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Public Finance

SEMESTER-V

ECONOMICS

BLOCK- 1



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COURSE INTRODUCTION

Under the BA programme of this University, you can study Economics as a Pass or Major subject. This course entitled *Public Finance* is a common paper for both Pass and Major subject.This course comprises of 15 units and has been divided into two blocks. The first block comprises eight units and the second block comprises seven units.

BLOCK INTRODUCTION

This is the first block of the course and comprises of eight units. The first unit of the course discusses the basic concepts of public finance like meaning & scope of public finance, distinction between public finance and private finance, and the concetps of public goods and private goods . The second unit deliberates on the revenue side of the government. Important concepts discussed in the unit include meaning, sources and need of public revenue and the distinctions between revenue and non-revenue receipt. The third unit will introduce you to one of the most important aspects of public finance, ie., taxation. After going through this unit, you will be able to discuss the meaning and features of taxation, canons of taxation, concepts of shifting and incidence of tax. Apart from these, you will also be able to differentiate between direct and indirect taxes as well as discuss the merits and demerits of both these types of taxes. The fourth unit explains the diffirent types of taxes like income tax,corporate tax,capital gains tax, expenditure tax, gift tax,sales tax,VAT and GST. The fifth unit discusses taxation and its role on the economic activites. The sixth unit will help you to acquire knowlege about the fundamental principles of taxation. The seventh unit deals with public expenditure. Thus, the important aspects of public expenditure like canons of public expenditure and the theories of public expenditure have been discussed in the unit. The eighth unit discusses the effects of public expenditure on production, distribution and economic stability. This unit will also help you to understand the role of public expenditure in developing economy.

While going through a unit, you will notice some along-side boxes, which have been included to help you to know some of the difficult, unseen terms. Again, we have included some relevant concepts in "LET US KNOW" along with the text. And, at the end of each section, 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.

UNIT 1: NATURE AND SCOPE OF PUBLIC FINANCE

UNIT STRUCTURE

1.1 Learning objectives

1.2 Introduction

1.3 Meaning & Scope of Public Finance

1.4 Public Finance and Private Finance

1.5 Public Goods, Private Goods, Club Goods and Local Public Goods

1.6 Public Goods, Free Riders and Market Failure

1.6.1 Common Resources and Tragedy of commons

1.7 Let Us Sum Up

1.8 Further Reading

1.9 Answers to Check Your Progress

1.10 Model Questions

1.1 LEARNING OBJECTIVES

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

- state the meaning of Public Finance and describe its scope
- distinguish between public finance and private finance
- explain the concept of public goods and distinguish it from private goods
- describe how the provision of public goods leads to market failure.

1.2 INTRODUCTION

This unit will introduce you to the discipline of Public Finance, which is a very important component of Economics. First, it will explain how the definition of Public Finance had evolved over the years. Then, the scope of Public Finance will be discussed. The unit also tries to distinguish between public finance and private finance. Finally, an attempt will be made to contrast public goods with Private goods and also explain how the provision of Public goods results in market failure.

1.3 MEANING AND SCOPE OF PUBLIC FINANCE

Meaning of Public Finance: Traditionally, Public Finance refers to the study of the principles that govern the spending and raising of funds by the public authorities. It deals with how the government mobilizes the resources to finance its expenditure. This view concerns the definition of Public Finance that was put forward by Hough Dalton who states that "Public Finance is concerned with the income and expenditure of public authorities and the adjustments of one to the other." From the above discussion we can understand that Public Finance deals with the income and expenditure of the government and also how any gap between the two is adjusted. However, in recent years, Public Finance has come to be considered as something more than merely the science of public revenue and expenditure. Now, it is recognized as a science that is more concerned with the attainment of:

- Optimum allocation of resources.
- Economic stability with an acceptable level of growth and employment.
- An equitable distribution of income and wealth.

Thus, the three instruments of Public Finance, i e public revenue, public expenditure and public borrowing, are not ends in themselves. Rather, they are the means to achieving critical economic objectives like optimal allocation, economic stability with high growth and employment, and a more equitable distribution of income and wealth.

Scope of Public Finance: The scope of public Finance can be discussed under the following heads:

- **The theory of Public Revenue:** This part of public finance traces the sources of all Public Revenue. It also presents the various principles that determine the choice between the alternative forms of public revenue.

The main attention in this section is paid to the tax revenue. Here, we observe the characteristics of a good tax system, and the various principles governing it. Besides, we look at the various types of taxes, discuss their merits and demerits and analyze their effects

on the economy.

- **Theory of Public Expenditure:** Compared to the theory of Public Revenue, the theory of Public Expenditure has received its due recognition only in recent years. It includes the principles and theories of public expenditure, and also the effect of public expenditure on production, distribution and stabilization.

  Besides, in this section, we analyse the efficacy of public expenditure as a fiscal instrument to achieve various economic objectives like optimal allocation, economic stability and a more equitable distribution.

- **Public Debt and Debt Management:** In this area of Public Finance, we identify the various sources of public borrowing. We also look at the various methods of public borrowing and also at the ways and means of redemption of public debt. Besides, we analyse the efficiency of Public Debt as a fiscal instrument, and also explore ways and means of enhancing the management of such debts.

- **Federal Finance:** An important area of Public Finance is the Federal Finance. The subject matter of federal finance consists in the principles that govern the sharing of resources between the different tiers of governments, namely central, state and local governments in a federation. It looks at the issues of financial flows, financial imbalances and their rectification.

  Thus, the above mentioned areas broadly touch the scope of Public Finance.



LET US KNOW

- Public Finance is concerned with the income and expenditure of the public authorities and how the two are adjusted with each other. But it is more concerned with how these functions can be used to achieve important economic objectives.
- Stated economic objectives of the Public Authorities relate to optimum allocation of resources, economic stability with high

growth and employment and an optimum distribution of income.

- The three main fiscal instruments are Taxation, Public Expenditure and Public borrowing.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are True (T) or False (F) :

(a) Public Finance is merely the study of public revenue and public expenditure. (True/False)

(b) Sharing of resources between different tiers of government is a subject matter of federal finance. (True /False)

Q 2: What are the three instruments of public finance? (Answer in about 20 words)

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1.4 PUBLIC FINANCE AND PRIVATE FINANCE

Public Finance and Private Finance have some similarities, yet they are dissimilar in many ways. Let us first discuss the similarities between the two and then identify their differences.

SIMILARITIES:

- **Satisfaction of human wants:** While private finance is concerned with the satisfaction of individual wants, public finance attempts to fulfill social wants. Hence, both forms of finance attempt to fulfill human wants.
- **Scarce means and multiple ends:** Both individuals and public authorities are confronted with the problem of limited resources and unlimited objectives. Hence, in both cases, an attempt is made to make the optimum use of these scarce resources.

- **To meet the deficit:** Just as private borrowing is revenue, public borrowing under public finance is resorted in order to close the gap between public expenditure and public revenue.

DISSIMILARITIES:

- **Scope:** Private Finance is confined to the adjustment of income and expenditure of private households through private borrowing, which is pursued for entirely personal interest.

  On the contrary , public finance refers to the operation of the public budget, where revenue components of public expenditure are sought to be adjusted, while achieving at the same time various stated social objectives.
- **Volume:** The volume of public financial transaction is huge, because their source of resources is flexible, and can be increased or decreased according to needs. On the other hand, with limited access of financial resources, the financial transaction in the case of private finance is very limited.
- **Adjustment of income-expenditure:** In the case of private finance, expenditure is sought to be adjusted with the income. On the contrary, in public finance, public revenue is adjusted with the anticipated public expenditure. This is so because private income is generally limited, whereas in the case of public finance, public expenditure is anticipated and the flexible public revenue can be adjusted accordingly.

  Again, the private individual only can borrow from others i.e., the borrowing is internal. But in the case of public finance, public authorities can borrow from itself, as well as from foreign countries and international financial institutions. Thus, public borrowing can be both internal and external.
- **Printing of currency notes:** If needed, public authorities have the option of printing new currency to augment its undertaken to meet the deficit of current expenditure over regular revenue. This option, however, is not available for private finance.

LET US KNOW



- Borrowing has to be undertaken in the case of both public and private finance, when expenditure exceeds income/revenue.
- Activities associated with both public and private finance results in saving, investment and capital formation. This directly contributes to the growth of national income.
- While private finance is used for personal profit, public finance is pursued for the greater social interest.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are True (T) or False (F) :

(a) Both public authorities and private units have the options of printing new currency. (True/ False)

(b) Gap between revenue and expenditure is filled by public borrowing. (True/ False)

Q 4: State any two similarities between private finance and public finance. (Answer in about 40 words)

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1.5 PUBLIC GOODS, PRIVATE GOODS, CLUB GOODS AND LOCAL PUBLIC GOODS

Private goods are goods which has two basic characteristics. They are rival and excludable. Thus, private goods are rival in the sense

that its consumption by an individual will ensure that the amount available to other consumers will be reduced by that amount. Thus, all consumers of private goods are rivals, as they compete with each other to consume the limited amount of private goods. The individuals who get to consume the goods, do so, at the expense of their rivals whose consumption is reduced by the same amount. For example, a cake that is shared. Besides, private goods are excludable since people who do not pay for it can be excluded from its consumption. For example, a meal in a restaurant.

On the other hand, public goods are typically non-rival and non-excludable. Public goods are non-rival as its consumption by one individual does not reduce the amount available for other consumers. Thus, once produced, it can be consumed equally by all consumers without the shares of individual consumers decreasing. For example, a street light. Besides, public goods are non-excludable in the sense that it is impossible or exorbitantly expensive to exclude anyone from consuming it. Thus, when a village is provided with a flood control project, it is impossible to exclude any one individual in the village from enjoying its benefit. Similarly, it is next to impossible to prevent someone from enjoying the benefits from a street light which is provided in the neighbourhood.

Club goods and local public goods are subset of public goods. *Club goods* are highly excludable and either non-rivalrous or partly rivalrous in consumption. Examples of Club goods are satellite TV, private parks, movie theatres etc. *Local public goods* are those public goods which are available only within a limited geographical area and the benefits of such goods can be enjoyed only within that geographical area. Example of such local public goods includes a television signal that can be received only within a limited distance of the transmitter.



CHECK YOUR PROGRESS

Q 5 : State whether the following statements are True (T) or False (F) :

(a) Consumption of private goods are excludable. (True/False)

(b) Provisioning of school education at public schools is an example of public good. (True/ False)

Q 6 : Fill in the blanks.

(a) Public goods are typically _____and non-excludable.

(b) Private goods are _____ since people who do not _____ for it can be excluded from its consumption.

1.6 PUBLIC GOODS, FREE RIDERS AND MARKET FAILURE

The market mechanism operates well in the provision of private goods. Here, the consumers bid for various products and the producers sell to the highest bidder. The consumer, who succeeds in purchasing the product by making the highest bid, enjoys exclusive rights over that product. Such a private goods is a “rival” (consumption by one consumer means it is not available for consumption by other potential consumers) and “exclusive” (those who do not pay are excluded from its consumption) in nature.

However, in contrast to private goods, public goods are both “non-rival” and “non-exclusive”. By “non-rival”, we mean that the consumption of a good by someone does not reduce the amount of that good available to other consumers. And the “non-excludability” character of public goods implies that it is impossible or financially non-viable to exclude someone from consuming the goods, even when the consumer refuses to pay for it.

Given these two characteristics of public goods, consumers will refrain from making voluntary payment to the suppliers of such goods. This happens because each consumer knows that his consumption of that good will make no difference to the quantity available for others and also that he can not be excluded from the consumption of the goods, even when he refuses to pay for it. Thus, in the case of consumption of public goods like street light, flood control project, pollution control project etc., all the consumers would attempt to be 'free-riders'. A free rider is a person, who derives benefits from resources, goods or services without paying for them. Existence of too many free riders results in underprovision of those resources, goods or services. This problem is commonly associated with public goods i.e. goods with non excludable benefit.

Without any promises of revenue, private suppliers will not produce and supply these public goods, as the "price" which serves as a link between buyers and sellers does not exist. Consequently, 'market failure' results, as the market is unable to provide this class of goods.

Such states are resolved with the public authorities supplying the public goods through the government budget.

1.6.1 Common Resources and Tragedy of Commons

Most of the common resources are public goods as they possess the characteristics of non-excludability and non rivalry. In 1968, Garrett Hardin proposed a particularly influential concept about the possibilities for common resources to be exploited and depleted which is known as the tragedy of commons, According to this concept, communities are aware of the facts that over exploitation of common resources by themselves are against their long term interest, even then they over exploit such resources. (We will discuss this topic in detail in the next semester in the course on Environmental Economics in the major curriculum).



LET US KNOW

- Public Goods are non-rival and non-excludable.
- Market failure results in the provision of public goods as all consumers attempts to be 'free riders'.
- Examples of public goods include street light, flood control project, defence etc.
- Examples of private goods include car, cloth, food, education etc.



CHECK YOUR PROGRESS

Q 7: State whether the following statemens are True (T) or False (F) :

(a) Market mechanism works efficiently in the provision of private goods (True/False).

(b) Public Goods are brought and sold at the market price. (True/ False).

Q 8: What do you mean by 'non-rivalry' and 'non-excludability' of public goods? (Answer in about 50 words)

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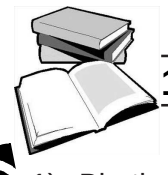


1.7 LET US SUM UP

- Public Finance deals with how the government mobilizes its resources to finance its expenditure. Besides, it is also concerned with the attainment of:

- Optimum allocation of resources
- Economic stability with an acceptable level of growth and employment.
- An equitable distribution of income and wealth

- Scope of public finance includes –
  - The theory of public revenue.
  - The theory of public expenditure
  - Public Debt and Debt Management
  - Federal Finance.
- Public Finance and Private Finance have many similarities and also many differences.
- The two characteristics of public goods, namely “non-rival” and “non-excludable” lead to market failure.



1.8 FURTHER READING

1) Bhatia, H.L. (2005). *Public Finance.* New Delhi : Vikas Publishing House Pvt. Ltd.
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3) Menkar, V.G. and Sarma, L.S. (2001). *Public Finance* : *Theory and Practice.* Mumbai : Himalaya Publishing House.
4) Prakash, O. (2008). *Public Economics* : *Theory and Practice.* Jalandhar : Vishal Publishing House.

1.9 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: The three instruments of public finance are: public revenue, public expenditure and public borrowing.

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

Ans to Q No 4 : Two important similarities between private finance and public finance are -

- First, both individuals and public authorities are confronted with the problem of limited resources and unlimited objectives. Hence, in both cases, an attempt is made to make optimum use of these scarce resources.
- Secondly, just as private borrowing is undertaken to meet the deficit of current expenditure over revenue, public borrowing under public finance is resorted in order to close the gap between public expenditure and public revenue.

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

Ans to Q No 6 : (a) non-rival (b) excludable, pay

Ans to Q No 7 : (a) True (b) False

Ans to Q No 8 : Non-rivalry of public goods means that consumption of commodity by someone does not reduce the amount of that commodity available to other consumers.

Non-excludability of public goods means that it is impossible to exclude someone from consuming the goods even when the consumer refuses to pay for it.



1.10 MODEL QUESTIONS

Short-type Questions (Answer each question in about 150 words)

Q 1: What is meant by the term public finance?

Q 2: What is meant by the term 'market failure'?

Q.3: Explain the consequences of market failure.

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

Q 1: Discuss the scope of public finance.

Q 2: Discuss the similarities and differences between private and public finance.

Q 3: Discuss the two characteristics which are typical of public goods. Explain how market failure results in the provision of public goods.

*** ***** ***

UNIT 2 : PUBLIC REVENUE

UNIT STRUCTURE

2.1 Learning objectives

2.2 Introduction

2.3 Basic Concepts of Public Revenue

2.3.1 Meaning of Public Revenue

2.3.2 Distinction between Revenue and Non-revenue Receipt

2.3.3 Need for Public Revenue

2.4 Sources of Public Revenue: Tax Revenue and Non-Tax Revenue

2.5 Let Us Sum Up

2.6 Further Reading

2.7 Answers to Check Your Progress

2.8 Model Questions

2.1 LEARNING OBJECTIVES

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

- explain the meaning of public revenue
- distinguish between revenue and non-revenue receipt
- appreciate the need for public revenue
- identify the sources of public revenue.

2.2 INTRODUCTION

The State requires resources to maintain itself and also to carry out its various functions. The source of these resources is public receipt. Public receipt may be mobilised as revenue or as borrowings. The manner of mobilisation has different effects on state finance and on the economy. This unit will identify the different ways and means of mobilising resources by the state and accordingly classify them into different categories.

2.3 BASIC CONCEPTS OF PUBLIC REVENUE

In this section, we shall discuss a few basic concepts of public revenue, viz., its meaning, distinction between revenue and non-revenue receipts and the need for public revenue.

2.3.1 Meaning of Public Revenue

Public revenue constitutes a part of the public receipt. It is an important source of revenue mobilisation of a state. Through public revenue, the state mobilises funds without incurring a corresponding increase in its debt obligation. To put it simply, funds mobilised as public revenue are income to the state and hence does not need to be returned.

Another characteristics of public revenue is that it is recurring in nature. Thus, public revenue is mobilised year after year, and hence constitutes a reliable and perennial source of state funds.

Public revenue can be classified into tax revenue and non-tax revenue. *(We will discuss these two concepts in detail in section 2.4 of this unit).*

2.3.2 Distinction between Revenue and Non-revenue Receipts

Public receipt may be classified into revenue receipt and non-revenue receipt. Revenue receipt increases the financial resources of the state without a corresponding increase in their debt obligation. As explained earlier, funds mobilised in the form of public revenue belongs to the state and hence do not have to be returned and also no interest payments have to be made. Besides, as we have already said, revenue receipts are recurring in nature as a result of which it provides a regular source of funds to the state. Given the facts that public revenue is regular in nature and also that it does not add to the debt obligation, it provides a very sustainable source of finance for the operation of the state. Revenue receipt may either be in the

form of tax receipt or it could flow in as non-tax receipt.

On the other hand, non-revenue receipt (also called capital receipt) mostly flows into the state treasury in the form of public borrowings, small savings, recoveries of loans etc. In the case of non-revenue receipt, the financial resources of the state increases, but along with this increase, there is a corresponding increase in its debt obligations. In other words, the funds mobilised as non-revenue receipt belong to other people. As they have only been borrowed, these funds have to be repaid along with interest. Hence, the net position of the state treasury does not improve with non-revenue receipt as they only increase the usable funds with the state with a corresponding increase in its debt obligation.

Besides, non-revenue receipts are usually non-recurring in nature. This implies that they do not offer a regular or reliable source of funds for the state. Given the fact that, non-revenue receipt adds to the debt obligation of the state and also that it is non-recurring in nature, such a source of fund by itself is considered to be unsustainable in the long run for an economy.

2.3.3 Need for Public Revenue

We have already mentioned that like any other economic units, the state requires resources to maintain itself and also to carry out all its activities. These resources are raised from various sources of the economy and by various means.

Among all the sources, tax revenue constitutes the most important source for mobilisation of state funds. Tax revenue (along with non-tax revenue and capital receipts) are mobilised by the state to finance its various activities designed to attain the stated economic and social objectives.

Among various economic objectives, revenue receipts are used to achieve the most optimal allocation of resources so as to achieve the highest possible growth rate. Besides, an appropriate



Egalitarian society —

That society which believes that all people are equally important and should have the same rights and opportunities in life.

taxation strategy is adopted to maintain price stability during the periods of economic fluctuations.

Public revenue instruments are often used as fiscal tools to strive for the social objective of an ***egalitarian society***. Thus, besides mobilising resources for the state, public revenue instruments also facilitate the endeavour towards the establishment of a more equal society.

As mentioned above, although most of the expenditures of the state can be financed through public borrowing (i.e., capital receipt), however, this is not a sustainable option. In the long run, any expenditure programme of the state can only be sustained if it is covered by public revenue. This, in fact, constitutes the greatest significance of public revenue.



CHECK YOUR PROGRESS

Q1: State whether the following statements are True (T) or False (F) :

(a) Capital Receipt is another term for non-revenue receipt. (True/ False)

(b) Public revenue increases the debt obligation of the state. (True/False)

Q 2 : Distinguish between revenue receipt and capital receipt. Which one is the more sustainable source of public expenditure? (Answer in about 60 words).

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LET US KNOW

Ideally, recurring state expenditure should be financed by revenue receipt and the non-recurring expenditure should be financed by capital receipt.

2.4 SOURCES OF PUBLIC REVENUE

Public revenue is the income of the state that is mobilised from the economy. Broadly, public revenue can be classified into tax revenue and non-tax revenue.

- **Tax revenue:** Tax revenue is the revenue mobilised by the state through taxation. This, in fact, constitutes the most important source of revenue of a state.

  A Tax is defined as a compulsory payment made to the state without any direct '***quid-pro-quo***' between the tax payers and public authorities. Thus, the two basic characteristics of tax are -

  - It is a compulsory payment.
  - There is no direct benefit extendable to the tax-payer.

  Tax revenue can be classified into direct taxes and indirect taxes. The principal direct taxes include income tax, corporation tax and consumption tax. The first two taxes are imposed on income whereas the third is imposed on expenditure. Besides, direct taxes are also imposed on property and also include wealth tax, death duty, gift tax and land revenue. On the other hand, indirect taxes are essentially taxes on commodities and resources that are offered for sale. They are imposed in the form of sales tax, excise duty, custom duties and value added tax (VAT). (We will study the different type of direct and indirect taxes in unit 4)



***quid-pro-quo* —**

Means a thing given in return of something else.

- **Non–tax revenue:** Besides tax revenue, non–tax revenue constitutes another source of revenue receipt for the state. The major non-tax revenues are broadly classified and briefly explained under the following heads:

- **Commercial revenues :** Commercial revenues accrue to the state as it produces and supplies goods and resources to the public. This type of revenue accrues in the form of:
  - dividend as it accrues to the state from the profit earned by the public sales enterprises, and
  - price that is paid by the public while consuming goods and services which is provided by government owned public utilities.
- **Administrative revenues :** The government extends various public services through its administrative infrastructure like civil and police administration, agriculture and allied services, transport and communication, education, medical and various other services. From administrative services, revenue accrues to it which is referred to as Administrative revenue.

  Administrative revenue also arises in the form of fees, licences, permits, fines and forfeitures and special assessments. Finally, non–tax administrative revenue can also accrue as grants, gifts and ***escheats***.
- **Earnings from currency and credit :** The government earns an income as it mints coins and issues currencies. These constitute an important source of non–tax revenue.

  Besides, the interest earned from government lendings also constitutes non-tax revenue.



***escheats* —**

The escheats refer to the claim of the state over properties of a dead person who has left no heir.



LET US KNOW

Sources of non-revenue receipts or capital receipts include : public borrowing, small savings of the public and recoveries of loans etc.



CHECK YOUR PROGRESS

Q3: State whether the following statements are True (T) or False (F) :

(a) Income tax and corporation tax are important forms of indirect taxes.(True/ False)

(b) Funds coming to the state in the form of gift and grants constitute part of non –tax revenue. (True/False)

Q4 : Mention the various sources of public revenue. (Answer in about 50 words)

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2.5 LET US SUM UP

- The state requires resources to maintain itself and also to carry out its various functions.
- Public receipt may be classified into revenue receipt and non-revenue (or capital) receipt.
- Public revenue increases the funds at the disposal of the state without adding to its debt obligation.
- Besides acting as a source of state funds, instruments of public revenue can be used for achieving fiscal objectives.
- Public revenue is mobilized as tax revenue and non-tax revenue.



2.6 FURTHER READING

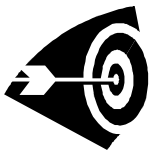
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4) Prakash, O (2008). *Public Economics* : *Theory and Practice.* Jalandhar : Vishal Publishing Co.

2.7 ANSWERS TO CHECK YOUR PROGRESS



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

Ans to Q No 2: Revenue receipt increases the financial resources of the state without affecting its debt obligation. Capital receipt also increases the funds of the state but results in a corresponding increase in its debt obligation.

Even when most of the expenditures of the state can be financed through public borrowing (i.e., capital receipt), however, this is not a sustainable option. In the long run, any expenditure programme of the state can only be sustained if it is covered by public revenue.

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

Ans to Q No 4: Broadly, public revenue can be classified into tax revenue and non-tax revenue. Tax revenue can be classified into direct taxes and indirect taxes. Besides tax revenue, non–tax revenue constitutes another source of revenue receipt for the state. The major heads of non-tax revenue are commercial revenues, administrative revenues, and earnings from currency and credit.

2.8 MODEL QUESTIONS

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

Q 1: Write short Notes on –

a) Revenue Receipt b) Capital Receipt c) Tax revenue

Q 2: Discuss the importance of public revenue.

B. Long Questions (Answer each question in about 300-500 words)

Q 1: Distinguish between revenue receipt and capital receipt. Which form is more sustainable source of public expenditure?

Q 2: Discuss the various sources of tax and non-tax revenues.

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UNIT 3 : INTRODUCTION TO TAXATION

UNIT STRUCTURE

3.1 Learning objectives

3.2 Introduction

3.3 Meaning and Features of Taxation

3.4 Canons of Taxation

3.5 Shifting and Incidence of Tax

3.6 Direct and Indirect Taxes

3.6.1 Merits and Demerits of Direct Taxes

3.6.2 Merits and Demerits of Indirect Taxes

3.7 Let Us Sum Up

3.8 Further Reading

3.9 Answers to Check Your Progress

3.10 Model Questions

3.1 LEARNING OBJECTIVES

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

- define the concept of taxation and also state its characteristics
- discuss the canons of taxation
- distinguish between direct and indirect taxes
- explain the concepts of shifting and incidence of taxation.

3.2 INTRODUCTION

Taxation is a primary source of public revenue and a critical tool used in financial policy. It has characteristics which are unique and require certain pre-conditions in its imposition to ensure its efficacy. Taxes are either direct or indirect, with each having its merits and demerits.

3.3 MEANING AND FEATURES OF TAXATION

A tax is a compulsory contribution imposed by the public authorities on the people without any direct benefit rendered in return. Taxation has the following features:

- **Compulsory contribution:** A tax is a compulsory contribution in the sense that it is mandatory for the individual or entity on which it is imposed. Refusal to pay taxes is considered to be a cognigible offence and attracts legal action.
- **No *'quid-pro quo'*:** Payment of taxes does not ensure any direct benefits from the state in return to the tax payer. Resources mobilized through Taxes are disbursed as public expenditure to the general public, and any one tax payer can not claim any privileges in that disbursal.
- **Fiscal instrument:** Besides being a source of public revenue, Taxes are also used to achieve desirable objectives to and restrict the undesirable ones. Hence, it is one of the three fiscal instruments. For example, heavy taxation is imposed on alcohol and tobacco consumption. On the contrary, Tax on essential items are minimized to facilitate their consumption.

3.4 CANONS OF TAXATION

Canons of taxation indicate the attributes of a good tax system. Initially four canons of taxation were prescribed by Adam Smith. However, later writers have added a few more canons to the assigned list.

- **Canon of Equity:** The canon of equity requires that the burden of tax should be equitably distributed. This is achieved by taxing every individual according to his ability to pay. Thus, equity demands that the richer sections of the society should bear a greater burden of the tax as compared to the poorer sections.
- **Canon of Certainty:** The canon of certainly requires that the tax that one has to pay must be certain and non –arbitrary. This implies that the amount of tax, the time of payment and the manner of

payment must be clearly stated to the tax payers and also to every member of the public. The certainty principle prepares the taxpayer towards how much tax he has to pay and when. Besides, it enables the state to ascertain how much of tax revenue that it can hope to mobilize.

- **Canon of Convenience:** The canon of convenience requires the time and the mode of payment of tax to be such that it causes minimum inconvenience to the tax payers. Thus, in the words of Adam Smith," every tax ought to be levied at the time or in the manner in which it is most likely to be convenient to pay it." Thus, for example ,agricultural tax should be collected during the harvest season ,as it is the most convenient time to make payment for the agriculturists. Similarly, a convenient mode of tax payment for salaried persons is for tax to be deducted at source, when they receive their salaries.
- **Canon of Economy:** The canon of economy requires that the cost of collection of Tax must be minimum. Thus a good tax system would need to incur the least expenditure on the collection of taxes.

  According to Adam Smith," every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state". Thus, tax requiring excessive collecting cost should be avoided.

  Since the days Adam Smith, a few more canons have come to be widely accepted in the discipline of public finance. They are-
- **Canon of Productivity:** With revenue mobilisation as one of the primary objectives of taxation, the canon of productivity requires the tax that is imposed to be productive. It adheres to the principle that it is better to have a few taxes that are productive rather than to have a large number of taxes whose yields are low.
- **Canon of Simplicity:** The structure of the taxation system and the laws that govern it should be simple so that it is easily understood

by the common people. This enables people to make their necessary tax payments without any difficulties and prevents them from becoming involuntary tax-evaders.

- **Canon of Elasticity:** This canon requires the taxation system to be elastic or flexible in nature. Accordingly, tax revenue mobilised should rise and fall in line with the respective upswing and downswing of the economy.
- **Canon of Diversity:** This canon requires the tax system to be diversified with a large number and variety of taxes. On the one hand, this allows the state to bring all sections of the population within the tax net, whereas on the other hand, it provides the state with alternative sources of revenue if one tax fails to mobilise the expected revenues.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are True (T) or False (F) :

(a) Tax is a compulsory payment made under a 'quid-pro-quo' arrangement. (True/False)

(b) Taxation constitutes one of the three basic fiscal instruments. (True/False)

(c) Canon of equity requires that the tax that one has to pay must be certain and non-arbitrary. (True/False)

Q.2: Mention the four initial canons of taxation as propounded by Adam Smith. (Answer in about 30 words).

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3.5 SHIFTING AND INCIDENCE OF TAX

The incidence of tax is upon that individual who bears the direct money burden of the tax. However, the incidence of tax may not necessarily rest on the individual who bears the initial money burden (i.e the import of the tax). This happens when the individual on whom the imposed tax falls, succeeds in shifting the burden to another individual. Thus, here the impact of the tax is on the first individual whereas the incidence is on the second individual to whom the tax had been shifted. Shifting is usually undertaken by raising the price of a commodity sold by an amount equal to the tax. Hence, the impact refers to the initial money burden of the tax. The process of transferring the direct money burden of tax to another individual is called the shifting of the tax. Finally, the incidence of tax is on the person who ultimately bears the burden. Thus, it is the final resting place of the direct money burden of tax.

3.6 DIRECT AND INDIRECT TAXES

Taxes can be classified into direct taxes and indirect taxes.

A direct Tax cannot be shifted. Thus, in the case of direct tax, the impact of the tax as well as its incidence is on the same person. Income tax is a typical example of a direct tax, as its impact as well as its incidence falls on the same individual. This happens because shifting of income tax is not possible.

On the other hand, an indirect tax is a tax that can be shifted. Thus, in the case of an indirect tax, the impact of the tax falls on the person, who successfully shifts it to another person. Subsequently, the incidence of the tax falls on the second person. A typical example of an indirect tax is sales tax. Here, the initial burden of (i.e the impact) of the tax falls on the dealers of a commodity that is being sold. However, the dealer shifts the tax to the buyer by adding the amount of tax to the price of the commodity. In this case, although the impact is on the dealer, however the incidence is shifted to the buyers.

Common direct taxes include income tax, wealth tax, gift tax, property tax, estate duty etc. On the other hand, common indirect taxes would include sales tax, excise duties, export duty, import duty, entertainment tax etc.

3.6.1 Merits and demerits of Direct Taxes

Merits: Direct taxes have the following merits:

- **Equitable:** Direct taxes are equitable because their burden falls more heavily on richer section of the society. This happens because direct taxes are based on the principle of" Ability to Pay "where richer people make bigger tax contribution, while the poorer people are asked to make a relatively smaller contribution. In fact, people below a particular level of income and wealth are exempted from paying income taxes.

- **Distributive justice:** Direct taxes are usually progressive in nature. This implies that their burden falls more heavily on the richer sections of the society than that of the relatively poor.

  As most of the public expenditure financed by tax resources targets the poor, direct taxes induces income redistribution in favour of the relatively poor sections of the society.

- **Certainty:** Direct taxes satisfy the canon of certainty as it enables the state to estimate the resources that it can generate in the coming period. Similarly, the tax payers are also in a position to know how much tax they have to pay and in what point of time in the future.

- **Elasticity :** Direct taxes are elastic as their yields can be easily increased or decreased by increasing or decreasing either the tax rates or the tax coverage.

Besides, they are buoyant because the yields from direct taxes expand as the economy enjoys upswings and contracts as it suffers from downswings.

- **Economy and convenience :** Direct taxes are economical in collection and administration. As they are progressive in nature, an increase in revenue through direct taxes can be brought about without a corresponding increase in the cost of collection.

  They are convenient to collect as they are deducted at source in the case of salaried income earners. Besides, non-salaried tax payers can pay the tax at a particular time period which enhances collection efficiency.

Demerits : Despite their merits, direct taxes suffer from some serious limitations.

- **Not popular :** Direct taxes are unpopular because they have to be paid by the taxpayer in lump sums at one go. This imposes great burden on the tax payer who earns his income in smaller amounts throughout the year.

  Besides, the requirement of submission of detailed account of income, wealth etc and the filing of tax returns impose additional burden of tax which is highly resented.

- **Tax Evasion :** Direct taxes are usually progressive in nature. This induces many tax payers to evade tax by understating their income and wealth. As only the honest people end up bearing the full burden of direct taxes, hence sometimes it is said that “direct taxes are a premium on honesty”.

- **Arbitrary :** Direct Taxes are usually progressive and is based on the principle of ‘ability to pay’. However, in the absence of an objective measure of ‘ability to pay’, tax rates are fixed arbitrarily. Here, there is a strong possibility of underestimation or overestimation of the taxable capacity of the people.

- **Inadequate in a poor country :** In poor and underdeveloped countries, the vast majority of the population is poor and lies within the exemption limit of direct taxes. Given the small number of eligible tax payers, proceeds from direct tax prove to be inadequate to meet the revenue requirement of the public authorities.



LET US KNOW

- Direct taxes are usually imposed on income and wealth whereas indirect taxes are imposed on goods and services.
- While direct taxes are progressive, their coverage is limited. Again, although indirect taxes ensure greater coverage, they tend to be regressive.

3.6.2 Merits and Demerits of Indirect Taxes

Merits: Indirect taxes exhibit the following merits:

- **Greater Coverage :** Unlike direct taxes, indirect taxes ensure greater coverage of the population. This is very significant in poor countries where large segments of the population remain untouched by direct taxes. In fact, in many such countries revenue mobilized from indirect taxes largely exceeds what is mobilised by direct taxes.
- **Convenient and less unpopular :** Indirect Taxes are hidden in the price of goods and services and are payable only in small amounts. As the burden is spread over an extended period of time, people find it convenient and hence it is less unpopular as a tax.

- **Less tax evasion:** As indirect taxes are included in the price of goods and services, they are difficult to evade. The only way to avoid indirect taxes is to stop consumption. However, indirect taxes are evaded by smuggling which can be controlled by more effective policing.

- **Promotion of social welfare:** Indirect taxes can be heavily imposed on harmful commodities like alcohol, tobacco etc. to curb their consumption. Conversely, merit goods like milk, medicine etc can be lightly taxed to promote their use.

Demerits: Indirect taxes suffer from the following demerits.

- **Regressive and Inequitable :** Indirect taxes have to be paid equally by all sections of the society, without any distinction being made between the rich and the poor. Given their relatively lower income, the real burden of such taxes are much more on the poor than on the rich. Hence, indirect taxes are considered to be regressive and inequitable.

- **Uncertainty in mobilization:** As resources mobilized through indirect taxes depend on consumption expenditure, the precise amount of resources that can be mobilized is difficult to estimate.

  Besides, the demand for same goods falls when their tax induces the prices to go up. For such goods, it is difficult to estimate the tax that can be collected through indirect taxation.

- **High collection cost:** Indirect taxation includes a very high collection cost as large tax machinery needs to be maintained to ensure tax compliance and to minimize tax evasion. Hence, in many instances, the 'canon of economy' is not found in the case of indirect taxation.

- **Inflation:** A major demerit of indirect taxation is that it generates inflation in the economy. Hence, as taxes increase the price of the commodities, inflation in the economy ensues. In fact, higher prices for taxed commodities induce a rise in the factor prices which in turn raises the production cost leading to further increases in commodity prices. Hence, indirect taxes result in a cumulative upward spiral in the commodity prices and induce cost-push inflation.



CHECK YOUR PROGRESS

Q3: State whether the following statements are True (T) or False (F) :

(a) Incidence is the final resting place of the direct money burden of a tax. (True/False)

(b) A direct tax can be shifted by one individual to the other. (True/False)

(c) A merit of indirect tax is that it enables greater coverage of the population. (True/False)

Q4: How does indirect tax result in less tax evasion? (Answer in about 40 words)

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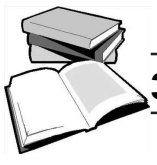
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3.7 LET US SUM UP

- Taxation is a primary source of public revenue.
- A tax is a compulsory payment made to the public authorities without any direct benefit received in return.
- There were initially four canons of taxation, which were expanded with the addition of more canons in subsequent periods.
- Impact is the initial money burden of the tax. This money burden is transferred through the process of shifting. The incidence is the ultimate money burden of the tax.
- Direct taxes cannot be shifted and conversely shifting is possible in the case of indirect taxes.
- Direct and indirect taxes have their own typical merits and demerits.



3.8 FURTHER READING

1) Bhatia, H. L. (2006). *Public Finance.* New Delhi : Vikas Publishing House Pvt.

2) Lekhi, R. K. (2006). *Public Finance and Fiscal Policy.* Ludhiana : Kalyani Publishers.

3) Menkar and Sarma. (2001). *Public Finance* : *Theory and Practice.* Mumbai : Himalaya Publishing House.

4) Prakash, O. (2008). *Public Economics : Theory and Practice*. Jalandhar : Vishal Publishing Co.

3.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (a) False (b) True (c) False

Ans to Q No 2: The initial four canons of taxation as prescribed by Adam Smith are:

- canon of equity,
- canon of certainty,
- canon of convenience, and
- canon of economy.

Ans to Q No 3: (a) True (b) False (c) True

Ans to Q No 4: Indirect taxes are included in the price of goods and services, and therefore, they are difficult to evade. The only way to avoid indirect taxes is to stop consumption. However, indirect taxes are evaded by smuggling which can be controlled by more effective policing.



3.10 MODEL QUESTIONS

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

Q 1: Explain the concepts of impact, shifting and incidence of tax.

Q 2: Distinguish between direct and indirect taxes.

Q 3: Discuss the meaning and features of taxation.

B. Long Questions (Answer each question in about 300-500 words)

Q 1: State and explain the canons of taxation.

Q 2: Compare the merits and demerits of direct taxes with those of indirect taxes.

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UNIT 4: SOME IMPORTANT TAXES

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Income Tax

4.4 Corporate Tax

4.5 Capital Gains Tax

4.6 Expenditure Tax

4.7 Gift Tax

4.8 Sales Tax

4.9 VAT

4.10 GST

4.11 Lets Sum Up

4.12 Further Reading

4.13 Answers to Check Your Progress

4.14 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit you will be able to-

- explain the important types of taxes
- distinguish among different types of taxes
- analyse the superiority of one form of taxes over another
- trace the sources of different types of taxes.

4.2 INTRODUCTION

Taxes are compulsory contributions made to the government (whether local, regional or national) of any country by the public that has no quid pro quo (i.e. something in exchange for something). Taxes are applied to money value of income, property, transaction etc. Taxes constitute one of the

important sources of revenue for the government to fund public expenditure. A failure to pay taxes is punishable by law. Taxes are typically divided into direct and indirect taxes. Some of the important types of taxes are discussed in the following sections.

4.3 INCOME TAX

Income tax occupies a prominent place in the field of direct taxation. According to the Central Board of Direct Taxation, income tax is a tax levied by the Government of India on the income of every person. The provisions governing the income-tax are covered in the Income-tax Act, 1961. However, while imposing it, people with a certain level of income are exempted. Again the rates of tax are different for different scales of taxable income. Income tax is applied to earned income (dividends, interests and rents). However, in India the income tax is the domain of central government. The Indian Constitution does not provide any right to the state governments to impose income tax. The Constitution of India, Schedule VII has given the power to the central government to levy a tax on any income other than agriculture income.

Income tax may be of two types- personal income tax and corporation income tax. Income tax generally indicates the personal income tax. Personal income tax is a direct tax levied on the income of a person. A person means an individual, an ordinary partnership, a non-juristic body of person and an undivided estate. In general, a person liable to personal income tax has to compute his tax liability, file tax return and pay tax, if any, during a financial year.



LET US KNOW

Income tax means the tax imposed on individuals or business entities on their income or profit. However, while imposing it, people with a certain level of income are exempted. Again the rates of tax are different for different scales of taxable income. Income tax is categorized into personal income tax and corporation tax.



CHECK YOUR PROGRESS

Q1. What is meant by tax? (Answer in about 50 words)

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Q2. Define income tax (Answer in about 50 words)

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Q3. State whether the following statements are True (T) or False (F):

(a) Taxes are classified into direct and indirect taxes.(True / False)

(b) Income tax is divided into personal income tax and corporation tax.(True / False)

4.4 CORPORATE TAX

All incomes are not directly received by individuals. A large portion of the society's income originates from income of the Joint Stock Companies also called corporate business organizations or simply business corporations which are owned by a large number of shareholders. Corporate tax or corporation tax is a tax placed on the taxable profits of companies and other profit organizations. Such tax is placed on the taxable profits of a company or organization. Taxable profits include profits from taxable income gains. Companies, both private and public, which are registered in India under the Companies Act, 1956, are liable to pay corporate tax. Corporate tax is imposed in India only by the Union Government.

The income earned by the corporations may or may not be distributed to shareholders currently. A part of the profit income may be retained by the company for reinvestment. The profit income is distributed among the shareholders as dividends. Countries may tax corporations on its net profit. Also shareholders will be taxed when the corporations pay a dividend. Such taxes are also known income tax or capital gain tax.



LET US KNOW

Corporate tax is an assessment levied by a government on the profits of a company. It is a tax imposed on the net income of the company. The profit income which is distributed among the shareholders is called dividends.



CHECK YOUR PROGRESS

Q4. What is meant by Corporate tax ? (Answer in about 50 words)

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4.5 CAPITAL GAINS TAX

The value of any property does not remain the same. With time its value will either increase or decrease. When the value of the property increases, capital gains occur with every increase. Capital gains for tax refers to the tax levied on appreciated value of capital assets. In other words, increase in current value over and above the purchase value of a capital asset is the amount of capital gains. The most important sources of capital gains are sale of stocks, bonds, precious metals and property. The gains are not

applicable when an asset is inherited because there is no sale or transfer. All countries do not implement capital gains tax and most have different rates of taxation for individuals and corporations.

One of the main advantages of capital gains tax is that it is equitable and it can be used as a counter cyclical measure. Capital gains tax is considered to be highly progressive as it typically targets the rich. But this type of tax has certain disadvantages also. Firstly it does not fulfill the canon of certainty. Secondly, it might discourage risk taking ventures. Thirdly it also suffers from the difficulty of administration.



LET US KNOW

Capital gains tax refers to the tax levied on appreciated value of capital assets. In other words, increase in current value over and above the purchase value of a capital asset is the amount of capital gains. The most important sources of capital gains are sale of stocks, bonds, precious metals and property.



CHECK YOUR PROGRESS

Q5. Define capital gains tax. (Answer in about 50 words)

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Q6. Mention some important sources of capital gains.

(Answer in about 20 words)

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4.6 EXPENDITURE TAX

Expenditure tax has been viewed by many writers as an alternative to income tax. Famous economists Alfred Marshall and J. S. Mill considered expenditure tax to be superior to income tax. According to J.S Mill,savings are exempted in case of expenditure tax and Marshall was of the view that ability to pay is better measured under it. Expenditure tax is a tax which is levied on the total consumption expenditure of an individual. It is a tax imposed on personal expenditure and collected when the income is spent on consumption purposes. It is a form of indirect tax which is added to the selling price of a good or service and which is borned by the consumers of these products. It may be proportional or progressive taxes. (Proportional tax refers to that system of taxes under which each tax payer pays the same rate of taxes irrespective of their income. Progressive taxes on the other hand refer to that tax system under which tax payers who have higher incomes pay taxes at higher rates). Expenditure tax along with various taxes on income is used by the government to raise revenue and as a means of regulating the level of spending in the economy. One of the main advantages of expenditure tax is that it eliminates the supposed adverse effects of the personal income tax on investment and saving incentives. But such type of taxes is very difficult to administer.



LET US KNOW

Expenditure tax is a tax which is levied on the total consumption expenditure of an individual. It is a tax imposed on personal expenditure and collected when the income is spent on consumption purposes. It is a form of indirect tax which is added to the selling price of a good or service and which is borned by the consumers of these products. It may be either proportional or progressive tax.



CHECK YOUR PROGRESS

Q.7. What is meant by expenditure tax? (Answer in about 50 words)

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Q.8. How is expenditure tax superior to income tax? Write briefly (Answer in about 60 words)

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Q.9. State whether the following statement is True (T) or False (F) : Expenditure taxes may be proportional or progressive.

4.7 GIFT TAX

A gift tax is a tax applied to an individual giving anything of value to another person. In other words, it is a tax on money or property that is transferred from one person to another without the giver receiving something of equal value in return. The transfer of property may take place either during the life time of the owner or at his death. If it takes place during the life time then it is termed as gift and if it takes place at his death it is termed as bequest. The levy on transfer of wealth during the life time of the donor is known as gift tax. On the other hand the taxation of bequest is the death duty. In case of gift tax, the giver is required to pay the gift tax and the receiver may pay the gift tax or a percentage of it, on the giver's behalf.

In a country like India, people often show their affection towards their family members through gifts. These gifts may be in any form like cash, jewellery,

movable or immovable property etc. The income tax rule of Government of India has specified relatives from whom tax free gifts can be received. They are- parents, spouse, brothers and sisters (including spouses'), brothers and sisters of one's parents, a person's lineal descendants (including spouses). According to the Income Tax Act, 1961, if the value of gifts received is more than Rs. 50,000 a year then such amount is taxed as income in the hands of the receiver. There are some gifts which are not taxable no matter what their value is, e.g. an item given as promotion.



LET US KNOW

Gift tax is a tax applied to an individual giving anything of value to another person. In other words it is a tax on money or property that is transferred from one person to another without the giver receiving something of equal value in return. In case of gift tax, the giver is required to pay the gift tax and the receiver may pay the gift tax or a percentage of it, on the giver's behalf.



CHECK YOUR PROGRESS

Q10. Define gift tax. (Answer in about 50 words)

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Q11. State whether the following statements are True (T) or False (F):

(a) The giver is required to pay the gift tax and the receiver may pay a percentage of it. (True / False)

(b) If the transfer of property takes place during the life time of an individual then it is known as gift. (True / False)

4.8 SALES TAX

Sales tax is an indirect tax which is paid to a regulating or governing body for the sale of goods and services. In other words, it is a consumption tax levied on goods and services purchased at the retail level, paid by the consumer and submitted by the retailer to the governing tax authority. A sales tax is levied at the point of sale collected by the retailer and passed on to the government. Different jurisdiction change different sales taxes, which often overlap, as states, countries and municipalities each levy their own sales taxes. In addition to the state sales tax, it can be applied by countries, cities and regions. Although in different countries there are different categories of sales tax but there is some universal sales tax too. They are retail sales tax, wholesale sales tax, manufacturer's sales tax, use tax and Value Added Tax(VAT). According to the Organization for Economic Cooperation and Development (OECD) sales taxes are one of the least harmful types of taxes for the economy and they will less affect growth and investment. One of the disadvantages of sales tax is that it is regressive in nature as it is a larger burden for low- income earners.



LET US KNOW

Sales tax is an indirect tax which is paid to a regulating or governing body for the sale of goods and services. In other words it is a consumption tax levied on goods and services purchased at the retail level, paid by the consumer and submitted by the retailer to the governing tax authority. A sales tax is levied at the point of sale collected by the retailer and passed on to the government.



CHECK YOUR PROGRESS

Q.12. What is meant by sales tax? (Answer in about 50 words)

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Q13. Name the types of sales taxes that are universal for all countries. (Answer in about 40 words)

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4.9 VAT

Value Added Tax or simply VAT is one type of indirect taxes on different stages of production. It is paid by the original producers upon the change in goods or upon the transfer of goods to its buyers. In simple words VAT is a tax that is imposed on the value added to goods and services. Here tax is collected in each stage on the value added on the goods. It is a multi-stage tax levied only on value that is added at each stage in the cycle of production of goods and services. Under this tax system, no exemptions are given and a tax will be levied at every stage of manufacture of a product.

More than 130 countries worldwide have introduced VAT over the past three decades. It forms a part of the national GDP as it is payable on the goods and services. India is one amongst the last few countries to introduce VAT. It was introduced from 1st April 2005. The existing General Sales Tax Laws were replaced with the Value Added Tax Act (2005) and associated VAT rules. Among the Indian states, Haryana became the first state in the country

that adopted the taxation on 1st April 2003. By 2nd June, 2014, VAT was implemented in all the states and union territories of India, except in Andaman and Nicobar Islands and Lakshadweep Islands.



LET US KNOW

Value Added Tax or simply VAT is one type of indirect taxes on goods. In simple words VAT is a tax that is imposed on the value added to goods and services. Here tax is collected in each stage on the value added on the goods. It is a multi-stage tax levied only on value that is added at each stage in the cycle of production of goods and services.



CHECK YOUR PROGRESS

Q14. Define VAT. (Answer in about 50 words)

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Q15. State whether the following statements are True (T) or False (F) :

(a) VAT forms a part of the national GDP. (True / False)

(b) West Bengal was the first Indian state to adopt VAT. (True / False)

Q16. In which year was VAT introduced in India?

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4.10 GST

GST or Goods and Services Tax is a comprehensive tax levied on manufacture, sale, and consumption of goods and services. This tax has been adopted by most of the countries in the world. It's rate ranges from 15 to 20 percent. In India it was introduced in the Lok Sabha on December 19, 2014 by the Finance Minister Arun Jaitley. Officially it is known as the

Constitution (One Hundred and Twenty Second Amendment) Bill, 2014. The tax came into effect from 1st July, 2017. It is a single tax which subsumes 17 indirect taxes and 23 cesses such as central indirect taxes on consumption like excise duty, countervailing duty, service tax and also state levies like value added tax, octroi and entry tax, luxury tax etc. The final consumer will bear only the GST charged by the last dealer in the supply chain with set- off benefits at all the previous stages. GST is divided into five tax slabs for collection of tax. They are 0%, 5%, 12%, 18%, and 28%. But petroleum products, alcoholic drinks, electricity are not taxed under GST and are taxed separately by individual state governments, as per the previous norms. Apart from this there is a special rate of 0.25% on rough precious and semi-precious stones and 3 % on gold. A cess of 22% or other rates on top of 28% GST applies on few items like aerated drinks, luxury cars and tobacco products. Under the GST model taxes is administered by both the Union and State governments. Transactions made within a single state are levied with central GST (CGST) by the central government and state GST (SGST) by the state governments. For inter state transactions and imported goods or services an integrated GST (IGST) are levied by the central government. According to reports the total gross GST collected in September, 2018 is Rs 94442 crore of which CGST amounts to RS 15318 crore, SGST is Rs 21061 crore and IGST is Rs 50070 crore.



LET US KNOW

GST or goods and services tax is a comprehensive tax levy on manufacture, sale, and consumption of goods and services. Officially it is known as the Constitution (One Hundred and Twenty Second Amendment) Bill, 2014. It is a single tax which subsumes central indirect taxes on consumption like excise duty, countervailing duty, service tax and also state levies like value added tax, octroi and entry tax, luxury tax.



CHECK YOUR PROGRESS

Q17. Define GST. (Answer in about 30 words)

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Q18. When was GST introduced in India and when did it come to effect? (Answer in about 30 words)

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Q19. How many people consist in the GST council?

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4.11 LET US SUM UP

- Taxes are compulsory contribution made to the government (whether local, regional or national) of any country by the public that has no quid pro quo. It constitutes one of the important sources of revenue for the government. Taxes can be classified into direct taxes and indirect taxes.
- Income tax means the tax imposed on individuals or business entities on their income or profit. However, while imposing it, people with a certain level of income are exempted.
- Corporate tax or corporation tax is a tax placed on the taxable profits of companies and other profit organizations. Such tax is placed on the taxable profits of a company or organization.

- Capital gains tax refers to the tax levied on appreciated value of capital assets. In other words, increase in current value over and above the purchase value of a capital asset is the amount of capital gains.
- Expenditure tax is a tax which is levied on the total consumption expenditure of an individual. It is a tax imposed on personal expenditure and collected when the income is spent on consumption purposes. It is a form of indirect tax which is added to the selling price of a good or service and which is borne by consumers of these products.
- A gift tax is a tax applied to an individual giving anything of value to another person. In other words it is a tax on money or property that is transferred from one person to another without the giver receiving something of equal value in return.
- Sales tax is an indirect tax which is paid to a regulating or governing body for the sale of goods and services. In other words it is a consumption tax levied on goods and services purchased at the retail level, paid by the consumer and submitted by the retailer to the governing tax authority.
- Value Added tax or simply VAT is one type of indirect taxes imposed on goods. It is paid by the original producers upon the change in goods or upon the transfer of goods to its ultimate consumers. In simple words VAT is a tax that is imposed on the value added to goods and services.
- GST or goods and services tax is a comprehensive tax levy on manufacture, sale, and consumption of goods and services. Officially it is known as the Constitution (One Hundred and Twenty Second Amendment) Bill, 2014. It is a single tax which subsumes 17 indirect taxes and 23 cesses like excise duty, countervailing duty, service tax and also state levies like value added tax, octroi and entry tax, luxury tax etc.

4.12 FURTHER READING

1) Choudhury, R. K and R. Chakraborty (2016). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers.
2) Lekhi, R. K. (2002). *Public Finance.* Ludhiana: Kalyani Publishers.
3) Mithani, D. M. (2001). *Money, Banking, International Trade and Public Finance.* Mumbai: Himalaya Publishing House.

4.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Taxes are compulsory contribution made to the government (whether local, regional or national) of any country by the public that has no quid pro quo. Taxes are applied to some form of money received by a tax payer. It constitutes one of the important sources of revenue for the government to fund public expenditure

Ans to Q No 2: Income tax means the tax imposed on individuals or business entities on their income or profit. However, while imposing it, people with a certain level of income are exempted. The rates of tax are different for different scales of taxable income.

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

Ans to Q No 4: Corporate tax or corporation tax is a tax placed on the taxable profits of companies and other profit organizations. Such tax is placed on the taxable profits of a company or organization. Taxable profits include profits from taxable income gains. Companies, both private and public which are registered in India under the Companies Act, 1956, are liable to pay corporate tax.

Ans to Q No 5: Capital gains tax refer to the tax levied on appreciated value of capital assets. In other words, increase in current value over and above the purchase value of a capital asset is the amount of capital gains. The most important sources of capital gains are sale of stocks, bonds, precious metals and property. The gains are not

applicable when an asset is inherited because there is no sale or transfer.

Ans to Q No 6: Some important sources of capital gains are sale of stocks, bonds, precious metals and property.

Ans to Q No 7: Expenditure tax is a tax which is levied on the total consumption expenditure of an individual. It is a tax imposed on personal expenditure and collected when the income is spent on consumption purposes. It is a form of indirect tax which is added to the selling price of a good or service and which is borned by consumers of these products.

Ans to Q No 8: Famous economists Alfred Marshall and J. S. Mill considered expenditure tax to be superior to income tax. According to J.S Mill savings are exempted in case of expenditure tax and Marshall was of the view that ability to pay is better measured under it.

Ans to Q No 9: True

Ans to Q No 10: A gift tax is a tax applied to an individual giving anything of value to another person. In other words it is a tax on money or property that is transferred from one person to another without the giver receiving something of equal value in return. The transfer of property may take place either during the life time of the owner or at his death.

Ans to Q No 11: (a) True (b) True

Ans to Q No 12: Sales tax is an indirect tax which is paid to a regulating or governing body for the sale of goods and services. In other words it is a consumption tax levied on goods and services purchased at the retail level, paid by the consumer and submitted by the retailer to the governing tax authority.

Ans to Q No 13: The type of sales tax that is universal for all countries are retail sales tax, wholesale sales tax, manufacturer's sales tax, use tax and VAT.

Ans to Q No 14: Value Added Tax or simply VAT is one type of indirect taxes imposed on goods. It is paid by the original producers upon

the change in goods or upon the transfer of goods to its ultimate consumers. In India VAT was introduced on 1st April, 2005.

Ans to Q No 15: (a) True (b) False

Ans to Q No 16: VAT was introduced in India on 1st April, 2005.

Ans to Q No 17: GST or goods and services tax is a comprehensive tax levied on manufacture, sale, and consumption of goods and services. Officially it is known as the Constitution (One Hundred and Twenty Second Amendment) Bill, 2014. It is a single tax which subsumes central indirect taxes on consumption like excise duty, countervailing duty, service tax and also state levies like value added tax, octroi and entry tax, luxury tax etc.

Ans to Q No 18: In India GST was introduced in 2014 by the Finance Minister Arun Jaitley. The tax came into effect from July 1, 2017.

Ans to Q No 19: The GST council consists of the Union Finance Minister as chairman, the Union Ministry of State of Finance and the Finance Minister of each state.



4.14 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by income tax?

Q 2: Define the meaning of expenditure tax.

Q 3: Explain briefly the concept of Corporation tax.

Q 4: Write a short note on gift tax.

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

Q 1: Explain how expenditure tax is superior to income tax.

Q 2: Explain some important types of tax.

Q 3: Explain the capital gains tax with its merits and demerits.

Q 4: With the implementation of GST, the problems associated with the structure in the levy of VAT both at central and state level could be tackled. Discuss the statement.

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UNIT 5: TAXATION AND THE ECONOMY

UNIT STRUCTURE

5.1 Learning objectives

5.2 Introduction

5.3 Tax Ratio and Taxable Capacity

5.4 Effects of Taxation

5.4.1 Effects on Production

5.4.2 Effects on Distribution

5.4.3 Effects on Economic Stability

5.5 Let Us Sum Up

5.6 Further Reading

5.7 Answers to Check Your Progress

5.8 Model Questions

5.1 LEARNING OBJECTIVES

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

- discuss the concept of tax ratio
- define taxable capacity and appreciate its importance
- analyse the effects of taxation on production, distribution and economic stability.

5.2 INTRODUCTION

The concept of tax ratio is very important in the theory of taxation as it provides a fair indication of the taxable capacity of an economy. The effects of taxation, on the other hand, depend to a great extent on the economy's taxable capacity. This unit discusses the concept of tax ratio and taxable capacity and traces their relevance in analyzing the effects of taxation on an economy.

5.3 TAX RATIO AND TAXABLE CAPACITY

Tax Ratio : Tax Ratio is the ratio of tax structure to the Gross National Product (GNP) of a country. Thus, it is the percentage of the GNP that is mobilized in the form of the revenue. The Tax ratio is a general indicator of the taxable capacity of a country and is determined by its per capita income, standard of living, national income growth trends, and also by the efficiency of the taxation system. Given the determinants, the tax ratio is lower in less developed countries (LDC) in comparison with developed countries.

Taxable capacity : Taxable capacity, when loosely interpreted, refers to the maximum amount of taxation that an individual or an economy can withstand, without production effort and economic efficiency being adversely affected. Given the subjective nature of the concept, there had been diverse groups of economists who had defined taxable capacity in different ways.

Considering the numerous definitions, taxable capacity may be loosely defined as the maximum revenue that can be raised from the community without adversely affecting -

- the maximum level of consumption,
- the existing standard of living,
- the productive capacity and
- the economic efficiency.

As defined above, the absolute tax capacity is not a constant figure, rather it continuously changes with changes in the level of production capacity and economic development, and also with alternation in the distribution of income and wealth.

Absolute and relative taxable capacity : Absolute taxable capacity, as discussed earlier, refers to the maximum tax that can be collected from an individual tax payer or from a group of tax payers under consideration. Since the maximum amount of tax is a subjective notion, it becomes very difficult to quantify the concept of absolute taxable capacity and convert it into an operational tool.

In contrast, in relative taxable capacity, a comparison is made between the absolute taxable capacities between two or more individual tax payers, or their groups, or even countries. Hence, relative taxable capacity can be defined as the ratio of the taxable capacity of one group of tax payers to that of some other groups.

Thus, for example the relative taxable capacity of a group of people will be twice that of the second group, if the absolute taxable capacity of the first group is double than that of the second group. On the basis of the measures of relative taxable capacity the first group can be taxed more heavily than the second group.

Comparatively, relative taxable capacity is a more meaningful and applicable concept than absolute taxable capacity which is vague and unquantifiable. This is because the former does constitute a basis on which two or more tax paying entities can be compared and taxed.

As is evident from the above discussion, the concept of taxable capacity is not precisely defined nor is it specifically quantified. Generally, it is affected by a number of factors which are stated below:

- **Size of the national income :** Larger the volume of national income, higher will be the taxable capacity.
- **Size of the population :** Larger the population size, higher the volume of income will be spent on consumption. Thus, with the increase in income taxable capacity is reduced.
- **Distribution of income and wealth :** Taxable capacity is higher in societies with inequitable distribution of income and wealth. This is because government can raise the tax rates on the richer sections of the people and thus collect higher tax revenues.
- **Economic situations :** Taxable capacity will be higher when the economy prospers because, then the level of production will be higher. This leaves the taxable capacity to be higher.
- **Nature and size of public expenditure :** Public expenditure incurred on productive activities help the economy to grow. This will help taxable capacity to be higher. On the other hand, public

expenditure on unproductive areas like defence, interest payments etc. does not directly help the economic activities of the economy. Thus, such expenditures do not help the taxable capacity to be higher.

- **'Propensity to consume' on the part of the people:** Propensity to consume on the part of the people also affects the taxable capacity. In general, essential commodities are exempted from taxes. On the contrary, higher taxes may be imposed on unessential commodities. Thus, if the propensity of people to consume is higher in case of essential commodities, the taxable capacity will be lower. On the other hand, higher propensity to consume of the non-essential commodities will raise the taxable capacity.
- **Administrative efficiency:** An efficient administrative machinery can help prevent tax evasion and thereby to increase the taxable capacity.
- **Other factors:** Other important factors that affect the taxable capacity include pattern of taxation, its purpose, political condition of the country, standard of living of the people of the country, etc.



CHECK YOUR PROGRESS

Q1: State whether the following statements are True (T) or False (F) :

(a) Tax Ratio is the legal entity on which tax is imposed. (True/ False)

(b) Absolute Taxable capacity compares the taxable capacity between two or more tax-paying entities. (True/False)

Q2: What do you mean by absolute taxable capacity? (Answer in about 30 words)

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5.4 EFFECTS OF TAXATION

Taxation is a very important fiscal instrument along with public expenditure and public borrowing. Besides its primary function as an instrument of resource mobilization, taxation can also be used to bring about various desirable objectives in the economy. Thus, a typical taxation policy will strive to attain:

- optional allocation of resources so that the maximum growth rate is achieved,
- economic stability by checking price and output fluctuations while maintaining an acceptable level of employment in the economy, and
- equality in the distribution of income and wealth by facilitating a redistribution process.

This is while ensuring that the revenue mobilized is adequate for the effective functioning of the state.

Given its far-reaching effects on the economy, a good taxation policy requires the fulfillment of the above objectives at the maximum level. In the following section, we discuss the manifold effects of taxation on production, distribution and economic stability.



LET US KNOW

While taxation reduces the disposable income of the public, public expenditure, financed through taxation, increases it. Hence, the comprehensive effect of taxation on the economy cannot be analyzed without taking into account the effects of public expenditure.

5.4.1 Effects on Production

According to Dalton, taxation affects production through its effects on —

- **Effects on ability to work, save and invest:** Taxation reduces the purchasing power of the taxpayer. This leads to

a direct reduction in his consumption affecting his ability to work. The effect is more on the poorer sections of the society who may even fail to consume adequate quantities of essential goods and services due to the imposition of the tax.

As taxation reduces the **deposable income** of the people, it has a direct adverse impact on their savings. Reduction in saving erodes the source of investment. Hence, taxation by reducing disposable income diminishes the volume of saving and investment.

Disposable income : Income after taxation

- **Willingness to work, save and invest:** Taxation affects different individuals' willingness to work, save and invest, differently. This happens because individuals' attitude towards work, saving and investment in the context of taxation differs.

An individual who seeks to maintain his standard of living will work harder when he is burdened with a tax. He will do so to compensate for the income forgone as tax with additional earnings. On the contrary, if the individual is not concerned about maintaining his pre-tax standard of living, then imposition of tax may seriously hamper his incentive to work. The tax payer here will not be willing to work hard since a large portion of his income is taken away as tax payments.

At this point, it is pertinent to note that the incentive to work is more adversely affected by direct tax than by indirect tax. This is because the burden of direct tax is more severe on the tax payer than that of indirect tax.

In the case of business firms, the decision to work, save and invest depends on a lot of complex factors. However, the overriding determinant of any business decision is the expectation of profit. Thus, so far the imposition of taxation does not seriously hamper profit expectations, taxation will

not adversely affect the willingness to work, save and invest of this category of taxpayers.

- **Diversion of economic resources:** Taxation can not only affect the size and growth of production, but it also has an influence on its composition. Thus by imposing high rates of taxation on a particular industry, public authorities can induce a diversion of resources, from it to some other industry or industries. For example, tobacco industry is subject to high rates of taxation to affect its growth and to divert economic resources from it to some other beneficial sectors like textile, health, education etc.

  Similarly, diversion of resources may be brought about from one developed region to another region that is relatively underdeveloped, by imposing high taxation rates in the former region relative to low taxation or even subsidy grants in the second region. Thus, taxation can be utilized as an instrument to bring about balanced development in an economy.

5.4.2 Effects on Distribution

One of the important objectives of public Finance is to reduce the inequality in the distribution of income and wealth. Accordingly, taxation is used as one of the principle instruments of redistribution so as to establish a more equalitarian society.
Direct taxes are usually progressive in nature where the rich are taxed more heavily than the poor. The resources so mobilized are used to finance public expenditure on items like health, housing, education etc. which usually benefit the poorer sections of the society. The direct taxes result in a redistribution of income and wealth in favour of the poorer sections of the population.

On the contrary, indirect taxes tend to be regressive in nature. Also referred to as commodity tax, these taxes have to

be paid equally per unit of goods and services consumed, by both the rich and the poor. Given the fact that the burden on the poor is more than on the rich, indirect taxes have a tendency to induce a redistribution of income against the poor and in the process aggravate inequality in the economy.

However, an indirect tax structure formulated with due sensitivity can to a great extent, be made progressive. Hence under such a structure luxury goods which are consumed mostly by the rich can be heavily taxed which will enable the public authorities to subsidise essential items which are usually purchased by the poor. Here, it becomes viable to have a redistribution of income and wealth in favour of the poor, even with the imposition of indirect taxes.

5.4.3 Effect on Economic Stability

Inherent to a free market economy are the phases of economic upswings and downswings. An upswing is associated with abnormal inflationary pressures on the economy leading to sustained and significant increase in the price level. Conversely, during a downswing, deflationary pressure on the economy leads to falling prices.

Taxation can be used as a fiscal instrument to maintain the price level stability in both the two conditions. Thus, during an economic upswing, price rise can be checked by soaking up the excess purchasing power in the hands of the people. This can be achieved by raising the rates of existing taxes, imposing new taxes, and by doing away with subsidies.

On the contrary, additional purchasing power needs to be pumped into the economy to check falling prices that characterise an economic downswing. Thus deflationary pressure can be largely controlled and reversed by cutting the rates of existing taxes, withdrawing some of the taxes, and increasing the level of tax exemptions and subsidies.



CHECK YOUR PROGRESS

Q3: State whether the following the statements are True (T) or False (F) :

(a) Resource mobilization is the sole motive of taxation (True/ False)

(b) High Tax rates imposed on particular industry can induce a diversion of resources from it to other industries. (True/False)

Q4: Why are the indirect taxes regressive? (Answer in about 40 words)

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5.5 LET US SUM UP

- Tax ratio refers to the percentage of GDP that is mobilized in the form of tax revenue.
- Taxable capacity is the maximum amount of taxation that an individual or an economy can withstand without productive effort and economic efficiency being adversely affected.
- Relative taxable capacity is a comparative statement of the absolute taxable capacities of two or more taxable entities.
- Taxable capacity of a country depends on many factors. The factors include: the size of national income, size of the population, distribution of income and wealth, economic conditions, nature and size of public expenditure, propensity to consume of the people and administrative efficiency among others.
- Besides revenue mobilisation, taxation is also used as an

instrument to attain optimum allocation, economic stability and equality in distribution.

- Taxation affects production by influencing people's ability and willingness to work, save and invest. It also causes diversion of resources between employment and regions.
- Taxation can be used to bring about redistribution in the income and wealth in favour of the poorer sections of the society.
- Price stability in the economy can be maintained by using appropriate taxation strategy to check and reverse inflationary upswing and deflationary downswing in the economy.



5.6 FURTHER READING

1) Lekhi, R. K. (2006). *Public Finance and Fiscal Policy.* Ludhiana : Kalyani Publishers.

2) Menkar and Sarma. (2001). *Public Finance. Theory and Practice.* Mumbai : Himalaya Publishing House.

3) Prakash, O. (2008). *Public Economics* : *Theory and Practice.* Jalandhar : Vishal Publishing Co.



5.7 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: Absolute taxable capacity refers to the maximum tax that can be collected from an individual tax payer or from a group of tax payers under consideration.

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

Ans to Q No 4: Indirect taxes are regressive in nature because, these taxes have to be paid equally per unit of goods and services consumed, by both the rich and the poor. As a result, it adversely affects the poorer sections of the society than the richer sections.



5.8 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Write short notes on :

(i) Taxable Capacity

(ii) Tax Ratio

(iii) Taxation and production

(iv) Taxation and distribution

(v) Taxation and economic stability

Long Questions (Answer each question in about 300-500 words)

Q 1: Distinguish between Absolute and Relative Taxable capacities.

Q 2: Discuss the effects of taxation on production, distribution and economic stability.

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UNIT 6 : FUNDAMENTAL PRINCIPLES OF TAXATION

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Concept of Equity in Taxation

6.3.1 The Benefit Principle of Taxation

6.3.2 The Principle of Ability to pay

6.4 Rate Schedules of Taxation

6.5 Let Us Sum Up

6.6 Further Reading

6.7 Answers to Check Your Progress

6.8 Model Questions

6.1 LEARNING OBJECTIVES

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

- discuss the concept of equity in taxation
- explain the benefit principle of taxation
- appreciate the ability to pay approach to taxation
- explain the rate schedules of taxation.

6.2 INTRODUCTION

Tax Revenue is the most important source of revenue receipt of the state. While mobilising tax revenue, the burden of taxation has to be distributed among the tax-payers. Principles of taxation provides the theoretical basis on which a tax system is structured. They determine how the burden of taxation will be allocated among the citizens and justify the basis of such allocations.

6.3 CONCEPT OF EQUITY IN TAXATION

It is universally agreed that a taxation system should be equitable. Here the concept of equity in taxation is associated with the idea of fairness and justice, with regards to how the burden of taxation should be allocated among the tax payers.

The equity principle is the most important principle of taxation. It has two basic implications:

- **Horizontal Equity:** "Like people should be treated in a like manner". This implies people in similar circumstances should be taxed equally.
- **Vertical Equity:** "Unlike people should be taxed in an unlike manner". The implication is that people in different circumstances should be treated unequally.

However over the years there had been no agreement regarding an universally acceptable definition of equity. Besides, taxation principles have found it difficult to specify how equally should unequals be taxed.

Again, in attempting to satisfy the demands of attaining vertical and horizontal equity the domain of taxation theory has evolved on the basis of two broad approaches:

- The Benefit Principle of Taxation, and
- The Ability-to-Pay Approach.

6.3.1 The Benefit Principle of Taxation

The benefit principle of taxation considers tax as a price paid for the benefit received from the state. Thus, it considers the relationship between the tax payers and the state, as one of exchange, based on the principle of ***'quid-pro-quo'***.

The implications of the benefit principle are as follows -

- Just like market transactions tax payment is made only against benefit received in form of goods and services from the government.
- The amount of tax paid by an individual must equal the marginal benefit that he receives from the public good and



Quid-pro-quo: Give and take. In the present context, this means that the government has to offer something to the taxpayer for his tax payment.

service.

- The total provision of public goods must equal its total demand. Besides the total cost of provision of public goods must be covered by the total tax revenue mobilised.

  The benefit principle can be interpreted on the criteria of:

  - Cost of service, and
  - Value of service

  Under the *cost of service* criterion, the tax contribution by an individual must cover the cost of provision of the public goods that he consumes.

  On the other hand, the *'value of service'* criterion, is applicable when the cost of the public good provided cannot be determined. Here the contribution of the tax payer is determined on the basis of the worth or value of the public good to him.

The benefit principle has found wide support on grounds of equity and justice. This is because taxation here, is justified with the argument that it is imposed policy against benefit extended by state provision of goods and services.

Although the benefit principle of taxation dates back to the writings of Adam Smith, however modern version of this principle is most suitably articulated by Erick Lindahl in his Voluntary Exchange Model.

The benefit principle is widely acknowledged as it is consistent with principles of equity and justice. The rationale that people should be taxed in accordance with the benefit that they receive found universal acceptance.

However, the concept of taxation rejects the premises of this principle, as tax is considered to be a mandatory contribution which has no *'quid-pro-quo'* connotation. Besides benefit is a subjective concept, which cannot be specifically measured. Hence operationally it is impossible to equate tax paid to the benefits received from public provision.

6.3.2 The Principle of "Ability-to-Pay"

A tax is defined as a compulsory payment without any 'quid-pro-quo' relationship between the tax payer and the state. Hence in keeping with this definition the benefit principle fails to satisfy the basic spirit of taxation.

The "Ability-to-Pay" Approach to taxation is based on the principle that people should be taxed in accordance with their ability to pay. Thus taxation imposed on the Ability-to-Pay principle would ensure that people with more income and wealth are more heavily taxed than people whose income and wealth are relatively less, so that every tax payer ends up making equal sacrifice (or bearing the same burden).

Thus, in the words of Dalton, "Ability-to-pay principle requires that the burden of taxation should be so distributed that the directed real burden on all tax-payers is equal".

In the ability-to-pay principle of taxation, ability has been measured by —

- Subjective Approach, and
- Objective Approach
- **The Subjective Approach :** In the subjective approach to the ability-to-pay principle, the tax burden is interpreted in terms of the sacrifice undergone by the tax payer. Thus here, it is assumed that the ability-to-pay principle would be satisfied by an allocation of tax burden which would ensure that all tax-payers make equal sacrifice, when they pay their individual tax amount.

  Given the fact that income is subject to the law of diminishing utility, an application of the equal sacrifice rule on the tax payers would imply that richer people are taxed more heavily, than people who have relatively lesser income and wealth.

In fact, there are three distinct interpretations of equal sacrifice principle.

- Equal Absolute Sacrifice,
- Equal Proportional Sacrifice, and
- Equal Marginal Sacrifice.

Equal absolute sacrifice implies that the total loss of utility or sacrifice should be equal for all the tax-payers irrespctive the income groups they belong to. Thus, according to this principle, persons belonging to higher income group should pay higher taxes compared to a person belonging to a lower income group. This principle was very popular among economists, however, later it has been criticised; as this principle endorses *regressive taxation*.

The priniple of *equal proportional sacrifice* on the other hand propagates that loss of utility as a result of tax payment should be proportional to the total income of the tax-payers. Thus, according to this principle, the higher income group should pay higher taxes compared to the lower income group; however their ratio of tax payment to their total income will be the same.

The principle of *equal marginal sacrifice* is also known as '*Principle of Least Aggregate Sacrifice*'. Economists point out that this principle is superior to others. This principle is equitable, as well as it has been derived from the basic *utilatarian* principle of maximum happiness. This principle argues that the object of the state is to maximise the economic welfare. Again it is a general fact that tax payment creates disutility to the taxpayers. That is why taxes should be distributed in accordance with the principle of least aggregate sacrifice, i.e., the marginal sacrifice imposed by taxation on each taxpayer should be equal. This will minimise the agrregate

sacrifice of the community; at the same this will lead to maximum welfare to all the taxpayers in the community.

Given the differences in the definition among the three interpretations, different tax rate schedules are required to satisfy these three rules of equal sacrifice.

- **The Objective Approach:** In contrast to the subjective approach, the objective approach considers income and wealth to be the basis of ability to pay of the tax payers. There are three important indices of ability to pay in this approach.
  - *Income:* In a modern economy, income is universally accepted as an index of ability-to-pay of a tax payer. Thus, accordingly individuals with greater income are taxed more heavily than individuals whose incomes are relatively lower.
  - *Wealth:* Earlier wealth (or property) was considered to be the more important index of ability-to-pay of a tax payer. It was argued that people with more wealth were capable of paying more tax.

    However, it was realised that people with large income but no wealth (or property) might avoid taxation, if wealth was the sole criterion for taxation. In contemporary economics wealth is used only as a supplement to income in assessing the taxable capacity of an individual.
  - *Consumption Expenditure:* Many prominent economists have suggested that consumption expenditure truly reflects the ability-to-pay of a tax-payer. This index is also supported because it does not act as an dis-incentive to work, save and invest.

    However, this index is dis-favoured on the ground of equity as a person with more dependents would be severely penalised if he is taxed on the basis of his consumption expenditure.

To conclude, there has been a universal acceptance of the ability-to-pay principle of taxation as a basis for the allocation of tax burden. This is because, it satisfies the ideals of horizontal and vertical equity and secures social justice for the people.

However, this approach suffers from the fact that there is no unanimous definition or criterion of ability to pay. In the subjective approach, equal sacrifice as a criterion of ability is difficult to measure or to define. Similarity, in the objective approach there is difference of opinion with regards to which index to adopt to measure ability.



CHECK YOUR PROGRESS

Q1: State whether the following statements are True(T) or False(F):

(a) Benefit Principle considers tax to be a "quid-pro-quo" transaction. (True/False)

(b) Ability-to-pay Approach considers wealth to be the only basis for taxation (True/False)

Q2: Mention the three interpretations of equal sacrifice principle. (Answer in about 30 words)

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6.4 RATE SCHEDULES OF TAXATION

A taxation system can have three distinct tax rate schedules. They are:

- **Proportional Taxation:** Under proportional taxation, all tax payers are taxed at the same rate, whatever be their income. Thus here, each tax payer pays a fixed proportion of his income as tax.

In proportional taxation, taxes vary in direct proportion to change in income. This implies that, whatever be the base, the ratio between the tax liability and the tax base always remains constant.

Thus, for example, if the income of a person (i.e. tax base) increases from Rs. 10,000 to Rs. 20,000, he will continue to be taxed at the same rate, i.e. 10%. This implies, his tax liability will double from Rs. 1000 to Rs. 2000, with a doubling of his tax base.

The system of proportional taxation has been favoured on grounds of equity (as the tax liability is proportional to the tax payer's income) and neutrality (as it does not disturb the distribution of income). Besides proportional taxation is more convenient to administer as everyone is taxed at the same rate.

However, this system has been criticised on the grounds that it violates the principle of equity as the real burden of tax is more heavy on the poorer people who are taxed at the same rate, as are the rich.



LET US KNOW

Tax-base refers to the legally defined object on which tax is imposed. Thus, the tax base for income tax is the income of the tax payer.

- **Progressive Taxation :** Under progressive taxation, the tax liability increases more than in proportion to increase in the tax base. Here the ratio of tax liability to tax base increases, as the tax base expands.

  In a progressive taxation system, bigger the income higher will be the tax rates. Thus for example, if a individual with an income of Rs. 1000 is taxed at 5%, then individuals with bigger incomes like Rs. 2000 and Rs. 3000, will be taxed a higher rates of 7% and 10% respectively.

  Progressive taxation is promoted on the ground that since the marginal utility of money for a rich person is smaller than that of a poor person, equity requires the richer person to be taxed at a higher rate than a poor person.

Again it is generally agreed that productive capacity and consumption increases faster than increase in income and wealth. Hence it is only just that richer people should be taxed at a high rate than relatively poorer people.

- **Regressive Taxation :** In regressive taxation, the rate of tax decreases as the tax base expands. Thus, under this system, the ratio of tax liability to tax base decreases with an increase in the tax base.

Thus, in a regressive tax schedule, a richer person will be taxed at a lower rate whereas a poorer person will be taxed at a higher rate. For example, a tax schedule will be regressive if a person with income of Rs. 10000 is taxed at 5% whereas a person with a smaller income of Rs. 5000 is taxed at 10%.

As is obvious, regressive taxation is inequitable and unjust, because it imposes the greatest burden of taxation on the poorest in the society. Besides being unjustifiable from the ethical point of view, it also is socially unacceptable as it accentuates inequalities in income and wealth in the society.



CHECK YOUR PROGRESS

Q3: State whether the following statements are True (T) or False (F) :

(a) Under proportional taxation, tax rates increase with the expansion of tax base. (True/False)

(b) Progressive taxation does not satisfy the principle of equity. (True/False)

Q4: Distinguish between regressive taxation and progressive taxation. (Answer in about 60 words)

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LET US KNOW

Elasticity of taxation measures the responsiveness of tax yield to changes in the tax rate or to tax coverage



6.5 LET US SUM UP

- Principles of taxation determine how the tax burden in the economy is to be allocated.
- The concept of equity in taxation calls for horizontal and vertical equity.
- The benefit principle considers tax as the price paid against benefits received from the state.
- The 'ability to pay' approach states that people should be taxed in accordance with their ability to pay.
- In a modern economy, income is accepted as the most ideal index of ability to pay.
- A taxation system has three distinct tax rate schedules -
  - ➤ Proportional Taxation
  - ➤ Progressive Taxation
  - ➤ Regressive Taxation



6.6 FURTHER READING

1) Bhatia, H. L. (2006). *Public Finance.* New Delhi : Vikas Publishing House Pvt. Ltd.

2) Lekhi, R. K. (2006). *Public Finance and Fiscal Policy.* Ludhiana : Kalyani Publishers.

3) Menkar and Sarma (2001). *Public Finance* : *Theory and Practice*. Mumbai : Himalaya Publishing House.

4) Prakash, O (2008). *Public Economics : Theory and Practice.* Jalandhar: Vishal Publishing Co.



6.7 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: The three interpretations of equal sacrifice principle are:

- Equal Absolute Sacrifice,
- Equal Proportional Sacrifice, and
- Equal Marginal Sacrifice.

Ans to Q No 3: (a) False (b) False

Ans to Q No 4: In the system of progressive taxation, higher the income higher will be the tax rates. But contrary to this, in the system of regressive taxation, the rate of tax decreases as the tax base expands.

Progressive taxation is promoted on the ground that since the marginal utility of money for a rich person is smaller than that of a poor person, equity requires the richer person to be taxed at a higher rate than a poor person. Contrary to this, regressive taxation is inequitable and unjust, because it imposes the greatest burden of taxation on the poorest in the society. It is also criticised as unjustifiable from the ethical point of view.

Regressive taxatin is also socially unacceptable as it accentuates inequalities in income and wealth in the society.

6.8 MODEL QUESTIONS

Short questions (Answer each question in about 150 words)

Q 1: Explain the concept of equity in taxation.

Q 2: State one merit and one demerit of the benefit principle.

Q 3: Why is income considered to be a better indicator of 'ability-to-pay' than wealth or consumption expenditure?

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

Q 1: Explain the three tax-rate schedules. Examine their merits and demerits.

Q 2: Compare the benefit principle of taxation with the ability to pay approach. Which one is superior operationally? Explain.

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UNIT 7: PUBLIC EXPENDITURE

UNIT STRUCTURE

7.1 Learning objectives

7.2 Introduction

7.3 Meaning of Public Expenditure

7.4 Canons of Public Expenditure

7.5 Theories of Public Expenditure

7.5.1 The Theory of Maximum Social Advantage

7.5.2 The Principle of Maximum Aggregate Benefit

7.6 Let Us Sum Up

7.7 Further Reading

7.8 Answers to Check Your Progress

7.9 Model Questions

7.1 LEARNING OBJECTIVES

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

- explain the meaning of public expenditure
- state the canons of public expenditure
- discuss the theories of public expenditure.

7.2 INTRODUCTION

Public Expenditure is an important instrument of fiscal policy in recent times. It has a huge impact on production, distribution and stability of an economy. This unit deals with public expenditure and the various theories associated with it. It will explore the recent growing significance of public expenditure in Public Finance.

7.3 MEANING OF PUBLIC EXPENDITURE

Public expenditure is the expenditure incurred by the public authorities (i.e., central, state or local governments) for:

- satisfying the collective needs of the citizens,
- for promoting the economic and social welfare of the society, and
- the defence of the country from external aggression.

Traditionally, in Economics literature, public expenditure was considered to be an unavoidable evil and it was advised that it should be limited to the "three basic duties of the sovereign", viz., maintenance of law and order, defence against foreign aggression and undertaking various public works. Such an attitude can be attributed to the universal acceptance of the policy of "laissez–faire" which calls for non-intervention by the government in the economy. This translates into the perception that "that state is best which governs the least".

However, in recent times, and especially after the great depression of the 1930's in Europe, the role of public expenditure as an important instrument of fiscal policy, is getting more and more recognition. Thus, besides the traditional functions of the state as mentioned above, public authorities now have the added responsibility of securing the –

- optimum allocation of resources,
- maintaining economic stability along with an acceptable growth rate and employment level, and
- ensuring an equitable distribution of income and wealth.

And all these objectives are sought to be achieved by the state using the instrument of public expenditure along with other fiscal instruments such as public revenue and public borrowing.

7.4 CANONS OF PUBLIC EXPENDITURE

The canons of public expenditure indicate the tenets of judicious use of public funds. While some of the canons cover various aspects of administrative safe-guard of public expenditure, others direct the public

authorities to undertake the most efficient strategy of public expenditure in order to achieve the stated objectives and goals.

- **Canon of Economy:** Given the fact that the resources are scarce and objectives to attain are many, it is imperative that public expenditures do not result in wastages.

  Wastage in public expenditure arising out of faulty planning, poor execution, corruption, unaccountability, avoidable delay and cost escalations etc. need to be avoided.

- **Canon of Benefit:** Any form of public expenditure needs to be evaluated in terms of the benefit that accrues from it. The benefit emerging from public expenditure is associated in terms of the positive impact it has on the allocation of resources, price stability and growth, and the distribution of income and wealth.

  This canon is consistent with the principle of maximum social advantage which asks public expenditure to be distributed among different items in such a manner that maximises social benefit.

- **Canon of Sanction:** This canon requires that previous sanction is mandatory for carrying out public expenditure. Besides, it also requires the expenditure to be carried out exactly on the head on which it is sanctioned. These requirements are expected to discourage unnecessary and unscrupulous expenditure as well as to act as a check on misappropriation of funds. In a democratic set up, the sanctioning authority is the legislature, which sets up different authorization authorities for various tiers of public spending agencies. However, it needs to be pointed out that some flexibility is imported to the sanctioning requirements in the case of emerging and other unexpected purposes.

- **Canon of Surplus:** This canon asserts that the government should operate within its means. It should aim to finance its current expenditure with current revenue. It also suggests that the government must try to generate surplus over the years so that it can meet unavoidable deficits in some years with that surplus.

However, this view is contested in recent years. This is because public expenditure is now looked upon as an important instrument in maintaining stability in the economy. Thus, the choice of a surplus or deficit budget is now dictated by the requirement of the economy, rather than the above stated canon.

- **Canon of elasticity:** This canon requires that the public expenditure policy should not be rigid, but flexible so that it can adapt to the changing requirements in the economy. Thus, the volume of public expenditure should be elastic, so that it can be increased or decreased with the changing circumstances in the country.
- **Canon of productivity:** Public expenditure should be productive in the sense that it has a positive impact on production and productivity. This would lead to higher incomes and greater welfare for the people in the future.
- **Canon of certainty:** Public expenditure must be incurred only after the extent of the expenditure and the purpose for which it is incurred is clear. Thus, the spending agency must be certain about the amount that is available for expenditure and also the purpose for which it has been earmarked. This canon is usually satisfied by the public budget, where non-existence may result in wastages and over spending.
- **Canon of programmes:** As public expenditure is incurred to attain certain predetermined objectives, specific programmes must be framed so that efficient and optimal use of funds is ensured. The presence of programmes directs the spending agencies and ensures that priority, budget and time schedules are maintained.
- **Canon of performance:** This canon requires that there should be an outcome of the public expenditure. Such a review, pursued by performance budgeting, will impart accountability to the spending public agencies and ensure vigilance and utmost care in their effort. This would ensure the most efficient utilization of the precious public resources.

LET US KNOW

Public expenditure is financed by public revenue.

If public revenue is insufficient to cover the public expenditure, the gap is filled by public borrowing. This is called “deficit financing”.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are True (T) or False (F) :

(a) Canons of public expenditure indicate wastages in public expenditure. (True/False)

(b) Public expenditure is discouraged by modern economists. (True/ False)



Q 2: What do you mean by ‘canon of benefit’ of public expenditure? (Answer in about 40 words)

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Q 3: What is meant by ‘canon of surplus’ of public expenditure? (Answer in about 50 words)

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7.5 THEORIES OF PUBLIC EXPENDITURE

Public expenditure was largely ignored in public finance by the early economists, who concentrated on the theory of public revenue. However, after the great depression of the 1930's, the significance of the theory of public expenditure gradually came to be recognized. The theory of public expenditure is an indispensable part of modern public finance, and has special relevance in the areas of allocation, stability and distribution in the economy.

Among the various theories of public expenditure, we will discuss the following two important theories in this section.

- The Theory of Maximum Social Advantage
- The Theory of Maximum Aggregate Benefits.

7.5.1 The Theory of Maximum Social Advantage

The theory of Maximum Social Advantage was put forward by Hugh Dalton. In this theory, Dalton argues that public expenditure must be incurred to the point where the benefit reaped by a marginal increase in public expenditure is balanced by the cost incurred due to a marginal increase in taxation, required to finance the expenditure. Thus in the words of Dalton:

> "Public Expenditure in every direction must be carried out so far that the advantage to the community of a further small increase in any direction is balanced by the disadvantage of a corresponding small increase in taxation and in respects from any other sources of public income. This gives the ideal of both of public expenditure and of public income".

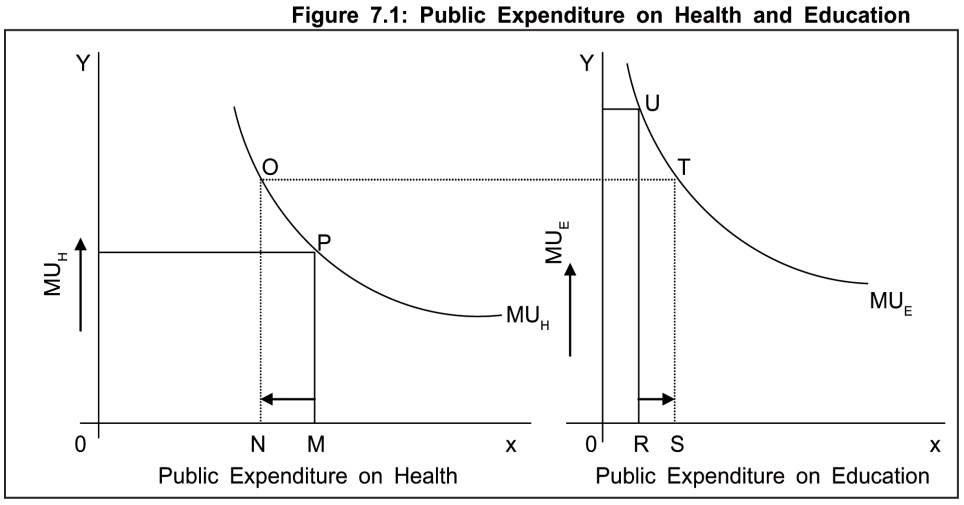
Thus, public expenditure benefits the recipients whereas the tax imposed to finance that public expenditure results in sacrifice for the tax payers. As long as the benefit coming from the marginal unit of resources expended as public expenditure is greater than the sacrifice involved in the marginal unit of tax

imposed, it pays to go on increasing the level of expenditure. However, the optimum level of public expenditure is attained when the benefit from the marginal unit of public expenditure is equal to the cost of the marginal unit of tax, imposed to finance it. This optimal level of public expenditure, according to Dalton, will result in the maximum social advantage for the society.

The principle of Maximum Social Advantage can also be explained in terms of the law of equi-marginal returns, as applied to individuals after some minor modifications. Thus, we can state that public expenditure will achieve maximum social advantage if the last unit of resources spent on different public goods yield the same amount of utility.

For example, let public expenditure be incurred on two items education and health. Now, if the marginal utility of public expenditure on education (MUE) is greater than the marginal utility of public expenditure on health (MUH), then it pays to transfer resources from health to education. In fact, the dimension of resources should continue until the marginal utility accruing from expenditure on both the heads are the same.

Figure 7.1: Public Expenditure on Health and Education



In the above figure 7.1, initially OM amount of public expenditure was incurred on health. Given the marginal utility curve of expenditure on health (MU_H), the corresponding marginal utility that occurred in health was PM. This, however, was less

than the marginal utility that has occurred in education (i.e UR), When OR of public expenditure were incurred in that sector.

To attain the state of maximum social advantage, public expenditure needs to be redirected from health to education, until the amount spent on education increases by RS to OS , whereas the expenditure on health goes down by MN to ON. This will ensure that the marginal utility of public expenditure on health and education are equalized:

i.e ON = TS

$$\therefore MU_H = MU_E$$

This principle, however, is very difficult to apply in practice. This is because the concept of marginal utility is very subjective and is difficult to determine. However, it does give a broad indication of how public expenditure should be distributed among different items.

7.5.2 The Principle of Maximum Aggregate Benefit

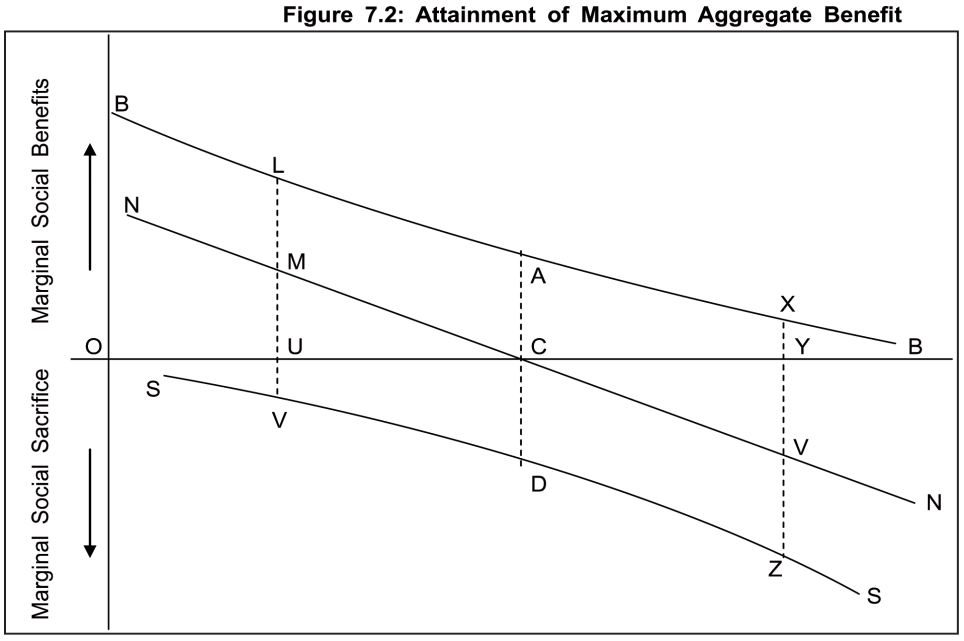
The principle of Maximum Aggregate Benefit was put forward by A.C. Pigou. This theory is basically very similar to the principle of Maximum social Advantage of Dalton. Here, Pigou calls for public expenditure to be pursued in such a manner that it results in maximum aggregate benefit for the society. According to him, “expenditure should be pushed in all directions up to the point at which satisfaction obtained from the last shilling expended is equal to the satisfaction lost in respect of the last shilling called upon in government service” .In other words, public expenditure should be continuously expanded as long as marginal utility accruing from it is greater than the marginal sacrifice associated with the taxation imposed to finance it. The optimum level of public expenditure would be determined at the point where the marginal utility generated becomes equal to the marginal sacrifice imposed by the corresponding taxation.

It is evident that this theory determines the optimal level of public expenditure that promises maximum aggregate benefit for the society. Besides, it simultaneously determines the corresponding level of tax that the state has to impose.

Pigou's theory is based on the law of equi-marginal returns as applied to public transactions. It may be stated as "Public expenditure would attain maximum aggregate benefit if the marginal utility accruing from the last rupee spent on different heads are equalized".

Besides that, the attainment of the maximum aggregate benefit also requires the equality between marginal social benefit and marginal social sacrifice. This can be illustrated by the following figure 7.2.

Figure 7.2: Attainment of Maximum Aggregate Benefit



In the above figure 7.2, the budget size (i.e the amount of public expenditure /taxation) is indicated in the horizontal axis. On the other hand, marginal social benefit from public expenditure, and marginal social sacrifice from taxation are measured along the vertical axis.

We have:

BB → marginal social benefit curve (MSB)

SS → marginal social sacrifice curve (MSS)

and

NN → net marginal social benefit curve [NSB] (which is obtained by estimating the surplus of benefit and sacrifice at various budget sizes)

i) When budget size = OU;

MSB = LU and MSS = UV

∴NSB (MSB-MSS) = LU-UV = MU

Here, NSB is +ve, and it pays to expand the public budget i.e., more public expenditure and more taxation.

ii) When budget size = OC

MSB = AC and MSS = CD;

where, MSB = MSS [∵ AC – CD = O]

This is the optimum size of the public budget , where maximum aggregate benefit occurs to the society .

iii) When budget size = OY

MSB = XY and MSS = YZ

∴NSB = MSB – MSS

= XY – YZ = (-) YV

Thus, there is excess of public expenditure which results in a negative net marginal social benefits.

From the analysis, it is evident that the budget size of OC is optimal for the society.

To conclude, we must state that although the principle of maximum aggregate benefit is structurally very attractive, yet in practice it is not very useful. This is because there is no objective method to determine or to construct the MSB and MSS values. However, like the theory put forward by Dalton, it provides a general indication as to how public expenditure should be carried out and also to what extent.

LET US KNOW

- Maximum social advantage from public expenditure is attained when the marginal benefits from public expenditure is equal to the marginal cost of the tax required to finance the expenditure.
- Modern theories of public expenditure include Erick Lindahl's voluntary exchange theory and Paul Samuelson's Benefit Theory. These theories are beyond the scope of our present study.



CHECK YOUR PROGRESS

Q4: State whether the following statements are True (T) or False (F) :

(a) Pigou propounded the theory of maximum social advantage. (True/False)

(b) Maximum Social advantage is attained when marginal utility occurring from public expenditure on all the heads are equal. (True/ False)

(c) The optimum budget size is attained at the point where the net marginal social benefit is positive. (True/False)

Q5: On what ground has Dalton argued for incurring public expenditure? (Answer in about 50 words)

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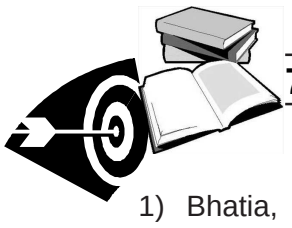
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7.6 LET US SUM UP

- Public expenditure is the expenditure incurred by the public authorities, i.e., central, state and local governments.
- Besides the traditional functions like law and order, defence, and provision of public works, public expenditure also attempts to secure optimum allocation, maintain economic stability with growth and promote equitable distribution.
- Canons of public expenditure indicate the tenets of judicious use of public funds.
- The theories of public expenditure put forward by Dalton and Pigou have identical objectives, i.e., the attainment of maximum social advantage or aggregate benefit.



7.7 FURTHER READING

1) Bhatia, H. L. (2006). *Public Finance.* New Delhi : Vikas Publishing House Pvt. Ltd.
2) Lekhi, R. K. (2006). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers.
3) Menkar and Sarma (2001). *Public Finance : Theory and Practice*. Mumbai : Himalaya Publishing House.
4) Prakash, O (2008). *Public Economics: Theory and Practice.* Jalandhar : Vishal Publishing Co.

7.8 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: Canon of benefit of public expenditure asserts that any form of public expenditure needs to be evaluated in terms of the

benefit that accrues from it. Benefit emerging from public expenditure is associated in terms of the positive impact it has on the allocation of resources, price stability and growth, and distribution of income and wealth.

Ans to Q No 3: Canon of surplus asserts that the government should operate within its means. It should aim to finance its current expenditure with current revenue. It also suggests that the government must try to generate surplus over the years so that it can meet unavoidable deficits in some years with that surplus.

Ans to Q No 4: (a) False (b) True (c) False

Ans to Q No 5: Dalton has put forward the theory of Maximum Social Advantage which propagates for incurring public expenditure. Thus, according to him, public expenditure must be incurred to the point where the benefit reaped by a marginal increase in public expenditure is balanced by the cost incurred due to a marginal increase in taxation required to finance the expenditure. This optimal level of public expenditure, according to Dalton, will result in the maximum social advantage for the society.



7.9 MODEL QUESTIONS

Short-type Questions (Answer each question in about 150 words)

Q 1: What is meant by the term public expenditure?

Q 2: Mention the different canons of public expenditure. Elucidate any two.

Q 3: Write short notes on:

(a) Principle of Maximum Social Advantage

(b) Principle of Maximum Aggregate Benefit

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

Q 1: Discuss the requirements of public expenditure in a modern economy.

Q 2: Rationalize the importance of the canons of public expenditure in

actual act of public expenditure.

Q 3: Explain the theory of public expenditure put forward by Pigou. How is it different from the principle of maximum social advantage?

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UNIT 8: EFFECTS OF PUBLIC EXPENDITURE

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Effects of Public Expenditure

8.3.1 Effects on Production

8.3.2 Effects on Distribution

8.3.3 Effects on Economic Stability

8.4 Role of Public Expenditure in Developing Economy

8.5 Let Us Sum Up

8.6 Further Reading

8.7 Answers to Check Your Progress

8.8 Model Questions

8.1 LEARNING OBJECTIVES

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

- explain the effects of public expenditure on production, distribution and economic stability
- describe the role of public expenditure in developing economy
- appreciate the role of public expenditure on the economy as a whole.

8.2 INTRODUCTION

Public expenditure or government expenditure refers to the expenses of the public authorities either in protecting the citizens or in promoting their economic and social welfare. Public expenditure has a huge impact on production, distribution and stability. The unit will analyze the effects of public expenditure on the economy in these various aspects.

8.3 EFFECTS OF PUBLIC EXPENDITURE

The effects of public expenditure on production, distribution and economic stability are discussed in the following -

8.3.1 Effects on Production

Public expenditure can help the economy in various ways in attaining higher levels of production. The following points will explain the effect of public expenditure on production.

- **Development of Infrastructure:** An improved infrastructure is essential for the development of any economy. Public expenditure made on the development of infrastructure leads to increase in production. Creation of roadways, railways, ships, irrigation facilities, generation of power, etc. improve productive capacity and efficiency in production. Since such facilities cannot be expected to be developed by the private sector, therefore only through public expenditure it can be developed.
- **Increase of effective demand:** There may exist the problem of effective demand both in developed and developing countries. In both the cases public expenditure can increase the level of effective demand. In case of developed countries public expenditure can add to the effective demand directly. This will generate favourable conditions for the market forces to push up production. On the other hand, developing countries where the production capacities remain underutilized, public expenditure can be planned in such a way that it enhances the purchasing power of those who would spend most of it and add to effective demand.
- **Encouragement to private sector industries:** Public expenditure can be used to create demand for various products and stimulate private production. Public expenditure can be incurred for supplying essential raw materials, equipment and other technical services at subsidized rates to private industries. Public expenditure may also be directed to help other industries to import machineries, technical expertise, equipment etc. from industrially advanced countries. All

such steps will encourage the private industries to increase production.

- **Re- allocation Effect on Production:** Public expenditure can increase the level of production through changes in the pattern and composition of production. By offering subsidies and concessions public expenditure can divert resources from less essential products to more essential products. A re-allocation of resources between products of present and future consumption will enhance production. Accordingly public expenditure on irrigation, flood control, power plants, transport and communication etc. will benefit future generations through increased production.

8.3.2 Effects on Distribution

The distribution of income and wealth in a developing economy is unequal. A properly planned public expenditure can go a long way to reduce this inequality by diverting resources from the rich to the poor. The effects of public expenditure on distribution can be understood from the following points-

- **Benefit to the weaker section:** Public expenditure made on the weaker sections of the society will reduce the gap between poor and rich to some extent. Public expenditure on educational, medical facilities, supply of food grains and other essential commodities at subsidized prices will help the poor people to increase their work efficiency and increase their level of income. Social security measures like provision of old age pension, unemployment allowance benefits, sickness and accident benefits, life insurances etc. will help in reducing the inequality gap.
- **Wage structure and larger real incomes:** Inequality of income in the society can be reduced by a proper wage structure which will narrow down the wage gap between the highly paid workers and the low wage earners. Provisions of free housing, subsidized rationing, promotion, medical and educational facilities to the children

of employees etc. will raise the real income of the weaker sections and hence will reduce inequality.

- **Development of backward regions:** Public expenditure directed to develop the backward regions, both agriculturally and industrially, will raise the incomes of the people and their standard of living. Public expenditure on agriculture such as subsidized supply of fertilizers, hybrid seeds, and provision of agricultural credit helps the small farmers and the landless labourers. Promotion of industries in the backward regions creates more employment opportunities for the rural unemployed labourers. This has great distributive effect.

8.3.3 Effects on Economic Stability

Economic stability of a country depends on its public expenditure. Economic stability means ensuring full employment with neither inflation nor deflation. The most important ways of achieving economic stability through public expenditure are-

- **Curbing inflation:** During inflation there is a rise in prices. The supply of goods and services falls short of its demand. To save the economy from inflation the excess purchasing power has to be wiped out. Expenditure on unproductive activities should be reduced and emphasize should be given to productive activities. Also less urgent public investment may be postponed. For example, expenditure like unproductive subsidies, travel expenses of ministers and bureaucrats, routine celebrations etc. can be curtailed to cool off excess demand.
- **Removing deflation:** During deflation and depression savings exceed investment which results in low aggregate demand. Income, prices, savings, investment and marginal propensity to consume decline. In such a situation the economy needs additional purchasing power so that the effective demand rises. Government expenditure on public works projects creates employment in these projects which increases the wage levels and the demand for commodities.

This will increase the volume of production in the economy and as a result more workers will get employment and this process of multiple expansion of employment, income and output will continue.



LET US KNOW

Public expenditure is the expenses of the government, be it central, state and local government. Such expenses are taken either in protecting the citizens or in promoting their economic and social welfare. Public expenditure has certain effects on production, distribution and economic activity.Public expenditure affects production by the development of infrastructure, increasing effective demand, encouraging private sector industries and certain re- allocation effect on production.A well planned public expenditure helps in reducing the inequality by diverting resources from the rich to the poorer sections of society. By providing various benefits to the weaker sections, improving the wage structure and developing the backward regions the public expenditure brings about a distributional effect to the economy.Public expenditure helps in maintaining economic stability at times of inflation and deflation. During deflation, public expenditure should be directed towards raising the incomes of the people and during inflation public expenditure should be planned so as to divert it from unproductive items.



CHECK YOUR PROGRESS

Q1. What is meant public expenditure? What are the effects of public expenditure? (Write in about 50 words)

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Q2. Explain the effect of public expenditure on production (Write in about 150 words)

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Q3. Explain the effect of public expenditure on distribution (Write in about 150 words)

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Q4. State whether the following statement is True (T) or False (F) : Public expenditure helps in reducing the gap between rich and poor. (True / False)

8.4 ROLE OF PUBLIC EXPENDITURE IN DEVELOPING ECONOMY

A developing economy suffers from various problems and deficiencies. For rapid economic development, huge expenditure is required in various sectors. These include socio economic overheads, industrial base, modernization of agriculture, creation of basic public amenities and so on. The private sector is unable to cover such huge investments which involve long gestation period and low return. Hence public expenditure has to play a much larger role in a developing economy. In a way public expenditure has to break the vicious cycle of poverty and usher in growth and development

The role of public expenditure in a developing economy can be understood from the following points-

- **Balanced Regional Development:** There exist regional imbalances in the developing economies. Public expenditure can remove this imbalance by focusing on the backward areas and underdeveloped regions. Development of agriculture and opening up new industrial units in such areas will help in the improvement of such backward areas. There will be an increase in production, incomes and employment on the one hand and reduction of inequality on the other.
- **Development of Infrastructure:** One of the basic problems faced by the developing economies is that of poor infrastructure. Public expenditure on the development of roads, railways and other modes of transport, supply of power etc. will attract industries to develop. Also the productive capacity can be increased if public investment is done on educational and health facilities. Thus the improvement in infrastructure will lead to economic development.
- **Full Utilisation of Economic Resources:** In developing economies there are huge amount of natural resources and manpower which remains unutilised. If such resources are utilized properly then they can contribute to economic development. Thus the public sector should come forward in such cases to and make necessary investment for the proper use of the resources. Full utilisation of manpower and the natural resources will not only increase production but also create employment opportunities.
- **Poverty Alleviation Programmes:** Developing economies suffer from huge poverty problem. To reduce this problem government can take various initiatives to reduce poverty and inequality of income. Poverty alleviation programmes help the poor section to take the government benefits and improve their conditions to some extent. For example in India there have been various poverty alleviation programmes such as Integrated Rural Development Programme, National Rural Employment Programme, Rural Landless and

Employment Guarantee Programme, Integrated Rural Development Programme (IRDP) and so on.

- **Public Sector and Key Industries:** Some basic and key industries without which development is not possible are steel, cement, engineering goods etc. Not only the agricultural sector but also various industrial units are dependent on the products of these key and basic industries. It is the public sector that has to invest on the development of such industries as the private sector is unwilling to invest because of the time period involved in the production process.
- **Promotion of Agriculture and Land Reforms:** The agriculture sector in developing countries like India is characterized by low productivity, peasant farming, dependence on weather conditions, surplus labours, disguised unemployment etc. Public expenditure can greatly influence farming technique and productivity. Expenditure on irrigational and flood control facilities and supply of improved seeds, fertilisers, mechanized agricultural tools, can improve the agricultural productivity and also incomes of the people. Along with that proper land reform measures and introduction of co-operative farming will help in improving the conditions of the weaker sections of agricultural sector.
- **Economic-Social Welfare:** Economic and social welfare in a country depends upon the amount of government expenditure incurred on them. Economic and social welfare programme like labour welfare, child welfare, women welfare, welfare of physically and mentally handicap persons, welfare of scheduled castes, scheduled tribes etc. requires huge amount of government investment
- **Population Control and Family Welfare:** Developing countries suffer from heavy pressure on population. Large population means poor per capita income, poor national income and large magnitude of unemployment. Government can take up schemes for controlling population, maternity welfare and healthy development of infants. So public expenditure has to be done on these areas so that there

is increased per capita income, increased productivity and reduced magnitude of unemployment.

- **Economic Stability:** Maintenance of economic growth with stability in prices is essential for developing economies. The quantity of public expenditure determines the economic stability of a country. In case of depression, heavy government expenditure has to be incurred to for increasing investment, capital formation, employment and also to save the economy from the adverse effects of depression. On the other hand in periods of boom, public expenditure has to be incurred in such a way so that it increases production and control the rising price level in the economy.
- **Development of Labour Intensive Industries:** Developing economies are characterized by huge population and surplus labourers in agriculture sector. One way through which these surplus labourers can be employed is through the development of small-scale industries. Public expenditure directed on the development of small- scale industries through introduction of attractive incentive schemes will help the surplus labourers to be gainfully employed.



LET US KNOW

Public expenditure has to play a huge role in the development of economy specially the developing ones. Such economies suffer from various deficiencies and so private sector cannot cover the huge investments that involve long time period. Therefore public expenditure has to come forward. Expenditure on some basic and key industries such as cement, steel etc. has to be undertaken by the public sector. Public expenditure on agriculture and land reforms can greatly influence the farming technique and productivity.Economic and social welfare as well as population control and family welfare are improved with the help of public expenditure.

The quantity of public expenditure determines the economic stability of a country. Therefore public expenditure helps in growth with stability in prices. With the development of small scale industries the surplus labourers of a developing economy are gainfully employed. Thus public expenditure on the development of labour intensive industries helps in the employment of such labourers.



CHECK YOUR PROGRESS

Q 5. Explain the role of public expenditure in developing countries (Write in about 150 words)

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Q 6. How does public expenditure help in maintaining economic stability in an economy? Explain (Write in about 50 words)

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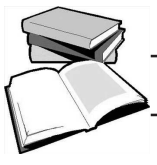


8.5 LET US SUM UP

- Public expenditure or government expenditure refers to the expenses of the public authorities either in protecting the citizens or in promoting their economic and social welfare. Public expenditure

has a great effect on the economy as a whole. Public expenditure has its effect on production, distribution and economic activity.

- The effects of public expenditure on production can be studied in terms of its impact on development of infrastructure, increase of effective demand, encouragement to private sector industries and re-allocation effect on production.
- The effects of public expenditure on distribution can be studied in terms of its impact on benefit to weaker section, wage structure and larger real income and development of backward regions.
- The effects of public expenditure on economic stability can be studied in terms of its impact on curbing Inflation and removing Deflation.
- Public expenditure plays an important role in the development of a developing economy. Apart from maintaining balanced regional development, economic stability, full utilisation of economic resources and socio- economic welfare in a developing economy, public expenditure plays important role in the development of infrastructure, agriculture, public sector and key industries.



8.6 FURTHER READING

1) Basotia, G. R. (2005). *Public Finance.* Jaipur: Shree Niwas Publications.

2) Bhatia, H. L. (2012). *Public Finance.* New Delhi: Vikas Publishing House Pvt. Ltd.

3) Choudhury R. K. and Chakraborty R. C. (2016). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publisher.

4) Jhingan M. L. (2013). *Money Banking, International Trade and Public Finance.* New Delhi: Vrinda Publications.

5) Paul R. R. (2009). *Money Banking and Public Finance.* Ludhiana: Kalyani Publisher.

8.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q no 1: Public expenditure or government expenditure refers to the expenses of the public authorities either in protecting the citizens or in promoting their economic and social welfare. The effects of public expenditure are-

- Effects on production
- Effects on distribution
- Effects on economic stability

Ans to Q no 2: Following points explain the effect of public expenditure on production.

- Development of Infrastructure: An improved infrastructure is essential for the development of any economy. Public expenditure made on the development of infrastructure both in the private and public sector leads to increase in production.
- Increase of effective demand: There may exist the problem of effective demand both in developed and developing countries. In both the cases public expenditure can increase the level of effective demand. In case of developed countries public expenditure can add to the effective demand directly. This will generate favourable conditions for the market forces to push up production. On the other hand developing countries where the production capacities remain underutilized, public expenditure can be planned in such a way that it enhances purchasing power of those who would spend most of it and add to effective demand.
- Encouragement to private sector industries: Public expenditure can be incurred for supplying essential raw materials, equipment and other technical services at subsidized rates to private industries. Public expenditure may also be directed to help other industries to import machineries, technical expertise, equipment etc. from industrially advanced countries.

- Re- allocation effect on production**:** Public expenditure can increase the level of production through changes in the pattern and composition of production. By offering subsidies and concessions public expenditure can divert resources from less essential products to more essential products.

Ans to Q no 3: The effects of public expenditure on distribution can be understood from the following points-

- Benefit to the weaker section: Public expenditure made on the weaker sections of the society will reduce the gap between poor and rich to some extent. Public expenditure on educational, medical facilities, supply of food grains and other essential commodities at subsidized prices will help the poor people to increase their work efficiency and increase their level of income.
- Wage structure and larger real incomes: Inequality of income in the society can be reduced by a proper wage structure which will narrow down the wage gap between the highly paid workers and the low wage earners. Provisions of free housing, subsidized rationing, promotion, medical and educational facilities to the children of employees etc. will raise the real income of the weaker sections and hence will reduce inequality.
- Development of backward regions: Public expenditure directed to develop the backward regions both agriculturally and industrially will raise the incomes of the people and their standard of living. Public expenditure on agriculture such as subsidized supply of fertilizers, hybrid seeds, and provision of agricultural credit helps the small farmers and the landless labourers. Promotion of industries in the backward regions creates more employment opportunities for the rural unemployed labourers.

Ans to Q no 4: True

Ans to Q no 5: The role of public expenditure in a developing economy can be understood from the following points-

- Balanced regional development: Public expenditure can remove the regional imbalance by focusing into the backward areas and underdeveloped regions.
- Development of infrastructure: The major problem faced by the developing economies is poor infrastructure and public expenditure can play a vital role here.
- Full utilisation of economic resources: In developing economies huge amount of natural and human resources are in unutilized and underutilized form and the public sector make the necessary investment for the proper utilisation of such resources.
- Poverty alleviation programmes: Developing economies are suffering from huge poverty problem and to reduce this problem government can take various effective initiatives.
- Promotion of agriculture and land reforms: Public expenditure can greatly influence the agriculture sector in developing countries by enhancing the productivity.

Ans to Q no 6: The quantity of public expenditure determines the economic stability of a country. In case of depression, heavy government expenditure has to be incurred to for increasing investment, capital formation, employment and also to save the economy from the adverse effects of depression. On the other hand in periods of boom, public expenditure has to be incurred in such a way so that it increases production and controls the rising price level in the economy.

8.8 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q1: How does the public expenditure affect production?

Q2: What are the effects of public expenditure on economic stability?

Q3: Briefly explain how public expenditure helps to curtail inflation and deflation.

Q4: Briefly explain the role of public expenditure in removing the regional imbalances in a developing economy.

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

Q1: Explain the effect of public expenditure on the economic activity.

Q2: Discuss the effects of public expenditure on economic stability and production.

Q3: Discuss the role of public expenditure in a developing economy.

Q4: A properly planned public expenditure can reduce the inequality of income and wealth in a developing economy by diverting resources from rich to poor. Explain the statement.

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