GEC S5-01(M/P)
Exam Code : ECP5A /ECM5A

Public Finance

SEMESTER-V

ECONOMICS

BLOCK- 2

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

Subject Experts

Prof. Madhurjya P. Bezbaruah, Department of Economics, Gauhati University

Prof. Nissar Ahmed Barua, Department of Economics, Gauhati University

Dr. Gautam Mazumdar, Department of Economics, Cotton University

Course Co-ordinator : Utpal Deka, KKHSOU

SLM Preparation Team

Units	Contributors
9,14	Prof. Nissar Ahmed Barua Gauhati University
10	Prof. Nissar Ahmed Barua Gauhati University Ms. Nibedita Goswami Ascent Academy
11	Ms. Nissar Ahmed Barua Gauhati University Utpal Deka KKHSOU
12,13,15	Dr. Parag Dutta Dispur College, Guwahati

Editorial Team

Content : **Prof K. Alam (Retd.),** Gauhati University
Dr. Gautam Majumdar, Cotton University
Dr. Chandrama Goswami, KKHSOU

Language : **Prof Robin Goswami** (Retd.), KKHSOU
Dr. Manab Medhi, Bodoland University

June, 2019
ISBN : 978-93-89123-83-8

This Self Learning Material (SLM) of the Krishna Kanta Handiqui State Open University is made available under a Creative Commons Attribution-Non Commercial-Share Alike 4.0 License (international): http://creativecommons.org/licenses/by-nc-sa/4.0/

Printed and published by Registrar on behalf of the Krishna Kanta Handiqui State Open University

The University acknowledges with thanks the financial support provided by the Distance Education Bureau, UGC for the preparation of this study material.

Head Office : Patgaon, Rani Gate, Guwahati-781 017
City Office : Housefed Complex, Dispur, Guwahati-781 006
Web: www.kkhsou.in

CONTENTS

UNIT 9: Public Debt **113-123**

Basic Concepts of Public Debt: Meaning, Distinction between public Debt and Private Debt, Sources of Public Debt; Burden of Public Debt; Methods of Public Debt Redemption

UNIT 10: Fiscal Policy **124-135**

Basic Concepts of Fiscal Policy: Meaning, Objectives, Instruments, Compensatory Fiscal Policy and Pump Priming; Role of Fiscal Policy in Developing Economies

UNIT 11: Public Budget **136-146**

Concept; Components; Classification of Public Budget; Incremental and Zero Base Budgeting; Budget deficit: Revenue Deficit, Fiscal Deficit and Primary Deficit

UNIT 12: Public Utilities **147-159**

Meaning of Public Utilities; Characteristics of Public Utility Services; Forms of Public Utility Undertakings; Role of Public Utility Services; Peak Load pricing

UNIT 13: Public Sector Undertakings **160-174**

Meaning; Forms; Role of Public Sector Undertakings (PSU_S) in developing economy; Performance and shortcomings of PSU_S in India.

UNIT 14: Federal Finance **175-187**

Concept of Fiscal Federalism; Principles of Federal Finance; Horizontal and Vertical Fiscal Balances; Instruments of Inter-governmental Resource Transfer

UNIT 15: Finance Commissions of India **188-201**

Finance Commission of India and its role; Recommendation of Current Finance Commission of India.

BLOCK INTRODUCTION

This is the second block of the course and comprises of seven units. The ninth unit deliberates on public debt. Thus, the concepts like meaning and sources of public debt, distinction between public debt and private debt as well as burden of public debt have been explained in this unit. The tenth unit will lend you to the aspects of fiscal policy. The important concepts like meaning of fiscal policy, compensatory fiscal policy and pump priming, role of fiscal policy in a developing economy have been discussed in this unit. The eleventh unit deals with the concept, components and classification of public budget. Apart from these some types of budget deficit like revenue deficit, fiscal deficit and primary deficit are also discussed in this unit. The twelfth unit explains the meaning, characteristics and role of public utilities. The thirteenth unit deals with the meaning, forms and role of public sector enterprises. This unit will help you to understand the performance and shortcomings of public sector enterprises in India. The fourteenth unit outlines the area of federal finance. Thus, the concept of fiscal federation, its principles as well as various instruments of inter-governmental resource transfer have been discussed in this unit. The final unit will help you acquire knowledge about the Finance Commission of India and its role. In this unit we will also discuss the current Finance Commission of India.

While going through a unit, you will notice some along-side boxes, which have been included to help you know some of the difficult, unseen terms. Some “ACTIVITY’ (s) have been included to help you apply your own thoughts. 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 9: PUBLIC DEBT

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Basic Concepts of Public Debt

- 9.3.1 Meaning of Public Debt
- 9.3.2 Distinction between Public Debt and Private Debt
- 9.3.3 Sources of Public Debt

9.4 Burden of Public Debt

9.5 Methods of Public Debt Redemption

9.6 Let Us Sum Up

9.7 Further Reading

9.8 Answers to Check Your Progress

9.9 Model Questions

9.1 LEARNING OBJECTIVES

After going through this, you will be able to -

- explain the concept of public debt
- distinguish between public and private debt
- trace the sources of public debt
- determine the burden of public debt
- state the methods of debt redemption.

9.2 INTRODUCTION

In earlier periods public borrowing was considered to be undesirable and the state was expected to function within its means. However, in modern times public borrowing has become an important part of state finances together with its revenue receipts. The significance of public debt has increased over the years with the government adopting an aggressive policy of public borrowing to finance its development efforts as well as to administer an appropriate fiscal policy.

9.3 BASIC CONCEPTS OF PUBLIC DEBT

In this unit, we shall discuss a few basic concepts of public debt viz. its meaning, distinction between public debt and private debt and the sources of public debt.

9.3.1 Meaning of Public Debt

Public Debt is created when the state undertakes short-term and long-term borrowings. Thus, according to Prof. Findlay Shirras, *"Public debt is a debt which a state owes to its subjects or to the nationals of other countries"*.

In India public debt consists of the borrowings by the state in the form of treasury bills, special bearer bonds, market loans, special loans and securities issued by the RBI. Besides these, public debt would also include all the public borrowing from external sources.

Basically, public borrowing is resorted to in order to bridge the gap between public expenditure and public revenue i.e. the budget deficit.

9.3.2 Distinction between Public Debt and Private Debt

Public debt like private debt has interest obligations. Besides the resources mobilised by both forms of debt are used to fill deficits in consumption as well as investment.

However, private debt can be distinguished from public debt on several counts as shown below:

- An individual cannot borrow from itself i.e. cannot borrow internally. However, a state can borrow from its citizens and from within the country, i.e. it can borrow internally.
- When resources mobilised by public borrowing is disbursed as public expenditure the benefits accrue to all the citizens including the lender. However, the benefits flowing from the use of private debt is available only to the borrower and the

lender is excluded from it.

- When a private debt is repaid the burden of repayment is borne by the borrower. However, in the case of public debt the state has the option of taxing the people in order to mobilise the funds to repay its debt. Hence, here, the burden of debt repayment falls on the community which includes the lender.
- Private debt has no effect on the economy whereas public debt has an all pervasive impact on the various macro variables in the economy, such as capital accumulation, price level, income and employment and economic growth.

9.3.3 Sources of Public Debt

Public borrowing can be both internal as well as external. In internal borrowing, the state can borrow from individuals, organisations, financial institutions, commercial banks and the central bank. On the other hand, external borrowing may be resorted to from foreign individuals, international financial institutions and foreign governments.

- **Internal sources of public debt :** Internally, the state can borrow from:
  - Individuals by selling them government bonds which accrue pre-fixed interest. This enables the state to mobilise funds from the public which otherwise would have been consumed or invested elsewhere or would have lain idle.
  - Non-banking financial institutions like insurance companies, mutual funds, investment trusts etc. which invest in government bonds. These institutions invest in government bonds in order to reduce their idle cash-balance investing in a financial asset which is risk free and highly liquid.
  - Commercial banks, which are obliged to maintain a part

of their cash reserve in liquid form, i.e. either as cash or government securities. When commercial banks lend to the government securities, there is creation of credit.

- The Central Bank (in India, the RBI), which purchases government bonds by crediting the amount payable to the government account. The government in turn makes payments to its creditors by drawing cheques on the account maintained in the central bank. This augments the cash revenue of the commercial banks enhancing their capacity to create credit. Hence the most expansionary source of public borrowing is the central bank.

➢ **External sources of public debt:** Besides borrowing from the internal sources, the government may also borrow from external sources to finance its import of capital goods, military equipments, petroleum etc. Besides, during crises like war and natural disasters borrowing from foreign countries becomes a indispensible necessity.

Sources of external borrowing include:

- International Financial Institutions like **IMF, World Bank, IFC, IDC, ADC etc.** which grant short term loans to various countries to overcome disequilibrium in their balance of payment. Besides these institutions also grant long term loans to finance development projects.
- Friendly countries who extend loans to finance the development activities to correct the balance of payment problem and to tide over natural and man-made crises.
- International commercial credit is accessed to finance various public sector enterprises. Such a source of finance is available only for a relatively short period and at a higher cost.

IMF : International Monetary Fund
IFC : International Finance Corporation
IDC : International Development Corporation
ADB : Asian Development Bank



LET US KNOW

The total external debt of India has come down from 3.1% of the GDP in 2000-01 to 2.41% in 2007-08.



CHECK YOUR PROGRESS

Q1: State whether the following statements are true or false:

(a) Public debt is created when the state imposes taxation. (True/False)

(b) Public borrowing is undertaken to close the deficit between public expenditure and public revenue. (True/False)

(c) Both public and private debt carry interest obligations. (True/False)

Q2: Mention the external sources of public debt. (Answer in about 50 words)

.....

.....

.....

.....

.....

9.4 BURDEN OF PUBLIC DEBT

Burden of Internal Public Debt : It is widely agreed that internal debt does not impose any direct money burden on the society because it results in a mere transfer of resources from the community to the state, which is returned back to the community in the form of public expenditure. Again, the resources mobilised to repay the debt along with interest payment is raised through taxation. This implies that here a transfer of resources (through taxation) that takes place from the community to the state which is returned back to the community as public debt redemption and interest payment. Hence, an internal public

debt does not impose any direct money burden on the society as it is a debt owed by the people to themselves.

However, if the taxpayers and government bond holders (i.e. lenders to the state) are different people, then the creation of public debt and their ultimate repayment might result in a redistribution of income in favour of the bond-holders. Thus, the redistribution of income and wealth due to the public debt may be taken to involve a direct real burden to the community.

Besides, indirect real burden of public debt might emerge with the imposition of additional taxation to finance the debt repayment programme. Here greater taxation may reduce the incentive to work, save and invest of the tax payers resulting in a fall in overall output and welfare.

Burden of External Public Debt: External public debt imposes both money burden as well as real burden on the economy. Thus, to repay the external debt with interest, the country has to use up its foreign currency reserve which constitutes the money burden of the debt.

Again, to earn that foreign currency, it must export more than it imports. Thus, there is an outflow of goods and services from the country resulting in a loss in the overall level or welfare. This is the real burden of the public debt.

However, external public debt does not always need to be harmful. If the resources mobilised through such borrowing are utilised for productive investment then the productivity in the economy is enhanced leading to an increase in income and output. Thus, subsequent debt repayment along with interest can be financed from the additional income generated which will ensure that no additional burden in created.

The size and the use of external debt has to be decided with the utmost care. This is because unchecked external borrowing may plunge a country into a precarious crisis referred to as debt trap. A debt trap is a situation where a country has to create new debt in order to meet the obligations of the old debt. This infact, is a vicious

circle which any debtor country seriously needs to avoid.



CHECK YOUR PROGRESS

Q3: State whether the following statemens are true or false:

(a) The government is able to borrow from internal sources only. (True/False)

(b) Government has to avoid external public debts as these are always harmful. (True/False)

Q4: What is meant by the real burden of public debt? (Answer in about 50 words)

.....

.....

.....

.....

.....

.....

9.5 METHODS OF PUBLIC DEBT REDEMPTION

Redemption of public debt means the repayment of the public debt. The state as a debtor has many options regarding how to repay its debt. This includes:

- **Repudiation:** Repudiation of public debt is nothing but a refusal to repay the principal and the interest. Since here the government outrightly refuses to meet its debt liabilities, its financial credibility takes a serious beating.

  In case of repudiation of internal debt there is unrest among the lenders and the ability of the state to raise future debts is seriously hampered. On the other hand, repudiation of foreign debt results in financial black listing and sanctions against the country and in extreme cases external aggression.

- **Refunding:** Refunding as a method of debt redemption consists in raising new loans by the state in order to pay-off the existing loans. Here the new public debts are created at a lower rate of interest as compared to the interest that is payable against the old existing debts.
- **Conversion:** Conversion is a special type of refunding where a loan with high interest obligation is converted into a loan where the interest payable is significantly lower. Thus, strictly speaking, conversion is not really a method of debt redemption; rather it is used to lower the interest obligation of the existing debts of the government.

  In conversion, the existing government bond holders are given the option of extending the maturity period of their bonds at a rate of interest which is lower than what is currently prevailing against their bonds but higher than the existing market rate of interest; otherwise the government can liquidate those bonds at maturity by raising fresh loans at a significantly lower market rate of interest. As is evident, conversion does not reduce the volume of public debt, rather it lowers the interest obligation of the government.
- **Sinking Funds:** Sinking Fund is a fund to which the government contributes regularly. The amount accumulated over the years are used to pay off public debt that attains maturity.

  The contributions made to the sinking fund are set aside out of the annual budget of the government. The excess balances in the fund are invested and the interest income earned is credited to the fund.

  The maintenance of the sinking fund by the government is considered to be a prudent debt management as it spreads the burden of debt servicing over a period of time while at the sametime it enhances the credit worthiness of the state.
- **Capital Levy:** Capital Levy is a one time imposition of a very heavy tax on capital which is used to finance a “all at once” repayment of unproductive and dead weight debt (i.e. war debt) of the state.

Capital levy is especially recommended to liquidate war debt for two reasons. First, it will enable the state to avoid imposing heavy taxation year after year on the public, which is bound to be very unpopular. And second, the burden of war debt should be borne by those capitalists who have made spectacular profits operating in a war economy.

Redemption of External Debt: External Debt has to be repaid in the creditor country's currency. Hence, to repay external loans a country needs to export more than they import so that there is a net earning of foreign exchange.

Hence, external public debt should be created with utmost care and efforts should be made to redeem a part of the debt every year so that such debts do not become unmanageable.



LET US KNOW

A debt raised without any obligation of repayment is called funded debt. Conversely, unfunded debts are those that are raised with the repayment obligation on the part of the state



CHECK YOUR PROGRESS

Q5: State whether the following statements are True(T) or False(F):

(a) Repudiation is the refusal to repay the public debt. (True/False)

(b) External debts do not carry any direct real burden on the community. (True/False)

Q6: What do you mean by conversion? Is it a proper method of public debt redemption. (Answer in about 50 words)

.....

.....

.....

.....

.....



9.6 LET US SUM UP

- Public Debt is created when the state undertakes short-term and long term borrowings.
- Public debt differs from private debt on many counts.
- Public borrowing may be undertaken both from internal as well as external sources.
- Internal public debt does not carry any direct money burden.
- External debt imposes both direct money and direct real burden.
- The state has the option of choosing from different methods of debt redemption.



9.7 FURTHER READING

1) Menkar, V.G. and Sarma, L.S. (2001). *Public Finance* : *Theory and Practice.* Mumbai : Himalaya Publishing House.

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

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

9.8 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: External sources of public debt are :

- International Financial Institutions like IMF, World Bank, IFC, IDC, ADC etc.
- Friendly countries which extend loans to finance the development

activities to correct the balance of payment problem and to tide over natural and man-made crisis.

- International commercial credit is accessed to finance various public sector enterprises. Such a source of finance is available only for a relatively short period and at a higher rate of interest.

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

Ans to Q No 4 : To earn foreign currency, a country must export more than it imports.Thus there is an outflow of goods and services from the country resulting in a loss in the overall level or welfare. This is the real burden of the public debt.

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

Ans to Q No 6: Conversion is a special type of refunding where a loan with high interest obligation is converted into a loan where the interest payable is significantly lower. Strictly speaking, conversion is not a proper method of debt redemption; rather it is used to lower the interest obligation of the existing debts of the government.



9.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Why does a state create public debt ?

Q 2: Distinguish between private and public debt.

Q 3: Write short note :

(a) Sinking Fund (b) Refunding (c) Conversion

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

Q 1: Discuss the burden of Public debt. Is the burden of external debt different from that of internal debt ?

Q 2: Explain the methods of public debt redemption.

*** ***** ***

UNIT 10: FISCAL POLICY

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Basic Concepts of Fiscal Policy

10.3.1 Meaning of Fiscal Policy

10.3.2 Objectives of Fiscal Policy

10.3.3 Instruments of Fiscal Policy

10.3.4 Compensatory Fiscal Policy and Pump Priming

10.4 Role of Fiscal Policy in Developing Economies

10.5 Let Us Sum Up

10.6 Further Reading

10.7 Answers to Check Your Progress

10.8 Model Questions

10.1 LEARNING OBJECTIVES

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

- define the meaning of fiscal policy and know its objects
- explain the instruments of fiscal policy
- appreciate the role of a compensatory fiscal policy
- outline the role of fiscal policy for a developing economy.

10.2 INTRODUCTION

Fiscal policy is one of the principal instruments of macro economic policy. It is used in conjunct with other macro instruments like monetary policy, foreign trade policy, income and trade policy, income and employment policy, saving and investment policy etc. to attain various desirable economic objectives. The principal instruments used in fiscal policy are taxation, public expenditure and public borrowing.

10.3 BASIC CONCEPTS OF FISCAL POLICY

This section deals with a few basic concepts of fiscal policy, viz., its meaning, objectives, instruments and concepts of compensatory fiscal policy and prime priming .

10.3.1 Meaning of Fiscal Policy

Fiscal Policy refers to the policy under which the state uses its three budgetary instruments i.e., taxation, public expenditure and public borrowing, to achieve various economic and social objectives. Thus, for example, taxation may be used to encourage or discourage the production of a particular commodity without considering its primary function(i.e, revenue mobilisation) to be the sole deciding factor in adopting that policy. Similarly, the primary function of public expenditure and public borrowing are social objectives, when these two instruments are used as part of a fiscal policy.

Thus, in a fiscal policy the three budgetary instruments, i.e, taxation, public expenditure and public borrowing, are collectively used over and above their primary functions to achieve various economic and social objectives.

10.3.2 Objectives of Fiscal Policy

The objectives of fiscal policy are disussed below–

- **Full employment :** Full employment is a common objective of fiscal policy in both developed and developing countries. Fiscal policy should aim at reducing the extent of unemployment and under- employment. Public expenditure on social overheads, public sector enterprises all help to create employment opportunities. Tax holidays and subsidies to start industries in rural areas help to generate employment.
- **Price Stability :** Price stability is an important objective for all countries in general. Fiscal policy should aim at avoiding both depression and

inflation. Little rise in prices is considered as an incentive for capital formation and investment but high rate of inflation would remove the gains of development. There will be imbalance between aggregate demand and aggregate supply.

- **To accelerate the rate of economic growth :** Primarily, fiscal policy in a developing economy, should aim at achieving an accelerated rate of economic growth. But high rate of economic growth cannot be achieved and maintained without stability in the economy. Therefore fiscal measures should be used properly, so that production, consumption and distribution may not be adversely affected. It should promote the economy as a whole which in turn helps to raise national income and per capita income.
- **Optimum allocation of resources :** Resources are scarce in developing economy. Hence, optimum allocation of such scarce resources becomes a primary objective of fiscal policy. Fiscal measures can greatly affect the allocation of resources in various occupations and sectors.
- **Equitable distribution of wealth and income :** Extreme inequalities of income and wealth are harmful to economic development. Such inequalities exist in a large extent in developing countries. Suitable fiscal policy of the government can be devised to bridge the gap between the incomes of the different sections of the society.
- **Economic Stability :** Fiscal measures promote economic stability in the face of short-run international cyclical fluctuations. These fluctuations cause variations in terms of trade, making the most favourable to the developed and unfavourable to the developing economies. So, for the purpose of bringing economic stability, fiscal methods should incorparate flexibility in the budgetary system so that income and expenditure of the government may automatically provide compensatory effect on the rise or fall of the nation's income.
- **Capital Formation and Growth :** Fiscal policy can be adopted as a crucial tool for the promotion of the highest possible rate of capital

formation. A developing economy is encompassed by a vicious circle of poverty' on account of capital deficiency. Therefore, a balanced growth is needed to breakdown the vicious circle which is only feasible with higher rate of capital formation.

- **Encouraging investment :** Investment can be increased from capital accumulation. More investment requires more saving or foreign assistance, voluntary savings of people are not enough. The capacity of people to save, particularly in developing countries, is very low. It is, therefore, the fiscal policy programmes which will have to make savings and investment possible.

10.3.3 Instruments of Fiscal Policy

The various instruments of fiscal policy are as follows–

- **Public Expenditure :** Public Expenditure is an important tool of fiscal policy. The appropriate variation in public expenditure can have more direct effect upon the level of economic activity than even taxes. The increased public spending will have a multiple effect upon income, output and employment exactly in the same way as of increased investment has its effect on them. Similarly, a reduction in public spending, can reduce the level of economic activity through the reverse operation of the government expenditure multiplier.
- **Taxation :** Taxation is a powerful instrument of fiscal policy in the hands of public authorities which greatly affect the changes in disposable income, consumption and investment. An anti- depression tax policy increases disposable income of the individual, promotes consumption and investment. Obviously, there will be more funds with the people for consumption and investment purpose at the time of tax reduction. This will ultimately result in the increase of spending activities.
- **Government Borrowing :** The third fiscal instrument is government borrowing. Public debt policy influences aggregate demand through the volume of liquid assets. When the government floats a loan there

is a transfer of liquid funds from the public to the government which reduces the purchasing power of the public. At the time of interest payments and repayment of debt, there is transfer of funds from the government to the public which increases the purchasing power in the hands of the public.

- **Public Budget :** A public budget is a financial statement indicating the expected receipts and proposed disbursement in the coming fiscal year.We will discuss in details about public budget in next unit.
- **Public Works :** Keynes has highlighted public works programme as the most significant anti-depression device. There are two forms of expenditure. These are – Public Works and Transfer Payments. The public works include - roads, rail-tracks, schools, parks, buildings, airports, hospitals, irrigation canals etc. Transfer payments are payments like interest on public debt, subsidy, pension, insurance, social security benefits etc.

Public works are supported as an anti-depression device on the following grounds :

- They reduces unemployment
- They increase the purchasing power of the community and thereby stimulate the demand for consumption goods
- They help to create economically and socially useful capital assets.

10.3.4 Compensatory Fiscal policy and Pump Priming

Capitalist economies are characterised by fluctuation which causes upswings and downswings. If unchecked, an upswing may transform into a boom whereas downswing may plunge into a depression. During an upswing, aggregate demand exceeds aggregate supply leading to rising prices, increasing profits and expanding income, output and employment. However, when such an upswing is not regulated it can result in runaway inflation causing great instability in the economy. Conversely if the aggregate demand is less than the aggregate supply, then

there is a continuous fall in the price level, leading to falling profits, and contraction of investment, output, income and employment and, when unchecked, it transforms into a depression.

As an anti-fluctuation measure, compensatory fiscal policy seeks to maintain price stability by confronting both inflation and deflation which are sources of instability in the economy. Thus the strategy consists of reducing aggregate demand during inflation and increasing aggregate demand during deflation.

Thus, during inflation, the state responds by increasing taxation and reducing public expenditure. It also attempts to mop up surplus funds in the economy through public borrowing. Conversely, during deflation , the aggregate demand in the economy is sought to be increased by cutting taxation and increasing public expenditure. The state also attempts to put more purchasing power in the hands of the public by repaying its previous debts.

Thus, as indicated above a fiscal policy directed towards maintaining price stability in the economy is referred to as compensatory Fiscal policy. Here the state using an appropriate combination of taxation, public expenditure and public debt management attempts to correct inflation and deflation that may arise out of business upswings and downswings.

Pump Priming: Pump priming is a one time fiscal intervention by the state to revive a stagnant economy or an economy that is showing signs of slowing down. Under pump priming a substantial amount of purchasing power is injected into the economy by a one-time government expenditure. Such an effort is expected to increase the aggregate demand resulting in a rise in prices which in turn leads to higher profit, greater investment, and expansion in income, output and employment.

Despite its uses, pump-priming, because of its “one-

time" nature, fails to reverse a severe downswing. Hence, as an anti-cyclical measure, its effect is only temporary and for a more effective and rewarding effort it needs to be supplemented by other fiscal and monetary measures.



CHECK YOUR PROGRESS

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

(a) During inflation the state decreases taxation and increases public expenditure.(True/False)

(b) Pump Priming is an one time injection of government expenditure. (True/False)

Q 2: State two objectives of fiscal policy.(Answer in about 50 words)

.....

.....

.....

.....

.....

Q3: How does a compensatory fiscal policy attempt to maintain price stability? (Answer in about 30 words)

.....

.....

.....

10.4 ROLE OF FISCAL POLICY IN DEVELOPING ECONOMIES

Although Fiscal policy has a significant role to play in both developed and developing economies, its role differs in the two economies.

A developing economy is characterised by low level of income, high unemployment, inadequate capital formation, low saving and investment, and high inflation. In fact, any economic fluctuations that take place, are around a very low income level.

Given the stagnancy of the market in the developing economy, it is widely recognised that the state intervention is essential to supplement the market forces to pull such an economy out of the stagflation. Fiscal policy in developing economies has the following objectives:

- **To achieve rapid economic growth:** Developing economics have a low rate of growth because they have inadequate capital. Hence, an appropriate fiscal policy should aim to promote capital formation, both in the public as well as in the private sector. Special attention should be paid towards the creation of economic and social infrastructure, and towards investment in heavy and basic industries.

  While the above measures are useful to promote industrial development, a balanced growth must be pursued by providing various incentives to the agricultural sector. This is important as industry and agriculture supplement each other as the economy strives to attain the objective of maximum growth.
- **Redirect flow of investment:** Fiscal policy can be used to redirect scarce investment from speculative and unproductive purposes to more productive use. This can be done by imposing high taxation on speculative activities and socially unproductive investment and correspondent tax cuts and subsidy offers to investment in socially important activities.
- **To control inflation:** Huge government development expenditure, increasing state welfare activities, expanding administrative steps, and a high propensity to consume of the people, all add up to create huge inflationary pressure on the economy. Usually most of the time, excess of aggregate demand over aggregate supply fuels the demand pull inflation in the economy.

Fiscal policy in this case, can be used as an anti-inflationary instrument to wipe out the excess purchasing power in the economy which in the process reduces aggregate demand and thus moderates the price rise.

- **To administer distributive justice:** Given the huge inequality in the distribution of income and wealth, the fiscal policy in a developing economy must strive to bring about significant redistribution.

In pursuance of such an objective, a taxation policy should consist of a direct taxation structure which is progressive in nature. Again, the indirect taxation structure should be such that only luxury items which are consumed by the rich should be taxed heavily. Conversely, items of necessity which are bought by the poor need to be taxed lightly.

On the expenditure side, the state may adopt a policy of subsidising these goods and services which are mostly consumed by the poor. These would include low cost housing, free medical services, and primary schooling. Besides, labour intensive industries may be promoted by a tax-holiday scheme or other forms of subsidy.

To conclude, fiscal policy is a very powerful tool which is used to achieve various socio-economic objectives in a developing economy. However, because of the structural weaknesses of the developing economies fiscal instruments have limited success as it attempts to serve the same objectives in less developed countries.



LET US KNOW

Although progressive direct tax results in distributive justice in a developing economy, however the revenue mobilisation by it is inadequate, as such poor economies have low direct tax base.



CHECK YOUR PROGRESS

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

(a) Fiscal Policy seeks to induce an upswing in the economy. (True/False)

(b) A developing country should design its tax structure as regressive in nature. (True/False)

Q5: How can the fiscal policy be utilised to redirect flow of investment from unproductive areas to productive areas? (Answer in about 40 words)

.....

.....

.....

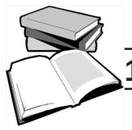
.....

.....



10.5 LET US SUM UP

- Under fiscal policy, the state uses taxation, public expenditure, and public borrowing to achieve various economic and social objectives.
- Objectives of fiscal policy are- optimum allocation of resources, to accelerate the rate of economic growth, economic stability etc.
- Compensatory fiscal policy is used by the state to maintain price-level stability in the economy.
- Pump Priming is a one time government expenditure aimed at reviving an economy from down swing.
- Fiscal policy in a developing economy has to play a different role from what it does in a developed economy.



10.6 FURTHER READING

1) Lekhi, R.K. (2006). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers.
2) Menkar, V.G. and Sarma, L.S. (2001). *Public Finance : Theory and Practice.* Mumbai: Himalaya Publishing House.
3) Paul, R. R. (2007). *Money, Banking and International Trade.* New Delhi: Kalyani Publishers.
4) Prakash, O. (2008). *Public Economics : Theory and Practice*. Jalandhar: Vishal Publishing House.
5) Singh S. K. (2010). *Public Finance in Theory and Practice.* New Delhi : S. Chand and Company Limited.

10.7 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: Two objectives of fiscal policy are:

- **Full employment :** Fiscal policy should aim at reducing the extent of unemployment and under- employment. Public expenditure on social overheads, public sector enterprises all help to create employment opportunities. Tax holidays and subsidies to start industries in rural areas help to generate employment.
- **Optimum allocation of resources :** Resources are scarce in developing economy. Hence, optimum allocation of such scarce resources becomes a primary objective of fiscal policy. Fiscal measures can greatly affect the allocation of resources in various occupations and sectors.

Ans to Q No 3: As an anti-fluctuation measure, compensatory fiscal policy seeks to maintain price stability by confronting both inflation

and deflation which are sources of instability in the economy. Thus the strategy consists of reducing aggregate demand during inflation and increasing aggregate demand during deflation.

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

Ans to Q No 5: Fiscal policy can be used to redirect scarce investment from speculative and unproductive purposes to more productive use. This can be done by imposing high taxation on speculative activities and socially unproductive investment and correspondent tax cuts and subsidy offers to investment in socially important activities.



10.8 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by fiscal policy ?

Q 2: Briefly explain the objectives of fiscal policy.

Q 3: Briefly explain the role of a compensatory fiscal policy.

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

Q 1: Frame a fiscal policy for a developing economy. Explain its significance.

Q 2: Discuss the various instruments of fiscal policy.

Q 3: Write short notes on:

(i) Consolidated Fund ii) Pump Priming

*** ***** ***

UNIT 11: PUBLIC BUDGET

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Public Budget

11.3.1 Concept of a budget

11.3.2 Components of a budget

11.3.3 Classification of a budget

11.4 Incremental and Zero Base Budgeting

11.5 Budget Deficit

11.6 Let Us Sum Up

11.7 Further Reading

11.8 Answers to Check Your Progress

11.9 Model Questions

11.1 LEARNING OBJECTIVES

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

- define the meaning of public budgets
- explain the components and classification of public budget
- distinguish between incremental and zero based budgeting
- describe the types of budget deficit.

11.2 INTRODUCTION

Public budget is an integral part of public finance and in modern economy public budget is used to direct the economic activities.It enables the authorities to decide about the proposed expenditure and anticipated revenue in the overall context of the policies.This unit deals with public budget and its components and classification. It will also explore the different types of budget deficit like revenue deficit, fiscal deficit and primary deficit.

11.3 PUBLIC BUDGET

We shall discuss the concept, components and classification of a budget in this section.

11.3.1 Concept of a Budget

A public budget is a financial statement indicating the expected receipts and proposed disbursement in the coming fiscal year. As discussed earlier, government receipts are from taxation and borrowing, whereas disbursement taxes place in the form of public expenditure.

Although a budget is a statement of future financial transaction, however a public budget is a composite statement of receipt and expenditure for three consecutive years.

Thus, for example the budget presented in 2007-08 could contain:

- The actual receipts and disbursements in the previous year i.e, 2006-07.
- The revised estimates of the current year i.e. 2007-08.
- And the estimated receipts and disbursements for the coming year i.e. 2008-09.

In India, the budget is presented for the fiscal year which comprises the period between 1st April to 31st March.

The budget in India undergoes four distinct stages -

- Initially the budget is framed.
- It is then presented to the legislative approval.
- After approval, the budget is implemented.
- Finally, the budget and its implementation is subjected to a financial scrutiny through an auditing of accounts.

A government budget is framed with a number of objectives in mind.

- It acts as a plan of action by which the government seeks to attain the economic objectives.

- It specifics how and how much resources are to be mobilised and disbursed.
- It allows the legislature on behalf of the people to have a say in the government programmes and policies.
- And finally, the budget provides a framework of various checks and balances, by which government receipts and disbursements are subject to accountabilities.

11.3.2 Components of a Budget



Contigency Fund: Fund kept aside in case it is needed urgently. Such funds are usually utilised for national calamities, emergencies etc.

A public budget may vary structurally from country to country. In India, the budget has three components: the consolidated fund, the contingency fund and the Public account fund.

In the consolidated fund, all receipts and disbursements be administered with the prior sanction of the concerned legislature. No resources can be raised in the form of taxation public borrowing unless it is approved by the legislative nor can any public expenditure be incurred unless the legislature sanctions it.

However, the government is allowed to undertake public from the ***contingency fund*** without any prior approval, but it is expected to get the expenditure approved by the legislature at the earliest opportunity. The contingency fund is set up to provide the government with funds at a short notice to meet emergencies and other unforeseen expenditures.

Finally, the public account fund includes receipts of provident funds, savings etc. As these funds belong to the contributors and not to the government, no prior sanction of the legislature is required by the government to spend from these funds or to mobilise them.

Besides, budgets in some countries are classified into revenue and capital account.

Under the revenue account, receipts would include tax and non tax receipts whereas disbursement would consist of revenue expenditure. Similarly in the capital account, receipt would be constituted by public borrowing and other capital receipt whereas as disbursement will take the form of capital expenditure.

11.3.3 Classification of Budget

In the following section we are discussing some selective types of budget:

- **Balanced budget:** When a budget shows that the proposed expenditure and anticipated revenue are equal, it is said to be a balanced budget. A balanced budget never indicates a deficit or surplus. To maintain a balanced budget is rather difficult, if not impossible, in a developing country.
- **Unbalanced budget:** A budget is said to be unbalanced, when the proposed expenditure and anticipated revenue are not equal. The imbalance implies either surplus or deficit budget. If there is excess of revenue over expenditure then it implies a surplus budget and in case of deficit budge there is excess of expenditure over revenue.
- **Revenue budget:** When a budget consists of revenue receipts of the government and the expenditure made from these revenues then it is known as revenue budget. Revenues include receipts from the taxes and other duties, fee and other receipts for services rendered by the government, interest, dividends etc.
- **Capital budget:** Capital budget consists of capital receipts and payments and the expenditure made from such receipts. The main items of capital receipts are the loan raised by the government from the public, borrowings of the government from the Central Bank, loans received from the foreign government and other organisations, recoveries of loans granted by the central

government to the state government, revenue received through divestment, small savings such as provident fund, post office savings deposits, Kisan Vikas Patras, NSS deposits etc.

- **Interim budget:** When a budget is prepared for an interim period i.e. for a period less than a full year then it is known as an interim budget. Normally such a budget is prepared to meet the expenditure in the intervening period if there is a delay in preparing a regular budget for the full year. The government of the day presents an interim budget if it does not have the time to present a full budget or because of the close proximity of national elections. In the latter situation, propriety demands that the task of framing the full budget be left to the incoming government. The budget for the year approved by Parliament gives the government spending rights only till the end of the financial year. If for any reason the government is not able to present a full budget before the financial year ends, it will need parliamentary authority for incurring expenditure in the new fiscal year until a full budget is presented. Through the interim budget, the Parliament passes a vote-on-account that allows the government to meet the expenses of the administration until the new Parliament considers and passes the budget for the whole year.
- **Supplementary budget:** A supplementary budget is made to meet the extra expenditure over and above what is provided in the regular budget under either of the following circumstances:
  - When during the course of a regular budget, the expenditure exceeds the revenue.
  - When the government is required to incur expenditure on some specific projects for which no provision was made in the regular budget.
- **Emergency budget:** When a budget is prepared to meet the emergency situations such as war, depression, natural calamities etc. then that budget is known as emergency budget.



CHECK YOUR PROGRESS

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

(a) The financial year in India is from 1st of March to 28th of February. (True/False)

(b) The government needs prior sanctions to spend from the contingency fund. (True/False)

Q 2: What is meant by budget? (Answer in about 40 words)

.....

.....

.....

.....

Q 3: Distinguish between interim budget and supplementary budget. (Answer in about 40 words)

.....

.....

.....

.....

11.4 INCREMENTNAL AND ZERO-BASE BUDGETING

In Incremental budgeting, previous outlays are assumed to be given and only new additions to or reductions from the previous outlay are considered for administrative and legislative review. This form of budgeting has come in for severe criticism as it is felt that in prudent budgeting previous expenditure must be subject to a thorough scrutiny along with fresh proposals of public expenditure. In the absence of such a policy there is a danger of “hardening of bureaucratic arteries, where old programmes go unexplained.

The limitation of incremental budgeting is done away in zero-

base budgeting. Zero-base budgeting is an innovative technique where the budget manager is required to justify his budget from the scratch (i.e. hence zero base). Thus, here the budget not only has to justify the new proposals but also has to justify the expenditure incurred on the ongoing and past operations. Thus, in the words of Peter A. Phyrr, "Zero base budgeting is a planning and budgeting process which requires each manager to justify his entire budget request in detail from scratch and shifts the burden of proof to each manager to justify why he should spend money at all for a particular activity under his charge". Zero-base budgeting has the following advantages over conventional budgeting -

- Leads to more effective allocation of resources.
- Imparts more flexibility in the allocation and reallocation of resources.
- Avoids duplication of tasks
- Strengthens the evaluation process and leads to greater accountability
- Enables the budget to meet its objectives more efficiently.



LET US KNOW

An outcome budget measures the development outcomes of all government programmes. Thus, it develops a linkage between the money spent by the government and the results which follow.



CHECK YOUR PROGRESS

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

(a) Incremental budgeting is superior to zero-base budgeting. (True/False)

(b) Zero base budgeting results in effective allocation of resources. (True/False)

Q5: Enumerate the advantage of Zero-base budgeting over

traditional budgeting. (Answer in about 40 words)

.....

.....

.....

.....

11.5 BUDGET DEFICIT

Budget deficit refers to a situation where the proposed total expenditure (both revenue and capital) exceeds the anticipated total receipts (both revenue and capital) of a budget. In the following section we are discussing some types of budget deficit:

- **Revenue Deficit**

The excess of total revenue expenditure of the government over its total revenue receipts is called revenue deficit. It includes only those transactions which affect the current income and expenditure of the government. Current revenue expenditure of the government is composed of plan and non-plan expenditure whereas the current revenue receipts include net tax revenue and non tax revenue of the government. It occurs when own earning of the government is insufficient to meet its spending.

In the form of an equation, revenue deficit is expressed as,

Revenue deficit = Total Revenue expenditure – Total Revenue receipts

- **Fiscal Deficit**

The excess of total budget expenditure over the total budget receipts excluding borrowings during a fiscal year is called fiscal deficit. It reflects the amount of money the government needs to borrow to meet the excess expenditure which is not met by its own resources.

In the form of an equation, fiscal deficit is expressed as,

Fiscal deficit = Total expenditure – Total receipts excluding borrowings

Or

Fiscal deficit = Total Expenditure (Plan and non plan) – Revenue receipts – Capital receipts excluding borrowing

● **Primary Deficit:**

The excess of fiscal deficit of current year over interest payments on previous borrowings is called primary deficit. It indicates how much the government borrowing is going to meet expenditures other than interest payments. The difference between fiscal deficit and primary deficit is that the former shows borrowing requirement inclusive of interest payment whereas the latter shows borrowing requirement exclusive of interest payment.

In the form of an equation, fiscal deficit is expressed as,

Primary deficit = Fiscal deficit – Interest payments



CHECK YOUR PROGRESS

Q6: Distinguish between fiscal and primary deficit.(Answer in about 30 words)

.....

.....

.....



11.6 LET US SUM UP

- A public budget is a financial statement of the government indicating expected receipts and proposed disbursements in the coming fiscal year.
- A budget is said to be balanced, when the proposed expenditure and anticipated revenue are equal.
- A revenue budget consists of revenue receipts of the government and the expenditure made from these revenues.
- In incremental budgeting, only the new addition to or the reductions

from the outlay is considered for review.

- In zero-base budgeting, the budget manager is required to justify his budget from the scratch.
- Revenue deficit = Total Revenue expenditure – Total Revenue receipts.
- Fiscal deficit = Total Expenditure (Plan and non plan) – Revenue receipts – Capital receipts excluding borrowing.
- Primary deficit = Fiscal deficit – Interest payments.



11.7 FURTHER READING

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

2) Menkar, V.G. and Sarma, L.S. (2001). *Public Finance : Theory and Practice.* Mumbai: Himalaya Publishing House.

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

11.8 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No2: A budget is a financial statement indicating the expected receipts and proposed disbursement in the coming fiscal year. Although a budget is a statement of future financial transaction, it is actually a composite statement of receipt and expenditure for-three consecutive years.

Ans to Q No 3: An interim budget is prepared to meet the expenditure in the intervening period if there is a delay in preparing a regular budget for the full year, whereas a supplementary budget is made to meet the extra expenditure over and above what is provided in the regular budget .

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

Ans to Q No 5 : Zero base budgeting (ZBB) has the following advantages over conventional budgeting -

- It leads to more effective allocation of resources.
- It imparts more flexibility in the allocation and reallocation of resources.
- ZBB avoids duplication of tasks
- It also strengthens the evaluation process and leads to greater accountability
- ZBB enables the budget to meet its objectives more efficiently.

Ans to Q No 6: The difference between fiscal deficit and primary deficit is that, the former shows borrowing requirement inclusive of interest payment, where as the latter shows borrowing requirement exclusive of interest payment .



11.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by public budget ?

Q 2: Distinguish between incremental budgeting and zero-base budgeting.

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

Q 1: Define Public Budget. Describe its various components.

Q 2: Explain the classification of public budget.

Q 3: Write short notes on:

(i) Budget deficit ii) Revenue and capital budget

*** ***** ***

UNIT 12: PUBLIC UTILITIES

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Meaning of Public Utilities

12.4 Characteristics and Pricing of Public Utility Services

12.5 Forms of Public Utility Undertakings

12.6 Role of Public utility Services

12.7 Peak Load pricing

12.8 Let Us Sum Up

12.9 Further Reading

12.10 Answers to Check Your Progress

12.11 Model Questions

12.1 LEARNING OBJECTIVES

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

- state the meaning of public utilities
- explain the characteristics of public utilities
- know the forms of public utility undertakings
- describe the role of public utility Services
- discuss the significance of peak load pricing.

12.2 INTRODUCTION

This unit is concerned with familiarizing the learners with the concepts such as meaning of public utilities, charcteristics of public utilities, forms of public utility servicse, role of public utility services and meaning and significance of peak load pricing.

Public utilities can be defined as those organization that supply necessary services to the people of the society. There are several unique

characteristics of public utilities which are different from other forms of organization. There are different forms of public utility undertakings such as public authority, public trust, joint ownership and public corporation etc. The main role of public utility undertakings is to provide essential services to each and every person without any discrimination of region, caste and creed.

Peak Load Pricing is a pricing strategy that sets the price at the highest level during times when demand is at a peak.

12.3 MEANING OF PUBLIC UTILITIES

In common parlance, a public utility is an enterprise that provides certain classes of services to the general public. Public utilities are those organizations which provide necessary services to the society. Typically such services include supply of electricity, power, gas and transport, water, sanitation, telephone and telegraph and similar services. All goods and services come under the category of public utility services are needed in the day-to-day life of all section of people. It is the responsibility of the government, particularly in under-developed countries, to supply these services to the citizens of the nation. Regular and uninterrupted supply of these services has a positive impact on overall economic development of a nation. It also helps to maintain and improve the standard of living of all sections of the people in the society.

12.4 CHARACTERISTICS AND PRICING OF PUBLIC UTILITY SERVICES

Characteristics of Public Utility Services :

From the previous section of the unit, we have an idea about the meaning of public utility. Now let us look at some of the important characteristics of public utilities. These are noted below-

- **Protection of Consumers:** This is the most important and significant characteristic of public utility services. Public utilities are basically meant for serving the consumers. The supply of services like electricity, water, power, and transport etc should be

adequately maintained. It is very difficult and practically impossible to survive without these services. These services should also be provided at reasonable prices and in adequate quantities. These services being necessities, consumer exploitation is possible and private sector may exploit the consumers. The supply of essential services should not only be at lower prices but they should be constantly maintained.

- **Monopoly Position:** Public utility undertakings are the outcome of special legislations to provide public utility to the public. As a result, public utility enterprises are usually given monopoly power in a particular area or business. The entry of other concerns is barred to these fields by special legislation. The status of monopoly position of public utility undertakings is necessary to avoid duplication in providing these services. This charcteristics of these undertakings can be assessed from the fact that it requires large capital investments. Small investors cannot enter these fields. The supply of essential services should be maintained regularly. Public utility service can be well maintained when the power to operate in a field is absolute.
- **Special Power and Privilege:** Public utility concerns are given special powers and privileges so that regular and satisfactory supply is maintained. The privileges and special status is conferred by the legislations passed for creating those concerns. The special feature of Public utility concerns are that it may acquire and use public property, if necessary. As powers conferred to the public utilities are given in good faith, these concerns should not make misuse of these powers.
- **Requirement of Heavy Investments:** All concerns regarding public utility services generally require large investments of capital. These type of investments are more in fixed assets. For example, electricity concerns require large investment on setting up lines. Similarly, in case of railways, large amounts are needed on providing

railway lines, purchase of engines and wagons and constructing railway stations. It is generally observed that cost per unit will go on decreasing with the expansion in service. As a result, the expansion and supply of these services reduces cost per unit as no heavy additional investment is required.

- **Public Regulations of Public Utility Undertakings:** Public utility undertakings are generally created by special legislation of Parliament and state legislature. Indian Railways are set up under a special act of Parliament. Electricity Boards of different states are set up by state legislatures of those states. Special acts are necessary because certain special powers and privileges are provided to those undertakings by these acts which are needed to maintain regular and efficient services.
- **Low Business Risks Involved:** Unlike other business undertakings, public utility undertakings usually do not suffer from business risks. The demand for public utility always remains intact and there is less risk on this aspect. Due to the monopoly or monopolistic set up, there is less competition in case of public utility undertakings. Another important feature is that there is always a possibility of increase in demand because the demand for these services is both direct and derived. The use of electricity in a house is a direct demand and the use of power for running a engine is a derived demand.

Pricing of Public Utility Services :

The primary aim of public utility services is to help the society in getting essential services at reasonable prices. The prices are also affected by the nature of demand and laws of returns. These concerns operate under decreasing cost conditions. So, they should charge reasonable prices. The pricing policy of these undertakings is generally guided by the government. Some margin of profit is allowed to maintain efficiency and expansion of these services. (You will get to know more about the concept in your further studies.)



ACTIVITY 12.1

Identify some public utility services of your local area.

.....

.....

.....

.....

.....



CHECK YOUR PROGRESS

Q1. State whether the following statements are True or False :

(a) The public utility services help to protect the consumers from exploitation. (True/False)

(b) Public utility is a business that provides everyday necessity to the public at large. (True/False)

Q2. Mention the basic characteristics of public utility services. (Answer in about 50 words)

.....

.....

.....

.....

.....

Q3. State the primary aim of public utility services. (Answer in about 20 words)

.....

.....

12.5 FORMS OF PUBLIC UTILITY UNDERTAKINGS

The form of public utility undertakings depends upon the nature and type of services provided by them. The ownership of these undertakings is always preferred to be in government hands. It ensures regular supply of these services without any discrimination to consumers. It also helps to protect the interests of consumers. Generally, the following forms may be used for these undertakings-

- **Public Authority:** This is one of the oldest forms of organisation of providing public utility services. In this form, the undertaking works as a part of government department. The finances are provided by the government and management is in the hands of the civil servants. The Minister of the Department is the ultimate in-charge of the undertakings. The Indian railways, post and telegraph, radio and television are working as government departments. As these undertakings are wholly dependent on government for finances, state treasury provides finances and surplus money is deposited in treasury. The budget of the departmnent is passed by the parliament or by the legislature. The accounting and audit control applicable to other government departments are applicable to public utility enterprises also.

- **Public Trust:** There are some public utility services which assume the form of public trust concerned with supply of services or regulation of activities affecting the society in general. Port authorities or port trust are the most common form of public trust. Public trust is an autonomous body and holding and operating its funds of the state in trust. The trust authority is governed by the legal act of the parliament with well-defined powers, functions and jurisdiction of authority.

- **Joint Ownership Concerns i.e., Public and Private Companies:** The joint owership type of public utility undertakings has a legal entity and like public corporation, can sue and be sued. They have financial freedom and administrative autonomy and yet are controlled by the government. This is one of the public utility undertakings in which private sector can participate in share capital. In other forms, contribution to capital can be made only through loans by the private sector. Sometimes government starts a joint stock company only to start with the process of development and then hands over the same to private sector. The transfer of ownership is easy in case of the company type because no legislative action is necessary for the purpose. This form of public utility undertakings is very popular in India.

- **Public Corporation:** An important form of public utility undertakings is called public corporation. A public corporation is an entity that is created by the to carry out public missions and services. Public corporation is independent in its decisions relating to its functions including management and personal policies, though it is wholly owned by the government. Although there is freedom in day to day administration, a public corporation should carry out the policies laid down by the legislature and should be accountable to the people for its performance.

12.6 ROLE OF PUBLIC UTILITY SERVICES

Since independence, among all the sectors that have contributed to the growth of Indian economy, public utility services have been the most consistent and prominent given their contribution towards the country. Public utility services have not only contributed in terms of providing essential services and merit goods, but also have assured self-reliance to the people of the country. It is through the services of the public utilities, the foundation for various other sectors have been laid higher growth and

prosperity. The main role of the public utility services can be captured by the following observations-

- The public utility undertakings are to provide services to each and every person without any discrimination of region, caste and creed.
- As discussed in the above section, the primary aim of public utility services is to help the society in getting essential services at reasonable prices. Public utility services help to provide the basic necessities of life. In a welfare state, such as India, it is the duty of the public authority to provide the basic necessity and thus raise the overall welfare of the society. Public utility enterprises are the intruments in the hand of the government to provide those necessities of life.
- Another significant role of public utility enterprises is that it can protect the consumers from exploitation from private enterprises. There are some of the services without which it is practically difficult to survive in a modern world. Public utility concerns can provide those and thus protect the consumers from being exploited.
- An important role of public utility service is that it provides merit goods such as education, health etc. These merit goods have huge positive externalities for the society. It helps to improve the overall welfare of the society. This is more relevant in under-developed countries where they are lagging behind than other developed countries in these vital sectors.
- Establishment of conducive conditions for heavy industries and creation of business enviorment is a role which is effeciently played by the public utility services. But while doing this, it has to give imporance on the fact that industries are equally distributed into different regions of the country.

12.7 PEAK LOAD PRICING

As stated in the introduction, Peak Load Pricing is a pricing strategy that sets the price at the highest level during times when demand is at a peak. The peak load pricing strategy is generally adopted to shift demand, or at least consumption of the goods or services and to accomodate supply. There are different advantages as well as disadvantages of peak load pricing strategy. The advantages and disadvantages of the policy of peak load pricing are discussed below-

Advantages:

The advantages of peak load pricing are listed below-

- The main advantage of Peak load pricing is that it helps to balance capacity usage. Low price of public utility services creates more demand beyond its capacity. As a result, it becomes difficult to supply as per demand of the consumers. The peak load pricing helps to overcome these kinds of situations.
- Another significant advantage of peak load pricing is that it helps to reduce the rate of growth of usage of public utility services during the prime time and maintain the balance between demand and supply.
- By charging customers in peak time, a higher peak price decreases the need for capacity expansion of the public utility services.
- Another advantage of peak load price is that it shifts a part of the load from the peak to the base load plants which called valley filling and charging off peak customer a lower off peak price. It thus has some savings in using fuels during peak time.

Disadvantages:

There are also some disadvantages of peak load pricing which are listed below-

- The main disadvantage of peak load pricing is the investment cost of installing time-sensitive measuring equipment. The new technology may entail switching costs. Producers may also have to hire field personnel and supervisors.

- Introducing Peak Load Pricing has some costs that need to be taken into consideration and must be weighed against the welfare gains of more efficient pricing. Peak Load Pricing requires sophisticated measurement of customer usage and advanced metering. Many utilities may lack information that allows differential pricing across periods of consumption and would therefore need to upgrade metering equipment so as to introduce Peak Load Pricing.
- The drawback of this strategy is that it abstracts from a more general behaviour in which at least some consumers may choose to shift their demand from one season to another in response to a lower price during their “less desirable” season.

- Another disadvantage of peak load pricing is that false prediction leads to wrong pricing regulation. In those circumstances, this pricing policy may not give the desired result.



ACTIVITY 12.2

List out some public utility services where the peak load pricing strategy is adopted.

.....

.....

.....

.....

.....



CHECK YOUR PROGRESS

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

(a) Peak load pricing helps to balance capacity usage. (True/False)

(b)Public authority is a form of public utility undertakings (True/False)

Q5. What is meant by peak load pricing? (Answer in about 50 words)

.....

.....

.....

.....

.....



12.8 LET US SUM UP

- Public utility is a service that provides everyday necessity to the public at large. Public utilities are those business undertakings which provide necessary services to the society.
- There are different characteristics of public utilities such as protection of consumer from expolitation, monopoly position, special power and privilege, requirement of heavy investment, regulation of public utility undertakings, low business risk involved etc.
- There are different forms of public utility undertakings such as public authority, public trust, joint ownership concern, public corporation etc.

- Public utility services of a nation has to play different roles such as providing services to each and every person without any discrimination of region, caste and creed, helping the people to get the essential services at reasonable prices, protecting the consumers from exploitation etc
- Peak Load Pricing is a pricing strategy where price will be set at the highest level during times when demand is at a peak. This pricing strategy has several advantages as well as disadvantages.



12.9 FURTHER READING

1) Musgrave, R.A. and Musgrave, P. B. (2017). *Public Finance in Theory and Practice.* McGraw Hill Education.

2) Choudhury, R. K and. Chakraborty, R. (2016). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers.

12.10 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2 : The basic characteristics of public utility services are as follows:

- Public utilities are basically meant for serving the consumers.
- Public utility undertakings are given monopoly in a particular area or business as they are the outcome of special legislations.
- Public utility concerns are given special powers and privileges so that regular and satisfactory supply is maintained.
- Public utility services generally require large investments of capital.
- Public utility undertakings usually do not suffer from business risks.

Ans to Q No 3 : The primary aim of public utility services is to help the society in getting essential services at reasonable prices without any discrimination.

Ans to Q No 4 : **(a)** True **(b)** True

Ans to Q No 5 : Peak Load Pricing is a pricing strategy that implies price will be set at the highest level during times when demand is at a peak. The peak load pricing strategy is generally adopted to shift demand or at least consumption of the goods or services and to accommodate supply.



12.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: State the meaning of public utilities.

Q 2: Explain the forms of public utility undertakings.

Q 3: Explain briefly the significance of peak load pricing.

Q 4: Write a short note on public utility Services.

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

Q 1: Explain the characteristics of public utility services.

Q 2: Discuss the role of public utility services particularly in developing countries.

Q 3: Explain in details the peak load pricing policy with its advantages and disadvantages.

*** ***** ***

UNIT 13: PUBLIC SECTOR UNDERTAKINGS

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Meaning of Public Sector Undertakings (PSUs)

13.4 Forms of PSUs

13.5 Role of PSUs in Developing Economy

13.6 Performance and Shortcomings of PSUs in India

13.7 Let Us Sum Up

13.8 Further Reading

13.9 Answers to Check Your Progress

13.10 Model Questions

13.1 LEARNING OBJECTIVES

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

- know the meaning of Public Sector Undertakings(PSUs)
- understand the forms of PSUs
- explain the role of PSUs in developing economy
- discuss the performance and shortcomings of PSUs in India.

13.2 INTRODUCTION

Public Sector Undertakings (PSUs) refer to those Undertakings in which ownership and management either wholly or predominantly belong to the government. Public Undertakings need not necessarily run on capital invested by the government alone; it may have private share-holdings. In this unit we will discuss the meaning, forms, role, performance and shortcomings of PSUs with reference to India.

13.3 MEANING OF PUBLIC SECTOR UNDERTAKINGS (PSUs)

As mentioned in the introduction part, public sector undertaking is a state-owned undertaking. These undertakings are basically owned by the union government of any country or any state or territorial government, or both. To be a public sector undertaking, the major share of the undertaking needs to be owned by the government.

In India, the need for creation of public Undertakings was felt after the attainment of independence. The role and the scope of the public sector undertakings in India were defined by the industrial policy resolution of 1948 and 1956. The expansion of the public sector in the field of industries took place in the Second Five Year Plan which gave top priority to rapid industrialisation in the country. The Second Five Year Plan of India adopted the socialistic pattern of society as a goal of the socio-economic policies of the government. Thus the expansion of the public sector in the field of industries took place in a big way with the starting of the Second Five Year Plan. Before independence, there were only few sectors such as railways, post and telegraph department, port trusts and some small factories which were under state control. But over the last six and half decades, the public sector has emerged as a major factor in the country's economic growth. Public Undertakings are different from private undertakings on various grounds. The main objective of private undertakings is maximization of profit whereas the maximization of social welfare and balanced economic development are the main objectives of the public sector undertakings. Another distinction of public and private undertakings is that private sector undertakings are owned by private entities but public undertakings are owned by the government. The capital of the private undertakings is basically raised by owners through loans, private sources and public issues. But the capitals of the public sector undertakings are raised from

Government funds and some times through public issues. Private sector undertakings operate in all areas with adequate return on investment whereas a public sector enterprise generally operates in basic and public utility sectors.

The Industrial policy in July 1991 has taken four major decisions in regard to public sector of India, which are mentioned below-

- Reduction in the list of industries reserved for the public sector from 17 to 8 and introducing selective competitions in reserved areas.
- Disinvestment of share in Public Sector Enterprises (PSEs) to raise resources and encourage wide participation of general public and workers in the ownership of the PSEs.
- Policy for Sick Public Undertakings to be the same as that for the private sector.
- Improving performance through the performance contract or memorandum of understanding (MOU) system by which management are to be granted greater autonomy and held accountable for results.

13.4 FORMS OF PSUs

In this section of the chapter, a discussion is carried out regarding the different forms of PSUs. The forms of public undertakings differ from country to country due to different structure and constitutional system of the government, economic background and socio-political system. Major forms of the public undertakings and their working principles are delineated below-

- **Departmental Undertaking:** Under this form of organisation, a public enterprise is run as a department of the government. A departmetal undertaking is primarily used for providing essential services such as railways, postal services and broadcasting etc. Departmental undertakings are directly subordinate to a ministry of the government department. This form of public undertaking is

considered suitable for those activities where the government has desire to control over them in view of the public interest. Various examples of departmental undertakings are Indian Railways, Bharat Sanchar Nigam Limited, Postal Department etc.

- **Statutory Corporation:** Statutory Corporation is a corporate body created by the parliament or the state legislature by a special Act which defines its powers, functions, and pattern of management. The finance of this type of organisation is wholly funded by the government. Various examples of these types of organisation can be given such as Life Insurance Corporation of India, General Insurance Corporation of India, State Trading Corporations, Cement Corporation of India and Oil and Natural Gas Corporation etc.
- **Government Company:** Government Company refers to those companies in which 51 percent or more of the paid up capital is held by the government. It is registered under the Companies Act and fully governed by the provisions of the Act. Most business units owned and managed by government fall in this category. Some of the examples of government companies are Braithwaite and Comapany, Bridge and Roof Company, Central Railside Warehousing Company, Cochin Shipyard, Goa Shipyard and Central Mine Planning and Design Institute and Air India Limited etc.

13.5 ROLE OF PSUs IN DEVELOPING ECONOMY

Public undertakings play significant role in less developed countries. Today, even in the develoed economies also public undertakings make a considerable amount of contribution to the nation's economy. It is generally observed in underdeveloped countries that people are poor, economic resources are remaining idle and private capital formation is low. Government has to play a significant role in utilising the scarce resources available as well as formation of capital for productive investment. Some of the major areas where PSUs play a crucial role in developing economy or under-developed countries are noted below-

- **Development of Infrastructure:** Public Sector Undertakings can play a significant role in the development of infrastructure of a country. Infrastructure is an area where huge investment of capital is required and the margin of profit is either meager or it can be obtained only after a long gestation period. The private sector hesitates to establish their undertakings in these areas. But these areas cannot be negleced in public interest. As such public enterprise can undertake different infrastructure projects in developing countries.
- **Source of Funds for Economic Development**: To bring the under-developed countries to the path of development, it requires huge amount of fund. The private sectors are always interested in those sectors where rate of profit are comparatively high and gestation period is comparatively low. It may happen that private sectors are involved in those sectors where increase in production is not required and they may neglect those sectors which have significance for economic development. Under such situation, the government, with the help of public enterprises, can provide the fund for economic development.
- **Savings and Capital Formation:** In underdeveloped countries of the world, usually the rate of savings is low. This is due to high marginal propensity to consume in the low income section of the people. As a result, the rate of capital formation is also comparatively low which leads to low investment. Public Undertakings can increase the rate of capital formation and in turn lead to increase in investment.
- **Increase in the Rate of Economic Growth:** The importance of public enterpeirse can be realised from that fact that it can play a significant role in attaining high rate of economic growth by creating a strong industrial base. With a solid and diversified industrial base, private capital finds a favourable ecosystem to grow further. To reduce the divergence between developed and under-developed

countries, the rate of economic growth of the underdeveloped countries should be comparatively high as compared to the developed countries.

- **Use of Resources Efficiently:** The crucial element of pace of development of any nation depends on how effectively they utilise the available resources of the country. The public enterprise of a nation can be given the task of utilising the available resources of the country. The optimum and sustainable use of these resources may lead the nation to the path of prosperity of all section of the people.

- **Pattern of Resource Allocation:** Along with efficient use of resources, it is also important that the distribution of the resources should be a properly balanced. The government, through public Undertakings, must ensure that there is sufficient flow of resources to the priority sectors such as health, education and infrastructure etc.

- **Removal of Regional Disparity:** India is a country with huge regional disparity. It is in fact one of the objectives of the Planning Commission of India to remove regional disparity across the nation. The government should establish public undertakings in the backward regions of the country so that it helps to reduce as well as remove regional disparity in the country.

- **Reduction of Inequality:** Reduction of inequality is an objective which can be achieved by the public sector undertakings. To increase the overall welfare of the nation, the first and foremost task is to ensure equal distribution of the resources of the country. Public undertakings can play a significant role in this aspect by giving employment and other opportunities to the poor section of the people.

- **Prevention of Exploitation by Private Sector Undertakings:** Public Undertakings can also play an active role in the prevention of private sector undertakings from exploiting the consumers. It is generally perceived that private sector has a tendency to exploit the consumers by charging higher prices and providing low quality product. This tendency of the private sectors can be prevented by public undertakings ensuring quality productions.

- **Self-Reliance:** In today's competitive world, every country should ensure that they are self-sufficient in crucial sectors, particularly in defense and basic facilities. Over-dependence on foreign countries may sometimes push the country into great trouble, particularly during emergency.

- **Public Undertakings as Model Employer:** Public undertakings must act as a model employer. While employing its staff, it must ensure that all the sections of the people get equal job oppourtunity. They may provide special provision of employment opportunities to the backward section of the society.

- **Export Promotion and Import Substitution**: Public sector undertakings can also play significant role in promotion of export. Governemnt can produce good quality exportable goods and in turn earn foreign exchange reserve. By producing import substitute goods, it can also save valuable foreign exchange reserve and also help the state to become self-sufficient.

- **Economic Welfare Services :** The main motive for intervention of the government in economic activities is to increase the overall welfare of the society. Public undertakings is an appropriate tool in the hands of the government in undertaking welfare activities such as provision of health care facilities, production of essential commodities and services, and providing employment/livelihood opportunities etc.



ACTIVITY 13.1

Trace out the significance of any one public sector undertaking in the state of Assam.

.....

.....

.....

.....

.....



CHECK YOUR PROGRESS

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

(a)The public sector undertakings are not guided by profit motive. (True/False)

(b) Providing savings and capital formation is one of the important roles of public sector Undertakings. (True/False)

Q2: Distinguish between private undertakings and public undertakings. (Answer in about 50 words)

.....

.....

.....

.....

.....

Q3: Define departmental undertakings with some examples. What kind of services is provided by departmental undertakings?(Answer in about 50 words)

……

……

……

……

……

13.6 PERFORMANCE AND SHORTCOMINGS OF PSUs IN INDIA

The financial performance of the public sector undertakings has been a matter of wide interest and concern. India has completed about six decades (1951-2017) of planning since independence. The PSEs, undoubtedly, have successfully extended significant contribution in bringing up the industrial base for the holistic development of the Indian economy. The PSU sector had gross turnover of Rs 20,66,057 crore in 2013-14. Public sector undertakings have helped to establish basic and heavy industries which have to be given equal importance in order to achieve balanced development. The performance of public sector in India can be assessed from the fact that it helps in continuation of development process. Public sector undertakings in India contribute toward the establishment of socio-economic infrastructure such as railways and road trasport, electricity generation, education and health. An impressive growth of public sector undertakings has been observed since the year 1956. Both the Central and State Government have set up industrial undertakings for production of both goods and services. The growth of public sector undertakings of the Central Government can be observed from the table 13.1.

Table 13.1
Growth of Central Public Sector Undertakings

Year	No. of Total Units	Cumulative Investment (Rs in Crore)
1951	5	29
1961	47	950
1980	179	18,150
1990	244	99,330
2000	240	252,745
2001	242	274,114
2005	237	357,849
2007	244	421,089
2008	242	4,55,409
2010	217	579,920
2012	200	—
2015	235	—

Source : Industrial Policy Handbook, Office of the Economic Advisor, Ministry of Commerce and Industry, Various issues.

It can be seen from table 13.1 that whereas there were only 5 industrial public sector units of central government with a capital investment of Rs 29 crore in 1951, the number went up to 244 in 1990 with investment of Rs 99,330 crore. At the end of March, 2010, the number of central government public sector undertakings stood at 217 with a total cumulative investment of Rs 5,79,920 crore. As on 31/03/2015, there were 235 operating central public sector undertakings covering 181 scheduled CPSEs (Central Public Sector Enterprises) and out of these, 54 CPSEs have been considered provisional. Although the performance of the public sector undertakings are generally judged on the basis of the profitability criterion, it is not considered to be appropriate. This is because the main

motive of the public sector undertakings is to fulfill various social objectives such as providing income and employment opportunity to the poor section of the people and supplying merit goods to all sections of people and removing regional disparity etc. In that respect, public sector undertakings have been able to achieve those objectives. But from the profitabilty aspect, most of the public sector undertakings have been incurring losses over the years except the Maha Ratna and Nava Ratna Undertakings. As on June 2016, there are seven (7) Maha Ratna central sector undertakings such as Bharat Heavy Electricals Limited (BHEL), Coal India Limited (CIL), Gas Authority of India Limited (Gail), Indian Oil Corporation Limited (IOCL), National Thermal Power Corporation Limited (NTPC), Oil and Natural Gas Corporation Limited (ONGC), Steel Authority of India Limited (SAIL). These seven (7) companies have an average annual net profit after tax of more than Rs 5000 crore during the last three (3) years. Similarly, there are seventeen (17) Navratna Central Public Sector Undertakings in India such as Bharat Electronics Limited (BEL), Bharat Petroleum Corporation Limited (BPCL), Hindustan Aeronautics Limited (HAL), etc. These Public Sector Undertakings have the criteria of positive net worth. Net worth implies the value of all non-financial and financial assets owned by an institutional unit or sector minus the value of all its outstanding liabilities.

But the performance of the public sector undertakings in India have been criticised by economists and policy makers on various grounds. Some of the shortcomings of the PSE in India are listed below-

- **Burden on Taxpayers:** Considering the amount of fund required for financing the public sector undertakings, the obligation of government to repay the principal and service the debt require huge taxation. This tax is paid by all section of the people and mainly by the poor if major reliance is placed on indirect taxation.
- **Improper use of Public Funds:** The losses of public sector undertakings have to be borne by the shareholders. There are innumerable instances in our country to show that after

spending crores of rupees, many projects had to be abandoned. It leads to improper use of public resources.

- **Poor Planning and Market Study:** Public sector undertakings are often suffereing from poor planning and lack of market study. Wrong production planning results in losses which have to be borne by the general public.
- **Corrupt Practices:** In many cases, investment decisions are taken under political pressure and under the influence of vested interests. It is not unusual to find alliance between corrupt civil servants, politicians and financiers.
- **Lack of Initiative:** The management of public sector undertakings always has the fear of public accounatability. As a result, they lack initiative in taking right decisions at the right time.
- **Lack of Business Experience:** In practice, the management of the companies is generally put into the hands of administrative service officers who often lack experience in managing the business organisation on professional lines. So, in most cases they fail to achieve the required effeciency level.
- **Change in Policies and Management:** The policies and management of these companies are generally kept on changing with the change of the government. Frequent change in rules, policies and procedure leads to an unhealthy situation of the business Undertakings.



CHECK YOUR PROGRESS

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

(a) Public sector undertakings in India contribute towards the establishment of socio economic infrastructure. (True/False)

(b) Public sector undertakings in India helps in balanced development of the economy (True/False)

Q5: How do public sector undertakings contribute towards the development process? Explan. (Answer in about 30 words)

.....

.....

.....



13.7 LET US SUM UP

- The business units owned, managed and controlled by central, state or local government are termed as public sector undertakings.
- There are some special charctaristics of the public sector undertakings such as it is owned by the government, financed from government funds. It is not guided by profit motive; it provides public utility servicse like transport, electricity and telecommunication etc.
- Public sector undertakings have been the mainstay of the Indian economy and were set up with the aims of serving the broad macroeconomic objectives of higher economic growth.
- Public sector undertakings also helps in achieving self-sufficiency in the production of goods and services, facilitate long-term equilibrium in the balance of payments, ensure stability in prices and create benchmark for prices of essential goods, promote redistribution of income and wealth and balanced regional development and create employment opportunities.
- In India the public sector Undertakings have played a crucial role in the development of capital intensive sector, development of agriculture, balanced regional development, increasing employment opportunity, employment generation, preventing concentration of economic power, export promotion and import

substitution, research and development and mobilization of resources etc.

- There are various shortcomings of the public sector undertakings such as lack of initiative on the part of the government, lack of business experience of the managing director and changes in economic policies of the government etc.



13.8 FURTHER READING

- Musgrave, R.A. and Musgrave, P. B. (2017). *Public Finance in Theory and Practice.* McGraw Hill Education
- Choudhury, R. K. and Chakraborty, R. (2016). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers

13.9 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: The distinction between the public undertakings and private undertakings are as follows:

Grounds	Private undertakings	Public undertakings
Basic objective	To maximize profit	To maximize social welfare and balanced economic development
Ownership	Owned by the individual	Owned by the government
Sources of capital	Capitals are raised by owners through loans and private sources	capitals are raised from government funds and some times through public issues
Areas of operation	Operates in all areas with adequate return on investment	Operates only in basic and public utility sectors

Ans to Q No 3: A public enterprise is run as a department of the government in departmental undertakings. Some examples of departmental undertakings are Indian Railways, Bharat Sanchar Nigam Limited, Brahmaputra Cracker and Polymer Limited and Oil India Limited etc.

A departmental undertaking is primarily used for provision of essential services such as railways, postal services and broadcasting etc.

Ans to Q No 4: (a) True **(b)** True

Ans to Q No 5: Public sector undertakings contribute towards the establishment of socio economic infrastructure services like railways, road transport, electricity generation, education and health, which are considered to be the wheel of development.

13.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: State the meaning of public sector undertakings.

Q 2: The objectives of public sector undertakings are different from private sector. Explain the statement.

Q3: Mention the major decisions that have been taken by the Industrial policy in July 1991 in regard to public sector of India.

Q 4: Write a short note on the public sector undertakings in India.

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

Q 1: Discuss the role of the public sector undertakings in India.

Q 2: Explain the different forms of public sector undertakings.

Q 3: Explain the performance of public sector undertakings in India.

Q 4: Explain the shortcomings of public sector undertakings in India.

*** ***** ***

UNIT 14 : FEDERAL FINANCE

UNIT STRUCTURE

14.1 Learning objectives

14.2 Introduction

14.3 Concept of Fiscal Federation

14.4 Principles of Federal Finance

14.5 Horizontal and Vertical Fiscal Balances

14.6 Instruments of Inter-governmental Resource Transfer

14.7 Let Us Sum Up

14.8 Further Reading

14.9 Answers to Check Your Progress

14.10 Model Questions

14.1 LEARNING OBJECTIVES

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

- define the concept of fiscal federalism
- state the principle of federal finance
- explain the concepts of horizontal and vertical fiscal balance
- describe the instruments of inter- governmental resource transfer.

14.2 INTRODUCTION

As federation is formed by coming together of the constituent states, in a federal state the political power is divided between the central government and the constituent state governments.

Federalism can range from a loose association of sovereign states which come together for some specific purposes (e.g., European Economic Union -EEU) to a strict unitary form of government (e.g., England). However actual federate lies between the two extremes, where a country is more unitary (or federal) when the concentration of power is more (or less) with the centre.

14.3 CONCEPT OF FISCAL FEDERALISM

As mentioned above, a federation is formed by the coming together of many states, which has a central government and various state governments. Depending on the type of the federation, the political and fiscal responsibilities are shared by the centre and the states.

In practice, the functions that pertain to the entire nation are assumed by the centre. Thus, for example, defence, foreign affairs etc. are always the responsibility of the centre. Besides, the functions that require inter-state co-ordination is also entrusted to the central government, e.g., tele- communication, railways etc.

On the other hand, the functions which are of the concern to the states are entrusted to the state governments. Thus, for example, agriculture, education, public health etc. fall in the domain of the states. Given the fact that the functions in a federation are divided between the centre and the states, it becomes necessary that each tier of government be given a source of revenue which is viable, sustainable and adequate so that they are able to fulfil their responsibilities.

Then, there is also the need for a mechanism by which the pool of revenue in a country can be distributed among the central, state and local governments. The gamut of issues surrounding the sharing of the revenue of a country between the different tiers of the government is referred to as 'fiscal federalism'.

In fiscal federalism, two issues need to be addressed:

- The diversity issue which concerns the need to satisfy the local needs and aspirations.
- The equivalence issue which focuses on the need to ensure that no state or region is discriminated against.

Thus, we have discuessed that the basic issues of fiscal

federation are the assignment of functions and the source of finance between different tiers of governments. Its domain of operations include evolving a mechanism to:

- resolve fiscal imbalances,
- arbitrate inter-governmental disputes, and
- foster harmonious inter- governmental relationship.



CHECK YOUR PROGRESS

Q1: State whether the following statement is True (T) or False (F) :

(a) Defence is entrusted to the state governments. (True/False)

Q2: What is meant by fiscal federalism? (Answer in about 40 words).

.....

.....

.....

.....

14.4 PRINCIPLES OF FEDERAL FINANCE

In any federation, there is clear-cut division of the financial powers between the Centre and the constituent states, along with their respective responsibilities. To maintain a healthy financial functioning of the federal set-up, some principles of federal finance need to be adopted. They include:

- **Independence and Repairability:** This principle calls for each constituent in a federation to have independent access to adequate financial resources so that they are able to perform their allocated functions.

Besides, each tier of the governments should be given responsibility of raising resources in the form of taxation and public borrowing so as to operate in their sphere of activities.

- **Adequacy and Elasticity:** The principle of adequacy requires that the resources available to different tiers of the government in a federation should be adequate to enable them to perform their functions satisfactorily.

  Besides, the elasticity principle calls for a flexibility to be imported to the constituent governments to raise the volume of resources especially during unforseen exigencies.

- **Administrative Economy and Efficiency :** This principle is critical for the success of federal finance. It calls for efficient fiscal operation of the government machinery which is free from red-tapism, procrastination and indifference. Besides, it requires avoidance of wastages, leakages, corruption which import inefficiency to the system.

- **Uniformity and Equity :** The uniformity principle calls for absence of discrimination against any of the constituent units in the federation. Thus, all the states should be treated equally in all financial accommodation.

  The principle of equity, on the other hand, calls for the sharing of the common burden in a federation on an equitable basis. Thus, each constituent state in a federation should be asked to contribute resources according to its ability. Thus, given the fact that different states have attained different levels of development, the richer states should contribute more taxes than the poorer states.

- **Accountability:** The principle of accountability requires all the governments operating in a federation to be accountable to their respective legislature for its financial receipts and disbursements.



CHECK YOUR PROGRESS

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

(a) Each tier of governments should be given responsibility of raising resources in the form of taxation and public borrowing so as to operate in their sphere of activities. (Ture/False)

(b) The principle of adequacy and elasticity of federal finance requires each state to contribute resources according to its ability. (True/False)

Q4: Mention the different principles of federal finance. (Answer in about 40 words).

.....

.....

.....

.....

14.5 HORIZONTAL AND VERTICAL FISCAL BALANCES

One of the most important problems in a federation is the existence of horizontal and vertical fiscal imbalances. Such imbalances are sought to be removed using strategies of tax sharing and federal transfer of resources.

- **Horizontal Fiscal Balance:** Horizontal fiscal equity means equal treatment of the equals. Thus, for two people living in different states, but with the same income, the horizontal fiscal balance requires that the tax liability of each on account of federal and state taxes should be equal. However if horizontal fiscal balance does not exist, then it can be corrected through an inter-state transfer of resources from the richer states to the poorer ones.

This corrective inter-state transfer of resources is also called *'fiscal residue'*. Thus, such fiscal residues can help in equalising the per capital income in different states. Musgrave, however, argues that such equalisation of fiscal residue can also be achieved through the application of ***benefit principle of taxation***.



Benefit principle of taxation:
This principle of taxation states that the burden of taxation must be in proportion to the benefit received by a person from the expenditure made by the government.

- **Vertical Fiscal Balance:** A federal setup usually has very elastic sources of revenue, which can be expanded or contracted whenever it is desired. Consequently, it has surplus resources at its disposal. On the contrary, the constituent states have revenue sources which are relatively inelastic, which means that they always face a resource crunch. Such a state of affairs results in vertical fiscal imbalance, between the centre and the states in the federation.

  Fiscal federalism attempts to re-establish vertical fiscal balance through a process referred to as *vertical co-ordination*, where the levels of public expenditures of the centre and the states are sought to be equated with the resources for financing them.

  The different instruments for establishing vertical fiscal balance in a federation are:

  - **Tax sharing:** The main purpose of tax sharing is to help the state governments to bridge the gap between revenue expenditure and revenue receipts. The arrangements of tax sharing between the centre and the states may be as per provision laid down in the constitution or as suggested by an expert committee.
  - **Selective grants-in-aid:** Grants-in-aid refers to transfer of resources from the centre to the states, so that revenue deficiency in the states can be corrected or some specific programmes can be implemented.

    Apart from these two, there are some other instruments which are not so frequently utilised. We shall discuss in detail about these two along with loans in the next section.



LET US KNOW

Tax credit: Tax credit is another insturment for establishing vertical fiscal balance. Under this system a credit is given against a tax; the tax payable is reduced by the amount of tax of the credit. The system of tax credit is utillised in various contexts. In federal finance, it is used when the individuals pay same taxes to different governments. Thus, for example, property tax is levied both the by centre and the state. Let us, again, suppose that a person has to pay Rs.150/ as central tax. But he has already paid Rs.100/ as property tax to the state government. So, he will have to pay Rs. 50/- (Rs.150/ - Rs.100/) to the central government. Such type of tax reduces competition among the governments, while, at the same time, it icreases tax mobilisation.



CHECK YOUR PROGRESS

Q5: State whether the following statement is True (T) or False (F) :

Fiscal imbalances can be removed using the strategies of tax sharing and federal transfer of resources. (True/False)

Q6: What is meant by tax sharing? (Answer in about 50 words)

.....

.....

.....

.....

.....

14.6 INSTRUMENTS OF INTER-GOVERNMENTAL FISCAL TRANSFER

Inter-governmental resource transfer is an effective tool adopted to correct both horizontal and vertical imbalances in a federation. The need for transfer arises because the constituent states in a federation are unable to raise adequate resources by themselves as they are allotted only the inelastic sources of revenue. The union government which retains all elastic sources of revenue share a part of the revenue mobilised with the states by transferring them through the mechanism of inter governmental transfer. There are usually three instruments of inter-governmental resource transfer in a federation. They are :

- Tax sharing,
- Grants-in-aid, and
- Loans



LET US KNOW

In the Indian constitution, the union list describes the powers and functions of the Union government, whereas the state list mentions the same for the states. However, the concurrent list describes the subject matters on which both the Union and the state governments can legislate.

- **Tax Sharing :** Tax-sharing is an arrangement whereby a higher unit of government administers and collects the tax which is subsequently distributed, either wholly or partly, to the constituent federating states. Thus, in tax sharing the government at the centre levies and collects the taxes, which are then completely or partly, distributed among the constituent states.

  The administration and collection of a tax by a central authority is justified on the grounds of the economy of tax collection, efficiency of tax administration, uniformity of tax rates, and avoidance of tax evasion.

Tax-sharing can be administered in two ways:

- The union government can levy and collect the tax, and the subsequent proceeds are shared with the state governments.
- The union government levies and collects the taxes but does not retain it. Here the entire proceeds are distributed among the constituent states.

- **Grants-in-aid:** Grants-in-aid refers to transfer of resources from the Centre to the states, so that the revenue deficiency in the states can be corrected or some specific programmes can be implemented. Grants-in-aid are released on two basic principles:
  - Principle of compensation
  - Principle of derivation

Under the *'principle of compensation',* grants-in-aid are released to achieve regional equality, by directing the flow of resources to the poorer regions. Thus, a transfer of resources takes place from the developed regions (who are taxed) to the under developed region (who receive the grants).

On the contrary, under the *"principle of derivation"* all revenues collected from states should be returned to them in the form of grants. Here, though the central government does not manage to mobilise a revenue greater than what the respective state governments would have done had they administered the tax, it however can collect the tax at a lower cost. While determining the nature of grants-in-aid, a prevalent central government needs to take into account the spirit behind both the principles.

Grant-in-aid may take three important forms -

- **Fiscal-need Grant:** The purpose of fiscal-need grant is to correct the overall revenue shortages in the states.
- **Conditional Grants:** Conditional grants are released by the Centre, to enable the recipient states to implement specific projects. Here the funds received must be used only for the specified purpose and cannot be diverted.
- **Matching Grants:** Matching grants is a particular form of

conditional Grants which specifies that a percentage of the total cost of a project needs to be contributed by the state, while the rest will be contributed by the central government as grants-in-aid. Under this system, the central component of the project cost will not be released unless the matching contribution by the states are made.

- **Loans :** Loans constitute another very important instrument of inter-governmental resource transfer. It serves as an instrument of efficient utilisation of central funds and a source of developmental investment for the states.

  Loans from the centre are specially suitable to finance those state projects which are productive and which can later pay for itself. The advantage of loans to finance such projects are :

  - The loan becomes an investment for the state which contributes to the economic growth.
  - There is better utilisation of the funds by the state, since the principal amount would have to be returned with interest.
  - They do not impose any burden on either the centre or on the state governments.
  - Because the loans are offered at concessional rates, the viability of the investment remains high.

  However it must be mentioned that all loans are not tied to some projects or programmes. Sometimes State governments borrow from the centre to cover their revenue deficits, or to meet various unforseen expenditures.



LET US KNOW

The Finance Commission is established under Article 280, of the constitution, to make recommendations on the distribution of tax proceeds and sanction of grant-in-aid to the states.



CHECK YOUR PROGRESS

Q7: State whether the following statements are True(T) or False(F) :

(a) Inter-government fiscal transfer is an instrument of government expenditure. (True/False)

(b) Matching Grants is a special form of conditional grant. (True/False)

Q8: What is meant by matching grant? (Answer in about 40 words)

.....

.....

.....

.....



14.7 LET US SUM UP

- A federation is formed by a union government along with the contituent state governments.
- Fiscal federalism deals with the assignment of functions and sources of funds to finance the different tiers of government in a federation.
- Principles of federal finance ensure the healthy financial functioning of a federal set-up.
- Federal Finance works towards the attainment of horizontal and vertical fiscal balance.
- There are three instruments of inter-government fiscal transfer -
  - ➢ Tax sharing,
  - ➢ Grants-in-aid, and
  - ➢ Loans



14.8 FURTHER READINGS

1) Bhatia, H.L. (2005). *Public Finance.* New Delhi : Vikas Publishing House Pvt. Ltd.

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

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.

14.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: False

Ans to Q No 2: There must exist a mechanism which facilitates the distribution of the pool of revenue in a country among the central, state and local governments. Thus, the issues relating to the sharing of the revenue of the country between different tiers of government is referred to as fiscal federalism.

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

Ans to Q No 4: The principles of federal finance are:

- Independence and repairability,
- Adequacy and elasticity,
- Administrative economic and efficiency,
- Uniformity and equity,
- Accountability, and
- Integration and co-ordination.

Ans to Q No 5: True

Ans to Q No 6: Tax sharing refers to the arrangement between different levels of government. The main purpose of tax sharing is to help the state governments to bridge the gap between revenue

expenditure and revenue receipts. Such arrangements of tax sharing between the centre and the states may be as per the provision laid down in the constitution or as suggested by an expert committee.

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

Ans to Q No 8: Matching grants is a particular form of conditional grants which specifies that a percentage of the total cost of a project needs to be contributed by the state, while the rest will be contributed by the central government as grants-in-aid. Under this system, the central component of the project cost will not be released unless the matching contribution by the states are made.



14.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Explain the concept of Federal Finance.

Q 2: Explain the concepts of vertical and horizontal fiscal balance.

Q 3: Write short notes :

i) Fiscal-need grants

ii) Conditional grants

iii) Matching grants.

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

Q 1: Describe the principles of federal finance.

Q 2: What is meant by inter-governmental fiscal transfer ? Describe the instruments of such a transfer.

*** ***** ***

UNIT 15 : FINANCE COMMISSIONS OF INDIA

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Meaning of the Finance Commission of India

15.4 Role and Responsibilities of the Finance Commission of India

15.5 Recommendation of the current Finance Commission of India

15.6 Let Us Sum Up

15.7 Further Reading

15.8 Answers to Check Your Progress

15.9 Model Questions

15.1 LEARNING OBJECTIVES

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

- know the meaning of the Finance Commission of India
- explain the role and responsibilities of the Finance Commissions of India
- discuss the recommendations of the current Finance Commission of India.

15.2 INTRODUCTION

The Finance Commission of India is a constitutional body constituted for recommendation of the devolution of proceeds from central taxes to states and grants for their developmental activities. The main role of the Finance Commission of India is to determine the principles of distributing statutory transfers in terms of grants in aid and shared taxes among the states of India.

In this unit we will discuss the role and responsibilities of the Finance Commission of India and the recommendations of the current Finance Commission of India.

15.3 MEANING OF FINANCE COMMISSION OF INDIA

As mentioned in the introductory section, the Finance Commission of India is a constitutional body constituted for recommendation of the devolution of proceeds from central taxes to states and grants for their developmental activities. As per the Constitution, the Commission is appointed every five years and till date, fourteen Finance Commissions have submitted their reports. The first Finance Commission of India was established on 22nd November, 1951. It was established under article 280 of the Indian Constitution by the President of India.

The Fourteenth Finance Commission of India was constituted on 2nd January 2013. The Commission's chairman was former Reserve Bank of India Governor Y. V. Reddy and the members included Sushma Nath, M. Govinda Rao, Abhijit Sen, Sudipto Mundle, and A. N. Jha. The recommendations for devolution of taxes and other fiscal measures of the Commission are applicable for the period from April 2015 to March 2020.

The next finance commission i.e; the Fifteenth Finance Commission of India was constituted in the year 2017 in the month of November. As this Commission is yet to give its recommendations, we shall discuss here the recommendations of the Fourteenth Finance Commission of India.

15.4 ROLE AND RESPONSIBILITIES OF THE FINANCE COMMISSION OF INDIA

It is the duty of the Finance Commissions to decide the principles of governing the shared taxes and grants-in-aid to the states . The roles and responsibilities of the Finance Commission of India have been summarized below:

- One of the important functions of the Finance Commission in India is to act as an instrument to divide proceeds of divisible taxes between the states and union government. It determines the principles of allocation of taxes collected by the centre to the states.

- The Finance Commission of India also determines the principles of governing the grants in aids of the revenues of the states out of the consolidated fund of India. It is considered to be important functions of the Indian Finance Commission.
- The commission has the responsibility of considering any matter referred to the commission by the President in the interest of sound finance.
- The Finance Commission distributes the proceeds of income tax between the union and states. But taxes on the payments of the central government are attributable only to the union territories.

15.5 RECOMMENDATION OF THE CURRENT FINANCE COMMISSION OF INDIA

The Fifteenth Finance Commission has been constituted in November, 2017 to give recommendation for devolution of taxes and other fiscal matters for five fiscal years from 1st April 2020. Nand Kishore Singh is appointed as the chairman of the Fifteenth Finance Commission. The Commission has two full time members - Shaktikanta Das and Anoop Singh. Along with that, the Commission has two part time members such as Ramesh Chand and Ashok Lahiri. The main task of this commission is to strengthen cooperative federalism, improve the quality of public spending and help to achieve fiscal stability.

The main aim of the Fifteenth Finance Commission is to give recommendations for devolution of taxes and other fiscal matters for five fiscal years commencing from 1st April, 2020. It is believed that the Commission's job was made harder because of the rollout of Goods and Service Tax as it had taken certain powers concerning taxation away from the union and the states, and, had given them to the newly formed GST Council.

The Terms of Reference (ToR) and the matters that shall be taken into consideration by the Fifteenth Finance Commission in making the recommendations have been provided below:

- The distribution of the net proceeds of taxes between the Union and the States may be divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds.
- The Commission shall review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States, and recommend a fiscal consolidation roadmap for sound fiscal management.
- While making its recommendations, the Commission shall have regard, among other considerations, to:
    - The resources of the Central Government and the State Governments for the five years commencing on 1st April 2020 on the basis of the levels of tax and the non-tax revenues likely to be reached by 2024-25. In the context of both tax and non-tax revenues, the Commission will also take into consideration their potential and fiscal capacity;
    - The demand on the resources of the Central Government particularly on account of defense, internal security, infrastructure, railways, climate change, commitments towards administration of UTs without legislature, and other committed expenditure and liabilities;
    - The demand on the resources of the State Governments, particularly on account of financing socio-economic development and critical infrastructure, assets maintenance expenditure, balanced regional development and impact of the debt and liabilities of their public utilities;
    - The impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following recommendations of the 14th

Finance Commission, coupled with the continuing imperative of the national development programme including New India – 2022;

- The impact of the GST, including payment of compensation for possible loss of revenues for 5 years, and abolition of a number of cesses, earmarking thereof for compensation and other structural reform programmes, on the finances of Centre and States; and
- The conditions that Government of India may impose on the States while providing consent under Article 293(3) of the Constitution.

- The Commission may consider proposing measurable performance-based incentives for States, at the appropriate level of the government, in following areas:
  - Efforts made by the States in expansion and deepening of tax net under GST
  - Efforts and Progress made in moving towards replacement rate of population growth
  - Achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure
  - Progress made in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams
  - Progress made in increasing tax/non-tax revenues, promoting savings by adoption of Direct Benefit Transfers and Public Finance Management System, promoting digital economy and removing layers between the government and the beneficiaries

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

- The Commission shall use the population data of 2011 while making its recommendations.
- The Commission may review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.
- The Commission shall indicate the basis on which it has arrived at its findings and make available the State wise estimates of receipts and expenditure.
- The Commission shall make its report available by 30th October, 2019, covering a period of five years commencing on the 1st of April, 2020.

The major recommendations of the Fourteenth Finance Commission:

The major recommendations of the Fourteenth Finance Commission are-

- The 14th Finance Commission decides to increase the share of tax devolution to 42 per cent of the divisible pool.
- They have not consented to the submission of States on minimum guaranteed devolution.

- They are of the view that use of dated population data is unfair, but are bound by the ToR and have assigned a 17.5 per cent weight to the 1971 population. On the basis of the exercises conducted, they concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. They, therefore, assigned a 10 per cent weight to the 2011 population.
- For area they have followed the method adopted by the FC-XII (Twelfth Finance Commission) and put the floor limit at 2 per cent for smaller States and assigned 15 per cent weight.
- The Fourteenth Finance Commission believes that large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. Considering all this, they have assigned 7.5 per cent weight to the forest cover.
- They have recommended to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50 per cent weight. They have calculated the income distance following the method of FC-XII.
- As service tax is not levied in the State of Jammu & Kashmir, proceeds cannot be assigned to this State.
- The Commission recommends that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations.
- The commission recommend that the books of accounts prepared by the local bodies should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission and grants for any agency functions assigned by the Union and State Governments.

- They recommend distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each state will be divided into two, a grant to duly constituted Gram Panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that state using the data of census 2011.
- They have worked out the total size of the grant to be Rs.2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs.2,00,292.20 crore and that to municipalities is Rs.87,143.80 crore.
- They have recommended grants in two parts - a basic grant and a performance grant for duly constituted gram panchayats and municipalities. In the case of gram panchayats, 90 percent of the grant will be the basic grant and 10 per cent will be the performance grant. In the case of municipalities, the division between basic and performance grant will be 80:20.
- The Fourteenth Finance Commission recommends that the grants should go to the gram panchayats, which are directly responsible for the delivery of basic services, without any share for other levels. They expect that the State Governments will take care of the needs of the other levels.
- The earmarked basic grants for gram panchayats will be distributed among them, using the formula prescribed by the respective State Finance Commission (SFC) for the distribution of resources.
- The basic grant for urban local bodies will be divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies) and the nagar panchayats (the tier III local bodies) using the formula given by the respective SFCs. The State Government should apply the

distribution formula of the most recent SFC, whose recommendations have been accepted.

- In case the SFC formula is not available, then the share of each gram panchayat as specified above should be distributed across the entities using 2011 population with a weight of 90 per cent and area with a weight of 10 percent. In the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10.
- To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years proceeding the year in which the gram panchayat seeks to claim the performance grant.
- In case some amount of the performance grant remains after disbursement to the eligible gram panchayats, this undisbursed amount should be distributed on an equitable basis among all the eligible gram panchayats.
- The grants recommended by the Fourteenth Finance Commission shall be released in two installments each year in June and October. This will enable timely flows to local bodies during the year, enabling them to plan and execute the works better. They recommend that 50 per cent of the basic grant for the year be released to the State as the first installment of the year. The remaining basic grant and the full performance grant for the year may be released as the second installment for the year. The States should release the grants to the gram panchayats and municipalities within fifteen days of it being credited to their account by the Union Government. In case of delay, the State Government must release the installment with interest paid from its own funds.

- They recommend that stern action should be ensured if irregularities in the application of funds are noticed or pointed out.
- They recommend that the State Governments should strengthen the State Finance Commissions (SFCs).
- They suggest that the existing rules be reviewed and amplified to facilitate the levy of property tax and the granting of exemptions be minimised.
- They suggest that States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source.
- They also recommend that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.
- They recommend raising the ceiling of professions tax from Rs. 2500 per annum to Rs.12, 000 per annum.
- The financing of the National Disaster Relief Fund (NDRF) has been done through the levy of cess on selected items. The Commission recommends that if the cesses are discontinued or subsumed under the GST in future, then the Union Government should consider ensuring an assured source of funding for the NDRF.
- The Commission recommends that all States contribute 10 percent to the State Disaster Response Fund during the award period, with the remaining 90 percent coming from the Union Government.
- They are in agreement with the views of the FC-XIII (Thirteenth Finance Commission) that the decision of constituting District Disaster Response Funds (DDRFs) is best left to the wisdom of the State Governments, and hence, separate grant for the financing of DDRFs are not recommended.

- The Fourteenth Finance Commission has recommended a total revenue deficit grant of Rs. 1, 94,821 crore during the award period for eleven States.



ACTIVITY 15.1

Trace out the significance of the Finance Commission of India for inter-state transfers.

.....

.....

.....

.....

.....



CHECK YOUR PROGRESS

Q1 : State whether the following statements are True or False :

(a) One of the important functions of the Finance Commission in India is to act as an instrument to divide proceeds of divisible taxes between the states and union government. (True/False)

(b) Nand Kishore Singh is the chairman of the Fifteenth Finance Commission. (True/False)

(c) The Finance Commission of India also determines the principles of governing the grants in aids of the revenues of the states out of the consolidated fund of India. (True/False)

Q2 : Mention the main role of Finance Commission of India. (Answer in about 20 words)

.....

.....

Q3: Briefly mention any two major recommendations of the Fourteenth Finance Commission of India. (Answer in about 40 words)

.....

.....

.....

.....



15.6 LET US SUM UP

- The Finance Commission of India is constituted for recommendation of the devolution of proceeds from central taxes to states and grants for their developmental activities.
- The main focus of the Finance Commissions is the financial relation between the state governments and central government.
- Sub-national governments in India enjoy considerable degree of financial autonomy due to the tax devolution and grants-in-aid by the Finance Commission.
- The recommendations as provided by the Finance Commissions of India determine the share of the state governments in the proceeds of income tax and grants-in-aid. The current Finance Commission is the Fifteenth Finance Commission. This Finance Commission is constituted in November 2017 to give recommendation for devolution of taxes and other fiscal matters for five fiscal years. Nand Kishore Singh is appointed as the chairman of the Fifteenth Finance Commission.
- The Fourteenth Finance Commission has radically enhanced the share of the states in the central divisible pool from the current 32 percent to 42 per cent which is the biggest ever increase in vertical tax devolution. The last two Finance Commissions viz. Twelfth (period 2005- 10) and Thirteenth (period 2010-15) had recommended a state share of 30.5 per cent (increase of 1 percent)

and 32 per cent (increase of 1.5 percent), respectively in the central divisible pool.

- The Fourteenth Finance Commission has also proposed a new horizontal formula for the distribution of the states' share in divisible pool among the states. There are changes both in the variables included and excluded as well as the weights assigned to them. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables: 2011 population and forest cover; and excluded the fiscal discipline variable.
- Several other types of transfers have been proposed including grants to rural and urban local bodies, a performance grant along with grants for disaster relief and revenue deficit. These transfers make up to approximately 5.3 lakh crore rupees for the period 2015-2020.



15.7 FURTHER READING

1) Sury, M.M (2017). *Finance Commission and Fiscal Federalism in India*. Indian Tax Foundation.
2) Musgrave, R.A. and Musgrave, P. B. (2017). *Public Finance in Theory and Practice.* McGraw Hill Education
3) Choudhury, R. K. and Chakraborty, R. (2016). *Public Finance and Fiscal Policy.* Ludhiana: Kalyani Publishers

15.8 ANSWERS TO CHECK YOUR PROGRESS

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

Ans to Q No 2: The main role of the Finance Commission of India is to determine the principles of distributing statutory transfers in terms of grants in aid and shared taxes among the states of India.

Ans to Q No 3: Two major recommendations of the Fourteenth Finance Commission are-

- The 14th Fourteenth Finance Commission decides to increase the share of tax devolution to 42 per cent of the divisible pool.
- They have not consented to the submission of States on minimum guaranteed devolution.



15.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Define Finance Commission.

Q 2: When was the Fifteenth Finance Commission of India constituted?

Q 3: Write a short note on the Fifteenth Finance Commission of India.

Q 4: Explain briefly the Fourteenth Finance Commission of India.

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

Q 1: Mention the general terms of reference of the Fifteenth Finance Commission of India.

Q 2: Discuss the role and responsibilities of the Finance Commission of India.

Q 3: Discuss the main recommendations of the Fourteenth Finance Commission of India.

Q4: "The main focus of the Finance Commissions is the financial relation between the state governments and central government." Explain the statement with reference to Finance Commission of India.

*** ***** ***



REFERENCES (For All Units of the Course)

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. (2016). *Public Finance and Fiscal Policy.* Ludhiana:Kalyani Publishers.
4. Jhingan, M. L. (2013). *Money, Banking, International Trade and Public Finance.* New Delhi: Vrinda Publications.
5. Lekhi, R. K. (2002). *Public Finance.* Ludhiana : Kalyani Publishers.
6. Lekhi, R. K. (2006): *Public Finance and Fiscal Policy.* Ludhiana:Kalyani Publishers.
7. Menkar and Sarma. (2001). *Public Finance :Theory and Practice.* Mumbai : Himalaya Publishing House, 5th Edition.
8. Mithani, D. M. (2001). *Money, Banking, International Trade and Public Finance.* Mumbai : Himalaya Publishing House.
9. Musgrave, R.A. and Musgrave, P. B. (2017). *Public Finance in Theory and Practice.* McGraw Hill Education.
10. Prakash, O. (2008).*Public Economics:Theory and Practice*. Jalandhar:Vishal publishing Co, 1st Edition.
11. Paul, R. R. (2009). *Money, Banking and Public Finance.* Ludhiana: Kalyani Publisher.
12. Singh, S. K. (2010). *Public finance in Theory and Practice.* New Delhi: S. Chand and Company Limited.
13. Sury, M.M. (2017). *Finance Commission and Fiscal Federalism in India*. Indian Tax Foundation.

Name of the Paper: Course Code:

Centre for Internal Quality Assurance (CIQA)
Krishna Kanta Handiqui State Open University
City Office, Housefed Complex, Guwahati- 06

Learner's Feedback on Course

Dear Learner,

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

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

1. Approximately how many hours did you spend for studying the units in the course? | | | |
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

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

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

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

   ---

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

Thank you for taking the time to complete this form.

******

(To be inserted as last page after the end of the last unit of the course)