

This, in its turn, will lead to fall in the rate of growth of the economy. So, decline in living standards is inevitable. This seems to be the most serious consequence of a large public debt. As Paul Samuelson has put it: "Perhaps the most serious consequence of a large public debt is that it displaces capital from the nation's stock of wealth. As a result, the pace of economic growth slows and future living standards will decline".

3. **Public debt and growth:** By diverting society's limited capital from productive private to unproductive public sector public debt acts as a growth-retarding factor. Thus, an economy grows much faster without public debt than with debt.

When we consider all the effects of government debt on the economy, we observe that a large public debt can be detrimental to long-run economic growth. Figure 6.2 shows the relation between growth and debt. Let us suppose an economy were to operate over time with no debt, in which case the capital stock and potential

output would follow the hypothetical path indicated by the solid lines in the figure.

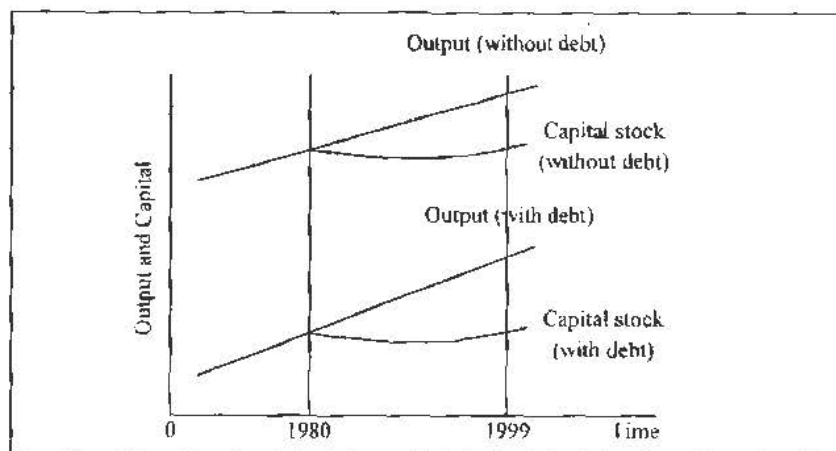


Figure 6.2: Public Debt, Capital Formation and Growth

Now suppose the government increase a huge deficit and debt; with the accumulation of debt over time, more and more capital is displaced as shown by the dashed capital line in the bottom of Figure 6.2. As the government imposes additional taxes on people to pay interest on debt, there are greater inefficiencies and distortions—which reduce further output.

What is more serious is that an increase in external debt lowers national income and raises the proportion of GNP that has to be set aside every year for servicing the external debt. If we now consider all the effects of public debt together, we see that output and consumption will grow more slowly than in the absence of large government debt and deficit as is shown by comparing the top lines in Figure 6.2.

This seems to be the most important point about the long-run impact of huge amount of public debt on economic growth. To conclude with Paul Samuelson and W. D. Nordhaus: "A large government debt tends to reduce a nation's growth in potential output because it displaces private capital, increases the inefficiency from taxation, and forces a nation to service the external portion of the debt".

Conclusion: There is no doubt a feeling among some people that interest payment on the national debt repayment is a drain on the nation's limited economic resources. It is pure waste of our resources to use them to pay interest on the debt.

This argument is wrong because interest payment on the debt, if domestically held, do not prevent a use of economic resources at all. It is, of course, true that if our debt is held by foreigners, we will suffer a loss of resources.

In the case of domestically held (internal) debt, internal payment on the debt involves a transfer of income from Indian taxpayers to Indian bondholders of the same generation. Since, in most cases, taxpayers and bondholders are different entities, a large national debt inevitably involves income redistribution effects. But internal debt does not involve any using up of the nation's real economic resources.

6.5 LIMIT TO PUBLIC DEBT

Though there is no clear end limit to internal debt there should be a definite limit to external debt. Moreover the upper limit to internal debt should be set by the annual rate of growth of per capita GNP.

Points to remember (for quick revision)

The costs of the public debt include:

1. The private sector output given up at the time the debt was incurred.
2. Lack of constraint on growth of the public sector.
3. Higher interest rates, discouraging private investment.
4. Externally held debt that must be repaid.
5. Problems of income redistribution when the debt is repaid.

Assessing the Debt

What kind of burden does the national debt impose on taxpayers and on future generations?

One of the most obvious and significant burdens of the national debt is the interest that must be paid to borrow and maintain a debt of this magnitude. The interest burden of the national debt cumulates as additional debt is incurred each year. Because the debt is not being retired, interest must be paid year after year.

The rising burden of the debt service—or interest cost of maintaining the debt—will be passed on to future generations who will have to pay the interest on the current debt. At the same time, however, many of those to whom the interest will be paid will be Indian citizens who own government securities.

Should the debt be paid off? First of all, it would be a huge, probably impossible, burden, even over several years to raise through taxes and other revenues, the amount needed to pay off the debt. Second, with repayment of the debt, a significant income redistribution would occur as the average taxpayer became poorer due to the increased tax burden and the holders of government securities became richer with their newly redeemed funds.

Also, some portion of the debt is external, or foreign-owned. While, under normal conditions, this is not a serious concern, in a period of accelerated repayment it would mean a sizable outflow of rupees from India. Finally, in order to pay off the public debt, a series of surplus budgets would be needed.

However, as Keynes pointed out, a surplus budget has a contractionary impact on the economy. While the debt was being paid off, economic activity would decline. In short, the opportunity cost of lowering the national debt would be a slowing down of the economic activities.

Check Your Progress

Fill in the blanks:

1. Public expenditure can be used as a policy instrument to _____.
2. In India, public debt refers to a part of the total borrowings by the _____.
3. In order to pay off the public debt, a series of _____ would be needed.
4. The shortage of capital in the private sector will push up the _____.

6.6 LET US SUM UP

- India recorded a government debt equivalent to 69.50 per cent of the country's Gross Domestic Product in 2016.
- Government debt to GDP in India averaged 73.42 per cent from 1991 until 2016, reaching an all-time high of 84.20 per cent in 2003 and a record low of 66 per cent in 1996.
- In industrially advanced countries like the USA, the term government or public debt refers to the accumulated amount of what government has borrowed to finance past deficits.
- The rising burden of the debt service—or interest cost of maintaining the debt—will be passed on to future generations who will have to pay the interest on the current debt.
- When the government borrows money from its own citizens, it has to pay interest on such debt.
- When a country borrows money from others it has to pay interest on such debt along with the principal.
- During British rule in India public debt had to be raised to construct railways, irrigation projects and other works.
- In the post-independence era, the government borrows from the public to meet the costs of development work under the Five Year plans and other projects.
- 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.

6.7 UNIT END ACTIVITY

Critically examine the reasons for the growth of public expenditure in India in recent times.

6.8 KEYWORDS

Expected: Think that something is likely to happen.

Debtor: A person who owes money.

6.9 QUESTIONS FOR DISCUSSION

1. Discuss the effects of public expenditure.
2. Describe the objectives of public expenditure.
3. "The burden of public debt". Discuss.
4. Explain the limit to public debt.

Check Your Progress: Model Answer

1. Curb Inflation
2. Union Government
3. Surplus Budgets
4. Rate of Interest

6.10 REFERENCES & SUGGESTED READING

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BLOCK III

UNIT- 7

PUBLIC FINANCE IN INDIA

CONTENTS

- 7.0 Aims and Objectives
- 7.1 Introduction
- 7.2 Trends in Receipts
- 7.3 Tax Revenue
- 7.4 Tax Expenditure
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- 7.5 Non-debt Capital Receipts
- 7.6 Trends in Expenditure
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 - 7.6.5 Provisional Outcome in 2015-16 (upto December) vis-a-vis BE 2015-16
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7.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Discuss the public finance in India
- Explain the trends in receipts
- Define tax revenue and tax expenditure
- Describe the trends in expenditure
- Explain the performance of departmental enterprises of the central government department of posts

7.1 INTRODUCTION

Financial year 2015-16 led to a new era of 'co-operative federalism with shared responsibilities' and more coordinated efforts between the centre and states for achieving development goals, following the recommendations of the 14th Finance Commission. As compared to the preceding years the General Budget 2015-16 was presented in a more stable economic environment, with the economy, showing signs of revival of growth. Hence, the fiscal policy for 2015-16 brought in three main objectives: (i) to amplify the growth revival with greater emphasis on public investment at a time when private investment was understandably lean; (ii) to institutionalize the changing structure of cooperative federalism; and (iii) to continue the commitment to fiscal consolidation.

Budget 2015-16 is required to achieve the subtle equilibrium between the concerns of rousing growth, accommodating the resource transfer that greater fiscal federalism entailed and ensuring fiscal consolidation. This was intended to be achieved through higher capital expenditure, greater net resource transfers to states, higher gross tax revenues and expenditure rationalisation. The budget 2015-16 also indicated government's intent on fiscal alliance with regards to all major deficit indicators (Table 7.1), although with a revised medium-term framework that opted for shifting the fiscal deficit target of 3% of the GDP by 1 year, from 2016-17 to 2017-18. Accordingly, the foreseen fiscal deficit to GDP targets were 3.9 per cent in 2015-16, 3.5 per cent in 2016-17 and 3.0 per cent in 2017-18.

Table 7.1: Major Fiscal Indicators of the Centre

Fiscal Indicator	2012-13	2013-14	2014-15 P	2015-16 BE	2012-13	2013-14	2014-15 P	2015-16 BE
	₹ lakh Crore				Per cent of GDP			
Revenue receipts	8.8	10.1	11	11.4	8.8	9	8.8	8.1
Gross tax revenue	10.4	11.4	12.5	14.5	10.4	10.1	10	10.3
Net tax to centre	7.4	8.2	9	9.2	7.5	7.2	7.2	6.5
Total expenditure	14.1	15.6	16.4	17.8	14.2	13.8	13.2	12.6
Revenue expenditure	12.4	13.7	14.6	15.4	12.5	12.2	11.7	10.9
Capital expenditure	1.7	1.9	1.9	2.4	1.7	1.7	1.5	1.7
Revenue deficit	3.6	3.6	3.6	3.9	3.7	3.2	2.9	2.8
Fiscal deficit	4.9	5	5	5.6	4.9	4.5	4	3.9
Primary deficit	1.8	1.3	1	1	1.8	1.1	0.8	0.7

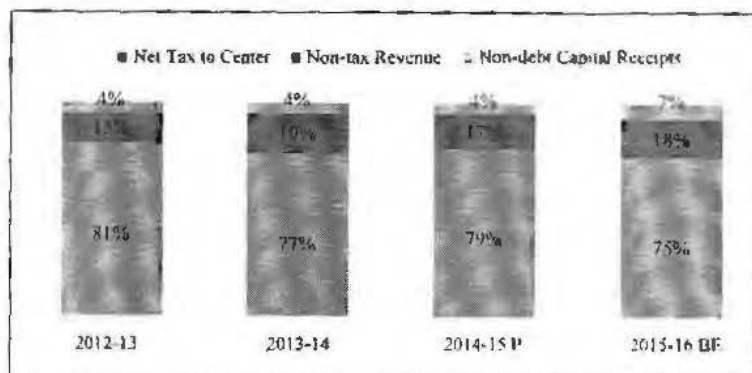
Note: BE is budget estimates P Provisional

Source: Budget documents, Comptroller General of Account (CGA) and Central Statistical Office (CSO)

7.2 TRENDS IN RECEIPTS

Central government receipts can broadly be divided into debt and non-debt receipts. The debt receipts mostly consist of market borrowings and other liabilities, which the government is obliged to repay in the future whereas the non-debt receipts comprise of

tax revenue, non-tax revenue, recovery of loans and disinvestment receipts. The composition of non-debt receipts is plotted in figure below. The decline in share of net tax revenue to the centre in non-debt receipts 2015-16 is mainly on account of the implementation of the 14th Finance Commission (FFC) recommendations that supported higher tax transfer to the states for fostering fiscal federalism.



Source: Budget documents and CGA

Figure 7.1: Composition of Non-debt Receipts

7.3 TAX REVENUE

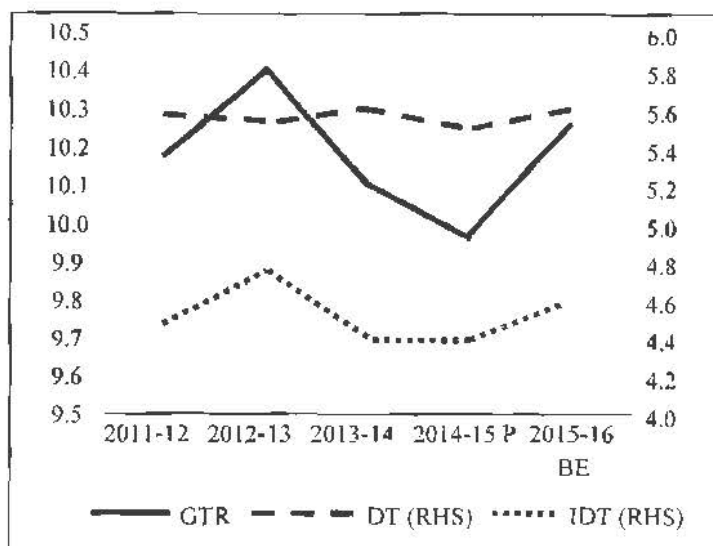
Fiscal alliance involves revenue augmentation and expenditure rationalisation. In the post- [Fiscal Responsibility and Budget Management Act, 2003 (FRBMA)] period from 2004-05 to 2007-08, major fiscal consolidation could be achieved largely due to buoyant tax revenues with net tax revenue to the centre increasing by 1.9% points of GDP. Fiscal alliance was paused post financial crisis that led to tax concessions and higher public expenditure, as part of the growth revival strategy and this probably continued longer than it was required.

Table 7.2: Sources of GTR (Rupee in lakh Crore)

	2011-12	2012-13	2013-14	2014-15 P	2015-16 BE
GTR	8.89	10.36	11.39	12.45	14.49
CT	3.23	3.56	3.95	4.29	4.71
IT	1.64	1.97	2.38	2.58	3.21
CD	1.49	1.65	1.72	1.88	2.08
UED	1.45	1.76	1.69	1.89	2.29
ST	0.98	1.33	1.55	1.68	2.1

Notes: GTR = gross tax revenue, CT = corporation tax, IT = income tax, UED = union excise duty, CD = custom duty, ST= service tax

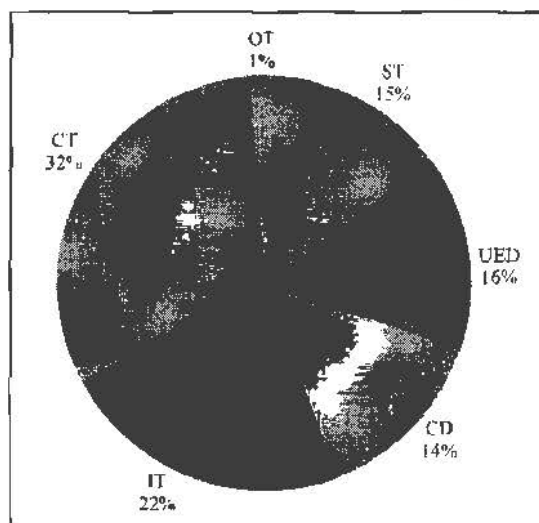
Source: Budget documents and CGA



Source: Budget documents, CGA and CSO

Figure 7.2: Tax Revenue as Per Cent of GDP

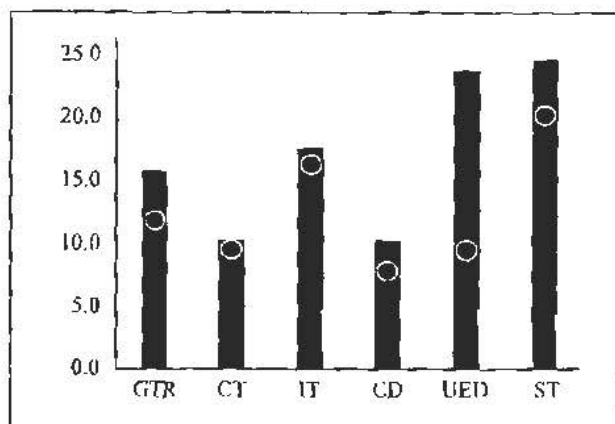
Budget 2015-16 foresaw a growth of 15.8% in Gross Tax Revenue (GTR) over the Revised Estimates (RE) of 2014-15. Gross Tax Revenue was estimated to be ₹ 14.49 lakh crore for 2015-16 (Table 7.2), which was 10.3 % of GDP (Figure 7.2). The growth in GTR was estimated to be led by 19.5% growth in indirect taxes (IDT), against a 13.1 % growth foresaw in direct taxes (DT). Roughly 54 % of the GTR was estimated to accumulate from direct taxes and the remaining 46% from indirect taxes.



Source: Budget documents and CGA

Figure 7.3: Contribution of Different Taxes in STR in 2015-16BE

The growth rate of tax revenues foreseen in the budget estimates (BE) of 2015-16 over Revised Estimates (RE) 2014-15 might have initially looked optimistic, especially for indirect taxes partly because the targeted growth in tax revenue was much higher than the average growth registered in the previous three years (Figure 7.4). In the first 9 months of 2015-16 the performance of indirect taxes indicated that the budget estimates are likely to be achieved and possibly exceeded partly on account of measures taken by the government to improve revenue by raising excise duty on petroleum products.

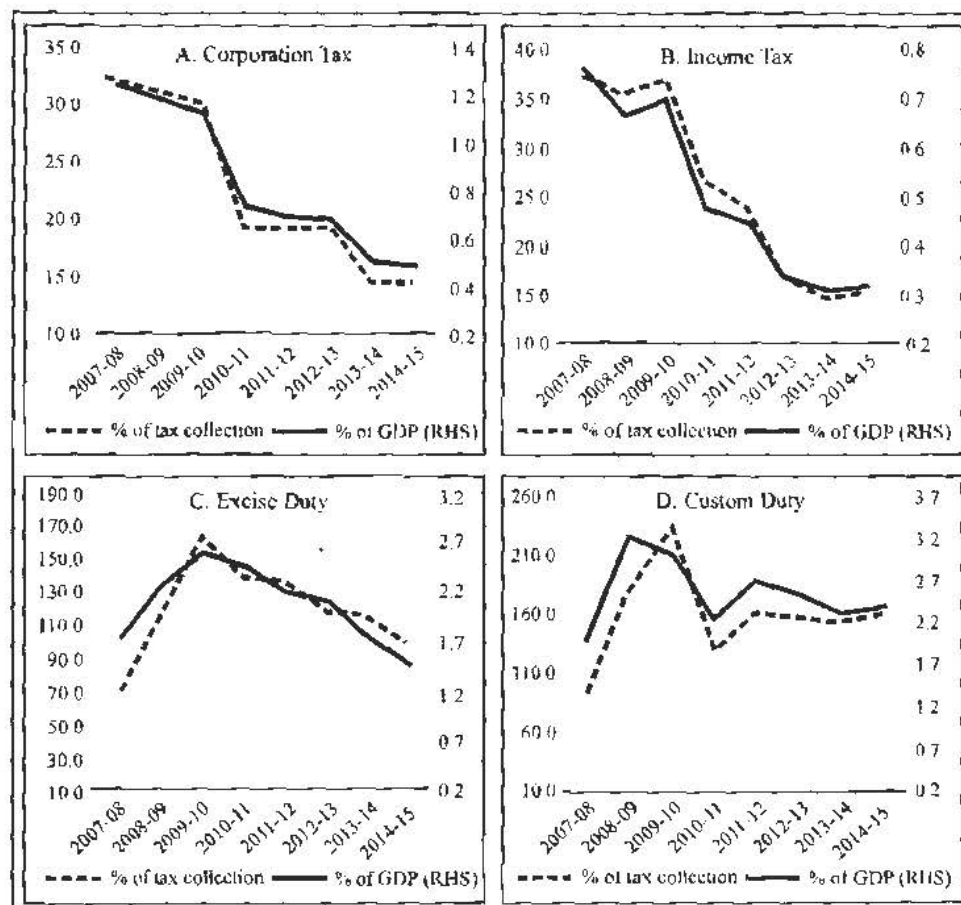


Source: Budget documents and CGA

Figure 7.4: Growth in Tax Revenue (Per cent)

7.4 TAX EXPENDITURE

The deviation between statutory tax rate and effective tax rate (defined as the ratio of total tax revenue collected to the aggregate tax base) is mainly on account of tax exemptions.



Note: Numbers for 2014-15 are projected.

Source: Statement of Revenue Foregone, Budget documents and CSO.

Figure 7.5: Tax Expenditure as Per Cent of Tax Collection under Respective Heads and as Per Cent of GDP

Tax expenditure is also known as 'Revenue Forgone', but it does not necessarily suggest that this quantum of revenue has been waived by the government. It should be interpreted as targeted incentives for the promotion of certain sectors that may not have come up in the absence of such incentives. Perhaps, high tax expenditure can make the tax system unduly complex. As a result of simplification of the tax system and enhancements in tax administration in recent years, tax expenditures have been brought down significantly (Figure 7.5).

7.4.1 Non-tax Revenue

Non-tax revenue mainly includes interest and dividend receipts, external grants and receipts from services provided by the central government which include fiscal services like currency and mint, general services like the Union Public Service Commission, police, etc., social services like education, health, etc. and economic services like irrigation and transportation. The Budget for 2015-16 envisaged generation of ₹ 2.22 lakh crore (Table 7.3) from non-tax revenue, which was 1.6 % of GDP and constituted 18 % of non-debt receipts.

Table 7.3: Trend in Non-tax Revenue (₹ in crore)

	2013-14	2014-15 P	2015-16 BE
Interest receipts	21868	24265	23599
Dividend and profit	90435	89912	100651
External grants	3618	1268	1774
Others	81475	80209	94413
Receipts of UTs	1474	1305	1296
Total	198870	196959	221733

Source: Budget documents and CGA

7.5 NON-DEBT CAPITAL RECEIPTS

Non-debt capital receipts mainly comprises of recovery of loans and advances and disinvestment receipts. The share of recovery of loans has been declining in non-debt capital receipts mainly because of the 12th Finance Commission's recommendation against loan inter mediation from the centre to states and allowing the states to directly borrow from the market. The Budget for 2015-16 placed non-debt capital receipts at ₹ 80,253 crore, comprising ₹ 10,753 crore of recovery of loans and ₹ 69,500 crore of other receipts (majorly disinvestment).

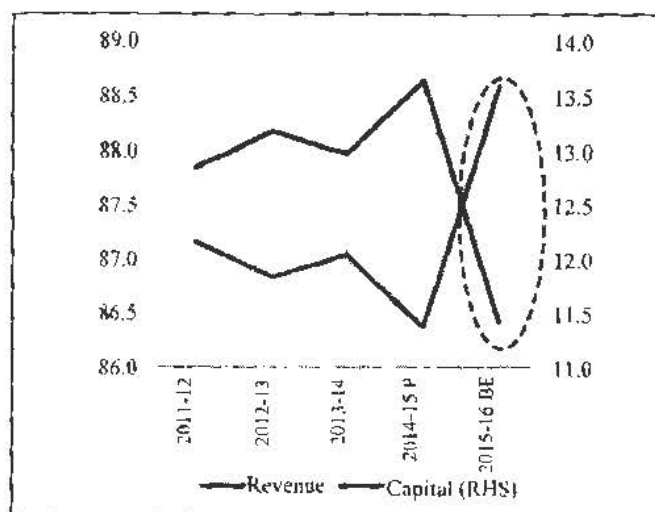
7.6 TRENDS IN EXPENDITURE

Reprioritisation and rationalisation of public expenditure is essential to fiscal reforms. It is actually a challenge to attain fiscal alliance while ensuring that sufficient funds are allocated for public investment, in the face of low tax to GDP ratio. Hence, enhancing the quality of expenditure becomes central to achieving sustained fiscal alliance.

7.6.1 Quality of Expenditure

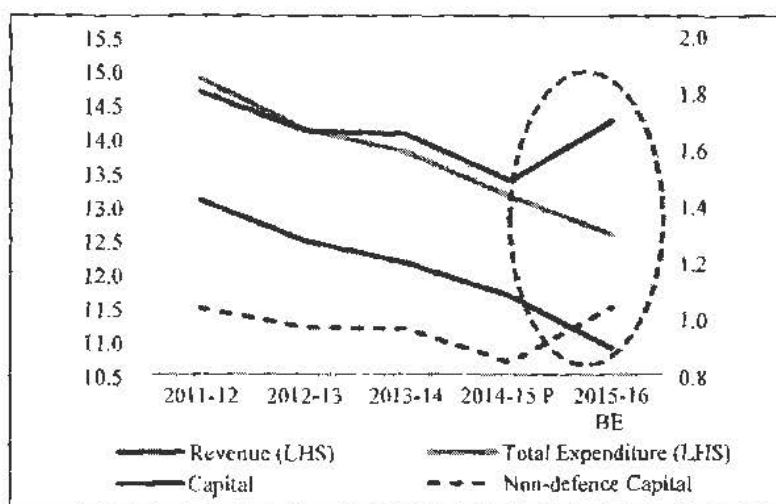
A total expenditure at ₹ 17.77 lakh crore was estimated in the budget for 2015-16, which was 5.7% higher than the revised estimate (RE) of 2014-15 and 8.1 % higher than the provisional estimates (P) of 2014-15. Within this, the expected growth in

capital expenditure was 25.5 % and growth in revenue expenditure was 3.2 % over RE 2014-15.



Source: Budget documents and CGA

Figure 7.6: Revenue and Capital Expenditure as Per Cent of Total Expenditure



Source: Budget documents, CGA and CSO

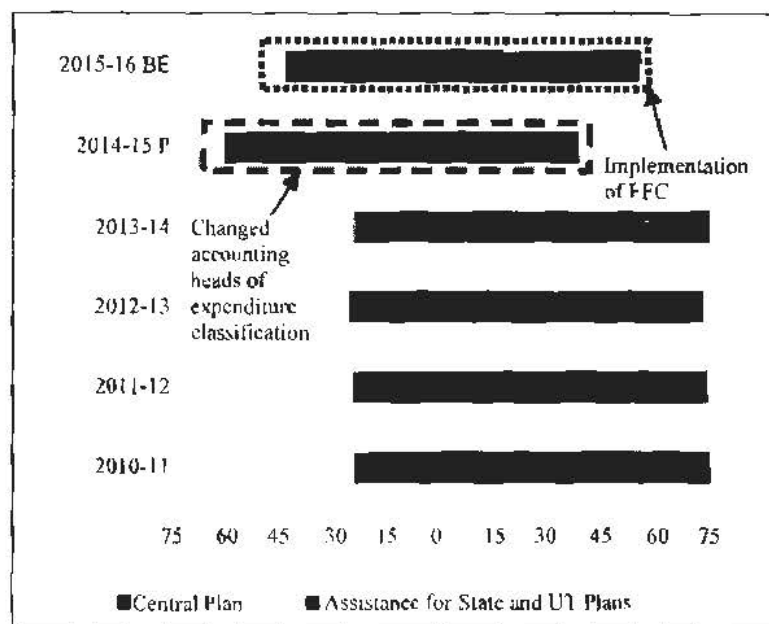
Figure 7.7: Revenue and Capital Expenditure as Per Cent of GDP

Highlighting the need for greater public investment to aid growth revival, budget 2015-16 ensured a higher share for capital expenditure from the total pool of expenditure (Figure 7.6). As a proportion of GDP, total capital expenditure and non-defence capital expenditure were both raised by more than 0.2 % points of GDP (Figure 7.7). Budget 2015-16 pursued to achieve the proposed expansion of capital expenditure on railways, roads and others without compromising defense capital expenditure.

7.6.2 Plan Expenditure

The two major developments transformed the whole plan expenditure regime that took place in two consecutive years. Firstly, in the budget for 2014-15, the centrally sponsored schemes were restructured and reclassified into 66 programs for greater synergy and effective implementation. CSS funds were released as central assistance to state plans and also routed through the state budgets. This provided greater

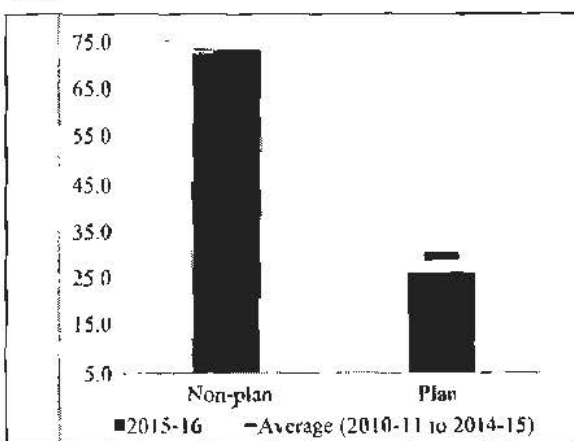
autonomy, authority and responsibility to the states in implementation of schemes. As a result, central assistance to the plans of states and union territories (UT) recorded a significant increase in 2014-15(P) (Figure 7.8).



Source: Budget documents and CGA

Figure 7.8: Share of Central Plan and Central Assistance for State and UT Plans in of Total Plan Expenditure (Per Cent)

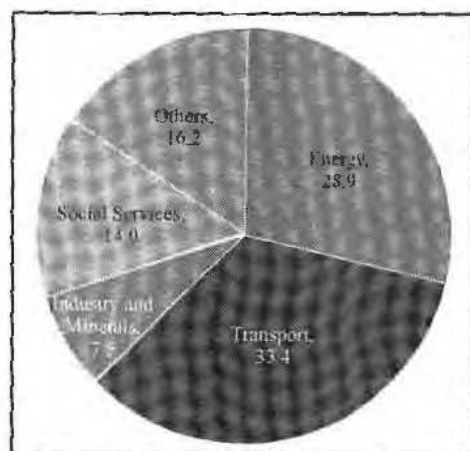
Secondly, there was a modification in the method of allocation of planned funds to the states in the budget for 2015-16, following the acceptance of major recommendations of FFC. The FFC had recommended allocation of greater resources to states through the automatic route by increasing the state's share in the divisible pool of taxes from 32% to 42%, and counter balancing this increase in devolution by limiting the resources transferred under central plan assistance to the states and also by changing the expenditure-sharing pattern. These developments translated into a decline in central assistance to the states (Figure 7.8) and also led to a decline in the share of plan expenditure in 2015-16 (BE) vis-à-vis the average of shares during 2010-11 to 2014-15 (Figure 7.9).



Source: Budget documents and CGA

Figure 7.9: Plan and Non-plan Expenditure of the Centre as Per Cent of Total Expenditure

The given change in the pattern of plan expenditure, the budget did well to allocate a plan outlay of ₹ 4.65 lakh crore in 2015-16 (₹ 2.60 lakh crore for central plan and ₹ 2.05 lakh crore for central assistance to states and UTs) as against ₹ 4.54 lakh crore in 2014-15 (P). Additionally, the broad sector-wise allocations of central plan outlay (gross budgetary support to central plan plus internal and extra-budgetary resources of the central public sector enterprises) indicated that transport, energy, social services and industry and minerals together constituted roughly 84 % of the BE of 2015-16 (Figure 7.10).

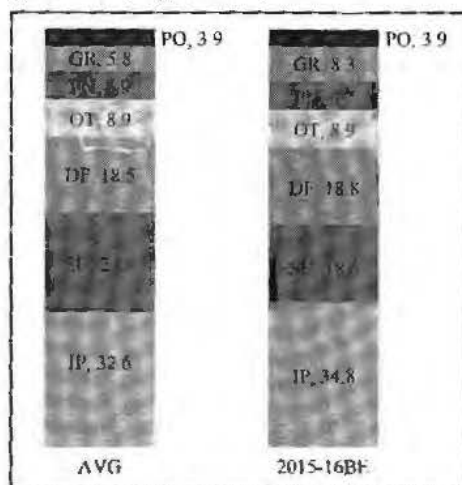


Source: Budget documents and CGA

Figure 7.10: Central Plan Outlay by Sectors in BE 201-16 (in per cent)

7.6.3 Non-plan Expenditure

Non-plan expenditure constituted 73.8% of the total expenditure in BE 2015-16, which is 3% points higher than the average of the last five years ending 2014-15. Out of the total non-plan expenditure of ₹ 13.12 lakh crore in BE 2015-16, revenue expenditure accounted for around 92%. The remaining 8 % was mainly defense capital expenditure. Secondly, the share of committed expenditure (interest payment and pension) was roughly 41.5 % as against the last five years' (ending 2014-15) average of approximately 38.6 % (Figure 7.11).



Note: IP=Interest payment, DF=Defence, SU=Subsidies, PO=Police, PN=Pension, OT=Others, GR=Grants to states and UTs. AVG= Average of last five year ending to 2014-15

Source: Budget documents and CGA

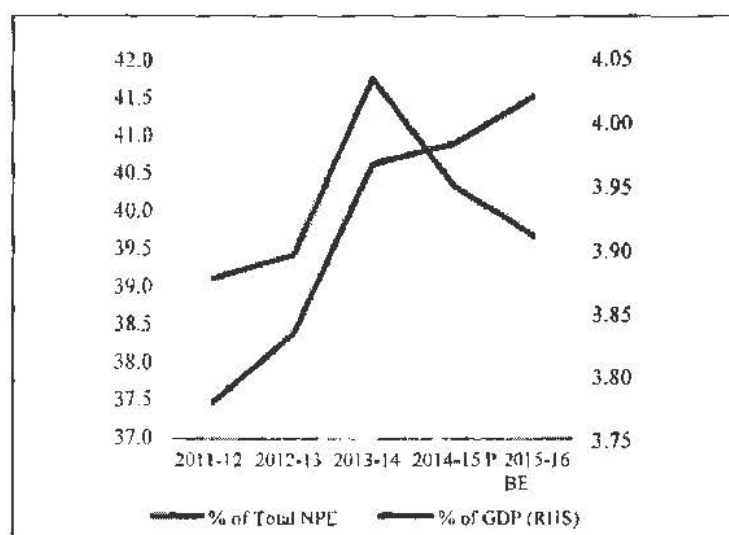
Figure 7.11: Composition of Non-plan Expenditure (in per cent)

Committed expenditure is one of the major constraints in the rationalisation of non-plan expenditure. Committed expenditure occurs on two counts: firstly, interest liability on debt incurred in the past, and secondly, pension payment to retired workforce from government services. BE 2015-16 estimated committed expenditure at ₹ 5.45 lakh crore, as against ₹ 4.87 lakh crore in 2014-15(P) (Table 7.4). The share of committed expenditure in total non-plan expenditure (NPE in Figure 7.11) has been constantly increasing, however it started declining post 2013-14 as a per cent of the GDP and BE 2015-16 estimated a decline to 3.86 % of the GDP, from 3.90% in 2014-15 (Figure 7.11).

Table 7.4: Committed Expenditure (₹ in crore)

	2013-14	2014-15 P	2015-16 BE
Interest payments	374254	404019	456145
Pensions	74896	82954	888521
Total	449150	486973	544666

Source: Budget documents and CGA



Source: Budget documents, CGA and CSO

Figure 7.12a: Committed Expenditure

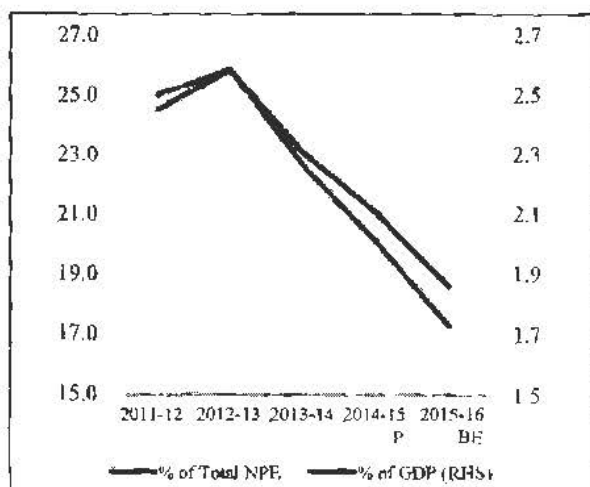
The deviating trends in committed expenditure seen under two different indicators (Figure 7.12a) are also the result of rationalisation in other categories of non-plan expenditure. For example, the decline in the subsidy bill increased the relative share of committed expenditure in non-plan expenditure.

The subsidy bill was placed at ₹ 2.44 lakh crore for BE 2015-16, which was 1.7 % of the GDP. The deregulation of petrol and diesel prices and direct benefit transfer of subsidy for domestic LPG, along with a decline in global crude oil prices, which helped in containing the petroleum subsidy bill at ₹ 30,000 crore in BE 2015-16 as against ₹ 57,769 crore in 2014-15 (P) (Table 7.5). The total subsidy bill as a proportion of GDP has been declining since 2012-13 and is expected to be below 2 % of GDP as per BE 2015-16 (Figure 7.12b). The rationalisation and reprioritisation of subsidies through better targeting would play a vital role in fiscal alliance and in targeting expenditure more towards inclusive development.

Table 7.5: Total Subsidies (₹ in crore)

	2013-14	2014-15 P	2015-16 BE
Food	92000	122676	124419
Fertilizer	67339	70967	72969
Petroleum	85378	60270	30000
Other	9915	—	16423

Source: Budget documents and CGA

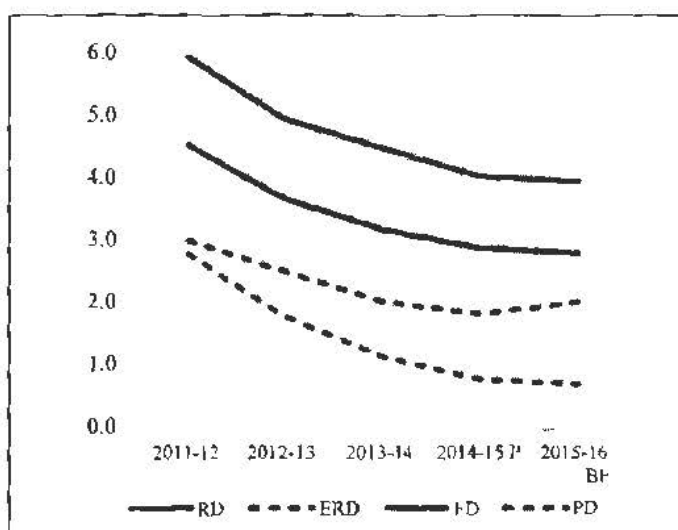


Source: Budget documents, CGA and CSO

Figure 7.12b: Subsidy Bill as Per Cent of GDP

7.6.4 Trends in Deficit and Financing of the Deficit

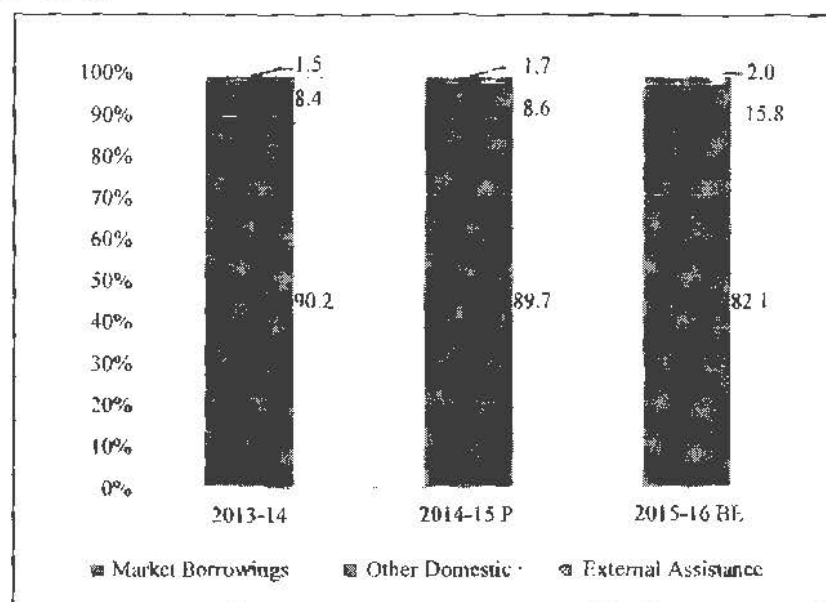
Budget 2015-16 sought to contain the fiscal deficit at ₹ 5.56 lakh crore (3.9% of GDP) as against ₹ 5.13 lakh crore (4.1% of GDP) in 2014-15 (RE). Revenue deficit (RD) was estimated at ₹ 3.94 lakh crore (2.8% of GDP) in 2015-16 (BE) as against ₹ 3.62 lakh crore (2.9% of GDP) in 2014-15 (RE) (Figure 7.13).



Source: Budget documents, CGA and CSO

Figure 7.13: Trend in Deficits as Per Cent of GDP

Unlike some other countries, in India the financing of fiscal deficit is mostly from domestic sources. Domestic sources constitute roughly 98 % of the deficit financing, and approximately 84% of domestic financing is from market borrowings (Figure 7.14).



Source: Budget documents and CGA

Figure 7.14: Financing of Fiscal Deficit

7.6.5 Provisional outcome in 2015-16 (upto December) vis-à-vis BE 2015-16

The accounts for April-December 2015-16, released by the Controller General of Accounts shows that the fiscal deficit of the union government at end-December 2015, as a percentage of BE, is lower than in the corresponding period of the last year (Table 7.6), but slightly higher than the average of the last five years, which was 82.3%. This fiscal outcome the year was due to improved tax buoyancy and prudent expenditure management with assistance from the decline in oil prices. The other important highlights of the fiscal outcome in the current year till December 2015 included increased tax devolution to the states in line with the recommendations of the FFC, by achieving the highest increase in capital expenditure in the last six years and decline in major subsidies.

The acceptance of the recommendations of the FFC for increased tax devolution has marked a watershed in India's cooperative federalism. In keeping with the changed rules for devolution, the taxes assigned to states/UTs were raised by 36.6 % in the current year so far. Hence, the growth so far in taxes net to the centre was less than the growth in GTR (Table 7.6). With the grants and loans to states/UTs declining by about 5.7%, the total resources transferred to states/UTs (during April-December 2015) increased by about 15.4 percent, as compared to April-December 2014 (Figure 7.15).

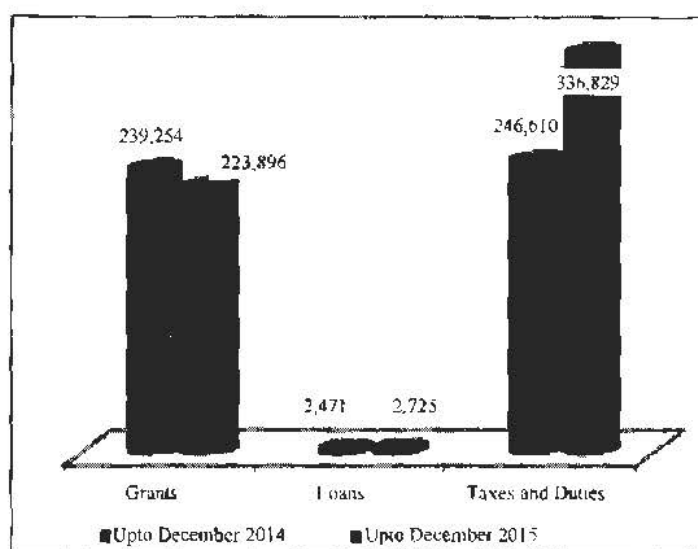


Figure 7.15: Resources Transferred to States and UTs (in crore)

The influential growth in GTR in the first three quarters of the year (Table 7.6) was aided by the 34.8% growth in indirect taxes, with union excise duties growing by about 68%. Excise collections may have been bolstered by improving dynamics of economic activity and also measures like increasing the excise duty on petrol and diesel in the backdrop of falling international prices of crude oil. Consequently, indirect tax collections as a ratio of BE at end-December 2015 stood at 71.3% of BE, as compared to 54.8 % by December 2014. Direct taxes — both on personal income and corporate income, grew by more than 10% during this period. While growth in non-tax revenue remained robust, disinvestment receipts (included in other capital receipts in Table 7.6) by December 2015, though higher than in the previous year, stood only at 18.5 % of the BE.

Table 7.6: Provisional Outcome for 2015-16 (Till December 2015)

	BE ₹ crore	April-December					
		Absolute number (₹ crore)		Per cent of respective BE		Growth over last year (per cent)	
		2015-16	2014-15	2015-16	2014-15	2015-16	2014-15
1 Revenue receipts	1141575	693275	803808	58.3	70.4	9.4	15.9
Gross tax revenue	1449490	705686	963229	58.3	66.5	7.0	21.1
Tax incl. (in cent)	919942	545714	622248	55.8	67.6	5.4	14.0
Non-tax revenue	221733	148059	181561	69.7	81.9	27.3	22.6
2 Capital receipts	635982	542615	510189	89.7	80.2	7.4	-6.0
Recovery of loans	10753	8282	9138	78.7	85.0	3.0	10.3
Other receipts	69500	1952	12866	3.1	18.5	-64.1	559.1
3 Total receipts	1777477	1236388	1313997	68.9	73.9	6.2	6.3
4 Non-Plan expenditure	1312300	883757	968119	72.4	73.8	8.8	9.5
a) Revenue account	1206027	813270	895386	73	74.2	11.2	10.1
Interest payments	456145	275220	302298	64.5	66.3	10.8	9.8
Major subsidies	727388	212418	208759	84.5	91.8	12.5	-1.7
Pensions	38521	68104	69467	83.1	78.5	26.4	2.0
b) Capital account	106173	70487	72633	67	68.4	-13.4	3.0
5 Plan expenditure	465277	352631	345978	61.3	74.4	0.4	-4.9
a) Revenue account	330020	282278	270656	62.2	69.9	3.0	-18.3
b) Capital account	135257	70353	115322	57.9	85.3	-8.9	63.9
6 Total expenditure	1777477	1236388	1313997	68.9	73.9	6.2	6.3
a) Revenue expenditure	1536047	1095548	1126042	69.9	71.3	9.0	2.8
b) Capital expenditure	241430	140840	187955	62.1	77.9	-11.2	33.5
7 Revenue deficit	394472	401775	522334	106.2	81.7	8.2	-19.8
8 Effective revenue deficit	283921	303912	229446	144.6	80.8	16.4	24.5
9 Fiscal deficit	555649	532381	408185	100.2	87.9	3.1	-8.3
10 Primary deficit	99504	25361	185857	246.9	186.8	-4.0	-27.7

Source: CGA monthly account and Budget documents.

Almost 33.5% increase in capital expenditure was on the plan side. Revenue expenditure in April-December 2015 was modestly higher; mainly on account of the 18.3% decline in plan revenue expenditure reflecting largely the change in pattern of devolution to the states/UTs. Grants-in-aid to states under this head declined from ₹ 2.05 lakh crore last year from April to December to ₹ 1.50 lakh crore this year. However, non-plan grants to states increased from ₹ 0.35 lakh crore to ₹ 0.74 lakh crore during the period.

The 1.7% decline in major subsidies was due to a near 44.7% decline in petroleum subsidy in April to December that occurred due to a steep decline in international crude oil prices. The other major subsidies — food and fertilizer — increased by 10.4% and 13.7% respectively during the period.

7.7 PERFORMANCE OF DEPARTMENTAL ENTERPRISES OF THE CENTRAL GOVERNMENT DEPARTMENT OF POSTS

The gross receipts of the Department of Posts in 2014-15 were placed at ₹ 11,636 crore. The gross and net working expenses during the year were ₹ 18,557 crore and ₹ 17,895 crore respectively, which resulted in a deficit of ₹ 6259 crore. In 2015-16, the gross receipts are expected to increase to ₹ 12,237 crore, with gross and net working expenses estimated at ₹ 20,185 crore and ₹ 19,540 crore respectively. The deficit is projected to be ₹ 7303 crore.

7.7.1 Railways

The key focus areas for Indian Railways includes fast tracking of increase in the capacity, network modernisation, asset utilisation and productivity improvement, modernisation of rolling stock and maintenance practices, improving the quality and pricing of services and improving energy efficiency in operations. Investments are being prioritised in important areas like dedicated freight corridors, high speed rail, high-capacity rolling stock, last mile rail linkages and port connectivity. During 2014-15, the freight earnings, passenger earnings (including coaching earnings) and gross traffic receipts of the Railways grew by 12.7%, 14.9 % and 12.3% respectively over 2013-14. Gross traffic receipts of the Railways were estimated to increase to ₹ 1.84 lakh crore in BE 2015-16, as against ₹ 1.57 lakh crore in 2014-15. The operating ratio of the Railways, which stood at 91.3% in 2014-15, and net revenue as a proportion of capital-at-charge, which was 7.0% in the previous year, are also likely to see improvements in 2015-16.

7.7.2 Government Debt

The public debt management policy in India focuses on maintaining a long run sustainable debt structure at lowest possible cost. Prolonged fiscal deficits lead to accumulation of debt beyond levels that are sustainable and can result in higher real and nominal interest rates, slower growth in capital formation and potentially lower rates of output growth. High and rising public debt levels may also impact public finances through debt servicing dynamics that deteriorate the government's fiscal position.

The total outstanding liabilities of the central government were ₹ 62.78 lakh crore by March end 2015, accounting for 49.6 % of GDP and comprising 39.2 % public debt (internal debt plus external debt) and 10.3 % other liabilities (small savings, provident funds, etc.) (Table 7.7). Total estimated outstanding liabilities were at ₹ 68.94 lakh crore in BE 2015-16.

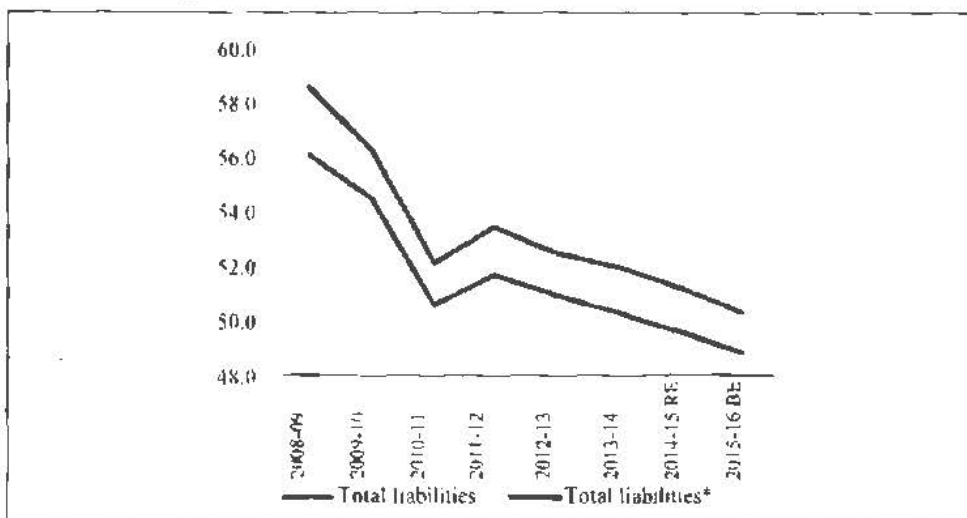
The robust GDP growth kept increasing the debt of the central government at sustainable levels, relative to the size of the economy is shown in Figure 7.16a. The figure also brings forward an issue of the sequential valuation of the external liabilities of the centre. The degree of external liability of the government, may change purely on account of currency movements, even without new borrowing as shown in Figure 7.16b. By any measure, however external debt is only a small fraction of the total liabilities of the centre and is a declining proportion of GDP (Table 7.7).

**Table 7.7: Total Outstanding Liabilities of the Central Government at end-March
(as per cent of GDP)**

	2011-12	2012-13	2013-14	2014-15 RE	2015-16 BE
1. Internal liabilities ^a	49.8	49.2	48.7	48.1	47.4
(a) Internal debt	37.0	37.8	37.6	37.7	37.6
(i) Market borrowings	28.8	30.0	30.5	30.8	30.9
(ii) Others	8.2	7.8	7.1	7.0	6.7
(b) Other internal liabilities	12.8	11.3	11.0	10.3	9.9
2. External debt (outstanding) ^a	1.9	1.8	1.6	1.5	1.5
3. Total outstanding liabilities (1 + 2)	51.7	51.0	50.3	49.6	48.9

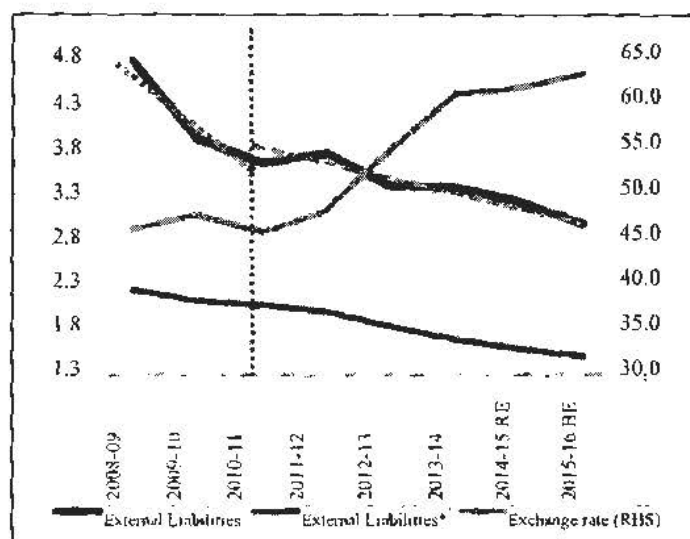
Notes: * External debt figures represent borrowings by central government from external sources and are based upon historical rates of exchange. ^a Internal debt includes net borrowing of ₹ 20,000 crore for 2015-16 (BE) under the Market Stabilization Scheme.

Source: Union budget documents and DMO



Source: Union budget documents, Reserve Bank of India (RBI) and Debt Management Office (DMO)

Figure 7.16a: Central Government Total Liabilities as Per Cent of GDP



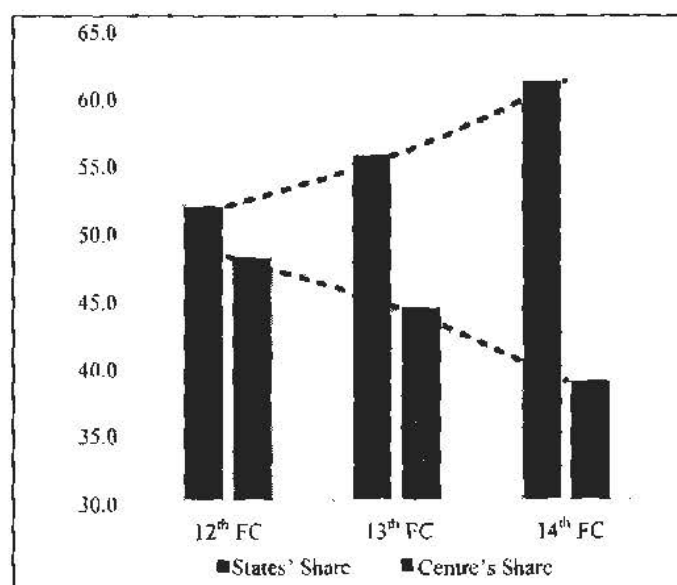
Notes: * External liabilities at historical exchange rate otherwise it is at current exchange rate

Source: Union budget documents, RBI and DMO

Figure 7.16b: Central Government External Liabilities as Per Cent of GDP

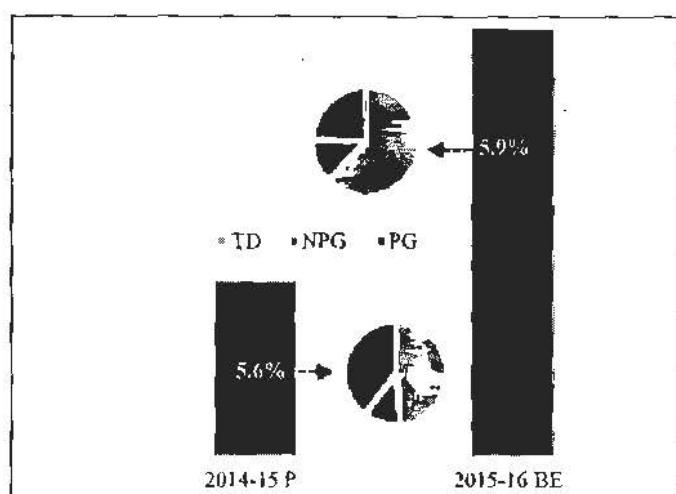
7.8 FISCAL PERFORMANCE OF THE GENERAL GOVERNMENT

In the new regime of fiscal federalism, an analysis of the general government offers greater insights than a separate analysis of either the centre or the states, mainly for two reasons. First, since the implementation of the recommendations of the 12th Finance Commission, has been increasing the share of states in national taxes as shown in Figure 7.17a; and, second, with the acceptance of the FFC recommendations, the transfer of untied resources from the centre to the states has increased considerably as mentioned Figure 7.17b.



Source: Budget documents of Centre and CGA

Figure 7.17a: Share of Centre and States in National Taxes (Per Cent)



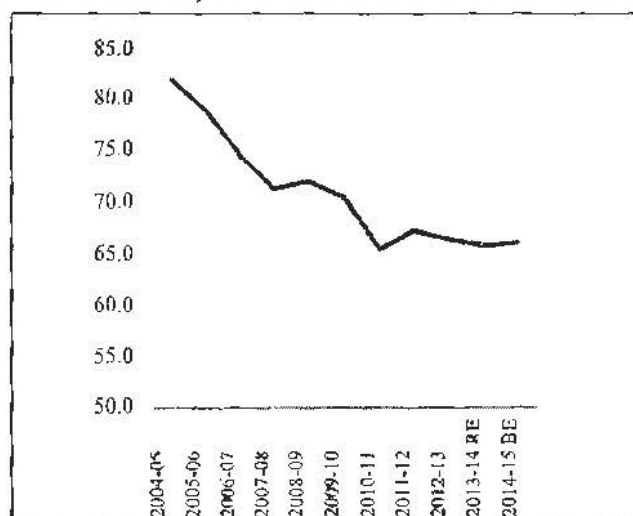
Source: Budget documents of Centre and CGA

Figure 7.17b: Resources Transferred to States (% of GDP)

The general government (centre plus states) has been on the path of fiscal consolidation and fiscal discipline, as reflected in the debt dynamics as shown in Figure 7.18. The fiscal deficit of general government is further expected to decline from 6.9% of GDP in 2014-15 (RE) to 6.3% of GDP in 2015-16 (BE) as per Figure 7.19.

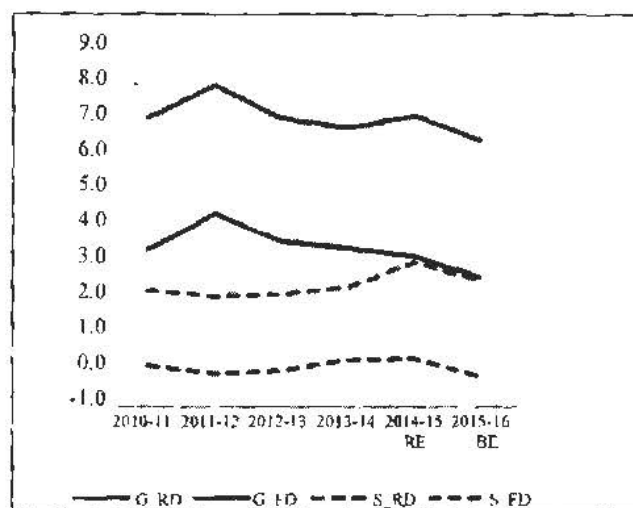
It is observed that both the centre and the states have stuck to the plan of ensuring quality of expenditure and boosting public investment, based on the first eight months data of the current year. The general government capital expenditure has increased by 26.9% in first the eight months of 2015-16 over the corresponding period of the previous year.

National taxes are sum of gross tax revenue of the Centre and States' own tax revenue. Period under 12th FC is 2005-10, 13th FC is 2010-15 and for 14th FC is 2015-16.



Source: RBI

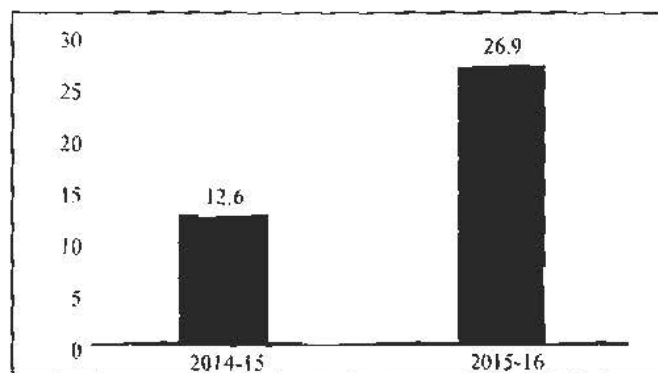
Figure 7.18: General Government Liabilities (Per Cent of GDP)



Notes: G_RD = General Government Revenue Deficit. G_FD=General Government Fiscal Deficit. S_RD=State Governments Revenue Deficit. S_FD=State Governments Fiscal Deficit.

Source: RBI

Figure 7.19: General and State Government RD and FD (% of GDP)



Source: CAG

Figure 7.20: Growth in General Government Capital Expenditure in (April-November) (Per Cent)

Significant increase in revenue receipts, led by buoyant indirect tax collections, higher level of capital expenditure on the plan side however lower level of subsidies on petroleum products helped in a large measure by declining international prices of crude oil, and enhanced untied resources transferred to the states following the acceptance of the recommendations of the FFC are some of the salient developments of the fiscal performance in 2015-16 so far. Given the pattern of revenue and expenditure in the first nine months of the current financial year, inspite of the challenges posed by a lower than projected nominal GDP growth, the fiscal deficit target of 3.9 per cent of GDP seems to be achievable.

The coming year is expected to be a challenging one from the fiscal point of view. With global slowdown likely to persist, the chances of India's growth rate in 2016-17 increasing significantly beyond 2015-16 levels are not very high. Similarly, in contrast to the current year, the subsidy bill on petroleum products may not reap the advantages of steeply declining oil prices. The implementation of the Pay Commission recommendations and the One Rank One Pension (OROP) scheme will put additional burden on expenditure. Improving tax compliance through better tax administration, tapping new sources of revenue, etc. could help raise more revenue and keep the fiscal deficit at levels projected in the revised fiscal road map.

Check Your Progress

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Public Finance in India

Fill in the blanks:

1. Central government receipts can broadly be divided into _____ and _____ receipts.
2. Non-debt capital receipts mainly comprises of recovery of _____ and disinvestment receipts.
3. _____ and _____ of public expenditure is essential to fiscal reforms.
4. _____ is one of the major constraints in the rationalisation of non-plan expenditure.

7.9 LET US SUM UP

- The debt receipts mostly consist of market borrowings and other liabilities.
- The non-debt receipts comprise of tax revenue, non-tax revenue, recovery of loans and disinvestment receipts.
- Fiscal alliance was paused post the financial crisis that led to tax concessions and higher public expenditure, as part of the growth revival strategy and this probably continued longer than it was required.
- The Budget for 2015-16 envisaged generation of ₹ 2.22 lakh crore from non-tax revenue which was 1.6% of GDP and constituted 18% of non-debt receipts.
- It is actually a challenge to attain fiscal alliance while ensuring that sufficient funds are allocated for public investment, in the face of low tax to GDP ratio.
- A total expenditure at ₹ 17.77 lakh crore was estimated in the budget for 2015-16, which was 5.7% higher than the Revised Estimate (RE) of 2014-15 and 8.1% higher than the provisional estimates (P) of 2014-15.
- Non-plan expenditure constituted 73.8% of the total expenditure in BE 2015-16, which is 3% points higher than the average of the last five years ending 2014-15.
- Committed expenditure occurs on two counts: firstly, interest liability on debt incurred in the past, and secondly, pension payment to retired workforce from government services.
- Unlike some other countries, in India the financing of fiscal deficit is mostly from domestic sources.
- High and rising public debt levels may also impact public finances through debt servicing dynamics that deteriorate the government's fiscal position.
- The implementation of the Pay Commission recommendations and the One Rank One Pension (OROP) scheme will put additional burden on expenditure.

7.10 UNIT END ACTIVITY

Taking housing sector as an example, discuss how tax expenditure influences budgetary policies of the government.

7.11 KEYWORDS

Deflation: Lacking of currency and prices.

Invest: To use money into financial schemes, shares or property with the expectation of making.

7.12 QUESTIONS FOR DISCUSSION

1. Highlight the important areas of public finance in India.
2. Discuss on the tax and non-tax revenue of the last 5 years in India.

Check Your Progress: Model Answer

1. Debt, non-debt
2. Loans and advances
3. Reprioritisation, Rationalisation
4. Committed expenditure

7.13 SUGGESTED READINGS

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UNIT- 8

CONCEPT AND TYPES OF BUDGET

CONTENTS

- 8.0 Aims and Objectives
- 8.1 Introduction
- 8.2 Objectives of Budget
- 8.3 Revenue Budget
 - 8.3.1 Revenue Receipts
 - 8.3.2 Revenue Expenditure
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- 8.5 Concept of Deficit Financing
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 - 8.6.1 Types Budgetary Deficit
 - 8.6.2 Implications of a Government Budget Deficit
- 8.7 Deficit Financing in Developing Countries
- 8.8 Deficit Financing in Developed Countries
- 8.9 Financial Relation between Central and State Central Sources of Revenue
- 8.10 Let Us Sum Up
- 8.11 Unit End Activity
- 8.12 Keywords
- 8.13 Questions for Discussion
- 8.14 Suggested Readings

8.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain the concept and types of budget
- Define fiscal deficit, deficit financing and deficit budget
- Discuss the financial relation between central and state

8.1 INTRODUCTION

To meet the objectives of social and economic growth, the Government has several policies to implement in overall task of performing its functions. It has to spend huge amount of funds on defense, administration and development, welfare projects and various other relief operations for implementing these policies. It is therefore

necessary to find out all possible sources of getting funds so that sufficient revenue can be generated to meet the mounting expenditure. Planning process of assessing revenue and expenditure is termed as budget. The term budget is derived from the French word "Budgette" which means a "leather bags" or a "wallet". It is a statement of the financial plan of the government which shows the income and expenditure of the government during a financial year, which runs generally from 1st April to 31st March. Budget is the most important information document of the government. One part of the government's budget is similar to company's annual report. This part presents the overall picture of the financial performance of the government. The second part of the budget presents government's financial plans for the period upto its next budget. So, every citizen of a nation from the common man to the politician is eager to know about the budget as they would like to get an idea of the following things listed below:

- Financial performance of the government over the past one year.
- To know about the financial programs and policies of the government for the next one year.
- To know how their standard of living will be affected by the financial policies of the government in the next one year.

Definitions of Budget

According to Tayler, "Budget is a financial plan of government for a definite period".

According to Rene Stourm, "A budget is a document containing a preliminary approved plan of public revenues and expenditure".

8.2 OBJECTIVES OF BUDGET

The important objectives that are required to be achieved through a budget in an economy are discussed below:

1. ***Allocation of resources:*** The socio-economic and other objectives which a government wants to achieve, the resources are allocated through budget. In India, the most important activity is to increase the rate of economic development and for that resources are allocated on a large scale.
2. ***Redistributive activities:*** Country like India which is a developing economy is generally the victim of many social and economic problems which needs to be solved as early as possible. The important problems are the problem of poverty, unemployment, income inequalities, illiteracy, etc. In India, serious efforts are being made to solve these problems. The government redistributes income and wealth to reduce inequalities, by incurring expenditures on social security and giving subsidies for public, etc.
3. ***Economic stability:*** From economic point of view, both inflation and deflation are not virtuous. Therefore, besides other corrective measures, it is appropriate budgetary steps should be taken to control the situation whenever a country suffers from inflation or deflation. When a country suffers from the bout of depression, cyclical un-employment is created on a very large scale as well as economic activities get depressed. In such a situation government has to adopt various fiscal measures to improve the health of the economy.
4. ***Management of public enterprises:*** To curb monopolies in heavy, basic and key sectors owned and managed by private enterprises, government establishes and operates such units in the public sector. This is necessary to avoid distortion of priorities of the government and society.

5. **Redistribution of income and wealth:** It is one of the most important objective of the government budget. The government imposes heavy taxation on a high income groups redistribute it among the people of weaker section in the society. The government can provide subsidies and other amenities to people whose income levels are low. These increase their disposable income and this reduces the inequalities.
6. **Economic Growth:** Another purpose of the government budget today is to study the generation of savings, investment, consumption and capital formation to assess the trend of growth in the economy to improve the standard of living of the people.
7. **Reducing regional disparities:** The government budget aims to reduce regional disparities through its taxation and expenditure policy for encouraging setting up of production units in economically backward regions.

8.3 REVENUE BUDGET

This financial statement of the government includes the revenue collected by ways of taxes and other receipts. It also contains the items of expenditure met from such revenue.

8.3.1 Revenue Receipts

These are the incomes which are received by the government from all sources in its ordinary course of governance. These receipts do not create a liability or lead to a reduction in assets.

Revenue receipts are further classified as tax revenue and non-tax revenue:

1. **Tax Revenue:** Tax revenue comprises of the income received from different taxes and other duties imposed by the government. It is the major source of public revenue. Every citizen, by law is bound to pay tax and non-payment of the same may be treated as an offence. Again taxes are of two types: Direct Taxes and Indirect Taxes.
 - (a) *Direct taxes* are those taxes which have to be paid by an individual on whom they are charged. The burden of direct tax cannot be shifted to someone else. For example, income tax, property tax, corporation tax, estate duty, etc. There is no direct benefit to the tax payer in such type of tax.
 - (b) *Indirect taxes* are those taxes which are imposed on commodities/goods and services and it affects the income of a person through their consumption expenditure. The burden of indirect tax can be shifted to another person. For example, custom duties, sales tax, services tax, excise duties, etc.
2. **Non-tax Revenue:** Apart from taxes, governments receive revenue from other non-tax sources. The non-tax sources of public revenue are as follows:
 - (a) *Fees.* The government provides a variety of services for which fees have to be paid. For example, fees paid for registration of property, births, deaths, etc.
 - (b) *Fines and penalties.* Fines and penalties are imposed by the government for not following (violating) the rules and regulations.
 - (c) *Profits from public sector enterprises:* Many enterprises are owned and managed by the government. The profits received from them is an important source of non-tax revenue. For example, in India, the Indian Railways, Oil and Natural Gas Commission, Air India, Indian Airlines, etc. are owned by the Government of India. The profit generated by them is a source of revenue to the government.

(d) *Gifts and grants*: Gifts and grants are received by the government when there are natural calamities like earthquake, floods, famines, etc. Citizens of the country, foreign governments and international organisations like the UNICEF, UNESCO, etc. donate during times of natural calamities.

(e) *Special assessment duty*: It is a type of levy imposed by the government on the people for getting some special benefit. For example, in a particular locality, if roads are improved, property prices will rise. The property owners in that locality will benefit due to the appreciation in the value of property. Therefore, the government imposes a levy on them which is known as special assessment duties.

3. *India's Revenue Receipts*: The tax revenue provides major share of revenue receipts to the central government of India. In 2006-07 tax revenue (direct + indirect taxes) of central government was ₹ 3,27,205 crores while non-tax revenue was ₹ 76,260 crores.

8.3.2 Revenue Expenditure

The following expenses are included in revenue expenditure:

- Expenditure made by the government on consumption of goods and services.
- Expenditure made on agricultural and industrial development, scientific research, education, health and social services.
- Expenditure made on defence and civil administration.
- Expenditure made on exports and external affairs.
- Grants given to state governments even if some of them may be used for creation of sets.
- Payment of interest on loans taken in the previous year.
- Expenditure made on subsidies.

8.4 CAPITAL RECEIPTS

The budget that includes receipts and expenditure on capital account projected for the next financial year is termed as capital receipts. Capital budget consists of capital receipts and capital expenditure. Items included in capital receipts are the main items of capital receipts.

- Market loans raised by the government from the public through the sale of bonds and securities.
- Borrowings by government from RBI and other financial institutions through the sale of treasury bills.
- Loans and aids received from foreign countries and other international organizations like International Monetary Fund (IMF), World Bank, etc.
- Receipts from small savings schemes like the National saving scheme, President funds, etc.

8.5 CONCEPT OF DEFICIT FINANCING

Deficit refers to the difference between expenditure and receipts. In public finance, it means the government is spending more than what it is earning. Government expenditure and revenue can be split into capital and revenue. Capital expenditure generally includes those expenses which result in creation of assets. Revenue

expenditure is primarily that which does not result in asset creation—for example interest payments, salaries, subsidies, etc. Similarly, on the receipts side, whatever the government receives as taxes is revenue receipt. Receipts not of a recurring nature are generally capital receipts. These include domestic and external borrowings, proceeds of disinvestment, recovery of loans given by the Union government, etc.

Deficit financing refers to the financing of the excess expenditure over the total revenue receipts of the government during a year, by various methods.

$$\text{Deficit Financing} = \text{Total Public Expenditure} - \text{Total Public Revenue}$$

According to Mc. Graw Hill Dictionary of Modern Economics deficit financing is a practice by a government of spending more than what receives in revenue. Thus a government is said to be practicing deficit financing when it spends in excess of its current revenue. Deficit financing assumes different meanings in the western context and in India.

In India, the term deficit financing is used in a different sense. It is considered as the most popular method of raising additional resources for economic development. In India deficit financing has been treated mainly in terms of expansions of currency.

In the first five year plan document, planning commission has defined the term as "deficit financing is used to denote the direct addition to gross national expenditure through budget deficit whether the deficits are on the revenue account or on capital account. The essence of such a policy lies therefore in governments spending in excess of the revenue it receives in the shape of the taxes earnings of state enterprises, loans from 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". It includes borrowing from the central bank and withdrawal of cash balances, and excludes market borrowing.

That is borrowing from the public and from the commercial banks. Public loans are raised out of the savings of the people. It results merely in the transfer of purchasing power from the hands of the public to the government without a net addition to total money supply. In short in the Indian context deficit financing took place.

8.5.1 Major Objectives of Deficit Financing

Deficit financing is mainly resorted to attain the following objectives:

1. Deficit financing is used as the simple and effective fiscal device to meet the financial requirements of the government during emergencies such as war.
2. Keynes popularized deficit financing as an effective fiscal instrument to control the economic fluctuations and to raise the level of the employment and output.
3. In developing countries, deficit financing is considered as a method to mobilize resources for planned economic development.
4. Another objective of deficit financing is to raise the level of effective demand and thereby to stimulate private spending in a depression economy.
5. J.M. Keynes advocated deficit financing as instrument to mobilize surplus labour and other idle and unutilized resources during depression, for achieving economic development.
6. In developing economies the main objective of deficit financing is to remove the vital issue such as unemployment, poverty and income inequality.

8.5.2 Problems of Deficit Financing

The basic intention behind deficit financing is to provide the necessary impetus to economic growth by artificial means. However, deficit financing helps to a certain extent only and beyond that it may cause havoc. Here are some of the problems of deficit financing.

1. **Deficit Financing Leads to inflation:** Deficit financing may lead to inflation. Due to deficit financing money supply increases & the purchasing power of the people also increase which increases the aggregate demand and the prices also increases.
2. **Adverse effect on saving:** Deficit financing leads to inflation and inflation affects the habit of voluntary saving adversely. Infact it is not possible for the people to maintain the previous rate of saving in the state of rising prices.
3. **Adverse effect on Investment:** Deficit financing effects investment adversely when there is inflation in the economy trade unions make demand for higher wages for that they go for strikes and lock outs which decreases the efficiency of Labour and creates uncertainty in the business which a decreases the level of investment of the country.
4. **Inequality:** In case of deficit financing income distribution becomes unequal. During deficit financing deflationary pressure can be seen on the economy which makes the rich richer and the poor, poorer. The fix wage earners are badly affected and their standard of living deteriorates thus no gap b/w rich & poor increases.
5. **Problem of balance of payment:** Deficit financing leads to inflation. A high price level as compared to other countries will make the exports more expensive and thus they start declining. On the other hand rise in domestic income and price may encourage people to import more commodities from abroad. This will create a deficit in balance of payment and the balance of payment will become unfavourable.
6. **Increase in the cost of production:** When deficit financing leads to the rise in the price level the cost of development projects also raises this means a larger dose of deficit financing is required on the part of government for completion of these projects.
7. **Change in the pattern of investment:** Deficit financing leads to inflation. During inflation prices rise and reach to a very high level in that case people instead of indulging into productive activities they start doing speculative activities.

8.6 CONCEPT OF DEFICIT BUDGET

The Deficit Budget is the financial situation wherein the expenditures exceed the revenues. The Deficit Budget generally relates to the government's expenditure and not the business or individual's spending. Thus, the budget deficit is the excess of government expenditures over government receipts (income). When the government is running a deficit, it is spending more than its receipts. The government finances its deficit mainly by borrowing from the public, through selling bonds; it is also financed by borrowing from the Central Bank.

The government's collective deficits are termed as "National Debt". In the case of a budget deficit, be it the Government or any business, it has to resort to the external borrowings in order to escape the bankruptcy. The investors or analyst study the budget deficit of the country or business to judge its financial health.

8.6.1 Types of Budgetary Deficit

There can be different types of budget deficits that can be classified on the basis of types of receipts and expenditures taken into the consideration. These are:

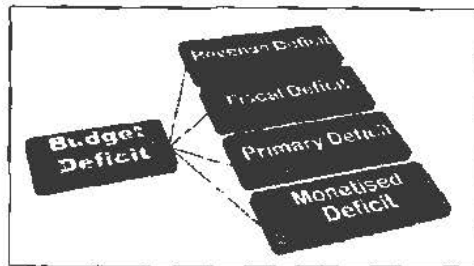


Figure 8.1: Different Types of Budget Deficits

Revenue Deficit

The revenue deficit refers to the financial position wherein the government's revenue expenditure exceeds its total revenue receipts. This means that government's own earnings are not sufficient to meet the day-to-day functioning of its departments and other provisions of services.

Symbolically, such financial situation can be expressed as:

$$\text{Revenue Deficit} = \text{Total Revenue Expenditures} - \text{Total Revenue Receipts}$$

The revenue deficit is only concerned with the revenue receipts and the revenue expenditures of the government. Obviously, when the government spends more than what it earns has to resort to the external borrowings, thus the revenue deficit results into the borrowings.

Fiscal Deficit

Fiscal deficit refers to the financial situation wherein the government's total budget exceeds the total receipts excluding borrowings made during the fiscal year. Thus, it can be expressed as:

$$\text{Fiscal Deficit} = \text{Total Expenditure} - \text{Total Receipts Excluding Borrowings}$$

Through fiscal deficit, the government can determine the amount that needs to be borrowed in case it lacks adequate resources.

The fiscal deficit can occur even if the revenue deficit is not there if the following conditions prevail:

- Revenue budget is balanced, but the capital budget is in deficit.
- Revenue budget is in the surplus, and the capital budget is in deficit, and the deficit is more than the surplus.

Primary Deficit

The primary deficit is the difference between the fiscal deficit of current year and the interest paid on the previous borrowings. Thus, primary deficits are government's borrowings exclusive of interest payment.

Generally, the loan raised by the government is inclusive of the interest amount, and if that amount is deducted from the principal loan amount, the balance amount is called as the primary deficit. The purpose of measuring such deficit is to know the amount of borrowings that government can utilize in the expenses other than the interest payments.

Symbolically, it can be represented as:

$\text{Primary Deficit} = \text{Fiscal Deficit} - \text{Interest payments on the previous borrowings}$

In case, the primary deficit is zero; then the fiscal deficit becomes equal to the interest payment, which means government resort to borrowings just to pay off the interest payments. Thus, the low or zero primary deficits indicate that the government was forced to resort to the external borrowings to meet out its previous interest obligations, and nothing gets added to the existing loan.

Monetised Deficit

The monetised deficit is the extent to which the RBI helps the central government in its borrowing programme. In other words, monetised deficit means the increase in the net RBI credit to the central government, such that the monetary needs of the government could be met easily.

The monetized deficit results in the increase in the net holdings of treasury bills by the RBI and also the RBI contribution towards the government's market borrowings increases. With the issue of more money to the government, the money supply in the economy increases, as a result of which the inflationary pressure prevails. Hence, we can say that monetised deficits are the part of a fiscal deficit that leads to the inflation in the economy.

Thus, it can be concluded that monetised deficit occurs when the government takes a monetary support from the RBI to finance its debt obligations and try to reduce its unnecessary expenditures.

8.6.2 Implications of a Government Budget Deficit

The budget surplus is opposite of budget deficit where the revenues exceed the expenditures, and when the spending is equal to the revenues, the budget is said to be balanced. The major implications of a Government budget deficit are:

- Slower economic growth
- Increased tax revenue
- High unemployment rates
- High Government spending

Investors expect high inflation rates due to which the real value of debt reduces and thus, the investors expect higher interest rates for their future loans to the government.

Ideally, for any investor the budget deficits are a threat, but he must understand the reasons behind such a deficit. The reason for such a deficit could be the investments made in the infrastructure development or any other profitable investments that will yield profits in the future could be seen as healthier than the situation, where a country or a business entity is facing a deficit due to unsustainable expenses.

8.7 DEFICIT FINANCING IN DEVELOPING COUNTRIES

The problems of developing countries like India, Pakistan, Bangladesh, etc. are different from those in the developed countries. Thus, the rationale behind or justification for deficit financing in developing countries like India is entirely different.

The main reasons for deficit financing in India are discussed below:

1. **Mobilization of physical resources:** There is a vast amount of physical resources which are unutilized or underutilized or misutilized by the private sector such as

iron ore, different kinds of minerals, water, of land, etc. Public revenue is insufficient to use them efficiently and rationally. Underdeveloped countries are rich natural resources such as mines and forests. They have abundance of unemployed labour. Through deficit financing, these idle resources can be activated and gainfully used for national development.

2. **Social overhead expenditure:** In developing countries, there is low development of private sector industries due to lack of infrastructural facilities. Since huge expenditure is essential for such facilities and also there is no large and quick profit, the government of a developing country has to spend a huge amount on social overhead capital for creating infrastructural facilities such as of power, communication and transport, etc. Deficit financing is necessary for this purpose as the government tax and non-tax revenue is insufficient to meet this expenditure.
3. **Monetizing the rural sector:** In modern days of money economy, it is necessary to monetize all sectors of a developing economy. A substantial part of the rural sector is barter economy. Deficit financing is suitable mechanism to change the barter sectors of the economy into monetized sectors. In such sectors, new money created can be used to popularize the use of money.

Under Article 280, a provision was made for the appointment of a Finance Commission by the President at an interval of five years or earlier to make recommendations relating to the sharing of income and excise taxes and grants-in-aid of state revenues. It is a quasi-judicial body whose recommendations, once accepted by the government become binding on it. Further, the institution of the Finance Commission is a unique feature of our constitution.

Terms of Reference

The Finance Commission is required to recommend financial transfers from the central government to the states with a view of reducing vertical as well as horizontal fiscal imbalances. The terms of reference of the Finance Commission are fixed in a broad way by the constitution under Article 280(iii). Though the central government is prevented from determining randomly the terms of reference of the Finance Commission, yet there is a scope for some flexibility under clause 3(c) of Article 280 which reads: "*any other matter referred to the Commission by the President in the interest of sound finance*". The government has put certain restrictions on the working of the Finance Commissions leading to controversies on several occasions under this clause. According to the terms of reference, the Finance Commission's role was confined with the advent of planning and development, importance to the examination of non-plan revenue accounts of states budget.

The commission was delegated with the task of recommending as to the following matters:

1. The distribution between the union and the states of the net proceeds of taxes which are to be, or may be, divided between them under Part-XII of the constitution and the allocation between the states of the respective shares of such proceeds.
2. Under Article 275 of the constitution, principle we which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India and the sum to be paid to the states which are in need of assistance by the way of grants-in-aid of their revenues.
3. Consolidated fund of state to supplement the resources of the panchayats and municipalities in the states on the basis of the recommendation made by the finance commission of the state fourteenth finance commission.

The fourteen finance commission was instructed on 2nd Jan, 2013 under the chairmanship of Dr. Y.V. Reddi (Reserve Bank of India) following are its members:

1. Prof. Abhijeet Sen, Member Planning Commission
2. Ms. Sushina Nath, Former Union Finance Secretary
3. Dr. M. Govind Rao
4. Dr. Sudipto Mundle, Former acting chairman, national statistical commission.

Ajay Narayan Jha, Secretary describes the main points of consideration under 14th commission are as follows:

1. The commission setup under the provision of constitution on sharing of tax proceeds between the union and states: will apply from April 1, 2015.
2. The commission would look into the need for insulating the pricing of public utility services such as drinking water, irrigation, power and public transport from policy fluctuation, through statutory provisions.
3. On basis of recommendation of state finance commission measures are suggest to increase resources of panchayat and Nagar Palika (Municipal Commission) by increasing the capital and savings of state government.

Direct taxes such as:

1. A surcharge of 10 % on individuals whose taxable income exceeds 1 crore per annum, this will apply to individuals, Hindu Undivided families, firms and entities with similar tax status.
2. Surcharge was also increased from 5% to 10% on domestic companies whose taxable income exceeds 10 crore per year. In the case of foreign companies who pay higher rate of corporate tax, the surcharge was increased from 2% to 5%.
3. All other cases such as dividend distribution tax or tax on distributed income, the existing surcharge of 5% was then increased to 10%. The additional surcharge in all the above cases is to remain enforced for only one year, i.e., the financial year 2013-14.
4. Some benefit was given to the first-home buyer in the payment of interest on loans taken from financial and banking institution.
5. The rate of the tax on the payment of royalty and fees for technical services to non-residents was raised from 10% to 25%.
6. The following reduction were announced in the rates of securities transaction tax (STT):

Equity features:

- ❖ From 0.17 to 0.01 per cent MF/ETF redemptions at fund counts.
- ❖ From 0.25 to 0.001 per cent MF/ETF purchase and sale on exchanges.
- ❖ From 0.1 to 0.001 per cent, only on the seller.

7. Commodities Transaction Tax was introduced in a limited way at 0.01% of the price of trade.
8. The Direct Taxes Code is proposed to be introduced not as an amended version of the Income tax Act, 1961 but as a new code based on the first international practices that will be compatible with the needs of a fast developing country.

The recommendations of the Standing Committee on finance have been submitted and the Finance Ministry is examining them.

Indirect Taxes

1. The first announcement made by the Finance Minister in the case of indirect taxes was, there will be no change in the peak rate of basic customs duty of 10% for non-agricultural products, no changes in the normal rate of excise duty of 12% and the normal rate of service tax of 12%.
2. In the case of excise duty route for readymade garment industry which is in the throes of crises was announced in addition to the GEN VAT route available at present.

Similarly, excise duty was exempted in the case of handmade carpets and textile floor covering of jute or coir. Relief was increased by 18% similar increases were proposed for cigars, chariots and cigarillos. Excise duty on SUVs raised from 22% to 30%, on marble from ₹ 30 per square meter to ₹ 60 per square meter, on mobile phone priced at more than ₹ 2,000 by 6%.

Goods and Services Tax

The Finance Minister had mentioned the Goods and Services Tax (GST) in the budget speech for 2007-08 and had hoped that it would be brought into effect from 1.4.2010. This could not happen. The Empowered Committee of State Finance Ministers, led the Union Finance Minister to believe, as he announced in his budget speech of 2013-14, that the overwhelming majority of states are agreed that these are needed for a constitutional amendment. He was hopeful that this consensus would be taken forward in the next few months and brings to this Lok Sabha a draft bill on the constitutional amendment and draft bill on GST. He announced the first decisive step by announcing the setting apart in the Central Budget 2013-14 a sum of ₹ 9,000 crore.

8.8 DEFICIT FINANCING IN DEVELOPED COUNTRIES

In developed countries, the total revenue receipts include tax and non-tax revenue and exclude all borrowings. That means deficit financing in developed countries refers to the financing of expenditure, through borrowings, whether internal or external and whether from the central bank, commercial banks, non-banking institutions or from individuals and corporations.

Deficit financing is an extraordinary fiscal device of development finance in modern times. In developed countries J.M. Keynes, popularized this concept, with a view to fight and control depression which is often accompanied by unemployment.

Prof. J.M. Keynes through the instrument of pump-priming, advocate deficit financing to finance public works projects in developed countries during the nineteen thirties depression period.

Increased public expenditure, financed through deficit financing was considered as an effective fiscal tool to mitigate the evils of unemployment and deficiency in private spending and investment in developed economies is made possible through the effect of multiplier on employment and income.

8.9 FINANCIAL RELATION BETWEEN CENTRAL AND STATE CENTRAL SOURCES OF REVENUE

Taxes within union jurisdiction are enumerated in List I, of the Seventh Schedule as under:

1. Taxes on income other than agricultural income (item 82).
2. Duties of customs including export duties (item 83).

3. Duties of excise on tobacco and other goods manufactured or produced in India except:
 - (a) Alcoholic liquors for human consumption.
 - (b) Opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance included in paragraph (b) of inventory (item 84).
4. Corporation tax (item 85).
5. Taxes on capital value of assets, exclusive of agricultural land, on individuals and companies, taxes on capital of companies (item 85).
6. Estate duty in respect of property other than agricultural land (item 87).
7. Terminal taxes on goods or passengers, carried by railway, sea or air, taxes on railway fares and freights (item 88).
8. Taxes other than stamp duties on transactions in stock exchange and future markets (item 90).
9. Rates of stamp duty in respect of bills of exchange, cheque, promissory notes, bills of lading, letter of credit, policies of insurance, transfer of shares, debenture, proxies and receipts (item 91).
10. Taxes on sale or purchase of newspapers and on advertisements published therein (item 97).
11. Taxes on the sale and purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce (item 92A).

Check Your Progress

Fill in the blanks:

1. According to _____, "Budget is a financial plan of government for a definite period".
2. The burden of _____ can be shifted to another person.
3. _____ consists of capital receipts and capital expenditure.
4. _____ = Total Public Expenditure — Total Public Revenue.

8.10 LET US SUM UP

- Planning process of assessing revenue and expenditure is termed as Budget.
- The term budget is derived from the French word "Budgette" which means a "leather bags" or a "wallet".
- The important problems in India, are the problem of poverty, unemployment, income inequalities, illiteracy, etc.
- The tax revenue provides major share of revenue receipts to the central government of India.
- Tax revenue comprises of the income received from different taxes and other duties imposed by the government. It is the major source of public revenue.
- Gifts and grants are received by the government when there are natural calamities like earthquake, floods, famines, etc.
- Capital budget consists of capital receipts and capital expenditure.

- When the total estimated expenditure exceeds the aggregate estimated receipts during a year, the gap between the two is to be filled by the term known as "deficit financing".

8.11 UNIT END ACTIVITY

Critically examine why Indian budget is always made budget of deficit.

8.12 KEYWORDS

Budget: Income illegally obtained or not declared for tax purposes.

Expenditure: Cash paid or to be paid for the purchase of an item or for a service performed.

Federal Receipts: Funds received from the federal government to support state programs or projects. The legislature appropriates federal funds along with other state funds.

Indirect Costs: Overhead expenditures which cannot be directly charged to the program providing services.

Office of Management and Budget: The division within the office of the Governor responsible for preparing the Governor's budget.

8.13 QUESTIONS FOR DISCUSSION

1. Describe the concept of budget.
2. Explain the objectives of budget.
3. Discuss revenue budget.
4. Deficit financing = Total public expenditure – Total public revenue. Discuss.
5. Why is deficit budget important in advanced countries? Highlight all important points.
6. Why is deficit budget important in developing countries? Highlight all important points.
7. Discuss the latest financial commission.

Check Your Progress: Model Answer

1. Tayler
2. Indirect tax
3. Capital budget
4. Deficit financing

8.14 REFERENCES & SUGGESTED READING

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UNIT- 9

FINANCE COMMISSION

CONTENTS

- 9.0 Aims and Objectives
- 9.1 Introduction
- 9.2 Constitution of Finance Commission
- 9.3 Key Role of Finance Commission
- 9.4 Recommendation of Latest Finance Commission
 - 9.4.1 14th Finance Commission
- 9.5 Let Us Sum Up
- 9.6 Unit End Activity
- 9.7 Keywords
- 9.8 Questions for Discussion
- 9.9 References & Suggested Readings

9.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Discuss the constitution of finance commission
- Explain the key role of finance commission

9.1 INTRODUCTION

The Finance Commission is a quasi-judicial body. Finance Commission, provided under article 280 of the Constitution of India, is a quasi-judicial body which is constituted by the President of India every fifth year or at such an earlier time as he considers necessary. The Constitution of India envisages the Finance Commission as the "Balancing Wheel of Fiscal Federalism" in India. Finance Commission consists of a chairman and four other members (they are eligible for reappointment), to be appointed by the President. The Parliament enacted the Finance Commission Act in 1951, specifying the qualifications of the Chairman and the members of the Commission. Finance Commission of India was formulated with the purpose of allocation of 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. The Commission was structured according to the world standards. The objective of forming the Finance Commission was to allocate resources of the revenue between the Union and the State Governments in India adequately.

9.2 CONSTITUTION OF FINANCE COMMISSION

The Finance Commission of India was established on 22nd November, 1951. It was established by the president of India under Article 280 of the Indian Constitution. It was formed to describe the financial relations between the centre and the state.

The Finance Commission has been provided for the Indian constitution as part of the scheme of division of financial resources between the two different sets of governments. Finance Commission also serves as constitutional body for the purpose of allocation of certain resources of income between the Union and the State Governments.

The Finance Commission shall comprise of one chairman and four other members. The chairman of the fourteenth Finance Commission is Dr. Y.V. Reddy. The other members of the commission are Professor Abhijit Sen, Dr. M. Govinda Rao, Ms. Sushama Nath and Dr. Sudipto Mundle. The secretary of the commission is Mr. Ajay Narayan Jha.

The Indian constitution empowers the Parliament for laying down the qualifications, disqualifications and the mode of appointment of members of the commission.

Therefore, the first Finance Commission (Miscellaneous Provisions) Act, was passed in 1951 which was amended in 1955. This Act lays down the qualification and disqualification of the chairman and members of the Finance Commission.

Qualifications of the Finance Commission: The chairman shall be appointed from among persons of public eminence and the four members should be:

- Qualified to become the judges of the High Court, or
- Have special knowledge of finances and accounts of the Government, or
- Have wide experience in financial administrative or economic affairs.

The President must see that prior appointment of any member that he does not have any financial or other interests that will prejudice his functions as a member of the finance commission.

Disqualifications of the Finance Commission: A person is disqualified to become a member of the finance commission if:

- The person is mentally unsound, or
- The person is an undischarged insolvent, or
- The person has been convicted and found guilty of immoral offence, or
- The person has such interests (including financial interest) that may be detrimental for the effective functioning of the commission.

The act also provides that the commission shall determine its own procedure and it shall have the control of a civil court. It may summon any person or authority to furnish any such information as may be essential for its own work.

9.3 KEY ROLE OF FINANCE COMMISSION

1. The key role of Finance Commission in India is to act as an instrument to divide proceeds of divisible taxes between the states and the Union government or in cases of taxes that are collected by the centre but the proceeds of which are allocated between the states, to determine the principles of such allocation.

2. The Finance Commission of India also determines the principles of governing the grants in aids of the revenues of states out of the consolidated fund of India. It is an important function of the Indian Finance Commission. The commission has the responsibility of considering any matter referred to the commission by the President in the interest of sound finance.
3. The President under Article 280 lays the recommendations of the finance commission before each House of the Parliament with an explanatory note as to the action to be taken on the recommendations.
4. The Finance Commission distributes of proceeds of Income-tax between the union and the states. But taxes on the payments of the central government are attributable only to the union territories.

Under Article 280 (C), the President may refer any matter to the Finance Commission in the interest of "sound finance". Till now the President of India has asked the commission to make recommendations on the principles governing distribution of the net proceeds of estate duty in respect of property tax on railway fare and excise duties on sugar and tobacco. The President also sought recommendations on the rates of interest, and terms of repayment of loans to the various states by the Government of India.

Finance Commissions mainly focuses on the financial relations between the State government and the Central government. These recommendations progressively increase share of the state governments in the proceeds of the income tax. They also increased gradually the amount of grants-in-aids to be given to the states. As a result the states now enjoy considerable degree of financial autonomy so necessary for the proper functioning of the federation.

It can be said that the Finance Commission as an autonomous body has served a wonderful purpose. In as complex a society as India is, it acted as an agency to bring about co-ordination and cooperation for smooth working of a federal system.

Under the 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 finance.

The recommendations of the commission together with an explanatory 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 evaluate the increase in the consolidated fund of a state to affix the resources of the municipalities in the state.

The commission has been given passable powers to perform its function and 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 relevant. It can function as a civil court in discharging its duties.

The key functions of financial commission are discussed ahead. The commission makes recommendations to the president with regards to:

1. The distribution of the proceeds of taxes between the union and the states.
2. The principles which should govern the grants-in-aid to be given to the states.

3. Any other matter referred to the commission by the President in the interest of sound finance.
4. The recommendations of the commission are generally accepted by the Union Government as well as by the parliament.

9.4 RECOMMENDATION OF LATEST FINANCE COMMISSION

Let us discuss about all the finance commission of India. So far 14 finance commissions have been appointed. List of finance commissions are as follows:

Table 9.1: List of Finance Commission

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

9.4.1 14th Finance Commission

Major recommendations of 14th finance commission headed by Prof. Y V Reddy are:

1. The 14th finance commission is of the view that tax devolution should be the primary route for transfer of resources to the states.
2. In understanding the states' needs, it has ignored the plan and non-plan distinctions.
3. According to the commission, the increased devolution of the divisible pool of taxes is a "compositional shift in transfers" – from grants to tax devolution.
4. In recommending a horizontal distribution, it has used broad parameters – population (1971), changes in population since then, income distance, forest cover and area, among others.
5. It has recommended distribution of grants to states for local bodies using 2011 population data with weight of 90 % and area with weight of 10%.
6. Grants to states are divided into two:
 - (i) Grant to duly constituted gram panchayats.
 - (ii) Grant to duly constituted municipal bodies.
7. And, it has divided grants into two parts; a basic grant, and a performance one for gram panchayats and municipal bodies.

8. The ratio of basic to performance grant is 90:10 for panchayats; and 80:20 for municipalities.
9. The total grant recommended is ₹ 2,87,436 crore for a five-year period. Out of which, the grant to panchayats is ₹ 2,00,292 crore and, the reminder goes to municipalities.
10. The commission has significantly departed from previous commission vis-à-vis recommendation of the principles governing grants-in-aid to the states by the centre.
11. It has chosen to take the entire revenue expenditure for this purpose. Hence, it has decided to take into account a state's entire revenue expenditure needs without making a distinction between plan and non-plan expenditure.
12. The commission is of the view that sharing pattern in respect to various centrally-sponsored schemes need to change. It wants the states to share a greater fiscal responsibility for the implementation of such schemes.

Check Your Progress

Fill in the blanks:

1. Major recommendations of 14th finance commission headed by _____.
2. The Finance Commission of India was established on _____.
3. It was established by the president of India under _____ of the Indian constitution.
4. The commission has all the powers of the Civil Court as per the _____.

9.5 LET US SUM UP

- The Finance Commission of India was established on 22nd November, 1951.
- Financial Commission was formed to describe the financial relations between the centre and the state.
- The Indian constitution empowers the Parliament for laying down the qualifications, disqualifications and the mode of appointment of members of the commission.
- The President must see that prior appointment of any member that he does not have any financial or other interests that will prejudice his functions as a member of the finance commission.
- Under Article 280 (C), the President may refer any matter to the Finance Commission in the interest of "sound finance".
- Under the 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 Commission has been given passable powers to perform its function and within its area of activity. It has all the powers of the Civil Court as per the code of Civil Procedure, 1908.

9.6 UNIT END ACTIVITY

Examine what kind of work a finance commission has to do.

9.7 KEYWORDS

Commission: An instruction, command, or role given to a person or group, a group of people entrusted by a government or other official body.

Insolvent: Person or firm whose liabilities exceed the value of owned assets.

Devolution: Devolution is the statutory delegation of powers from the central government of a sovereign state to govern at a subnational level, such as a regional or local level.

Civil Court: Civil court is a government institution that settles disputes between two or more entities, typically in the same courthouse that also tries criminal cases.

9.8 QUESTIONS FOR DISCUSSION

1. Discuss about the constitution of financial commission.
2. Highlight the key role of finance commission.

Check Your Progress: Model Answer

1. Dr. Y. V. Reddy
2. 22nd November, 1951
3. Article 280
4. Code of Civil Procedure, 1908

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BLOCK IV

UNIT- 10

THE LATEST BUDGET

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10.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Discuss the challenges faced in budget 2017-18
- Define demonetisation
- Explain the merits and demerits of demonetisation

10.1 INTRODUCTION

The modern democracies have the legislatures playing an important role in the managing of public finances. The taxes that are collected and the revenues that are generated by the government through several means are to be used for the development and welfare of the society. The emergence of the Welfare State made it important that the government money is being judiciously used to better the living conditions of society in general and the marginalized sections in particular. The government expenditure is funded by a common pool of tax payer's money and the policies that are formed with this money are further used to fund projects. The catch here lies in the fact that the people who actually are paying for these policies are the larger group while the people who benefit from these policies might be a much smaller group, which translates that one might not be enjoying the benefits for which one is paying money. Such scenario leads to an excessive spending of public money on policies which are not beneficial to the society as a whole. Such situations are prevalent in democracies which are multi-lingual, multi-ethnic and divided on the basis of regions, religions and other factors.

10.2 CENTRAL GOVT. LATEST BUDGET

In the last two and half year's administration has moved from discretionary, favouritism based to system and transparency based system. Inflation was brought under control and CPI-based inflation declined from 6% in July 2016 to 3.4% in December, 2016.

Economy has moved on a high growth path. India's current account deficit declined from about 1% of GDP last year to 0.3% of GDP in the first half of 2016-17. FDI grew 36% in H1 2016-17 over H1 2015-16, despite 5% reduction in global FDI inflows. Foreign exchange reserves have reached 361 billion US Dollars as on 20th January, 2017. War against black money was launched by the government. Government continued on path of fiseal consolidation, without compromising on public investment and the Indian economy has been robust to mild shocks and IMF forecasts as India to be one of the fastest growing major economies in 2017.

Budget 2017 was unique because it changed the age-old tradition of being presented on the last day of February, and for the first time in independent India, the Railway budget was combined with the general budget. However, what was possibly more unique were the circumstances under which it was being presented. Not only the global headwinds of an unprecedented nature, but also the huge uncertainty regarding where the current year will finally end in terms of GDP growth and related tax collections as well as the mid-year GST roll out and its attendant uncertainties, created complexities in estimating tax revenues for the coming year. In the midst of having to balance fiscal prudence, throw in a good measure of populism to blunt the pain of demonetisation and to spur both private and Government investment to get back to double-digit growth in the medium-term was not going to be easy.

However, it is hard to find a major negative or a large missed opportunity in the proposals, and most of Budget 2017 seeks to do just what it promises—TEC India “Transform, Energize and Clean India.”

Demonetisation and its after-effects will continue to remain focused for atleast the first half of 2017, and while there is no doubt that there will be a blip in the GDP graph for 2016-2017, how soon and by how much the economy will bounce back depends on who you ask but with both the IMF and the World Bank forecasting between 7.7% and 7.8% for 2018-19, the next target will be to hit the magical double digit.

Demonetisation has also brought the digital agenda to the fore like never before, and having painstakingly laid down in the speech the low rate of tax compliance in the country. The Government recognises that in order to make quantum leaps in the levels of compliance and overall tax revenues, it is only the digital payment infrastructure and GST that can make it happen. The setting up of a Payments Regulatory Board under the Reserve Bank of India is an interesting move, and coupled with a clear intent to implement the recommendation of the Committee of Chief Ministers on digital transactions (many of which have already been introduced in the tax proposals), the narrative will remain centered around the digital economy in the short to medium term.

The digitization agenda and the curbing of the cash economy will also be supported by the bold statements associated with cleaning up electoral funding and the issuance of electoral bonds.

The statement on doing away with the FIPB underpinned the reforms in the financial sector. Clear statements on the listing of CPSEs as part of the disinvestment policy and launching a new ETF reflect a continuation of policy decisions that are working well. Listing of security receipts by ARCs and the allocation for recapitalisation of banks, along with some related tax measures will help deal with the growing NPAs

On the tax side, the key proposals are mostly in the nature of anti-abuse provisions, and it will be incumbent on the administration to ensure that their implementation does not lead to harassment and targeting of genuine and legitimate transactions. Particularly noteworthy are the provisions relating to withdrawal of the capital gains exemption on sale of equity shares on the stock exchange in certain situations, and unfortunately, this once again has an element of being retrospective in nature. Changes have also been made regarding contribution of assets to a trust and in relation to transfer of shares for lower than the fair value. There have also been several changes aimed at ending litigation and the clarifications on conversion of preference shares to equity, and the taxability of Joint Development Agreements will be hugely welcome.

The area of speedier dispute resolution remains unaddressed, and while there is a proposal for merging the Authorities for Advance Rulings (AAR) under Direct and Indirect tax laws, the need of the hour is to operationalise additional benches and truly make it a forum for seeking clarity and certainty. The introduction of GAAR will accentuate the need for this to happen, and how the vacancies in the benches can be rapidly filled will be a task that the Government needs to get to with some intensity.

There was a widespread expectation that corporate tax rates will be reduced across the board, particularly with the global developments whereby the US tax rates are expected to go down to 15% under the new administration. With a headline rate of 30% and the high rates of Minimum Alternate Tax (MAT) and Dividend Distribution Tax, India could perhaps lag behind on this key score. Moreover, rather than small tweaks to the rates and increased credit carry over for MAT, a bold and decisive across-the-board reduction is what should come next. Several positive measures were

also announced for the real estate sector (especially affordable housing) and there were some rationalisations for start-ups.

The use of enhanced technical tools and data mining and analytics has already been employed on the demonetisation deposits, and it is expected that more of these measures will be adopted. The reduction in the audit timelines in a phased manner to 12 months is testimony to this.

The BEPS-driven reform agenda also continues with the introduction of thin capitalisation rules.

Leaving the indirect tax rates unchanged and amending only a few critical areas that needed attention is symbolic in that it shows the desire and belief of the Government to roll out GST by 1st July, 2017. The scrapping of the age-old R&D cess is also a major step in this direction. With the reach out efforts planned from 1st April, 2017, and with trade and industry having got an additional three months to ready itself, GST seems on course for now.

With some clever balancing on the fiscal side, and a commitment to reduce the deficit to 3% next year, the Government has its task cut out. It needs to rapidly increase the tax base, and revive the sluggish private investment. With some control on the quality of expenditure and the tax realisations from the demonetisation deposits, there should be adequate elbow room for the Government to continue to push forward with its reform agenda.

The world economic growth for 2016, at an estimated 3.1%, is the weakest growth since 2008–09. This is owed largely to the turbulence in the world financial market in the first half of 2016 due to major setbacks such as Brexit, China's slowdown, low oil prices and overall weakness in the economies of Japan, US and Europe. Meanwhile, these setbacks were offset by stronger than expected economic activity during the second half of 2016 in the advanced economies, especially the US, which saw a deceleration in the unemployment rate, and the UK, which had higher than expected domestic demand following Brexit. Assuming that this trend will continue, the world economy is expected to pick up steam in 2017 and grow by 3.4%, this time on the back of previously lackluster advanced economies. This is expected to be supplemented by the projected policy stimulus of the new US administration and its global consequences.

On the other hand, Emerging Market and Developing Economies (EMDEs) are projected to grow by 4.5% in 2017, which is 10 basis points lower than the previous projection. Among these economies, China is expected to show strong growth at 6.5% (as compared to the previous estimate of 6.2%) on account of its policy stimulus measures; however, moderation in the growth prospects is expected among large economies such as India, Brazil and Mexico.

10.2.1 Indian Economy

India has become the sixth largest manufacturing country in the world, rising up from the previous ninth position, and thus retaining its bright spot in the world economic landscape. Post the demonetisation announcement, the pace of remonetisation has picked up, and it is expected that the effects of demonetisation will not spill over into the next financial year.

The IMF expects the Indian economy to grow by 6.6% in 2016-17, which is not only a significant one percentage point lower than the previous estimate, but also brings India back to the status of the second-fastest growing economy, especially as China is expected to outgrow by 6.7%. However, this is cited as the result of short-term disruption caused by the government's move to invalidate high-value currencies,

which dampened the economy's biggest growth drivers – consumption and investment demand. Recognising the strength of Indian economic fundamentals, the IMF expects the impact of demonetisation to fade away gradually, as it pegs the 2017-18 growth at 7.2%, overtaking China again by a good 0.7 percentage points. The World Bank, however, is more optimistic and has projected a GDP growth of 7% in 2016-17, 7.6% in 2017-18 and 7.8% in 2018-19.

Clearly, what makes India resilient to global flurries, to a great extent, is its rock-solid domestic demand, accounting for about 60% of the GDP. This figure is 37% for China, and this has led the Chinese economy's restructuring and rebalancing to rely less on exports and investment and more on consumption demand.

The broad macroeconomic indicators based on latest data are as follows:

Inflation: The retail inflation stayed above the comfort zone of 5% till August 2016, but it started moderating thereafter during the normal monsoon, dropping to a two-year low of 3.4%. The average for the year-to-date (April-December 2016) stood at 4.85%, a tad higher than 4.8% during the same period of the previous year.

Fiscal Deficit: The fiscal deficit as a percentage of GDP was budgeted at 3.5% for 2016-17 in the previous year's budget. This is revised to 3.2% for 2017-18.

Trade Deficit: India's trade deficit narrowed by 25% in the cumulative period of April to December 2016 when it stood at \$76.5 billion, as against \$100.1 billion in the corresponding period of the previous year. This is on the back of a 7.4% decline in imports coupled with a meagre growth of 0.75% in exports during said period. Imports of both oil and non-oil products dropped during this period by 10.76% and 6.42%, respectively, reflecting the subdued gross capital formation.

Currency: The rupee saw a depreciation of 3.3%, as it stood at an average of ₹ 67.21 per US dollar during April 2016 to January 2017 against an average of ₹ 65.01 per US dollar during the same period in the previous year.

Outlook: According to the Central Statistical Organisation's first advance estimates for 2016-17, the GDP is expected to grow by 7.1%, which is slower than 7.6% in the previous year. However, this discounts the impact of demonetisation. Factoring in this impact, we expect the growth to decline by another about 50 basis points.

10.2.2 Challenges Faced in 2017-18

Challenges faced in 2017-18 are discussed below:

- World economy faces considerable uncertainty, in the aftermath of major economic and political developments during the last year.
- The US Federal Reserve's intention to increase policy rates in 2017, may lead to lower capital inflows and higher outflows from the emerging economies.
- Uncertainty around commodity prices especially that of crude oil, has implications for the fiscal situation of emerging economies.
- Signs of retreat from globalisation of goods, services and people, as pressures for protectionism are building up.

10.3 KEY REFORMS

The year 2016 was one of reforms with the major thrust being on elimination of black money, corrective measures for various sectors, transparency and tackling of the issue of bureaucratic deadwood.

- The foreign direct investment (FDI) policy was further liberalised, resulting in almost 90% of proposals falling under the automatic route. This had a positive impact as the FDI inflows increased from \$350 billion to \$361 billion over the previous year. This is particularly creditable as it occurred during a period when global FDI flows declined.
- Additionally, the government announced a slew of schemes for the poor, farmers, senior citizens and small businesses towards the end of 2016. Two housing schemes were announced for the urban and rural poor. For the urban poor, the Prime Minister announced 4% and 3% interest exemption on loans of up to ₹ 9 lakh and ₹ 12 lakh, respectively, and for the rural poor, A 3% interest exemption was announced on loans of up to ₹ 2 lakh. Besides, the interest for 60 days on loans taken by the farmers from cooperative banks will be paid by the government.
- The government launched the Income Declaration Scheme that charges a one-time effective tax rate of 45% on undisclosed income or property to give a chance to domestic taxpayers to declare undisclosed income or assets by 30th September, 2016, and avail immunity from prosecution under the Income-tax Act, Wealth-Tax Act and Benami Transactions (Prohibition) Act. An estimated amount of ₹ 65 thousand crores is said to have been collected under this scheme. Additionally, the Pradhan Mantri Garib Kalyan Yojana (PMGKY), 2016, was notified after the Taxation Laws Second (Amendment) Bill, 2016, came into force on 15th December, 2016. The bill has been introduced to arrest the illegal exchange of ₹ 500 and ₹ 1,000 currency notes and also provides financial support to the PMGKY.
- For micro, small and medium enterprises, the limit of loans that the government guarantees to them was doubled to ₹ 2 crore. In addition, the cash credit limit to these businesses was raised from 20% to 25%. As for senior citizens, a minimum of 8% interest will be paid to them on deposits of up to ₹ 7.5 lakh made for 10 years.
- Several measures were announced by the Department of Industrial Policy and Promotion to bring India in the list of the top 50 countries in the World Bank's "Ease of doing business" index, climbing several rungs up the ladder from the current rank of 130. These measures include the following: loading of the e-Biz portal with services required for starting a business; reduction in the number of days to start a business to four days; use of the Shram Suvidha portal for filing returns and challans; and contributions to EPFO and ESIC.
- The General Anti Avoidance Rule (GAAR) is expected to see the light of the day from 1st April, 2017. GAAR prevents companies from routing transactions through other countries to avoid tax.
- The Direct Tax Dispute Resolution Scheme, 2016, came into force on 1st June, 2016, with the purpose of settling retrospective tax disputes with the government. The scheme waives off interest and penalties if the principal amount involved in retrospective tax cases is paid.
- The Benami Transactions (Prohibition) Act was brought into force on 1st November, 2016, as a measure to curb black money. The act prohibits illegal benami transactions and also makes a provision for up to seven years of imprisonment and penalty. The act also serves as a corrective measure to the real-estate sector and is aimed at making the sector more transparent.
- Another positive step in ensuring transparency and accountability in the real-estate sector was the implementation of the Real Estate (Regulation and Development)

Act, 2016, with effect from 1st May, 2016, which provided a boost to the sector as a whole by attracting more investments and opportunities for FDI.

- In line with the JAM troika (Jan Dhan-Aadhaar-Mobile), the Aadhaar (Targeted Delivery of Financial and other Subsidies, Benefits and Services) Act, 2016, provided for efficient, transparent and targeted delivery of subsidies, benefits and services. On the growth path February 2017 PwC expenditure for which is incurred from the Consolidated Fund of India, to individuals residing in India by assigning unique identity numbers to such individuals.
- The long process of winding up a bankrupt company contributes to overall legal paralysis and locks up assets and intellectual property that could be deployed elsewhere. The Insolvency and Bankruptcy Code, 2016, that governs the liquidation process, insolvency for corporations, and regulation of insolvent professionals would help in alleviating the woes of public sector banks already burdened with bad loans and improving the ease of doing business.
- The enforcement of the Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, which amended four key laws including the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002 and the Recovery of Debts due to Banks and Financial Institutions Act of 1993, is expected to help banks in the case of loan default.
- Schemes such as the Pradhan Mantri Garib Kalyan Yojana (PMGKY) saw higher tax collections as a result of increased disclosure.
- A special scheme for creating employment was launched in the textile sector, and the government now proposes to launch similar scheme for the leather and footwear industries.
- The Union Government has approved the re-designation of the Delhi-Mumbai Industrial Corridor Project Implementation Trust Fund (DMICPTF) as the National Industrial Corridor Development and Implementation Trust (NICDIT). The NICDIT will be the apex body to oversee the integrated development of all industrial corridors across the country. It will implement all five proposed industrial corridors, together covering 15 states.

10.3.1 Transformational Reforms in Last Year

Let us discuss the points of transformational reforms in last year:

- Passage of the Constitution Amendment Bill for GST and the progress for its introduction.
- Demonetisation of high denomination bank notes.
- Enactment of the Insolvency and Bankruptcy Code; amendment to the RBI Act for inflation targeting; enactment of the Aadhar bill for disbursement of financial subsidies and benefits.

10.4 THREE MAJOR REFORMS - BUDGET 2017-18

Budget 2017-18 contains three major reforms are:

- First, presentation of budget advanced to 1st February to enable the ministries to operationalise all activities from the commencement of the financial year.
- Second, merger of Railways Budget with General Budget to bring Railways to the centre stage of Government's Fiscal Policy.

- Third, removal of plan and non-plan classification of expenditure to facilitate a holistic view of allocations for sectors and ministries.

10.4.1 Fiscal Deficit

The revised estimate of fiscal deficit in 2016-17 is 3.2% of the GDP, down from a budgeted 3.5%. It is expected to stay at 3.2% in FY2018 and then down to 3.0% in the following year, in accordance with the recommended 3.0% fiscal deficit for the next three years by the newly constituted FRBM committee. The FRBM committee recommends a sustainable debt target with a debt-to-GDP ratio of 60% per cent by 2023 and the fiscal deficit to come down to 3.0%.

The gradual decline in fiscal deficit assures prudent fiscal consolidation without sacrificing public expenditure, while private sector investment is expected to be sluggish. The focus now will be on revenue and capital expenditure as the new budget does away with the plan and non-plan expenditure.

The total expenditure in Budget 2017-18 has been placed at ₹ 21.47 lakh crores. With the abolition of plan and non-plan classification of expenditure, the focus is now on revenue and capital expenditures, said the Union Minister of Finance and Corporate Affairs while presenting the General Budget 2017-18 in Parliament today.

He said that considering the fiscal deficit roadmap for the next three years and the need for higher public expenditure in the context of sluggish private sector investment and slow global growth, the fiscal deficit for 2017-18 has been pegged at 3.2% of the GDP, and he further committed to achieve 3% in the following year, that is, in 2018-19.

10.5 DEMONETISATION

Demonetisation of currency means discontinuity of the particular currency in the country from circulation and replacing it with a new currency. In the current context, it is the elimination of the 500 and 1000 denomination currency notes as a legal tender.

The government stated the objective behind the demonetisation policy are as follows:

- First, it is an attempt to make India corruption free.
- Second, it is done to curb black money,
- Third, to control escalating of price rise,
- Fourth, to stop funds flow to-illegal activity,
- Fifth, to make people accountable for every rupee they possess and pay income tax return and
- Finally, it is an attempt to make a cashless society and create a Digital India.

Other characteristics of demonetisation can be discussed below as:

- Bold and decisive measure to curb tax evasion and parallel economy.
- Government's resolve to eliminate corruption, black money, counterfeit currency and terror funding.
- Drop in economic activity, if any, to be temporary.
- Generate long term benefits including reduced corruption, greater digitisation, and increased flow of financial savings and greater formalisation of the economy.
- Pace of demonetisation has picked up and will soon reach comfortable levels.
- The surplus liquidity in the banking system will lower borrowing costs and increase the access to credit.

- Announcements made by the Honourable Prime Minister on 31st Dec, 2016 focusing on housing for the poor; relief to farmers; credit support to MSMEs; encouragement to digital transactions; assistance to pregnant women and senior citizens; and priority to dalits, tribals, backward classes and women under the Mudra Yojana, address key concerns of our economy.

There is a background to the current decision of demonetisation of 500 and 1000 rupee notes. The government has taken few steps ahead in this direction much before its announcement November 8, 2016.

As a first step the government had urged people to create bank accounts under Jan Dhan Yojana. They were asked to deposit all the money in their Jan Dhan accounts and do their future transaction through banking methods only.

The second step that the government initiated was a tax declaration of the income and had given October 30, 2016 deadline for this purpose. Through this method, the government was able to mop up a huge amount of undeclared income.

However, there were many who still hoarded the black money, and in order to tackle them; the government announced the demonetisation of 500 and 1000 currency notes.

The demonetisation policy is being seen as a financial reform in the country but this decision is fraught with its own merits and demerits.

10.5.1 Merits of Demonetisation

- The demonetisation policy will help India to become corruption-free. Those indulging in taking bribe will refrain from corrupt practices as it will be hard for them to keep their unaccounted cash.
- This move will help the government to track the black money. Those individuals who have unaccounted cash are now required to show income and submit PAN for any valid financial transactions. The government can get income tax return for the income on which tax has not been paid.
- The move will stop funding to the unlawful activities that are thriving due to unaccounted cash flow. Banning high-value currency will rein in criminal activities like terrorism, etc.
- The ban on high value currency will also curb the menace of money laundering. Now such activity can easily be tracked and income tax department can catch such people who are in the business of money laundering.
- This move will stop the circulation of fake currency. Most of the fake currency put in circulation is of the high value notes and the banning of 500 and 1000 notes will eliminate the circulation of fake currency.
- This move has generated interest among those people who had opened Jan Dhan accounts under the Prime Minister's Jan Dhan Yojana. They can now deposit their cash under this scheme and this money can be used for the developmental activity of the country.
- The demonetisation policy will force people to pay income tax returns. Most of the people who have been hiding their income are now forced to come forward to declare their income and pay tax on the same.
- Even though deposits up to ₹ 2.5 lakh will not come under Income tax scrutiny, individuals are required to submit PAN for any deposit of above ₹ 50,000 in cash. This will help the income tax department to track individuals with high denominations currency.
- The ultimate objective is to make India a cashless society. All the monetary transaction has to be through the banking methods and individuals have to be

accountable for each penny they possess. It is a giant step towards the dream of making a digital India. If these are the merits, there are demerits of this policy as well.

10.5.2 Demerits of Demonetisation

The announcement of the demonetisation of the currency has caused huge inconvenience to the people. They are running to the banks to exchange, deposit or withdraw notes. The sudden announcement has made the situation become chaotic. Tempers are running high among the masses as there is a delay in the circulation of new currency.

- It has deeply affected business. Due to the cash crunch, the entire economy has been made to come to a standstill.
- Many poor daily wage workers are left with no jobs and their daily income has stopped because employers are unable to pay their daily wage.
- The government is finding it hard to implement this policy. It has to bear the cost of printing of the new currency notes. It is also finding it difficult to put new currency into circulation. The 2000 rupees note is a burden on the people as no one likes to do transaction with such high value currency. Some critics think it will only help people to use black money more easily in future.
- Further, many people have clandestinely discarded the demonetised currency notes and this is a loss to the country's economy.

10.5.3 Roadmap and Priorities

Agenda for 2017-18 are discussed below:

“Transform, Energise and Clean India” – “TEC India”

TEC India seeks to:

- Transform the quality of governance and quality of life of our people;
- Energize various sections of society, especially the youth and the vulnerable, and enable them to unleash their true potential; and
- Clean the country from the evils of corruption, black money and non-transparent political funding.

Ten distinct themes to foster this broad agenda:

- **Farmers:** committed to double the income in 5 years;
- **Rural population:** providing employment and basic infrastructure;
- **Youth:** energizing them through education, skills and jobs;
- **The poor and the underprivileged:** strengthening the systems of social security, health care and affordable housing;
- **Infrastructure:** for efficiency, productivity and quality of life;
- **Financial sector:** growth and stability by stronger institutions;
- **Digital economy:** for speed, accountability and transparency;
- **Public service:** effective governance and efficient service delivery through people's participation;

- **Prudent fiscal management:** to ensure optimal deployment of resources and preserve fiscal stability;
- **Tax administration:** honouring the honest.

Farmers

- Target for agricultural credit in 2017-18 has been fixed at a record level of ₹ 10 lakh crores.
- Farmers will also benefit from 60 days' interest waiver announced on 31st Dec., 2016.
- To ensure flow of credit to small farmers, Government to support NABARD for computerisation and integration of all 63,000 functional Primary Agriculture Credit Societies with the Core Banking System of District Central Co-operative Banks. This will be done in 3 years at an estimated cost of ₹ 1,900 crore.
- Coverage under Fasal Bima Yojana scheme will be increased from 30% of cropped area in 2016-17 to 40% in 2017-18 and 50% in 2018-19 for which a budget provision of ₹ 9000 crore has been made.
- New mini labs in Krishi Vigyan Kendras (KVKs) and ensure 100% coverage of all 648 KVKs in the country for soil sample testing.
- As announced by the Honourable Prime Minister, the Long Term Irrigation Fund already set up in NABARD to be augmented by 100% to take the total corpus of this Fund to ₹ 40,000 crore.
- Dedicated Micro Irrigation Fund in NABARD to achieve 'per drop more crop' with an initial corpus of ₹ 5,000 crore.
- Coverage of National Agricultural Market (e-NAM) to be expanded from 250 markets to 585 APMCs. Assistance up to ₹ 75 lakh will be provided to every e-NAM.
- A model law on contract farming to be prepared and circulated among the states for adoption.
- Dairy Processing and Infrastructure Development Fund to be set up in NABARD with a corpus of ₹ 2000 crore and will be increased to ₹ 8000 crore over 3 years.

Rural Population

- Over ₹ 3 lakh crores spent in rural areas every year, for rural poor from central budget, state budgets, bank linkage for self-help groups, etc.
- Aim to bring one crore households out of poverty and to make 50,000 Gram Panchayats poverty free by 2019, the 150th birth anniversary of Gandhiji.
- Against target of 5 lakh farm ponds under MGNREGA, 10 lakh farm ponds would be completed by March, 2017. During 2017-18, another 5 lakh farm ponds will be taken up.
- Women participation in MGNREGA has increased to 55% from less than 48%.
- MGNREGA allocation to be the highest ever at ₹ 48,000 crores in 2017-18.
- Pace of construction of PMGSY roads accelerated to 133 km roads per day in 2016-17, against an average of 73 km during 2011-2014.
- Government has taken up the task of connecting habitations with more than 100 persons in left wing extremism affected Blocks under PMGSY. All such

habitations are expected to be covered by 2019 and the allocation for PMGSY, including the state's share of ₹ 27,000 crores in 2017-18.

- Allocation for Pradhan Mantri Awaas Yojana – Gramin increased from ₹15,000 crore in BE 2016-17 to ₹ 23,000 crore in 2017-18 with a target to complete 1 crore houses by 2019 for the houseless and those living in kutchha houses.
- Well on our way to achieving 100% village electrification by 1st May, 2018.
- Allocation for Prime Minister's Employment Generation Program and Credit Support Schemes has been increased three fold.
- Sanitation coverage in rural India has gone up from 42% in Oct. 2014 to about 60%. Open defecation free villages are now being given priority for piped water supply.
- As part of a sub mission of the National Rural Drinking Water Programme (NRDWP), it is proposed to provide safe drinking water to over 28,000 arsenic and fluoride affected habitations in the next four years.
- For imparting new skills to people in rural areas, mason training will be provided to 5 lakh persons by 2022.
- A programme of "human resource reforms for results" will be launched during 2017-18 for human resources development in Panchayati Raj Institutions.
- Total allocation for Rural, Agriculture and Allied sectors is ₹ 187223 crores.

Youth

To introduce a system of measuring annual learning outcomes in our schools:

- Innovation fund for secondary education proposed to encourage local innovation for ensuring universal access, gender parity and quality improvement to be introduced in 3479 educationally backward districts.
- Good quality higher education institutions to have greater administrative and academic autonomy.
- SWAYAM platform, leveraging IT, to be launched with atleast 350 online courses. This would enable students to virtually attend courses taught by the best faculty.
- National Testing Agency to be set-up as an autonomous and self-sustained premier testing organisation to conduct all entrance examinations for higher education institutions.
- Pradhan Mantri Kaushal Kendras to be extended to more than 600 districts across the country. 100 India International Skills Centres will be established across the country.
- Skill Acquisition and Knowledge Awareness for Livelihood Promotion programme (SANKALP) to be launched at a cost of ₹ 4000 crores. SANKALP will provide market relevant training to 3.5 crore youth.
- Next phase of Skill Strengthening for Industrial Value Enhancement (STRIVE) will also be launched in 2017-18 at a cost of ₹ 2,200 crores.
- A scheme for creating employment in the leather and footwear industries along the lines in textiles sector to be launched.
- Incredible India 2.0 campaign will be launched across the world to promote tourism and employment.

The Poor and the Underprivileged

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The Latest Budget

- Mahila Shakti Kendra will be set up with an allocation of ₹ 500 crores in 14 lakh ICDS Anganwadi Centres. This will provide one stop convergent support services for empowering rural women with opportunities for skill development, employment, digital literacy, health and nutrition.
- Under Maternity Benefit Scheme ₹ 6,000 each will be transferred directly to the bank accounts of pregnant women who undergo institutional delivery and vaccinate their children.
- Affordable housing to be given infrastructure status.
- National Housing Bank will refinance individual housing loans of about ₹ 20,000 crore in 2017-18.
- Government has prepared an action plan to eliminate Kala-Azar and Filariasis by 2017, Leprosy by 2018, Measles by 2020 and Tuberculosis by 2025 is also targeted.
- Action plan has been prepared to reduce IMR from 39 in 2014 to 28 by 2019 and MMR from 167 in 2011-13 to 100 by 2018-2020.
- To create additional 5,000 post graduate seats per annum to ensure adequate availability of specialist doctors to strengthen secondary and tertiary levels of health care.
- Two new All India Institutes of Medical Sciences to be set up in Jharkhand and Gujarat.
- To foster a conducive labour environment, legislative reforms will be undertaken to simplify, rationalise and amalgamate the existing labour laws into 4 codes on (i) wages; (ii) industrial relations; (iii) social security and welfare; and (iv) safety and working conditions.
- Propose to amend the Drugs and Cosmetics Rules to ensure availability of drugs at reasonable prices and promote use of generic medicines.
- The allocation for Scheduled Castes has been increased by 35% compared to BE 2016-17. The allocation for Scheduled Tribes has been increased to ₹ 31,920 crore and for Minority Affairs to ₹ 4,195 crore.
- For senior citizens, Aadhar based Smart Cards containing their health details will be introduced.

Infrastructure

- For transportation sector as a whole, including rail, roads, shipping, provision of ₹ 2,41,387 crores has been made in 2017-18.
- For 2017-18, the total capital and development expenditure of Railways has been pegged at ₹ 1,31,000 crores. This includes ₹ 55,000 crores provided by the Government.
- For passenger safety, a Rashtriya Rail Sanraksha Kosh will be created with a corpus of ₹ 1 lakh crores over a period of 5 years.
- Unmanned level crossings on Broad Gauge lines will be eliminated by 2020.
- In the next 3 years, the throughput is proposed to be enhanced by 10%. This will be done through modernisation and upgradation of identified corridors.
- Railway lines of 3,500 kms will be commissioned in 2017-18. During 2017-18, at least 25 stations are expected to be awarded for station redevelopment.

- 500 stations will be made differently abled friendly by providing lifts and escalators.
- It is proposed to feed about 7,000 stations with solar power in the medium term.
- SMS based Clean My Coach Service has been started.
- 'Coach Mitra', a single window interface, to register all coach related complaints and requirements to be launched.
- By 2019, all coaches of Indian Railways will be fitted with bio toilets. Tariffs of Railways would be fixed, taking into consideration costs, quality of service and competition from other forms of transport.
- A new Metro Rail Policy will be announced with focus on innovative models of implementation and financing, as well as standardisation and indigenisation of hardware and software.
- A new Metro Rail Act will be enacted by rationalising the existing laws. This will facilitate greater private participation and investment in construction and operation.
- In the road sector, budget allocation for highways increased from ₹ 57,976 crore in BE 2016-17 to ₹ 64,900 crore in 2017-18.
- 2,000 kms of coastal connectivity roads have been identified for construction and development.
- Total length of roads, including those under PMGSY, built from 2014-15 till the current year is about 1,40,000 kms which is significantly higher than previous three years.
- Select airports in Tier 2 cities will be taken up for operation and maintenance in the PPP mode.
- By the end of 2017-18, high speed broadband connectivity on optical fibre will be available in more than 1,50,000 gram panchayats, under BharatNet. A DigiGaon initiative will be launched to provide tele-medicine, education and skills through digital technology.
- Proposed to set up strategic crude oil reserves at 2 more locations, namely, Chandikhole in Odisha and Bikaner in Rajasthan. This will take our strategic reserve capacity to 15.33 MMT.
- Second phase of Solar Park development to be taken up for additional 20,000 MW capacity.
- For creating an eco-system to make India a global hub for electronics manufacturing a provision of ₹ 745 crore in 2017-18 in incentive schemes like M-SIPS and EDF.
- A new and restructured Central scheme with a focus on export infrastructure, namely, Trade Infrastructure for Export Scheme (TTES) will be launched in 2017-18.

Financial Sector

- Foreign Investment Promotion Board to be abolished in 2017-18 and further liberalisation of FDI policy is under consideration.
- An expert committee will be constituted to study and promote creation of an operational and legal framework to integrate spot market and derivatives market in the agricultural sector, for commodities trading, e-NAM to be an integral part of the framework.

- Bill relating to curtail the menace of illicit deposit schemes will be introduced. A bill relating to resolution of financial firms will be introduced in the current Budget Session of Parliament. This will contribute to stability and resilience of our financial system.
- A mechanism to streamline institutional arrangements for resolution of disputes in infrastructure related construction contracts, PPP and public utility contracts will be introduced as an amendment to the Arbitration and Conciliation Act 1996.
- A Computer Emergency Response Team for our financial sector (CERT-Fin) will be established.
- Government will put in place a revised mechanism and procedure to ensure time bound listing of identified CPSEs on stock exchanges. The shares of Railway PSEs like IRCTC, IRFC and IRCON will be listed in stock exchanges.
- Propose to create an integrated public sector 'oil major' which will be able to match the performance of international and domestic private sector oil and gas companies.
- A new ETF with diversified CPSE stocks and other government holdings will be launched in 2017-18.
- In line with the 'Indradhanush' roadmap, ₹ 10,000 crore for recapitalisation of Banks provided in 2017-18.
- Lending target under Pradhan Mantri Mudra Yojana to be set at ₹ 2.44 lakh crore. Priority will be given to Dalits, Tribals, Backward Classes and Women.

Digital Economy

- 125 lakh people have adopted the BHIM app so far. The government will launch two new schemes to promote the usage of BHIM; these are, referral bonus scheme for individuals and a cashback scheme for merchants.
- Aadhar pay, a merchant version of Aadhar enabled payment system, will be launched shortly.
- A mission will be set up with a target of 2,500 crore digital transactions for 2017-18 through UPI, USSD, Aadhar Pay, IMPS and debit cards.
- A proposal to mandate all government receipts through digital means, beyond a prescribed limit, is under consideration.
- Banks have targeted to introduce additional 10 lakh new POS terminals by March, 2017. They will be encouraged to introduce 20 lakh Aadhar based POS by September, 2017.
- Proposed to create a Payments Regulatory Board in the Reserve Bank of India by replacing the existing Board for Regulation and Supervision of Payment and Settlement Systems.

Public Service

- The government e-market place which is now functional for procurement of goods and services.
- To utilise the Head Post Offices as front offices for rendering passport services.
- A centralized Defense Travel System has been developed through which travel tickets can be booked online by our soldiers and officers.
- Web based interactive Pension Disbursement System for Defence Pensioners will be established.

- To rationalise the number of tribunals and merge tribunals wherever appropriate.
- Commemorate both Champaran and Khordha revolts appropriately.

Prudent Fiscal Management

- Stepped up allocation for capital expenditure by 25.4% over the previous year.
- Total resources being transferred to the States and the Union Territories with Legislatures is ₹ 4.11 lakh crore, against ₹ 3.60 lakh crore in BE 2016-17.
- For the first time, a consolidated outcome budget, covering all ministries and departments, is being laid along with the other budget documents.
- FRBM committee has recommended 3% fiscal deficit for the next three years, keeping in mind the sustainable debt target and need for public investment, fiscal deficit for 2017-18 is targeted at 3.2% of GDP and government remains committed to achieve 3% in the following year.
- Net market borrowing of Government restricted to ₹ 3.48 lakh crore after buyback in 2017-18, much lower than ₹ 4.25 lakh crores of the previous year.
- Revenue Deficit of 2.3% in BE 2016-17 stands reduced to 2.1% in the Revised Estimates. The Revenue Deficit for next year is pegged at 1.9%, against 2% mandated by the FRBM Act.

Promoting Affordable Housing and Real Estate Sector

- Between 8th November and 30th December 2016, deposits between 2 lakh Rupees and 80 lakh Rupees were made in about 1.09 crore accounts with an average deposit size of ₹ 5.03 lakh. Deposits of more than 80 lakh were made in 1.48 lakh accounts with average deposit size of ₹ 3.31 crores.
- Under the scheme for profit-linked income tax deduction for promotion of affordable housing, carpet area instead of built up area of 30 and 60 Sq.mtr. will be counted.
- The 30 Sq.mtr. limit will apply only in case of municipal limits of 4 metropolitan cities while for the rest of the country including in the peripheral areas of metros, limit of 60 Sq.mtr. will apply.
- For builders for whom constructed buildings are stock-in-trade, tax on notional rental income will only apply after one year of the end of the year in which completion certificate is received.
- Reduction in the holding period for computing long term capital gains from transfer of immovable property from 3 years to 2 years. Also, the base year for indexation is proposed to be shifted from 1.4.1981 to 1.4.2001 for all classes of assets including immovable property.
- For Joint Development Agreement signed for development of property, the liability to pay capital gain tax will arise in the year the project is completed.
- Exemption from capital gain tax for persons holding land on 2.6.2014, the date on which the State of Andhra Pradesh was reorganised, and whose land is being pooled for creation of capital city of Andhra Pradesh under the government scheme.

10.6 MEASURES FOR STIMULATING GROWTH

- Concessional withholding rate of 5% charged on interest earned by foreign entities in external commercial borrowings or in bonds and government securities

is extended to 30.6.2020. This benefit is also extended to Rupee Denominated (Masala) Bonds.

- For the purpose of carry forward of losses in respect of start-ups, the condition of continuous holding of 51% of voting rights has been relaxed subject to the condition that the holding of the original promoter/promoters continues. Also the profit (linked deduction) exemption available to the start-ups for 3 years out of 5 years is changed to 3 years out of 7 years.
- MAT credit is allowed to be carried forward up to a period of 15 years instead of 10 years at present.
- In order to make MSME companies more viable, income tax for companies with annual turnover upto ₹ 50 crore is reduced to 25%.
- Allowable provision for Non-Performing Asset of Banks increased from 7.5% to 8.5%. Interest taxable on actual receipt instead of accrual basis in respect of NPA accounts of all non-scheduled cooperative banks also to be treated at par with scheduled banks.
- Basic customs duty on LNG reduced from 5% to 2.5%.

10.7 PROMOTING DIGITAL ECONOMY

- Under scheme of presumptive income for small and medium tax payers whose turnover is upto 2 crore, the present, 8% of their turnover which is counted as presumptive income is reduced to 6% in respect of turnover which is by non-cash means.
- No transaction above ₹ 3 lakh would be permitted in cash subject to certain exceptions.
- Miniaturised POS card reader for m-POS (other than mobile phones or tablet computers), micro ATM standards version 1.5.1, Finger Print Readers/Scanners and Iris Scanners and on their parts and components for manufacture of such devices to be exempt from BCD, excise/CV duty and SAD.

10.7.1 Transparency in Electoral Funding

- Need to cleanse the system of political funding in India.
- Maximum amount of cash donation, a political party can receive, will be ₹ 2000 from one person.
- Political parties will be entitled to receive donations by cheque or digital mode from their donors.
- Amendment to the Reserve Bank of India Act to enable the issuance of electoral bonds in accordance with a scheme that the Government of India would frame in this regard.
- Every political party would have to file its return within the time prescribed in accordance with the provision of the Income-tax Act.
- Existing exemption to the political parties from payment of income-tax would be available only subject to the fulfilment of these conditions.

10.7.2 Ease of Doing Business

- Scope of domestic transfer pricing restricted to only if one of the entities involved in related party transaction enjoys specified profit-linked deduction.

- Threshold limit for audit of business entities who opt for presumptive income scheme increased from ₹ 1 crore to ₹ 2 crore. Similarly, the threshold for maintenance of books for individuals and HUF increased from turnover of 10 lakh to 25 lakh or income from 1.2 lakh to 2.5 lakh.
- Foreign Portfolio Investor (FPI) Category I and II exempted from indirect transfer provision. Indirect transfer provision shall not apply in case of redemption of shares or interests outside India as a result of or arising out of redemption or sale of investment in India which is chargeable to tax in India.
- Commission payable to individual insurance agents exempt from the requirement of TDS subject to their filing a self-declaration that their income is below taxable limit.
- Under scheme for presumptive taxation for professionals with receipt upto ₹ 50 lakhs p.a. advance tax can be paid in one instalment instead of four.
- Time period for revising a tax return is being reduced to 12 months from completion of financial year, at par with the time period for filing of return. Also the time for completion of scrutiny assessments is being compressed further from 21 months to 18 months for Assessment Year 2018-19 and further to 12 months for Assessment Year 2019-20 and thereafter.

10.7.3 Personal Income-Tax

- Existing rate of taxation for individual assesses between income of ₹ 2.5 lakh to 5 lakh reduced to 5% from the present rate of 10%.
- Surcharge of 10% of tax payable on categories of individuals whose annual taxable income is between ₹ 50 lakh and ₹ 1 crore.
- Simple one-page form to be filed as Income Tax Return for the category of individuals having taxable income upto ₹ 5 lakh other than business income.
- Appeal to all citizens of India to contribute to nation building by making a small payment of 5% tax if their income is falling in the lowest slab of 2.5 lakh to 5 lakh.

10.7.4 Goods and Services Tax

- The GST council has finalised its recommendations on almost all the issues based on consensus on the basis of 9 meetings held.
- Preparation of IT system for GST is also on schedule.
- The extensive reach-out efforts to trade and industry for GST will start from 1st April, 2017 to make them aware of the new taxation system.
- RAPID (Revenue, Accountability, Probity, Information and Digitisation)
- Maximise efforts for e-assessment in the coming year.
- Enforcing greater accountability of officers of Tax Department for specific act of commission and omission.

Viewpoint

- GDP growth is expected to exceed the 7% mark in Financial Year 2018 after suffering from the transient negative impact of demonetisation in Financial Year 2017. On the contrary, through greater tax compliance, increased digitalisation and investments in capital formation, demonetisation is expected to leave a positive impact on the economy. Besides, in order to mitigate the adverse impact

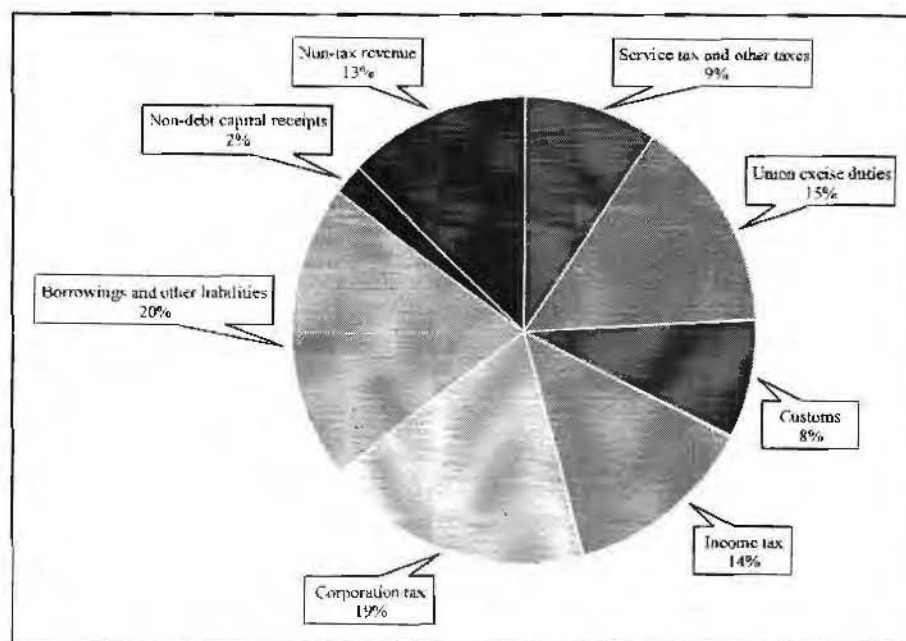
of demonetisation, several pro-poor and pro-rural initiatives have been taken in the budget to spur demand, contributing towards economic growth.

- Demonetisation also led to an increase in bank deposits. Flushed with cash, the banks are expected to cut lending rates. Real-estate prices are also expected to remain low.
- The Goods and Services Tax (GST) Bill is expected to be implemented by 1st July, 2017, and it is likely to lead to urging growth, competitiveness, indirect tax simplification and greater transparency. Apart from widening of the tax net, GST will also contribute significantly to the GDP. However, although making projections and targets for GST revenue in its first year of implementation would be difficult, we believe that GST will help boost GDP figures, and the estimated impact on the GDP may vary between 1% to 2%.
- While a fiscal deficit of 3.5% of the GDP was achieved in 2016-17, the expected fiscal deficit for 2017-18 is 3.2% of the GDP, which seems to be achievable given the expected thrust in tax collection after the implementation of GST and also greater tax compliance after demonetisation.
- The current account deficit has declined to reach about 0.3% of the GDP in the first half of the year 2017, and it is expected to be at around sub-one percent level in FY2018.
- The festering twin balance sheet has been a pressing concern effecting private investment. While the Indradhanush Scheme aims to infuse ₹ 70 thousand crore of capital into public sector banks, how far will this address the issue remains to be seen. The survey proposes to set up a Public Sector Asset Rehabilitation Agency (PARA) as a resolution strategy.
- The retail inflation declined substantially to 3.4% at the end of December, and it is expected to be below the Reserve Bank of India's target of 5%.

Table 10.1: Budget Financials 2016-17

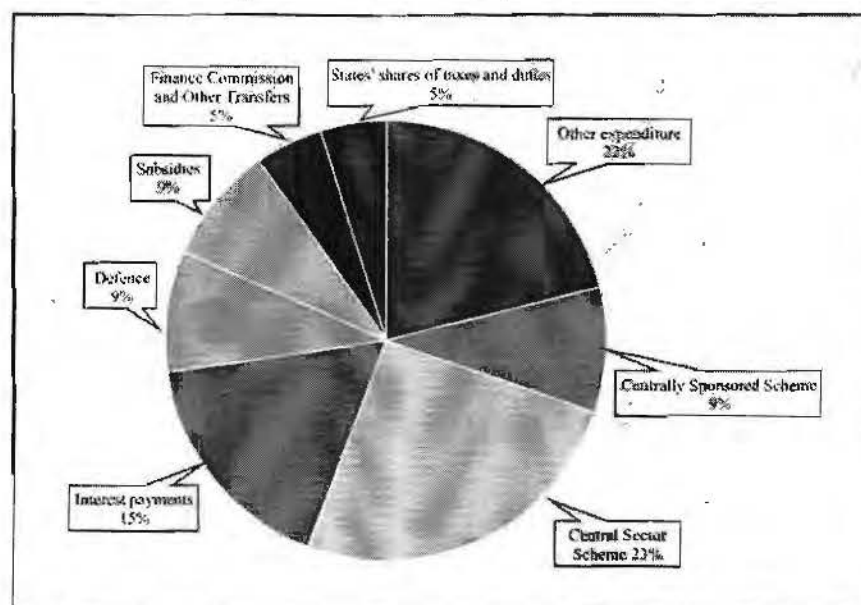
	FY 2015-16 (Actuals) (Billion INR)	FY 2016-17 (Budget) (Billion INR)	FY 2016-17 (Revised) (Billion INR)	FY 2016-17 (Budget) (Billion INR)
Revenue Receipts	11950.25	13770.2	14235.62	15157.71
Capital Receipts	5957.48	6010.38	5908.45	6309.64
Total Receipts (1 + 2)	17907.73	19780.6	20144.07	21467.35
Scheme Expenditure	7251.14	8019.66	8698.47	9450.78
Expenditure on Other than Schemes	10656.69	11760.94	11445.6	112016.57
Total Expenditure (4 + 5)	17907.83	1978.6	20144.07	21467.35
Revenue Account	15377.61	1731.37	17345.6	18369.34
Revenue Receipts	11950.25	13770.22	14235.62	15157.71
Revenue Deficit (7-8)	3427.36	3540.15	3109.98	3211.63
As a percentage of GDP	2.5%	2.3%	2.1%	1.9%
Fiscal Deficit (6- (11+ recoveries of loans + loans + other receipts))	5327.91	5339.04	5342.74	5465.32
As a percentage of GDP	3.9%	3.5%	3.2%	3.2%
Primary Deficit (10-interest payments)	911.32	412.34	512.05	234.54
As a percentage of GDP	0.7%	0.3%	0.3%	1.0%

Source: PwC.



Source: PwC

Figure 10.1: Where the Rupee comes from



Source: PwC

Figure 10.2: Where the Rupee Goes to

10.8 MADHYA PRADESH BUDGET ANALYSIS 2017-18

The Madhya Pradesh Finance Minister, Mr. Jayant Malaiya, presented the budget for Madhya Pradesh for the financial year 2017-18 on March 1, 2017.

10.8.1 Budget Highlights

- The Gross State Domestic Product of Madhya Pradesh at current prices for 2017-18 is estimated to be ₹ 7,35,246 crore. This is 13.9% higher than the revised estimate for 2016-17.

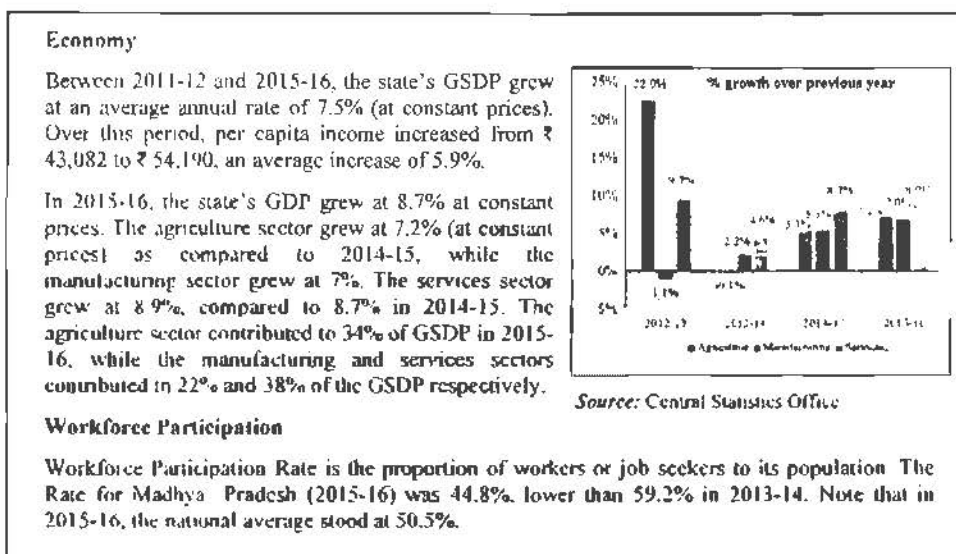
- Total expenditure for 2017-18 is estimated to be ₹ 1,69,954 crore, an 8.5% increase over the revised estimate of 2016-17. The revised estimate for 2016-17 is ₹ 2,083 crore lower than the budgeted target.
- Total receipts (excluding borrowings) for 2017-18 are estimated to be 11.4% higher, at ₹ 1,45,111 crore. In 2016-17, they fell short of the budgeted target by ₹ 4,111 crore.
- Revenue surplus for the next financial year is targeted at ₹ 4,596 crore, or 0.63% of the Gross State Domestic Product (GSDP). Fiscal deficit is targeted at ₹ 25,689 crore (3.49% of GSDP). The Fiscal Responsibility and Budget Management Act, 2005 mandates a fiscal deficit ceiling of 3.5% of GSDP. Primary deficit is targeted at ₹ 14,148 crore (1.9% of GSDP).
- ₹ 33,564 crore has been allocated for the Agriculture Budget in 2017-18. ₹ 400 crore has been allocated to the Rashtriya Krishi Vikas Yojana, and ₹ 305 crore has been allocated to the National Food Security Mission.
- Allocations to the departments of Urban Administration and Development, School Education and Rural Development increased by 22%, 10% and 7% respectively, over the revised estimates of 2016-17. However, allocation to the Department of Energy has decreased by 21%.

10.8.2 Policy Highlights

Irrigation: ₹ 9,850 crore is proposed to be spent as capital expenses for irrigation schemes. In addition, ₹ 140 crore has been allocated for micro-irrigation.

Education: 36,000 new teachers are proposed to be recruited; 520 high schools and 240 higher secondary schools are proposed to be upgraded.

Energy: ₹ 4,622 crore is proposed to be spent on the UDAY scheme in 2017-18. In 2016-17, ₹ 7,568 crore was provided as assistance to power distribution companies under UDAY scheme.



Source: Lok Sabha Unstarred Question No. 682. Answered on February 6, 2017.

Figure 10.3: Madhya Pradesh: State of Economy

10.8.3 Budget Estimates for 2017-18

The total expenditure in 2017-18 is targeted at ₹ 1,69,954 crore. The expenditure in 2016-17 was ₹ 1,56,630 crore, which is 1% (or ₹ 2,083 crore) less than the budgeted target.

The expenditure in 2017-18 is proposed to be met through receipts (other than borrowings) of ₹ 1,45,111 crore and borrowings of ₹ 24,392 crore. Total receipts for 2017-18 (other than borrowings) are expected to be 11% more than the revised estimate of 2016-17.

Table 10.2: Budget 2017-18 – Key Figure (₹ in crore)

Items	2015-16 Account	2016-17 Budgeted	2016-17 Revised	% change from RE to BE of 2016-17	2017-18 Budgeted	% change from RE 2016-17 to BE 2017-18
Total Expenditure	1,19,766	1,58,713	1,56,630	-1.3%	1,69,954	8.5%
A. Borrowings (net)	15,125	24,175	25,635	6.0%	24,392	-4.9%
B. Receipts (except borrowings)	1,05,451	1,34,419	1,30,308	-3.1%	1,45,111	11.4%
Total Receipts (A+B)	1,20,576	1,58,594	1,55,944	-1.7%	1,69,503	8.7%
Revenue Deficit (-)/Surplus (+)	5,740	3,510	1,535		4,596	
As% of state GDP	1.02%	0.49%	0.24%		0.63%	
Fiscal Deficit (-)/Surplus (+)	-14,065	-24,914	-29,899		-25,689	
As% of state GDP	-2.49%	-3.49%	-4.63%		-3.49%	
Primary Deficit (-)/Surplus (+)	-5,974	-14,680	-19,962		-14,148	
As% of state GDP	-1.06%	-2.06%	-3.09%		-1.92%	

Note: BE is Budget Estimate; RE is Revised Estimate; Borrowings are net of receipts. GSDP for 2017-18 is taken from Budget at a glance, as ₹ 7,35,246 crore, at current prices.

Source: State Budget Documents; PRS.

10.8.4 Expenditure in 2017-18

Government expenditures can be divided into (a) revenue expenditure, such as payment of salaries, and (b) capital outlay, which affects the assets and liabilities of the state.

Total revenue expenditure for 2017-18 is proposed to be ₹ 1,34,519 crore, which is an increase of 8% over revised estimates of 2016-17. Total capital outlay is proposed to increase by 10.3% to ₹ 35,435 crore from the revised estimates of 2016-17. This includes creation of assets, repayment of loans, etc.

Table 10.3: Expenditure Budget 2017-18 (₹ in crore)

Items	2015-16 Account	2016-17 Budgeted	2016-17 Revised	2017-18 Budgeted	% change from RE 2016-17 to BE 2017-18
Revenue Expenditure	99,771	1,22,585	1,24,516	1,34,519	8.0%
Capital Outlay	19,995	36,128	32,114	35,435	10.3%
Total Expenditure	1,19,766	1,58,713	1,56,630	1,69,954	8.5%
A. Interest Payments	8,091	10,233	9,937	11,541	16.1%
B. Loan repayment	4,860	9,105	4,899	9,546	94.8%
Debt servicing (A+B)	12,951	19,338	14,836	21,087	42.1%

Note: BE is Budget Estimate and RE is Revised Estimate.

Source: State Budget Documents, PRS.

10.8.5 Department Expenditure in 2017-18

The departments listed below account for 42% of the budgeted expenditure of Madhya Pradesh in 2017-18

Table 10.4: Department-wise expenditure for Madhya Pradesh Budget 2017-18 (₹ in crore)

Department	2016-17 Revised	2017-18 Budgeted	% change from RE 2016-17 to BE 2017-18	Budget proposals for 2017-18
School Education	18,044	19,873	9.8%	<ul style="list-style-type: none"> A provision of ₹ 214 crore has been allocated for the construction of school buildings. ₹ 92 crore has been allocated for the purchase of NCERT books. A provision of ₹ 48 crore has been made for the establishment, management and security of girls' hostels. ₹ 703 crore for ST students, ₹ 740 crore for SC students and ₹ 850 crore for OBC students as scholarships/stipends.
Energy	21,183	16,802	-20.7%	<ul style="list-style-type: none"> This allocation includes ₹ 4,622 crore under the UDAY scheme. A scheme of ₹ 4,200 crore is proposed to convert temporary connections into permanent connections.
Rural Development	13,480	14,388	6.7%	<ul style="list-style-type: none"> ₹ 2,000 crore has been made to the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS). ₹ 2,850 crore has been allocated to the Pradhan Mantri Gram Sadak Yojana (PMGSY). ₹ 1,127 crore has been allocated for the provision of basic amenities to Panchayats.
Urban Development and Environment	9,394	11,489	22.3%	<ul style="list-style-type: none"> A provision of ₹ 600 crore has been made for the Swachh Bharat Abhiyan. ₹ 700 crore has been allocated for AMRUT Yojana, and ₹ 700 crore has been allocated for the Smart Cities Mission. Sugar and Satna city are proposed to be included in phase two.
Public Works	7,296	8,576	17.6%	<ul style="list-style-type: none"> ₹ 5,966 crore has been allocated for the construction of roads and bridges.
Expenditure of Departments	69,447	71,127	2.4%	
Total Expenditure	1,56,630	1,69,954	7.1%	
% of total expenditure	44.3%	42%	-3%	
Other Departments	87,183	98,827	11.4%	

Source: Press note of Madhya Pradesh State Budget 2017-18. PRS

Other Announcements

Police force: ₹ 5,850 crore has been allocated to the police force. ₹ 402 crore has been allocated for construction works for police personnel, and ₹ 98 crore has been allocated to purchase new arms and vehicles for the police force.

Skill Development: ₹ 100 crore has been allocated under skill development scheme, for the 'Mukhyamantri Kaushal Samwardhan and Kaushalya Scheme', to train 2.5 lakh youngsters and two lakh women.

Scheduled Castes and Scheduled Tribes: ₹ 25,862 crore has been allocated to the Scheduled Tribe sub-scheme in 2017-18, and ₹ 16,381 crore has been allocated to the Scheduled Castes sub-scheme.

Receipts in 2017-18

The total revenue receipts for 2017-18 are estimated to be ₹ 1,39,116 crore. The tax to GSDP ratio is targeted at 6.8% in 2017-18, same as 6.8% in the revised estimates of 2016-17.

Tax revenue is expected to increase by 14% (or ₹ 6,160 crore) in 2017-18 over the revised estimates of 2016-17. Non-tax revenue is estimated to increase by 12.2% (or ₹ 1,270 crore) in 2017-18.

Grants from the centre are set to increase by ₹ 593 crore to ₹ 26,034 crore in 2017-18. The other component of transfers from the centre, which is the state's share in central taxes, is estimated to increase by ₹ 5,042 crore, to ₹ 51,106 crore in 2017-18.

Table 10.5: Break up of State Government Receipts (₹ in crore)

Items	2015-16 Account	2016-17 Budgeted	2016-17 Revised	2017-18 Budgeted	% change from RE 2016-17 to BE 2017-18
State's Own Tax	40,240	46,500	44,135	50,295	14.0%
State's Own Non-tax	8,569	11,482	10,410	11,680	12.2%
State's share in Central Taxes	38,371	43,676	46,064	51,106	11%
Grants-in-aid from Centre	18,330	24,437	25,441	26,034	2.3%
Total Revenue Receipts	1,05,511	1,26,095	1,26,051	1,39,116	10.4%
Recovery of Loans and Advances, and other capital receipts*	191	7,704	680	5,150	657.0%
Borrowings (net)	15,125	24,175	25,635	24,392	-4.9%
Public Account Receipts	-251	620	3,577	846	-76.4%
Total Capital Receipts	15,066	32,499	29,893	30,387	1.7%
Total Receipts	1,20,576	1,58,594	1,55,944	1,69,503	8.7%

Note: * includes recovery of debt of electricity distribution companies, this is being converted to equity and an equivalent amount is shown as capital expenditure. BE is Budget Estimate and RE is Revised Estimate

Source: State Budget Documents, PRS

Total tax revenue of Madhya Pradesh is estimated to be ₹ 50,295 crore in 2017-18. The composition of the state's tax revenue is shown in Figure 10.4.

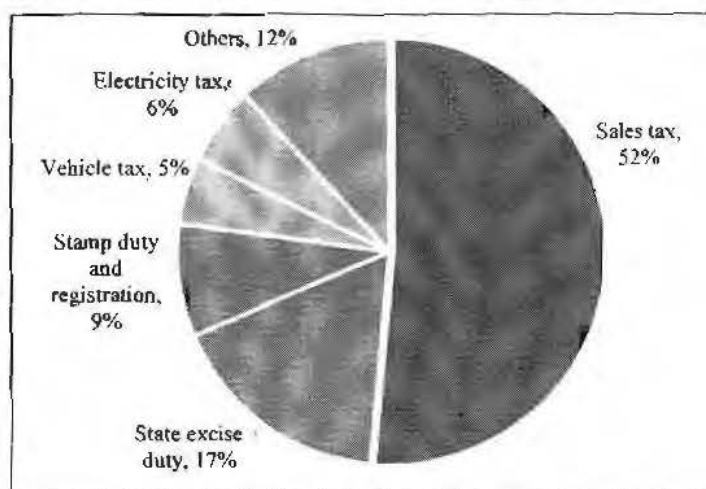


Figure 10.4: Composition of Tax Revenue in 2017-18 (BE)

Decrease in tax revenue collected in 2016-17. In 2016-17, the revised estimate of Madhya Pradesh's tax revenue fell short of the budgeted estimate by ₹ 2,365 crore (5.1%). This is mainly owing to a decrease in state excise duties collected from the licensing fees of domestic and imported liquor stores (₹ 1,300 crore decrease), and revenues from stamp duty and registration charges (₹ 600 crore decrease) and vehicle tax (₹ 300 crore decrease).

Tax Revenue

Among all sources of tax revenue, sales tax is the largest component. Sales tax is levied on the sale of goods in the state is expected to generate ₹ 25,910 crore (52% of tax revenue).

The state is expected to generate ₹ 8,600 crore (17%) through levy of state excise duty on the production of various forms of alcohol.

In addition, revenue will be generated through stamp duties, registration charges on real estate transactions, electricity duties, among others.

Non-tax Revenue

Madhya Pradesh has budgeted to generate ₹ 11,680 crore through non-tax sources.

In 2016-17, the state expected to generate a revenue of ₹ 4,143 crore from education (such as licensing fees); however, the revised estimate is ₹ 1,038 crore lower than the budgeted estimate. In 2017-18, ₹ 3,310 crore is estimated to be generated from education.

₹ 3,700 crore is estimated to be generated from mining in 2017-18, compared to ₹ 3,100 crore as per the revised estimate of 2016-17 (19% increase).

10.8.6 Deficits, Debts and FRBM Targets for 2017-18

The Madhya Pradesh Fiscal Responsibility and Budget Management (FRBM) Act, 2005 provides annual targets to progressively reduce the outstanding debt, revenue deficit and fiscal deficit of the state government.

Revenue deficit: It is the excess of revenue expenditure over revenue receipts. A revenue deficit implies that the recurring receipts of the government are unable to cover its recurring expenditures. The revenue surplus is expected at ₹ 4,596 crore (or 0.63% of state GDP) in 2017-18. This is better than the target of eliminating revenue deficit prescribed by the state's FRBM Act and by the 14th Finance Commission.

Fiscal deficit: It is the excess of total expenditure over total receipts. This gap is filled by borrowings by the government, and leads to an increase in total liabilities of the government. In 2016-17, fiscal deficit increased from the budgeted target of ₹ 24,914 crore to ₹ 29,899 crore (4.63% of GSDP). This increase includes ₹ 7,361 crore taken up as market borrowings on account of the UDAY scheme. The revised estimate in 2016-17 exceeded the 3.0% limit under the 14th Finance Commission, and the 3.5% limit under the FRBM Act. In 2017-18, fiscal deficit is estimated at ₹ 25,689 crore (3.49% of GSDP).

Outstanding Liabilities: It is the accumulation of borrowings over the years. In 2017-18, the outstanding liabilities are expected at 24.9% of GSDP, an increase over the 24.6% as per revised estimates of 2016-17. They are estimated to further increase to 25.8% in 2018-19, 26.3% in 2019-20, and 26.5% in 2020-21. An increase in liabilities over time indicates that the state would be required to pay more in terms of interest payments as well as principle amount repayments over the coming years.

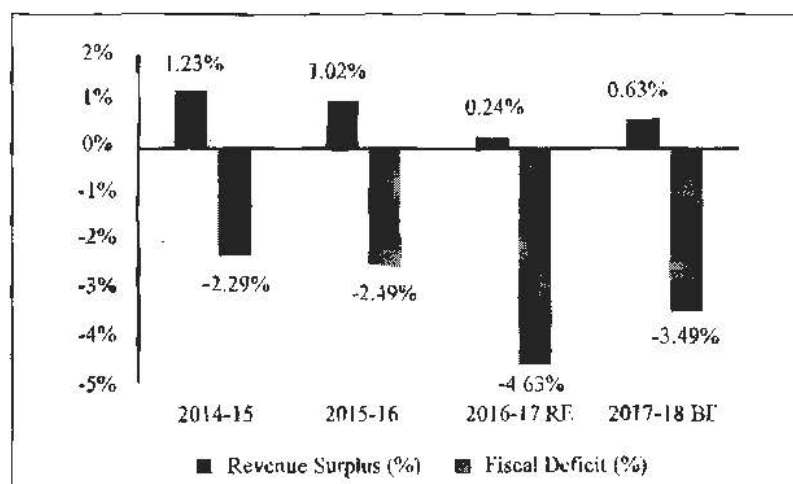
Table 10.6: Budget Targets for Deficits for the State of Madhya Pradesh (% of GSDP)

Year	Revenue Surplus	Fiscal Deficit	Outstanding Liabilities
2015-16	1.02	-2.49	23.32
RE 2016-17	0.24	-4.63	24.63
BE 2017-18	0.63	-3.49	24.94
Target 2018-19	Surplus	-3.49	25.79
Target 2019-20	Surplus	-3.25	26.30
Target 2020-21	Surplus	-3.00	26.51

Note: Figures as percentage of state GDP.

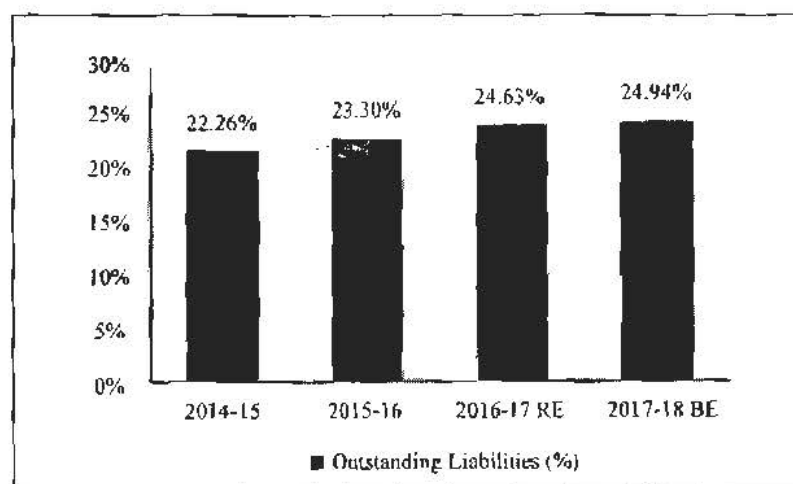
Source: Press Note, Madhya Pradesh State Budget 2017-18; PRS.

Figure 10.5 and 10.6 shows the trend in deficits and outstanding liabilities from 2014-15 to 2017-18.



Source: Madhya Pradesh State Budget Documents; PRS.

Figure 10.5: Deficits (a % of State GDP)



Source: Madhya Pradesh State Budget Documents; PRS.

Figure 10.6: Outstanding Liabilities (as % of GSDP)

Check Your Progress

Fill in the blanks:

1. The fiscal deficit as a percentage of _____ was budgeted at 3.5% for 2016–17 in the previous year's budget.
2. According to the _____ first advance estimates for 2016–17, the GDP is expected to grow by 7.1%, which is slower than 7.6% in the previous year.
3. The _____ was brought into force on 1st November, 2016, as a measure to curb black money.
4. _____ of currency means discontinuity of the particular currency in the country from circulation and replacing it with a new currency.

10.9 LET US SUM UP

- The introduction of GAAR will accentuate the need for this to happen, and how the vacancies in the benches can be rapidly filled will be a task that the Government needs to get to with some intensity.
- The use of enhanced technical tools for data mining and analytics has already been employed on the demonetisation deposits, and it is expected that more of these measures will be adopted.
- Demonetisation has also brought the digital agenda to the fore like never before, and having painstakingly laid down in the speech the low rate of tax compliance in the country.
- The world economic growth for 2016, at an estimated 3.1%, is the weakest growth since 2008–09.
- Assuming that this trend will continue, the world economy is expected to pick up steam in 2017 and grow by 3.4%, this time on the back of previously lackluster advanced economies.
- India has become the sixth largest manufacturing country in the world, rising up from the previous ninth position, and thus retaining its bright spot in the world economic landscape.
- The IMF expects the Indian economy to grow by 6.6% in 2016–17, which is not only a significant one percentage point lower than the previous estimate, but also brings India back to the status of the second-fastest growing economy, especially as China is expected to outgrow by 6.7%.
- The rupee saw a depreciation of 3.3%, as it stood at an average of ₹ 67.21 per US dollar during April 2016 to January 2017 against an average of ₹ 65.03 per US dollar during the same period in the previous year.
- For 2016–17, the GDP is expected to grow by 7.1%, which is slower than 7.6% in the previous year.
- Factoring in this impact, we expect the growth to decline by another about 50 basis points.

10.10 UNIT END ACTIVITY

In what ways do you think this demonetisation initiative will benefit the Indian economy?

10.11 KEYWORDS

Demonetisation: The act of stripping a currency unit of its status as legal tender.

Indian Economy: The world's sixth-largest economy by nominal GDP and the third-largest by purchasing power parity.

Currency Notes: An official currency of the Republic of India.

Black Money: Income illegally obtained or not declared for tax purposes.

10.12 QUESTIONS FOR DISCUSSION

1. Discuss the highlights of demonetisation. Mention the advantages and disadvantages of demonetisation.
2. Discuss the challenges faced in budget 2017-18.
3. Discuss the budget highlights of Madhya Pradesh 2017-18.

Check Your Progress: Model Answer

1. GDP
2. Central Statistical Organisation's
3. Benami Transactions (Prohibition) Act
4. Demonetisation

10.13 REFERENCES & SUGGESTED READINGS

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UNIT- 11

FINANCIAL RELATIONS BETWEEN CENTRAL AND STATE GOVERNMENT

CONTENTS

- 11.0 Aims and Objectives
- 11.1 Introduction
- 11.2 Relations between Central and State Government
- 11.3 Legislative Relations: Articles: A245-A255
- 11.4 Administrative Relations
- 11.5 Financial Relations
- 11.6 New Institutional Mechanisms Set Up
- 11.7 Main Heads of Revenue and Expenditure of Central and State Government
- 11.8 Income Taxes
- 11.9 Consumption Taxes
- 11.10 Property and Related Taxes
- 11.11 Other Taxes
- 11.12 Other Revenue from Own Sources
- 11.13 Let Us Sum Up
- 11.14 Unit End Activity
- 11.15 Keywords
- 11.16 Questions for Discussion
- 11.17 References & Suggested Readings

11.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Explain the financial relations between central and state government
- Describe the main heads of revenue of central and state government
- Discuss the main heads of expenditure of central and state government

11.1 INTRODUCTION

The financial relationship between the centre and the state is provided in the constitution. The constitution gives a detailed scheme of distribution of financial resources between union and states. Like other powers financial powers are also distributed between the two sets of government. The sources of income of the union government are those mentioned in the union list and sum of these sources are income tax other the agricultural income, customs and excise duties. The state government on

the other hand, draws its main income from the sources mentioned in union list while the state legislatures levy tax on items mentioned in state list.

11.2 RELATIONS BETWEEN CENTRAL AND STATE GOVERNMENT

The distribution of powers in countries adopting the federal system of government defines the financial relations between the central and state governments. However, there are some special problems that have to be solved within the federal financial system in determining the basis of division and the amount that should be divided between the centre and the state. The financial relation between the central (union) and the state is provided in the constitution. The constitution gives a detailed scheme of distribution of financial resources between union and states. The India constitution makes a broad distribution between the power to levy a tax and the power to appropriate the proceeds of a tax. Thus, the legislature which levies a tax is not necessarily the authority which retains the proceeds of a tax levied. The constitution grants the union parliament exclusive power to levy taxes on several items. The state legislature enjoys similar power with regard to other specified items. In general the union parliament levies tax on items mentioned in the union list while the state legislatures levy taxes on items mentioned in state list. The Constitution of India, being federal in structure, divides all power (legislative, executive and financial) between the center and the states. However, there is no division of judicial power as the constitution has established an integrated judicial system to enforce both the central laws as well as state law.

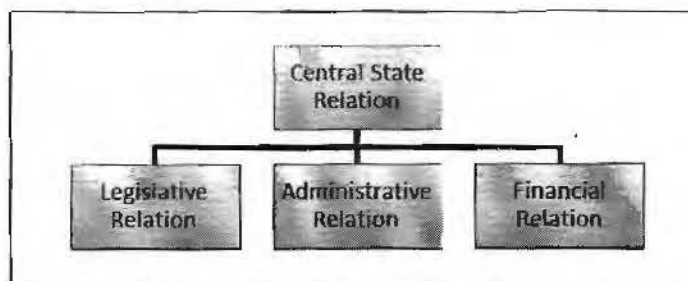


Figure 11.1: Central State Relation Divisions

11.3 LEGISLATIVE RELATIONS: ARTICLES: A245 - A255

Aspects in legislative relations are explained in below sections.

1. *Territorial extent of central and state legislation: Article 245*

Parliament: whole of the country [including sea border] (or) part of the territory + extra territorial legislation 'to make laws applicable to the Indian citizens and their property in any part of the world.

State: within the border of state (except: nexus in object between states).

Exceptions:

- ❖ *President:* regulations relating peace and development in 4 U.T's (A & N, laksh, D & NH, D & D) modify laws in tribal areas.
- ❖ *Governor:* not to apply (or) modify parliamentary laws in scheduled and tribal areas.

2. *Distribution of legislative subjects:*

Article 246, 247, 248, 254, 255:

42nd Amendment: 5 subjects from state to concurrent list

1. Education, 2. Forests, 3. Weights and measures, 4. Protection of wild animals and birds, 5. Administration of justice (all courts) except supreme and high courts.

Power of parliament (A247): To provide for establishment of additional courts for better administration of parliamentary laws (Union list).

Residuary power (A248): Subjects not mentioned in any of the list in Seventh schedule - parliament has the power to make law (includes new tax imposition).

Conflict between state and union laws (A254):

1. In case of conflict between the central law and the state law on a subject enumerated in the concurrent list, the Central law prevails over the state law.
2. Exception: If the state law has been reserved for the consideration of the president and has received his assent, the state law prevails in that state (but parliament can override it by making a law by subsequently making a law on the same matter).

3. **Parliamentary legislation in the state field:**

Articles 249, 250, 251, 252, 253:

National Interest (A249): Rajya Sabha must pass resolution (2/3rd majority) force for 1 year can be renewed any number of time ceases 6 months after resolution ceases (without renewing) state can make law but union law prevails over it.

National emergency (A250): Proclamation of national emergency by President of India inoperative after months (emergency ceases). State can make law but Union law prevails over it.

A251: The law made by parliament in state list (under A249 and A250), whether passed before or after the law made by state legislature of the state, prevails over the law made by state legislature made under the same subject

When states make request (A252): When 2 or more states request parliament to make law in prescribed subject (surrender of power of states to union). Other states can pass resolution to enact the law (same).

Examples: 1. Wild Life Act, 1972 2. Transplantation of Human Organs Act, 1994. 3. Water (Prevention and Control of Pollution) Act, 1974.

International agreements (A253): Parliament has the power to enact laws in state list for implementing international treaties, agreements and conventions (to fulfill international obligations).

Examples: 1. TRIPS 2. Environment related acts 3. Anti-hijacking Act, 1982 4. UN Act, 1947 5. Geneva Convention, 1960.

President's Rule (A356): Parliament empowered to make laws in state list. law made is operative even after the caesura of president's rule. But can be revealed or altered or re-enacted by state legislature.

4. **Centre's control over state legislation:** Governor can reserve certain types of bills passed by state legislature for the consideration of President (President enjoys ABSOLUTE VETO over them). Certain bills can be introduced in state legislature with previous permission from President (matters relating to freedom of trade and commerce).

Financial emergency (A360): President can direct the states to reserve (money, financial) bills for his consideration.

11.4 ADMINISTRATIVE RELATIONS

The administrative relations between the union and the states may well be studied as under: (i) normal and (ii) emergency conditions. The constitution has devised several techniques of control to be exercised over the states by the Union government under normal circumstances. The states shall not interfere with the legislative and executive policies of the Union government.

Articles 256-263

A256: The states are expected to comply with the laws of the parliament and not impede the exercise of the executive powers of the union.

A257: Center can issue direction regarding the construction and maintenance of communications of national or military importance. It can also give instructions to state for protection of railways. Expenses incurred by the states on this account are reimbursed by the union.

A258: The president can entrust officers of the states (with [agreement] or without [legislation under union list] the consent of state) certain functions of the Union, but the extra costs have to be met by the Union.

A258A: Governor of the state may, with [agreement] the consent of the central Government, entrust to that government any of the executive functions of the state (no legislative delegation possible for state).

A260: Govt. of India can (by agreement) make law to territories outside India.

A261: Full faith and credit shall be given throughout the territory of India to public acts, records and judicial proceedings of the union and of every state.

11.5 FINANCIAL RELATIONS

A268 - A293 Part XII of the Constitution. The states are greatly dependent on the center in this sphere as well. Though the constitution provides independent sources of revenue to states (levy taxes on item numbers 45-63 of the state list), these are not adequate. Therefore, the states have to depend on the center for subsidies and contributions.

1. **Distribution of Taxes:** The 80th Amendment of 2000 was enacted to give effect to the recommendations of the 10th Finance Commission. The commission recommended that out of central taxes and duties 29% should go to the states.

Alternative Scheme of Devolution came into effect retrospectively from Apr 1, 1996. The 88th Amendment added new article 268-A dealing with service tax. Also inserted new subject to union list Service Tax (92-C). Levied by center but collected and appropriated by both union and state.

- (a) **Taxes Levied by Center but Collected and Appropriated by State (A 268):** The proceeds of these duties levied within any state do not form part of the consolidated fund of India but are assigned to that state (stamp duties bills of exchange, cheques, promissory notes, policies of insurance, transfer of shares, excise duties containing alcohol and narcotics).
- (b) **Service Tax Levied by the Central Government but Collected and Appropriated by Center and States (A 268-A):** The principles of appropriation are formulated by Parliament.
- (c) **Taxes Levied and Collected by the Center but Assigned to the States (A 269):** Taxes on sale of purchase of goods in course of inter-state trade and

commerce. Taxes on the consignment of goods in the course of inter-state trade or commerce. Principles laid down by Parliament.

- (d) *Taxes Levied and Collected by the Center but Distributed between the Center and the State (A 270)*: All taxes in the union list except: Duties and taxes referred in A268, A268-A, A269, A271 and any cess levied for special purpose. Distribution is prescribed by President of India on the advice of finance commission.
- (e) *Surcharge on Certain Taxes and Duties for the Purpose of Center (A 271)*: Parliament can levy surcharges and duties as mentions in A269 and A270. Goes fully to union.
- (f) *Taxes Levied and Collected and Retained by the States*: Enumcrated in state list - 20 in numbers. Tolls, capitation, fees, sales tax ,land revenue, excise duties, tax on agri income, etc.

2. *Distribution of Non-tax Revenue:*

Center: Posts, telegraph, banking, broadcasting, railways, coinage currency, psu's, escheat and lapse.

State: Irrigation, forests, fisheries, psu's (state), escheat and lapse.

3. (a) *Grants-in-Aid to the States: Statutory Grants: (A 275)*

- ❖ A275 Parliament - financial assistance to state.
- ❖ Charged from consolidated fund of India.
- ❖ Both general and special purpose.
- ❖ On the recommendations of finance commission.

(b) *Discretionary Grants (A 282)*: On the advice of planning commission (to help states fulfill plan targets, influence state and effectuate the national plan).

- ❖ Not necessary to give.
- ❖ Both center and state can make grants for special purpose.
- ❖ Largest part of the grant (C- S) hence P.C gained significance.

Besides the exclusive power of taxation of union and states government there are other three categories of tax:

- (a) Taxes levied by the union government but collected and appropriated by the state. Stamp duty on bills of exchange, excise duties on medicinal and toilet preparation fall in this category.
- (b) Secondly, certain duties are levied and collected by union but the net proceeds of such taxes are distributed among the states. Each state gets that amount of the tax as is collected within its territory. Succession duty, estate duty on property other than agricultural land, taxes on railway fares and advertisements, etc. fall in this category.
- (c) Thirdly, certain taxes are levied and collected by the union but proceeds and distributed between the central and states. Taxes on non-agriculture income (Article 270) and excise duties on it, in the union list except medicinal and toilet preparation, fall in this category. In this scheme of resources distribution, the central government in India, indeed in every federation more money than it needs.

This is because the central government is the government at a distance where the state government are the government at hand to the people. The most productive

sources of revenue in every federation are with the central, while the more expensive head of expenditures are with the state for the state government are directly responsible for the maintenance of law and order and are charged with the responsible of carrying on welfare activity such as education, healthcare, etc. State should be given more financial autonomy than it is given now to make their political autonomy real.

Objectives

1. Appropriate the proceeds of a tax.
2. Equally financial resources should be divided between the union and states government of federation units.
3. Expert efforts by providing assistance of the state government.
4. Trends in combined (central and state) tax revenue.
5. Creating appropriate infrastructure for the development and growth.
6. Projects of national and regional importance.
7. Equity allocation of funds.
8. Additional duties of excise in lieu of sales tax.
9. Grants in lieu of railway passengers fares tax.
10. Setting up electronic and other relation infrastructure in export conclave.
11. Taxation of agriculture's income.
12. Sharing of revenue from certain central taxes.
13. There shall be a state level export promotion committee (SLEPC) is to approve a specific project and service the implementation.
14. Identify the project in advance.
15. In exception cases, no few projects have a gestation period of more than 2 years.

Description

The Indian Constitution provides for the appointment of a Finance Commission every five years to determine the criteria and amount of finance to be divided between the centre and the states. Transfer of resources takes places in the following three ways: share in taxes and duties, grants and loans. However transfers through the Finance Commission contribute only about one-third of the total transfers from the centre to the states. The rest are channeled through the Planning Commission and discretionary grants from the centre to the states. This has led to arbitrary distribution with backward states suffering a disadvantage and has led to an erosion of state autonomy. The revenue raising capacity of the states is also restricted because of the nature of the taxes assigned to them. The scope of the Finance Commission should therefore be enlarged to reduce the interference of the centre in the financial management of the states. In the context of raising revenues the recommendation of the Tenth Finance Commission to increase the role of industry, needs to be seriously considered. India has a federal structure i.e., there are division of power between central and state. These divisions of power can be classified into following types:

1. **Legislation Power:** (Enumerated in article 245 to 255 in part xi of the constitution) The constitution of India very clearly distributed the legislature power between the central and state. Both the sets of government on frame laws independently in their respective spheres.

There are three list of power given in the constitution:

- (i) *Union list* There are 99 subjects. The law on all these subjects can be framed by the federal government i.e., the Parliament of India.
 - (ii) *State list*. There are 62 subjects. These subjects can be legislated upon by the state. subjects mentioned in the lists are like a law and order police, jail, public health, education, agriculture, local-self government, hospital, justice, organisation of judiciary, except Supreme Court and High Court, and unemployment, etc.
 - (iii) *Concurrent list*: There are 55 subjects in the concurrent list. The subjects mentioned in the concurrent like are marriage, divorce, criminal law, newspaper, books and printing press, etc.
2. **Administrative Relation:** This constitution provides for concurrent administrative jurisdiction to the union and states over the subject of the concurrent list. When we analyze these provisions we find that in the sphere of administrative relation also the union enjoy a superior position vis-a-vis state - Appointed governors, protection of central property in India, power to appoint inquiry commission against chief minister, etc.
 3. **Financial Power:** Financial Relation power between the centre and states in India. Article 268 says about duties to be levied by the Union but collected and appropriated by the states. It includes duties on medicinal and toilet preparations, excise on tobacco, corporation tax, customs and import duties, estate duty, terminal taxes on goods and passengers, tax on goods for inter-state trade, etc. Article 269 says about taxes to be levied and collected by the Union but assigned to the states. It includes duties in respect of succession to property other than agricultural land, estate duty in respect of property other than agricultural land, terminal taxes on goods and passengers carried by rail, sea or air taxes on railway fares and freights, taxes on the sale and purchase of newspapers and advertisements given therein, etc. Article 270 says about taxes to be levied and collected by the Union and distributed between the Union and the states. It includes tax on income other than agricultural. Article 272 says about the taxes to be levied and collected by the Union and which may be distributed between the Union and the states. It includes many items given in the Union list as railways and post telegraph telephones, wireless, foreign exchange, foreign loans, customs and export duties etc. Article 275 says about the grant-in-aid given by the Union to the states for implementing its planning programmes as well as for the development of the Scheduled Castes, Scheduled Tribes and other weaker sections of the community. It is provided that the President shall determine special grants to some states like Assam, Bihar, Orissa and West Bengal in lieu of export duty on jute and jute products, etc. India became an independent country from British Columbia rules in August 15, 1947. There are several federation provides us legislature, administration and financial powers to constitution.

11.6 NEW INSTITUTIONAL MECHANISMS SET UP

Central and state federation has many divisions of powers like legislation, administrative and financial powers. These powers are constitution specific article and laws.

These are certain impacts on economy like

Legislation power: Only legislation parliament is empowered to make laws on the subject given in the union list, state list and concurrent list. In this case disagreement the legislature passed by any government parliament shall prevail over the law passed by the legislation government list. The Constitution of India, under Article 263,

envisaged the creation of institutional mechanisms for investigating, discussing and advising on specific issues of concern to the centre and the states. One of the most important of these institutions, the National Development Council (NDC), was set up in 1952 with the Prime Minister as chair and the chief ministers of all the states as members. The NDC was supposed to strengthen and mobilise efforts in support of the five-year plans. Its role was subsequently expanded in 1967, when following the recommendations of the Administrative Reforms Commission, it became a consultative body involved in the preparation of the plans and conducting their mid-term reviews. In 1990, there emerged another important institutional mechanism – the Inter-State Council (ISC), with the prime minister as chair, chief ministers of all the states, six ministers of cabinet rank appointed by the PM as members, and another four ministers of cabinet rank as permanent invitees. While the NDC involved the states in determining planning priorities, the ISC was expected to facilitate a more comprehensive dialogue. In recent times, the ISC has prepared an action plan on good governance and scrutinized the implementation of the Sarkaria commission's recommendations on centre-state relations. Over the years, several other institutions have been set up to enhance co-operation between the centre and the states. While most of these are advisory bodies, in the changing political scene they have been able to play a positive role. Zonal councils were established under the States Reorganization Act of 1956. With the Home Minister as chair and the chief ministers of states in the region as members, these councils meet to resolve differences between the states and with the centre and to promote balanced socio-economic development in the region. There are now five such councils and they offer concerned states an opportunity to deliberate on issues of shared interest; last year, the focus was on rural development, infrastructure, tourism, mining and internal security. Besides the Zonal Councils, there are a number of inter-state consultative bodies that review policies on specific issues: e.g., the National Water Resource Council, the Advisory Council on Food Grains Management and Public Distribution and the Mineral Advisory Board. In addition, institutions have been set up under Article 263 to provide data for policies on specific issues. There are at present separate central councils of health, local self government, family welfare, transport development, sales tax and sales excise duties, and research in traditional medicine. Also, from time to time, the government sets up a finance commission to re-commend the distribution of resources from the centre to the states. There exists, as well, a provision for the creation of tribunals to settle disputes between states on the sharing of river water.

Conclusion

The Indian Constitution recognises that due to changing needs and circumstances it might become necessary to change the criteria and amount of vision between the two levels of government (centre and state) from time to time. Hence it did not lay down any hard and fast rules in this regard. Each government i.e., central and state enjoying powers assigned to them. Equally financial relation between union and state government. There should be a co-ordination of efforts by the both government central and state. The financial relation between both the given in constitution. There should be a complete separation between central and state government powers. And the funds should be transferred from state for a proper functioning of them. Central and state government has equally empowered rules regulation and laws.

11.7 MAIN HEADS OF REVENUE AND EXPENDITURE OF CENTRAL AND STATE GOVERNMENT

In order to carry on their functions, governments must obtain the services of labour and other factor units and (except in a completely socialist economy) acquire goods produced by private business firms.

Public expenditure consists of expenditure by the central government and state governments, local authority (such as municipalities and public corporations), with central government accounting for the major portion of such expenditure. Thus, the central government is required to maintain good roads, bridges, defence activities, canals and harbours, to protect trade, to maintain the coinage and to provide social security, education and religious instruction.

Categories of Government Expenditures

Government expenditures can be classified into several categories:

First, some outlays are for direct government purchases of goods and services. Purchases of goods and services include government expenditures on the services of individuals, such as those in the armed forces, and on goods, such as food, medicine, schools, hospitals, highways and motor cars. Many of the purchases the government makes are for goods and services that are provided for all members of the society - including those who have not paid for them use.

When a good or service is provided for everyone and no one can be excluded from its use, it is termed a public good. Flood control and national defense systems are examples of public goods. When government provides a good or service that could be sold in a private market, such as education or fire protection, it is providing a quasi-public good. The provision of public and quasi-public goods is a widely recognised function of the government.

A second category of government expenditure is transfer payments, which are payments from the government for which nothing is received in return. Social security benefits, compensation to unemployed people, benefits to senior citizens and pensions to retired government employees and freedom fighters are all examples of transfer payment programs.

Interest paid on borrowed funds is another type of government expenditure. At times, government units finance some of their activities through borrowing, and the interest on those borrowed funds is an expense that the government unit must meet.

The government may also incur expenses for running or contributing to the operation of various public enterprises such as toll roads, airports and hospitals, or for providing intergovernmental grants. These grants are given primarily by the central government to state and local governments.

The main heads of central government's revenue expenditure are as follows:

1. ***Defence Services:*** They account for nearly 20% of the total revenue expenditure of the Central Government in India.
2. ***General Services:*** The expenditure on civil administrative services as also on tax collection, police, pensions, etc. come under this heading.
3. ***Social and Development Services:*** Expenditure on social and development services are now the most important head of Central Government's revenue expenditure and fall into the following two broad groups of services:
 - (a) Social and community services which seek to improve and build-up the human capital and social infrastructure of the country; and
 - (b) Economic services which are directed towards the development and strengthening of the economic infrastructure and other economic activities in the country.

4. **Interest Payments:** India has been raising more and more loans — both internal and foreign for the execution of its development plans. So it has to pay interest on borrowed funds.
5. **The Principles of Public Expenditure:** Public expenditure refers to the expenditure incurred by the Central Government. There are different types of such expenditure. The usual distinction is between consumption expenditure and investment expenditure. Another distinction is between revenue expenditure and capital expenditure.

Public expenditure is likely to have beneficial effect on society, i.e., reduction of income inequality, control of business cycles, and achievement of full employment and so on.

It is guided by the following five principles:

1. **Economic Development:** A developing country like India must undertake various projects such as road and bridge construction, irrigation dams, power plants and so on. These constitute infrastructure of the economy or social overhead capital and are of vital importance for accelerating the pace of economic development. Investment in such projects is so high and return from them is so low that private investors do not undertake such projects voluntarily.

The government usually takes a long view of the economy's requirements. So it is imperative that the government undertakes such projects. In India and other developing countries, such development projects are undertaken through the planning system.

2. **Fiscal Policy:** Public expenditure creates jobs and incomes during depression and unemployment. This is why Keynes advocated the policy of increasing public expenditure for creating effective demand and thus helping the economy to achieve full employment.

Contrarily, a cut-back in government expenditure is necessary when the economy faces the problem of inflation. Such variation in public expenditure is necessary to control business cycles or to stabilise the economy. So, variation of public expenditure is a part of the anti-cyclical fiscal policy.

3. **Maximum Social Advantage:** One of the objectives of a modern government is to achieve the social goal of income equality. For this, it is necessary to reduce poverty and inequality. This is why the government transfers incomes or purchasing power from one section of society to another through various tax-subsidy measures. The government collects revenue, mainly, by imposing taxes and selling bonds. The money raised in the process is utilised to pay wages and compensation of government employees and the suppliers of various materials to government departments and public sector undertakings.

Moreover, in a modern mixed economy, payments are made to certain sections of society without requiring them to provide anything to the government in exchange. Such payments are called transfer payments. Examples are unemployment compensation, widow pensions, subsidies (concessions) to the freedom fighters, payments to needy families, the handicapped and so on.

Moreover, outright subsidies are also paid to the small farmers, artisans and other weaker sections of society at the cost of the tax-payers. Such measures are taken to improve the existing pattern of income distribution or for reducing income inequality.

Since the marginal (extra) utility of every rupee to a poor man is much greater than that to a rich man, appropriate use may be made of fiscal (i.e., the

government's combined revenue-expenditure) policy to secure maximum social advantage. However, care has to be taken to ensure that taxes are not too high to have unfavourable effects on incentives to produce, earn and save.

Richard Musgrave has suggested that the government should use public expenditure-cum-tax policy to maximise society's welfare, i.e., to secure the maximum possible net advantage. This implies that the government should make the difference between the benefit of public expenditure and social cost involved in raising the money (to finance the expenditure) as large as possible.

However, in practice, it is very difficult to measure or quantify social welfare.

4. **Economy:** It may also be noted, in this context, 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.

The use or purpose of such expenditure determines the adequacy and effectiveness of such expenditure. Excessive expenditure may cause inflation. Moreover, if the government has to impose taxes at high rates, there will be loss of incentives (mainly due to the present system of progressive taxation). So it is necessary to avoid unnecessary expenditure to the maximum possible extent.

It is very important to drastically curtail or totally avoid wasteful expenditure that causes uneconomic use of resources.

There are two ways of securing such 'economy' in government expenditure:

- (a) The annual budget of the central government must lay down the amount to be spent for particular purposes and the government servants or departments should not be permitted to spend in excess of the budgetary allocations.
 - (b) As soon as the budget grants are spent, the accounts are to be scrutinised by the Public Accounts Committee of the Parliament.
5. **Avoidance of Harmful Effects:** Finally, it is of considerable importance to ensure that government expenditure does not have any injurious effect on production and distribution. It is equally vital to ensure that the government expenditure is solely in the public interest and does not serve any private interest or that of any group of persons.

11.8 INCOME TAXES

- (a) **Personal Income Tax:** Encompasses general levies on income of individuals and unincorporated businesses as well as special levies on income, such as a surtax that governments charge from time to time. The proceeds from the income tax on capital gains of individuals and unincorporated businesses are included here. Some provinces, for example Ontario, levy health premiums based on the incomes of individuals and the revenues raised are not specifically designated to finance their hospitalisation, medical care and drug insurance programs. In these instances the revenues are classified as income taxes. Also, refundable personal income tax credits are in this category. Revenue and expenditures are both grossed up by the full amount of the refundable tax credit. A refundable tax credit could be considered as an expenditure program delivered via the tax system. Consequently such a credit reduces the tax liabilities and the portion of the credits remaining, after the tax liabilities are reduced to zero, is refunded to the tax payer. The Ontario sales tax credit represents a good example. Until 1992/1993, the credit was delivered through the budgetary expenditure appropriation called "Sales tax grants to pensioners". After 1992/1993 the Ontario government decided to switch

to the income tax mechanism by incorporating the Ontario sales tax credit to deliver the assistance to pensioners.

- (b) **Corporation Income Tax:** Includes most federal, provincial and territorial taxes on taxable profits of corporations. It also includes special taxes which are occasionally levied on profits of corporations. Corporate Income Tax (CIT) revenues are shown on a gross basis by including the full amount of the CIT refundable tax credits as revenue. An equivalent amount of the refundable tax credit is also shown as an expenditure.
- (c) **Mining and Logging Taxes:** Accounts for specific taxes which are sometimes levied on profits of natural resource based industries. Also included are refundable tax credits that are grossed up as revenue and expenditures. These taxes were previously classified to natural resource revenue.
- (d) **Taxes on Payments to Non-residents:** Includes the federal tax withheld at source on payments to non-residents (both individuals and corporations) of dividends, interest, rents, royalties, alimony, managerial fees and amounts arising from trusts and estates as well as withholdings on foreign insurance companies.
- (e) **Other Income Taxes:** Includes income taxes which cannot be allocated to any of the other categories.

11.9 CONSUMPTION TAXES

- (a) **General Sales Tax:** The proceeds of the federal Goods and Services Tax (GST) and of provincial retail sales taxes are recorded in this category. In April 1996, the federal government reached an agreement with three provinces to harmonize their provincial retail sales taxes with the federal GST (Newfoundland and Labrador, New Brunswick and Nova Scotia). The federal remittances to these provinces for this Harmonized Sales Taxes (HST) are classified under the general sales tax. However, the onetime compensation of the federal to the provinces for harmonization is included under general purpose transfers. Where amusement taxes and other specific consumption taxes are reported in the source documents with revenue from the general sales taxes, the proceeds from these specific taxes, e.g., the Ontario amusement tax, are excluded from this category and reported under their appropriate group. Hotel and motel taxes, telecommunications and advertising taxes and the Quebec sales tax on insurance premiums are not part of the general sales tax.
- (b) **Alcoholic Beverages Taxes:** Two sub-groups have been devised:
 - (i) **Liquor gallonage taxes:** Encompasses a levy on volume of alcoholic beverages produced.
 - (ii) **Other liquor taxes:** Includes all forms of special levies, excise tax, excise duty or other, imposed on the production and sale of alcoholic beverages. When a general sales tax applies to alcoholic beverages, the related proceeds are classified under the "General sales tax" group. Similarly, customs duties on imported alcoholic beverages are classified under the "Custom duties" heading.
- (c) **Tobacco Tax:** Encompasses special levies such as excise tax, excise duty and provincial specific taxes on the production and sale of tobacco products. General sales taxes and customs duties applicable to tobacco products are included under their respective headings.
- (d) **Amusement Tax:** Includes tax receipts from admissions to theaters, cinemas, recreational, cultural or other entertainment activities. Taxes levied by provincial

and territorial governments on *pari-mutuel* betting at horse race tracks and on casinos' gaming activities are also included here.

- (e) **Gasoline and Motive Fuel Taxes:** Includes the proceeds of specific taxes on gasoline, on aviation and diesel fuel and on propane or other substances when used as motive fuel.
- (f) **Customs Duties:** Applies only to the federal level and take into account the proceeds from levies on commodities imported into Canada such as manufactured goods and food, beverages and tobacco.
- (g) **Remitted Liquor Profits:** Accounts for total remitted profits of government owned liquor boards. Because government owned liquor boards operate as fiscal monopolies their profits are treated as taxes on products (indirect taxes). They were previously classified as investment income.
- (h) **Remitted Gaming Profits:** Accounts for total remitted profits of government owned lottery and other gaming corporations because government owned lottery and other gaming corporations operate as fiscal monopolies, their profits are considered as taxes on products (indirect taxes). Those amounts were previously classified as investment income.
- (i) **Other Consumption Taxes:** Three sub-groups have been devised:
 - (i) **Air transportation tax:** Accounts for the tax levied by the federal government on the price of air transportation purchased either in Canada or outside the country for the use of air transportation facilities in Canada. This tax was discontinued on November 1, 1998.
 - (ii) **Taxes on meals and hotels:** Includes the proceeds from special taxes on meals and hotel accommodations.
 - (iii) **Miscellaneous consumption taxes:** Accounts at the federal level for the yield of special excise levies on jewellery and watches, toilet preparations and an assortment of sundry items and for revenue paid to the federal government from provincial lottery corporations. At the provincial level, it includes the proceeds from special taxes on telecommunications and advertising taxes, computer software, electricity, gas, coal, and fuel oil and on other goods and services as well as the Quebec tax on insurance premiums.

11.10 PROPERTY AND RELATED TAXES

(a) General Property Taxes

- (i) **Real property Taxes:** In Canada, taxation of real property (land and improvements) is shared by provincial and local governments. The amount shown as revenue from real property taxation by provincial governments is exclusive of amounts collected for and passed on. Local governments' real property taxes include the amount collected for and remitted to local governments as well as the amount they collected themselves. Property owned and occupied by most general governments is exempt from property tax. To compensate a government for the loss of revenue due to the exemption, grants in lieu of taxes are paid by the federal and provincial governments to provincial and local governments levying property taxes. See paragraph 11.8 (a) (Miscellaneous general property taxes) ahead.
- (ii) **Lot Levies:** Includes imposts or additional lump sum development charges levied on properties benefiting from local improvements or additional capital facilities. The imposition of these imposts or levies involves an agreement

between the developer and the municipality, whereby, the developer is required to pay a levy to the municipality to finance specific services.

(iii) *Special Assessments*: Are levies made by a municipality on a specific group of properties to pay for a service, such as the provision of a sidewalk, supplied to those properties only.

(iv) *Grants in Lieu of Taxes*: Includes provincial, territorial and local government revenue from higher levels of government as grants in lieu of property taxes, which are isolated for each level of government concerned. Prior to the 1997 historical revision, this item was classified under general purpose transfers from other levels of government.

(v) *Miscellaneous General Property Taxes*: Includes any other general property taxes.

(b) *Capital Taxes*: Includes the taxes levied by federal, provincial and territorial governments on the paid-up capital of corporations.

(c) *Other Property-related Taxes*

(i) *Land transfer tax*: Includes the proceeds of levies on the value of property transferred.

(ii) *Business taxes*: Includes taxes levied on businesses in lieu of, or in addition to, property taxes. Taxes on income or profits of such businesses are classified under income taxes.

(iii) *Wealth transfer taxes*: Includes succession duties and gift taxes. The federal succession duties and gift taxes were eliminated in 1971 and by mid-1985 all provinces had withdrawn from these fields of taxation. However, governments are still collecting duty related to unsettled cases prior to the taxes being abandoned.

(iv) *Miscellaneous property-related taxes*: Any other property related taxes.

11.11 OTHER TAXES

This category now includes different kinds of licences and permits. During the 1997 historical revision of the CSNA, the FMS adopted the following recommendations of the 1993 System of National Accounts (SNA):

1. Payments by a household for specific licenses such as licenses to own or use a vehicle, boat or aircraft, and licenses to hunt, shoot or fish are to be treated as taxes. Payments for all type of other licenses are to be treated as sales of goods and services.
2. Licenses purchased by businesses are to be considered taxes. This "Other taxes" category is divided into four sub-categories:
 - (a) *Payroll Taxes*: This revenue sub-category encompasses tax revenues that are collected from employers as a percentage of their payroll. Payroll taxes collected from employees as a percentage of their salaries and wages are classified as personal income taxes. However, those that are designated for social insurance plans are classified as contributions to social insurance plans. In some provinces, the proceeds from these taxes are used to help finance a number of functions while in others they are specifically assigned to health and/or education or to workers training. As of 1998, four provinces were levying a payroll tax, Newfoundland and Labrador, Quebec, Ontario and Manitoba. Employer contributions to Canada Pension Plan (CPP), Quebec Pension Plan (QPP), Employment Insurance (EI), etc., which to an extent are

also based on salaries and wages paid by the employer are found under the category "Contributions to social insurance plans".

- (b) *Motor Vehicle Licences:* Accounts for the proceeds of registration fees, drivers' licences, permits and other fees relating to the ownership and operation of motor vehicles. These amounts were previously classified to "Privileges, licences, and permits" a category that was eliminated during the 1997 historical revision of the CSNA.
- (c) *Natural Resource Taxes and Licences:* Accounts for the proceeds of taxes levied on private properties and/or production of natural resources. Freehold mineral right tax is classified under this category. This category also includes licence fees paid to be able to conduct activities related to natural resources but excludes activities related to exploration of natural resources.
- (d) *Miscellaneous Taxes*
 - ◆ **Agricultural insurance premiums:** Includes agricultural insurance premiums levied by most provinces. The proceeds are used specifically to finance crop insurance and farm income stabilisation insurance schemes.
 - ◆ **Insurance premium taxes:** Encompasses the proceeds of special taxes levied on gross insurance premium income earned by insurance companies, on life, sickness, accident, fire and other insurance. At the federal level, it includes taxes on certain premiums for insurance contracted outside Canada.
 - ◆ **Hunting and fishing licences, liquor licences and other licences and permits:** Includes licences paid by persons to hunt, shoot or fish; liquor licences to retailers of alcoholic beverages; all business licences other than motor vehicle licences and liquor licences mentioned above. At the local government level, it includes all licences because data limitations prevent any allocation to other revenue categories.
 - ◆ **Business fines and penalties:** Accounts for fines and penalties imposed by tax authorities on overdue taxes by businesses.
 - ◆ **Business donations:** Includes contributions and gifts from businesses.
 - ◆ **Other miscellaneous taxes:** This category brings together the field of taxes not elsewhere specified such as premiums paid by financial corporations to federal and provincial deposit insurance corporations.

Health and drug insurance premiums: Includes premiums levied by some provinces and used specifically to finance their hospitalisation, medical care and drug insurance programs. This category and the category "Contributions to social insurance plans" are described in the next paragraph (11.9) are two new categories resulting from the division of the old category "Health and social insurance levies". To harmonize with the System of National Accounts (SNA), health insurance premiums and contributions to social insurance plans are no longer shown as taxes in the FMS. In the SNA, they are presented in separate series. Some provinces, for example Ontario, levy health premiums based on the incomes of individuals and the revenues raised are not specifically designated to finance their hospitalisation, medical care and drug insurance programs. In these instances the revenues are classified as income taxes.

Contributions to social insurance plans: These contributions are broken down into five types of plans. Contributions to social insurance plans are still reported on a gross basis. However, unlike prior to the 1997 historical revision,

government's own contributions are **not** offset against the corresponding revenue of the plans.

- (a) ***Employment Insurance (EI) Contributions:*** Covers employer and employee contributions toward income maintenance payments under the federal EI program.
- (b) ***Contributions to Workers' Compensation Boards (WCBs):*** Comprises government and non-government employer contributions to provincially-operated workers' compensation schemes. It is worth noting that most general governments act as their own insurers against risks of employee injury in the course of duty and do not contribute to their workers' compensation regular program. However, certain classes of their employees are covered under separate agreement with the boards.
- (c) ***Contributions to Non-autonomous Pension Plans:*** Covers employer and employee contributions to non-autonomous pension plans. A non-autonomous pension plan is a plan that is not backed by invested assets. All employer and employee contributions are deposited in the consolidated fund of the government and when pension payments are made, they come out of the consolidated fund. Although the governments do not maintain separate portfolio investments, they do show separate financial statements for the plans. The federal public service superannuation account is considered a non-autonomous pension plan.
- (d) ***Contributions to Canada and Quebec Pension Plans:*** This category covers contributions to the CPP by employers and employees outside the province of Quebec and the corresponding contributions to the QPP by employers and employees in Quebec.
- (e) ***Other Social Insurance Plan Contributions:*** Comprises contributions to social insurance plans not included elsewhere, such as employee contributions to pension plans that are embedded in the budgetary transactions of governments.

Sales of Goods and Services

As providers of public goods and services, institutions within the government component of the public sector engage in transactions of commercial nature with organisations or individuals in the private sector and with other institutions within the government component. The revenues generated from such transactions are called "Sales of goods and services," are defined as receipts of fees and charges paid in proportion to the cost or distribution of the government goods and services provided to the payer. These revenue sales are broken down into three components, namely:

- (a) ***Sales of goods and services to other government sub-sectors:*** Includes all sales of goods and services by a government sub-sector to another government sub-sector. For example, the sale of educational services by the provinces and school boards to the federal government or revenue received by provinces from municipalities for provincial police services.
- (b) ***Sales of goods and services to own business enterprises:*** Includes all sales of goods and services by a government sub-sector to own business enterprises. For example, fees charged to a provincial hydro-electric corporation by its provincial government for guaranteeing its debt.
- (c) ***Other sales of goods and services:*** Includes all sales of goods and services to persons, businesses, etc. For example, tuition fees charged to students or sale of government statutes to businesses and individuals.

Following is an extensive list of government goods and services sold:

Sales of goods include:

- Water, rents on buildings, equipment, etc., land, used buildings, used machinery and equipment, materials and supplies, livestock and animal products, furniture, publications, documents, forms and other printed material.

Sales of services include:

- court, and probate fees
- tolls for the use of transportation services and facilities
- concessions and franchises
- fees for the use of dockage or wharfage facilities
- admission fees to government museums, cultural and recreational facilities
- administrative and technical fees (search, certification and registration, assaying, testing and other laboratory fees)
- fees for other services rendered by government officials
- tuitions, correspondence course and examination fees
- amounts charged to patients for services (e.g., private or semi-private accommodations in hospitals and residential care facilities, charges to non-residents of a province, special duty nursing, etc.)
- royalties on books, recordings, films, etc.
- debt guarantee fees charged to government business enterprises, etc.
- sales of natural resources goods and services such as camping fees, crude oil marketing fees, research and mineral analysis fees, etc.
- all personal licenses other than licenses to own or use vehicles, boats or aircraft and licenses to hunt, shoot or fish

The sale and privatisation of government business enterprises and government revenue derived from them are not included in this category.

Investment Income: This category is divided into four sub-categories: natural resource royalties, remitted trading profits, interest income and other investment income.

(a) **Natural Resource Royalties:** Includes all royalties on natural resources. Royalties cover leases of land ("Rentals" including rentals and fees, and bonus bids) and royalties paid on extraction. It also includes revenue from the auction of licenses for the electro-magnetic spectrum. Royalties on books, recordings, films, etc. Revenue from the auction of the licenses of the electro-magnetic spectrum prior to 2008-2009 are amortized over the period of the license. Commencing in 2008-2009 the auction of licenses of the electro-magnetic spectrum is considered a sale of assets and the revenue from the auction is included in the year (period) it is received. Prior to the 1997 historical revision the natural resource royalties were included in the "Natural resource revenue" category.

(b) **Remitted Trading Profits:** Returns from own enterprises comprise two categories: remitted profits and dividends. Prior to the 1997 historical revision, remittances of profits of provincial liquor boards and lottery and gaming corporations were classified under this category. They are now included in the consumption taxes category. When a government business enterprise is privatized or when sale of selected facilities of a government business enterprise takes place, the revenue

created may be classified in a variety of ways, depending on the nature of the transaction and the entities involved in the transaction.

If a government sells a government business enterprise by disposing of its participation in the capital stock or in other equity of the enterprise, three cases are possible:

- (i) When the investment is recorded in the government's books, the gain or loss on sale of the securities constitutes a new flow of funds for the government. However, the FMS treats the value of the gain or loss as a balance sheet adjustment and excludes it from the government revenue.
- (ii) On the other hand, if the investment is recorded on the books of a government business enterprise, the gain or loss on the sale of the investments is classified by the FMS as a revenue (investment income) of the enterprise and the remittances of such gain to the government are considered as government revenue and classified as "Remitted trading profits" under the "Investment income" category.
- (iii) In the case where a production plant or a productive division (a physical asset) of a government owned business enterprise is sold, the gain or loss on the sale of the fixed assets represents a new flow of funds for the government business enterprise but the FMS treats this gain or loss as a balance sheet adjustment and excludes it from the enterprise revenue. However, the remittances of such gain to the government (dividends paid the parent government) are considered by the FMS, as government revenue and classified as "Remitted trading profits" under the "Investment income" category.
- (c) **Interest Income:** Includes interest received on loans and investments as well as interest on overdue taxes. Interest received by non-autonomous pension plans on the amount of debt the government is obligated to pay them, are also included here. Based on the FMS practice of showing revenue and expenditures on the gross basis of accounting, interest recovered from crown agencies and other public organisations are included in this category with an equivalent amount shown as interest on public debt on the expenditures side.
- (d) **Other Investment Income:** Consists of other return on investment not classified elsewhere. Prior to the 1997 historical revision, other investment income included gains or losses on foreign exchange transactions and gains or losses on sale of securities. Those gains or losses are no longer included in any revenue category. They are now part of the financing accounts.

11.12 OTHER REVENUE FROM OWN SOURCES

- (a) **Other Fines and Penalties:** Comprises personal paid fines and penalties arising from infractions of laws, by-laws and ordinances, whether civil or criminal.
- (b) **Capital Transfers from Own Sources:** Includes cancellation of a liability by a creditor or similar transactions that reduce net debt of the recipient.
- (c) **Other Donations:** Includes revenue from fund-raising campaigns and other donations in cash or securities from individuals, businesses, etc.
- (d) **Miscellaneous revenue from own sources:** Provides for revenue not elsewhere classified such as indemnities and recoveries under insurance policies, gifts, contributions from private sources, escheat and forfeitures of election deposits, as well as adjustments resulting from consolidation of two or more components of the public sector. The gains of the federal government on bullion are also reported here. Prior to the 1997 historical revision, seignior age were also included in this

category. Seignior age is now excluded from the revenue because it is treated as a liability of the government.

Transfers

General purpose transfers from other government sub-sectors: General purpose transfers are broken down by level of government from which the transfers originate. Transfers from the federal government are compiled as follows:

- (a) **General purpose capital transfers from federal government:** Includes cancellation of a liability by the federal government or similar transactions that increase the saving of the recipients. Transfers of land or buildings are not included here, because no payments or receipts occur.
- (b) **Statutory subsidies:** Includes provincial government revenue received in accordance with the Constitution Act and certain other legislation. The purpose of the program is to provide a source of revenue to the provinces, to compensate provinces for revenues lost on joining Confederation; and to support provincial and territorial governments and legislatures.
- (c) **Shares of federal taxes on preferred share dividends and on income of certain public utilities:** Since 1990/1991 the federal government shares with the provinces and territories the proceeds from the net taxes that it collects with respect to preferred share dividends paid by corporations. The proceeds are included here. The federal-provincial agreement on sharing the proceeds from the income tax on certain public utilities was discontinued in 1995-1996 but transitional payments to the provinces and territories will continue until 1999-2000.
- (d) **Tax revenue guarantees:** Represents money given to the provinces under the terms of the federal-provincial tax revenue guarantee agreement. Under this agreement, the federal government provides a guarantee that the provinces would not suffer a loss of revenue if they adopted their personal income tax acts modeled on the federal tax acts.
- (e) **Equalization:** Identifies transfers received from the federal government to reduce inter-provincial disparities in per capita fiscal capacity and to bring less endowed provinces up to a specified standard.
- (f) **Canada Health and Social Transfer (CHST):** Includes payments received under the CHST program which was introduced in 1996-1997. It replaced transfers to the provinces and territories under the Established Programs Financing (EPF) and Canada Assistance Plan (CAP) arrangements. The amounts for the CHST reported by the FMS, are net of the tax abatement allowed in Quebec since 1965.
- (g) **Canada Social Transfer (CST):** Includes payments under the CST program which was introduced in 2004/2005. The CHST was replaced by the CST and the Canada Health Transfer (CHT) beginning April 1, 2004.
- (h) **Reciprocal taxation:** The reciprocal taxation agreements were nullified by the goods and services tax (GST) legislation, effective January 1, 1991. Provincial governments are not subject to the GST on their purchases, and the federal government is exempt from provincial retail sales taxes. However, eight provinces and the federal government have agreed to pay each other's specific commodity taxes, (e.g., gasoline, tobacco and alcohol taxes) and signed an agreement to waive their right to a refund.
- (i) **Stabilisation:** Represents transfers received from the federal government to protect provincial governments from precipitous declines in revenue.

- (j) **Other general purpose transfers from federal government:** Consists of items not classified elsewhere. This includes:
- (i) Transfers from the federal government to territorial governments under the terms of the Territorial Formula Financing (TFF). This transfer enables territorial governments to provide a range of public services to their residents that are similar to that offered by provincial governments elsewhere. The new agreements that came into effect on April 1, 1999, cover Nunavut, Northwest Territories and Yukon.
 - (ii) The offshore offset payments from the federal government to the provinces under various federal-provincial offshore development agreements.
 - (iii) The one time federal compensation to provinces for their losses of revenue resulting from the harmonization of their retail sales tax with the federal GST.
 - (iv) Any other general purpose transfers from the federal government. At the federal level, it includes amounts equivalent to the proceeds of the 3.0 personal income tax points (granted to Quebec under the Youth Allowances Program). Because the program was abolished, Quebec returns the proceeds of the above tax points to the federal government.

Specific purpose transfers from other government sub-sectors: Specific purpose transfers are broken down by level of government from which the transfers originate. This group covers transfers that must be applied to particular activities such as: federal transfers to provinces for the improvement of certain highways; provincial transfers to municipalities for sewage and refuse disposal; provincial transfers to education and health institutions to help them finance their operations.

Check Your Progress

Fill in the blanks:

1. The _____ which levies a tax is not necessarily the authority which retains the proceeds of a tax levied.
2. The _____ can direct the states to reserve (money, financial) bills for his consideration.
3. The _____ is the government at a distance where the state government are the government at hand to the people.
4. The _____ of the Finance Commission should therefore be enlarged to reduce the interference of the Centre in the financial management of the States.

11.13 LET US SUM UP

- The distribution of powers in countries adopting the federal system of government defines the financial relations between the central and state governments.
- The constitution of India, being federal in structure, divides all power (legislative, executive and financial) between the centre and the states.
- Parliament has the power to enact laws in state list for implementing international treaties, agreements and conventions (to fulfill international obligations).
- Governor can reserve certain types of bills passed by state legislature for the consideration of President.

- The 80th amendment of 2000 was enacted to give effect to the recommendations of the 10th Finance Commission
- The Indian constitution provides for the appointment of a Finance Commission every five years to determine the criteria and amount of finance to be divided between the centre and the states.
- Central and state federation has many divisions of powers like legislation, administrative and financial powers.

11.14 UNIT END ACTIVITY

Critically examine which tax yields the largest revenue to the government of India.

11.15 KEYWORDS

Legislative: To have the power to make law.

Administrative: Pertaining to activities related to an organisations or business' administration and management.

Financial relations: Segment of a public relations department that primarily focuses on public relations concerning financial/investment matters.

Council: A council is a group of people who come together to consult, deliberate or make decisions.

Committee: is a body of one or more persons that is subordinate to a deliberative assembly.

Federalism: Federalism is a system of government in which a written constitution divides power between a central government and regional or sub-divisional governments

State: A state is any politically organised community living under a single system of governments.

11.16 QUESTIONS FOR DISCUSSION

1. Describe the financial relations between central and state government.
2. Discuss the main heads of revenue of central and state government.
3. Explain the main heads of expenditure of central and state government.

Check Your Progress: Model Answer

1. Legislature
2. President
3. Central Government
4. Scope

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