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Public Finance and Policy

SEMESTER-II

ECONOMICS

BLOCK : 2

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BLOCK INTRODUCTION

This is the second and final block of the course Public Finance and Policy and consists of seven units. Unit 8 discusses public receipts. Here, the concepts of revenue and capital receipts have been discussed. Other than that, the concepts of tax buoyancy, elasticity of taxation, tax rate schedules among others have been discussed. In Unit 9, we shall discuss the different principles of taxation. Other important concepts discussed in the unit include tax shifting, incidence of taxation etc. Unit 10 deliberates on public debt. Apart from the concepts like external and internal burdents of public debt, crowding out effect etc. have been disccussed. Unit 11 deals with fiscal policy. Here, the objectives of fiscal policy, its functions, fiscal policy and stabilization function and the cocept of balanced budget multiplier have been discussed. The next unit is on public budget. Here, the meaning of public budget, its different types, components have been discussed along with some other relevant concepts. Unit 13 is on federal finance. Here, the concepts of fiscal federalism, its principles, horizontal and vertical finance and the different instruments of inter-Governmental resource transfer have been discussed. The last unit of the Course, i.e., Unit 14 basically deals with Finance Commission of India. Here, a brief background of the Finance Commission, its role have been discussed. Other than that, grants-in-aid to states, and the terms of reference of the Fifteenth Finance Commission have been discussed.

On ovearll, after going through this course, you will acquire a great deal of concepts in the subject Public Finace and Policy.

While going through a unit, you will notice some along-sode boxes, which have been included to help you know some of the difficult, unseen terms. Some ‘ACTIVITY’ (s) has been included to help you apply your own thoughts. Again, we have included some relevant concepts in ‘LET US KNOW’ along with the text. At the end of sections, you will get ‘CHECK YOUR PROGRESS’ questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with ‘ANSWERS TO CHECK YOUR PROGRESS’ given at the end of each unit.

CONTENTS

Page No.

UNIT 8: Public Receipts 143-160

Revenue and Capital Receipts and their Sources; Concepts in Taxation: Tax Ratio, Buoyancy and Elasticity of Taxation; Tax Credit and Tax Deduction; Neutral and Non-Neutral Taxes; Average and Marginal Tax Rates and Tax Rate Schedules

UNIT 9: Principles of Taxation 161-186

Principles of Taxation: The Benefit Principle, The Lindahl's Model, The Bowen's Model, The Ability-to-Pay Principle, Applications of the Ability to Pay Principle of Taxation; Concepts and Theories of Tax Shifting and Incidence: Tax Shifting, Incidence of Taxation, Interaction between Elasticity and Tax Incidence, Theories of Tax Shifting and Incidence

UNIT 10: Public Debt 187-200

Public Debt: Sources of Public Debt; Burden of Public Debt: Internal Burden of Public Debt, External Burden of Public Debt; Pay -As -You- Use and Pay -As- You -Go Finance: Pay -As -You- Use Finance, Pay -As -You- Go Finance, Crowding Out Effect; Redemption of Public Debt

UNIT 11: Fiscal Policy 201-216

Definition, Meaning and Concept: Classical Concept of Fiscal Policy, Modern Concept of Fiscal Policy; Objectives of Fiscal Policy; Major Functions of Fiscal Policy; The Fiscal Policy and Stabilization Function; Balanced Budget Multiplier

UNIT 12: The Public Budget 217-234

Public Budget: Meaning of Public Budget, Types of Public Budget; Components of the Public Budget; Performance and Zero-Based Budgeting; Concepts of Budget Deficit: Revenue Deficit, Fiscal Deficit, Primary Deficit

UNIT 13: Federal Finance 235-248

Concept of Fiscal Federalism; Principles of Federal Finance; Horizontal & Vertical Finance; Instruments of Inter - Governmental Resource Transfer

UNIT 14: Finance Commissions of India 249-270

A Brief Background; Role of The Finance Commission; Distribution of Funds Between Centre And States: Vertical Distribution, Horizontal Distribution, Grants-in-Aid, Terms of Reference (ToR), Plan and Non-Plan Challenge; Fifteenth Finance Commission: Terms of Reference of Fifteenth Finance Commission

UNIT 8: PUBLIC RECEIPTS

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Revenue and Capital Receipts and their Sources

8.4 Concepts in Taxation: Tax Ratio, Buoyancy and Elasticity of Taxation

8.5 Tax Credit and Tax Deduction

8.6 Neutral and Non-Neutral Taxes

8.7 Average and Marginal Tax Rates and Tax Rate Schedules

8.8 Let Us Sum Up

8.9 Further Reading

8.10 Answers to Check Your Progress

8.11 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the concepts of revenue and capital receipts and their sources
- discuss the concepts in taxation: tax ratio, buoyancy and elasticity of taxation
- explain the concepts of tax credit and tax deduction
- describe neutral and non-neutral taxes
- discuss the concepts of average and marginal tax rates and tax rate schedules.

8.2 INTRODUCTION

This unit basically deliberates on public receipts. Already we have discussed many concepts like public revenue, public expenditure, public debt etc. In this unit, we shall basically discuss the concepts of revenue

and capital receipts and their sources. Again, a few concepts in taxation, viz., tax ratio, buoyancy and elasticity of taxation have been discussed. Apart from that, the concepts of tax credit and tax deduction have also been discussed. After going through this unit, you will also be able to derive the concepts of neutral and non-neutral taxes, as well as the concepts of average and marginal tax rates and tax rate schedules.

8.3 REVENUE AND CAPITAL RECEIPTS AND THEIR SOURCES

Government receipts are broadly categorised as revenue receipts and capital receipts. Let us briefly discuss these concepts. All government receipts which either create liability or reduce assets are termed as capital receipts. On the other hand, receipts which neither create liability nor reduce assets of government are termed as revenue receipts. Now let us discuss these two concepts in some detail.

Revenue Receipts: Revenue receipts include the proceeds of taxes, interest and dividend on government investment, cess and other receipts for services rendered by the government. These are current income receipts of the government from all sources. Government revenue is the means for government expenditure.

Capital Receipts: Government receipts which either (i) create liabilities (e.g. borrowing) or (ii) reduce assets (e.g. disinvestment) are called capital receipts. Thus, when govt. raises funds either by incurring a liability or by disposing off its assets, it is called a capital receipt.

Examples of Capital Receipts which increases liability of the government include: (a) borrowing and (b) raising of funds from Public Provident Fund (PPF) and Small savings deposits. This is because borrowings create liability of returning loans. Similarly, funds raised from PPF and small savings also creates liability, as the Government has to repay these. On the other hand, examples of capital receipts which reduces assets of the Government are (a) disinvestment and (d) recovery of loans. Disinvestment by government means selling a part or whole of its shares

of public sector undertakings (e.g., LIC, IOC, and FCI). Funds raised from disinvestment reduce government assets. Similarly, recovery of loan is also capital receipt as it reduces government assets. Suppose, the Government of Assam had taken a loan of Rs 500 crore from the Union Government in 2018. Now, in 2020, Government of Assam repays 100 crore to the Union Government. As a result, the value of Union Government assets of Rs 500 crore is now reduced to Rs 400 crore because of partial recovery of loan.

Sources of Revenue and Capital Receipts: Based on the above discussion, the sources of revenue and capital receipts can be summarised as follows.

Sources of Revenue Receipts: Taxes, interest and dividend on government investment, cess and other receipts for services rendered by the government.

Sources of Capital Receipts: Borrowing, raising of funds from public deposits, disinvestment, recovery of loans.

Distinction between Revenue and Capital Receipts: The major distinction between revenue receipts and capital receipts is that in the case of revenue receipts, government is under no future obligation to return the amount, i.e., they are non-redeemable. But In case of capital receipts which are borrowings, government is under obligation to return the amount along with Interest. Similarly, revenue receipts does not reduces government assets, but capital receipts in the form of disinvestment or recovery of loans reduces its assets.

Debt-creating and Non-debt creating capital receipts: Capital receipts can broadly be categorised as debt-creating and non-debt creating. Examples of debt creating receipts include: net borrowing by government at home or loans received from foreign governments, borrowing from Reserve Bank of India etc. On the other hand, examples of non-debt creating capital receipts include: recovery of loans, proceeds from sale of public enterprises (i.e., disinvestment), etc. These do not give rise to debt.

8.4 CONCEPTS IN TAXATION: TAX RATIO, BUOYANCY AND ELASTICITY OF TAXATION

The tax to GDP ratio represents the size of a country's total tax collection in relation to its GDP. It is a representation of the size of government tax revenues expressed as a percentage of GDP. The higher the Tax to GDP ratio, the better is the financial position of the country. This ratio represents that the government can finance its expenses. A higher tax to GDP ratio means that the government is able to expand its fiscal activities. It also reduces government dependency on borrowings.

Its importance: A higher tax to GDP ratio means that the economy's fiscal position is strong, as the share of tax revenue increases in line with the increase in the country's GDP. Given the high growth rate, India has struggled to broaden its tax base. The low tax-to-GDP ratio forces the government to restrict its spending on infrastructure and puts pressure on the government to meet its fiscal deficit targets.

India's recent position: India's total tax and GDP growth in the year 2018-19 was lower because of the lower than expected GST collection. The tax-to-GDP proportion has been reduced to 10.9 percent. Over the years, India has struggled to increase its tax-to-GDP ratio, an indication of how well the government manages the country's economic resources. The low tax-to-GDP ratio poses significant challenges for the government in spending money to build the necessary infrastructure and increase investment in the economy.

How the Tax-to-GDP ratio can be improved? The most important way to improve the tax-to-GDP ratio is to ensure that citizens pay taxes. The introduction of direct tax law may contribute to better compliance in this regard. Streamlining GST and moving to a two-rate structure can also help improve compliance and end tax avoidance. Measures to improve tax compliance and expand the tax base will lead to higher tax revenues, but the importance of higher economic growth cannot be ignored.

Tax Buoyancy: Tax buoyancy is an indicator to measure efficiency and responsiveness of revenue mobilization in response to growth in the Gross domestic product or National income. A tax is said to be buoyant if the tax revenues increase more than proportionately in response to a rise in national income or output. For example, a tax is said to be buoyant when revenues increase by more than, say, 1 per cent for a 1 per cent increase in GDP.

There is a close link between government tax revenue and economic growth. The simple fact is that as the economy grows faster, so does government tax revenue. Tax recovery explains the relationship between government tax revenue growth and changes in GDP. That change in GDP is related to the response to tax revenue growth. When a tax floats, its income increases without raising the tax rate.

How does Tax Buoyance work? A simple example in terms of our economy shows the power of this concept. In 2007-08, everything was going well for the economy. GDP growth rate was around 9 percent. The government's tax revenue, especially direct taxes, increased by 45 percent in 2007-08. We can say that the tax buoyancy was five (45/9). The following year, after the impact of the global financial crisis, GDP growth fell to 6%. Growth in tax revenue has also fallen sharply at 18 percent. This means that the tax buoyancy for the year was 3. We can imagine that if GDP growth fell to 4 percent next year, tax revenue growth would have fallen to 8 percent, indicating a tax buoyancy of 2.

Therefore, tax buoyancy reflect the relation between the performance of the economy and the tax revenue realisation of the government. This reflects a high sensitivity of tax revenue realisation in proportion to the growth in GDP. This concept reveals interesting aspects as well as interesting questions.

The first thing is that the government can feel relieved and happy if the economy achieves a high growth rate. It may not borrow much to finance the budget. New plans and programs can be formulated due to strong income growth. In 2007-08, then FM, P Chidambaram could not hide

his happiness in declaring that he was the happiest of all FMs. Of course, the biggest beneficiary of a high GDP growth rate is the government.

Second, tax buoyancy is the highest for the direct taxes. As the economy grows rapidly, extra income may go to rich groups. A part of this, they have to pay the government in the form of taxes. Therefore, if GDP growth is high, for example 9 per cent, direct income tax collection will accelerate. In general, direct taxes are more sensitive to GDP growth.

Tax elasticity: Tax elasticity refers to changes in tax revenue in response to changes in tax rate. For example, how tax revenue changes if the government reduces corporate income tax from 30 per cent to 25 per cent, is shown by tax elasticity.

Symbolically, elasticity of an individual tax, T, is given by the numerical value of:

$$Et = \{DT/T\}/\{DCR/CR\}$$

$$= \{DT/DCR\}\ \{CR/T\}$$

where CR denotes coverage and/or rate of the tax T.

It is quite important to note that when elasticity of a tax is calculated with reference to its base, it (in a way) becomes a case of its buoyancy with the difference that, as in the case of a rate revision, the rise in the base is a consequence of a deliberate government intervention with the intention of raising receipts of tax revenue. It would, therefore be safer if we use phrases like 'rate elasticity of an excise tax' (corresponding to, price elasticity of demand for good X), or 'base elasticity of an excise and so on.

This leads us to an observation that is meaningful and important. If there is no change in its foundation, a change in the rate of tax T will yield an equally proportionate change in its revenue. On the other hand, if a rise in the tax rate also triggers a rise in its foundation, the change in tax revenue would be the cumulative total of the two effects it creates, which can be called the 'rate effect' and the 'base effect.' They were named 'arithmetic effect' and 'income effect' by Laffer.

Laffer is credited with illustrating and elaborating on the accompanying receipts of its taxes in the form of 'tax revenue as a function of tax rates' and graphically depicting this two-headed impact of a rise in the rate of income tax.



CHECK YOUR PROGRESS

Q 1: What is meant by revenue receipts? Answer in about 40 words. .....

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Q 2: What is meant by tax to GDP ratio? Answer in about 40 words.

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8.5 TAX CREDIT AND TAX DEDUCTION

Meaning of Tax Credit: A tax credit is a sum of money that can be subtracted by taxpayers from taxes owed to their government. Tax credits decrease the total amount of tax due, unlike deductions and exemptions, which reduce the amount of taxable profits. The value of a tax credit depends on the extent of the credit; persons or companies in particular areas, classifications or sectors are given certain forms of tax credits.

Types of Tax Credits: Tax Credits are of three basic types, viz., non-refundable, refundable and partially-refundable.

Non-refundable tax credits: Non-refundable tax credits are things legitimately deducted from the expense obligation until the assessment due reaches the specified limit. Any sum more prominent than the duty owed, bringing about a discount for the citizen, isn't paid out—thus, the name "non-refundable." The rest of the aspect of a non-refundable tax break that can't be used is lost, essentially.

Non-refundable tax credits are only valid in the year of the return, expire after the return is filed, and cannot be carried over to subsequent years. For this reason, non-refundable tax credits can have a negative impact on low-income taxpayers, as they often cannot use the full amount of the credit. If a refundable tax credit reduces the tax liability below the specified limit, the taxpayer is due a refund.

Refundable Tax Credits: This are most beneficial as they are paid out in full. Thus, it means that a taxpayer, regardless of his/her income or tax liability is entitled to the entire of the credit. If the refundable tax credits reduces the tax liability to below threshold limit, the taxpayer is due a refund. Examples of such refundable tax credits may be health insurance premium. In certain countries, health insurance premiums paid by an individual taxpayer is fully reimbursed by the Government.

Partially refundable Tax Credits: Certain tax credit are partially refundable. Thus, this type of tax credits both decrease taxable income and lowers tax liability.

Meaning of Tax Deduction: Tax deduction means an amount of deduction that lowers a person's tax liability by lowering their taxable income. Deductions are typically expenses that the taxpayer incurs during the year that can be applied against or subtracted from their gross income in order to figure out how much tax is owed.

It is important to note that tax deductions and tax credits may both decrease the income tax burden of a person, but they do so in various ways. Tax deductions decrease taxable income; their value depends, therefore, on the marginal tax rate of the taxpayer, which increases with income. Because deductions cannot reduce taxable income below zero, their value until applying the deduction is restricted to the tax liability of the filer. Tax credits, on the other hand, explicitly minimise the tax burden of an individual and therefore have the same value for all taxpayers whose tax liability is at least equal to the credit. Furthermore, certain refunds are refundable; they are not restricted by the tax liability of the taxpayer. Tax

deductions make the most sense, as a general policy rule, for products that reflect decreases in the ability to pay tax, such as casualty losses. For subsidies given by the tax system, credits are more suitable.

8.6 NEUTRAL AND NON-NEUTRAL TAXES

A tax measure is said to be neutral if it does not influence the economic choices of economic agents, viz., producers and consumers. For example, a one-time tax levy, imposed without warning, would be neutral, because economic agents would not have an opportunity to alter their behaviour in response to it. Tax neutrality is thus concerned only with preventing the distortion of economic behaviour by an extraneous influence and not with the fairness of tax consequences to those who bear them.

Tax neutrality is a concept relating to tax provisions which follow or comply with an ideal tax system. In order to base decisions taken by the system on their economic merits rather than on tax grounds, the tax system should endeavour to be impartial and should not be biased. There are several situations where it is difficult to achieve this neutrality and policy makers have to take certain proactive measures to achieve such objectives. While policy makers may offer support to such particular objectives in certain areas, such as the provision of health care or charitable donations, there can be occasions where neutrality is undesirable. The scrutiny of strategies by which the tax system approaches or departs from neutrality can be an effective tool for focusing on a variety of tax policy and economic issues.

The tax system's most important role is to collect the revenue that the government needs for the functioning of the political system. The purpose behind raising this revenue is not to change the choices that people or companies would otherwise opt for for purely economic reasons. For instance, if people are given the opportunity to choose between a chocolate-chip ice cream and a vanilla ice cream, they will certainly make their choices based on their personal tastes and the cost of these products.

On the other hand, if only chocolate-chip ice cream and not vanilla ice cream are taxed by politicians, then people may have to choose even the less desirable product (vanilla ice cream) because vanilla ice cream becomes cheaper.

Moreover, apart from altering one's decisions, non-neutralities in the tax system lead individuals or companies, by consulting accountants or lawyers, to structure or manage financial transactions in such a way that they have to pay the minimum amount of tax liability, to adopt different methods of reducing their tax payments.

8.7 AVERAGE AND MARGINAL TAX RATES AND TAX RATE SCHEDULES

In debates about taxation, misunderstandings about two different forms of tax rates sometimes cause uncertainty. The average tax rate (or effective tax rate) of a taxpayer is the share of income he or she pays in taxes. On the other hand, the marginal tax rate of a taxpayer is the tax rate levied on his or her last rupee of income.

For each tax bracket applicable to the tax payer, the marginal tax rate is the amount of tax added to his/her income. Essentially, the marginal tax rate is the amount of taxable income taken from the next rupee above a pre-defined income level.

The marginal tax rate includes income taxes levied by different levels of public authorities (e.g., at union, state and local levels), as well as taxes levied on payroll and self-employment taxes. This is distinct from the average tax rate, which, as a percentage of all income received, is the total tax charged.

The average tax rate may be worked out by dividing the total income tax owed by the total income of the tax payer. The average tax rate covers taxes charged at all income levels, so it will naturally be lower than the marginal rate, although in case of very high income earners, the average and marginal tax rate of an individual tax payer are likely to be similar. In general, a tax payers' average tax rates are usually much lower than their marginal rates.

Let us consider an example for the better explanation of these concepts. For the purpose, let us consider the tax rates for individuals of India during the financial year 2019-19 (April 1, 2019 to 31st March, 2020).

Table 8.1: Tax Rates for Individuals (For the Financial Year: April 1, 2019 – March 31, 2020)

Income Tax Slab (in Rupees)	Tax Rate for Individual Below the Age Of 60 Years
0 to 2,50,000*	Nil
2,50,001 to 5,00,000	5% of total income exceeding 2,50,000
5,00,001 to 10,00,000	Tax Amount of 12,500 for the income up to 5,00,000 + 20% of total income exceeding 5,00,000
Above 10,00,000	Tax Amount of 1,12,500 for the income up to 10,00,000 + 30% of total income exceeding 10,00,000

Suppose, an individual tax payer's total income during the financial year 2019-20 is Rs 10,00,000.00. In this case, the total tax payable will be:

Rs. 12,500 + (20% of Rs 500,000.00) =

= Rs. 12,5000 + 100,000.00 = Rs. 1,12,500.00.

Thus, average tax rate is: Rs. 1,12,500 / 10,00,000 = 12.5 %.

Marginal tax rate is 20 %. (Tax rate applicable in the 5,00,001 - 10,00,000 tax bracket).

Tax Rate Schedule: In order to calculate the approximate taxes due, an individual or corporate taxpayers use a tax schedule. Thus, a tax schedule may be defined as a rate sheet used by individual or corporate taxpayers to determine their estimated taxes due. For some ranges of taxable income, as well as for specific taxable situations, the schedule provides tax rates.

The rate plan or the tax rate schedule is also called the tax schedule.

Tax Rate Schedules in India (For the Financial Year: April 1, 2019 – March 31, 2020): Under the Income Tax Act, 1961 – the percentage of income that is payable as tax to the Government is based on the amount of income that a person has earned during a year.

Keeping in mind, the fact that the outgoing of tax is tougher for people earning lower income –in India the rate of tax gets higher for people earning higher amounts in a financial year. This is done by applying a different tax

rate for different amounts of annual income. These slabs are tweaked by the government in the annual budget announcements.

For the financial year 2019-20, which means the year from April 1, 2019 – March 31, 2020 – the tax rate slabs have been fixed as below.

(a) Income Tax Slabs for Individuals

Individuals have been categorized into three categories of taxpayers:

1. Individuals who are below the age of 60 years
2. Senior citizens who are between 60 years and 80 years old.
3. Super senior citizens who are above 80 years old.

Tax Rates for Individuals: Tax rates for individuals as per budget 2019-2020 have been shown with the help of Table 8.1. (Please refer to the previous table shown in the previous section).

Tax Rates for Super Senior Tax payers above the age of 80 years: Tax rates for Super Senior Tax payers above the age of 80 years have been shown with the help of Table 8.2.

Table 8.2: Tax Rates for Super Senior Tax payers above the age of 80 years

Income Tax Slab	Income Tax Slab Rate
Up to Rs.10,000	10% of Income
Rs.10,000 to Rs.20,000	20% of Income exceeding Rs.10,000
Over Rs.20,000	30% of Income exceeding Rs.20,000

SOME IMPORTANT POINTS:

- The income tax rates are applied to the annual income calculated. Thereafter Surcharge and Cess is added to the tax payable.
  - A surcharge is also applicable slab wise. The surcharge is calculated on the Tax amount. If the income is:
- Above Rs.50,00,000 and up to Rs.1 crore – then 10% surcharge is applicable.
- Above Rs.1 crore and up to Rs.2 crore – then 15% surcharge is applicable.

In the Union Budget 2019-20, a new surcharge on income tax for super-rich individuals has been levied. So, individuals earning:

- Between Rs.2 crores and up to Rs.5 crore –then 25% surcharge is applicable;
- For Above Rs. 5 crore – then 37% surcharge is applicable.
- An additional Cess of 4% for Health & Education is applicable to the income tax plus surcharge.

Investments under Section 80C can be made up to the tune of Rs.1,50,000 in different investments such as PPF, NSC, etc. and an additional Rs.50,000/- under Section 80 CCD(1B) in NPS can be made.

Section 87A allows tax rebate to Individuals whose total annual income falls below Rs.5,00,000. This rebate is limited to Rs.12,500/- and essentially acquits people from having to pay taxes under Rs.5,00,000/-, However, the return of income has to be filed if income is over Rs.2,50,000/-. Individuals with income exceeding Rs.5,00,000/- do not get the benefit of any rebate under section 87A

Exempted Income Categories

Income which is exempt from Tax is stated under Section 10 of the Income Tax Act. These include among others income from agriculture, special allowances etc.

(b) Income Tax Slabs for HUF

The Income Tax Slab for Hindu Undivided Family (HUF) is the same as the Tax slabs for Individuals under the age of 60 years in the year 2019 – 2020.

(c) Income Tax Slabs for Partnership Firms

There is a flat tax rate for Partnership Firms and LLPs (Limited Liability Partnerships) and they are to pay Income Tax at the rate of 30%.

Added to the tax amount is:

- Surcharge on tax: 12% in cases where the annual income is more than Rs.1 Crore

- Cess for Health & Education: is at the rate of 4% - calculated on tax amount plus surcharge

(d) Income Tax Slabs for Local Authorities

Local Authorities too are to be taxed at a flat tax rate of 30%. Added to the tax amount is:

- Surcharge on tax: 12% in cases where annual income is more than Rs.1 Crore
- Cess for Health & Education: is at the rate of 4% - calculated on tax amount plus surcharge

(e) Income Tax Slabs for Domestic Companies

Domestic Companies have received a boost. With the turnover raised from 250 crores to 400 crores for a tax rate of 25%. The turnover slab wise tax calculation has been shown in Table 8.3.

Table 8.3: Tax rates for domestic companies

Turnover Particulars	
Gross turnover up to 400 Cr. in the previous year	25% (subject to conditions as set out in the Taxation Laws Amendment Ordinance, 2019)
Gross turnover exceeding 400 Cr. in the previous year	30% (subject to conditions as set out in the Taxation Laws Amendment Ordinance, 2019)

Added to the tax amount is:

Surcharge on tax:

- 7% in cases where annual income is between Rs.1 Crore to Rs.10 Crore.
- 12% in cases where annual income is more than Rs.10 Crore.

Cess for Health & Education: is at the rate of 4% - calculated on tax amount plus surcharge.

(f) Income Tax Slabs for Foreign Companies

Foreign Companies are taxed at a rate of 40%.

Added to the tax amount is:

- Surcharge on tax: 2% in cases where annual income is between Rs.1 Crore to Rs.10 Crore.

- 5% in cases where annual income is more than Rs.10 Crore.
- Cess for Health & Education: is at the rate of 4% - calculated on tax amount plus surcharge.

(g) Income Tax Slabs for Co-operative Societies

Income tax slabs for co-operative societies has been shown in Table 8.4.

Table 8.4: Tax rates for co-operative societies

Income Tax Slab	Income Tax Slab Rate
Up to Rs.10,000	10% of Income
Rs.10,000 to Rs.20,000	20% of Income exceeding Rs.10,000
Over Rs.20,000	30% of Income exceeding Rs.20,000

Added to the tax amount is:

- Surcharge on tax: 12% in cases where annual income is more than Rs.1 Crore
- Cess for Health & Education: is at the rate of 4% - calculated on tax amount plus surcharge
- So, to calculate your tax liability for the year, you should keep a track of your annual income to know what Income slab you will be falling under for the year 2019 – 2020.



CHECK YOUR PROGRESS

Q 3: Define the term tax rate schedule. Answer in about 50 words.

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Q 4: What is meant by tax deduction? Answer in about 50 words.

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8.8 LET US SUM UP

- Government receipts are broadly categorised as revenue receipts and capital receipts.
- Revenue receipts include the proceeds of taxes, interest and dividend on government investment, cess and other receipts for services rendered by the government.
- Government receipts which either (i) create liabilities (e.g. borrowing) or (ii) reduce assets (e.g. disinvestment) are called capital receipts. The major distinction between revenue receipts and capital receipts is that in the case of revenue receipts, government is under no future obligation to return the amount, i.e., they are non-redeemable. But In case of capital receipts which are borrowings, government is under obligation to return the amount along with Interest.
- The tax to GDP ratio represents the size of a country's total tax collection in relation to its GDP. It is a representation of the size of government tax revenues expressed as a percentage of GDP.
- The most important way to improve the tax-to-GDP ratio is to ensure that citizens pay taxes.
- Tax buoyancy reflect the relation between the performance of the economy and the "happiness" (tax revenue) of the government. This reflects a high sensitivity of tax revenue realisation in proportion to the growth in GDP.
- Tax elasticity refers to changes in tax revenue in response to changes in tax rate.
- A tax credit is a sum of money that can be subtracted by taxpayers from taxes owed to their government.

- Tax deduction means an amount of deduction that lowers a person's tax liability by lowering their taxable income.
- Tax neutrality is a concept relating to tax provisions which follow or comply with an ideal tax system.
- The tax system's most important role is to collect the revenue that the government needs for the functioning of the political system.
- A tax schedule may be defined as a rate sheet used by individual or corporate taxpayers to determine their estimated taxes due.



8.9 FURTHER READING

1) Bhatia, H. L. 2008. Public Finance. New Delhi: Vikash Publication House Ltd.

2) Hyman N. D. 2007. Public Finance: A Contemporary Application of Theory to Policy. Thomson South-Western Publication.

3) Jha, R. 1998. Modern Public Economics. Routledge Publication.

4) Musgrave, R. & Musgrave, P. B. 1976. Public Finance in Theory & Practice. McGraw Hill Kogakysha Ltd.



8.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Receipts which neither create liability nor reduce assets of government are termed as revenue receipts. Revenue receipts include the proceeds of taxes, interest and dividend on government investment, cess and other receipts for services rendered by the government.

Ans to Q No 2: The tax to GDP ratio represents the size of a country's total tax collection in relation to its GDP. It is a representation of the size of government tax revenues expressed as a percentage of GDP.

Ans to Q No 3: A tax schedule may be defined as a rate sheet used by individual or corporate taxpayers to determine their estimated taxes due. For some ranges of taxable income, as well as for specific taxable situations, the schedule provides tax rates. The rate plan or the tax rate schedule is also called the tax schedule.

Ans to Q No 4: Tax deduction means an amount of deduction that lowers a person's tax liability by lowering their taxable income. Deductions are typically expenses that the taxpayer incurs during the year that can be applied against or subtracted from their gross income in order to figure out how much tax is owed.



8.11 MODEL QUESTIONS

A) Answer the following questions (In about 150 words each)

Q 1: Write short notes on: (a) Tax Ratio, (b) Tax Buoyancy and (c) Elasticity of Taxation.

Q 2: Distinguish between neutral and non-neutral taxes.

B) Answer the following questions (In about 300-500 words each)

Q 1: Discuss the concepts of revenue and capital receipts and their various sources. Distinguish between the two.

Q 2: Discuss the concepts of tax credit and tax deduction with appropriate examples.

Q 3: Discuss the concept of Tax Rate Schedules with the help of appropriate examples.

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UNIT 9: PRINCIPLES OF TAXATION

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Principles of Taxation

- 9.3.1 The Benefit Principle
- 9.3.2 The Lindahl's Model
- 9.3.3 The Bowen's Model
- 9.3.4 The Ability-to-Pay Principle
- 9.3.5 Applications of the Ability to Pay Principle of Taxation

9.4 Concepts and Theories of Tax Shifting and Incidence

- 9.4.1 Tax Shifting
- 9.4.2 Incidence of Taxation
- 9.4.3 Interaction between Elasticity and Tax Incidence
- 9.4.4 Theories of Tax Shifting and Incidence

9.5 Let Us Sum Up

9.6 Further Reading

9.7 Answers to Check Your Progress

9.8 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the principles of taxation
- put forward the concepts and theories of tax shifting and incidence
- describe the interaction between elasticity and tax incidence
- discuss the important theories of tax shifting and incidence.

9.2 INTRODUCTION

As studied in pervious unit, the major objective of taxation is to raise revenues for government. But in designing of tax system various other

objectives are also important. Tax policy includes the tax yield, equity, social and economic effects and the requirements of the country. Government requires guidelines in framing its policy in terms of the goals which are accepted as the appropriate objectives of the economic system.

In this unit, we shall discuss the principles as well as the concepts of tax shifting and incidence of taxes.

9.3 PRINCIPLES OF TAXATION

The principles of taxation, that is, the appropriate criteria to be employed in the development and evaluation of the tax structure. It means recognising the purpose of taxation to be paid for government services and the application of appropriate criteria in developing tax structure. This problem has received the notice of economist from the earliest day of the study of public finance. Before Adam Smith developed his famous canons of taxation, Mercantilist and Physiocrats had advance doctrine of tax principles. Besides Adam Smith many other classical writers look up this question at length. In the early year of the present century, Pigou and Dalton dealt with this question. Since then, little progress is seen old doctrine are repeated and new lights thrown on them. The development of principles of taxation is essentially an application of the theory of economic welfare and for the progress depend in large measures upon advancement in this theory. At the present time the state of welfare theory is such that it can do you little more than assist in the development of very broad principles of taxation. In the contest of advanced Western economics for the attainment of optimum economic welfare the following three goals are considered to be important:

Maximum freedom of choice consistent with the Welfare of others.

Optimum standard of living in terms of available resources and techniques and in the light of consumer and factory owners' reference.

A distribution of income currently acceptable to society.

Thus, many attempts have been made to find the basis for distributing the burden of taxation. One principle states that tax liability should be based on the cost that the state incurred in providing and

services to the society or community. According to another principle it should be based on the benefit that the society derived from the activity of the state. The third principle lays emphasize on the paying ability of the taxpayer as the basis for determining tax liability. Thus we will touch upon the following two principles of taxation, viz., the benefit principle and the ability to pay principle.

9.3.1 The Benefit Principle

The benefit principle recognises that benefit is the purpose of taxation to pay for government services. If taxes are imposed according to the benefit principle, people pay taxes in proportion to the benefits they receive from government spending.

Therefore, those who derive the maxi-mum benefits from government services such as roads, hospitals, public schools and colleges should pay the maximum tax. However, if the benefit principle of taxation is followed, the government will be required to esti-mate how much various individuals and groups benefit and set taxes accordingly. The benefit principle holds that people should be taxed in proportion to the benefits they receive from goods and services provided by the government. This principle is based on the feeling that one should pay for what one gets.

Several theories of taxation exist in public economics. Governments at all levels (national, regional and local) need to raise revenue from a variety of sources to finance public-sector expenditures.

Adam Smith in *The Wealth of Nations* (1776) wrote:

> [Such things as defending the country and maintaining the institutions of good government are of general benefit to the public. Thus, it is reasonable that the population as a whole should contribute to the tax costs. It is also reasonable to demand certain other things of a tax system – for example, that the amounts of tax individuals pay should bear some relationship to their abilities

to pay… Good taxes meet four major criteria. They are: (1) proportionate to incomes or abilities to pay, (2) certain rather than arbitrary, (3) payable at times and in ways convenient to the taxpayers and (4) cheap to administer and collect.]

In modern public-finance literature, there have been two main issues: who can pay and who can benefit (Benefit principle). Influential theories have been the ability theory presented by Arthur Cecil Pigou and the benefit theory developed by Erik Lindahl. There is a later version of the benefit theory known as the ”voluntary exchange” theory.

The economists have put forward many theories or principles of taxation at different times to guide the state as to how justice or equity in taxation can be achieved.

According to this theory, the state should levy taxes on individuals according to the benefit conferred on them. The more benefits a person derives from the activities of the state, the more he should pay to the government. This principle has been subjected to severe criticism on the following grounds:

First, if the state maintains a certain connection between the benefits conferred and the benefits derived. It will be against the basic principle of the tax. A tax, as we know, is compulsory contribution made to the public authorities to meet the expenses of the government and the provisions of general benefit. There is no direct quid pro quo in the case of a tax.

Second, most of the expenditure incurred by the slate is for the general benefit of its citizens. It is not possible to estimate the benefit enjoyed by a particular individual every year.

Third, if we apply this principle in practice, then the poor will have to pay the heaviest taxes, because they benefit more from the services of the state. If we collect more from the poor by way of taxes, it is against the principle of justice.

The benefit principle is a concept in the theory of taxation from public finance. In its use for assessing the efficiency of

taxes and appraising fiscal policy, the benefit approach was initially developed by Knut Wicksell (1896) and Erik Lindahl (1919), two economists of the Stockholm School. Wicksell's near-unanimity formulation of the principle was premised on a just income distribution. The approach was extended in the work of Paul Samuelson, Richard Musgrave, and others. It has also been applied to such subjects as tax progressivity, corporation taxes, and taxes on property or wealth. The unanimity-rule aspect of Wicksell's approach in linking taxes and expenditures is cited as a point of departure for the study of constitutional economics in the work of James Buchanan. Thus, considered in themselves, in their own nature, in their normal state, and apart from all abuses, public services are, like private services, purely and simply acts of exchange.

The benefit principle takes a market-oriented approach to taxation. The objective is to accurately determine the optimal amount of revenue that should be spent on public goods. The basic considerations in this regard are: (a) More equitable/fair rate of taxes, because taxpayers, like consumers, would "pay for what they get". (b) Taxes are more akin to prices that people would pay for government services. (c) Consumer sovereignty - specific rather than general charges are more direct. So, the preferences of taxpayers, rather than government planners, are given more weight. (d) More efficient allocation of limited resources. It is less likely that funds will be overinvested in low priority programs.

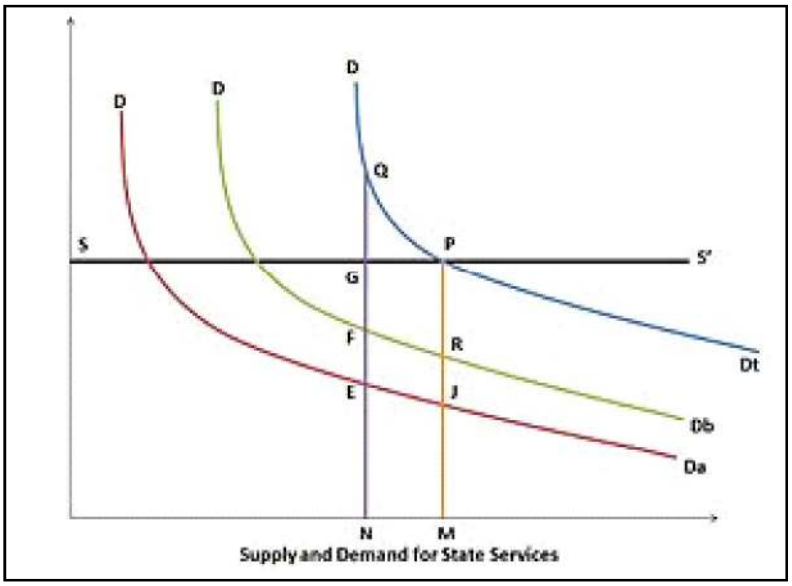
Under the benefit theory, tax levels are automatically determined, because taxpayers pay proportionately for the government benefits they receive. In other words, the individuals who benefit the most from public services pay the most taxes. Here, two models adopting the benefit approach are discussed: the Lindahl model and the Bowen model.

9.3.2 The Lindahl's Model

Lindahl in his study tries to solve three problems, viz., (a) Extent of state activity (b) Allocation of the total expenditure among various goods and services, and (c) Allocation of tax burden.

The Lindahl equilibrium proposes that individuals pay for the provision of a public good according to their marginal benefits in order to determine the efficient level of provision for public goods. In the equilibrium state, all individuals consume the same quantity of public goods but may face different prices because some people may value a particular good more than others. The Lindahl equilibrium price is the resulting amount paid by an individual for his or her share of the public goods. It has been explained with the help of Figure 9.1.

Figure 9.1: The Lindahl Model of Taxation



In the Lindahl model, as shown in figure 9.1, if SS is the supply curve of state services it is assumed that production of social goods is linear and homogenous. DDa is the demand curve of taxpayer A, and DDb is the demand curve of taxpayer B. The Horizontal summation of the two demand curves results in the community's total demand schedule for state services. A and B pay different

proportions of the cost of the services which is vertically measured. When ON is the amount of state services produced, A contributes NE and B contributes NF; the cost of supply is NG. Since the state is non-profit, it increases its supply to OM. At this level, A contributes MJ and B contributes MR (the total cost of supply). Equilibrium is reached at point P on a voluntary-exchange basis.



CHECK YOUR PROGRESS

Q 1: State the basic principle of benefit principle of taxation. (Answer in about 50 words)

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Q 2: State the basic principle of taxation put forward by Lindahl. (Answer in about 50 words)

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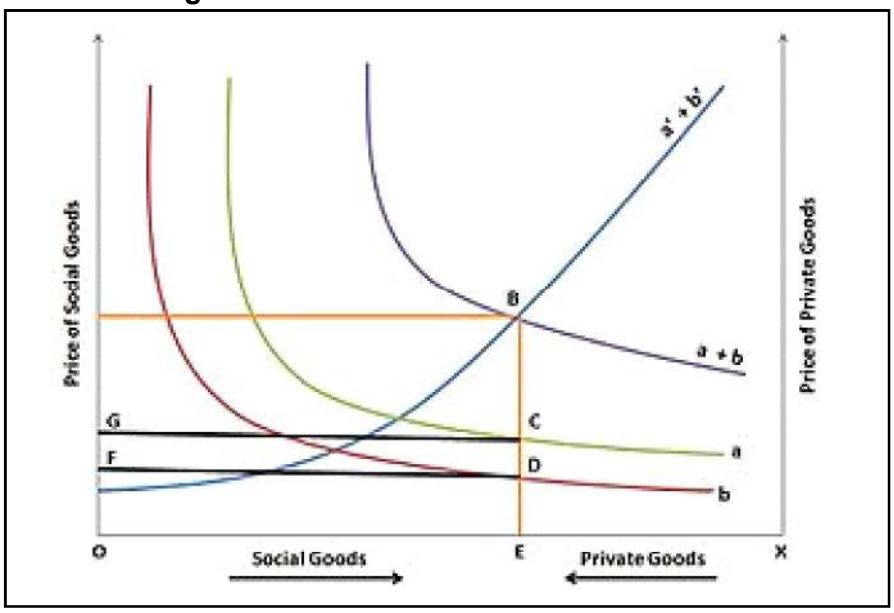
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9.3.3 The Bowen's Model

Bowen's model has more operational significance, since it demonstrates that when social goods are produced under conditions of increasing costs, the opportunity cost of private goods is foregone. The Bowen modes has been explained with the help of Figure 9.2.

In Figure 9.2, one social good and two taxpayers (A and B), their demand for social goods is represented by a and b; therefore, a+b is the total demand for social goods. The supply curve is shown by a'+b', indicating that goods are produced under conditions of increasing cost. The production cost of social goods is the value of

Figure 9.2: The Bowen Model of Taxation



foregone private goods; this means that a'+b' is also the demand curve of private goods. The intersection of the cost and demand curves at B determines how a given national income should (according to taxpayers' desires) be divided between social and private goods; hence, there should be OE social goods and EX private goods. Simultaneously, the tax shares of A and B are determined by their individual demand schedules. The total tax requirement is the area (ABEO) out of which A is willing to pay GCEO and B is willing to pay FDEO.

In practice, the policy of a government can hardly be based solely on any of the above principles. These principles set merely as guidelines to the gov-ernment in framing its tax policy which is prepared having regard to various considerations like the tax yield, equity, social and economic effects and the requirements of the country.

One clear example is road tax. Receipts from road taxes typically are set aside for maintenance and construction of roads. Thus, those who drive on the roads pay the tax. But one question remains unanswered: do those who use the roads pay the tax roughly in proportion to the amount they use them?

The principle also leads to an economically efficient solution to the questions of how much government should provide and who should pay for it. However, using the benefit principle has several practical difficulties that render it impossible to apply it for many publicly supplied goods and services.

When a good or service supplied by the government has the exclusive and rival characteristics of a private good, benefits can be computed rather easily and users can be charged accordingly. Examples include road tax, toll tax and transit fees. When a publicly provided service is non-rival and non-exclusive (a pure public good) the benefit principle is just a theoretical concept because the benefits cannot be measured.

At different times, certain principles of taxation have been suggested on the basis of Smith's four basic canons. According to the so-called benefit principle, the amount a person should pay in taxes should be related to the benefit he might expect to receive in return.

But this principle is difficult to apply in reality since, under this principle, lower income groups would be called upon to pay most. Similar and equally impracticable is the cost of service principle, according to which a person's tax liability would be based on the cost of the public services which he enjoys.

9.3.4 The Ability-to-Pay Principle

This principle seeks to impose a higher tax on people with a higher income and a lower tax on people with a lower income, ceteris paribus. This way lower income people aren't taxed excessive amounts relative to their overall income.

This is the fundamental principle in the progressive tax system of the United States, which seeks income redistribution. The amount of money spent by wealthy consumers is higher than their basic necessities. Conversely, the amount of money spent by lower-income

consumers is lower than their basic necessities. With this concept, the lower-income people can meet their tax obligations because they are lower than those of the higher-income people.

This concept also extends beyond simple tax brackets and income levels. For instance, individuals shouldn't be taxed on transactions in which they don't receive any cash. An example of this is stock options. An employee who is granted stock options receives something of value that is subject to taxation, but because they didn't receive any cash, they can delay the tax on the options until they cash them in.

The ability-to-pay approach treats government revenue and expenditures separately. Taxes are based on taxpayers' ability to pay; there is no quid pro quo. Taxes paid are seen as a sacrifice by taxpayers, which raises the issues of what the sacrifice of each taxpayer should be and how it should be measured:

Equal sacrifice: The total loss of utility as a result of taxation should be equal for all taxpayers (the rich will be taxed more heavily than the poor)

Equal proportional sacrifice: The proportional loss of utility as a result of taxation should be equal for all taxpayers

Equal marginal sacrifice: The instantaneous loss of utility (as measured by the derivative of the utility function) as a result of taxation should be equal for all taxpayers. This therefore will entail the least aggregate sacrifice (the total sacrifice will be the least).

The most popular and commonly accepted principle of equity or justice in taxation is that citizens of a country should pay taxes to the government in accordance with their ability to pay. It appears very reasonable and just that taxes should be levied on the basis of the taxable capacity of an individual. For instance, if the taxable capacity of a person A is greater than the person B, the former should be asked to pay more taxes than the latter.

It seems that if the taxes are levied on this principle as stated above, then justice can be achieved. But our difficulties do not end here. The fact is that when we put this theory in practice, our difficulties actually begin. The trouble arises with the definition of ability to pay. The economists are not unanimous as to what should be the exact

measure of a person's ability or faculty to pay. If the objective of the government is to redistribute income, it should set taxes according to the ability-to-pay principle. However, it is difficult to measure ability. There are, in general, three measures of ability: income, expenditure and property. The main view points advanced in this connection are as follows:

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

  Some economists are of the opinion that ownership of the property is a very good basis of measuring one's ability to pay. This idea is out rightly rejected on the ground that if a persons earns a large income but does not spend on buying any property, he will then escape taxation. On the other hand, another person earning income buys property, he will be subjected to taxation. Is this not absurd and unjustifiable that a person, earning large income is exempted from taxes and another person with small income is taxed?

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

  It is also asserted by some economists that the ability or faculty to pay tax should be judged by the expenditure which a person incurs. The greater the expenditure, the higher should be the tax and vice versa. The viewpoint is unsound and unfair

in every respect. If we make expenditure, as the test of one's ability to pay, the former person who is already burdened with many dependents will have to' pay more taxes than the latter who has a small family so this is unjustifiable.

- **Income as the Basics**: Most of the economists are of the opinion that income should be the basis of measuring a man's ability to pay. It appears very just and fair that if the income of a person is greater than that of another, the former should be asked to pay more towards the support of the government than the latter. That is why in the modern tax system of the countries of the world, income has been accepted as the best test for measuring the ability to pay of a person. Income is said to be a better measure of ability than wealth. But here also some difficulties are encountered. All work do not involve the same sacrifice. A man earning Rs.500 through toil and trouble will not be a position to pay taxes as one earning the same amount without any effort (from paternal property) or gambling or through chance (lottery).

  One with the same level of income as another may have more dependents and more liability and thus lower ability to pay. Moreover, the marginal utility of money differs from man to man. It is higher to a man with lower income and vice versa. So, in the ultimate analysis, income is not a good test of ability.

9.3.5 Applications of the Ability to Pay Principle of Taxation

Two basic indices (measures) of the ability to pay, viz., income and wealth provide a justification for progressive personal taxes. If taxes are imposed on the basis of the ability to pay principle, higher taxes will be paid by those with greater ability to pay, as measured by income and/or wealth.

The measures of ability differ from tax to tax. For example, in income taxation, the measure of ability is income; in wealth taxation, it is the value of property (wealth). A practical problem arises when

we try to translate the idea (or notion) into practice.Let us consider the three alternative income tax plans listed in Table 9.1:

Table 9.1: Three Alternative Income-Tax Plans

Income (Rs.)	Tax Payments (Rs.)			Average Tax Rate (%)		
	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
1,000	100	100	100	10	10	10
10,000	2,000	1,000	500	20	10	5
1,00,000	40,000	10,000	2,500	40	10	2.5

Under all three plans, families with higher incomes pay higher income taxes. So, all these plans may be said to be operate on the ability to pay principle of taxation. Yet they have different distributive consequences.

Plan 1 is a progressive tax: the average tax rate is higher for richer families. Plan 2 is a proportional tax; every family pays 10% of its income. Plan 3 is quite regressive: since tax payments rise more slowly than income, the tax rate for richer families is lower than that for poorer families.

It appears that under plan 3 the principle of 'fairness' is violated. How-ever, the modern system of progressive personal income tax seems to be based on the notion of vertical equity. Other things being equal, progressive taxes are seen as 'good' taxes in some ethical sense while regressive taxes are seen as -bad'. On these grounds, advocates of greater equality of income support progressive income taxes and oppose sales taxes.

However, progressivity in taxation is not necessary for vertical equity. A proportional income-tax system could well satisfy the equity principle.



CHECK YOUR PROGRESS

Q 3: State the applications of the ability to pay principle of taxation. (Answer in about 40 words)

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9.4 CONCEPTS AND THEORIES OF TAX SHIFTING AND INCIDENCE

Before we discuss the theories of tax shifting and incidence, let us briefly discuss the concepts of tax shifting and tax incidence.

9.4.1 Tax Shifting

Tax shifting is quite widely thought of in a literal sense as the transfer of the burden of a tax from the person with the statutory liability for the tax to another person(s). Shifting is process of transferring money burden of tax to someone else. Shifting finally ends in incidence. When a person on whom tax is levied tries to shift tax on to the other, he may succeed in shifting tax completely, partly, or may not succeed at all. In this view, tax shifting is seen as little more than the efforts by producers or sellers of the taxed product or service to make others pay the tax, either by raising the price of the product or service or by reducing the price paid for the production inputs used to produce it. Tax shifting, however, is not usefully perceived merely as the “passing forward” or “passing backward” of the tax. Shifting is not simply the taxpayer’s raising the price to the buyer of the taxed product or service or cutting the payments to the suppliers of the inputs used to produce the product or service. This is not to say that the taxpayer makes no attempt to pass the tax forward or backwards, in this sense, but that such efforts, whether or not they succeed, involve only a part of the shifting adjustments. Of at least equal importance is how buyers or suppliers respond to any such efforts. These responses, in turn involving adjustments by other persons elsewhere in the economy, are much more complex and extensive than merely the initial changes in prices of outputs or inputs that the taxpayer can effect. Tax shifting is not a one-shot adjustment.

Tax shifting is a process consisting of all of the economic adjustments that people make in response to the changes in relative prices and costs that result from the imposition of the tax. For the businesses directly affected, and their employees and suppliers, these responses result in: (a) decreases in the amount of their output of the taxed commodity or service, (b) higher prices for that reduced output, (c) reduced use of the inputs employed in producing the taxed items, (d) reduced prices or compensation of those inputs, (e) changes in the composition of the businesses' product lines, and (f) reduction in the amount of plant and equipment devoted to producing the taxed items. For the buyers of the taxed product, the shifting process includes: (a) decreases in the purchases of the product and changes in the composition of buyers' total outlays, (b) decreases in their disposable incomes. These changes may be identified as the partial equilibrium adjustments made by the directly affected businesses in their product and input markets and by the buyers of the taxed product. In turn, these adjustments lead to changes throughout the economy in the composition of spending, in the use of production inputs, in the mix of products and services that come to the market, and often in the volume of total production. These changes are the processes by which the economy as a whole moves toward a new general equilibrium. Together, these changes, the indirect as well as direct consequences of the imposition of the tax, clearly go significantly beyond merely the efforts of producers or sellers of the taxed products or services to transfer the tax to their customers in the form of higher prices or to their input suppliers in the form of lower prices.

Types of Shifting: There are basically two types of tax shifting.

- *Forward Shifting:* A forward-shifted tax is imposed on producers but passed on to consumers. The amount of a tax shifted forward depends on the price elasticity of demand for the taxed good.
- *Backward Shifting:* A backward-shifted tax is borne by firms and input suppliers. The amount of backward shifting to input suppliers depends on their responsiveness to changes in input prices.

9.4.2 Incidence of Taxation

Taxes are not always borne by the people who pay them in the first instance. They are often shifted to other people. Tax incidence means the final placing of a tax. Incidence is on the person who ultimately bears the money burden of tax. According to the modern theory, incidence means the changes brought about in income distribution by changes in the budgetary policy.

Impact and Incidence: The impact of a tax is on the person who pays it in the first instance and the incidence is on the one who finally bears it. Therefore, the incidence is on the final consumers.

Incidence and Effects: The effect of a tax refers incidental results of the tax. There are several consequences of imposition of tax, for example, decreased demand.

Money Burden and the Real Burden: The money burden of a tax is represented by the total amount of money received by the treasury. For example, the consumer has to spend Rs. 50 more on sugar monthly, it is the money burden that he has to bear. But if he has to reduce his consumption of sugar it means there is a reduction in economic welfare. This inconvenience, pinching, sacrifice or in short the loss of economic welfare is the real burden of tax.

Factors determining Tax Incidence: The major factors are:

- **Elasticity:** While considering incidence we consider both elasticity of demand and elasticity of supply. If the demand for the commodity taxed is elastic, the tax will tend to be shifted to the producer but in case of inelastic demand, it will be largely borne by the consumer. In case of elastic supply, the burden will tend to be on the purchaser and in the case of inelastic supply on the producer.
- **Price**: Since shifting of the tax burden can only take place through a change in price, price is a very important factor. If the tax leaves the price unchanged, the tax does not shift.
- **Time**: In short run, the producer cannot make any adjustment in plant and equipment. If, therefore, demand falls on account of

price rise resulting from the tax, he may not be able to reduce supply and may have to bear the tax to some extent. In the long run, however, full adjustment can be made and tax shifted to the consumer.

- **Cost:** Tax raises the price; rise in price reduces demand and reduced demand results in the reduction of output. A change in the scale of production affects cost and the effect will vary according as the industry is decreasing, increasing or constant costs industry. For instance, if the industry is subject to decreasing cost, a reduction in the scale of production will raise the cost and hence price, shifting the burden of the tax to the consumer.
- **Nature of tax**: The incidence of taxation will definitely depend on the nature of tax. For example, an indirect tax's burden is fall on the consumer.
- **Market form**: Another factor determining the incidence of taxation is the market form. Under perfect competition, no single producer or single purchaser can affect the price; hence shifting of tax in either direction is out of the question. But under monopoly, a producer is in a position to influence price and hence shift the tax.

9.4.3 Interaction between Elasticity and Tax Incidence

Typically, the incidence, or burden, of a tax falls both on the consumers and producers of the taxed good. But if we want to predict which group will bear most of the burden, all we need to do is examine the elasticity of demand and supply.

In the tobacco example above, the tax burden falls on the most inelastic side of the market. If demand is more inelastic than supply, consumers bear most of the tax burden. But, if supply is more inelastic than demand, sellers bear most of the tax burden.

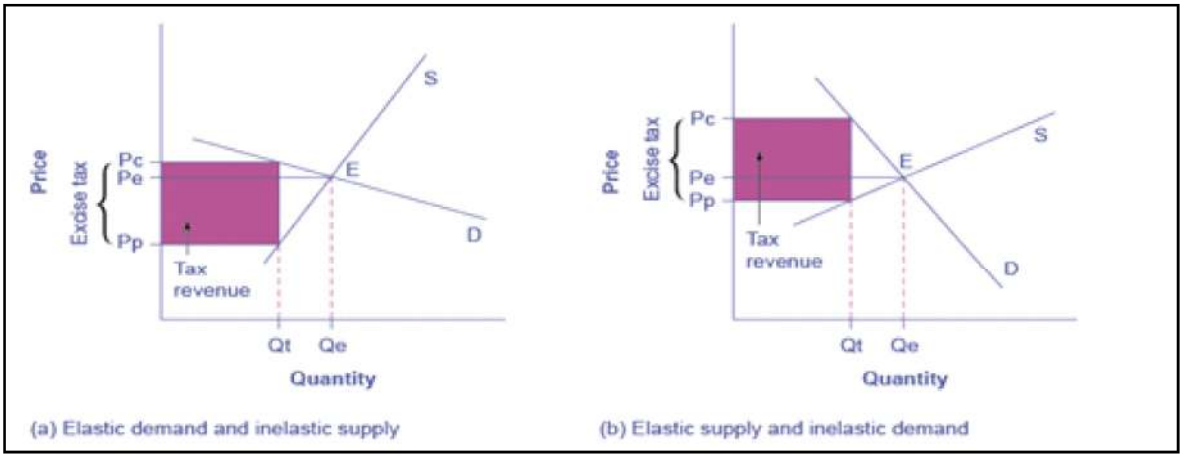
Just consider it this way—when the demand is inelastic, consumers are not very responsive to price changes, and the quantity demanded remains relatively constant when the tax is introduced. In the case of smoking, the demand is inelastic because consumers

are addicted to the product. The seller can then pass the tax burden along to consumers in the form of higher prices without much of a decline in the equilibrium quantity.

When a tax is introduced in a market with an inelastic supply—such as, for example, beachfront hotels—sellers have no choice but to accept lower prices for their business. Taxes do not greatly affect the equilibrium quantity. The tax burden in this case is on the sellers. If the supply were elastic and sellers had the possibility of reorganizing their businesses to avoid supplying the taxed good, the tax burden on the sellers would be much smaller, and the tax would result in a much lower quantity sold instead of lower prices received. You can see the relationship between tax incidence and elasticity of demand and supply represented with the help of Figure 9.3.

Two graphs that represent the relationship between elasticity and tax incidence. Graph A shows the situation that occurs when demand is elastic and supply is inelastic— tax incidence is lower on consumers. Graph B shows the situation that occurs when demand is inelastic and supply is elastic—tax incidence is lower on producers.

Figure 9.3: Interaction between Elasticity and Tax Incidence



In Figure 9.3 (a), above on the left, the supply is inelastic and the demand is elastic—as it was in the beachfront hotels example. While consumers may have other vacation choices, sellers can't easily move their businesses. By introducing a tax, the government essentially

creates a wedge between the price paid by consumers, Pc, and the price received by producers, Pp,. In other words, of the total price paid by consumers, part is retained by the sellers and part is paid to the government in the form of a tax. The distance between Pc and Pp, is the tax rate. The new market price is Pc, but sellers receive Pp. per unit sold since they pay Pc”Pp, to the government. Since a tax can be viewed as raising the costs of production, this could also be represented by a leftward shift of the supply curve. The new supply curve would intercept the demand at the new quantity Q, t, end text. For simplicity, the diagram above omits the shift in the supply curve.

The tax revenue is given by the shaded area, which is obtained by multiplying the tax per unit by the total quantity sold, Qt. The tax incidence on the consumers is given by the difference between the price paid, Pc, and the initial equilibrium price, P, e. The tax incidence on the sellers is given by the difference between the initial equilibrium price, Pe, end text, and the price they receive after the tax is introduced, Pp.

In part (a), above on the left, the tax burden falls disproportionately on the sellers, and a larger proportion of the tax revenue—the shaded area—is due to the resulting lower price received by the sellers than by the resulting higher prices paid by the buyers.

On the other hand, if we go back to our example of cigarette taxes, the situation would look more like diagram B—above on the right—where the supply is more elastic than demand. The tax incidence now falls disproportionately on consumers, as shown by the large difference between the price they pay, Pc, and the initial equilibrium price Pe. Sellers receive a lower price than before the tax, but this difference is much smaller than the change in consumers’ price.

Using this type of analysis, we can also predict whether a tax is likely to create a large revenue or not. The more elastic the demand

curve, the easier it is for consumers to reduce quantity instead of paying higher prices. The more elastic the supply curve, the easier it is for sellers to reduce the quantity sold instead of taking lower prices. In a market where both the demand and supply are very elastic, the imposition of an excise tax generates low revenue.

People often think that excise taxes hurt mainly the specific industries they target. But ultimately, whether the tax burden falls mostly on the industry or on the consumers depends simply on the elasticity of demand and supply.

9.4.4 Theories of Tax Shifting and Incidence

The important theories of tax shifting are concentration or surplus, diversion or diffusion theory and the modern theory. In this section, we shall briefly discuss these theories.

- **Concentration Theory or Surplus theory:** This theory was developed by the Physiocrats in the eighteenth century. They believed that all taxes ultimately concentrate on a particular kind of people. They regarded agriculture as the only productive activity which alone yielded a surplus. Therefore, they advocated a single tax on the net income of land. According to them, diversity of taxes should be avoided. The major criticisms raised against the theory are: (a) all activities are productive and a single tax on land is not suitable for modern welfare states. (b) The burden should not be concentrated on a single section of the society but instead there should be equal distribution of tax burden on the entire society.

  However, the major advantage of the theory is that it stresses that all taxes are paid out of surplus. If there is no surplus the burden of the tax is shifted to others.

- **Diversion or Diffusion theory:** The diffusion theory explains that a tax is shifted and re-shifted till its burden eventually gets scattered throughout the entire society in such a way that each individual tax payer bears only a small portion of the tax –a

portion which ought to bear and is capable of bearing it. Thus, according to this theory, the process of diffusion took place through shifting or through process of exchange. This theory was propagated by French writers like Mansfield and Canard. According to Mansfield, "Tax is like a stone falling into a lake and making a circle till one circle produces and gives motion to another and the whole circumference is agitated from the centre." When a tax is imposed it gets diffused so that no one escapes from its burden. The diffusion occurs through the process of shifting. Equilibrium is reached when the tax burden is equally distributed among all the tax payers.

On the other hand, N.F. Canard compared the imposition of tax to extracting blood from one of the veins of a human being; although it is taken from a single vein, the loss is spread over the whole body and the body remains in equilibrium. Canard believed that old taxes are preferable to new taxes, as new taxes would upset equilibrium till it got diffused. He said, "Every tax is good, every new tax is bad."

The major criticisms raised against the diffusion theory are: (a) the burden of all taxes does not get diffused. If it is the case, it is not needed to distinguish between direct taxes and indirect taxes. (b) The theory is based on perfect competition. It is unrealistic. (c) The principle of equity is neglected in the theory.

- **The Modern Theory of Incidence (Demand & Supply Theory):** The modern theory of tax incidence was developed by Professor Dalton and was supported by modern economists like Seligman and Edgeworth. The theory possesses all the virtues of the earlier theories. It states that tax should be imposed on surplus. It also believed that tax is a part of cost of production and therefore, it enters into price. Shifting of tax burden is thus done through price changes. If there is no price transaction, shifting

of tax burden is impossible. So shifting is common in commodity taxation. In short, shifting and incidence depend on pricing. Pricing in turn depends on the interaction of the market forces of demand and supply. The factors influencing the demand and supply are therefore having paramount importance in understanding the nature of tax shifting and as well as to determine the incidence of a tax. The most important factors which affect demand and supply are the elasticity of demand, the elasticity of supply, the laws of returns, and market structure-perfect competition, monopoly, monopolistic competition, and oligopoly.

Let us consider the type of elasticity and the burden of incidence of taxation (on buyer and sellers). Prof. Dalton said, “Incidence of a tax is divided between buyers and sellers in the ratio of the elasticity of supply to elasticity of demand.” That is, Es/Ed where Es=elasticity of supply and Ed= elasticity of demand. The important propositions of the modern theory of incidence may be shown with the help of Table 9.2:

Table 9.2: Types of Elasticity and Burden of Tax Incidence on Buyers/Sellers

Types of Elasticity	Burden on Buyers	Burden on Sellers
Perfectly elastic demand	Zero	Entire
Perfectly inelastic supply	Zero	Entire
Perfectly inelastic demand	Entire	Zero
Perfectly elastic supply	Entire	Zero
Elasticity of demand=Elasticity of supply	Equal	Equal
Es> Ed	Higher	Lower
Ed>Es	Lower	Higher



ACTIVITY

Try to evaluate the effects of tax incidence with reference to different market conditions as well as different cost conditions (laws of returns to scale). You can take help of any standard textbook on this subject.

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CHECK YOUR PROGRESS

Q.4: State the concept of tax shifting. (Answer in about 50 words)

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Q.5: State the concentration theory of shifting of taxation. (Answer in about 50 words)

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9.5 LET US SUM UP

- Tax policy includes the tax yield, equity, social and economic effects and the requirements of the country. Government requires guidelines in framing its policy in terms of the goals which are accepted as the appropriate objectives of the economic system.
- Before Adam Smith developed his famous canons of taxation, Mercantilist and Physiocrats had advance doctrine of tax principles. The benefit principle recognises that benefit is the purpose of taxation

to pay for government services. If taxes are imposed according to the benefit principle, people pay taxes in proportion to the benefits they receive from government spending.

- The benefit principle takes a market-oriented approach to taxation. The objective is to accurately determine the optimal amount of revenue that should be spent on public goods.
- Lindahl in his study tries to solve three problems, viz., (a) Extent of state activity (b) Allocation of the total expenditure among various goods and services, and (c) Allocation of tax burden.
- The Lindahl equilibrium proposes that individuals pay for the provision of a public good according to their marginal benefits in order to determine the efficient level of provision for public goods.
- Bowen's model has more operational significance, since it demonstrates that when social goods are produced under conditions of increasing costs, the opportunity cost of private goods is foregone.
- The Ability to pay principle seeks to impose a higher tax on people with a higher income and a lower tax on people with a lower income, ceteris paribus. This way lower income people aren't taxed excessive amounts relative to their overall income.
- Two basic indices (measures) of the ability to pay, viz., income and wealth provide a justification for progressive personal taxes. If taxes are imposed on the basis of the ability to pay principle, higher taxes will be paid by those with greater ability to pay, as measured by income and/or wealth.
- Tax shifting is quite widely thought of in a literal sense as the transfer of the burden of a tax from the person with the statutory liability for the tax to another person(s). Shifting is process of transferring money burden of tax to someone else. Shifting finally ends in incidence.
- Typically, the incidence, or burden, of a tax falls both on the consumers and producers of the taxed good. But if we want to predict which group will bear most of the burden, all we need to do is examine the elasticity of demand and supply.
- The important theories of tax shifting are concentration or surplus, diversion or diffusion theory and the modern theory.



9.6 FURTHER READING

1) Choudhury R. (2009 Reprint). *Public Finance and Fiscal Policy,* Kalyani Publishers, Ludhiyana.

2) Mithani D. M. (2010 Reprint Ninth Edition). *Money, Banking, International Trade and Public Finance* , Himalaya Publishing House Pvt. Limited.

3) Bhatia H.L. (1993 Seventeenth revised edition). *Public Finance,* Hindustan Offset Printers, Delhi.



9.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: According to the benefit theory of taxation, the state should levy taxes on individuals according to the benefit conferred on them. The more benefits a person derives from the activities of the state, the more he should pay to the government.

Ans to Q No 2: According to Lindahl, individuals pay for the provision of a public good according to their marginal benefits in order to determine the efficient level of provision for public goods. Thus, in the equilibrium state, all individuals consume the same quantity of public goods but may face different prices because some people may value a particular good more than others.

Ans to Q No 3: The ability to pay principle seeks to impose a higher tax on people with a higher income and a lower tax on people with a lower income, ceteris paribus. This way lower income people aren't taxed excessive amounts relative to their overall income. This is the fundamental principle in the progressive tax system of the United States, which seeks income redistribution.

Ans to Q No 4: Tax shifting is quite widely thought of in a literal sense as the transfer of the burden of a tax from the person with the

statutory liability for the tax to another person(s). Shifting is process of transferring money burden of tax to someone else. Shifting finally ends in incidence.

Ans to Q No 5: The concentration theory was developed by the Physiocrats in the eighteenth century. They believed that all taxes ultimately concentrate on a particular kind of people. They regarded agriculture as the only productive activity which alone yielded a surplus. Therefore, they advocated a single tax on the net income of land. According to them, diversity of taxes should be avoided.



1.8 MODEL QUESTIONS

A) Very short type questions

Q 1: Discuss the benefit principle of taxation.

Q 2: Discuss the Lindahl model of taxation.

Q 3: Discuss the Bowen's model of taxation.

Q 4: Discuss the concept of tax shifting.

Q 5: Discuss the concept of incidence of taxation.

B) Short type questions

Q 1: Discuss the interaction between elasticity and tax Incidence.

Q 2: Discuss the modern theory of tax incidence.

Q 3: Discuss the ability-to-pay principle of taxation. Discuss certain important applications of the ability-to-pay principle of taxation.

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UNIT 10: PUBLIC DEBT

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Public Debt

10.3.1 Sources of Public Debt

10.4 Burden of Public Debt

10.4.1 Internal Burden of Public Debt

10.4.2 External Burden of Public Debt

10.5 Pay -As -You- Use and Pay -As- You -Go Finance

10.5 .1 Pay -As -You- Use Finance

10.5 .2 Pay -As -You- Go Finance

10.5 .3 Crowding Out Effect

10.6 Redemption of Public Debt

10.7 Let Us Sum Up

10.8 Further Reading

10. 9 Answers to Check Your Progress

10.10 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- Acquire knowledge on public debt and its sources.
- Understand various burden associated with public debt.
- Acquire knowledge on pay-as -you-use and pay-as- you-go finance
- Understand crowding out effect
- Understand various methods of redemption of public debt.

10.2 INTRODUCTION

In simple terms, public debt, also known as sovereign or national debt, is how much the government owes to lenders outside itself. Lenders

can be individuals, organizations, and even other governments. This unit accounts for various aspects associated with public debt. Public debt has become an important fiscal instrument of the government of a country. The first section of the unit describes different sources of public debt, followed by different types of burdens of public debt in the next. The third section describes: Pay-As –You-Use and Pay As-You –Go , followed by Crowding out effect of public debt. The last section describes redemption of public debt.

10.3 PUBLIC DEBT

According to Encyclopedia Britannica, public debt refers to "obligation of governments, particularly those evidenced by securities to pay certain sums to the holders at some future date." It is an important source to finance multi-faceted functioning of a modern welfare state, specially, of the developing economies. The developing economies do not possess a sound, systematic and uniform system of taxation. On the contrary, government of these economies need huge resources in order to finance various developmental as well as welfare schemes, besides maintaining law and order and ensuring security. Complete financing of these projects through taxation has become somewhat impossible. In order to meet huge revenue deficit, the government has to take resort of public debt.

10.3.1 Sources of Public Debt

Government takes debt through bonds. Bonds are the credit papers where all terms and conditions of borrowings such as rate of interest, maturity period are written. Bonds are purchased and sold in the money market and the bond holders are the lenders of funds to the government. Sources mentioned below are the buyers and sellers of government bonds. That is, these are the sources of public borrowing.

- Private individuals
- Financial institutions

- Commercial banks
- Central banks
- Small savings
- Unfunded debt
- Foreign governments
- Foreign individuals
- Foreign banks and other non-banking financial institutions
- International financial institutions.

Mainly because of security and tax concessions, people purchase government bonds. These types of borrowing , at the same time, do not reduce private consumption or investment.

Non –banking financial institutions are bulk purchasers of government bonds. Due to high liquidity and negotiable character, these institutions purchase government bonds.

Commercial banks are the third largest purchasers of bonds. These banks purchase government bonds through creation of credit. The banks used their excess cash reserves to purchase government bonds. Thus, the purchase of bonds does not reduce their loans and advances.

Central banking system of a country is the most expansionary source of public debt. When central bank purchases government bonds, it credits the amount (value of bonds) with the government account. In the process of spending of these funds the receivers of cheques from the government deposit in commercial banks. For commercial banks, these cheques are as good as cash reserves. They in turn, use these excess reserves to purchase government bonds. Thus, additional purchasing power is created in the economy by both central banks and commercial banks.

Government has two other sources of internal borrowing: small savings and unfunded debt.

External sources borrowing comprises of private individuals, commercial institutions and governments of the foreign countries. These bonds are floated for financing construction as well as

development projects. Moreover, several international institutions like International Monetary Fund, (IMF), World Bank (WB), Industrial Finance Corporation etc. offer loans for short-term and long-term purposes. Developing countries generally take short term loans for correcting disequilibrium in the balance of payments, while long-term loans are raised for financing development projects.

10.4 BURDEN OF PUBLIC DEBT

10.4.1 External Burden of Public Debt

In case of internal debt, borrowing is made from individuals and institutions within the country. So repayment of the same constitutes only a re-distribution of resources within the country. All payments cancel each other out in the aggregate community as a whole. Thus, there is no direct money burden of internal debt. Tax is collected from one section of the community servicing the debts is distributed among the bond –holders by way of repayment of loans and interest.

Quite often, the tax payers and the bond holders are the same. To the extent it happens, there will not be any net burden on the community. On the contrary, there will be a direct real burden of internal debt if the tax -payers and the bond- holders belong to different income-groups. Usually, the bulk of government securities are held by the rich. And if the proportion of taxes paid by the rich is smaller than the proportion of public securities held by the rich, it leads to a direct real burden of internal debt. It generally happens in practice and it is also the one of the causes of growing inequalities of income in the society. Even a progressive taxation will be incapable to counter-balance the income yield by the rich.

Moreover, bond holders are generally older generations and enterprises. Therese enterprises purchase bonds out of their idle and inactive resources, for which they earn a sizable return. At the same time, government imposes taxes on enterprises and earnings from forts for the benefit of the idle, inactive, old, leisurely mass of

bond-holders. In that way, work and productive risk-taking efforts are affected for the benefit of accumulated wealth. It is also a real burden of public debt.

Moreover, for servicing the debt, the government imposes taxation. Taxation reduces tax-payers' ability and willingness to work and save. General economic welfare may reduce which is an indirect real burden of public debt.

In addition to these, the bond-holders, with the prospect of receiving interest on bonds may become more lazy and passive. Their desire to work further reduces, which cause a further loss to production. It is an indirect real burden of internal debt.

10.4.2 External Burden of Public Debt

External burden of debt arises due to borrowing from foreign countries. As these loans augments income, at initial stages, they are beneficial. As far as repayment is concerned, external debts create direct and indirect money as well as real burden.

Direct money burden of external debt is the sum of money payments in the form of interest and principal to external creditors. Direct real burden amounts to the loss of economic welfare in terms of consumption of goods and services forgone, which could be consumed by the amount spent for repayment. The direct real burden of the people of the debtor country vary from person to person. Debts are re-payed out of payments made by the people of the debtors' country in the form of taxes. If the relative burden of taxation falls heavily upon the rich, the direct real burden of the community as a whole will be lesser than if the relative burden of taxation falls largely on the poor. It is because of the fact that deprivation of goods and services due to payment of taxes is more than the rich.

Moreover, for poor countries with small amount of foreign exchange reserves and inadequate export earnings, the future generations may be deprived of further improvement in its

consumption, investment and welfare. In such countries, external debt transfer from generations by generations. Very often a new loan has to be raised just for the sake of servicing the existing long-term foreign debts. It accounts for another real burden of debt.

It of course, depends on the purpose of taking external debt. Debts incurred for war expenditure or such unproductive use is definitely a real burden. Instead, debts incurred for productive investments in social and economic overheads or for expansion of export sector, the debtor country will gain various sorts of benefit and earning.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are true (T) or false (F).

(a) The repayment of internal public debt constitutes only a re-distribution of resources within the country always. (T/F)

b) External debt always create money and real burden. (T/F)

Q 2: What are the burden associated with external debt? (Explain in about 60 words)

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10.5 PAY-AS -YOU- USE AND PAY-AS- YOU-GO FINANCE

Government projects are financed either through taxes or through loans or debt. It is general consensus that savings depends on disposable income and investment depends on interest rate. Financing of projects through tax will reduce both private capital formation and consumption. Similarly, loan

finance will reduce private capital formation. Thus, tax finance affects both present and future consumption while loan finance affects future consumption. A crucial selection of the two has to be made beforehand.

10.5.1 Pay -As -You- Use Finance

In Pay -As –You- Use form of financing the development projects, the cost payment by taxpayers is made in such a way that the tax payers need not to pay the entire cost immediately. Instead, they can pay the taxes over those years, as the benefits are enjoyed by them. Pay-as- you –use finance through taxation do not create any problem if the capital outlay required for the project is of continuous nature; such as minor irrigation projects. In these type of projects tax finance of new projects becomes equivalent to pay-as-you-use finance of old projects. But in projects like setting up of a hospital complex requires full resource input in initial period. Financing of such projects through taxation may reduce productivity as well as consumption in the private economy.

This adverse effect can be overcome by loan finance. The actual cost of the project will be the principal and interest payment of this public debt. This cost will ultimately be borne by the tax payers. The burden of tax payers may be spread over a number of years as the benefits continue to be received by them. Thus, the people will be able to pay as they use the benefit of the project.

10.5.2 Pay -As -You- Go Finance

In Pay -As –You- Go finance, benefits comes to the people out of their contributions in the past. Old-age insurance is one better example of such type of finance. When the system is introduced, and people those who are already aged cannot receive any benefit since they did not contribute in the past. Those who are middle-aged at the time of introduction of the scheme will be able to contribute only for the remaining period of their working life.

The amount accumulated from contributions will be invested in the capital market. Earnings from such investment will be credited to a reserve fund and the aggregate earnings of the reserve fund will be added to the current contributions of workers. As the system matures, the contributions, along with the capital income will pay the benefit of the aged. Thus, the system of Pay -As –You- Go finance prohibits borrowings.

10.5.3 Crowding Out Effect

Crowding out effect is an economic term. Sometimes, with an intension to boost the economy, the government adopts expansionary fiscal policy, and funding of such projects is made through public debt, taxes or both.

It is to be noted here that when government borrows heavily to finance its expansionary fiscal policy, with unchanged money supply, it leads to a scarcity of capital in the economy. This pushes up the rate of interest that which discourages private investment. Thus government effectively pushes out private investment by crowding the market. Hence, the name 'crowding out'.

However, we need to keep in mind here that if government spends the money on creating basic infrastructure that facilitates smooth conducting of business and production. It may attract fresh private investment even when interest rates are high. This is called 'crowding in'.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are true (T) or false (F).

(a) Under Pay -As -You- Use Finance people will be able to pay as they use the benefit of the project. (T/F)

(b) In Pay -As -You- Go finance, benefits comes to the people out of their contributions in the past. (T/F)

Q 4: What is pay-as-you-use finance? (Answer in about 60 words)

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10.6 REDEMPTION OF PUBLIC DEBT

Public debt has to be repaid by the government. For this, the government adopts various strategies/methods. Some of these strategies need not result in actual reduction in the funds of treasury, while some do it. For discharging its repayment obligation, government may use the following methods.

- **Repudiation:** Repudiation implies denial. A government may simply refuse repayment obligation. Of course, it is not a normal course of action adopted by the government. Because, after adoption of this strategy, government lose faith of the people on it. Basically, denial of internal debt may lead to internal rebellion.
- **Refunding:** Through refunding, new loans are raised at lower interest rates in order to repay the old debt with higher interest rates. Refunding of debt may also be made from government revenues or from newly printed currency notes.
- **Conversion:** It is the conversion of existing loans to new ones. Before the maturity of public debt, fresh options are offered to the bond holders. The bond –holders are asked whether to lengthen the maturity period or to liquidate the debt on maturity. If the bond-holders are agreed for continuance, the existing loans are converted into new loans. To reduce interest obligations, to readjust maturity structure, to transfer public debt from banks to individual investors etc. are some of the important objectives for which this method is undertaken.

- **Sinking Fund Method:** Under it, the Government, out of its budgetary revenue, saves regularly in the heading of "sinking fund". The amount thus accumulated is used to repay the debt. The fund, before repayment, is invested to earn interest income.

  Although the method seems quite fruitful, it has been seem that many countries use this fund for other purposes. Moreover, some argue that such type of blocked of this fund in the name of repayment of debt is harmful, instead it should be used for productive purpose.

- **Year-wise Partial Repayment:** As the name indicates, through this method, from the budgetary revenue, a part of public debt is repaid every year. In this way, the total debt is paid off after some year

  In order to be successful through this method, the budget of a country should be a surplus one. If it fails to happen, either fresh loans have to be floated or other expenditure programme have to be sacrificed. With fresh loans, a part of old loans is cleared. This is a very useful one if maturity structure of various public debts is properly managed. That is, loans are to be arranged with different times of maturity over a long period.

- **Capital Levy:** Under it, a special type of tax on capital for raising revenue to pay off the heavily accumulated public debt (such as debt on war). It is an one time levy imposed upon the capitalists. Since capitalists earn profit during war, the rich are taxed, without effecting the common people.

- **Buying up Loans:** When the government has surplus income, it can spend them to purchase the already existed government bonds from the lenders. Afterwards, these bonds are again purchased and sold in the money market. Of course, the success of this method depends on the availability of the surplus budget with the government.

- **External Debt Redemption:** As external debt has to be paid in terms of the creditor's currency, its repayment requires earning of foreign exchange. And this foreign exchange can be earned from excess exports over imports. Utmost care should be taken to increase exports over imports. The foreign debt incurred should be used for productive

activity so that the earnings from production can be used for repayment of debt. Moreover, foreign debt should be used to produce those goods which have international market.

In every year, there may not be export surpluses. So, the best way is to pay a part of debt every year. In such a strategy, debt amount does not accumulate to a huge amount.



CHECK YOUR PROGRESS

Q 5: State whether the following statements are true (T) or false (F).

(a) Refunding is a method in which new loans are raised in order to repay the old debt. (T/F)

(b) Under Capital Levy, a special type of tax on goods and services is imposed to pay off the heavily accumulated public debt. (T/F)

Q 6: What is Sinking Fund Method of redemption of public debt? (Answer in about 60 words)

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10.7 LET US SUM UP

- There are both external and internal source of public debt.
- Burden of public debt are two types: external burden and internal burden.
- In terms of the nature of the burden concerned, there are two forms of burden: money burden and real burden.
- If tax payers and the bond holders are the same, there is no direct money burden of internal debt. Repayment of the same constitutes only a re-distribution of resources within the country.

- There will be a direct real burden of internal debt if the tax -payers and the bond- holders belong to different income-groups.
- Moreover, if the proportion of taxes paid by the rich is smaller than the proportion of public securities held by them, it leads to a direct real burden of internal debt.
- Direct money burden of external debt is the sum of money payments in the form of interest and principal to external creditors.
- Direct real burden of external debt amounts to the loss of economic welfare in terms of consumption of goods and services forgone, which could be consumed by the amount spent for repayment.
- Government projects are financed either through taxes or through loans or debt. Tax finance affects both present and future consumption while loan finance affects future consumption.
- In Pay -As –You- Use form of financing the development projects, the cost payment by taxpayers is made in such a way that the tax payers need not to pay the entire cost immediately. Instead, they can pay the taxes over those years, as the benefits are enjoyed by them.
- In Pay -As –You- Go finance, benefits come to the people out of their contributions in the past.
- The system of Pay -As –You- Go finance prohibits borrowings.
- For discharging its repayment obligation, government may use the various methods.
- A government may simply refuse repayment obligation through repudiation
- Through refunding, new loans are raised at lower interest rates in order to repay the old debt with higher interest rates.
- A government may convert existing loans to new ones through the method of conversion.
- Under Sinking fund method, the Government, out of its budgetary revenue, saves regularly in the heading of “sinking fund”. Loan is paid out of this fund.
- From the budgetary revenue, a part of public debt is repaid every year under the method of “Year-wise Partial Repayment”.

- Under "capital levy" method of redemption of public debt, a special type of tax on capital for raising revenue to pay off the heavily accumulated public debt .
- An external debt has to be repaid in terms of the creditor's currency, its repayment requires earnings of foreign exchange.



10.8 FURTHER READING

1) Choudhury, R. (2009). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers.

2) Mithani, D. M. (2010). *Money, Banking, International Trade and Public Finance.* Mumbai: Himalaya Publishing House Pvt. Limited.

3) Bhatia, H.L. (1993). *Public Finance,* Noida: Vikas Publishing House.



10.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) False b) False

Ans to Q No 2: External debt involves both money and real burden. Direct money burden of external debt is the sum of money payments in the form of interest and principal to external creditors. Direct real burden amounts to the loss of economic welfare in terms of consumption of goods and services forgone, which could be consumed by the amount spent for repayment. If the relative burden of taxation falls heavily upon the rich, the direct real burden of the community as a whole will be lesser than if the relative burden of taxation falls largely on the poor.

Ans to Q No 3: a) True b) True

Ans to Q No 4: In Pay-As-You-Use form of financing the development projects, the cost payment by taxpayers is made in such a way that the tax payers need not to pay the entire cost immediately. Instead, they can pay the taxes over those years, as the benefits are enjoyed by them. Pay-as-you-use finance through taxation

do not create any problem if the capital outlay required for the project is of continuous nature; such as minor irrigation projects.

Ans to Q No 5: a) True b) False

Ans to Q No 6: Through Sinking Fund Method, the Government, out of its budgetary revenue, saves regularly in the heading of "sinking fund". The amount thus accumulated is used to repay the debt. The fund, before repayment, is invested to earn interest income. However, it has been observed that many countries use this fund is used for other purposes as well.



10.10 MODEL QUESTIONS

A) Short Questions (Answer each question in about 150 words)

Q 1: What are various burden of public debt? .

Q 2: What is pay-as you-use and pay-as -you-go finance?

Q 3: What is crowding out effect?

B) Essay-type Questions (Answer each question in about 300-500 words)

Q 1: Explain different sources of public debt.

Q 2: Explain different methods adopted for redemption of public debt.

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UNIT 11: FISCAL POLICY

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Definition, Meaning and Concept

- 11.3.1 Classical Concept of Fiscal Policy
- 11.3.2 Modern Concept of Fiscal Policy

11.4 Objectives of Fiscal Policy

11.5 Major Functions of Fiscal Policy

11.6 The Fiscal Policy and Stabilization Function

11.7 Balanced Budget Multiplier

11.8 Let Us Sum Up

11.9 Further Reading

11.10 Answers to Check Your Progress

11.11 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- derive the meaning of fiscal policy
- outline the objectives of fiscal policy
- discuss various function which are carried out through fiscal policy
- explain how fiscal policy stabilises the monetary bases of states and a country's financial structure
- put forward the concept of balanced budget multiplier
- describe how balanced budget multiplier controls the money availability of an economy.

11.2 INTRODUCTION

To fulfil certain objectives of an economy, a Government tries to regulate and modify the economic affairs through certain instruments. These instruments come under macroeconomic policy. Fiscal policy is one of them.

Fiscal policy is conducted by the executive and legislative branches of the government and deals with managing a national and/or state budget. Fiscal policy refers to the taxation, expenditure and borrowing by the government. The economists now hold the government intervention through fiscal policy is essential in the matter of overcoming recession or inflation as well as for promoting and accelerating economic growth.

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply

11.3 DEFINITION, MEANING AND CONCEPT

According to J.M. Culbertson, "By fiscal policy we refer to government actions affecting its receipts and expenditures which we ordinarily takes as measured by the government's net receipts, its surplus or deficit."

Arthur smithies defines fiscal policy as "a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment." Though the ultimate aim of fiscal policy is the long run stabilisation of the economy, yet it can only be achieved by moderating short run economic fluctuations. Otto Eckstein defines fiscal policy as "Changes in taxes and expenditures which aim at short run goals of full employment and price -level stability."

Fiscal policy relates to the government decision-making with respect to:

- taxation
- government spending
- government borrowing and
- management of the government debt.

Tax policy relates to government decisions which influence the degree and manner in which funds are withdrawn from private economy. Expenditure policy involves decisions which influence the flow of funds from government into private economy. Debt management policy refers to

the government decisions made with respect to the stock of government debt outstanding and involves decisions as to the types of issue to be marketed, their maturity, distribution and rate of interest to be paid on them. Basically fiscal policy in these different facets deal with flow of funds out of the private spending and saving stream into the hands of government and the flow of funds from government into the private economy.

10.3.1 Classical Concept of Fiscal Policy

Classical economists believed in the policy of *laissez faire.* They believed that supply creates its own demand, therefore, general overproduction and involuntary unemployment is just next to impossible. For instance, if there is any unemployment and competition for available jobs, it will reduce wages and increase profit to a point where the employer finds it profitable to purchase more labour. Unless the state or the trade union or other exogenous factors interfere with working of economic system, unemployment will liquidate itself eventually through the process of wage reduction. Hence, there is no necessity of government or any other exogenous interference in the economy. They believed that government should undertake minimum essential functions (i.e. protecting national frontiers, security of life and property and so on) and should not interfere with the working of the economic system. They called this as the principle of sound finance.

Classical economists advocated the principle of a balanced budget. They considered a surplus or a deficit budget as undesirable. A surplus budget, created by means of additional taxes or higher tax rates, while maintaining the expenditure constant, would reduce the amount of resources available for productive investment in private sector. Moreover, additional taxation transfers resources from private sector to public sector, which they considered as unproductive. On the other hand, a deficit budget would need borrowing from the public which would again reduce resources available for private investment. This would decrease the private sector output and raise the general

price level. The government may impose additional taxation for the repayment of interest on borrowed funds, and capital to lenders. The additional taxation would cause transfer of resources from private sector to public sector, which they considered unproductive and undesirable. Therefore according to classical economists, balanced budget was a guide for the transfer of resources from private to public sector.

The classical theory of fiscal policy has limitations. It has been argued the classical belief of neutral effects of balanced budget on the economy of a country is not acceptable. A balanced budget can have expansionary effects. During an inflationary period, the tax revenue increase even without changing the tax rates and may create a budget surplus, which should entail a reduction in taxes or expansion in public expending, so as to maintain a budget balance. On the other hand, in depression, an economy faces a fall in tax revenues. Consequently, the government in order to maintain a balanced budget will have either to impose fresh taxes or to reduce the public spending. In either case, the slump will depend further. It is thus obvious that the annually balanced budget may have a destabilising effect on the economy.

10.3.2 Modern Concept of Fiscal Policy

The classical concept of fiscal policy has not been accepted by the modern economist like Keynes and Learner. They believed that the government has to pay a positive role so as to regulate and control the economy by means of taxes and expenditure, which they called as the principle of functional finance. Modern fiscal policy is a technique to attain and maintain full employment by manipulating public expenditure and revenue in such a way so as to keep equilibrium between effective demand and supply of goods and services at that time.

Keynes believed that in an advanced economy, the propensity to consume tends to diminish as income increases. Hence, a large

portion of additional income is saved. The tendency of less consumption and large savings result in lowering the demand for goods and services produced at that time; therefore, disequilibrium occurs in the economy. Thus, to maintain income and employment at present level, it is necessary to offset the effects of decrease in demand for output due to decrease in consumption by a corresponding increase in public expenditure. Hence, if unemployment is to be avoided, the gap between the income and expenditure must be filled by government expenditure. For instance, during depression, the effective demand is not enough to absorb the available supply of goods and services, resulting in unemployment and underemployment. To maintain full employment and income, government needs to increase public expenditure by undertaking public works programmes on large scale and thereby inducing people to spend more.

11.4 OBJECTIVES OF FISCAL POLICY

The importance of fiscal policy is high in underdeveloped countries. The state has to play an active and important role. In a democratic society direct methods are not preferred. So, the government has to depend on indirect methods of regulations. In this way, fiscal policy is a powerful weapon in the hands of government by means of which it can achieve the objectives of development. The principle objectives of fiscal policy are given below:

- **Development by Effective Mobilisation of Resources** The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by mobilisation of financial resources. The financial resources can be mobilised by taxation, public savings, and private savings.
- **Reduction in inequalities of Income and Wealth:** Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. This is done through various tax structures. The direct taxes such as income tax are charged more

on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items which are mostly consumed by the upper middle class and the upper class. To improve the conditions of poor people in society, the government invests a significant proportion of its tax revenue in the implementation of poverty alleviation programmes.

- **Price Stability and Control of Inflation:** One of the main objectives of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, productive use of financial resources.
- **Employment Generation:** The government put efforts to increase employment in the country through effective fiscal measures. Through investment in infrastructure, government creates employment. By Lowering taxes and duties on small-scale industrial (SSI) units, government encourages more investment in these units and encourages the new entrepreneurs to start these units. Consequently this generates more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.
- **Balanced Regional Development:** Through public expenditure, government invest money on various projects like building up dams, schools, roads, electricity, industrial projects etc. to mitigate the regional imbalances in the country.
- **Reducing Deficit in the Balance of Payment:** Fiscal policy attempts to encourage more exports by various measures like exemption of tax on export earnings, exemption of sales tax, exemption of central excise duties and custom duties etc. By providing fiscal benefits to import substitute industries, imposing customs duties on imports etc. are also used to improve the foreign exchange reserve. The foreign exchange earned by way of exports and saved by way of import

substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected.

- **Increases National Income:** The fiscal policy aims to increase the national income of a country because fiscal policy facilitates the capital formation. This result in economic growth leads to increase the GDP, per capita income and national income of the country.
- **Development of Infrastructure:** The fiscal policy measures generate revenue to the government. A part of the revenue is invested in infrastructural development the country. A well developed infrastructure paves the way to all sectors development of a country. This will lead to the economic growth of that country.
- **Capital Formation:** One of the objectives of fiscal policy is to accelerate the capital formation rate to speed up the rate of economic growth. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage spending.
- **Foreign Exchange Earnings:** when the central government of the country gives incentives like, exemption in custom duty, concession in excise duty while producing things in the domestic markets, it motivates the foreign investors to increase the investment in the domestic country.

The objectives of fiscal policy can only be achieved through effective implementation it's the tools.

11.5 MAJOR FUNCTIONS OF FISCAL POLICY

- **Allocation:** The first major function of fiscal policy is to determine exactly how funds will be allocated. This is closely related to the issues of taxation and spending, because the allocation of funds depends upon the collection of taxes and the government using that revenue for specific purposes. The national budget determines how funds are allocated. This means that a specific amount of funds is set aside for purposes specifically laid out by the government. This has a direct economic impact on the country.

- **Distribution:** Whereas allocation determines how much will be set aside and for what purpose, the distribution function of fiscal policy is to determine more specifically how those funds will be distributed throughout each segment of the economy.
- **Stabilization:** Stabilization is another important function of fiscal policy. The purpose of budgeting is to provide stable economic growth. Without some restraints on spending, the economic growth of the nation could become unstable, resulting in periods of unrestrained growth and contraction. The unrestrained growth cannot continue for an indefinite period. When growth periods end, they are followed by contraction in the form of recessions and later moved into depression. Fiscal policy is designed to anticipate and mitigate the effects of such economic turmoil.

Economic Growth: Economic growth leads to overall development of the economy in long run. However, fiscal policy is far more complicated than determining how much the government will tax citizens one year and then determining how that money will be spent. True economic growth occurs when various projects are financed and carried out using collected government money prudently. This stems from the belief that the private sector cannot grow the economy by itself. Instead, some government input and influence are needed. Borrowing funds for economic growth by spending on infrastructure and capital goods is one way in which the government brings about development.



CHECK YOUR PROGRESS

Q 1: Fiscal policy is conducted by the .....and .....branches of the Government. (Fill in blanks)

Q 2: What do mean by Fiscal Policy? (write within 50 words)

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Q 3: State the classical concept of fiscal policy(write within 50 words)

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Q 4: State two functions of fiscal policy (write within 50 words)

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11.6 THE FISCAL POLICY AND STABILIZATION FUNCTION

Fiscal policy can promote macroeconomic stability by sustaining aggregate demand and private sector incomes during an economic downturn and by moderating economic activity during periods of strong growth. An important stabilising function of fiscal policy operates through the so-called “automatic fiscal stabilisers”. These work through the impact of economic fluctuations on the government budget and do not require any short-term decisions by policy makers. The size of tax collections and transfer payments, for example, are directly linked to the cyclical position of the economy and adjust in a way that helps stabilising aggregate demand and private sector incomes. Automatic stabilisers have a number of desirable features. First, they respond in a timely and foreseeable manner. This helps economic agents to form correct expectations and enhances their confidence. Second, they react with an intensity that is adapted to the size of the deviation of economic conditions from what was expected when budget plans were approved. Third, automatic stabilisers operate symmetrically over the economic cycle, moderating overheating in periods

of booms and supporting economic activity during economic downturns without affecting the underlying soundness of budgetary positions, as long as fluctuations remain balanced.

In principle, stabilisation can also result from discretionary fiscal policy-making, whereby governments actively decide to adjust spending or taxes in response to changes in economic activity. Many believe that discretionary fiscal policies are not normally suitable for demand management, as past attempts to manage aggregate demand through discretionary fiscal measures have often demonstrated. First, discretionary policies can undermine the healthiness of budgetary positions, as governments find it easier to decrease taxes and to increase spending in times of low growth than doing the opposite during economic upturns. This induces a tendency for continuous increases in public debt and the tax burden. In turn, this may have adverse effects on the economy's long-run growth prospects as high taxes reduce the incentives to work, invest and innovate. Second, many of the desirable features of automatic stabilisers are almost impossible to replicate by discretionary reactions of policy makers. For instance, tax changes must usually be adopted by Parliament and their implementation typically follows the timing of budget-setting processes with a lag. Not surprisingly, therefore, discretionary fiscal policies aiming at aggregate demand management have tended to be pro-cyclical in the past, often becoming effective after cyclical conditions have already reversed, thereby exacerbating macroeconomic fluctuations.

However, discretionary policies are needed to implement long-term structural changes in public finances and to deal with exceptional situations, particularly when the economy experiences extraordinary shocks. Discretionary policies in fact reflect the changing tastes about the desirable size of the public sector, about the priorities of public spending, and about the level and characteristics of taxation. These policies determine the structure of public finances and substantially affect the functioning of the economy but also the features of a country's automatic stabilisers. Discretionary fiscal policy decisions are also needed to preserve the sustainability of public finances in the medium-term. This is the precondition

for automatic stabilisers to operate freely, as fiscal policy can only act as an effective stabilising tool when there is the necessary room to manoeuvre.

11.7 BALANCED BUDGET MULTIPLIER

The budget is the most important instrument of fiscal policy, since the necessary finance is obtained and the public expenditure is made through budget. Thus, it can be used to mitigate economic fluctuations. A budget can be of two types; balanced and unbalanced budget. A government budget is said to be balanced when its tax revenues and expenditures are equal. When a budget is not balanced, it is either deficit or surplus budget. The policy of deficit budget is advocated to mitigate the situation of unemployment and depression while the policy of surplus budget is formulated to face the situation of inflation and related issues.

The effect of change in government expenditure and tax receipts on national income or output is known as expansionary effect. The expansionary effect of a balanced budget is called the balanced budget multiplier (BBM). Here an increase in government spending matched by an increase in taxes results in a net increase in income by the same amount. This may be illustrated with the help of an example. Let us assume an MPC of 0.75. If government expenditure increases by Rs. 20 crore national income would increase to Rs. 80 crore.

This can be obtained by using the formula for government spending multiplier, K_G:

$$\Delta Y = \frac{1}{1-MPC}\Delta G$$

$$80 = \frac{1}{1-0.75}.20$$

Now, an increase in taxes by the same amount (i.e. Rs. 20 crore) would lead to a reduction in aggregate output of Rs. 60 crore.

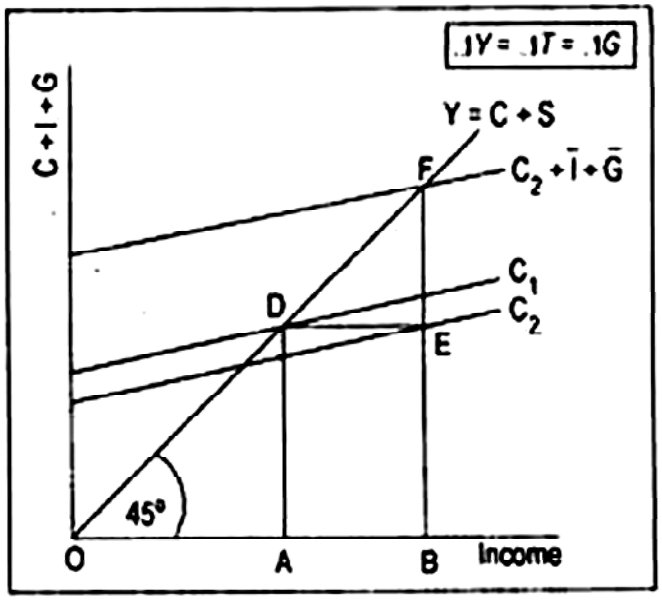
Applying the formula for tax multiplier, K_T, we obtain:

$$\Delta Y = \frac{-MPC}{1-MPC}.\Delta T$$

$$-60 = \frac{-0.75}{1-0.75}.20$$

This happens because with the increase in taxes of Rs. 20 crore, consumption would decline to Rs. 15 crore and not Rs. 20 crore, since the value of MPC being 0.75. (i.e., 0.75x 20 = Rs. 25 crore). Reduction in consumption by Rs. 15 crore leads to a decline in income by Rs. 60 crore. As a result, the net increase in national income (Rs. 80 – Rs. 60 crore) becomes Rs. 20 crore. Thus, the BBM, defined as the net increase in income (Rs. 20 crore) caused by an increase in government spending (Rs. 20 crore), and increase in taxes (Rs. 20 crore) will have a value of 1. This result is known as the balanced budget theorem or unit multiplier theorem which must have a value of one, no matter whatever the value of MPC.

Figure 11.1: Balanced Budget Multiplier



We ca C_1 is the consumption line before the launching of the tax-expenditure programme. C_2 is the post-tax consumption line, DE being the tax receipt. If the entire DE amount of tax receipt is spent by the government, the aggregate demand curve would be represented by $C_2 + \bar{I} + \bar{G}$ where investment and government expenditure are assumed to be autonomous.This curve intersects the 45° line at point F. As a result, national income rises from OA to OB. Note that AB = DE = EF.

Since AB represents the increase in income (“Y), DE is the increase in tax (“T) and EF is the increase in government expenditure (“G), we may write:

$\Delta Y = \Delta T = \Delta G$

$\therefore \Delta Y/\Delta G = \Delta Y/\Delta T = 1$

The value of BBM (symbolised by K_B) is unity. It can also be expressed in the following way:

$$K_B = K_G + K_T$$

$$K_B = \frac{1}{MPS} - \frac{MPC}{MPS} = \frac{1-MPC}{MPS}$$

$$\therefore K_B = \frac{1-MPC}{1-MPC} = 1 \ (\because MPS = 1 - MPC)$$

Since K_G is positive and K_T is negative, the net effect of balanced budget is not neutral. Income changes by an amount equal to a change in government expenditure and tax receipt. So the value of BBM must be 1. Since K_T is one less than K_G, a balanced budget must have a value of one.



CHECK YOUR PROGRESS

Q 5: Budget can be either ..... or .....(Fill in blanks)

Q 6: Deficit or surplus budget are forms of balanced budget.(State whether 'true' or 'false')

Q 7: What do you mean by balanced budget multiplier (write within 50 words)

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11.8 LET US SUM UP

- To fulfil certain objectives of an economy, a Government tries to regulate and modify the economic affairs through certain instruments. These instruments come under macroeconomic policy.

- According to J.M. Culbertson, "By fiscal policy we refer to government actions affecting its receipts and expenditures which we ordinarily takes as measured by the government's net receipts, its surplus or deficit."
- Arthur smithies defines fiscal policy as "a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment."
- Tax policy relates to government decisions which influence the degree and manner in which funds are withdrawn from private economy. Expenditure policy involves decisions which influence the flow of funds from government into private economy. Debt management policy refers to the government decisions made with respect to the stock of government debt outstanding and involves decisions as to the types of issue to be marketed, their maturity, distribution and rate of interest to be paid on them.
- Classical economists believed in the policy of *laissez faire.* They believed that supply creates its own demand, therefore, general overproduction and involuntary unemployment is just next to impossible.
- Modern fiscal policy is a technique to attain and maintain full employment by manipulating public expenditure and revenue in such a way so as to keep equilibrium between effective demand and supply of goods and services at that time.
- The importance of fiscal policy is high in underdeveloped countries. The state has to play an active and important role. In a democratic society direct methods are not preferred. So, the government has to depend on indirect methods of regulations.
- Fiscal policy can promote macroeconomic stability by sustaining aggregate demand and private sector incomes during an economic downturn and by moderating economic activity during periods of strong growth.
- The budget is the most important instrument of fiscal policy, since the necessary finance is obtained and the public expenditure is made through budget.

- The effect of change in government expenditure and tax receipts on national income or output is known as expansionary effect. The expansionary effect of a balanced budget is called the balanced budget multiplier (BBM).

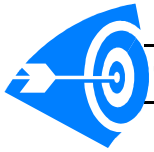


11.9 FURTHER READING

1) Banerjee, P. (1986). *Fiscal Policy in India.* New Delhi: Gyan Publication.

2) Reddy, Y. V., Valluri, N., Ray, P. (2014). *Financial and Fiscal Policies: Crises and New Realities.* New Delhi: Oxford University Press

3) S. Dey. (2017). *India's Fiscal Policy: Prescriptions, Pragmatics and Practice*. New Delhi: Cambridge University Press



11.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Executive and legislative branches of the government

Ans to Q No 2: Fiscal policy is a policy under which government uses its expenditure and revenue programmes to produce desirable effect on national income, production and employment. It is the policy of the government to achieve and maintain the stability, full employment and growth of an economy.

Ans to Q No 3: As a believer of free economy, the classical economist argued that government should undertake minimum essential functions (i.e. protecting national frontiers, security of life and property) and should not interfere with the working of the economic system. They called this as the principle of sound finance. Classical economists advocated the principle of a balanced budget.

Ans to Q No 4: Two functions of fiscal policy are allocation of resources and economic growth. The first function of fiscal policy is to determine exactly how funds will be allocated. This is closely related to the issues of taxation and spending, because the allocation of funds depends upon the collection of taxes and the

government using that revenue for specific purposes. The government funds collected by various taxes are invested in different sectors of the economy.

Ans to Q No 5: Balanced or unbalanced

Ans to Q No 6: False

Ans to Q No 7: The effect of change in government expenditure and tax receipts on national income or output is known as expansionary effect. The expansionary effect of a balanced budget is called the balanced budget multiplier (BBM). Here an increase in government spending matched by an increase in taxes results in a net increase in income by the same amount.



11.11 MODEL QUESTIONS

A) Short Questions (Answer each question in about 150 words)

Q 1: Discuss meaning of fiscal policy.

Q 2: Discuss the modern concept of fiscal policy.

Q 3: Discuss the balanced budget multiplier with example

B) Essay-type Questions (Answer each question in about 300-500 words)

Q 1: Make a comparative analysis on the classical and modern concept of fiscal policy.

Q 2: What are the objectives of fiscal policy?

Q 3: Explain the various functions of fiscal policy.

Q 4: Explain the role of fiscal policy as an instrument to stabilise the economy.

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UNIT 12: THE PUBLIC BUDGET

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Public Budget

- 12.3.1 Meaning of Public Budget
- 12.3.2 Types of Public Budget

12.4 Components of the Public Budget

12.5 Performance and Zero-Based Budgeting

12.6 Concepts of Budget Deficit

- 12.6.1 Revenue Deficit
- 12.6.2 Fiscal Deficit
- 12.6.3 Primary Deficit

12.7 Let Us Sum Up

12.8 Further Reading

12.9 Answers to Check Your Progress

12.10 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- put forward the meaning of public budget or government budget
- discuss various types of budget
- discuss the various components of public budget
- put forward the meaning of zero-based budgeting
- discuss the types of budget deficits
- put forward the measures to check deficits in budget

12.2 INTRODUCTION

In the previous unit, we have discussed about fiscal policy. Fiscal policy refers to the government policy which is concerned with receipts and expenditure of the government. It includes taxation, public expenditure,

public debt and the matters related to the budget. In this unit, we shall try to understand the concept of public budgeting and its types and components.

Public budgeting is a field of public administration and therefore it becomes a discipline in the academic study. It can be defined as a financial plan that estimates the receipts and expenditures of the government for the given financial year, usually one-year period, started from 1st of April to 31st of March.

There are different types of public budget, such as surplus budget, balanced budget, deficit budget, revenue budget, capital budget, incremental budget, zero-base budget, etc. In addition, these categories of public budget, there are few more types of budget.

There are three types of budget deficits, namely, revenue deficit, fiscal deficit and primary deficit.

12.3 PUBLIC BUDGET

As we have already stated that the public budget is a field of public administration. With the increase in responsibilities and functions of the government, the role of the public budget has also become more important. By the term 'budget' we mean a well-prepared plan for the accomplishment of some programmes to attain determined objectives and goals within a specified period of time, including an estimate of resources required together with an estimate of resources available. A good budget is that which satisfies all the criteria identified for this purpose and is prepared on the basis of well-recognized principles.

12.3.1 Meaning of Public Budget

Public budget refers to a financial statement of expected receipts and anticipated expenditure of the government for a given year, usually a financial year. It shows item wise estimates of receipts and expenditure of the government during a given financial year, i.e., from 1st April of one calendar year to 31st March of next calendar year. Public budget is prepared at different levels such as Central

Government, State Government and also the Local Government. Public budget is just an estimate of expected amount of receipts and anticipated expenditure not the actual receipts and expenditure of the government. Government estimates the amount of expected receipts from different sources of public revenue and the amount of anticipated expenditure to achieve various objectives and goals of the government.



CHECK YOUR PROGRESS

Q 1: State whether following statements are true or false (T/F):

(i) Public budget is a field of public administration. (T/F)

(ii)By the term 'budget' we mean a well-prepared plan for the accomplishment of some programmes to attain determined objectives and goals within a specified period of time. (T/F)

(iii)Public budget refers to a financial statement of expected receipts and anticipated expenditures of the government for a given period of one year. (T/F)

(iv)The duration of one year from 1st April to 31st March is known is financial year. (T/F)

(v)Public budget shows the statement of actual receipts and actual expenditures of the government. (T/F)

Q 2: Define public budget.

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12.3.2 Types of Public Budget

There are various types of public budget. Some of the important types of public budget are explained below:

- **Legislative Budget:** A public budget is a document prepared by the government or other political entity presenting its expected receipts and anticipated expenditure for the forthcoming financial year. A legislative budget is formulated by a legislate committee which will get the budget adopted by the legislature. This budget is important due to its prescription of the maximum amount, which is to be appropriated for the given financial year.
- **Executive Budget:** An executive budget is formulated by the chief executive with the help of his budget department. The executive branch of the government takes the initiative to prepare this form of budget and to get approved by the legislature. This type of budget is practiced in the United States and also some other countries. In England, it is presented by the Chancellor of Exchequer as the representative of the Prime Minister and in India, it is presented by the Finance Minister, Govt. of India.
- **Superiority of Executive Budget over Legislative Budget:** The executive budget is considered as superior over the legislative budget. Following are the causes of superiority of executive budget over the legislative budget:
  - Firstly, the executive budget is prepared by the chief executive with his department, who is accountable to the public for the budgetary actions. Therefore, the executive budget is more appropriate than the legislative budget.
  - Secondly, if the executive is asked to implement the budget and to achieve the objectives and goals of the budget which is formulated by someone else, then the executive may find it less interested and frustrated and as a result of which the efficiency in execution will decline.
  - Thirdly, the effectiveness of the budget is dependent upon the preparation and implementation of the budget, which is further dependent upon the expertise of the persons engaged in the process. It is the executive which is well equipped with expertise for the formulation of a sound

budget and efficient implementation of the budget. Therefore, the executive budget is better than the legislative budget.

- **Balanced Budget:** A balanced budget can be defined as the budget in which the estimated receipts are equal to the anticipated expenditure of the government for a given financial year. In case of balanced budget, the expected receipts from all the sources are exactly equal to the estimated expenditure of the government for all purposes for forthcoming fiscal year. Usually the balanced public budget is pursued in the economically developed countries at a time when their economy faces neither the situation of inflation nor the situation of deflation. The balanced budget is aimed at maintaining full employment and price stability in the economy. It is very rare to find a balanced budget in underdeveloped or developing countries.
- **Unbalanced Budget:** Unbalanced budget refers to a type of budget in which the estimated receipts of the government are not equal to the estimated expenditure of the government for a given period of one year, usually a financial year. That is, a public budget is said to be an unbalanced budget if either the estimated receipts of the government are more or less than the estimated expenditure of the government for a given financial year. Therefore, unbalanced budget can be of two different types: (i) surplus budget and (ii) deficit budget. *Surplus budget* is the public budget in which the estimated receipts of the government are more than the estimated expenditure of the government for a given financial year. On the other, *deficit budget* is the budget in which the estimated receipts are less than the estimated expenditure of the govt. for a given financial year. Usually, the economically developed countries can pursue the surplus budget. On the other hand, the underdeveloped or developing countries pursue the deficit budget as they have limited sources of receipts but have to spent more for the development of the economy.

- **Revenue Budget and Capital Budget:** There are many countries, specially the less developed countries (LDCs), who prepare their budget which is consisting of two parts, namely, revenue budget and capital budget. This is done mainly because the government has to spend more on building of socio-economic infrastructure without which economic development cannot achieve.

  Revenue budget is that part of public budget which deals with the revenue aspect of the public budget. Revenue budget explains how revenue is generated or collected by the government and also how revenue is allocated among various expenditure heads. It has further two parts – revenue receipts and revenue expenditures.

  On the other hand, *capital budget* is that part of the public budget which deals with the capital aspect of the public budget. Capital budget is consisting two parts – capital receipts and capital expenditures.

Incremental Budget: Incremental budget refers to the budget, which is prepared using a previous year's budget or the actual performances as a basis with incremental amounts of expenditure added for the new budget period. In order to be a sound budget for the achievement of objectives and goals of the budget, the budget should be assessed occasionally and also request for the grant of fund should be properly and timely reviewed. There is need of review of the budget at both administrative and legislative levels so that the goals of the budget can be achieved. In case of incremental budget, the allocation of resources is based upon the allocations from the previous period. Usually this approach is not recommended because it does not follow the changes occurred and thus it fails to take into account changing circumstances. Moreover, it encourages spending up to the budget to ensure a reasonable allocation in the next budget period.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are true or false (T/F):

(i) A legislative budget is a budget prepared by the government or other political entity presenting its expected receipts and anticipated expenditures for the forthcoming financial year. (T/F)

(ii) An executive budget is the budget which is formulated by the chief executive with the help of his budget department. (T/F)

(iii) A legislative budget is superior budget over the executive budget. (T/F)

(iv) A balanced budget is the budget in which the estimated receipts is not equal to the anticipated expenditure of the government for a given financial year. (T/F)

(v) Unbalanced budget is the budget in which the estimated receipts of the government are not equal to the estimated expenditure of the government. (T/F)

Q 4: Give the definition of the following terms:

(i) Surplus budget: .....

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(ii) Deficit budget: .....

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(iii) Incremental budget: .....

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12.4 COMPONENTS OF PUBLIC BUDGET

There are two major components of public budget. These are (i) revenue budget and (ii) capital budget. Further revenue budget and capital budget have their sub-components. These are explained bellow:

- **Revenue Budget:** Revenue budget is that part of public budget which deals with the revenue aspect of the public budget. Revenue budget explains how revenue is generated or collected by the government and also how revenue is allocated among various expenditure heads. It has further two parts – revenue receipts and revenue expenditures.
- **Revenue receipts** are those receipts which neither create any liability nor cause any reduction in the assets of the government. Revenue receipts are regular and recurring in nature. The government receives these receipts in its normal course of activities. There are mainly two major sources of revenue receipts – tax revenue and non-tax revenue.

Tax revenue refers to the sum total of receipts from taxes and other duties imposed and collected by the government. There are two major types of taxes – direct taxes and indirect taxes. A tax is said to be direct tax if the impact and incidence of the tax fall upon the same person. In case of direct tax, the burden of the tax cannot be shifted to others. For instance, income tax, corporate tax, wealth tax, capital gain tax, etc. On the other hand, a tax is said to be indirect tax if the impact and incidence of the tax fall upon different persons. In case of indirect tax, the burden of the tax can be shifted to others. For examples, sales tax, services tax, excise duty, custom duty, etc.

Non-tax revenue refers to those receipts which are received by the government from all the sources other than those of tax receipts. For examples, interest, profits and dividends, fees, fines and penalties, gifts and grants, escheats, forfeitures, special assessment, etc.

- **Revenue expenditures** are those expenditures incurred by the government which neither create any asset nor cause a reduction in any liability of the government. The revenue expenditures are recurring in nature. These are incurred for normal functioning of the government and also for providing various services to the people.

- **Capital Budget:** Capital budget is that part of the public budget which deals with the capital aspect of the public budget. Capital budget is consisting two parts – capital receipts and capital expenditures.

Capital receipts are those receipts received by the government which either create a liability or cause a reduction in the assets of the government. Capital receipts are non-recurring and also non-routine in nature. For instances, public borrowing, sale of shares of public enterprises, etc. There are some sources of capital receipts such as borrowings, recovery of loans, disinvestment, small savings, etc. Public borrowings are the funds raised by the government from different sources to meet excess expenditures of the government. On the other hand, government also grants various loans to the state governments or union territories and recovery of such loans is considered as capital receipts because the recovery of loans reduces the assets of the government.

Disinvestment is the act of selling a part or the whole of shares of selected public sector undertakings held by the government. Disinvestment is considered as capital receipts as it reduces the assets of the government. Government also receives capital receipts in the form of small savings. These are the funds which are raised from the public in the form of Post Office deposits, National Saving Certificates (NSC), Kisan Vikas Patras, etc. Small savings are capital receipts as they increase the liability to the government.

Capital expenditures are the expenditure incurred by the government which either creates an asset or causes a reduction in the liability of the government. These are non-recurring in nature. Capital expenditures result in addition to the capital stock of the economy. They also lead to an increase the productivity of the economy when the government spend on the developmental programmes.

The components of budget can also be classified and stated on the basis of receipts received and expenditure incurred by the government. On the basis of the receipts and expenditure, there are two major components of budget – (i) budget receipts and budget expenditures. Budget receipts are the estimated money receipts of the government expected from all the sources during a given period one year, i.e., budget year, which is usually a financial year. The budget receipts are the sum

total of revenue receipts and capital receipts received by the government. On the other hand, budget expenditures are the sum total of revenue expenditures and capital expenditures incurred by the government. We have already discussed about the revenue receipts, revenue expenditures, capital receipts and capital expenditures in the previous part of the components of government or public budget.



CHECK YOUR PROGRESS

Q 5: State whether the following statements are true or false (T/F):

(i) Tax revenue refers to the sum total of receipts from taxes and other duties imposed and collected by the government. (T/F)

(ii)Non-tax revenue refers to those receipts which are received by the government from all the sources other than those of tax receipts. (T/F)

(iii) Disinvestment is the act of purchasing a part or the whole of shares of private sector undertakings held by individuals or private organizations. (T/F)

(iv)Budget receipts are the sum total of revenue receipts and capital receipts received by the government. (T/F)

(v)Budget expenditures are the sum total of revenue expenditures and capital expenditures incurred by the government. (T/F)

Q 6: Mention two examples of each of revenue receipts and capital receipts.

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12.5 PERFORMANCE AND ZERO-BASED BUDGETING

- Budget can also be categorised as performance budget and zero-based budget. These are explained below:

- **Performance Budget:** A performance budget refers to the practice of preparing a budget which is based on the evaluation of the productivity or outcomes of the different operations in an organisation. It mainly focuses on outcomes of the activities carried out as per the budget. The operations which are contributing the most to the profitability or the attainment of the desired goals and objectives of the budget, the larger share of the budget resources is allocated to that division. As a result, it leads to the optimum utilization of the available resources such as finance, skills of the staff, use of the productive time, etc.

  Generally, the government departments and not for profit organization use to prepare a performance budget. This type of budget is commonly used by government bodies and agencies to show the link between taxpayer's funds and the final outcomes of services provided by the federal, state or local governments. A performance budget requires an evaluation of the performance and productivity from one budget period to another budget period. It is used to justify the application of money. Hence, it is the process of identifying the results achieved by each division of the organization. The final outcomes are analysed. Performance budget is a motivating tool for the staff.

- **Zero-based Budget:** Zero-based budget can be defined as the budgetary process which requires each ministry or department to justify its entire budget in details. Zero-based budget is a system of budget in which all public expenditures must be justified for each new budget period. It is necessary to regularly examining the expenditure components in the light of anticipated outcomes of the budget as all expenditures incurred by the government for the attainment of some objectives and goals.

  Zero-based budget requires to start afresh not to take previous year's expenditure. That is, government should start from zero point while preparing its budget for the forthcoming budget period instead of treating the current budget as the base for the new budget.

Therefore, it is necessary to re-examination of the current budgetary programmes and activities to assess their continued utility instead of following the incremental approach while preparing the new budget for a given period.

12.6 CONCEPT OF BUDGET DEFICIT

On the basis of budget receipts and budget expenditures, public budget can be of two types – balanced and also imbalanced. The imbalanced budget can be further classified as surplus budget and deficit budget. Budgetary deficit can be defined as the excess of total anticipated expenditure, i.e., sum total of revenue expenditures and capital expenditures, over the total expected and estimated receipts, i.e., revenue receipts and capital receipts, of the government in the budget for a given period of one year. Thus, when the total estimated expenditure of the government is more than the total estimated receipts of the government in the budget, then the budget is said to be in deficit. Budgetary deficit with respect to Indian government can be classified into three categories and these are – (i) revenue deficit, (ii) fiscal deficit and (iii) primary deficit.

12.6.1 Revenue Deficit

Revenue deficit is associated with the revenue budget, which is one of the major components of the government budget. It is concerned with the revenue receipts and revenue expenditures of the government. Revenue deficit can be defined as the excess of revenue expenditures over the revenue receipts of the government in the revenue budget during the given budget period, i.e., a financial year. Thus,

Revenue Deficit = Revenue Expenditures – Revenue Receipts

Revenue deficit implies that the revenue collected by the government is inadequate to meet the expenditures incurred by the government on normal functioning of the various government departments and the provisions for providing various services. Thus,

the revenue deficit of the government indicates the inability of the government to meet its expenditures those are regular and recurring in nature.

12.6.2 Fiscal Deficit

Fiscal deficit can be defined as the excess of total expenditures over the total receipts excluding borrowings of the government during a given budget period, i.e., a given financial year. Thus,

Fiscal Deficit = Total Expenditures – Total Receipts excluding borrowings

Fiscal deficit, which presents a more comprehensive view of budgetary imbalances, is widely used as a budgetary tool for understanding and explaining the budgetary developments in India. It signifies the total requirements of public debt.

12.6.3 Primary Deficit

Primary deficit can be defined as the difference between the fiscal deficit of the current year and the interest payments on the previous public debt taken by the government. Thus,

Primary Deficit = Fiscal Deficit – Interest Payments on the Previous Public Debt

Primary deficit signifies the amount of public debt required to meet the public expenditures other than the interest payments. The difference between the fiscal deficit and primary deficit shows the amount of interest payments on the past public debt taken by the government.



CHECK YOUR PROGRESS

Q 7: State whether the following statements are true or false (T/F):

(i) A performance budget refers to the practice of preparing a budget which is based on the evaluation of the productivity or outcomes of the different operations in an

organisation. (T/F)

(ii) Zero-based budget can be defined as the budgetary process which requires each ministry or department to justify its entire budget in details. (T/F)

(iii) Revenue deficit is the excess of revenue receipts over the revenue expenditures of the government in the revenue budget during the given budget period. (T/F)

(iv) Fiscal deficit is the excess of total expenditures over the total receipts excluding borrowings of the government during a given financial year. (T/F)

Q 8: What is meant by primary deficit?

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12.7 LET US SUM UP

- Fiscal policy refers to the government policy which is concerned with receipts and expenditure of the government and it includes taxation, public expenditure, public debt and the matters related to the budget.
- By the term 'budget' we mean a well-prepared plan for the accomplishment of some programmes to attain determined objectives and goals within a specified period of time, including an estimate of resources required together with an estimate of resources available.
- Public budget refers to a financial statement of expected receipts and anticipated expenditure of the government for a given year, usually a financial year.
- A good budget is that which satisfies all the criteria identified for this purpose and is prepared on the basis of well-recognized principles.
- A legislative budget is formulated by a legislate committee which will get the budget adopted by the legislature. This budget is important due to its prescription of the maximum amount, which is to be appropriated for the given financial year.

- An executive budget is formulated by the chief executive with the help of his budget department. The executive branch of the government takes the initiative to prepare this form of budget and to get approve by the legislature.
- The executive budget is considered as superior over the legislative budget.
- A balanced budget can be defined as the budget in which the estimated receipts are equal to the anticipated expenditure of the government for a given financial year.
- Unbalanced budget refers to a type of budget in which the estimated receipts of the government are not equal to the estimated expenditure of the government for a given period of one year, usually a financial year.
- Surplus budget is the public budget in which the estimated receipts of the government are more than the estimated expenditure of the government for a given financial year.
- Deficit budget is the budget in which the estimated receipts are less than the estimated expenditure of the government for a given financial year.
- Incremental budget refers to the budget, which is prepared using a previous year's budget or the actual performances as a basis with incremental amounts of expenditure added for the new budget period.
- There are two major components of public budget. These are (i) revenue budget and (ii) capital budget.
- Revenue budget is that part of public budget which deals with the revenue aspect of the public budget.
- Revenue budget is consisting of two parts – revenue receipts and revenue expenditures.
- Revenue receipts are those receipts which neither create any liability nor cause any reduction in the assets of the government.
- There are mainly two major sources of revenue receipts – tax revenue and non-tax revenue.

- Revenue expenditures are those expenditures incurred by the government which neither create any asset nor cause a reduction in any liability of the government.
- Capital budget is that part of the public budget which deals with the capital aspect of the public budget.
- Capital budget is consisting of two parts – Capital receipts and capital expenditures.
- Capital receipts are those receipts received by the government which either create a liability or cause a reduction in the assets of the government.
- Disinvestment is the act of selling a part or the whole of shares of selected public sector undertakings held by the government.
- Capital expenditures are the expenditure incurred by the government which either creates an asset or causes a reduction in the liability of the government.
- The components of budget can also be classified and stated on the basis of receipts received and expenditure incurred by the government.
- On the basis of the receipts and expenditure, there are two major components of budget – (i) budget receipts and budget expenditures.
- Budget receipts are the sum total of revenue receipts and capital receipts received by the government.
- Budget expenditures are the sum total of revenue expenditures and capital expenditures incurred by the government.
- Performance budget refers to the practice of preparing a budget which is based on the evaluation of the productivity or outcomes of the different operations in an organisation.
- Zero-based budget can be defined as the budgetary process which requires each ministry or department to justify its entire budget in details.
- Budgetary deficit can be defined as the excess of total anticipated expenditure over the total expected and estimated receipts.
- Budgetary deficit with respect to Indian government can be classified into three categories and these are – (i) revenue deficit, (ii) fiscal deficit and (iii) primary deficit.

- Revenue deficit is associated with the revenue budget, which is one of the major components of the government budget.
- Fiscal deficit can be defined as the excess of total expenditures over the total receipts excluding borrowings of the government during a given budget period, i.e., a given financial year.
- Primary deficit can be defined as the difference between the fiscal deficit of the current year and the interest payments on the previous public debt taken by the government.



12.8 FURTHER READING

1) Bhatia, H.L. (1993). *Public Finance,* Noida: Vikas Publishing House.
2) Choudhury, R. K. (2015). *Public Finance and Fiscal Policy.* New Delhi: Kalyani Publishers.
3) Tyagi, B. P. (2005). *Public Finance.* Meerut, UP: Jai Prakash Nath and Co.



12.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (i) True (ii) True (iii) True (iv) True (v) False

Ans to Q No 2: Public budget refers to a financial statement of expected receipts and anticipated expenditure of the government for a given year, usually a financial year.

Ans to Q No 3: (i) True (ii) True (iii) False (iv) False (v) True

Ans to Q No 4: (i)Surplus budget is the public budget in which the estimated receipts of the government are more than the estimated expenditure of the government for a given financial year.

(ii) Deficit budget is the budget in which the estimated receipts are less than the estimated expenditure of the government for a given financial year.

(iii) Incremental budget refers to the budget, which is prepared using a previous year's budget or the actual performances as a basis with incremental amounts of expenditure added for the new budget period.

Ans to Q No 5: (i) True (ii) True (iii) False (iv) True (v) True

Ans to Q No 6: Two examples of revenue receipts are taxes and fees. And two examples of capital receipts are borrowing and disinvestment.

Ans to Q No 7: (i) True (ii) True (iii) False (iv) True

Ans to Q No 8: Primary deficit can be defined as the difference between the fiscal deficit of the current year and the interest payments on the previous public debt taken by the government.



12.10 MODEL QUESTIONS

A) Short Questions (Answer each question in about 150 words)

Q 1: State the difference between legislative budget and executive budget.

Q 2: Why is the executive budget superior over the legislative budget?

Q 3: What are the different types of unbalanced budget?

Q 4: What is meant by performance budget?

Q 5: What is called budgetary deficit?

B) Essay-type Questions (Answer each question in about 300-500 words)

Q 1: Discuss the various components of public budget.

Q 2: Discuss the various budget deficits.

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UNIT 13: FEDERAL FINANCE

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Concept of Fiscal Federalism

13.4 Principles of Federal Finance

13.5 Horizontal & Vertical Finance

13.6 Instruments of Inter - Governmental Resource Transfer

13.7 Let Us Sum Up

13.8 Further Reading

13.9 Answer to Check Your Progress

13.10 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the conceptual framework of federal finance
- outline the principles of federal finance, viz., relating to allocations, distribution stabilization, inter - governmental government fiscal relations and the theory of grant
- state the differences between horizontal and vertical finance
- explain the different Instruments of Inter - governmental resource transfer

13.2 INTRODUCTION

The term federal finance was first time introduced by American economists Richard Musgrave in year 1959. Encyclopedia Britannica defines that fiscal federalism is branch of knowledge that deals with financial relations among the units of governments in a federal system. In federalism multiple governments exist i.e. central government, provincial government and local government. Fiscal federalism deals with the divisions of governmental functions and financial relations among them. The issue of

fiscal federalism has received much attention in the literature of public finance in the recent past due to several reasons.

Musgrave further argued that federal government needs to manage nation's money and give it to the state governments that can be distributed locally as and when required The U.S. government have accepted fiscal federalism that is complex and bureaucratic in nature. Under this arrangement, federal government provides money to roads, schools and health care. This money is provided through federal 'grant-in-aids'.

The prime responsibilities of modern government include distribution of income, efficient allocation of resources & economic stability. The philosophy of fiscal federalism assumes that federal system of government could be effective to solve these problems. Federal government/ central government being flexible can easily deal with the issues like economic stability and equal distribution of income. The allocation of resources can be effectively performed by state and local governments. This is the crux of arguments of Richard Musgrave, an authority of public finance.

13.3 CONCEPT OF FISCAL FEDERALISM

Modern governments are classified in three categories – federal or central, state and local government. A federation is basically an association of two or more states. The member states of federation have a federal / Union government for the entire country and state governments for parts of the country. In this regard, a fiscal federalism is the system of assigning of source of revenue to the central as well as state government for the resourceful discharge of their function. For this purpose, clear – cut division is made for the allocation of resources of revenue between central and state governments.

According to Sir Robert Garran, federation is the form of government in which sovereignty or political power is divided between the central and the local government, so that each of them within its own sphere is independent of the others. The theory of fiscal federalism initially started with the presumption of the allocation of stabilization and distribution of income to the central or federal government and assigning sub – central roles to

provincial/state or local government. From this perspective, it is clear that the main task of fiscal federalism is to identify the functions and finance of sub – central governments because this is the way to maximize the welfare of community.

At this juncture, we must remember that the idea of federation is not a static and rigid concept; it is evolving and will evolve in the coming years. Interestingly, the concept have developed and evolved in to different forms in different countries. But, the broad tendency revealed that the functioning of federation that covers entire nation – state is concentrated towards the central government and the functions that have regional character are retained with the state government. The dependence of center and state government on each other highlights the need for greater coordination among all units of government. Therefore, we can say that fiscal finance is all about divisions and coordination of different item of income and expenditure between central, state and local government.

Thus, fiscal federalism aptly recognizes that modern governments are multilevel governments and therefore, the issues arising from it need to be studied, analyzed and solved. This argument encourages us to find out the rationale for advocating fiscal federalism. Let's understand the rational for fiscal federalism.



CHECK YOUR PROGRESS

Q 1: State whether the following statement is true or false (T/F).

(i) The term federal finance was introduced by Richard Musgrave. (T/F)

(ii) There exist multiple governments in federal state. (T/F)

Q 2: Explain the concept of fiscal federalism. (Answer in about 40 words) .....

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13.4 PRINCIPLES OF FEDERAL FINANCE

The academic literature of the principle of federal finance could be divided into five aspects, viz., (a) allocation aspect, (b) distribution aspect, (c) stabilization aspect, (d) inter-governmental fiscal relations and (e) the theory of grant.

The allocation aspect is primarily concerned with the most important issue like – whether social goods & services would be provided by federal government or state government in a decentralized mode? If the state government is going to provide the social goods & service, what kind of arrangement we need to set up?

The distribution function is one of the most important functions of the government. Fiscal redistribution can be employed with the progressive income tax system especially designed for upper class of the society and at the same time income scale and transfer made available for lower class. But this process needs uniformity because it involves high degree of capital and labour mobility.

Fiscal policies plays important role in stabilization of economy. Fiscal policies (Government expenditure and taxation) conducted by central government plays significant role in stabilizing the economy. In short, the decentralizing measures would not be effective in establishing stabilization; the role of central government becomes important.

So far we have seen that there is need to design efficient fiscal structure that facilitates stabilization and distribution function. In this design, we also understood the role of and jurisdictions of central or federal government. The allocation function may be assigned to state / provincial or local government. But remember, this arrangement needs specific set of rules and regulations when each government deals with each other. These rules and regulations that facilitate and coordinate the fiscal transactionsare broadly recognized as intergovernmental fiscal transactions / relations. The significance of these fiscal relations needs to be understood due to several reasons. These are: –

- The interventations of higher level of government authority are necessary in order to correct for spillover benefits.
- If the federal government consider that provincial/state or local government services are merit goods and that needs to be subsidize in order to maximize social welfare.
- The idea of fiscal federalism considers that that role of state or local government is equally significant. Therefore, this attitude helps to create the order of based on the principle of equalization.
- Large fiscal differentiation may result in to inefficiencies that need to be corrected.

The theory of grant specifies the grants made to achieve intergovernmental objectives. Similarly, while granting, choices are given to the provincial / State or local government and above all if they functions well, an incentives are provided in the form of reward. In order to understand the purpose and significant role of grant, we need to understand the types of grants. In a broad context, grants are classified in the categories like: (a) general grant, (b) conditional grants, and (c) non-conditional grants.

Apart from these broad view points, there are few more principles of federal finance& that are explained below:

- **Principle of Uniformity:** In the federal system where there is co-existence of federal / central and provincial / state or local government. In this system, each state pays equal taxes to the federal government. But this principle cannot be followed in practice because the capacity of each provincial or local unit is not the same. Therefore, the principle of uniformity focuses on uniformity of the pattern of expenditure in all states / local governments& not the paying of equal taxes. The condition of equal contribution to federal system is likely to adversely affect the economically backward states. Therefore, this principle needs to be applied carefully.
- **Principle of Equity:** The equity point emphasized on the equal distribution of resources among all the states despite of their share

in the federal revenue. The principle of equity suggests that there should be equal distribution of resource among all states / provincial units irrespective to their contribution to the federal revenue.

- **Principle of Efficiency:** This principle is one of the important aspects of entire financial system. This is because efficiency not only ensures smooth functioning of financial system but also restricts the possible misuse or frauds. Efficiency also ensures that there will be no double taxation.
- **Principle of Accountability:** Accountability needs to be fixed up especially when there is federal set – up where central, provincial / state and local government exists. All governments are free and autonomous as long as their financial functions are concerned. Therefore, each government is accountable for its own financial decisions and its consequences.
- **Principle of integration and coordination:** The ultimate objective of this fiscal mechanism is to integrate the financial system in order to have smooth coordination among the different governments. In fact, this is pre – condition for the thriving financial system in the country. The integration and coordination would ensure the overall economic development of the country.

Principle of Adequacy of Resources: Adequate financial resources are the significant aspect of federal finance. Ideally, the central, state or local government should have adequate resources to carry out their short term and long term objectives. There should be adequate provisions or resources to carry their financial activities of each government. The resource pool needs to be sufficient enough to carry out present functions as well as the future needs to the population. Similarly, the resource pool should be sufficient enough to carry unforeseen spending like – at the time of war or natural calamity.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are true or false (T/F).

(i) Federation is a static concept. (T/F)

(ii) In a federal state, there is no coordination among center & state. (T/F)

Q 4: Explain the principle of efficiency. (Answer in about 40 words)

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Q 5: Explain the principle of equity. (Answer in about 40 words)

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13.5 HORIZONTAL AND VERTICAL FISCAL FINANCE

Issues in Federal Finance: Federalism is a system where two or more sovereign units of governments are exist in the same political environment. The federal system provides a platform for the smooth functioning of intergovernmental fiscal issues between the various forms of the government. The sources of revenues are explicitly elaborated in the federal constitution. This enables various forms of government to decide the patterns of expenditure in coordination with the expected revenue. Recent literature of public finance has also highlighted the issues related to decentralize fiscal system. These issue arises because of two reasons i.e. sovereignty of the various governments and the extended theory & scope of public goods. It has been also observed that the inability of federal government to allocate uneven resources to the various types of government is emerging as a one of the significant issue in the literature of public finance.

The imbalance distribution of resources among the various governments is one of the root causes of conflict in the federal fiscal finance. The issues of federal finance need reconsideration of the fiscal rules. In this context, it must be noted that the functions of federal, state and local government are different in each federal country.

Economists who have made significant contribution in public finance have advocated that federal government needs to focus on significant issues like – defense, foreign affairs, foreign trade, post & telegraph and other key industries of the economy. On the contrary, the issues related to regional importance are allocated to state government& state governments will have full jurisdictions over these issues. The state jurisdiction mainly includes the subjects like – education, health, public work, internal law & order etc.

Horizontal Fiscal Finance or Imbalance: When the fiscal imbalance occurs among the different units of government (State or Local Government) this imbalance is also known as horizontal fiscal imbalance. The problem of horizontal imbalance is most common problem of all federal states where multiple governments exists. Each state or local governments have different abilities in terms of providing services to the people and collecting tax revenue from them.

The main reason behind the emergence of horizontal fiscal imbalance is that each government entity provides essential services to the people but each government does not have an ability to generate the much needed tax revenue to continue to support the supply of these services. This is because of the differences of each state or local government has distinct demographic set of population & their tax paying abilities are different due to several reasons. In short, this is the difference between different governments and their ability to garner enough amounts of resources. In a nutshell the horizontal imbalance mainly arises because of differences inrevenues and expenditures of states. It also means that the differences arise because of the ability of individual state or local government to raise enough amounts of resources.

Vertical Fiscal Finance or Imbalance: It has been observed that there exists significant gap between the revenue sources of state government and expenditure requirement of the government.We cannot neglect the fact that that there is massive increase in government

expenditure (State and Local Government) in recent past due to welfare functions of the governments. These welfare activities includes like – education, health, social welfare, urban management, schemes for weaker sections of the society and rural development program. The growing responsibilities towards the welfare work, put pressure on fiscal management of the government and invariably it results in vertical fiscal imbalance. In other worlds, vertical fiscal imbalance arises when the revenue collection of the state government do not match with expenditure of the state government.



CHECK YOUR PROGRESS

Q 6: State whether the following statements are true or false (T/F).

(i) Horizontal imbalance is common problem to all federal states? (T/F)

(ii) Horizontal imbalance arises due to differences in revenue & expenditure.(T/F)

Q 7: What is vertical finance? Explain. (Answer in about 40 words)

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Q 8: What is horizontal imbalance? Explain. (Answer in about 40 words)

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13.6 INSTRUMENTS OF INTER - GOVERNMENTAL RESOURCES TRANSFER

There are different methods of achieving vertical fiscal balance. These measures are known as instruments of inter – governmental resources

transfer. Let's understand in detail all the instruments of inter – governmental resource transfer. These instruments include: (a) tax sharing, (b) loan from central government, (c) tax deductibility, (d) tax denial and (e) grants – in – aid. Grants-in-aid has two components, viz., conditional grants and unconditional grants. These have been discussed in some detail in the following:

- **Tax Sharing:** This is one of the significant instruments of inter – governmental transfer. In tax sharing arrangement, central government levies and collects certain taxes. Then the proceeds are shared partly or wholly among the states governments. Tax sharing is based on certain principles of the constitution (Law of the Land) or principles let down by central government. The basis of tax sharing is also depends on the strength and weakness of an economy, the nature of tax, the principle of uniformity and the strategy to curb the tendency of tax evasion. The tax sharing process is performed from divisible pool. What is divisible pool? Divisible pool is the gross proceeds minus cost of tax collection.

  Further, tax sharing from divisible pool to each state is determined on the basis of certain criterion. These criterionsinclude the contribution of each state in to the divisible pool, the population of state, socio-economic backwardness of state etc. For example – In India, income tax and excise duty are levied and collected by central government. But the proceeds are shared among various state governments.

- **Loan from Central Government:** State government performs several developmental works under its jurisdiction. But the inability of state government is to finance all the development work simultaneously. In this condition, state government approach to central government for a loan that will assist them to complete the developmental projects. Central government does provide financial assistance to the development project carried out by state government. But while taking loan from center, state governments are cautious because these loans might be associated with repaying conditionality's like – rate of interest & repaying conditionality.

- **Tax deductibility:** This method is primarily used to correct vertical fiscal imbalance. In this method, one government is allowed to deduct tax paid from tax payer upon which another government levies taxes.
- **Tax denial:** In this arrangement, the federal government may restrict the tax raising power of state or local government. Federal government may deny certain areas where state government or local government cannot levy taxes. Federal government can allow state government to partially levy tax if central government feels necessary to do so.
- **Grants in Aid:** This method is the most widely used method of resources transfer in the world to correct the vertical fiscal imbalances. There are three methods of grants to transfer the resources to state governments namely, general grant, selective grant and matching or non-matching grant. While defining grant – in – aid, Herman Finer said that 'Grant in aid is a sum of money assigned by a superior to an inferior government authority either out of the exchequer of the former or out of source of revenue especially designated'. The objectives of providing Grant in aid to the state governments are – reducing regional disparities among the states, providing additional financial resources to states to meet their developmental requirement, providing certain services to states without enhancing tax burden and bringing uniformity and balance among the functions and resources among the states.
  - *Conditional Grant:* Federal government also provides conditional and unconditional grants to state government. Conditional grants are provided to state to achieve specific objectives. States cannot use this grant for other purposes other than the designated purpose for which the grant is sanctioned. These grants are provided to states to complete their developmental work. For example - In this category, central government may provide grant to the state by asking the enhance representation of backward class (SC/ST) students in higher education. While utilizing this grant, state government must ensure that the representation of SC and ST students must raised in higher education.

- *Unconditional Grants:* As the name suggests this grants is not attached with any conditionality from the central government. Therefore, state governments are free to use this grant as per their requirement. This grant is provided to the states with the objective to bridge the gap between revenue and expenditure.



13.7 LET US SUM UP

- The term federal finance was first time introduced by American economists Richard Musgrave in year 1959. Encyclopedia Britannica defines that fiscal federalism is branch of knowledge that deals with financial relations among the units of governments in a federal system.
- The philosophy of fiscal federalism assumes that federal system of government could be effective to solve these problems.
- The theory of fiscal federalism initially started with the presumption of the allocation of stabilization and distribution of income to the central or federal government and assigning sub – central roles to provincial/ state or local government.
- Fiscal federalism aptly recognizes that modern governments are multilevel governments and therefore, the issues arising from it need to be studied, analyzed and solved.
- The academic literature of the principle of federal finance could be divided into five aspects, viz., (a) allocation aspect, (b) distribution aspect, (c) stabilization aspect, (d) inter-governmental fiscal relations and (e) the theory of grant.
- Federalism is a system where two or more sovereign units of governments are exist in the same political environment. The federal system provides a platform for the smooth functioning of intergovernmental fiscal issues between the various forms of the government. The sources of revenues are explicitly elaborated in the federal constitution.

- When the fiscal imbalance occurs among the different units of government (State or Local Government) this imbalance is also known as horizontal fiscal imbalance.
- It has been observed that there exists significant gap between the revenue sources of state government and expenditure requirement of the government.
- There are different methods of achieving vertical fiscal balance. These measures are known as instruments of inter – governmental resources transfer.



13.8 FURTHER READING

1) Bhatia, H. L. 2008. *Public Finance.* New Delhi: Vikash Publication House Pvt. Ltd.

2) Hyman, N. D. 2007. *Public Finance: A Contemporary Application of Theory to Policy*. Thomson South-Western Publication.

3) Jha, R. 1998. *Modern Public Economics*. Routledge Publication.

4) Musgrave, R. & Musgrave, P. B. 1976. *Public Finance in Theory & Practice*. McGraw Hill Kogakysha Ltd.



13.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (i) True (ii) True

Ans to Q No 2: Fiscal federalism is the system of assigning of source of revenue to the central as well as state government for the resourceful discharge of their function. For this purpose, clear – cut division is made for the allocation of resources of revenue between central and state governments.

Ans to Q No 3: (i) False (ii) False

Ans to Q No 4: ——Try it yourself ——

Ans to Q No 5: ——Try it yourself ——

Ans to Q No 6: (i) True (ii) True

Ans to Q No 7: ——Try it yourself ——

Ans to Q No 8: When the fiscal imbalance occurs among the different units of government (State or Local Government) this imbalance is also known as horizontal fiscal imbalance. The problem of horizontal imbalance is most common problem of all federal states where multiple governments exists.



13.10 MODEL QUESTIONS

A) Essay Type Questions. (Answer each questions in 300-500 words)

Q 1: Explain the concept of fiscal federalism.

Q 2: Explain the principle of uniformity in federal finance.

Q 3: Explain the principle of accountability in federal finance.

Q 4: Explain the principle of efficiency in federal finance.

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UNIT 14: FINANCE COMMISSIONS OF INDIA

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 A Brief Background

14.4 Role of The Finance Commission

14.5 Distribution of Funds Between Centre And States

- 14.5.1 Vertical Distribution
- 14.5.2 Horizontal Distribution
- 14.5.3 Grants-in-Aid
- 14.5.4 Terms of Reference (ToR)
- 14.5.5 Plan and Non-Plan Challenge

14.6 Fifteenth Finance Commission

- 14.6.1 Terms of Reference of Fifteenth Finance Commission

14.7 Let Us Sum Up

14.8 Further Reading

14.9 Answers To Check Your Progress

14.10 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- know about the Finance Commission of India
- describe the background of the constitution of Finance Commission of India
- explain its role towards handling the financial matters of the country
- discuss vertical and horizontal distributions of funds as well as grants-in-aid distribution between centre and states
- discuss the 15th Finance Commission of India.

14.2 INTRODUCTION

The Finance Commission is a constitutionally mandated body at the Centre of fiscal federalism. Set up under Article 280 of the Constitution, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them and lay down the principles determining the distribution of these taxes among States. Its working is characterised by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism. Its recommendations are also geared towards improving the quality of public spending and promoting fiscal stability. The first Finance Commission was set up in 1951 and there have been fifteen so far. Each of them has faced its own unique set of challenges. In this unit, we shall discuss a brief overview of the finance commissions in India. We shall also discuss the role played by these finance commissions. Towards the end of the unit, the point of reference of the fifteenth finance commission of India has been discussed.

14.3 A BRIEF BACKGROUND

Having made provisions for federal assistance to the states, both as grants-in-aid and as a share of specified taxes, the Constitution visualised the necessity for a machinery independent of Union Government to determine the measure of assistance that should be afforded and also the principles on which this assistance should be made available. This machinery was created in the form of Finance Commission to be appointed by the President every five years so that such periodical adjustments can be made in the union-state financial relationship as are needed in the light of the emerging situation. The Finance Commission is a unique experiment in the Indian federal system. It has been envisaged by the framers of the Indian Constitution as “a quasi-arbitral body whose function is to do justice between the centre and the states”. The only other body which, bears some resemblance to it is the Commonwealth Grants Commission of Australia.

However, there are significant differences between the two institutions as regards their status and the scope of their competence. The Indian Finance Commission is created by the Constitution and it is not a standing body. It sits only once in five years. On the other hand, the Common-wealth Grants Commission was set up in 1933 by the Commonwealth Parliament and it is a standing body and recommends fiscal-need grants to the deficit states of Western Australia and Tasmania. While in Australia, members are appointed for three years, in India they are appointed for nearly a year and after the Commission has completed its assigned task. The Indian Finance Commission has larger functions to discharge than its Australian counterpart in that the former has to recommend tax-sharing between the Union and the states as well as fiscal-need grants to states. In addition, other questions of inter- governmental financial relationship are also referred to it from time to time. The provision of Finance Commission is intended to assure the states that the scheme of distribution will be made not by the Union arbitrarily but will be based on the recommendations of an independent commission, which will assess the changing needs of the states in making them.

Article 280 of the Constitution which provides for the constitution of the Finance Commission authorized Parliament to determine the qualifications required for appointment as members of the commission, the manner in which they should be selected and to prescribe the powers of the commission for the performance of their functions. Accordingly, the Finance Commission (Miscellaneous Provisions) Act, 1951, was enacted by Parliament. Under the Act, the commission is to consist of Chairman and four other members. As for qualifications, the chairman is required to be a person who has had experience of public affairs and its members should be persons who (a) are, or have been, or are qualified to be, appointed as judges of a High Court, or (b) have special knowledge of the finances and accounts of the government; or (c) have had wide experience in financial matters and in administration; or (d) have special knowledge of economics.

14.4 ROLE OF THE FINANCE COMMISSION

Article 280 (3) of the Constitution lays down the functions of the Finance Commission of India. The functions of the commission is to make recommendations to the President of India in the following matters:

- The distribution between the Union and the states of the net proceeds of taxes which are to be or may be divided between them and the allocation between the states of the respective shares of such proceeds
- The principles which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India
- Any other matter referred to the commission by the President in the interests of sound finance. Under the Constitution, the decision on the commission's recommendations with respect to income tax is taken by the President and with respect to other taxes, grants-in-aid, etc., by Parliament.
- d) Measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State. The last function was added following the 73rd and 74th amendments to the Constitution in 1992 conferring statutory status to the Panchayats and Municipalities.

These Constitutionally mandated functions are the same for all the Finance Commissions and mentioned as such in the terms of reference (ToR) of different Finance Commissions. The commission is empowered to determine its own procedure of business, and has been given the powers of a civil court in the matter of summoning and enforcing the attendance of witnesses, requiring the production of any documents and requisitioning any public record from any court or office. The commission is also authorized to require any person to furnish information on such points or matters, as in the opinion of the commission, may be useful for or relevant to in the matter under its consideration.

There have been major changes in the public finances of the Union and the States during the period of over 55 years covered by the Finance Commissions. How the different Finance Commissions have discharged their responsibilities in the ever changing fiscal situation is covered in the following sections under different heads.

Table 14.1: Different Finance Commissions and their periods

Finance Commissions	Year of establishment	Name of the chairman	Operational duration
1st	1951	K.C. Niyogi	1952-57
2nd	1956	K. Santhanam	1957-62
3rd	1960	A.K. Chanda	1962-66
4th	1964	P. V. Rajamannar	1966-69
5th	1968	Mahavir Tyagi	1969-74
6th	1972	K. Brahmanand Reddy	1974-79
7th	1977	Justice J. M. Shelat	1979-84
8th	1983	Y. B. Chavan	1984-89
9th	1987	N.K.P. Salve	1989-95
10th	1992	K. C. Pant	1995-2000
11th	1998	Prof A. M. Khusro	2000-05
12th	2002	Dr. C. Rangarajan	2005-2010
13th	2007	Dr Vijay L. Kelkar	2010-2015
14th	2013	Dr. Y. V. Reddy	2015-2020
15th	2017	N. K. Singh	2020-2025

Source: Finance Commission website/reports

CHECK YOUR PROGRESS



Q 1: The first finance commission was set in ..... (fill in the blanks)

Q 2: The Finance Commission of India is appointed by (choose the correct option)

(a) Prime Minister (b) President (c) Vice President

Q 3: Define Finance Commission of India. (Answer within 50 words)

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Q 4: State two functions of Finance Commission of India. (Write within 50 words)

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14.5 DISTRIBUTION OF FUNDS BETWEEN CENTRE AND STATES

In this section, we shall discuss the distribution of funds between centre and states in India.

14.5.1 Vertical Distribution

The vertical distribution implies the net proceeding from taxes divided between state and center. Initially, the Constitution provided for the sharing of only two Central taxes with States. Article 270 permitted mandatory sharing of the net proceeds of income tax levied and collected by the Union with the States. Such proceeds assigned to States did not form part of the Consolidated Fund of India. Article 272 provided for sharing of Union excise duties, if Parliament by law so provided. The shares of the States in Union excise duties were to be paid from the Consolidated Fund of India. This position continued till the 80th amendment of the Constitution in 2000 which provided for sharing of the proceeds of all Union taxes and duties with the States, except the Central sales tax, consignment taxes, surcharges on Central taxes and earmarked cesses. This was done taking into account the recommendation of the Tenth Finance Commission to

enable the States to derive the advantage of sharing the buoyancy of all Central taxes, to ensure greater certainty in the resource flows to the States and to facilitate increased flexibility in tax reforms.

As per the then Constitutional provisions, tax sharing recommended by the first ten Finance Commissions was restricted to the proceeds of income tax and Union excise duties. The share of States in the proceeds of income tax as recommended by the Finance Commission witnessed a significant jump from 55 per cent (the First Commission) to 85 per cent (the Ninth Commission). For the first time, the Tenth Commission lowered the shares of States to 77.5 per cent on the ground that the authority that levied and administered the tax should have a significant and tangible interest in its yield.

As far as the distribution of the proceeds of Union excise duties was concerned, initially the share of States was restricted to certain specified commodities. From the Fourth Commission onwards, States were being given a share in the proceeds of the tax on all the commodities. The shares of States in the Union excise duties as recommended by the First, Second and Third Finance Commissions were 40 per cent of the proceeds of the tax on three commodities, 25 per cent of the proceeds of the tax on eight commodities and 20 per cent of the proceeds of the tax on 35 commodities, respectively. During the periods covered by the Fourth to Sixth Commissions, the shares of States remained static at 20 per cent of the net proceeds of the tax on all commodities. The Seventh Commission made a major departure by recommending an increase in the share of the States from 20 per cent to 40 per cent. That Commission felt that the Union excise duties should have a predominant role in the transfer of financial resources to States, considering the size of the proceeds.

The system of recommending shares of States in the proceeds of income tax and Union excise duties gave way to recommending shares of States in the total net proceeds of all taxes, heralding a new phase in tax devolution to States. This was facilitated by the eightieth amendment of the Constitution in 2000, which was done on

the recommendation of the Tenth Finance Commission. The Eleventh Finance Commission was the first Commission to make recommendations on tax shares under the new dispensation. The Eleventh Finance Commission recommended that the States' share in Central taxes be fixed at 29 per cent.

The Eleventh Finance Commission, for the first time, introduced the concept of overall ceiling on total Central transfers to States from all channels on the revenue account. The indicative ceiling recommended by the Commission was 37.5 per cent of the gross revenue receipts of the Centre. This was raised to 38 per cent by the Twelfth Finance Commission. This indicative ceiling was based on the then prevailing level of transfers on the revenue account. The recommendation of the indicative ceiling seems to have been prompted by considerations relating to macro-economic and fiscal stability. This has prompted States to demand that the total revenue account transfers might be fixed at 50 per cent of the gross revenue receipts of the Centre on the ground that this was the level reached in the year 1999-2000.



ACTIVITY

After the introduction of Goods and Service Taxes (GST) in India, there has been certaion remarkable changes in the financial devolution between the Centre and the states. Prepare an outline of the major changes.

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14.5.2 Horizontal Distribution

After making recommendations regarding tax devolution, it is the task of the Finance Commissions to recommend its inter se distribution amongst States. The criteria used by the Finance Commissions for the inter se distribution of tax shares across States

can be broadly grouped under, a) factors reflecting needs, such as population and income measured either as distance from the highest income or as inverse, b) cost disability indicators, such as area and infrastructure distance and c) fiscal efficiency indicators, such as tax effort and fiscal discipline. While the weightage assigned to population has declined considerably, weightage assigned to income distance and efficiency factors has increased considerably in recent years.

In the inter se distribution of income tax, the first seven Commissions assigned an overwhelming weightage to population ranging from 80 to 90 per cent and the residual weightage ranging from 10 to 20 per cent was assigned to contribution. It was for the first time that considerations relating to equity gained prominence in the formula for inter se distribution of income tax proceeds in the recommendation of the Eighth Commission. This Commission assigned a weight of 22.5 per cent to the inverse of per capita income of States and 45 per cent weightage to the distance of the per capita income of a State from the highest per capita income while reducing the weightage to population from 90 per cent to 22.5 per cent and retaining the weightage to contribution at 10 per cent. The Eighth Commission, again for the first time, adopted a common formula for the distribution of 90 per cent share of States in income tax proceeds and the States' share of Union excise duties. The shift in the different components in the formula for inter se distribution in favour of equity was carried forward by the subsequent Commissions. The Tenth Finance Commission had done away with the weightage given to the contribution in the interse distribution of States' share of income tax on the ground that the States' efforts in collecting their own taxes was more relevant rather than its contribution to the collection of Central taxes.

The introduction of elements of equity in the formula for the interse distribution of Union excise duties took place much earlier. The Second Finance Commission while giving 90 per cent weightage

to population assigned the remaining weightage of 10 per cent to certain adjustments. This marked the introduction of a factor which was intended to correct the large weightage given to population. All the subsequent Commissions assigned small weightages to factors like index of backwardness, distance of per capita income, income adjusted total population, etc. The Seventh Finance Commission reduced drastically the weightage assigned to population to 25 per cent and increased the weightages assigned to equity. The principle of the same formula governing the interse distribution of income tax and Union excise duties introduced by the Eighth Commission was followed by the Ninth and Tenth Commissions. The Tenth Finance Commission for the first time assigned weights to efficiency parameters in the distribution formula. That The Commission assigned a weight of 10 per cent to fiscal self-reliance as measured by the share of own revenues in total revenue expenditure of a State. The Tenth Commission also inducted disability factors represented by area and infrastructure distance into the distribution formula for the first time. The Commission assigned a weight of 5 per cent each to these factors. Since then, the successive Commissions have been assigning weights to area. The Twelfth Commission did not assign any weight to infrastructure distance. The introduction of elements of equity in the distribution formula was by and large welcomed.

The Eleventh Finance Commissions carried forward the shift in favour of equity considerations in the formula for the inter se distribution of States' share in all Union taxes. The recommendation of the Commission to reduce the weightage given to population to 10 per cent and to assign a weightage of 62.5 per cent to per capita income distance had resulted in the reduction of shares of high income and middle-income States in tax devolution. The Twelfth Finance Commission increased the weight to population from 10 to 25 per cent and reduced the weight assigned to distance of per capita income from 62.5 per cent to 50 per cent.

It has been argued in some quarters that there has been an accentuation of inequalities across States and that the Finance Commission transfers failed to arrest this trend. But one cannot look at the Finance Commission transfers in isolation. While transfers designed by the Finance Commissions in recent years have laid considerable emphasis on equity, transfers effected through other channels may not necessarily be guided by equity considerations. Besides, private investment plays a major role in explaining growth differentials across States. By and large, Finance Commission transfers remained more progressive relative to other transfers. The initial imbalances were too large to be addressed by the Finance Commission transfers alone. Compared with tax devolution, grants have a greater redistributive role. Grants have ranged between 7 per cent and 27 per cent of the total transfers recommended by the Finance Commissions. Surprisingly, even backward States have expressed a preference for tax devolution as a major channel of transfer because of its buoyancy as compared with grants which are fixed.

14.5.3 Grants-in-Aid

Horizontal imbalances or regional disparities are addressed by the Finance Commission through the system of tax devolution and grants-in-aid, the former instrument used more predominantly. Under Article 275 of the Constitution, Finance Commissions are mandated to recommend the principles as well as the quantum of grants to those States which are in need of assistance and that different sums may be fixed for different States. Thus one of the pre-requisites for grants is the assessment of the needs of the States. The First Commission had laid down five broad principles for determining the eligibility of a State for grants. The first was that the Budget of a State was the starting point for examination of a need. The second was the efforts made by States to realize the potential and the third was that the grants should help in equalizing the standards of basic services across States. Fourthly, any special burden or obligations of national concern, though

within the State's sphere, should also be taken into account. Fifthly, grants might be given to further any beneficent service of national interest to less advanced States. By and large, these principles have guided the grants recommended by all the Finance Commissions.

Grants recommended by the Finance Commissions are predominantly in the nature of general purpose grants meeting the difference between the assessed expenditure on the non-plan revenue account of each State and the projected revenue including the share of a State in Central taxes. These are often referred to as 'gap filling grants'. The issues relating to non-plan deficit grants are discussed in detail in a separate section. Up to the Fifth Commission, grants were recommended only for covering the non-plan revenue deficits of States after tax devolution with only a few exceptions. The First Commission recommended grants for the expansion of primary education The Third Commission recommended grants to cover 75 per cent of the revenue component of State Plans. The Government of India did not agree with this recommendation on the ground that since Central assistance was specifically sanctioned for the Third Five-Year Plan, there was no need for grants for Plan purpose.

The position began to change with the Sixth Finance Commission when that Commission was asked to consider the requirements of States which were backward in standards of general administration with a view to bringing them to the levels obtaining in the more advanced States. It took the view that a Finance Commission was basically concerned with expenditure on revenue account and therefore recommended upgradation grants for meeting the revenue expenditure deficiencies of certain States in areas like general administration, administration of justice, jails, police, primary education, medical and public health and welfare of scheduled castes, scheduled tribes and other backward classes. The Seventh Commission was asked to consider upgradation of standards in non-developmental sectors and services. The Commission restricted the scope of grants to administration of taxes, treasury and accounts

administration, judicial administration, general administration, police and jails. Like the Seventh, the Eighth and the Tenth Commissions were asked to consider non-developmental sectors. 22. As indicated earlier, the Sixth Commission considered grants for meeting revenue expenditure alone. The Seventh took the view that there was no restriction imposed by Article 275 in making grants for capital expenditure. The Seventh Finance Commission took into account the requirements on capital account while recommending grants under upgradation and special problems. Even so, the scope of the Finance Commission grants remained grants-in-aid of the revenues to enable States to meet capital expenditure. These grants were by no means capital resource devolution.

The Eighth & Ninth Finance Commission recommended special problem grants for the year 1989-90 but did not recommend any such grants for the period 1990-95 on the ground that such problems were meant to be dealt with by the Plan itself. The Tenth, Eleventh and Twelfth Finance Commissions also recommended grants for solving special problems. The Commission adopted a new approach by recommending grants for the maintenance of roads and bridges and public buildings. These grants are in addition to the normal expenditure that the States would be incurring on the maintenance of these assets.

14.5.4 Terms of Reference (ToR)

As indicated earlier, the three constitutionally mandated responsibilities of a Finance Commission are the distribution between the Union and the States of the net proceeds of shareable Central taxes, determining the grants to States which are in need of assistance and recommending measures to augment the Consolidated Fund of a State to supplement the resources of local bodies. These are mentioned as such in the Presidential Order constituting a Finance Commission. In addition to the substantive functions, any other matter can be referred to a Finance Commission in the interest of sound

finance under Article 280 (3) (d) of the Constitution. It has become customary to mention certain considerations in the Presidential Order appointing a Commission, which the Commission may consider, among others, while making its recommendations. The Presidential Order listing out the main functions, additional matters and considerations constitutes the Terms of Reference (ToR) of a Finance Commission. In fact, the First Finance Commission was not given any ToR. It proceeded with its work based on the substantive duties enumerated in the Constitution.

14.5.5 Plan and Non-Plan Challenge

A major debate regarding the recommendations of Finance Commissions relates to Finance Commissions restricting their assessment of State finances to non-plan revenue account. There is no distinction between the expenditure on the plan and non-plan account in the constitution. the budgetary classification of expenditure into plan and non-plan came into vogue with the introduction of centralized planning in India. There were no specific ToR for the first Commission. The Second and the Third Commissions were asked to take into account the requirements on account of the plan. The Second Commission recommended grants under Article275 to enable States to meet their entire revenue expenditure on plan and non-plan account along with Plan grants and additional resource mobilization. The Third Commission took into account 75 per cent of the estimated revenue component of the Plan while recommending tax devolution and grants-in-aid. The government did not accept the Plan grants recommended by the Commission on the ground that Central assistance was specifically granted for the Third Five-Year Plan and that there was no need for the Commission to again consider the question of Plan grants. The Fourth, Fifth and the Sixth Commissions were asked to take into account the requirements of States to meet the committed expenditure on the maintenance of Plan schemes completed. The Seventh and Eighth Finance Commissions were asked to take into account requirements of States on revenue account to meet non-

plan commitments. These Commissions did not take into account Plan expenditure by implication.

The Ninth Commission was asked to keep in view the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment. The Commission took the stand that unless the entire revenue account was considered, it would not be possible to balance the revenue account. The Thirteenth Finance Commission, for the first time, has been asked to take into account the gross budgetary support to the Central and State Plans as a demand on the resources of the Centre.



CHECK YOUR PROGRESS

Q 5: Article ..... permitted to share net proceeds of income tax levied and collected by the Union with the States. (fill in the blanks)

Q 6: Horizontal distribution of resources (choose the correct option)

(a) Among states (b) Between centre and states

(c) Among district and states.

Q 7: What is horizontal distribution of resources? (Answer within 50 words) .....

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Q 8: Write a note on grants-in-aid head of finance commission. (Answer within 50 words)

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14.6 FIFTEENTHTH FINANCE COMMISSION

The Fifteenth Finance Commission was constituted by the Government of India on 27 November 2017 to give recommendations for devolution of taxes and other fiscal matters for five fiscal years, commencing 1st April, 2020. The chairman of the commission is N. K. Singh, with its full-time members being Ajay Narayan Jha, Ashok Lahiri and Anoop Singh. In addition, Ramesh Chand has been appointed as a part-time member.

The Union Cabinet extended the term of 15th Finance Commission, which is to decide on division of tax and other resources between the centre and the states, by one-year to October 30, 2020. The cabinet approved the 15th Finance Commission to submit first report for the first fiscal year viz. 2020-21 and to extend the tenure of 15th Finance Commission to provide for the presentation of the final report covering Financial Years 2021-22 to 2025-26 by October 30, 2020.This extension will help the commission examine various comparable estimates for financial projections in view of reforms and to finalise its recommendations.

Please note that as recommendations of the 15th finance commission is yet to be published, therefore the terms of reference of the 15th finance commission is provided here

14.6.1 Terms of Reference of Fifteenth Finance Commission

Terms of Reference and the matters that shall be taken into consideration by the Fifteenth Finance Commission in making the recommendations are as under:

- 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 Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
- The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India

and the sums to be paid to the States by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and

- The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.
- The Commission shall review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States, and recommend a fiscal consolidation roadmap for sound fiscal management, taking into account the responsibility of the Central Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency. The Commission may also examine whether revenue deficit grants be provided at all.
- While making its recommendations, the Commission shall have regard, among other considerations, to:
  - The resources of the Central Government and the State Governments for the five years commencing on 1st April 2020 on the basis of the levels of tax and the non-tax revenues likely to be reached by 2024-25. In the context of both tax and non-tax revenues, the Commission will also take into consideration their potential and fiscal capacity;
  - The demand on the resources of the Central Government particularly on account of defence, internal security, infrastructure, railways, climate change, commitments towards administration of UTs without legislature, and other committed expenditure and liabilities.

- The demand on the resources of the State Governments, particularly on account of financing socioeconomic development and critical infrastructure, assets maintenance expenditure, balanced regional development and impact of the debt and liabilities of their public utilities;
- The impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following recommendations of the 14th Finance Commission, coupled with the continuing imperative of the national development programme including New India – 2022;
- The impact of the GST, including payment of compensation for possible loss of revenues for 5 years, and abolition of a number of cesses, earmarking thereof for compensation and other structural reforms programme, on the finances of Centre and States; and
- The conditions that GoI may impose on the States while providing consent under Article 293(3) of the Constitution.

➢ The Commission may consider proposing measurable performance-based incentives for States, at the appropriate level of government, in following areas:

- Efforts made by the States in expansion and deepening of tax net under GST;
- Efforts and Progress made in moving towards replacement rate of population growth;
- Achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure;
- Progress made in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams;
- Progress made in increasing tax/non-tax revenues, promoting savings by adoption of Direct Benefit Transfers and Public Finance Management System, promoting digital

economy and removing layers between the government and the beneficiaries;

- ❍ Progress made in promoting ease of doing business by effecting related policy and regulatory changes and promoting labour intensive growth;
- ❍ Provision of grants in aid to local bodies for basic services, including quality human resources, and implementation of performance grant system in improving delivery of services;
- ❍ Control or lack of it in incurring expenditure on populist measures; and
- ❍ Progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation.

- ➢ The Commission shall use the population data of 2011 while making its recommendations.
- ➢ The Commission may review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.
- ➢ The Commission shall indicate the basis on which it has arrived at its findings and make available the State wise estimates of receipts and expenditure.



CHECK YOUR PROGRESS

Q 9: The 15th Finance Commission was constituted on ……. (fill in the blanks)

Q 10: State the composition of 15th Finance Commission? (write within 50 words)

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14.7 LET US SUM UP

- Finance Commission is a constitutionally mandated body at the Centre of fiscal federalism.
- The Finance Commission is a unique experiment in the Indian federal system. It has been envisaged by the framers of the Indian Constitution as “a quasi-arbitral body whose function is to do justice between the centre and the states”. The only other body which, bears some resemblance to it is the Commonwealth Grants Commission of Australia.
- Article 280 of the Constitution which provides for the constitution of the Finance Commission authorized Parliament to determine the qualifications required for appointment as members of the commission, the manner in which they should be selected and to prescribe the powers of the commission for the performance of their functions.
- Article 280 (3) of the Constitution lays down the functions of the Finance Commission of India.
- After making recommendations regarding tax devolution, it is the task of the Finance Commissions to recommend its inter se distribution amongst States.
- It has become customary to mention certain considerations in the Presidential Order appointing a Commission, which the Commission may consider, among others, while making its recommendations. The Presidential Order listing out the main functions, additional matters and considerations constitutes the Terms of Reference (ToR) of a Finance Commission.
- The Fifteenth Finance Commission was constituted by the Government of India on 27 November 2017 to give recommendations for devolution of taxes and other fiscal matters for five fiscal years, commencing 1stApril, 2020. The chairman of the commission is N. K. Singh.



14.8 FURTHER READING

1) Bhatia, H.L. (1993). *Public Finance,* Noida: Vikas Publishing House.

2) Reddy Y. V., Reddy G. R. (2019). *Indian Fiscal Federalism.* New Delhi: Oxford University Press.



14.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: In the year 1951

Ans to Q No 2: b) The President of India.

Ans to Q No 3: The Finance Commission is a constitutionally mandated body at the Centre of fiscal federalism. Set up under Article 280 of the Constitution, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them and lay down the principles determining the distribution of these taxes among States.

Ans to Q No 4: Two functions of Finance Commission of India are

(a)The distribution between the Union and the states of the net proceeds of taxes which are to be or may be divided between them and the allocation between the states of the respective shares of such proceeds

(b)The principles which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India

Ans to Q No 5: Article 270 of the constitution.

Ans to Q No 6: a) Among states.

Ans to Q No 7: When resources are divided among states, it is know as horizontal distribution of resources. In the distribution of resources among the states in India, the weightage assigned to population has declined considerably, while weightage assigned to income distance and efficiency factors has increased considerably in recent years.

Ans to Q No 8: ------Try it yourself -------

Ans to Q No 9: 27th November, 2017.

Ans to Q No 10: The chairman of the commission is N. K. Singh, with its full-time members being Ajay Narayan Jha, Ashok Lahiri and Anoop Singh. In addition, the commission also has a part-time member as Ramesh Chand.



14.10 MODEL QUESTIONS

A) Short Questions (Answer each question in about 150 words)

Q 1: State the role of Finance Commission of India?

Q 2: Write about vertical distribution of funds of Finance Commission?

Q 3: Write about plan and non-plan confusion of Finance Commission?

B) Essay Type Question (Answer each question in about 300-500 words)

Q 1: Explain the background of the constitution of the Finance Commission of India.

Q 2: Explain the Terms of reference 15th Finance Commission.

*** ***** ***



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Name of the Paper: .....
Course Code: .....

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Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

The Director, Centre for Internal Quality Assurance, KKHandiqui State Open University
Housefed Complex, Dispur, Guwahati-781006
(E-mail id: ciqa@kkhsou.in)

1) Approximately how many hours did you spend for studying the units in the course? ☐☐☐

2) Please give your opinions (by ✓ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I)	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II)	The units of the SLM could satisfy my academic needs and expectations					
III)	The Unit writers have excellent knowledge about the course contents					
IV)	Language and contents of the units were presented at a level which I could readily understand					
V)	Ample opportunity for participation in the activities provided in the units					
VI)	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
VII)	Quality of content is engaging, relevant, and up-to-date					
VIII)	The self check questions are very helpful					
IX)	The Possible/model questions and the answers to check my progress have benefited me a lot					

Additional Comments: *(Please feel free to provide your open comments)*

1) Which aspects of the SLM, according to you, worked well?

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2) What sort of changes/improvements do you feel KKHSOU could implement to improve the overall quality of the SLM?

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Thank you for taking the time to complete this form.